Twenty Years after the Asian Financial Crisis*

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Exactly twenty years ago, a major financial crisis had hit the countries of East and South East Asia in July 1997. This crisis was a watershed in the history of third world development, in the sense that these "tiger economies" which had seen extraordinarily high growth rates until that time, remained permanently crippled thereafter. Just around the time that they were shaking off the effects of the 1997 crisis on their respective economies, the collapse of the "housing bubble" in the United States plunged the entire world capitalist system into a crisis which also affected them, so that they could never recapture their earlier growth trend.

The earlier growth performance of these Asian economies had been used by the World Bank, the IMF and the OECD (the rich countries' club) to debunk the growth strategy pursued by India and a host of other third world economies in the immediate aftermath of decolonization (what we call the "Nehruvian strategy") which visualized delinking from world capitalism through trade and capital controls, and emphasized dirigiste development based on the domestic market, for breaking out of the colonial pattern of international division of labour. It was argued against such a strategy of "economic nationalism" that the Asian economies were doing remarkably well by hitching themselves to the global economy and eschewing dirigisme and controls.

Put differently, the argument was that a break from the inherited pattern of international division of labour would occur spontaneously under capitalism; it did not require the paraphernalia of State intervention and controls. Indeed countries which resorted to the latter had come a cropper, while countries, exemplified by the "Asian tigers", which adopted economic liberalism and "left things to the market", had performed so much better. Since the former economic strategy had grown out of a certain understanding of world capitalism, namely that it was marked by "imperialism" which tended to produce "underdevelopment" in the third world, the experience of the East and South East Asian economies was used to debunk the idea of "imperialism", certainly in the post-colonial world and even as a necessary economic accompaniment of the earlier political system of colonialism.

The OECD had published several volumes in 1970 containing case-studies of third world countries, which argued this thesis and launched an attack on the dirigiste strategy. The Left too had been critical of the dirigiste strategy (in our case the "Nehruvian strategy"), but on entirely different grounds. It had staunchly supported whatever anti-imperialist thrust this strategy had, but had criticized it for its inability to introduce radical land reforms and break land concentration, which kept both the size of the home market and its rate of growth, restricted (the latter owing to the low rate of growth of agriculture within a largely unreformed agrarian structure). The limitation of the strategy, the Left had argued, arose from this source and not from its adoption of import substitution, State investment, capital and trade controls, and restrictions on domestic and international big business.

It turned out on closer examination that the East Asian strategy had not actually been what the OECD, IMF and World Bank economists had claimed. It was not based on relying on free markets, eschewing State intervention, and giving capital a free run.

On the contrary the State had essayed even micro-level intervention, exhorting capitalists to export, allowing them to dump goods abroad (by charging higher prices at home), and setting up export-processing zones which domestic and foreign (mainly Japanese) capital could use as bases to launch export drives. Their strategy had been neo-mercantilist rather than neo-liberal, with the State playing a major role, though a role different from that in countries like India; and it had succeeded because imperialist countries had allowed them market access.

The opening of these economies to freer flows of international finance is what knocked them off their growth trajectories. These economies had launched a programme of "financial liberalization" just a few years before the crisis which had brought in huge amounts of foreign finance. The very opening up of fast-growing but hitherto financially-closed economies (they had been getting direct foreign investment but not foot-loose finance) to free flows of finance, would have brought large financial inflows anyway. But additionally such inflows were aided by an interest differential. In the U.S. interest rates had been kept low in the beginning of the nineties in a bid to stimulate growth, while the interest rates were comparatively higher in the fast-growing Asian economies. With financial liberalization, this made domestic firms turn to cheaper foreign funds, and it also made foreign banks and financial institutions pour funds into the Asian economies to obtain larger interest earnings.

Whenever there is a surge of financial inflows into an economy, then, no matter what it does, this economy gets into difficulties. Just think of the various possibilities. If it simply allows these funds to come in without any intervention and domestic expenditure does not increase, then the exchange rate appreciates, which has a contractionary effect on domestic output and employment, even as the external liabilities of the country go up. This is a bizarre situation, a case of "debt-financed deindustrialization", i.e. borrowing from abroad to ruin one's own economy.

If with larger inflow of funds, the current deficit expands because of larger domestic expenditure, then too there are problems. If the increase is in consumption expenditure, then effectively the country is borrowing short-term funds to indulge in a consumption splurge, typically of the rich; and when such funds are taken out, there is a foreign exchange crisis, which causes a squeeze, typically on the consumption of the poor, to generate resources for the outflow. On the other hand, if it uses the funds for investment purposes, then the country is "borrowing short to invest long", i.e. using short-term funds for long-term investment, which means that when the funds are taken out, it would face a liquidity crisis.

It can of course simply hold reserves and prevent any appreciation of the exchange rate. But since reserves (which are equivalent to lending abroad) earn very little by way of returns, while the funds coming into the economy earn much higher rates of return, holding larger reserves, though averting the prospects of a foreign exchange crisis in the event of funds being taken out, entails the country's "borrowing dear to lend cheap", which is patently absurd. Thus any large inflow of short-term foreign funds is necessarily fraught with danger for the host economy.

The Asian economies typically enlarged their investment rates when there was this surge in foreign financial inflows. Some of these inflows had arisen anyway because domestic firms were borrowing abroad to raise investment; additionally, other firms jacked up their investment with the easy availability of funds owing to these inflows, some of which found their way to local banks. These economies, South Korea being a prime example, were thus not only "borrowing short to invest long", but borrowing in foreign exchange to finance non-foreign exchange earning investments, such as in the infrastructure sector.

When the crisis came, there was both a run on foreign exchange and a run on banks; and these two reinforced one another. As the exchange rate fell, banks' liabilities which were in foreign currency increased relative to their assets which were in domestic currency, making them vulnerable. And this very fact made foreign investors take out their deposits which further made the exchange rate collapse.

The policies imposed by the IMF to which these economies turned made matters worse, since the IMF, while extending loans, insisted that those taking out funds must be allowed to do so. The IMF loans therefore were used for financing capital flight, while the draconian austerity and "denationalization" measures (handing over domestic assets to foreigners) took a heavy toll on people's lives and the countries' sovereignty. Ironically the country that came out of the crisis at the earliest and with the least painful effects on the people was Malaysia which imposed capital controls to prevent the flight of finance.

Since the crisis, these economies (and other third world countries too including India) have started holding much larger foreign exchange reserves in order to avoid a repetition of such an eventuality. But at the same time their debt to foreigners, as distinct from foreign currency debt, has gone up substantially. This distinction can be understood as follows: when a foreign national brings in foreign currency, exchanges it for local currency and buys domestic assets with it, then there is a debt to foreign nationals but not a foreign currency debt. But since, in the absence of capital controls, the foreign national can always sell the asset and take money out by changing the domestic currency into foreign exchange, the threat to the country's economy is no less with the former kind of debt than with the latter. If both kinds of debt are added up, then the foreign exchange reserves of these countries still remain woefully inadequate, relative to this total debt, to prevent a recurrence of a crisis in the event of a capital outflow. But while these countries remain as vulnerable as before, and are well below the growth trajectory they were pursuing earlier, foreign control over their assets has increased dramatically. The problem in short lies in allowing free capital flows, including financial flows, and not in specific policy measures within such a regime.

The hegemony of international finance capital, which led to economies "opening" themselves up to the vortex of global financial flows, demolished both Nehruvian dirigisme and East Asian neo-mercantilism. And the same hegemony has now brought the world capitalist economy to a crisis from which it is in no position to recover.

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