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FROM DRAGONS TO DWARFS: REEXAMINING NEO-LIBERAL EXPLANATIONS OF THE SOUTHEAST ASIAN FINANCIAL CRISIS[1]

Rajah Rasiah[2]

Abstract

The Asian dragon economies, which were considered models for development lessons for around a decade suddenly crashed following the rupture of the Thai baht in 1997. The alarming collapse of these economies has led to a search for answers not only by the economies gripped by the crisis, but also others learning from them. Malaysia has managed to avoid a catastrophic destruction of its engines of growth through largely its positive overall balances that prevented a forced recourse to external assistance, while Indonesia and Thailand had to seek IMF help. Despite the resumption of economic growth, uncertainties still loom over these economies. Efforts to conceptualize the future development of the region inevitably require a profound understanding of the dynamics of both national and international forces behind the crisis. This paper argues that neo-liberal prescriptions were at the heart of the Southeast Asian financial crisis. Government interventions generally either favored or blended with private interests demonstrating the skewed nature of market manifestations.

INTRODUCTION

The debate on suitable economic regimes for growth has re-emerged again in the wake of the Asian financial disaster. Despite the pervasive nature of state intervention behind the success of the Northeast Asian economies (see Deyo, 1995; Amsden, 1989; Wade, 1990; Chang, 1994; Rasiah, 1998), neo-liberal analyses for long either presented it as market-conforming or mutually cancelling distortions that did not seriously affect growth (see Bhagwati, 1988; Balassa, 1988). The World Bank (1993) made a substantial shift in incorporating the endless stream of works contesting neo-liberal explanations of East Asian growth by acknowledging interventions in Northeast Asia but considered them as less useful for lessons than the experience of Southeast Asia, which was argued to be liberal and hence more suitable for the deregulating currents of globalization. Hence, global institutions such as the World Bank and IMF recommended South American, African, South and West Asian, and the transitional economies to learn from the miraculous growth experience of these economies. The standard prescription was to

[1] This paper was presented at a DIR seminar at Aalborg University: Assessing the Recovery Plans of Asian Economies Destabilized by Financial Crisis. Valuable comments are acknowledged from Stanislav Menchikov, Jacques Hersh, and Johannes Schmidt, although the argument remains the responsibility of the author.
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deregulate and export. Some went as far as to picture their growth experience as being the result of falling levels of distortions and corruption.[3]

As the ensuing regional contagion swept across these nations bankrupting thousands of firms and making millions jobless, neo-liberal arguments have changed their story to explain the failure of these economies as being caused by state intervention, cronyism and corruption.[4] Strangely what was considered the basis of Southeast Asian growth – i.e., liberalization especially since the mid-1980s until the mid-1990s - seem to be ignored now. The unquestioning support for the paradigm of free markets has prevented a serious reassessment of neo-liberal conjectures epistemologically. The very spirit of intellectual discourse – subjecting propositions continuously to new evidence scientifically – seems to have taken a back seat.

This essay attempts to examine the causes of the financial crisis in the context of government-market failures with specific attention to challenging neo-liberal contentions of growth and crash involving the Southeast Asian second-tier Newly Industrializing Economies (NIEs). The paper argues that while Indonesia, Malaysia, the Philippines and Thailand were already poised to slow down from the mid-1990s because of the lack of institutional development to sustain long term growth, the suddenness of the crash was a direct result of liberal capital and currency markets.

LIBERALIZING CURRENTS

Global markets have become increasingly liberal since the 1970s following the dismantling of the fixed exchange rate mechanism. Orthodox neo-liberal policies began to unfold dramatically following the decline of Keynesianism, which began to breakdown in the welfare states of developed economies since the end of the 1960s. The golden age of economic growth, beginning after 1945 reached its limits when both inflation and unemployment began to rise.[5] The spread of neo-liberal ideology influenced the liberalization of economic institutions across the globe. The pervasive promotion of free currency and capital markets has sucked in individuals, institutions and economies in the international economy under conditions of increasingly weakening social bonds. Social welfare goals have been increasingly compromised as liberalism unfolded from the 1970s and 1980s.

The collapse of the fixed exchange rates mechanism in 1971 and its subsequent impact on exchange rates and international reserves sent the first destabilizing waves in financial markets. The United States was not only able to deflate its real international payment commitments denominated in US dollars owing to its fallen value, but was also

[3] See for example Lee (1993).
[4] See for example Hughes (1998); Friedman (1997).
[5] Samuelson and Solow had found evidence to support the Phillip's curve which posits an inverse relationship between inflation and unemployment using the experience of developed economies.

able to use its huge domestic financial market to enjoy scale advantages over other economies. With the rise of monetarism across the world as economies attempted to balance their budgets by slashing government expenditure, the welfare state began to crumble across Europe since the 1970s. Even with better legal frameworks and public accountability, developed economies' institutions increasingly became slanted towards liberalism. Developing economies lacking institutional development became substantially more vulnerable to the forces of liberalization.

Increasing liberalization of currency and capital markets began to expand the volume of currency transactions unrelated to trade. The quantum expansion in portfolio equity investment across the globe increased the vulnerability of small open economies. Annual exports and currency transactions in the world exceeded US$1.3 trillion and US$4.6 trillion respectively in 1977, rising to US$4.8 trillion and US$325 trillion respectively in 1995 (Korten, cited from Khor 1997: 15). In other words transactions unrelated to trade had expanded from 78.1 per cent in 1977 to 98.5 per cent in 1995. The alarming expansion in currency transactions unrelated to international trade deepened systemic risks facing open developing economies in the international economy. Small open economies such as the Southeast Asian second tier NIEs capital and currency markets became increasingly susceptible to the destabilizing effects of sudden capital flights, whether driven by actual economic fundamentals or predatory behavior by speculators. Keynes had warned against such unproductive and harmful conduct and hence called for controls when the Bretton Woods institutions were formulated in 1944.

The continued stagnation of the developed economies of the United States and Western Europe in the 1980s when faced with a massive inflow of liquidity arising initially from petrodollars that multiplied following the second oil crisis of 1979-80, found a haven in developing economies enjoying strong macroeconomic foundations. The aggressive promotion of stock markets led to the opening and strengthening of stock markets in developing economies. Hence, the surplus cash in the developed economies found a vent in the NIEs – first, second and third tiers. From negligible in the 1970s, portfolio equity flows to developing economies expanded from the mid-1980s (see Tables 1 and 2). The collapse of the socialist experiment amplified such flows as neo-liberal orthodoxy saw equity flows as the best mechanism to shape resource allocation – that individual investors with less influence on markets – would enter and exit firms based on their performance record. Hence, stock markets grew strongly in the 1990s, including in the transitional economies. Although portfolio equity inflows still constituted less than a third of FDI inflows to developing economies, its rapid rate of expansion brought wide ramifications for capital volatility. As a proportion of GNP, portfolio equity capital[6] rose from 0.00 percent in 1975-82 to 0.02 per cent in 1983-89 and 0.54 per cent in 1990-98, overtaking the contribution of bonds and long-term bank credit (see Table 1). Net

[6] The World Bank defined portfolio equity flows to include national savings, deposit receipts and direct stock purchases by foreign investors.

portfolio equity and related flows in overall capital flows to developing markets rose from 4.4 per cent in 1988 to 20.1 per cent in 1991 and 41.5 per cent in 1993 before falling to 26.9 per cent in 1995 (see Table 2). The commensurate flows to Asia rose from 3.8 per cent in 1987 to 15.2 per cent in 1989, 33 per cent in 1993 before falling to 24.1 per cent in 1995.

Table 1: Private Capital Inflows to Developing Economies in GNP, 1975-98 (%)

	1975-82	1983-89	1990-98
Private Inflows	3.33	1.29	3.97
Non-debt Creating Inflows	0.42	0.55	2.21
FDI	0.42	0.53	1.67
Portfolio Equity	0.00	0.02	0.54
Bonds	0.11	0.05	0.52
Bank Credit	2.46	0.44	1.17
Short-term	1.10	0.10	0.72
Long-term	1.36	0.34	0.44

Source: Extracted from Akuyz and Cornford (2000: Table 1); compiled from estimates of UNCTAD Secretariat and World Bank (1999).

With the Plaza Accord forcing capital outflows from Northeast Asia and Singapore following the floating of their currencies and the subsequent withdrawal of the Generalized System of Preferences from the Asian NIEs, Southeast Asian economies became a major target of foreign capital inflows from the mid-1980s. The governments of Indonesia, Malaysia, the Philippines and Thailand aggressively attracted capital inflows – both FDI and portfolio equity capital – using extremely generous ownership conditions and fiscal incentives (see Rasiah, 1998). In the absence of effective governance to ensure socially acceptable investment flows, quick profits drove hot capital flows across Southeast Asia as governments increasingly opened their economies for them. Indeed, portfolio capital and related flows to developing economies expanded sharply from the late 1980s (see Table 2).

Table 2: Net Portfolio Equity Capital and Related Flows to Developing Economies, 1986-1995

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Developing Markets	4.7	3.0	4.4	10.4	9.4	20.1	19.4	41.5	34.7	26.9
Asia	4.8	3.8	5.2	15.2	9.5	13.7	11.7	33	31.9	24.1
Africa dan Middle East	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.0	16.5	43.3
Latin America	0.0	0.9	1.8	4.9	11.0	29.5	31.7	58.7	40.2	21.9
Eastern Europe and Central Asia		0.0	76	53.4	67.5	62.6	24.3	67.7	81.2	76.8

Source: UNCTAD (1988)

The explosive growth in stock markets took place at a time when the Southeast Asian economies were rapidly deregulating to meet global trading arrangements. Indonesia, Malaysia and Thailand were faced with deregulation pressures in the 1990s as the World Trade Organisation (WTO), Asia Pacific Economic Cooperation (APEC) forum and ASEAN Free Trade Area (AFTA) liberalization processes were implemented. The Philippines had already deregulated extensively following the imposition of the IMF-led structural adjustment package in 1984 (Ofreneo, 1998).

Attracted by rising rentier opportunities from rapid growth, the political regimes in Indonesia, Malaysia, the Philippines and Thailand focused on the short-term benefits of liberalization (see Jomo et al, 1996; Rasiah, 1998). Liberalization without adequate installation of effective governance instruments began to expose the East Asian economies to external volatilities. The dangers of unfettered deregulation began to emerge strongly as resource and factor limits were stretched. Indonesia, Thailand and the Philippines in particular were already building up unsustainable short-term debt problems. The Philippines and Thailand were in addition gripped by chronic current account deficits.

While the overwhelming blowout of the affected economies were a result of a sudden loss in confidence which drove away investors and savers to exit liberal domestic markets and financial institutions causing panic-ridden herd behavior, these economies had reached crisis proportions as a consequence of debt-driven growth. The exit of such

a massive amount of capital suddenly, seriously affected exchange rates, interest rates and asset-liability ratios. The ensuing free fall crippled economic transactions, whether driven by good economic fundamentals or otherwise.

The experiences of the individual economies were different. Thailand, Malaysia and the Philippines were already affected by a severe worsening of their current account deficits. The commensurate deficits in Indonesia were not as severe. Thailand, the Philippines and Indonesia faced a sharp aggravation of short-term debt problems. Thailand, the Philippines and Indonesia were not able to pay their international commitments (debt service and current account commitments) when the loss in confidence exhausted their capacity to borrow. These economies had to go to the IMF as lender of last resort. Malaysia did not face such a situation owing to its relative surplus of international reserves and hence enjoyed the freedom to experiment with policies unconditioned by the IMF.

Rapid growth since 1987 helped build international confidence which came along with equity investments. The macroeconomic variables of East and Southeast Asia improved considerably (see Table 3). The whole regional stock market(s) began to expand with its peak in 1993 and its subsequent decline was too gentle to suggest a crash was around the corner (See Table 4). The continued growth of the real economy, despite narrowly defined structural change and massive physical expansion attracted international investment. The huge build up in trade surpluses in Japan in the face of its ailing domestic economy and low interest rates drove significant outflows to Southeast Asia. Japanese investment also expanded into property development – from hotels to malls. Despite the build up of systemic risks in particular in South Korea and Thailand where the short-term debt commitments and current account deficits as a share of international reserves had soared to unserviceable limits, international investors continued to flow into these economies because of the almost mytical categorization of the East Asian economies.[7] In Thailand, the expansion in unhedged loans from abroad supporting growth in the real estate and property sectors due to asset inflation became unsustainable when the bubble burst. Private interests driven by short-term profit making motives expanded their operations in these sectors.

Stock markets received greater emphasis than social welfare. Irrespective of their origination, stock market capitalization was supported strongly by all four Southeast Asian governments without much concern for effective corporate governance. Privatization in the Southeast Asian second-tier NIEs saw the colossal transfer of ownership of public institutions to private interests. Stock market capitalization of

[7] Data on the catastrophic developments in these economies are published annually by the Bank of International Settlements (BIS) in Switzerland, and UNCTAD (1996) published its first systematic account of its dangers in its 1996 Trade and Development report.

privatized public institutions were handled to favor dominant interests as preferential shares and participation in privileged projects – involving especially governments - were favorably awarded to the politically connected (see Gomez and Jomo, 1997).[8]

Table 3: Macroeconomic Statistics of East Asia, 1990-98

	GDP Growth Rate			Inflation Rate			Unemployment Rate#		
	90-95	96	97	90-95	96	97	90	96	98
Indonesia	8.0	7.8	4.9	8.7	7.9	6.6	-	4.1	9-12
Malaysia	8.9	8.6	7.7	3.7	3.5	4.0	6.0	2.5	3.2
China	10.7	9.6	8.8	11.3	8.3	2.8	-	3.0	5-6
Philippines	2.3	5.8	5.2	10.6	9.1	6.0	-	7.4	13.1
Singapore	8.6	6.9	7.8	2.7	1.4	2.0	-	1.8	4.5
South Korea	7.8	7.1	5.5	6.6	5.0	4.5	-	2.6	7.6
Taiwan	6.4	5.7	6.8	3.8	3.1	0.9	-	-	-
Thailand	9.0	5.5	-0.4	5.0	5.9	5.6	-	1.1	4.4
	Savings/GDP			Investment/GDP			(Savings-Investment)/GDP		
	90-95	96	97	90-95	96	97	90-95	96	97
Indonesia	31.0	27.3	29.9	31.3	30.7	31.3	-0.3	-3.4	-1.4
Malaysia	36.6	42.6	43.8	37.5	41.5	42.0	-0.9	1.1	1.8
China	40.8	40.5	41.5	38.8	39.6	38.2	2.0	0.9	3.3
Philippines	16.6	18.5	20.3	22.4	23.1	23.8	-5.8	-5.3	-3.5
Singapore	47.0	51.2	51.8	34.9	35.3	37.4	12.1	15.9	14.4
South Korea	35.6	33.7	33.1	36.8	38.4	35.0	-1.2	-4.7	-1.9
Taiwan	26.9	25.1	24.8	24.0	21.2	22.0	2.9	3.9	2.8
Thailand	34.4	33.7	32.9	41.0	41.7	35.0	-5.6	-8.0	-2.1
	Incremental Capital-Outpit Ratios*			Fiscal balance/GDP			Current Account/GDP		
	87-89	90-92	93-95	90.95	96	97	90-95	96	97
Indonesia	4.0	3.9	4.4	0.2	0.2	0.0	-2.5	-3.4	-1.4
Malaysia	3.6	4.4	5.0	-0.4	0.7	1.8	-5.8	-5.0	-5.3
China	-	-	-	-1.0	-0.8	-0.7	1.2	0.9	3.2
Philippines	3.3	22.8	6.0	-1.1	0.3	0.1	-3.7	-4.7	-5.3
Singapore	-	-	-	9.4	6.8	3.3	0.6	15.4	15.4
South Korea	3.5	5.1	5.1	0.2	0.5	-1.4	-1.2	-4.7	-1.8
Taiwan	-	-	-	-5.0	-6.6	-6.3	4.2	4.0	2.7
Thailand	2.9	4.6	5.2	3.2	2.4	-0.9	-3.9	-7.9	-2.0

[8] Information for Thailand, Philippines and Indonesia were obtained from private communications with Vorawidh C, Rene Ofreneo and Bomer Pasaribu respectively in 1998-99.

Source: * -Radelet and Sachs (1998:Table 11); Others from ADB (1999)

The origin and spread of the crisis to Thailand, Indonesia, Malaysia and the Philippines had much to do with their willful integration into an increasingly liberalizing international financial system. Despite the quasi peg, participants – individuals and institutions – enjoyed the freedom to purchase and sell huge amounts of cash without approval from the authorities in the crisis-affected economies. This freedom was often lauded as it offered the dominant interest groups the opportunity to transfer money instantly without public accountability. In Malaysia for example, until the rupture of the quasi peg, only single transactions exceeding RM20million required notification to the Central Bank. Along with exports and imports reaching between 100-180 percent of GDP, Indonesia's, Malaysia's, the Philippines', and Thailand's exposure to external capital movements had become extremely high. Clearly both the currency and capital markets in Indonesia, Malaysia, the Philippines and Thailand – all small and extremely open - were left seriously vulnerable when the baht crashed in July 1997. Once Thailand floated the baht following massive losses in international reserves from efforts to defend the currency from speculative attacks, it easily spread to the regional markets.

The build up in short-term debt and current account deficits in Thailand, was clearly unsustainable at the time the baht fell though government finances was positive (see Tables 3 and 4). Indonesia's current account was in surplus but its debt service had already become unsustainable. The Philippines had remained weak with economic fundamentals despite aggressive deregulation under an IMF-style structural adjustment package introduced since the mid-1980s. Despite its growing current account deficits, Malaysia's international reserves still exceeded its international bills (current account deficits plus foreign debt service commitments) to prevent potential default and therefore did not warrant a collapse. The financial crisis ravaged all the four crisis-affected economies causing chaos as the damage spread from currency and capital markets to their real economies. Driven by sentiments, large amounts of portfolio investment – both domestic and foreign – quickly exited Indonesia's, Malaysia's, the Philippines' and Thailand's stock markets. The bearish response dragged even savers – driven by panic and herd conduct - away from domestic banks who exchanged their money for foreign currencies, especially dollars to seek refuge in relatively safe havens.

On 1 September 1998, the stock market composite indices in Bangkok, Kuala Lumpur, Jakarta and Manila contracted to 40.0, 24.4, 44.5 and 42.3 percent respectively of their values on 1 July 1997 (see Table 4). The contagion spread across East Asia as stock markets in Tokyo, Hong Kong, Singapore and Seoul contracted to 71.2, 46.5, 42.8 and 40.9 percent respectively in the same period. Singapore, Hong Kong and Taiwan shielded their currency and stock markets through tightening of corporate governance practices and instruments to prevent large scale movements of currencies unrelated to

trade. Governments in all these economies enjoyed considerable autonomy over dominant private interests to effect corporate governance.

Table 4: Index of Main East and Southeast Asian Stock Markets, 1997-2000

Index	Peak	July 1, 1997	September 1, 1998	January 1, 1999	June 30, 1999	February 18, 2000
Kuala Lumpur	1332	1079	263	562	811	1013
Tokyo	38957	20176	14370	13416	17530	19789
Hong Kong	16820	15197	7062	9809	13532	16599
Seoul	1145	758	310	588	883	879
Singapore	2190	1924	823	1400	2168	2177
Bangkok	1789	527	211	357	522	408
Jakarta	743	732	326	394	662	599
Manila	3448	2816	1192	1981	2487	1884

Source: NEAC-MTEN (1999); Sidhu (*Star*, February 21, 2000: 2).

The sudden outflow of portfolio equity capital was one of the prime reasons for the aggravation of the equity-liability ratios, which expanded the non-payment loans (NPLs) in Southeast Asia. A sharp decline in sentiments affected capitalization of firms - both enjoying strong as well as weak financial fundamentals. Rising interest rates caused by a sharp fall in liquidity and the velocity of circulation in the face of falling East Asian demand crippled several firms. The exit of savings and portfolio capital abroad and into foreign currencies forced the baht, rupiah, ringgit and peso, to fluctuate downwards. The problem was worst when involving firms with liabilities in foreign currencies and receipts in domestic currencies. The initial adoption of contractionary policies – arising from tightening of credit and rising interest rates starved firms of much needed cash. Only export-oriented firms receiving payments in strong foreign currencies such as palm oil companies continued to enjoy strong growth. In addition, a significant amount of the ringgit, rupiah and baht sought refuge in Singapore's offshore banks.

The IMF added fuel to fire by prescribing neo-liberal policies calling for further deregulation, emphasizing the generation and dissemination of reliable data, closure of insolvent financial institutions and firms, removal of rigidities in the labor market, budget balancing to ameliorate the problems of rising risks, which included rising interest rates and tightening of collateral for loans. The contractionary policies debilitated demand and starved investment so much that a crippling crisis ensued as falling demand crushed the real sectors in all the economies. Only the foreign dominated

sectors and commodity export markets survived the credit crash? as the foreign exchange generated from exports helped them avoid the deflationary drop that was accelerating. Because Indonesia's, the Philippines' and Thailand's international payables exceeded receivables and the fall in confidence stopped inflows of foreign exchange, their governments had to seek IMF aid. Malaysia did not face that situation and hence avoided similar consequences.

Dominant private interests located in both developed and developing economies promoted risky channels of capital flows including the freedom to enter and exit suddenly for raising profit making opportunities rather than to ensure social stability. When the disastrous effects of the financial crisis spread across East Asia, the IMF merely used its standard neo-liberal diagnosis to solve the crisis. Hence, while Taiwan, Singapore and Hongkong reduced the damage by introducing shields in their currency and capital markets, IMF-advised economies got worse. As experts reviewed their conjectures again, it was clear that the crisis was turning back Keynes (1973) on his feet. The dangers of freeing both markets – capital and currency – as being dangerous and harmful for the real sectors had become increasingly obvious. As the individual economies were clearing the debris left behind by the crisis, the Southeast Asian blowout has raised serious doubts over neo-liberal calls for free global currency and capital markets.

INCREASING SUPPORT FOR LIBERALIZATION DOMESTICALLY

While Western governments and global institutions such as the IMF promoted free financial markets, Southeast Asian political regimes were also dramatically transferring public institutions to private ownership and readily deregulating their economies. Liberalization was not accompanied by effective development of legal and civil institutions to ensure public accountability. The unleashing of market forces in inherently imperfect underdeveloped locations – was both favored by dominant domestic interests as well as conditioned by international capital. While the internationally conditioning IMF rescue packages of Indonesia, the Philippines and Thailand pushed for further deregulation, Malaysia's capital controls only shielded currency and capital markets and to a large extent rescued the dominant private interests crippled by the financial crisis.

While the stifling conditions imposed by the IMF to quicken further deregulation and shift private failures to governments has undermined domestic capitalist accumulation in Indonesia, the Philippines and Thailand, capital controls in Malaysia appear to merely shield private interests that in the past had been promoted through liberalization. The basic framework of deregulation has remained in Malaysia despite controls to cushion the domestic economy from external volatility. The regimes in Indonesia, Thailand, Malaysia and the Philippines were not opposed to the fundamental prescriptions

interests of the IMF prior to the mid-1990s. In fact Indonesia, Malaysia and Thailand were favored over South Korea and Taiwan for policy lessons by the World Bank (1993) due to their more liberal policies. Also, the ruling elites in these economies benefited and therefore supported the aggressive liberalization of their economies except that it was managed to also ensure continued creation of opportunities for rent capture.

Privatization Driven by Patronage

The prime domestic constraint Indonesia, Malaysia, the Philippines and Thailand faced was a lack of instruments to filter harmful capital flows and transactions, including a lack of an early warning system to alert against systemic volatility from the external environment. However, it took almost two months for the Thai storm to destabilise Indonesia and Malaysia. This time lag was more than sufficient to prevent excessive damage if only neo-liberal diagnoses had not prevailed at that time and governments had introduced instruments to prevent predatory conduct and panic from ruining both the capital and currency markets. Information and sufficiently equipped planes and pilots are critical to chart courses that help bypass strong winds. When planes still come against pounding winds because of information imperfections, adequately installed covers would help minimise damage.

Liberalization premised on claims that government failures were inherently more serious than market failures has been driven by rhetoric rather than reality. Similarly extensive dirigisme calling for state intervention as the central basis of accumulation is also often fraught with failures. It is the recognition of both failures that has helped the building of effective government-market co-ordination to minimise the excesses of both in the successful reduction of its impact by Singapore and Taiwan. Privatization and state-sponsored growth was promoted with considerable zeal prior to the crisis in Indonesia and Malaysia. Indirect features of industrial policy evolved in Thailand (see Jomo, 1997). The Philippines lost their industrial policy strategies following the introduction of structural adjustment packages under the IMF since 1984. All four economies have retained their privatization processes after the financial crisis. Malaysia has continued with both policies even after the crisis. On the one hand heavy industries such as steel, automobiles and cement enjoy strong government support even when under private interests. On the other hand, the government has increased the pace of privatization of public utilities involving critical institutions.

Consistent with neo-liberal prescriptions, stock markets were promoted aggressively by all the governments – both domestically and internationally – so that portfolio capital entered and exited capital markets with little restrictions prior to the crisis. As with FDI flows, governments guaranteed the free entry and exit of equity capital flows and stock market counters were expanded across the economies. The local media's coverage presented a glowing account of the profiteering potential of investing in stock markets as

negative reports were carefully censored. The fairly stable exchange rate - albeit it rose gently because of its quasi peg with a basket of currencies – helped establish international confidence in the domestic stock market. Hence, both domestic and international investors flooded stock markets in all four economies.

Financial markets in all four economies increasingly became open. Governments did not install filters to prevent the inflow of hot money, and sudden entry (entries?) and exits of portfolio equity capital. To woo FDI and portfolio capital, governments offered guarantees of free capital movement through investment guarantees that included the repatriation of profits. In Malaysia, individuals only had to notify *Bank Negara* when making cross border cash transactions exceeding RM20 million prior to the financial crisis. From virtually negligible participation in stock markets, foreign portfolio equity investment rose sharply from the mid-1980s, but its aggressive promotion without effective governance exposed these economies to considerable volatility (see Jomo, 1998; Rasiah, 1998). In Malaysia for example, short selling was only suspended in 1997 after the contagion had already penetrated the currency and stock markets. Hence, when sentiments crashed in 1997, substantial amounts of foreign portfolio capital left (see Table 4).

Indonesia, Malaysia, the Philippines and Thailand supported liberalization initiatives that expanded private ownership of economic resources. Ruling elites in these economies were indeed building their fortresses under similar but outmoded capitalist practices as few actually achieved international competitiveness (see Jomo, Felker and Rasiah, 1999). Engels had referred to the early merchant capitalists especially of the 17th Century as barbarians for whom plunder, piracy and pillage appeared more honorable than productive work. The entrepreneurs of the 17th Century gradually adapted their risk bearing and profit-making initiatives following developments in legal and civil institutions in Europe. Hence, business operations in developed Europe demonstrate far higher corporate and public accountability than in the developing economies. Rapid growth in social structures that have been both imperfect and underdeveloped has created a wide gap between dominant private interests and the masses in Southeast Asia. In the absence of sufficient civil and consumer rights, liberalization has been pursued blindly in circumstances of high incidence of market failure as well as government failure, which is a general tendency involving unfettered liberalization.

Unlike the Brazilian, Mexican and Russian financial crises, which can be attributed primarily to public debt problems, the Southeast Asian financial crisis was caused by private debt problems. Claims of moral hazard arising from inadequate disclosures lacked sufficient empirical evidence. The default pressure and the problems faced by Indonesian, Malaysian, Filipino and Thai companies were primarily aggravated by private interests at the time of the crisis and served to meet private interests even when involving individuals whose responsibilities were public. Rising privatization since

1983-86 saw divestments driven through a patronage system where either private officials - connected to the state - or state officials accessing control themselves – owned much of the privatized projects. Governments in Indonesia, Malaysia and Thailand increasingly privatized profitable ventures, often understating their share values and offering considerable economic rents by limiting new entrants in related final markets. Large holding companies with political connections expanded into a whole range of public goods markets and shielded private goods markets even in spheres that were new to them. Without sufficient learning experience and sufficient levels of creative competition, these conglomerates produced and distributed products and services at sub-optimal levels thereby exposing themselves to economic doom when faced with foreign competition. Holding companies in Malaysia were running up their debt in domestic banks without effective deepening of their fundamentals. Similar operations typified large domestic private interests in Indonesia, the Philippines and Thailand except they were increasingly accessing loans from abroad.

Despite aggressive industrialization initiatives in Indonesia, Malaysia and Thailand, none of the four economies have instituted the necessary instruments to stimulate industrial transition. The growing human capital and innovation deficits in these economies have continued to grow. Despite a massive expansion in institutions, Malaysia still lacks the requisite coordination mechanisms to help firms make the transition to higher value added activities. Revival efforts seem to reinforce the problems that confronted capability building prior to the crisis. The resurgence in capital inflows to East Asia and the stability offered by capital controls after September 2, 1998 have merely revived capital supply to industry along the channels that were in place prior to the crisis. The broad property sector, which was pointed out earlier as a major cause of the bubble - has become a major target of Danaharta. The intensification of IMF-led liberalization in Indonesia, the Philippines and Thailand currently threatens to stall the conversion of latent capabilities to assist them realise their competitive advantage.

Thailand still suffers from financial illiquidity problems as almost 50 percent of its banking sector remained non-performing in late 1999. Indonesia has been torn by political chaos so seriously that even the liquification of its financial system has not returned the country towards steady growth. Insolvent banks were closed in Indonesia and Thailand. The Philippines did not suffer seriously from the crisis because of its low macroeconomic credentials. While recovery efforts in Malaysia have been more successful than the other crisis-affected Southeast Asian second tier NIEs, problems of public accountability still confront several directives. Bank mergers to ameliorate the financial sector problems still remain unresolved. The pre-crisis strategy of managing banking mergers involving over-exposed banks such as Bank Bumiputera with Commerce Bank and Sime Bank with Rashid Hussein Bank was extended to reduce the number of banks to six, and later expanded to 10 anchor banks. That strategy hit a snag

following complaints by several banks that the selection of anchor banks was not based on performance criteria.

The masses were seriously affected by the sudden downswing in Indonesia, the Philippines and Thailand when unemployment and underemployment soared following closures (see Table 3). The IMF's deregulatory strategies made the livelihoods of everyone more painful as deflationary prescriptions contracted these economies causing scarcity and job losses. These developments alongside poorly developed industrial relations and labor laws institutions exposed the workers to untold sufferings from oppressive labor-shedding, pay cuts and retrenchment practices. Democratisation in Thailand and Indonesia offered the working class and trade unions more room to voice their differences but their disorganised structures have restricted collective action. Moves in Thailand to integrate the seven national centres into a unified single center has yet to produce better institutional support for workers. In Indonesia, democratization did not translate into strong political support for working class leadership. Trade unions have remained a disjointed force in the Philippines with intense rivalries between them often favoring employers (see Rasiah and Chua, 1998). In Malaysia, the political manoeuvering that followed the financial crisis attracted the once independent labor movement in the country to the government. However, the Malaysian Trades Union Congress (MTUC) has failed to influence government policy.[9] Typical of neo-liberal approaches – which call for the removal of rigidities that distort market clearing wage rates in labor markets - all the four economies remain without effective institutionalization of industrial relations practices. The further liberalization of trade union policies, despite democratization in Indonesia and Thailand, is likely to expose workers to greater misery as external volatility rises. Such strategies will only strengthen the low road to industrialization or casualisation tendencies of unfettered liberalization.

Structural Confusion

With the exception of the Philippines, the Southeast Asian crisis-affected economies achieved rapid growth and low inflation and unemployment rates in the period 1986-96 (see Table 4). However, growth was already slowing down by the mid-1990s because of growing deficits in technical change and productivity. In addition, the lack of development of the requisite institutional framework restricted the innovative capabilities necessary to sustain competitiveness. Malaysia enjoyed considerable expansion in physical infrastructure, but the institutions and co-ordination relationships necessary for firms to make the transition from low value added low wage production to high value added high wage production did not evolve adequately.

[9] While the past practice of dismissing crudely incisive suggestions by trade union leaders seems to have stopped, the government has yet to demonstrate a movement towards offering the labor movement space for social corporatism.

Financial institutions in the crisis-affected economies continued to expand their loans despite a slowdown in the real sectors in the period 1993-96. Loans by the banking sector in Malaysia grew swiftly in the 1990s, though its foreign debt situation was more favorable than Thailand's, the Philippines' and Indonesia's (see Table 5). All four economies' gross fixed capital formation (GFCF) continued to grow faster than GDP (see Rasiah, 1998a), pushing their incremental capital output ratios higher and higher without commensurate productivity increments (see Table 5),[10] supporting the assertion that growth was driven by inputs and factors of production more rather than by disembodied technical change. A combination of government promotion and growing confidence in the private sector attracted investments beyond optimal levels so that the nominal returns continued to rise instead of diminishing. Much of the loans in Malaysia were drawn from local financial institutions or through foreign funds deposited domestically. However, the build up of foreign loans in Malaysia was rising sharply in the mid-1990s so it could easily have exceeded its international reserves had the crash been delayed by two years. International claims involving Malaysia that were held by foreign banks rose from US$16.8 billion at the end of 1995 to US$28.8 billion by mid 1997, though, it was much smaller than those of Indonesia, the Philippines, South Korea and Thailand (Radelet and Sachs, 1998: Table 5). The private sector's share of such foreign banks' claims of Malaysia rose from 67.5 percent at the end of 1995 to 93.4 per cent in mid-1997.[11] All four economies faced expansionary banking policies in the 1990s, which, given the slowdown in the real sectors of manufacturing and agriculture, bloated the bubble. The easy expansion of credit especially in the 1990s raised the loans/equity ratios to extremely high levels. The collapse in currency and share values aggravated the imbalances further.

Malaysia had the worst loans/GDP ratio when the financial crisis struck. Domestic credit provided by the banking sector as a share of GDP in Malaysia had risen from 77.9 percent in 1990 to 166.6 percent in 1997 (World Bank, 1999: Table 16). The commensurate percentages for the other crisis affecting Southeast Asian economies were much smaller: Indonesia – 45.5 percent in 1990 and 54.3 percent in 1997, the Philippines – 26.8 percent in 1990 and 83.4 percent in 1997 and Thailand – 90.8 percent in 1990 and 124.3 percent in 1997. Nevertheless, the bubble in Malaysia was easier to handle as the bulk of the loans was domestically denominated compared to loans in Thailand, Indonesia and the Philippines, which were primarily from abroad, and hence the need to seek IMF redress.

[10] Nevertheless, considering the early stage of growth and rapid structural change, capital and total factor productivity measures should not be a major source of alarm as it is generally associated with large intial outlays of lumpy investments.
[11] Computed from Radelet and Sachs (1998: Table 5)

Table 6[12]: Debt Service and Short-term Debt, 1980-96

	Debt Service as a proportion of exports (%)			Short-term Debt (Billion US$)#				Current Account Deficit Plus Short-term Debt as Proportion of International Reserves (%)*			
	1980	1992	1995	1992	1994	1995	1996	1992	1994	1995	1996
Indonesia	13.9	32.1	30.9	18.2	14.0	16.2	17.9	191	139	169	138
Malaysia	6.3	6.6	7.8	3.6	7.6	7.5	8.5	29	46	60	55
Philippines	26.6	27.7	16.0	4.4	9.7	11.0	12.0	100	212	203	149
South Korea	-	-	-	-	-	-	-	-	-	-	251
Thailand	18.9	14.1	10.2	14.7	29.2	41.1	44.0	101	127	152	153

Sources: UNCTAD (I 997: Table 14); World Bank (I 994: Tables 20, 23, 1997: Table 17).

The rising tide of liberalization in all four economies from the mid-1980s, which, given their domestic political structures, magnified crony privatization. Privatization initiatives guided by neo-liberal consultants from the West magnified in scale as a consequence. The private sector's role in allocation and co-ordination, either through opaque crony alliances or via banking, finance and stock market expansion, became dominant. Hence, when governments began divesting shares of public companies the allocation procedures followed patronage lines, polarising wealth distribution as a consequence; the Gini coefficient of income inequality in Malaysia worsened from 1990 to 1995 (see Rasiah and Ishak, forthcoming). The excesses did not seem overly draining in the late 1980s and early 1990s due to rapid growth and the consequently widespread rent-generating opportunities. When the real sectors began slowing down from 1993-96, shrinking rents and unsustainable expenditures involving mega projects began to undermine profitability. Contrary to neo-liberal references to privatization in these economies to be state-driven or dirigiste reference to them as being dictated by private sector initiatives, private interests working hand in hand with the politically powerful began to dominate the financially profitable but rentier activities. In the absence of normal risk bearing requirements - as several ventures enjoyed state guarantees of domestic market control - a significant section of the newly created business class hardly showed critical elements of productive capitalism. [13]

Unproductive ventures, including property and share purchasers, attracted financing from banks and other financial institutions which, given their huge assets in the 1990s,

[12] Year end figures as percentage of reserves measured by dividing the current account deficit plus short-term debt by international reserves (1992 figures computed from World Bank data

[13] The central mechanism of industrial capitalism as argued by Marx (1962) and re-emphasised by Brenner (1982) is the approaporiation of relative surplus value to ensure the renewal and transformation of the means of production. Marx considered competition as important in forcing old modes of technology to give way to new ones. Schumpeter (1934) echoed these points when referring to competition as having the “gales of creative destruction”.

launched aggressive lending strategies.[14] Dominant private interests with political connections enjoyed considerable support from the government in all the four economies in the property and real sectors. Colossal losses – e.g. Perwaja Steel in Malaysia, double floor highway in Thailand and Timur-Kia venture in Indonesia – did not force the introduction of better corporate practices. In addition, while a number of the mega projects of governments can be argued to contain potential ammunition for substantial multiplier effects, the lack of effective screening and reliance on patronage rather than proven productive entrepreneurship to award contracts saw the failure of several. Private banks and finance companies facing liberal regulations began to extend loans based on quick returns, collateral and links with powerful politicians.[15] All the four economies showed a fall in loans to the agricultural, manufacturing and trade sectors between the years 1990-96 (see Table 7). The share of loans to construction, finance and real sector and service and household sectors expanded.

Table 6: Loans and Advances by Commercial Banks, 1990-96 (%)

	Indonesia		Malaysia		Philippines		Thailand	
	1990	1996	1990	1996	1990	1996	1990	1996
Agriculture	9.0	6.0	6.4	2.4	13.8	6.5	6.2	3.5
Manufacturing	35.0	27.0	21.3	22.0	38.5	32.3	23.7	23.1
Construction	-	-	7.0	8.9	2.7	3.9	3.8	4.1
Trade and Tranportation	34.0	24.0	16.5	12.1	18.2	22.2	25.5	21.7
Finance and Real estate	-	-	39.5	39.2	16.9	21.8	19.2	21.5
Service Industr	18.0	31.0	-	-	-	-	-	-
Households	-	-	2.4	3.7	-	-	13.8	16.3
Others	3.0	11.0	6.9	11.8	10.0	13.3	7.9	9.7

Source: ADB (1999)

While industrial policy equipped the first-tier Asian NIEs with strong institutional support for driving technical change, it has yet to do so in the crisis-affected Southeast Asian economies. Singapore successfully developed and maintained the institutions necessary to sustain its leading role as the Southeast Asian regional hub for medium to high technology-intensive production and services. South Korea and Taiwan successfully developed the necessary institutions to not only speed up the absorption and development of technologies, but also to strengthen their capacity to support new product development (see Lall, 1996). Excessive credit expansion and the lack of accountable supervision sowed the seeds for the financial crisis in 1997, but glacial (Jeg

[14] Interviews by author with a Vice President of a local commercial bank in 1998.
[15] Interviews by author with a Vice President of a local commercial bank in 1998.

kan ikke gennemskue meningen med denne sætning) deepening in the real sectors had already slowed down Southeast Asia's crisis-affected economies' growth potential (see Rasiah, 1998a). With the exception of resource based industries, such as palm oil processing, much of the manufacturing firms in Malaysia have yet to go beyond OEM capabilities, and does not have the institutions to adequately generate the requisite human and other technological capabilities to support rapid technical change. With the exception of food processing and jewelry, Thailand is plagued with the same problems. Indonesia has yet to develop any viable manufacturing industry despite its grip on over 50 percent of the world's plywood market. The little semblance of industrial policy during the Marcos' government, albeit implemented unproductively, disappeared since the mid-1980s.

The lack of institutional deepening to sustain efficiency improvements seriously restricted the performance of real sector firms in Indonesia, Malaysia, the Philippines and Thailand. Malaysia embarked on ambitious programmes to ameliorate these gaps but coordination problems has debilitated such efforts (see Rasiah, 1999). Burgeoning trade imbalances, high import shares in domestic demand and heavy concentration of production in narrowly defined segments of product chains threatens to inhibit further structural change in Malaysia and Thailand. Indonesia and the Philippines still face serious demand constraints, which is why their unemployment and underemployment rates soared to 11-18 percent and 40-50 percent respectively in 1997-99. Malaysia was at the crossroads at the time the financial crisis struck with its supply-side resources such as labor and infrastructure services overheating. The over-reliance on labor-intensive foreign capital in the face of supply-side constraints attracted foreign labor substitution, thereby slowing down the transition to higher skill and technology stages of production in Malaysia. Foreign labor substituted around 15-25 percent of the labor force of around 9 million in 1997. Because the emphasis in these economies were on meeting rather than managing market demand to enhance labor, employment strategies were generally decoupled from job permanence and skills enrichment. The deregulated labor market in Philippines without adequate developments in social welfare frameworks has increasingly expanded the share of casualised labor in the labor force (see Rasiah and Chua, 1998).

Policies to support local and indigenous firms across the crisis-affected Southeast Asian economies have still to materialise on the global stage as these firms are still primarily rent-dependent. While it is still early to predict the future of these economies, the admission of China into WTO may stimulate a major slowdown in FDI inflows as its labor reserves reaches around three times that of Southeast Asia. The recovery in global demand has helped revive foreign-owned export-oriented industries in all of them, though the prime beneficiary is Malaysia. Electronics in particular has picked up strongly from early 1999. With the fallen values of domestic currencies, these economies have become competitive again in low wage activities. In Malaysia, the

Industrial Production Index (IPI) grew by 8.9 percent with manufacturing recording a growth of 12.7 percent in the period 1998-99 (New Straits Times, February 10, 2000: 22). Domestically shielded industries such as cars have also begun to grow rapidly, but these industries have not expanded their export shares, suggesting that they are still heavily rent-dependent. However, unless the technological architecture of Indonesia, Malaysia, the Philippines and Thailand changes to support industrial upgrading, the second wind offered by currency depreciation could easily be wasted as relative costs rise and new sites become more attractive.

The Southeast Asian crisis-affected economies' exposure to the financial whirlpool could have been made less painful if only they had in place effective controls to prevent the sudden exit and entry of large amounts of capital. Good corporate practices would have strengthened the capacity of firms and institutions to ward off systemic disturbances. Also, the slowdown in the real sectors and the gradual build up in current account deficits could have been avoided if these economies had developed the requisite institutions effectively. In the absence of these conditions, the crisis-affected Southeast Asian economies became easy prey to the inherent disturbances of an increasingly unguarded international economy. Instead of recognising these flaws, neo-liberal economists seem to focus their attention on resource misallocation, cronyism and corruption. Clearly both initiatives – IMF-based liberalization and Malaysia's capital controls – have not departed from the fundamental flaws associated with? poorly governed capitalist growth.

Conclusions

This paper examined the fundamental neo-liberal flaws that caused the financial rupture. While making the argument that the harmful waves of increasingly free global currency and capital markets exposed these economies to tremendous systemic volatilities and hence was the prime cause of the financial crisis, the paper also argued that porous governance instruments as well as pursuance of privatization and business deals colored by patronage were driven by the dominant interest groups globally and nationally. Rapid growth was not accompanied by the strengthening of civil and legal rights and hence as the liberal waves became turbulent these economies easily capsized. IMF rescue packages initially aggravated the socio-economic conditions of Indonesia and Thailand as deflationary currents contracted these economies. Malaysia's capital controls offered shields as well as spurred investment with low interest rates and easier access to credit, though it merely reproduced the problems associated with pre-crisis patronage-based accumulation.

The Southeast Asian financial crisis was the result of both increasingly liberalising currents as well as government policies that were equally exposing the domestic economy to the vicissitudes of external volatility. All four affected governments were

actually peddling privatization and liberalization initiatives that favored the interests of politically connected dominant groups. Thailand, the Philippines and Indonesia succumbed to IMF pressures because of their overblown international commitments. Malaysia escaped such humiliation only because it enjoyed a relative surplus in international reserves.

It is clear that free currency and capital markets exposed the crisis-affected Southeast Asian economies to substantial systemic risks, destabilising them seriously when external volatility suddenly exploded. Despite a creeping slowdown, these economies were not expected to crash suddenly. While a major lesson to emerge from the Southeast Asian financial crisis is the need to institute regulation in the international financial system, the damage inflicted by the crisis could have been reduced if the requisite shields were in place. Malaysia's capital control efforts did not generate any apparent disastrous effects, though it could have been more successful if introduced in late 1997 and if it had been accompanied by strong emphasis on public accountability and transparency. The introduction of capital controls behind opaque rules suggests the continued pursuance of pre-crisis unproductive patronage arrangements designed to maintain the pre-crisis hegemony of the ruling elites and politically connected dominant interest groups.

Democratization without effective legal and civil instruments has prevented the strengthening of public accountability in Indonesia and Thailand, which is likely to reproduce disjointed structures of mass organisations as seen in the Philippines. The lack of democratization along with a draconian civil and legal framework has left Malaysia still without an adequate framework to ensure improvements in public accountability. Authoritarian regimes under pressure – whether from domestic or international forces – have often used nationalism cavalierly to gain currency for their own survival. While in Indonesia, Thailand and the Philippines (since Marcos in the mid-1980s) the advent of unguarded and populist liberalization was leaving them open to potentially dangerous international forces, in Malaysia the lack of democratization has deepened further compromises on freedom, social accountability and justice. Yet, none of the regimes have delinked from mainstream neo-liberal policies. Despite the introduction of capital controls, government policies in Malaysia generally favored politically connected private interests. The Malaysian domestic economy is also strongly powered by FDI, and the government's strong interest in foreign portfolio equity capital can be seen from the modest exit tax remaining in the stock market. It is only when international interests contradicted and destabilised the interests of the ruling elites and when it was threatened with collapse following the financial rupture that the government took drastic measures to shield them.

The Southeast Asian crisis affected economies nature of government interventions generally worked hand in hand with dominant private interests so that the short-term

profit-making benefits of liberalization were strongly promoted. While liberal currency and capital markets left these economies unguarded against turbulent capital movements and hence was the cause of the sudden crash, cronyism and corruption made matters worse. Yet, cronyism and corruption emerged largely as a consequence of the lack of development in civil and legal rights to improve public accountability, elements that are inherently part of unfettered deregulation.

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