The US Role in the Long Asian Crisis of 1990-2000[1]

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The world has been experiencing a "boom in busts"—a much higher frequency of financial instability in the 1980s and 1990s than in the post-World War II period up to the end of the Bretton Woods regime in the early 1970s. During the decade of the 1990s a major financial crisis erupted every two or three years.[2] During the longer period from the late 1970s to 1996 at least 69 countries had at least one major

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[2] The 1990s' episodes of financial instability and crisis in industrial countries started with the lingering effects of the US banking and real estate crises that began in the late 1970s and lasted for more than a decade; then came Japan's bursting of the bubble in early 1990, whose effects on financial instability and slow economic growth have lingered for a decade to date; then the Scandinavian crisis of 1991-92; the European Exchange Rate Mechanism crisis of 1992-93; and the major slump in industrial country stock markets in October 1998. Among the developing countries the 1990s' episodes include the Mexican peso debacle of 1994-95 and knock-on banking crises in Argentina and Brazil in 1994; the (non-Japan) Asian crisis beginning in mid 1997 and continuing; the Russian debt default of August 1998; the steep falls in many developing country stock markets in October 1998; the near-currency-crisis in South Africa, Africa's largest economy; the Brazilian devaluation of January 1999; and a wider severe Latin American downturn in 1999. Meanwhile old investment banks like BCCI (1991) and Barings (1995) collapsed, followed by new hedge funds like Long Term Capital Management (September 1998). The latter's collapse was considered to pose such a serious risk to the US financial system that the Federal Reserve organized a bail-out rather than let it go bankrupt.

banking crisis, when the net worth of the banking system sank to zero or less.[3] Between 1975 and 1995 at least 87 countries had at least one major currency crisis, when the currency depreciated by more than 25 percent in one year.

Both banking and currency crises are typically very expensive in terms of the amount of GDP lost (the fall in growth rates) and in terms of the portion of the remaining GDP that has to be diverted to resolving the crisis. The US banking and real estate ("Savings and Loan") crisis of the 1980s cost over 3.5 percent of GDP to restore the banks to viability--but does not make it into the list of the world's 25 most expensive banking crises since the early 1980s.[4] When banking and currency crises occur together the results are much worse--not just crisis but collapse. From the mid 1970s to the mid 1990s at least 10 countries, not including the Asian ones of 1997-99, experienced simultaneous banking and currency crises causing GDP falls of 5 to 12 percent in the first year and negative or only slightly positive growth for several years thereafter.

There is little doubt that the higher frequency of banking and currency crises since the 1980s is causally related to the much greater cross-border capital flows relative to GDP compared to the 1950s and 1960s, at least for the developed countries and the 20 or so developing countries of interest to international investors (the economies with emerging financial markets, named the "emerging market economies"). Large capital inflows and outflows place enormous strains on economies. However, the exact relationship between financial *opening* and the probability of banking or currency crises does not seem to have been investigated with cross-sectional data. On the other hand, "There is overwhelming evidence that financial *liberalization* [as indicated by the relaxation of controls on interest rates, for example] increases the vulnerability of countries to crises".[5] And domestic financial liberalization is often associated with financial opening. All in all, the cross-sectional and historical evidence suggests that quick financial opening, especially when it goes with domestic financial liberalization, substantially raises the probability of a major economic crisis within the next several years.

This essay takes for granted that the (non-Japan) East Asian crisis, whose onset is conventionally dated as July 1997, was due, *proximately*, in large part to the fast build-up of foreign capital stocks over the 1990s and then the precipitous flight of both foreign capital and domestic capital. Much of the literature about the crisis, by both economists and political scientists, focuses on the domestic economic and political factors—the "homegrown" factors, in the IMF's term—that explain the fast build-up of foreign capital stocks and then the precipitous capital flight. In political scientist Linda Weiss's formulation, for example, the key variable is "state capacity". "The relative weakness of state capacity (in Southeast Asia), and its marked if

[3] Including cases where the financial data is less than fully satisfactory (notably those of the former Soviet Union) would raise the figure to at least 89 countries. Gerard Caprio and Daniela Klingebiel, "Bank insolvencies: cross-country experience", Policy Research Working Paper 1620, World Bank.

[4] The US case does not make it into the top 50 when the sample includes countries for which the data is not fully satisfactory.

[5] Jason Furman and Joseph Stiglitz, "Economic crises: evidence and insights from East Asia", *Brookings Papers on Economic Activity*, issue 2, 1998, pp.1-114, p.17, emphasis added.

incomplete decomposition (in Korea), made these economies more prone to speculative investment (in the Korea case, over-investment), asset bubbles and current account deficits, and consequently more vulnerable to financial upheaval".[6] Her argument is that weak or decomposing state capacity resulted in failure to upgrade or coordinate in industry and failure to regulate in finance.

The problem with internally-focused explanations is that they take the external context as given. But if many middle-income developing countries and some highly developed countries have had major financial crises during the period from 1980 to 2000, many more than in 1950-1970,[7] this suggests that something might have changed in the external context to raise the probability of *any* country of interest to international investors experiencing a financial crisis.

The external factors, or some of them, are the subject of this essay. I describe, first, the "structural" role of the US economy and US state in generating excess Asian liquidity; and second, the "instrumental" role of the US state in effecting a quick financial opening and liberalization (FOLI) in Asia, making it easier for foreign capital and foreign financial services firms—specifically, US capital and US financial services firms—to enter Asia and reap higher Asian returns. The focus is on the creation of the bubbles. This again distinguishes the argument from the most of the rest of the literature, where the US appears, if at all, only at the stage of managing the crisis. In Weiss' formulation, for example, weak or decomposing state capacity made the economies vulnerable to bubbles and over-investment, which then became a "normal" crisis; then the US intervention in the handling of this normal crisis turned it into an "abnormal" crisis. I stress the US role in blowing out the bubbles in the first place, because once bubble dynamics took hold a crash became likely. The discussion is limited to the Asian crisis for the most part, or more exactly, to the "long Asian crisis" beginning in Japan in 1990; but the argument implies that much the same causality should be found in other financial crises. At the end I say something about policy lessons.

Blowing up the bubble

Discussion of the Asian crisis has been hobbled by treating it separately from the Japanese crisis. In fact, much the same mechanism that produced the Asian crisis also produced the earlier Japanese crisis. They should be considered as a single "long Asian crisis" of 1990 to 2000, the Japanese crisis feeding into the Asian crisis. ("Asia" is shorthand for non-Japan East and Southeast Asia).

[6] Linda Weiss, "State power and the Asian crisis", *New Political Economy*, 4 (3), 1999, 317-342, at 319.

[7] I omit the 1970s because the four fold rise in oil prices set off a turbulence that swamped the effects of the mechanism described here, whose effects can be seen more clearly after the 1970s inflation ended.

The invisible strings

The key to the long Asian crisis is the foreign capital inflows into Japanese and Asian banks during the 1980s and 1990s. These foreign capital inflows permitted an explosion of domestic credit. Without the foreign capital inflows (as in a closed economy), credit creation would have been constrained by the rate of domestic saving; and growth would have been slower and more sustainable. The difference between the rate of credit creation based on domestic savings and the actual rate of credit creation reflects the impact of the foreign capital inflows.

The credit was used to debt-finance a surge of (a) industrial capacity and (b) purchases of land and stocks. At some point the amount of foreign capital entering the economy began to exceed the amount that could accelerate economic growth without creating a bubble. Bubble dynamics based on euphoric expectations took hold. Lenders ratcheted up their lending on the basis of increasingly inflated collateral asset values.

Land and share prices rose by many times from the mid 1980s to the early 1990s, helping to support a several-times expansion of industrial capacity in both tradable goods industries and nontradable goods industries (property related industries, for example).

Eventually industrial capacity reached the point of overcapacity--relative to domestic demand, regional demand, and demand for Asian exports in the US market--where utilization rates fell to relatively low levels and corporate revenues and profit rates became insufficient to service the debt incurred in expanding the capacity. Asset values also eventually inflated to a similar point.

As this point approached creditors tried to pull back their loans, investors tried to sell their stocks, and creditors and investors tried to convert out of the domestic currency. The result was a stock market crash combined with overcapacity in industry and in property, that yielded sharp devaluation, deflation, economic contraction, rising unemployment, increased poverty, and erosion of the middle class.

Japan led the way with its financial sector crisis and general recession starting in 1990. In response, desperate Japanese banks intensified their lending into Asia. Asia in the 1990s experienced an even larger foreign capital surge than it had experienced earlier, coming from all three components of the core of the world economy--Japan, Europe, and the US. This inflow blew up the bubble which broke across the region in 1997, causing the financial cum currency collapse.

Conversely, and contrary to the great bulk of the crisis literature, even "best practice" corporate governance and bank regulation in Asia would have been unlikely to stop the bubble and crash if the foreign capital surge had not been prevented (limited to, say, half of what it actually was). Also, again contrary to much of the literature, the crisis was at its core a crisis of overcapacity in industry and of inflated values in asset markets. The banking and currency crises were by-products. Certainly the explosion of credit drove the overcapacity and inflated asset values; but resolving the financial sector crisis is only a necessary, not sufficient condition for restoring growth. Even if

a set of healthy new banks were established the economies would remain very vulnerable, because the overhang of excess capacity, debt and inflated asset prices will weigh down them down for long into the future—unless additional sources of demand are found.

The Japanese bubble and crash

Japan began to run large current account surpluses in 1983, when the surplus rose to almost three times the previous year's, and rose again by one and two thirds times the following year. For a time, however, the impact of these surpluses on central bank reserves was neutralized by massive Japanese capital exports to the US and to Asia. In 1986, the jump in surpluses was so large, from $49 billion to $86 billion, that the current account surpluses spilled over into central bank reserves, producing an almost 60 percent jump in reserves. The following year, 1987, reserves rose by 90 percent over the previous year's, and rose again by 20 percent in 1988. This explosive growth in Japan's central bank reserves set off a surge in credit in 1986-90, that financed a surge in property values, share prices, and fixed capital formation (plus continuing very high rates of Japanese capital formation in Asia). Industrial production rose 25 percent between 1986 and 1990.[8]

The bursting of the bubble began with the plunge in the Nikkei Index in early 1990. Industrial production rose slightly in 1990 and then fell by 10 percent between 1991 and 1993. The wholesale price index, that had fallen earlier in the 1980s because of falling prices of oil imports, then began to fall because of the fall in demand, indicating excess capacity. Credit growth fell sharply despite sharp falls in interest rates. Japan fell into a Keynesian "liquidity trap" where demand for credit is unresponsive to very low interest rates. The stock market and property prices also fell persistently.

The 1990s was a two-stage story. The first stage lasted to 1995-96. By this time share and land prices stopped falling and the banks were well on the way to dealing with the overhang of non-performing loans. Massive lending into fast-growing Asia helped to bolster bank balance sheets. Output, profits and inventories started increasing again and fiscal 1996 had 5 percent GNP growth. Assuming that the recession was past, the government started to put public finances on a sound footing again and increased taxes and social security charges--most notoriously with a 2 percent increase in sales tax. It expected that these tax increases would choke off consumption for about 6 months and then growth would resume in a sounder fiscal environment. At the point when recovery should have started two "exogenous" shocks aborted it. First, East Asia tipped into crisis, damaging Japan's exports and piling up more bad loans on bank balance sheets. Second, the "stern austerity" faction in the Finance Ministry prevailed, and the Finance Ministry got tough with banks that had been just about keeping their heads above water ("trading through"). A big bank and a big securities firm were allowed to go bust. The combination of

[8] IMF, *International Financial Statistics Yearbook*, 1996, pp.458-461.

these two shocks made fearful consumers save rather than spend and made gloomy industrialists hold back investment, prompting general alarm about a banking crisis and another downward spiral from which—thanks to massive deficit spending--Japan is sputteringly recovering in 2000.

The Thai bubble and crash

Thailand illustrates the Asian sequence. Unlike Japan, Thailand and the other southeast Asian countries were running current account deficits through the 1990s. They were nevertheless accumulating central bank reserves because of an inflow of foreign capital far larger than that needed to finance the current account deficit. The foreign capital poured in from Japan, the US and Europe as the owners and managers of capital in the core economies sought to package domestic savings, central bank reserves and financial capital attracted from the rest of the world and invest them in fast-growing Asia, all the more so because their own economies were in recession.

Thailand's central bank reserves spurted from 1986, growing at 20 percent or more in almost every year up to 1995 Between 1987 and 1990 they grew at 40 percent or more a year. Domestic credit spurted too—it being impossible for the monetary authorities to sterilize an appreciable part of such fast growing reserves. Domestic credit grew at 20 percent or more in every year up to 1995 . Gross fixed capital formation grew at 15 percent or more a year in most years between 1987 and 1995 .

Or in terms of averages over 1988 to 1995, central bank reserves grew at an annual rate of 30 percent, domestic credit grew at just under 30 percent a year, and GDP grew at about 9 percent a year—despite serious social and political unrest in 1991 and 1992. The stock market index rose 75 percent in the last quarter of 1993 alone, driven by a surge of hedge fund foreign investment. Industrial overcapacity became pervasive. Office space in Bangkok rose by four times between 1986 and 1995. Building cranes so filled the skyline of Bangkok as to prompt the quip that the building crane had become Thailand's national bird.

This was the Thai miracle, one of the fastest sustained growth records that the world has ever seen. But by the early 1990s a fast rising part of the growth increment was bubble growth rather than real growth. Most of the incoming capital, much of it from Japanese banks, took the form of short term, hot money deposited in Thai financial institutions to benefit from rates of interest much higher than in the core economies—and apparently secured against exchange rate risk by the commitment of the Thai authorities to a fixed exchange rate with the US dollar.

Once the pullout began in response to fears that debtors could not possibly service their debts the exchange rate fell 33 percent between June 1997 and the end of 1998; GDP fell about 10 percent in 1998; imports (in US dollars) fell 34 percent, exports (in US dollars) fell 7 percent in 1998.

The US's structural role: pumping out liquidity

All this is only half the story. The other half concerns where the foreign capital came from and why there was so much of it. This takes us to the US's "structural" role in the long Asian crisis.[9]

The end of Bretton Woods

The first point is the end of the Bretton Woods regime and the US role in ending it. The Bretton Woods regime contained a self-adjusting mechanism through the link between the US dollar (the main international currency) and gold. When the US ran current account deficits dollars accumulated abroad. The US's ability to continue to run the deficits was limited by its gold supplies. As other countries' central banks asked the US to pay for its deficits in gold, the fall in US gold reserves would squeeze bank lending in the US (lending being a function of reserves) and eventually also aggregate demand. The US demand for imports would fall, producers would have more incentive to find export markets, and the US deficit would shrink. In the surplus countries, on the other hand, the rise in central bank reserves would boost domestic money supply, raise aggregate demand, and thereby raise demand for imports and encourage diversion of exports to domestic market sale; the surpluses would shrink. The rules of the Bretton Woods international financial system therefore applied a discipline on both deficit and surplus countries that operated to cut their deficits and surpluses.

As the US continued through the second half of the 1960s to fight the Vietnam War and the War on Poverty simultaneously its budget and current account deficits reached the point where it could not continue both to run the deficits and maintain the link between the dollar and gold; it simply did not have enough gold. The Nixon administration in 1971 broke the link with gold. Henceforth the US dollar would be a fiduciary currency only. The US could finance US current account deficits by printing dollars or selling Treasury bills, with much less of a limit than had existed earlier.

Under Bretton Woods, as one (surplus) country gained central bank reserves another (deficit) country lost, so world central bank reserves increased only slowly. The new system had no such constraint. Persistent US current account deficits raised central bank reserves in the surplus countries without causing a fall in the US's. The result was a surge in world central bank reserves, which increased by over 7 times between 1969 and 1981 and another 2 times between 1982 and 1996. The expansion of reserves permitted a multiplied expansion of credit. An increase of reserves of, say, $100 million permitted a first round credit expansion of, say, $90 million (with $10 million put aside for reserves), the $90 million permitted a second round expansion

[9] I am indebted to Richard Duncan, "The origin of economic bubbles", processed, May 1998.

of $81 million ($9 million put aside for reserves), and so on. This set the stage for investment, property and stock market booms, overcapacity and asset bubbles, panic, and collapse.

US budgetary and current account deficits

The US role in changing the rules of the international financial system in a way that greatly weakened the self-adjusting mechanism is one part of its structural role in the long Asian crisis. The second part is the US's budgetary and current account deficits that began to grow fast after 1982. US budgetary deficits financed by government debt stimulated consumer demand, which stimulated demand for imports. The US income elasticity of demand for imports was higher than the rest of the world's income elasticity of demand for US exports. Except when US income growth was very low and aggregate demand depressed relative to foreign demand, the result was a US current account deficit. Persistent US deficits and persistent depreciation of the US dollar have been a source of imbalance and instability in the world economy.

The US current account deficit was financed for the most part by foreign capital inflows, much of it in the form of foreign purchases of US government debt denominated in US dollars. This accumulating US government debt then became part of the central bank reserves of the source countries, which allowed for multiplied domestic credit creation—at the same time as the US continued to enjoy increasing central bank reserves, domestic credit expansion, and sustained excesses of imports over exports.

For much of the 1980s and the 1990s up to 1995, relatively slow US growth kept the US current account deficit from becoming a major generator of global excess liquidity. The mid 1980s, however, was an exception, when a US enjoyed a spurt of growth above the OECD average and experienced a dramatic worsening of its current account deficit—the other side of which was the fast increase in central bank reserves in Japan and the onset of the Japanese bubble. In 1995 the US moved into a period of significantly faster growth than in the rest of the OECD and experienced a rapid deterioration of the current account—the other side of which was the fast increase in central bank reserves in Asia and the onset of bubble dynamics there.

In short, US current account deficits, and the change in the rules of the international payments regime in a way that enabled US deficits to continue more or less indefinitely (when US incomes were growing at or above the rest of the OECD), together caused a surge of world liquidity. The surge manifested itself first in the major current account surplus country, Japan, in the form of the Japanese bubble of 1985 to 1990, and then in the fast growing Asian countries in the form of the bubble of 1992 to 1997. Japan contributed to blowing up the Asian bubble both before its crash and especially afterwards; but its bubble and crash were themselves rooted in the earlier US deficits.

The US's instrumental role: pushing for capital opening

I take for granted that quick financial opening and liberalization (FOLI) in Asia was an important enabling condition of the crisis, more important than the factors emphasized in the bulk of the literature, such as cronyistic or "relationship-based" economic structure, moral hazard, and opacity of corporate and governmental accounts. FOLI enabled the huge inrush of foreign capital, setting in motion the dynamics just described. I also take for granted that Asian governments undertook FOLI not only for "domestic" reasons: not only because they believed that the technology of moving money made controls unworkable; or because they believed that to finance the current account deficits they had no choice but to lift controls; or because they believed (on the basis of good empirical evidence) that their economies would experience large net benefits from unrestricted capital mobility; or because they believed that they and their citizens would simply miss out on the train of history if they did not integrate domestic financial markets into the world financial market as quickly as possible; or because they were pushed to do so by a rapidly growing domestic constituency of owners of highly mobile assets, such as financial services firms and wealthy individuals, who succeeded through the late 1980s and 1990s in tipping the balance of influence away from "nationalists", including labor unions, local banks, and locally-oriented firms.

All these things may have been operating. But to understand them as "domestic" causes is to misunderstand the nature of US hegemony. Antonio Gramsci suggested that "the supremacy of a social group manifests itself in two ways, as 'domination' and as 'intellectual and moral leadership'". Gramsci went on to argue that, "A social group dominates antagonistic groups, which it tends to 'liquidate,' or subjugate perhaps even by armed force; it leads kindred or allied groups." The US in Asia, however, has applied *both* domination-coercion and intellectual and moral leadership strategies to the same group—the same Asian states—in order to secure Asian FOLI. It has not only raised the penalties against not undertaking rapid financial opening and liberalization; it has also sought to persuade Asians that FOLI is in their own best national interest. This is close to Gramsci's notion of hegemony as the additional power, beyond domination, that accrues to a dominant group by it convincing subordinate groups that its rule serves not only its own interests but also those of the subordinate groups. [10] The US role in Asian FOLI therefore has to include the US role in fostering Asian and world beliefs about the rightness of free capital mobility, as well as more direct US pressure on Asian and other governments to open up.

The push in Asia was just one part of a larger push to institutionalize free capital markets worldwide, prosecuted both bilaterally and through multilateral

[10] I draw on Giovanni Arrighi and Beverly Silver, "Hegemonic transitions: past and present", *Political Power and Social Theory*, 13, 1999, 239-275, at 254.

organizations including the World Bank, the IMF, the OECD, and the GATT/WTO, as well as by US consultancy firms with close ties to the Treasury and USAID, like the Harvard Institute for International Development (HIID). The campaign involved specific pressures of rewards and penalties on both the governments of emerging market economies and on the international financial institutions; also the diffusion of more ideological "definitions of reality" that identified open capital markets as a key part of the new realities that countries everywhere had to embrace if they wished not to be left behind; as well as the more capillary actions of promoting proponents of unrestricted free markets into positions of power in emerging market countries and in international organizations, and training large numbers of students from emerging market countries, especially Asians, in neoclassical economics at US universities. The following sections describe the various "track-laying" vehicles, and then the case of Korea.

The US government's campaign from Reagan to Clinton

The US Treasury was concerned to improve the access of US financial firms to foreign markets long before Asia mattered--from at least as far back as the early 1970s, when the Eurodollar market began to be important. More than its predecessors the Reagan Administration that began in 1980 pressed for free movement of capital worldwide. "*Our task is to knock down barriers to trade and foreign investment and the free movement of capital*", Reagan declared imperially.[11] Only a few years after the end of the mammoth Tokyo Round (in 1979), the US spearheaded the start of the Uruguay Round of trade negotiations in 1982, with the express purpose of liberalizing two domains that had been left off the agenda of the Tokyo Round, agriculture and services, especially financial services.

Meanwhile Europe was committing itself to open its capital markets. The Single European Act, signed in February 1986, called for the elimination of capital controls between European Community states and—more qualifiedly--for "the highest possible" degree of capital liberalization between member states and the rest of the world.

The Bush Administration (1988 to 1992) continued. President Bush described his Latin American initiative as a commitment to "free markets and to the free flow of capital, central to achieving economic growth and lasting prosperity". (Note that in these and other such statements, free trade and free capital mobility are treated as merely different aspects of the same good thing, free markets.)

By the late 1980s "financial deregulation" and "free flow of capital" had become ideas in good currency in the world's most powerful countries (like the related idea of an "independent central bank"). They were taken to denote governmental actions that would yield large benefits to all, and they thereby legitimized maximum pressure by the more powerful states on the less powerful not to "defect" from the

[11] Quoted from 1985 in Nicolas Kristof with David Sanger, "How U.S. wooed Asia to let cash flow in", *New York Times*, February 16 1999, A10, emphasis added.

possibilities of large *mutual* benefits.
In the North American Free Trade Agreement (NAFTA) negotiations of 1991-93 the US pressed Mexico hard to undertake domestic financial liberalization and financial opening. The Mexican banks were protected by quantitative restrictions on the share of total deposits that foreign banks could hold. The US wanted this protection lifted so that American banks could get a larger market share. The Mexican government resisted, insisting that the NAFTA agreement give banks a long phase-out of protection, the longest of any sector. After the Mexican crash of late 1994, when Mexico needed rescue, the government agreed to accelerate the phase-out of banking protection. The Mexican crash brought benefits to American banks, from this point of view.
The Clinton Administration, that started in 1993, intensified the push for financial opening. A senior Clinton Administration official remarked that, "We pushed full steam ahead on all areas of liberalization, including financial. I never went on a trip when my brief didn't include either advice or congratulations on liberalization". He went on to observe that, "Wall Street was delighted that the broad trade agenda now included financial services".[12] In 1997 Deputy Treasury Secretary Lawrence Summers said, "Financial liberalization, both domestically and internationally, is a critical part of the US agenda".[13]
But the Uruguay Round had been unable to reach an agreement on financial services, and the round was concluded in December 1993 with an agreement on agriculture but without a financial services agreement.
The Clinton administration responded with aggressive bilateral and multilateral pressure. Senior Treasury officials in 1995 wanted to force Chile to scrap its capital controls, for example. (Chile had a tax on capital inflows such that the tax was effectively higher the sooner the money was withdrawn.) They insisted on Chile lifting the controls as part of the negotiations over a free-trade agreement. In the end the agreement was not signed because of US congressional opposition, so the issue of forcing Chile to abandon its capital controls did not come to a head.
Of course, the administration paid special attention to Asia's capital controls, because Asia "was seen as a potential gold mine for American banks and brokerages", in the words of a *New York Times* report. [14] And the administration paid more attention than its predecessors to advancing the agenda not just through the GATT/WTO but also through other multilateral fora.

The International Monetary Fund and the World Bank

Throughout the late 1980s and 1990s, the IMF and the World Bank reinforced US pressure. This was not a case of independent convergence to the same agenda. As *The Economist* observed, "In recent years the Fund and the Bank have been hijacked

[12] Jeffrey Garten, a former senior Commerce Department official, quoted in Kristof with Sanger.
[13] "The case for mild repression," *The Economist*, September 18, 1997, p.81.
[14] Kristof with Sanger.

by their major shareholders for overtly political ends. Whether in Mexico in 1994, Asia in 1997 or Russia through the 1990s, the institutions have become a more explicit tool of western, and particularly American, foreign policy".[15] In the words of *The Financial Times*, "The future role of the International Monetary Fund in the global financial system is now under debate. At issue is whether Washington will be able to use its 18% shareholding in the IMF to continue (as it often has since its inception more than half a century ago) to use the Fund as an extension of US foreign policy".[16]

The International Monetary Fund

The Fund and the Bank claim that their decision-making procedures are blind to everything except criteria of "sound" economics, and especially blind to everything "political". The evidence suggests this is mostly untrue. Kendall Stiles examined seven cases of Fund lending, and found that in only one case did the Fund adopt a politically neutral, technocratic approach to lending.[17] Tony Killick found that of his 17 cases of countries with Fund programs, at least one third secured favorable loan terms on their programs because of the intervention of major shareholding countries on their behalf.[18]

The coup de grace is the recent study by Strom Thacker. He tested the hypothesis that the Fund's lending to a country—the probability that the Fund will lend to it--is positively related to (a) the country's political closeness to the US, as indicated by the extent to which its UN General Assembly (UNGA) representative votes with the US on votes that the US State Department deems "key" votes for the US, and (b) to the country's movement towards the US position, as indicated by reductions in the gap between its votes in the UNGA and those of the US on key votes. [19] Thacker found that in the pre-Cold War period, 1985-1989, countries that moved towards the US position were very likely to be rewarded with IMF loans, while the degree of static closeness seemed to have little effect. Since the end of the Cold War both the degree of static closeness and movement towards the US position seem to matter more. "This suggests that the U.S. is both playing the realignment game as vigorously as ever and is rewarding the allegiance of those who stay close without necessarily moving any closer."[20]

One might expect that the change in the structure of the international system represented by the end of the Cold War would make genuine multilateralism more

[15] *The Economist*, "Sick patients, warring doctors", September 18, 1999, p.81.
[16] Stephen Fidler, "Pruning the IMF", *The Financial Times*, 10 December 1999, p.14.
[17] Kendall Stiles, "*Negotiating Debt: The IMF Lending Process*, Boulder, Westview, 1991.
[18] Tony Killick, *IMF Programs in Developing Countries: Design and Impact*, London, Routledge, 1995.
[19] The US has systematically manipulated the UN for its own agenda, "as if its own brand of internationalism should not be polluted by this multilateral Tower of Babel".(Dominique Mosi, "World needs a referee with a rule book", Financial Times, December 20, 1999). As the chair of the Senate Foreign Relations Committee, Senator Jesse Helms, explained, "Americans…see [the UN] as just one aspect of America's diplomatic arsenal…If the United Nations…serves [the American people] as an effective instrument, it will earn and deserve their support. But a United Nations that seeks to impose its presumed authority on the American people…begs for…eventual U.S. withdrawal". (Jesse Helmes, speech to the United Nations Security Council, excerpted in "In the words of Helms: 'A Lack of Gratitude', New York Times, January 21, 2000, A8.)
[20] Strom Thacker, "The high politics of IMF lending", *World Politics*, 52, October 1999, 38-75, p.64.

likely. Thacker's results suggest, on the contrary, that "The ability of the U.S. to influence IMF behavior to achieve its own political goals has not eroded.... [M]ultilateralism, while useful for facilitating cooperation among a small number of like-minded states, may not be an effective buffer of U.S. power in the modern global political economy." [21] Thacker does not examine the mechanisms by which the US exerts its influence. Certainly the fact that the US share of voting rights gives it a veto is important, not least because it discourages Japanese or German assertion of leadership which the US can then present as "unwillingness" on the part of Japan and Germany to lead. Nor does Thacker examine the invisible strings between UN General Assembly votes and US Treasury decisions about what it wants the Fund to do, an interesting question during the Clinton administrations when relations between the State Department, that handles the UN, and the Treasury, that handles the Fund, have generally been bad.

In short, the studies of Stiles, Killick and Thacker confirm that Fund decisions about which countries get loans are influenced, strongly, by the preferences of the major industrial states, especially the US.

My argument here is related but different. It says that the Fund and the Bank promote--directly through conditionalities and more indirectly--a limited set of market institutions whose closest empirical referents are those of Anglo-American capitalism, among which open capital markets and linked systems of corporate governance are central. Conversely, they do not promote the institutional structures of, say, the continental European and Scandanavian welfare states, or Japanese capitalism, or Taiwanese or Korean capitalism.[22]

Through the 1990s the IMF contributed to the inclusion of financial liberalization and free capital mobility as a core element of "sound" policy, and pushed this agenda in its country consultations. But it had less influence in the "Asian miracle" countries than the Bank, until 1997.

The World Bank

The World Bank, in its Structural Adjustment Programs and in its dialogue with governments outside the context of Structural Adjustment Programs the Bank through the 1980s and 1990s, pushed the liberalization of foreign exchange and financial systems, the privatization of state-owned enterprises, the development of stock markets and their opening to foreign investors, and the liberalization of foreign direct investment rules.

The Bank's policy guidelines on financial sector operations as they were formulated in the late 1980s and early 1990s called for comprehensive financial liberalization in its borrowing countries, including removal of all interest rate controls and all directed

[21] Thacker, p.65.

[22] On the beliefs of American economists compared to those of several continental European countries, see Bruno Frey et al., "Consensus and dissensus among economists", *American Economic Review*, May, 1984. For example, asked to "agree", "agree with qualifications", "disagree" to the question, "Tariffs and import controls lower economic welfare", almost 80 percent of the American economists said "agree", compared to 27 percent of French economists, with the other national samples in between. **CHECK**

(or targeted) credit programs. [23] Its efforts to promote these guidelines in Asia led it into head-on disagreement with the Japanese government. The Japanese government, through aid and advice, was helping Asian governments strengthen financial systems to function more like Japan's during the catch-up phase, including interest rate controls and directed credit programs. However, the Japanese program largely failed, to the extent that Asian governments went ahead and liberalized along the lines advised by the World Bank, HIID and the US Treasury.

The power of the US over the Bank varies according to type of issue.[24] On some the US Treasury has a de facto veto (though it does not have a formal veto in the Bank, as distinct from the Fund). Increases in the capital base of the Bank are a case in point. On other issues the US has to act as leader of a G7 cartel. Decisions about whether to lend or not lend to a country tend to fall into this category. But where the US sees its vital interests at stake it can virtually always prevail in lending decisions. Examples are the Bank's refusing to lend to Vietnam in the 1980s, contrary to the Bank's articles of agreement, despite lending to many other countries with worse policies than Vietnam. Other examples include cutting off loans to Chile after Allende, to India after its nuclear test of 1998, and to China after Tienamen Square. And continuing to lend to Russia through the 1990s, despite very poor risk indicators. On other issues, where the US does not see vital interests at stake (and outside French West Africa, where France has a similarly hegemonic role), the Bank management has more autonomy.

In the 1980s and 1990s the US defined financial liberalization and free capital mobility as its vital interest, and the Bank, having to be very responsive, raised the priority of these issues in its own operations. The Bank in any case, like the Fund, contained a sizable constituency of neoclassically-trained economists who believed that rapid financial liberalization was the right thing to do.

The Multilateral Agreement on Investment and the Financial Services Agreement

In the 1990s the push to get Asian and other emerging market governments to do more capital liberalization continued in new fora. After the Uruguay Round was signed in 1994 things that it had taken off the table, notably investment and finance, became the subject of separate multilateral negotiations.

The newly formed World Trade Organization (formed out of the GATT in 1994) started to prepare negotiations for a Multilateral Agreement on Investment. The initial drafts of the MAI came from the International Chamber of Commerce and the Business and Investment Advisory Council (the multinational business group affiliated with the OECD). The content of the proposed agreement was all about the

[23] Wade, "Japan, the World Bank, the art of the paradigm maintenance: *The East Asian Miracle* in political perspective", *New Left Review* 217, May-June 1996, 3-36.

[24] I am indebted to Devesh Kapur for discussion of the US influence over the Bank; and to Catherine Gwin, "U.S. relations with the World Bank, 1945-1992", in Devesh Kapur, John Lewis, and Richard Webb (eds.), *The World Bank: Its First Half Century*, vol. 2, chapter 6, 195-274.

rights, the protection of foreign investors, not about their obligations; and contained nothing about the conditions in a signatory developing country that would warrant exceptions to the rights of investors. Moreover, "investment" was defined to go well beyond foreign direct investment, to include even *short-term speculative flows*. The agreement would also require signatory governments to grant foreign companies treatment no worse than that of national counterparts, leaving open the possibility than they could be granted better treatment. This would allow international firms to be exempt from "national" treatment when national treatment involved constraints they did not wish.

Developing country members of the WTO were not happy with such a lop-sided agreement. In the WTO developing countries have substantial influence in terms of being able to block things they do not like—and the WTO has an appeals procedure where developing countries can challenge rulings made under the agreement. In the circumstances, the US, leading the effort, thought it best to withdraw the MAI from the WTO and get it negotiated between the smaller number of OECD members alone, where it would be free of developing country obstruction. Developing countries would later be invited to sign on--or risk being by-passed by investors. Negotiations started in the OECD in 1995.

Meanwhile, the World Trade Organization began to negotiate the related Financial Services Agreement, intended to allow free trade in banking, insurance and securities services. This was to include not only free cross-border transactions in these areas but also—which takes it much further--the establishment of wholly foreign-owned or majority foreign-owned foreign financial services firms free to compete equally with domestic financial service firms. The US dominated the negotiations—"the power of the US was omnipresent", the US was "the de facto power broker in the negotiations", according to newspaper reports.[25] In June 1995 the US "walked away from a potential agreement, thereby scuttling the deal", an agreement that the Europeans were prepared to sign on to, because the US wanted developing countries to make greater concessions on market access to foreign banks and insurance companies. Malaysia was a prominent hold-out against US wishes. I come back to this case later.

Revision of the IMF's Articles of Agreement

Also in the mid 1990s the IMF, with strong backing from the US and UK Treasuries, began the process of renegotiating its Articles of Agreement so as to require member countries both to grant the Fund jurisdiction over the capital account and to commit themselves to liberalize the capital account.[26] This would make a fundamental change in the Fund's formal mandate agreed at the Bretton Woods negotiations, and give it much more power through its fully legitimated ability to use a country's slow

[25] For example, Hardev Kaur, "The world negotiates with US chief execs", *Business Times* (Malaysia), December 15, 1997; Aviva Freudmann, "WTO financial services agreement in sight, despite snags", *Journal of Commerce*, December 11, 1997.
[26] IMF, *Capital Account Convertibility: Review of Experience and Implications for IMF Policies*, Washington DC, 1995. Stanley Fischer, "Capital account liberalization and the role of the IMF", IMF, September 1997.

progress in opening the capital account to withhold Fund support and thereby also constrain other providers of support too.

The managing director of the Fund, Michel Camdessus, was strongly committed to the revision of the articles. As French Finance Minister, he had been a member of and chair of the European Monetary Committee (of central bank and finance ministry officials) between 1978 and 1984, and had made capital account opening among the European countries the main agenda of the monetary committee.

The US Treasury was equally in favor. In April 1997 US Treasury Secretary Rubin headed a meeting in which finance ministers of the G7 leading industrialized countries issued a statement "promoting freedom of capital flows" and urging that the International Monetary Fund charter be amended so that it could lead the push for capital account liberalization.[27] In September 1997 at the Hong Kong Annual Meetings of the Fund and the Bank, the Interim Committee of the IMF encouraged the Fund to move aggressively to encourage countries to institute full capital convertibility.

In short, the US Treasury (with sherpa help from the UK Treasury) has been leading the Big Push to change the rules of the world economy so as to hard-wire in free capital mobility and remove an array of capital controls from the legitimate instruments for national economic management. Multilateral agencies—the World Bank, the IMF, the OECD, the WTO—have become important vehicles for this purpose. The pressure on Asian countries was part of the wider push.

Complementary improvements in bank regulation?

Any of the American and British officials involved in the Big Push would have agreed that FOLI had to be supported by "strong" prudential regulation and oversight, and hence that liberalization had to be "sequenced", had to be "orderly". But they gave little attention to assessing the adequacy of Asian arrangements. Their attention was on getting the Asians to open up.

Joseph Stiglitz, chair of the White House's Council of Economic Advisors through the early and mid 1990s, was an exception. *The New York Times* cites a former senior Treasury official "ruefully" recalling arguments between Stiglitz and the Treasury, with Stiglitz warning about the need for slower "pacing" of financial liberalization abroad.[28] "Nobody listened", recalled the Treasury official. The official went on to say, "I viewed 'pace' as an excuse by countries to keep their markets closed". Or in the phrase of the supportive New Zealand Deputy Treasury Secretary, "reform delayed is reform denied".[29] Stiglitz was shortly afterwards invited to become chief economist at the World Bank, where he could be less influential in questioning

[27] Nicholas Kristof with David Sanger, "How the US wooed Asia", op.cit.
[28] Kristof with Sanger, op.cit.
[29] John Whitehead, temporary alternative governor, Asian Development Bank, statement to Board of Governors, 32nd Annual Meeting, 30 April-2 May 1999, Manila.

Treasury's designs, or so Treasury hoped.[30]

In short, attention to building "strong" regulatory arrangements and linking capital opening to the strength of those arrangements on the ground was deliberately discouraged lest it provide countries with excuses to delay—contrary to US objectives.

Furthermore, both before the crisis and even after the crisis, when the US talked of strengthening bank regulation it meant in the *borrowing* countries. One recalls the question once posed by Senator Proxmire, "Where were *our* bank regulators?...[T]hey did everything except what they are paid to do, and that is to regulate". He was speaking in a congressional hearing on the Latin American debt crisis, in 1983.[31]

Just how little attention has been given to the lenders' side is seen from Louis Uchitelle's *New York Times* article on the state of thinking about the causes of the Asian crash, in early 1999.[32] "The Clinton Administration had mostly blamed the countries, and still does. But its view, like that of the IMF, is starting to reflect a more nuanced appraisal. 'We have seen that countries need to pursue sounder policies and avoid lurching for short-term capital, as Mexico and Thailand did', said Lawrence H. Summers, the Deputy Treasury Secretary. But...he also called for 'more prudence on the part of the lenders'." The statement about the need for borrowing countries to pursue "sounder" policies—an elastic phrase--again puts the blame onto the borrowers, in keeping with the Treasury's response throughout the crisis. The statement about the need for more prudence on the part of the lenders shifts a little of the blame onto lenders. But it, and a statement from Summers that "Where countries have controls that restrict short-term lending we have not in general sought to dismantle them", constitute the sole evidence of the "more nuanced appraisal" said to be taking root in the Clinton Administration. This underlines the point that the US Big Push was carried out with little regard for the dangers of freer international capital flows and the need to strengthen regulation of the lenders.

US-Korea relations

Korea provides a case study of the wider US campaign.[33] Through the 1980s the US government became increasingly worried that Korea would be another Japan—a major industrial powerhouse using "mercantilist" policies to outcompete US firms in the US and abroad while allowing only restricted access to its domestic market. This worry became acute after the Plaza Accord of 1985, when the devaluation of the US

[30] The Treasury's wish to be rid of Stiglitz was an element in his move, but he had then been in the council for four years, longer than the normal term. As Chief Economist at the World Bank Stiglitz continued to voice his criticisms, sometimes in public, of some elements of Treasury/Fund policy, for example, the Treasury/Fund bail-outs in Asia and the privatization program in Russia. President Wolfensohn, seeing Treasury anger at Stiglitz as undermining support for his own reappointment to a second term, invited Stiglitz to step down as Chief Economist before his term was up.

[31] Quoted in Reinicke, p.106, emphasis added.

[32] Louis Uchitelle, "A crash course in economics: rethinking what's driving the emerging-markets crisis", *New York Times*, January 29. 1999.

[33] I am grateful to indefatigable Brown undergraduate Jordan Wolff for help in tracking down the material on which this argument is based.

dollar against the yen caused the Korean won also to devalue against the yen, raising the competitiveness of Korean exports to the US. The US made Korea one of the main scapegoats for the US trade deficits, all the more so as the Cold War became less determining of US foreign policy strategy in the late 1980s and Korea lost some of the economic grace it had enjoyed from US geopolitical interests. Determined not to let Korea get away with its mercantilism, the US government took an increasingly aggressive stance towards many of Korea's exports, including through Super 301 sanctions. (Under Super 301 the US government abrogates to itself the right unilaterally to retaliate with fines and tariffs against foreign countries for wrongs decided upon by competing US industries and the US Trade Representative—which could scarcely be more mercantilist, though in official US eyes mercantilism is something that others do.)

By the late 1980s US financial firms were becoming seriously exasperated at their restricted access to the Korean financial markets. In the early 1980s the Korean government had liberalized enough to allow a small number of US banks to operate in Korea, and the lucky few—Bank of America and Citibank among them—were making very high returns on capital. [34] Other US financial firms wanted in. But by the late 1980s the government "stalled" on financial liberalization, and US firms saw their prospects fading. They pressed the US Treasury to help.

The US Treasury proposed to bring the Koreans to the negotiating table in the Financial Policy Talks (FPTs). These talks went on from 1990 to 1992 (during the Bush presidency). They focused on complaints of US banks and securities firms about access restrictions to the Korean market: restrictions on access to local funding sources, on introducing new products, on access to the securities market (including a 10 percent ceiling on foreign investment in listed Korean firms); and above all, on "controls on foreign exchange and capital flows that impede foreign banks from competing in their natural lines of business", in the words of a US Treasury official.[35]

The same official continued, "As the [Financial Policy Talks] dialogue progressed, it became apparent that many of the difficulties faced by foreign financial institutions in Korea were connected to structural distortions in the financial sector resulting from the highly regulated nature of the system and government's heavy-handed intervention. *We* therefore shifted our focus in the FPT from individual issues to the need for *basic structural reform* of the Korean financial sector" (emphasis added).

Out of this came the Korean government's "Blueprint for Financial Liberalization". The World Bank was brought in to advise and supervise the government on the liberalization. This "Blueprint" then became the basis for the incoming Kim Young Sam government's Five Year Plan for Financial Liberalization of 1993.

By 1994 the US Treasury (now in the Clinton Administration) had achieved some of its agenda: higher ceilings on foreign participation in the Korean stock market,

[34] Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization*, Columbia University Press, 1991, p.193, passim. Woo cites returns on capital of over 300 percent in 1980.

[35] James Fall, "The US-Korea financial dialogue", in *US-Korea Economic Partnership*, (eds.) Kim Young-suk and Oh Kap-soo, Avebury Press, 1995.

guaranteed entry for some types of foreign financial institutions, higher ceilings for foreign ownership of Korean companies. And *the Korean government had taken two steps, specifically wanted by the Treasury, that were to lead directly to the crisis: the conglomerates (*chaebol*) were free to borrow internationally; and new merchant banks were free to set up and borrow abroad.* Twenty four merchant banks sprang up between 1994 and 1997.

The Treasury was not satisfied, however. It laid out detailed lists of further changes, including expedited interest rate liberalization and ceased reliance on "window guidance", reduced documentation requirements for forward exchange transactions, and removal of limits on lending to the 30 largest conglomerates. The last point is worth emphasising. The Korean government of Kim Young Sam sought to free the domestic financial system from the grasp of the conglomerates, and therefore tried to impose restrictions on their access to domestic credit. At the same time it eased their access to foreign credit—and even encouraged them to borrow *short-term* rather than long-term by imposing less onerous documentation requirements.[36] The US wanted the restrictions on the *chaebols'* access to domestic credit to be lifted as well (US financial firms already in Korea being in a good position to win this business). The US also pressed for funding and lending limits on US banks in Korea to be linked not to their *local* capital but to their global capital.

At about this time the US Treasury began to take a strong interest in pushing financial liberalization through the Asia Pacific Economic Council (APEC). Till then, from the start of APEC in 1989, the US had participated in APEC but not in a leadership role. Around 1994 it climbed into the driver's seat and began to make region-wide financial liberalization a top priority. It saw the regional forum as a way to make financial liberalization gains at lower cost than through multiple bilateral negotiations.

Korea and other Asian countries also wanted to promote APEC as a forum for financial liberalization discussions, in order to give them more protection from unilateral US pressure--and especially in order to allow the financial liberalization to be presented for the domestic audience as the result of mutual agreement rather than US arm-twisting. For the earlier Financial Policy Talks between the Korean Ministry of Finance and the US Treasury, from 1990 to 1992, had stirred up strong anti-American sentiment in Korea.

In the spirit of APEC's "open regionalism", the APEC countries agreed (in what was called the Osaka Action Agenda of 1995) that each would propose their own, self-initiated financial liberalization plan. The plan that Korea brought forward committed itself to full financial liberalization by 2010.

This looked like back-tracking to the US Treasury, and the US became unhappy with the APEC process. It resumed its arm-twisting of the Korean government to remove capital controls faster than the Korean government had planned, dangling the bait of

[36] Soogil Young, "Korea-US economic relationship in 1990s: conflict or cooperation?", in *Korea-United States Cooperation in the New World Order*, Institute for International Economics, Washington DC and Institute for Global Economics, Seoul, February 1996.

US support for Korea's entry into the OECD—an all-important objective of the Korean government, the very symbol of its arrival in the ranks of the "developed nations".

The New York Times quotes an internal Treasury memorandum, dated June 20, 1996, setting out the Treasury's negotiating position with the Koreans. The Treasury required as a condition of US support that the Korean government let foreigners buy Korean bonds ; also that the Korean government let Korean companies borrow abroad; and let foreigners buy Korean stocks more easily. These changes would make for a major change in the close relations between Korean companies and Korean banks--away from an "organizational" relationship towards an arms-length "market" relationship-- and hence further dismantling of the basic structure of the developmental state.

The three page document says nothing about the need for Korea to strengthen its bank regulation and legal institutions. "The goal", comments The New York Times, "is clearly to use the O.E.C.D. as a way of prying open Korean markets—in part to win business for American banks and brokerages".

US congressional leaders were also active in generating pressure on the Treasury and on the Korean government directly. Doug Bereuter, US House of Representatives member for Nebraska and chair of the Committee on International Relations Subcommittee on Asia and the Pacific, did not mince words in setting out a congressional agenda for improving US-Korea relations, in early 1995. "I intend to be very aggressive in doing what I can to expose the tariff quotas and the plethora of nontariff barriers that continue to frustrate US exporters in Asia....America has been tolerant about Korea's nontariff trade barriers for far too long. Now that the Cold War is over, we can and should demand an end to *the unfair treatment for the American side* in this bilateral relationship".[37]

This account of the US-Korea relation suggests how the US government pressured Korea to open its financial markets. It does not, however, pin down the importance of this external pressure relative to the wishes of segments of the Korean policy-making elite; nor does it say where the Korean government gets its policy "preferences" from. To what extent do its policies come from Washington ideas about a liberal economy, refracted through calculations of what determines "confidence" in international capital markets? To what extent did the Korean government move less fast than the US wanted? Does the fact that the Korean government moved much faster to let Korean firms borrow abroad than to let foreign financial firms operate in the domestic market suggest that the government retained some degree of autonomy? Does the aggressiveness of US language suggest the force of US pressure?

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[37] Doug Bereuter, "US congressional agenda", in *Korea-United States Cooperation in the New World Order*, pp.115-19, emphasis added.

Why the US wants free capital movement

In short, Asian governments came under pressure to open the financial system from US-based organizations, including the US Treasury, HIID, the World Bank and the IMF. This pressure became especially strong during the early to mid 1990s. A content analysis of the advice given to East Asian governments by the US government, the World Bank, and the IMF would show, I expect, that much more of it was about FOLI in 1990-95 than in the preceding five years.
The next question is why the US government gave much higher priority to FOLI in emerging market countries *in the 1990s*, especially in East Asia?

US assertion of a neoliberal world order, with finance as the last frontier

Since the Second World War the US has acted fairly consistently to expand the scope of a world social order based on Lockean individualism and democracy; as part of which it has acted to expand the opportunities and profitability of all US business abroad. This included finance. The United States helped establish a stable international monetary system that made it easy to transfer capital from one country to another.[38] And the US financial industry received various kinds of state support in its overseas ventures once US financial firms began to operate abroad in the 1960s and 1970s (with the development of Eurodollar market, the recession in the US, and the recycling of OPEC oil money). The state certainly helped US banks to lend to Latin America in the 1970s, and helped to assure their repayment after the debt crisis began in 1982.
Through the 1980s the Treasury orchestrated an aggressive "export activism" on behalf of US manufacturing and agricultural interests, seeking to curb the rising US current account deficits (of which the unilateral Super 301 was only one of several weapons). Over time the campaign broadened into "market access activism", the principle of which was that US firms, including financial services firms, must have the same freedom of access to foreign markets as foreign firms have to the US market. Anything else is "unfair" to the US.

The much higher priority given to FOLI in US foreign economic policy in the late 1980s and 1990s might then be explained in terms of changes in two things; the international distribution of power among states, with the US becoming even more dominant than it had been before; and finance becoming the "last frontier", as emerging market countries opened goods markets while delaying on opening and liberalizing financial markets.
All victors want to remake the world in their own image. The US after the end of the Cold War in Europe in 1989 was every bit as tempted to do so as other victors, its

[38] Stephen Krasner, *Defending the National Interest: Raw Materials Investments and U.S. Foreign Policy*, Princeton University Press, 1978, p.348.

confidence caught in Clinton's second Secretary of State Madeline Albright's self-flattering description of the US as "the indispensable nation". Or in Federal Reserve Chairman Alan Greenspan's words, "It is safe to say that we are witnessing this decade, in the United States, history's most compelling demonstration of the productive capacity of free peoples operating in free markets". The collapse of the Berlin Wall a decade ago, he went on to say, revealed not only the political success of civilised democracy, but also its economic achievement.[39]

As the US became the only great power in the late 1980s, its leaders became more focused on imposing their vision of what the global *economic* order should be like, less restrained by geopolitical considerations and less restrained by specific economic interests.

The content of that vision became even more single-mindedly neoliberal than in the past. Neoliberalism seemed to have an obvious "evidentiary" justification in the failure of all the alternatives: the failure of "communism", the failure of "the Soviet Union", the failure of "import-substituting industrialization" in Latin America and India, the failure of "Japan Inc" as the Japanese recession persisted through the 1990s. Wall Street, the City of London, and Anglo-American economics departments gave neoliberalism a firm institutional base. The deep institutionalization of the neoliberal outlook means that its translation into public policy is partly independent of particular people or particular blocs of interests.

In this vision, freedom to move one's money freely across borders is tied to ultimate values. As the *Financial Times* columnist Samuel Brittan put it, "The most basic argument against exchange control...is that it is one of the most potent weapons of tyranny which can be used to imprison citizens in their own country". (To which Benjamin Cohen replied, "That capital mobility might exercise its own form of tyranny...seems, in such thinking, to count for little".)[40]

So the change in the international distribution of power, with the US becoming even more dominant as the Cold War came to an end in the late 1980s, helped to explain why the US asserted even more energetically a neoliberal economic agenda in its dealings with other countries; and in that agenda finance had a central place partly for normative reasons.

Moreover, by the 1990s most other sectors had been covered by trade liberalization agreements under the Uruguay Round. Finance, investment and agriculture had, as noted, been taken off the table in the Uruguay Round so that disagreements over them would not jeopardize agreements for other sectors. These sectors therefore became "the last frontiers", and as the Uruguay Round neared its end in the early 1990s, they began to receive higher priority in US foreign economic policy. The idea of finance as the last frontier helps to explain why the US government made no distinction between free trade in goods and free trade in dollars; the latter was presented as merely the next step in the former.

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[39] Gerard Baker, "Greenspan hails US economic system", *Financial Times*, September 9, 1999, p.7.

[40] Benjamin Cohen, "Capital controls: why do governments hesitate?", paper at 1999 Annual Meeting of American Political Science Association, Septemberr 2-5, 1999, p.14.

Financialization and the Wall Street-Treasury complex

But this explanation of why the US government gave high priority to FOLI in emerging market countries during the 1990s—the broader assertion of a neoliberal foreign economic policy and finance as the last frontier in the neoliberal agenda--is too blunt. It overlooks the fact that the financial services industry in the US (and the UK) has not only grown rapidly to become a major sector of economic activity during the 1980s and 1990s, as it was not before, but also that it has come to dominate the economy over this period. "Financial encephalitization", the process might be called, or the "financialization of the economy" (FOE). Financialization has direct implications for capital flows to emerging markets and for the US foreign economic policy agenda.

Financialization has several sub-trends. One is the rapidly rising ratios of financial assets and flows to real assets and flows. For example, in the US total credit outstanding as a percentage of GDP rose from 148 percent in 1960, to 168 percent in 1980, then jumped to 245 percent in 1990 and up to 275 percent in 1999. The figures for the 1990s are the highest in US history.

A second sub-trend is the rapidly rising share of the financial sector in total credit, from 25 percent of the total in 1989 to 55 percent in 1999. This implies that the rapidly rising volume of financial transactions in the US economy is being supported by even more rapidly rising volumes of *borrowings*. Never before in US history have financial institutions borrowed more than they lend to non-financial customers. As analyst Jane D'Arista comments, "the amount of credit now required to accommodate US financial activity may be stronger evidence of a bubble than asset prices themselves".[41]

A third sub-trend is the growing importance of institutional investors (pensions funds, insurance companies, mutual funds, trust funds) relative to banks and other depository institutions, as savers have switched from the latter to the former. In the US, the share of total financial sector assets held by institutional investors rose from a third in 1978 to over a half (54 percent) in 1998, while the share of depository institutions fell from over a half (57 percent) to a quarter (27 percent) over the same period. This could be called the "portfolioization of savings".

We see, then, a rapid rise in the size and significance of the financial economy relative to the real economy over the 1980s and 1990s. The trend has gone much further in the US (also the UK) than in Germany and Japan. For example, the assets of institutional investors in Germany and Japan, relative to GDP, are less than half those in the US and the UK (table 1).

[41] Jane D'Arista, "Credit to the creditors", *Flow of Funds*, 1rst Quarter 1999, Financial Markets Center.

Table 1: Assets of institutional investors, to GDP (%)

	1980	1990	1992	1993
US	59	95	119	126
UK	64	124	137	165
Germany	20	42	43	47
Japan	23	56	54	N/A

Source: International Monetary Fund, International Capital Markets, August 1995

But FOE is more than the rising share of finance. It is the growing dominance of the financial industry over the rest of the economy, especially in the US, which has altered the system-ness of the economy. Financial dominance over the rest of the economy is achieved through mechanisms of institutional interlock and normative congruence, each mechanism reinforcing the other.

As the size of the financial sector has grown the stock market has become the economy's pivotal institution. In the *corporate sector* managers' financial incentives and their perceptions of their responsibilities have been transformed. Their remuneration increasingly takes the form of stock options rather than salaries; and at senior levels they are recruited from the external labor market rather than promoted from within. Both things together promote the notion that maximization of *shareholder* value is their sole legitimate objective. They raise or lower budgets, buy or sell bits of companies, with the objective of raising the share price, not only because they gain directly from stock options but also because the higher share price reduces the chances of hostile take-over--and their ouster. The same forces affect who becomes CEOs; they come increasingly from a financial background rather than one in engineering or marketing. And the substance of "corporate strategy" is increasingly focused on buying and selling companies, going with the rising incidence of takeovers.

In the *household sector*, financial markets have become the pace-setters of consumption markets through the wealth effect, amplifying economic cycles. Those in the top 20 percent or so of the household income distribution now typically have so much of their assets in the form of stocks that they are as concerned about the movements of financial markets as they are about house prices.

And a much larger percentage of the population is now directly affected by those movements, even if not directly invested in the stock market, because of the move away from "pay as you go" pensions (in which today's pensions are paid out of today's taxes on the incomes of those currently in work) towards "defined contribution" pensions (in which the individual's pension depends on the performance of their pension fund's investments in the stock market). The shift in the financing of pensions tends to consolidate a political common interest across a large part of the electorate in protecting *capital* income, perhaps even at the expense of labor incomes. Financialization of the economy has the fortunate consequence for

the beneficiaries of capital income that finance becomes too important—in the functioning of the economy and the polity—to be allowed to fail. Various public policy ratchets are put in place to socialize private losses while doing little to curb the taking of private profits.

These are examples of institutional interlock, by which other economic institutions—corporations, households, the pension industry—come to organize themselves around financial markets. Norms adjust, too. It is now taken for granted that the norms for judging economic performance should relate mainly to the returns to capital rather than to labor productivity. "Efficiency" is generally used to mean efficiency in the use of capital. The quality of corporate management is judged by its success in capital markets, not by its success in labor markets or by the employees' dedication to the firm and the firm's ties to its employees. The share price is accepted as the best composite index of company performance.

The recent OECD report, *Corporate Governance: Improving Competiveness and Access to Capital in Global Markets*, known as the Millstein Report (April 1998), is a telling illustration of how deeply rooted these norms are. It was written by a committee of people who are not all disciples of the American way. It adopted a studied neutrality between what it called the Anglo-Saxon model and the Rheinish model. Countries can and should have different social or employee-favoring objectives, it said; what matters is that the objectives and the ways of achieving them be "transparent". But transparent with respect, implicitly, to potential investors, not to potential employees. The subtitle says it all: the problem of corporate governance is defined to be largely about access to capital.

The active agent of this configuration of interlocking institutions and validating norms that produce FOE is the Wall Street-Treasury complex.[42] Wall Street denotes the sectoral interests, and Treasury (shorthand for Treasury, Commerce, State, CIA) denotes the state power. Both combine to promulgate the ideology and to shape the executive and legislative agendas. This complex is the seat of the pressures on the rest of the world—and on the international financial institutions, including the IMF and the World Bank--to open each part of the world's financial system.

The Wall Street-Treasury complex and free capital mobility

Financialization of the US economy has raised the US's premium on a world order of free capital mobility, including accomodative policies in emerging markets. (FOE causes FOLI.) First, the US has a strong national interest in being able to suck in savings from the rest of the world. It has become the world's biggest recipient of foreign capital inflows, which come in partly to fund the large and growing US external deficit. Foreign holdings of US financial assets are two thirds higher again

[42] I take the term Wall Street-Treasury complex from Jagdish Bhagwati, "The capital myth: the difference between trade in widgets and dollars", *Foreign Affairs*, May. In earlier papers I extended his usage to "the Wall Street-Treasury-IMF" complex. But adding IMF muddies the analytical waters, because the complex operates through several other organizations as well as the IMF.

than US holdings of comparable foreign financial assets (in 1999).
Second, the Treasury sees a strong US "national interest" in promoting market access for US financial services firms. US financial services firms have great advantages over competitors elsewhere in everything from securities placement, debt work-outs, privatizations, and mergers and acquisitions. Even in Europe, the surge of merger and acquisition (M & A) activity in 1999 was done largely by US financial service firms. "In spite of the shift of M & A activity towards Europe, the region's investment banks failed to overcome US banks' dominance of the sector", reports The Financial Times. The leader of the US investment banks was Goldman Sachs, involved in deals amounting to almost half of the total value of M & A activity in Europe in 1999.[43] The income earned from US foreign direct investment in finance was about equal to the income earned from US foreign direct investment in the whole of manufacturing, and the net income from finance would be very much greater.[44] Hence the US financial services sector earns a substantial current account surplus for the US. As the overall US current account deficits rise, the surpluses earned by the financial services firms become more and more valuable—and the Treasury becomes more and more concerned to open their surplus-earning opportunities still wider.
Third, the portfolioization of savings—the shift from depository institutions to institutional investors--accelerated the trend to cross-border financial transactions. The Wall Street investment houses had for a long time been building up their foreign operations in privatizations, mergers and acquisitions, and pension funds, in addition to buying and selling securities and underwriting bonds. As US savers increasingly placed their savings in private pension plans, life insurance companies, mutual funds, and investment trusts, and as these in turn invested their pools of savings in securities markets rather than depository institutions, the institutional investors needed to diversify their portfolios geographically. In the 1990s the institutional investors and the banks were also "restructuring" (cost-cutting, consolidating), following on from the restructuring in US manufacturing during the 1980s. As the financial firms merged, they looked for new global markets; and as new global markets beckoned, the financial services industry consolidated on a world level.
Fourth, the weighting of emerging markets in industrial countries' foreign portfolio investment has increased many times during the 1990s. In 1989 emerging markets constituted just 1 percent of industrial countries' foreign portfolio investment; in 1993 (the most recent year for which figures are readily available), 16 percent; the figure would certainly be much higher today.[45]
The switch in many emerging market countries from foreign capital inflows in the form of bank loans in the 1970s and 1980s to securities in the 1990s has itself contributed to the increasing weight of emerging markets in industrial countries'

[43] "European M & A activity doubles to hit $1,213bn", *Financial Times*, 23 December 1999.
[44] US Department of Commerce, *Survey of Current Business*, March 2000, table G.2.
[45] Jane D'Arista and Stephany Griffith-Jones, "The boom of portfolio flows to 'emerging markets' and its regulatory implications", table 5, in Manuel Montes, ed., in Manuel Montes, ed., Short-term Capital Movements and Balance of Payments Crises, Helsinki, World Institute for Development Economics Research, 1998.

portfolios. The flow of foreign funds into emerging market stock markets fuelled sharp stock market booms. The Mexican stock market rose by over 400 percent in dollar terms during the four year period 1990-93, before crashing in 1994. And East Asian stock markets rose very fast in the several years after 1993 as capital was diverted from Latin America after the Mexican crash. The stock market booms allowed emerging markets to absorb much larger volumes of inflows relative to GDP than otherwise, because the rise in the domestic stock market tends in itself to pull in more capital as price per share rises.

In short, the financialization of the US economy during the late 1980s and 1990s has raised the relative importance—in the eyes of US foreign economic policy decision-makers--of opening and liberalizing financial markets in emerging market countries. That goal was in any case receiving higher priority as finance became one of the last items on the neoliberal world order agenda.

The great blessing of financial opening for the US foreign economic policy agenda is that it has no domestic costs. Pushing other countries to open up just about any other sector does have domestic costs, because other countries may demand more access to the US market in related products (think of agriculture), and some of those imports may hurt US producers. No emerging market financial services firm is likely to be able to compete in the US, so the US can truthfully remove all barriers to entry and claim the same for its firms in emerging markets.

Conclusion

This paper has argued that a surge of foreign capital directly caused the Japanese bubble of 1985-90 and the Asian bubble of 1992-97. While the capital that blew up the Asian bubble came from Japan and Europe as well as from the US, the root source of burgeoning domestic credit in both Japan and Asia was growing US current account deficits. The US's structural role in the long Asian crisis of 1990-2000 is therefore (a) its contribution to the change in the rules of the international payments regime, whereby the dollar, the main international currency, became a strictly fiduciary currency, allowing the US to finance current account deficits without the checks of the Bretton Woods regime, and (b) the US's growing deficits, the other end of which were Japan's persistent surpluses.

The US's instrumental role in the long Asian crisis lay in inducing Asian governments to undertake rapid financial opening and liberalization (FOLI), with little attention paid to linking inflows to the strength of regulatory regimes (linking in such a way that the weaker the ability to subject the flows to the constraints of prudential regulation, the more the use of direct controls to keep inflows to below certain danger thresholds—to keep short-term foreign debt to foreign exchange

reserves well below 100 percent, for example).[46] "Inducing", as in "inducing Asian governments to undertake rapid financial opening and liberalization", occurred through a whole array of mechanisms and organizations, some bilateral, some multilateral. These became the vehicles which laid the track along which large quantities of capital could flow into Asia.

As for why the US government gave such a high priority to FOLI, perhaps the most important was the growing financialization of the US economy. This refers to a rapidly rising share of financial activity in total economic activity; to a change in structure from banks and other depository institutions to institutional investors and securities markets (the portfolioization of savings); and to financial dominance of the economy, as seen in the reconfiguring of the key economic institutions, including corporations and households, around the stock market as pivot. These trends have gone much further in the US than in the other core countries (apart from Britain).

Financialization of the economy (FOE) drove FOLI. The institutional investors sought to diversify their portfolios geographically, in such a way that they could move quickly in and out of any particular stock market. And as they consolidated, following the consolidation wave in manufacturing during the 1980s, the now larger firms looked for new global markets to justify their consolidation; and as they found new markets they further consolidated. Meanwhile, the switch in emerging market capital inflows from bank loans in the 1970s and 1980s to securities in the 1990s has allowed a still greater volume of inflows relative to GDP, because the inflows blew up stock market indices and as price per share rose more capital could be absorbed in the stock market.

Wall Street came together with Treasury (shorthand for the US state) in the Wall Street-Treasury complex to promote market opening and liberalization especially in Asia, where US financial firms could be sure of being prime beneficiaries. More generally, the complex has made the US into the world's great savings entrepot, taking in savings from the rest of the world, and repackaging them into other financial instruments, and selling them back to the rest of the world in return for fees and claims on foreign income flows.

Hegemonic states, it is said, act to create a set of rules that allow the smaller states to break out of "the tyranny of small decisions", in Kenneth Waltz's phrase, to overcome the tendency of separate states to pursue national interest without cooperating with other states to solve problems that require system-level solution. [47]
But in this case the hegemonic state, the US, has acted to subject smaller states to "the tyranny of the big decision", namely, the decision of how to maximize US interests as increasingly defined by the sectoral interests of finance.

It is not surprising, then, that current discussion assumes that the key to Asian recovery lies in restoring high volumes of capital inflows, and that these volumes will not be restored until institutional restructuring along the lines of a neoliberal

[46] There is another story to be told about the US's instrumental role, to do with US exchange rate diplomacy on Japan and Asian currencies. For example, the US Treasury pressured the Bank of Japan in the mid and late 1980s not to tightened credit, in order not to appreciate the yen and weaken the dollar. The failure to tighten monetary policy earlier made the bubble worse.

[47] Arrighi and Silver, op.cit., p.255.

model is undertaken. In the words of *The Financial Times*, "until bankruptcy procedures are improved, bad corporate debts written off and the banks restructured, capital inflows will be inhibited...While access to capital is constrained, the Asian economic machine cannot run at full speed."[48]

This argument is dangerous. It assumes that a lack of capital—a credit crunch—is inhibiting Asian recovery. It assumes that restoration of foreign capital inflows to close to pre-crisis levels is desirable. And it assumes that restoration of economic growth to pre-crisis levels is desirable.

If the problems of bad corporate debts, bank restructuring and inadequate bankruptcy procedures were magically solved, Asia would still face a fragile near-term future, because the problem of excess capacity would remain. In many sectors investment is now constrained not by lack of capital but by the fact that the existing capacity built up during the heady days of miracle growth can produce much more than can be sold domestically or abroad.

The danger is not that foreign capital inflows will not return to pre-crisis levels, but that they will. Given the fact of excess capacity, they would be seeking speculative short-term gains rather than long-term revenues. They might well blow out another speculative bubble. If a second crash occurs, governments, already saddled with high levels of public debt undertaken to bail out domestic banking systems, would be in much worse fiscal shape to respond than they were the first time.

There are two lines of solution. One is for the "international community" to accept that governments have a responsibility to limit capital inflows to below the levels at which bubble dynamics come to dominate the real economy, and below the levels at which panic withdrawals become likely. This calls for, among other things, the IMF abandoning the attempt to hard-wire a commitment to full—even if "eventual"– capital account liberalization as a condition of Fund membership (by way of an amendment to the Articles of Agreement).

The second is for Asia and Asian economies to become more reliant on domestic demand and less reliant on export demand, specifically US demand. Sustainable economic growth requires that supply and demand grow in some sort of balance. In Asian supply conditions (as distinct from, say, African supply conditions), the supply of manufactures is highly elastic with respect to the supply of credit. On the other hand, export demand growth is limited by slow growth in Japan and Europe, and by the financial fragility of the US economy. Domestic demand growth is constrained by low wages and high inequality. The line of solution is here, in expanding domestic demand. It can be boosted by such policies as government-mandated increases in minimum wages (perhaps just in export industries, perhaps by $1 a day each year for several years); increases in pensions; in social security; in inheritance taxes; student loan schemes; expansion of unionization, and civil and political rights. All these have been adopted in the West, and have helped to create the condition where millions of workers have the purchasing power to buy the products that they

[48] "Fallout from a global crisis", *The Financial Times*, December 8, 1999.

and their colleagues make—a condition not met in much of Asia. To be introduced on a sizable scale and fast enough to make a difference within a decade or two might require concerted adoption by regional groupings of states. Greater pie in the greater sky? Perhaps, but another financial crisis or two might drive serious action along these lines.