NATIONAL ECONOMIES AND GLOBAL FINANCE

T.J. PEMPEL

UNIVERSITY OF CALIFORNIA, BERKELEY

Paper prepared for the XXII World Congress of Political Science, Madrid, Spain
Panel on “Regional Responses to the Global Financial Crisis”

July 8-12, 2012
**ABSTRACT**

This paper analyzes the financial crises of 1997-98 and 2008-2009 in an effort to understand why Asian countries were so economically devastated by the first crisis but so relatively unscathed by the second. The paper argues that unfettered global capital movements combined with a liquidity crisis in several Asian countries was at the heart of the first crisis but that most of their economic fundamentals remained sound. Consequently, the IMF and US prescriptions for economic reform in Asia rang hollow in 1998 as did advice to move toward less regulatory governments and less politically encumbered markets. Asian governments did make a number of moves to reform in the late 1990s and early 2000s but the vast majority involved strengthening the underlying financial architecture and regulatory systems in Asia while also bringing them into closer regional financial and trade relations with one another and a reduced dependence on the United States.

The crisis of 2008-2009 was driven by the highly deregulated US capital markets that allowed a housing bubble to expand unchecked and that saw US financial institutions pumping trillions of dollars into exotic and highly vulnerable financial products. And when the US housing market collapsed, an interlinked network of US and global financial institutions deemed too big to fail were bailed out by a US government forced to abandon its ideological commitment to free markets.

A key lesson for developing countries today is to be wary of ideological market fundamentalism and to look to Asia for indications of how best to intersect with global capital markets in ways that will be more likely to create jobs and national prosperity and
to avoid the risks associated with free market fundamentalism that is too often a cover for “casino capitalism.”
To paraphrase Tolstoy, ‘financial situations without crisis are happily alike but every financial crisis creates unhappiness in its own way.’ Recognizing the differences among crises is particularly salient in examining the financial devastation that swept across Asia in 1997-98 together with that of the crisis that embroiled the United States and much of the rest of the world in 2008-2009. Both meltdowns were similar in their extensive repercussions, but each began from a very distinctive financial epicenter, each had quite different causes and the miseries generated by each in different economies were the consequence of highly individualistic vulnerabilities or strengths.

To focus on differences between the crises is at odds with the broad conclusion advanced by Reinhard and Rogoff (2009) in their ironically titled book, This Time is Different. They effectively demonstrate that eight centuries of what they label “financial folly” have emerged from a set of rather similar and clustered economic conditions that wreck havoc with surprisingly consistent levels of frequency, duration, and ferocity. Yet, historically, they contend, each time the common economic storm clouds have gathered, powerful voices challenge the worrying Cassandras by contending that past rules have changed, a new economic paradigm is present, and hence that ‘this time is different.’ Only after the same devastating consequences explode are the worriers proved right and the historically-myopic optimists proven wrong. Reinhard and Rogoff’s economic data is compelling in revealing the macroeconomic similarities across a wide swath of crises and in underscoring the relative ease with which collective greed can spawn mass delusion.

What their analysis ignores, however, and what this paper addresses, are the differing political conditions that facilitate individual crises. Focusing merely on macroeconomic similarities among crises is analogous to studying a sequence of
disastrous house fires and analyzing the commonalities in combustible materials, winds
and heat without addressing the divergent catalytic implications of lightning in one, a
smoker-in-bed in another, faulty wiring in a third, and an arsonist in the fourth.

This paper addresses the important political differences between the Asian crisis
of 1997-98 and the Lehman crisis of 2008-2009. It shows that both crises were similar in
being reflections of the tensions between the rising power of globally mobile capital and
the regulatory efforts of national governments. But the experiences of numerous Asian
economies during the two crises pose a fundamental challenge: why were so many Asian
economies devastated in 1997-98 only to emerge far less deeply scathed by the more
economically daunting crisis of 2008-2009?

The paper argues that the most severely affected countries in the AFC put in place
institutional and regulatory barriers that afforded important protections against the kind
of financial tsunami that swept over them in 1997-98. Moreover, most of Asia disdained
the advice to embrace the ever more complicated financial products being developed in
America and Europe. In these ways Asia decoupled itself from the network of enmeshed
vulnerabilities that subsequently engulfed the U.S. and much of Europe. Conversely, the
very absence of such actions in the United States left that county highly vulnerable to the
build up of the cluster of economic problems that have preceded numerous financial
crises in the past. In this regard, the paper also shows how Asia’s different experiences
with the two crises offer some promise that individual national governments can use state
powers of regulation to develop and sustain more competitive national economies in a
world of globalized and rapidly moving capital.
CONTRASTING PERSPECTIVES ON ECONOMIC WELL-BEING

Economic theorists from Ricardo to Keynes to Hayek have offered competing strategies for how national economies can best become more sophisticated and globally competitive. All emphasize various aspects of a competitive and ideally, global, economic marketplace as a key determinant of growth. Their normative focal point is the most efficient use of economic resources and the maximization of benefits to a world full of rationally-calculating individuals. From such a perspective, contemporary neo-liberal economics has clear cut advice for countries anxious to improve their GDPs: open your markets and embrace free trade and financial liberalization. Underlying such a pervasive view is the belief that markets are global and if politics is national, the optimal national political strategy should be the warm embrace of global economic realities.

In contrast, political economists from Mark and Engels through Karl Polanyi, Alexander Gerschenkron, Immanuel Wallerstein and Chalmers Johnson have argued that national economic strategies are inevitably constrained or enhanced by political choices and that national governments can and should seek to shape market forces in accord with their particular national political agendas rather than a-politically embracing a vision of the allegedly greatest global good for the greatest number.

A central complication for such nationally-rooted efforts, however, is the role of global capital. The rising power of communication and the speed with which mobile money can move into and out of markets have increasingly decoupled financial capital from the nationality of its holders. Rapid and global movements by vast sums of capital in search of the highest possible profits make it increasingly different for national
governments to erect constraints. This denationalization and global flexibility of capital is particularly nettlesome for national political leaders whose economies are relatively unsophisticated and those same leaders are seeking to play catch up economics through developmental prospects in their countries.

Neo-liberal economists, particularly those in the US and Britain, emphasize the generic benefits of free trade and financial liberalization and treat them as pivotal to any country’s long term economic development. Arms-length market transactions, they argue, allow capital to flow to its most efficient uses while liberalization of capital markets and financial institutions provide the citizens of developing countries with the greatest opportunities to enjoy global products at the cheapest prices. For them the ultimate measure of “success” is the efficient use of resources as measured by the widest possible distribution of goods and services across the broadest number of individuals—the greatest good for the greatest number. National economic development, they contend, will progress to the extent that such national markets become more open and less constrained by the inefficiencies introduced by politicians and governments.

Developmentalists, in contrast, focuses on national attempts to move up the technological gradient and to “catch up” with more economically sophisticated countries, even as they stress the difficulties that any country to do so. Integrating more fully into the global marketplace in ways that redound to the long term national well-being, they contend, requires strategies to concentrate scarce resources so as to develop and then foster globally competitive industries and firms which will eventually catapult the country up the competitiveness ladder and narrow the gap between itself and other vastly more developed countries. In stark contrast to the economists’ value set,
developmentalists are far more content to see the short-term well-being of individual citizens and consumers suppressed in favor of a longer term enhancement of the benefits for the nation’s citizenry at some future point in time.

In short, economists focus on the benefits of expanding the size of the global economic pie and the ways in which developing countries can take steps to expand the pie and hence their overall consumption capabilities. Developmentalists stress the longer term desire of national governments to ensure an ever larger share of the pie, and ideally a key role in baking it.

These competing perspectives were brought starkly into relief with the so-called Asian financial crisis of 1997-98. But they became even more crystallized and subject to evaluation during the more recent global crisis of 2008-2009. As Asia spiraled downward in 1997-98, many neo-liberal economists drew self-congratulatory portraits arguing that the crisis in Asia was evidence of the benefits of unfettered capital markets and the corresponding impediments of political interference with that free flow of funds. Such interference was derisively branded as ‘crony capitalism’ or “moral hazard.”

Such hubristic self-congratulations rang hollow, however, with the volatile explosion in 2008-2009. In that economic chaos, global financial markets cascaded downward from the disastrous interplay of the previously-lauded amalgam of free flowing and highly leveraged capital in the unmonitored pursuit of maximum profits, relying heavily on the unregulated sale of esoteric financial instruments, all laced with an unexamined optimism that asset markets would always move up (Lewis, 2009; Rajan, 2010; Reinhart and Rogoff, 2009, Sheng, 2009, inter alia). The rapidity with which global capital markets seized up and the range of countries that were plunged into recession or
depression quickly led US Secretary of the Treasury, Henry Paulson, a previously unshakable advocate of unfettered markets, to jettison his prior neo-liberal commitments and to move quickly to bail out the troubled financial institutions by recapitalizing them with a massive injection of government money through the Troubled Asset Relief Program (e.g. Rajan, 2010: 149). Within weeks over $1 trillion in government monies were allocated to the relief effort. Alan Greenspan, longtime head of the Federal Reserve another long time devotee of market freedom admitted during Congressional hearings in October, 2008 that “he had put too much faith in the self-correcting power of free markets and had failed to anticipate the self-destructive power of wanton mortgage lending” (New York Times, October 28, 2008: 1). By 2011, it was not clear that the pro-market lessons many had drawn from the Asian crisis carried anything like their prior legitimacy.

**ASIAN CRISIS AND RESPONSE**

Throughout the 1980s and into the 1990s, most East Asian national economies were expanding at staggering rates, providing the world with spectacular regionally specific evidence that economic development and national catch-up were indeed possible, and creating an outpouring of popular writing about the alleged “Asian miracle.” Developing countries in East Asia enjoyed a bracing cocktail of more sophisticated and productive infrastructures, rapid macro-level growth, expanding global markets for their products, ever-better employment opportunities for their citizens, rising middle classes, and the long term promise of improving wealth and prosperity for its citizens. Key to the
capitalization of their early development efforts was bank-lending, rather than stock or capital markets (Aoki and Patrick, eds. 1995; Johnson, 1982; Woo, 1991, inter alia.). Most Asian businesses borrowed needed capital from closely aligned banks, regularly rolling these loans over for long periods providing stable capital and encouraging long-term planning to firms, while generating steady interest payments to banks.

The World Bank’s study of this phenomenon of rapid Asian growth (World Bank, 1993) was heavily funded by ‘developmentalist’ government agencies in Japan but was operationalized by economists in the neo-liberal World Bank. The finished product was, not surprisingly, delightfully schizophrenic about the relative roles played by ‘getting the prices right’ as neo-liberal economists contended was critical to a back-handed acknowledgment that there may have been some merit in politicians ‘getting the prices wrong’ as developmentalists had long claimed was critical to Asia’s success (e.g. Amsden, 1989).

Not surprisingly, as the crisis of 1997-98 unfolded US government officials and the IMF, reflecting their deep skepticism about the developmentalist model employed in much of Asia, not to mention their own political and economic interest in showing its inadequacies, quickly highlighted what they saw as evidence of widespread “crony capitalism” and “moral hazard” in the affected Asian economies. They showed little self-reflection on the obvious question of why, if such problems were so structurally endemic to Asia’s economies, the crisis emerged in 1997 and not six months or two years before or after (Pempel, 1999, passim; Radelet and Sachs, 1998). Close ties among finance, government and business, they argued, had generated massive inefficiencies along with endemic problems of moral hazard in which banks and other financial institutions had
failed to provide adequate monitoring of actions by businesses. Not surprisingly, a more limited government economic role, along with reduced public subsidies and greater liberalization of both domestic finance and corporate organizations were at the core of the prescriptions offered by the IMF and the US to the affected economies. And as a reflection of America’s own structural, though less self-examined version of ‘crony capitalism,’ the rescue packages came with explicit requirements that the aided countries adopt policies consistent with neo-liberal economic theory thereby opening their markets to favored Western firms or sectors. As then Deputy Treasury Secretary Larry Summers crowed, “The IMF has done more to promote America’s trade and investment agenda in East Asia than thirty years of bilateral trade negotiations” (quoted in Hale 1998: 25).

Within Asia however (and among many analysts less enthralled by neo-liberal economics), the crisis told a devastatingly different story. That story centered on the mistaken ways in which pre-crisis financial liberalization had advanced in the most severely affected countries without adequate domestic regulatory buffers, as well as the extent to which Asian economic growth had become catastrophically dependent on unregulated penetration by global financial markets. Such views stressed that the crisis was one of liquidity imbalance rather than fiscal mismanagement. (Radelett and Sachs, 1998).

The Asian countries most deeply affected by the crisis had been unable to finance their massive investment booms by continuing to rely, as they had in the past, on domestic savings mediated by national financial institutions. Instead private capital began to supplant official capital with distinctly higher levels of borrowing from abroad. World figures for foreign direct investment show that in 1990 nearly 80 percent of total global
fdi went to the developed world while money going into Asia totaled just about 11 percent. That Asian figure rose rapidly to 15.6 percent in 1995 and to 17.2 percent in 1997 (United Nations 1998:7).

Within Asia, external capital inflows jumped from an average of 1.4 percent of GDP during 1986-90 to 6.7 percent during 1990-96 with even greater increases immediately prior to the onset of the crisis. Foreign funds, for example, constituted the equivalent of about 15 percent of GDP in Thailand and the Philippines, 8 percent for Malaysia and 5 percent for both Indonesia and the ROK. As these developing Asian economies began to succumb to the temptations of fluid and easily accessible global capital, they opted for what eventually proved to be a fragile mix.

Furthermore, between 15 and 40 percent of this incoming investment was injected, not into long term infrastructural projects, but rather into far more speculative areas such as property and stocks. The result was an explosion of ‘hot money’ and asset bubbles when Asia seemed unstoppably dynamic. But then once the crisis materialized that money was equally quick to move out of Asia as fluidly as it had moved in (Winters, 1999).

Additionally problematic, this rush of incoming capital most typically involved borrowing short term in dollars while lending long term in local currencies. This formula proved highly profitable to Asian borrowers for as long as the US dollar was declining in value and Asian exports were booming as was the case from 1990-95 (Winters, 1999: 90). Asian borrowers earned windfall profits. For a time, the positive benefits of more globalized finance were being reaped across Asia. However, when the dollar began to rise and exports slumped in 1995-96 short term Asian debts required ever larger amounts
of the local currency to be repaid from an ever-dwindling supply of foreign reserves. Currencies pegged to the dollar thus became highly vulnerable. Governments confronted the choice of either ending the peg or expending massive reserves in an effort to protect it. The darker side of global finance began to reveal itself. In the end the most severely affected economies depleted massive amounts of their scarce reserves before eventually seeing no alternative but to devaluing their currencies. This in turn hastened the outflow of most of the remaining liquid global capital. Financial losses quickly rippled through the ‘real economies’ of the affected countries. Output losses ranged from perhaps 17.6 percent to nearly 98 percent in the most severely affected countries (Sheng: 2009: 98), unemployment rates soared, and some 15-17 million Asian who were not there already fell below their nations’ poverty lines (Sheng: 2009: 309; See also MacIntyre, et al. 2008: 4-13).

One interesting thing about the Asian experience however was how quickly growth rates returned to their previous levels. The crisis was unmistakably sharp and severe but it was distinctly short-lived, resulting in a v-shaped recovery (See Figure 1). Painful as it was to participants at the time, hindsight demonstrates that the crisis did not derail the underlying and positive economic fundamentals that had long fueled East Asia’s economic growth. Asia’s real economy, as opposed to its financial vulnerabilities, proved to be on sound footing. By 1999-2000 GDP growth rates had returned to nearly their pre-crisis levels in Malaysia, Korea, Indonesia, Thailand and the Philippines. They remained largely on their earlier trajectories until the Lehman crisis of 2008-2009. Even more impressive than Asia’s recovery from 1997-98 was the relative immunity most Asian economies showed to the worst effects of the crisis of 2008-2009, a key point that
will be examined in greater detail below.

**Figure One: Annual GDP Growth (%) in Crisis Economies**

![Graph showing annual GDP growth (%) in crisis economies from 1993 to 2005 for Indonesia, Korea, Malaysia, Philippines, and Thailand. The graph highlights a significant drop in GDP growth in 1998, indicating the impact of the crisis.](image)

*Source: World Bank, World Development Indicators (online database) as in MacIntyre et al. 2008: 11.*

**THE CRISIS OF 2008-2009**

Competing perspectives on the links between economics and politics, as well as those for the Asian financial crisis, might well have remained more ideological than empirical until the more recent crisis of 2008-2009 when interpretations were subject to more striking tests. In March, 2008, Bear Stearns, a major US global investment bank and securities brokerage and a heavy investor in sub-prime mortgages, found itself on the verge of bankruptcy. In a move pressed by the US Federal Reserve, Bear Stearns was absorbed by other financial institutions at a fraction of the value it held a bare month
earlier. The Bear Stearns takeover proved to be but an early hint of the chaos that was to follow. On September 15 of that year, Lehman Brothers, a global financial services firm facing $60 billion in bad investments and unable to secure US government assistance, declared what was then the largest bankruptcy in American history, triggering a widespread panic in global financial markets and ushering in the largest recession in the United States since the Great Depression of 1929-33.

The crisis of 2008-2009 threatened to create a complete seizure of global capital markets and involved vastly larger capital losses than the crisis of eleven years earlier. But it was quickly apparent that the financial meltdown that took place in 2008-2009 affected the United States and the European Union vastly more seriously than it affected Asia. Combined with Asia’s relatively speedy recovery from that first crisis, its relative insulation from the worst effects of the second raise the fundamental question of why. An examination of the second crisis in combination with the havoc created in Asia by the hot money of global capital, reveals the inherent flaws in the faith that free flowing and unregulated capital markets will be inherently efficient, self-sustaining, and ultimately self-correcting. Most governments in Asia have been loath to adopt such a composite set of beliefs despite their widespread acceptance in the United States and among market devotees elsewhere.

The sources of the latest crisis trace to at least two different levels of problems. At the global macro-economic level, the world in the run up to the crisis faced an unsteady balance between an over consuming and under saving US economy on the one hand and an under consuming and over capitalized rest of the world (Rajan, 2010: 6; Frieden, forthcoming).
At the heart of this imbalance was the huge public and private sector borrowing by the United States, ranging between $500 billion and $1 trillion per year from 2000-2007, and the conversely limited consumption and high savings elsewhere, particularly in Asia. Escalating global sales plus low spending at home allowed foreign economies to move huge quantities of unspent foreign capital into the US to bolster the seemingly insatiable demands of American consumers. In effect Asia which had been so vulnerable to the onrush of global capital in 1997-98 found itself the provider of the capital that funded America’s and much of Western Europe’s unpaid-for consumption binge a decade later. Countries with excess capital could count on the US to reliably spend more than it produced. (e.g. little of the newly infused foreign money went into enhancing US infrastructural, manufacturing or productive capabilities.) Global financial markets, including those in the US, profitably mediated this relationship.

Yet the macro-economic explanation sheds little light on the more micro-political, or political economic aspects, of the meltdown. For this, it is necessary to examine the American political economy and the nature of the global financial system.

Global macro-economic imbalances dovetailed with an emerging problem within the US domestic economy: a soaring housing market that seemed to be a goose laying golden eggs for financial institutions operating on the premise of ‘arms length capital transactions’ and in search of maximum profits. But beneath the housing-financial link was America’s own variant of ‘crony capitalism.’

The bursting of the dot com bubble in the early 2000s had led to a collapse in the US stock market and to the rapid slowdown in America’s domestic economy. With so much of America’s manufacturing and export capabilities having been eviscerated, the
US found it virtually impossible to export its way out of the downturn. Instead, the US Federal Reserve lowered interest rates to stimulate demand. Quickly, vast quantities of cheap money began to slosh around the US as the consequence of both low interest rates domestically and the huge inflows of foreign capital from overseas. What proved eventually to be an oversized mirroring of Asia’s earlier asset bubble first emerged in the US as simply a clear path to profits for both financial institutions and housing buyers. Housing demand soared in conjunction with low mortgage rates, and rapidly rising housing prices fueled an upward spiral that to many appeared unending (See Figure 2).

**FIGURE TWO**

![Graph of U.S. House Prices, 1890-2008](image)
As prices on houses rose, homeowners and financial institutions found mutual benefit in a cascading refinancing of mortgages. Homeowners could periodically extract portions of their rising equity in order to finance consumption; financial institutions made regular profits with every such refinancing. And both could benefit from mortgages with low cost ‘teaser’ rates for the first two to five years of the mortgage, after which another round of re-financing could begin—on presumably higher paper values for the homes (Rajan, 2010: 38-41; Lewis, 2010 inter alia.)

Particularly problematic were so-called sub-prime loans in which financial institutions lent money at exceptionally low (but temporary and adjustable) interest rates to borrowers with highly dubious credit ratings. As mortgage profits rose, financial institutions kept up the search for ever newer borrowers. Companies such as New Century Financial led the way in making low cost loans available to potential home owners with ever more dubious ability to repay. With housing prices soaring parabolically from the early 1970s and accelerating astronomically in the 2000s, banks and other financial institutions became ever-more-willing to lend to ever-more dubious borrowers.

Many financial institutions found it highly profitable to encourage homeowners, even those with the most problematic credit ratings and little prospect of actually being able to pay their mortgages over a long period, to take out mortgages based on the low costs of entry. Low monthly payments, even if guaranteed only for short periods, put new home buyers into properties after which, their lenders convinced them, they could continue to refinance their now more valuable—at least on paper--homes with new
mortgages. Through such predatory lending financial institutions made huge profits in the issuance and then reissuance of these mortgages and all players had a strong interest in perpetuating the highly profitable system on the implausible presumption that housing prices would move ever upward.

Also integral to the rising housing market and its funding were the newly-created, and increasingly widespread, financial products known as ‘credit default swaps’ and their variant “credit default obligations.” Credit default swaps were not really ‘swaps’ at all, but rather insurance policies, typically on a corporate bond, with semiannual premiums and a fixed term (Lewis: 2010: 29). Essentially they constituted low cost bets that particular assets (including on such things as securitized mortgages) would not go into default. In the rapidly expanding housing market such credit default swaps seemed immune to any worries about default. As a result billions of dollars worth of highly profitable credit-default swaps were issued by financial institutions such as the American Insurance Group’s now-infamous financial products unit (AIGFP) with little attention to either the quality of the underlying mortgages and the borrowers who held them or to the fact that extensive numbers of securitized mortgages were poorly diversified across geographical areas or dates for refinancing. So long as housing prices soared, there would be no significant amount of default, and hence such credit-default swaps would never require payment. Few of those involved in the system anticipated that housing prices might go down, let alone collapse. Indeed in the early days of the mortgage bond business the biggest fear was that loans would be repaid too quickly, not that they would fail to be repaid at all (Lewis, 2010: 7). The issuance of such CDOs was perceived within AIGFP and other issuing firms as a no-risk license to print money.
These new mortgages were rarely held by the issuing banks until maturity as banks had previously done with the mortgages they issued. Instead mortgages became a new financial instrumentality by being bundled together, “securitized,” and sold as the equivalent of AAA bonds, a fiction made possible by the collusion of allegedly independent ratings agencies, such as Moody’s, which were paid fat fees by Wall Street firms for each deal they rated. Some 80 percent of this rising tower of debt was rated AAA (in sharp contrast to the roughly one percent of corporate bonds that received such a high rating). Michael Lewis correctly notes that such credit default obligations were in effect “a credit laundering service for the residents of Lower Middle Class America. For Wall Street [they were] a machine that turned lead into gold.” (Lewis: 2010: 73). The increasingly complex and interconnected nature of these credit default obligations and the rising number of arcane derivative products eventually created a mixture that stretched the ability of many and financial regulators to comprehend. (Sheng, 2009: 356; Lewis: 2010: 218).

Complicating this situation, many of the world’s (and especially the US’s) most allegedly sophisticated financial institutions and hedge funds had become highly leveraged in their pursuit of the “search for yield” while incentives for financial institutions and their managers became ever more tied to short-term, as opposed to longer term, profits. The result was the culmination of what Susan Strange (1986) over two decades ago labeled “casino capitalism.”

The American government played its role in fostering the entire operation in a Western version of crony capitalism. At least two elements are important. First, the wave of financial deregulation that had begun in the Reagan years meant limited to zero
political oversight of the increasingly complicated, interlinked, and risky financial practices noted above. In 2000 for example, the government explicitly chose not to subject derivatives to substantial regulatory oversight. And second, the Federal Reserve essentially committed itself to putting a floor under asset prices by refusing to raise interest rates even when they had reached dangerous levels approaching “irrational exuberance.” Meanwhile, as the Federal Crisis Inquiry Commission showed in its 2011 report, the US Federal Reserve remained, as Gretchen Morgenson put it (2011: C-1), “defiantly inert and uninterested in reining in the mortgage mania.” In criticizing Alan Greenspan on this matter, Raghuram Rajan (2010: 113) puts it bluntly: Greenspan recognized the possibility of asset bubbles; however, he essentially “told traders and bankers that if they gambled, the Fed would not limit their gains, but if their bets turned sour, the Fed would limit the consequences. All they had to ensure was that they bet on the same thing, for if they bet alone, they would not pose a systematic threat.” That government floor on capital losses became self-evident when the housing bubble burst and the credit-default swaps and related high risk bets had to be paid. Yet in a final burst of ‘crony capitalism,’ the US and other major governments showed an unflinching willingness to bail out almost all large financial institutions, with little new regulatory requirements, because they were collectively deemed ‘too big to fail.’

What began as a financial crisis quickly depressed the entire US economy. Job creation had already been terrible throughout the Bush administration. The Clinton presidency saw an average creation of 2.75 million new jobs per year; under Bush that number fell to 393,000 and for the first half of 2008 alone, there was actually a net loss of 348,000 jobs. Then, as credit markets seized up, numerous small and medium sized firms
found it virtually impossible to access needed credit leading many to shutter their doors, accelerating the rise in unemployment. State and local governments in turn saw tax revenues fall as the economy slowed, resulting in substantial public sector layoffs. The end result was an official rate of over 10 percent unemployment that barely budged for the next two years even as the banks and financial institutions returned to high levels of profitability following massive government bailouts. Further adding to the difficulty of recovery, the US since around 1980 has seen an ever-widening gap between the exceptionally rich and the rest of the citizenry spawning what Hacker and Paulson (2010: 17) have called the ‘hyperconcentration of wealth’ and an entrenched ‘winner take all’ politics. Consumption which makes up approximately 60-65 percent of the US economy stagnated as the average household found it ever more difficult to consume. And the federal budget saw a yawning gap between revenues and spending that made it politically difficult for added government spending to serve as an economic stimulus, further slowing the national recovery. In contrast to American stagnation, Asia was booming.

A SECOND EAST ASIAN MIRACLE?

Asia was hardly immune to the 2008-2009 crisis but it has fared far better than the US and Western Europe. As Michael Heise, Chief Economist of Allianz Dresdner Economic Research put it as the crisis took root: "No region is immune to the financial crisis. Asian economies will also see a slowdown in growth, but not a contraction. Emerging markets in Asia will still show a considerable degree of resilience." (The Economy News, December 12, 2008). This proved indeed to be the case as can be seen in
Table 1. GDP growth rates across Asia were generally positive while those of the US and Europe plummeted. China of course continued its rapid growth, but all the economies of Asia showed positive estimated growth by 2008 and were generally predicted to see continued or better growth in 2009.

Why was Asia so resilient? Part of the answer lies in Asia’s response to the crisis of 1997-98 and the other part in steps taken to avoid becoming too heavily integrated into the market fundamentalism and the consequent ‘casino capitalism’ that was sweeping the US and many markets in Europe.

<table>
<thead>
<tr>
<th>ANNUAL GDP GROWTH RATES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Developing Asia</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Vietnam</td>
</tr>
<tr>
<td>Thailand</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
<tr>
<td>Taiwan</td>
</tr>
<tr>
<td>S. Korea</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
<tr>
<td>Cambodia</td>
</tr>
<tr>
<td>Lao PDR</td>
</tr>
<tr>
<td>Malaysia</td>
</tr>
<tr>
<td>Phillipines</td>
</tr>
<tr>
<td>U.S</td>
</tr>
<tr>
<td>Euro Zone</td>
</tr>
</tbody>
</table>

Source: ADB Asia Economic Monitor 2008

In the wake of the 1997-98 crisis most of the affected governments continued to focus on their real economies, emphasizing manufacturing, exports, infrastructural
development and the fostering of a middle class. They avoided allowing their economies to be too subject to the vicissitudes of high finance. Instead, they moved to minimize the chances for any repeat of the devastation that had been wrecked upon them. One important step in this process is what Hamilton-Hart (2008: 46) has summarized as moves toward greater “market-based, competitive, and internationally open financial systems.” Overall, developing countries in Asia have moved away from their once high reliance on bank-lending for capital and become more market-based; they also became more open to consolidation and merger of their financial institutions with foreign counterparts. But these moves hardly implied the wholesale embrace of completely unfettering banking and finance. Asian governments also moved to ensure far stricter policy enforcement of regulations that had previously been on the books but largely ignored. With the possible exception of South Korea, none of the countries made wholesale moves to embrace neo-liberal economics by completely unfettering their capital markets.

Furthermore, national moves by Asian governments toward greater financial openness were augmented by a host of measures designed to reduce national and regional vulnerabilities to the fluid capital flows by which they were swamped in 1997-98. As I and others have noted (Pempel 2006, 2008a, 2008b, 2010; Aggarwal, 2006; Hamilton-Hart, 2008, Henning, 2008, Dent, 2003, Grimes, 2006, 2009, inter alia) Asian governments most seriously affected by the crisis, and many others in the region less directly affected, took political and regulatory steps that sought, among other things, to cut back on domestic demand, enhance their foreign reserve holdings, create tougher financial firewalls, engage in closer monitoring of short-term capital flows, make their
regulatory systems more sophisticated and more active, forge a series of currency swap
arrangements that have now been multilateralized (Grimes, 2009; Pempel, 2010) and
institute a flurry of bilateral and minilateral trade agreements, all of which have bolstered
the institutional intermediation between Asian economies and the broader global trade
and financial markets.

Throughout their developmental periods Asian governments have eschewed the
‘casino capitalism’ so prevalent in the West and governments remain conspicuously
active in the economies of nearly all Asian economies. Of particular significance has
been the rather systematic move by most governments to enhance their current account
balances and thus to expand their foreign reserve holdings. Six of the largest foreign
reserve holders are now in Asia (China, Japan, Taiwan, South Korea, Hong Kong and
Singapore). The result in large part has been that an export and savings oriented East Asia
became able to underwrite US and Western European overconsumption. As noted above
a happy macro-economic balance between the two was found as Asian monies flowed
into the US in the form of FDI but most importantly Treasuries. Asian surpluses from
exports allowed them to subsidize overconsumption within the US. Yet it was Asia’s
economies that were by far the stronger partners in this global financial marriage; it was
they who were producing (and creating jobs and wealth at home). Moreover, by avoiding
the uber-risky financial products of global finance, Asian governments also skirted the
risk of being pulled into the eddy of collapsing financial instruments so destructive of
Western economies.

Equally important, Asian governments collectively moved through regional
bodies such as the ASEAN Plus Three to create currency swaps and regional, locally-
denominated bond markets, designed to buffer them from excessive dependence on the IMF, the US dollar and the instruments of global finance. It remains to be seen just how actively such instrumentalities will be used. But the CMI has been expanding constantly in its funding and the once bilateral swap arrangements were multilateralized in 2009.

To paraphrase Jeffry Winters, as a result of such steps, East Asia ‘plugged into’ global financial markets, but with an unmistakable array of surge protectors. Asia has become far more buffered from global capital markets and has opted not to buy heavily into the arcane financial products that had become so popular (and initially so profitable) in the US, Britain and much of Western Europe.

As the result of such moves, Asia was far less pummeled by the 2008-2009 crisis than were institutions in the US or Europe. Their exports suffered as American demand sank, but Chinese consumption and its centrality in the production networks of the region helped minimize the negative consequences for Asia. Furthermore, Asian finance was less centrally involved in the excesses of the global financial markets. As the Asian Development Bank (2008: 25) has shown. “As of May 2008, total reported write-down and credit losses of the world’s 100 biggest banks and securities amounted to US$379 billion. Of these, Asia ex-Japan accounted for US$10.8 billion, which is less than 3% of global losses. Similarly, Asian institutions stayed largely on the sidelines as derivatives and credit-default swaps and the like became so seductive to their Western counterparts. As Table 1 below shows, the Asian proportion of capital eradicated by subprime losses was typically less than a tenth that of the US.
Asian exporting countries until recently had been highly dependent on the US market. In the mid-1990s the United States represented the largest or second largest export market for Japan (30 percent of total exports), Hong Kong (23 percent), South Korea (22 percent), Singapore (19 percent), Taiwan (26 percent), Malaysia (21 percent), Thailand (21 percent), Indonesia (15 percent) (Pempel, 1999: 71). That relationship has changed with China becoming the number one destination for virtually all of these exporters and with the US becoming a less central destination for Asian goods from all countries except China as can be seen from Table 2.

**Table 2: The Changing Direction of East Asian Trade**
(markets’ % share of total exports of the country in the first column)

<table>
<thead>
<tr>
<th></th>
<th>ASEAN</th>
<th>China</th>
<th>HK</th>
<th>Japan</th>
<th>EU</th>
<th>US</th>
<th>ASEAN+3+1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>11.1</td>
<td>2.1</td>
<td>4.6</td>
<td></td>
<td>20.7</td>
<td>31.7</td>
<td>24.4</td>
</tr>
<tr>
<td>1996</td>
<td>17.9</td>
<td>5.3</td>
<td>6.2</td>
<td></td>
<td>15.6</td>
<td>27.5</td>
<td>36.5</td>
</tr>
<tr>
<td>2000</td>
<td>14.3</td>
<td>6.4</td>
<td>5.7</td>
<td></td>
<td>16.8</td>
<td>30.1</td>
<td>32.8</td>
</tr>
<tr>
<td>2004</td>
<td>12.9</td>
<td>13.1</td>
<td>6.3</td>
<td></td>
<td>15.8</td>
<td>22.7</td>
<td>40.0</td>
</tr>
<tr>
<td>2009</td>
<td>13.8</td>
<td>18.9</td>
<td>5.5</td>
<td></td>
<td>12.4</td>
<td>16.4</td>
<td>46.3</td>
</tr>
<tr>
<td>China</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>6.7</td>
<td>-</td>
<td>43.3</td>
<td>14.7</td>
<td>10.2</td>
<td>8.6</td>
<td>65.3</td>
</tr>
<tr>
<td>1996</td>
<td>6.8</td>
<td>-</td>
<td>21.8</td>
<td>20.4</td>
<td>13.9</td>
<td>17.7</td>
<td>54.0</td>
</tr>
<tr>
<td>2000</td>
<td>7.0</td>
<td>-</td>
<td>17.9</td>
<td>16.7</td>
<td>16.4</td>
<td>20.9</td>
<td>46.1</td>
</tr>
</tbody>
</table>
Regional production networks that have been expanding across East Asia, along with the myriad new bilateral free trade agreements, have reduced East Asia’s prior dependence on the US market. Since the crisis, Japanese exports from Japan to the US fell from roughly 30 percent to 16 percent; those of Hong Kong dropped from 21 percent to 11 percent and ASEAN’s from 19 percent to 11 percent. Asian markets have become increasingly interconnected to one another and China has moved centrally into the nexus of these emerging production networks. In turn, China has increased its ultimate dependence on the US as a final market. Asia’s real economy rests heavily on production and increasingly on intra-regional transactions making the region less subject to rapid fluctuations in the US and Europe.

As a result of these shifts, the biggest impact of the crisis of 2008-2009 within Asia were felt largely in a short-term fall-off in demand for Asian goods rather than the result of underlying deficiencies in Asian finance or corporate strategies (See Table 3). Export success has led economic growth in Thailand, Indonesia, Malaysia, and Korea
with all returning to double digit growth in the early- to mid-2000s. But they dropped phenomenally in 2009 as global consumer demand fell off precipitously.

Table 3 Annual Growth Rates of East Asian Exports, 1996-2009 (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>-18.0</td>
<td>113.6</td>
<td>49.2</td>
<td>11.4</td>
<td>7.9</td>
<td>15.4</td>
<td>14.9</td>
<td>18.9</td>
<td>23.5</td>
<td>37.8</td>
<td>18.2</td>
<td>13.7</td>
<td>5.0</td>
<td>-5.3</td>
</tr>
<tr>
<td>China</td>
<td>1.5</td>
<td>21.0</td>
<td>0.5</td>
<td>6.1</td>
<td>27.8</td>
<td>7.0</td>
<td>22.1</td>
<td>34.6</td>
<td>35.4</td>
<td>28.5</td>
<td>27.1</td>
<td>25.7</td>
<td>17.3</td>
<td>-15.8</td>
</tr>
<tr>
<td>Indonesia</td>
<td>9.7</td>
<td>7.1</td>
<td>-8.6</td>
<td>-0.4</td>
<td>27.7</td>
<td>-9.3</td>
<td>1.5</td>
<td>6.8</td>
<td>17.2</td>
<td>19.7</td>
<td>17.7</td>
<td>13.2</td>
<td>20.1</td>
<td>-13.3</td>
</tr>
<tr>
<td>Japan</td>
<td>-7.1</td>
<td>2.4</td>
<td>-8.0</td>
<td>8.1</td>
<td>14.0</td>
<td>-15.6</td>
<td>3.3</td>
<td>13.2</td>
<td>19.9</td>
<td>5.1</td>
<td>8.7</td>
<td>10.5</td>
<td>9.5</td>
<td>-25.7</td>
</tr>
<tr>
<td>Korea, Rep</td>
<td>5.0</td>
<td>4.5</td>
<td>-7.8</td>
<td>8.5</td>
<td>19.8</td>
<td>-12.5</td>
<td>8.0</td>
<td>19.3</td>
<td>30.6</td>
<td>12.2</td>
<td>14.3</td>
<td>14.5</td>
<td>14.2</td>
<td>-16.0</td>
</tr>
<tr>
<td>Lao, PDR</td>
<td>3.1</td>
<td>-40.1</td>
<td>93.0</td>
<td>24.7</td>
<td>-15.4</td>
<td>-4.0</td>
<td>2.8</td>
<td>13.3</td>
<td>22.3</td>
<td>30.1</td>
<td>69.2</td>
<td>12.4</td>
<td>21.2</td>
<td>-4.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>6.1</td>
<td>0.9</td>
<td>-6.9</td>
<td>15.1</td>
<td>16.1</td>
<td>-10.1</td>
<td>5.9</td>
<td>12.4</td>
<td>20.5</td>
<td>11.4</td>
<td>14.0</td>
<td>9.7</td>
<td>13.2</td>
<td>-12.0</td>
</tr>
<tr>
<td>Myanmar</td>
<td>-1.2</td>
<td>-4.3</td>
<td>0.6</td>
<td>22.4</td>
<td>42.1</td>
<td>32.6</td>
<td>5.0</td>
<td>0.4</td>
<td>14.1</td>
<td>17.2</td>
<td>20.9</td>
<td>6.9</td>
<td>38.9</td>
<td>-16.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>18.4</td>
<td>22.7</td>
<td>16.9</td>
<td>20.3</td>
<td>7.7</td>
<td>-15.9</td>
<td>9.5</td>
<td>2.9</td>
<td>9.5</td>
<td>3.9</td>
<td>14.0</td>
<td>7.4</td>
<td>-2.6</td>
<td>-6.1</td>
</tr>
<tr>
<td>Singapore</td>
<td>5.9</td>
<td>0.2</td>
<td>-12.4</td>
<td>4.4</td>
<td>20.4</td>
<td>-11.7</td>
<td>2.8</td>
<td>27.8</td>
<td>24.1</td>
<td>15.5</td>
<td>18.7</td>
<td>10.0</td>
<td>13.2</td>
<td>-20.2</td>
</tr>
<tr>
<td>Taiwan*</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>12.8</td>
<td>10.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>-5.0</td>
<td>3.7</td>
<td>-5.1</td>
<td>3.9</td>
<td>17.9</td>
<td>-5.6</td>
<td>5.7</td>
<td>16.7</td>
<td>19.8</td>
<td>14.5</td>
<td>18.5</td>
<td>16.8</td>
<td>13.6</td>
<td>-12.3</td>
</tr>
<tr>
<td>Vietnam</td>
<td>32.8</td>
<td>27.1</td>
<td>-1.9</td>
<td>24.0</td>
<td>25.5</td>
<td>3.7</td>
<td>11.2</td>
<td>20.6</td>
<td>31.5</td>
<td>22.5</td>
<td>22.7</td>
<td>21.9</td>
<td>29.1</td>
<td>-10.9</td>
</tr>
</tbody>
</table>


Without a doubt, Asian governments and economies adjusted as well as they did to 1997-98 in large part because of the domestic financial changes they made as well as because of the strength of their underlying economic fundamentals and their altered regional economic relations. Such changes left them better buffered from the excesses of global capital movements than they were in 1997-98. But in addition, an important element in Asia’s resilience was its collective resistance to financial globalization in the most idealized and ideological forms so lionized by the IMF and the US. According to the IMF, the average share of foreign financial institutions in total domestic bank assets globally was 23 percent whereas East Asia’s level was only 6 percent. (Sheng: 2009: 315).
As a consequence, the direct exposure of Asian financial markets to the most deeply affected financial assets, like US subprime-related bonds and structured credit products, was quite small. In addition, unlike an overconsuming US, most Asian markets continue to have high savings rates, allowing Asian financial institutions to enjoy sound domestic deposit bases, and reducing their dependence on international wholesale refinancing transactions. Furthermore, many countries, but most especially China, have kept in place tight foreign exchange and capital controls that have in turn shielded them from volatile short-term capital movements.

CONCLUSION

In assessing why Asia did so well relative to the US and Europe during the great recession of 2008-2009, two important points deserve attention. First, Asian governments did not surrender their previously active roles in a blind embrace of market forces. Despite their 1997-98 crises and in opposition to much of the advice of the IMF and Western neo-liberal economists, most Asian governments abjured the kinds of sweeping financial deregulation and high risk financial instruments that eventually came to devastate the US and Europe in 2008-09. Following the 1997-98 crisis, Asian governments moved rapidly to increase their savings and their foreign reserve holdings as part of a collective effort to ward off any possible repeat of their vulnerability to hot money and global capital flows. Their economies continued to focus on savings over spending, on exports over consumption, and on manufacturing rather than finance as the engine of their growth.

Moreover, despite country to country differences, Asian governments generally took measures to insulate their economies from the possibility of any repeat of the crisis
in ways congruent with their own national development strategies. Japan and Korea, for example, reduced their prior dependence on bank loans for corporate investment. China, not directly hit by the first crisis, still chose to move away from its previously central state-owned enterprise system. Financial regulation in Asia moved closer to prudential international norms without embracing wholesale deregulation. Global financial and manufacturing firms have gained a more substantial presence across virtually all of post-crisis East Asia but they are hardly free to engage in many of the cavalier practices tolerated in the US.

The two crises in combination thus suggest that Asia for the most part has continued to create conditions for domestic and regional economic development that contrast sharply with the stagnation so widely evident in Africa, the Middle East and much of Latin America or with the financial vulnerabilities of the US and much of Europe. Much of that success has to be attributed to activist and regulatory governments unwilling to accept the implication that ‘government is the problem, not the solution.’ In contrast, the US and other countries which have followed strategies designed to let capital and financial markets operate freely and with minimal government intervention, found themselves hoisted on the pointed petard of unmonitored markets.

Clearly, successful economic development requires far more than just an ‘active’ government. Asia’s ability to break out of the trap of permanent underdevelopment relied on a wide array of policies that enhanced both infrastructure and human capital. This in turn was based on a beneficent mix of public-private collaboration and a fortuitous Cold War situation that created a munificent American military ally and market of last resort. And surely even Asia’s greatest admirers must admit that its success rested as well on not
a little bit of luck. But one lesson that Asia can offer to the now developing world is to be very cautious about the promises of unfettered markets and minimalist government. The massive recession of 2008-2009 shows the consequences of such a course of action.
REFERENCES


__________. 2009. Currency and Contest in East Asia: The Great Power Politics of


MacIntyre, Andrew, T.J. Pempel, and John Ravenhill (eds.) 2008 East Asia: Coping With the Crisis. Ithaca, Cornell University Press.


Ithaca.


Sheng, Andrew. 2009. From Asian to Global Financial Crisis: An Asian Regulator’s


