London School of Economic and Political Science

The Political Power of Economic Ideas: Comparative Policy Responses to the East Asian Financial Crisis in South Korea and Malaysia

A Thesis Submitted by

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Thesis Submitted for the Degree of Doctor of Philosophy in International Relations

University of London

May 2004

CONTENT

ABSTRACT

This thesis explores the politics of economic adjustment in South Korea and Malaysia. Empirically, it examines how Korea and Malaysia responded to the East Asian financial crisis. A widespread perception is that Korea pursued orthodox policies (the Washington consensus) while Malaysia used unorthodox policies (the post-Washington consensus). However, this interpretation exaggerates the divergence in macroeconomic adjustment policies (e.g., different exchange rate regime policy and their relationship with the IMF), thereby underestimating the 'policy' convergence in macroeconomic stabilisation and structural reform at least from late 1997 to mid-1998. For this reason, this thesis explores the convergence and divergence in a balanced perspective.

Theoretically, it interprets why the 'policy' convergence emerged between Korea and Malaysia from an ideational perspective. The convergence was caused, in part, by economic ideas – the Washington consensus or neoliberalism – that prevailed among both the international financial institutions (IFIs) and national policy makers. The consensus de-legitimised the existing economic system by attributing the underlying causes of the financial crisis to structural weaknesses in the financial and corporate sectors. In addition, the consensus provided a far-reaching blueprint for institutional change. This is why both countries embraced neoliberal policies particularly in structural reform, irrespective of IMF interventions.

The emphasis on economic ideas does not mean that ideational approaches overlook the role of interests and institutions. Vested interests – big business and organised labour – and state capacity had a considerable impact on policy-making. Thus ideas-oriented approaches are complementary to – rather than conflicting with – interest-oriented and institution-oriented approaches.

Key Words: East Asian Financial Crisis, South Korea, Malaysia, Washington Consensus
Policy Convergence

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ABBREVIATIONS & ACRONYMS

ADB: Asian Development Bank

AMF: Asian Monetary Fund

ASEAN: Association of Southeast Asian Nations

BA: Barisan Alternatif (Malaysia)

BIS: Bank for International Settlements

BN: Barisan Nasional (Malaysia)

BNM: Bank Nagara Malaysia

BOK: Bank of Korea

CCEJ: Citizens' Coalition for Economic Justice (Korea)

CDRC: Corporate Debt Restructuring Committee (Malaysia)

EAEC: East Asian Economic Caucus

EPB: Economic Planning Board (Korea)

FKI: Federation of Korean Industries

FTC: Fair Trade Commission (Korea)

GATT: General Agreement of Tariff and Trade

GNP: Grand National Party (the successor to NKP)

ILO: International Labour Organization

IMF: International Monetary Fund

KCTU: Korean Confederation of Trade Unions

FKTU: Federation of Korean Trade Unions

FSC: Financial Supervisory Commission (Korea)

KAMCO: Korean Asset Management Corporation

KDI: Korea Development Institute

KDIC: Korean Deposit Insurance Corporation

KERI: Korea Economic Research Institute

KLI: Korea Labor Institute

KLSE: Kuala Lumpur Stock Exchange

MCA: Malaysian Chinese Association

MDP: Millennium Democratic Party (the successor to NCNP)

MOF: Ministry of Finance (Korea)

MOFE: Ministry of Finance and Economy (Korea)

NDP: National Development Policy (Malaysia)

NEAC: National Economic Action Council (Malaysia)

NEP: New Economic Policy (Malaysia)

NCNP: National Congress for New Politics (Korea)

NKP: New Korea Party (Korea)

NJP: National Justice Party (Malaysia)

NUBE: National Union of Banking Employees (Malaysia)

OECD: Organisation for Economic Co-operation and Development
PAS: Parti Islam sa-Malaysia
PSPD: People's Solidarity for Participatory Democracy (Korea)
SC: Securities Commission (Malaysia)
SERI: Samsung Economic Research Institute
ULD: United Liberal Democrats (Korea)
UMNO: United Malays National Organisation
UNDP: United Nations Development Programme
WTO: World Trade Organisation

ACKNOWLEDGEMENT

Many people and institutions helped me in preparation of this thesis. My most important debt is to Dr. Andrew Walter who supervised me at LSE. Throughout the writing of the thesis, he gave me intellectual encouragement and moral support. I also owe intellectual debts to Professor Michel Yahuda and Fred Halliday who offered me thoughtful feedbacks in annual research panels.

It would be a fatal mistake to omit my mentors at Seoul National University. I am particularly obliged to mention Professor Young Sun Ha, Yong Chul Ha, Young Kwan Yoon, and Jung Woon Choi who enriched my knowledge on social science in general as well as international relations. In addition, Professor Hyun Jin Lim (Seoul National University), Professor Kun Young Park (Catholic University of Korea), Dr. Kisoo Kim and Dr. Hyun Ik Hong (Sejong Institute) provided me invaluable advice at different stages.

Two institutions made it easy for me to sharpen my ideas and to collect data and information. From July to September 2000, I was a visiting researcher in the Center for Pacific Asia Studies (CPAS), Stockholm University. I am deeply grateful to Dr. Masako Ikegumi for providing the opportunity to study in such a nice environment. As a research Associate, I conducted field research at the Institute of Southeast Asian Studies (ISEAS). In Singapore, Dr. Denis Hew (ISEAS) and Dr. Natasha Hamilton-Hart (National University of Singapore) helped me to arrange interviews with Malaysian policy makers and journalists. In Kula Lumpur, I met several Malaysian economists, policy makers and journalists. Among others, I express my gratitude to Professor K. S. Jomo and Ms. Tan Siok Choo (Institute of Strategic and International Studies) for in-depth interview. In Korea, Dr. Yun Jong Wang of Korea Institute for International Economic Policy (KIEP), Dr. Yong Ki Kim of Samsung Economic Research Institute (SERI) gave me his unpublished manuscripts and data.

I have benefited enormously from the comments and advice from friends: Kyung Ho Song, Hyo Je Cho, Jae Gang Lee, Moon Jong Lee, Jiman Lee, Yong Hyup Oh, Sang Yoon Ma, Il Chung Yi, Kwang Ho Chun, In Soo Chung, Yong Jin Kim, Joonho Byun, Sehyun Ahn, Jungwon Park, Jung Bien Moon, Sang Hyun Lee, Kap Soo Rim, Kwang Yong Chung, Kyung A Lee, Sang Woo Kim, and Seung Ho Kang.

In the wake of the financial crisis, I was very fortunate in being awarded Korean Government Overseas Scholarship of Ministry of Education, which enabled me to do PhD degree in the one of the most expensive cities. And I acknowledge my gratitude to the University of London Central Research Fund that covered some of my travel expenses during my fieldwork.

Finally, I could never have survived without love and support of my family. My sister and brother in law welcomed me whenever I visited the United States. Throughout my entire life, my parents have always encouraged and supported me whatever I did. Thus I would like to dedicate this thesis to them.

NOTE ON THE TEXT

1. For Korean, Japanese, Chinese and Malaysian names, the usual convention of putting surname first has been adopted with some exceptions.

2. In romanising the Korean language, I have used a new system proclaimed by the Ministry of Culture and Tourism on 4 July 2000. With respect to the name of political and business figures and the trading name of companies, I have used Korean names according to a person's own preference or as they have been published in major English-speaking journals. But in the bibliography, I have followed the Western bibliographic style for ease of reference.

2. In the thesis, most of data and statistics are drawn from IFI publications including the IMF and World Bank. Others are based on the publications of central banks and finance ministries. With regard to financial and corporate reform, the OECD, BIS and ADB have offered a good deal of data. The ILO and UNDP have also analysed the social impact of the financial crises.

3. Except where otherwise indicated, this thesis reflects information available through May 2004.

4. Unless otherwise stated, all references to dollars ($) are to US dollars.

Chapter I

Introduction

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

John Maynard Keynes [1]

Society's course will be changed only by a change in ideas. First you must reach the intellectuals, the teachers and writers, with reasoned argument. It will be their influence on society which will prevail, and the politicians will follow.

Friedrich von Hayek[2]

Clearly, globalisation of the financial market had enabled the West and their capitalists to destroy the threat to their economic and political dominance posed by the burgeoning tiger economies of East Asia. Cleverly, the West, aided by their control over the world media and the international institutions, have managed to put the blame for the economic collapse of these East Asian countries on the Government of these countries.

Mahathir Mohamad [3]

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[1] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1973[1936]), p.383.
[2] Cited from John Blundell, *Waging the War of Ideas*, second edition (London: Institute of Economic Affairs, 2003), p.50.
[3] Mohamad Mahathir, Globalisation and What It Really Means, *New Straits Times* (7 May 1999)

1. Main Question

The East Asian financial crisis of 1997-98 has provoked a number of policy and theoretical debates in international political economy (IPE). [4] By and large, the debates fall into two broad categories: the appropriateness of IMF-supported programmes and the way in which the IMF imposed the programmes on the crisis-affected countries. [5] The first issue has been extensively discussed by economists and policy makers at the international financial institutions (IFIs) and national governments. The second issue has not drawn as much attention as the first because the role of IMF intervention has been considered to be less important than the content of IMF-supported programmes. [6] However, the question of how the IMF involved in the countries is as significant as the question of whether IMF-supported programmes were good or bad for the countries. The reason is that economic policy is not free from political considerations.

Against this background, this thesis explores the politics of economic adjustment in South Korea (hereafter Korea) and Malaysia. It is widely believed that Korea and Malaysia responded to the financial crisis in a contrasting way. [7] While Korea implemented orthodox policies, Malaysia employed unorthodox measures. When it comes to macroeconomic stabilisation, Korea stuck to a pro-cyclical policy whereas Malaysia adopted a counter-cyclical policy. One of the most remarkable differences lies in foreign economic policy. Korea relaxed most restrictions on capital account transactions, moving to a free-floating regime. In contrast,

[4] According to the IMF, currency crisis can be defined as a sudden devaluation of a currency by speculative attacks or a massive reduction of foreign currency reserves in defending the value of currency. A financial crisis is a disruption of financial markets, which is often caused by actual or potential failures of financial institutions that compel the government to bail them out on a large scale. A financial crisis is occasionally accompanied by a currency crisis, but a currency crisis does not necessarily evolve into a financial crisis. See IMF, *World Economic Outlook* (May 1998), pp.74-75.
[5] In the thesis, the crisis-affected countries are referred to as Indonesia, Korea, Malaysia and Thailand.
[6] This tendency can be explained by the fact that most literature on the issues is written by mainstream (or neoclassical) economists, who base their methodologies upon mathematical models of equilibrium. For a discussion of the growing influence of economics in IPE, see Richard Higgott, Economics, Politics and (International) Political Economy: The Need for a Balanced Diet in an Era of Globalisation, *New Political Economy*, Vol.4, No.1 (1999); Geoffrey R. D. Underhill, State, Market, and Global Political Economy: Genealogy of an (Inter-?) Discipline, *International Affairs*, Vol.76, No.4 (October 2000); Philip G. Cerny, From 'Iron Triangles' to 'Golden Pentangles'? Globalizing the Policy Process, *Global Governance*, Vol.7. No.4 (October 2001)
[7] For example, see *Economist*, The Lost (Half) Decade: East Asian Economies (6 July 2002)

Malaysia imposed controls on capital outflows with the introduction of a pegged regime. With regard to structural policy, Korea pushed ahead with financial restructuring, the overhaul of corporate governance system and labour market flexibility. In Malaysia, structural adjustment was confined to the banking sector consolidation and the revision of corporate governance system.

Prime Minister Mahathir Mohamad's anti-Western rhetoric reinforces this interpretation. At the IMF-World Bank Annual Meeting in Hong Kong in September 1997, he accused George Soros of destabilising currency markets.

> [T]he currency traders have become rich, very very rich through making other people poorer... And when they are annoyed they destroy altogether, they can reduce us to basket cases... They will determine we proper or don't... Currency trading is unnecessary, unproductive and immoral. It should be stopped. It should be made illegal... If trade is to grow then currency values must be linked to the economic performance of the countries concerned. [8]

This outspoken criticism of hedge funds was starkly contrasted with President Kim Dae Jung's attitude towards George Soros. Just after the 1997 presidential election, Kim invited Soros to show his commitment to market-oriented reform. [9] In the inauguration in February 1998, he declared,

> The People's government [Kim Dae Jung government] will make an effort to induce foreign investment as well as encouraging exports. Foreign investment is the most effective way to repay foreign debts, enhance the competitiveness of domestic firms and increase transparency in our economy. [10]

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[8] Mohamad Mahathir, Address at the Annual Seminar of the World Bank (20 September 1997) For Soros's responses to his accusation, see *Far Eastern Economic Review*, Mahathir vs. Soros (2 October 1997)

[9] *Wall Street Journal*, Soros Expresses Interest in More Korean Investment (5 January 1998)

[10] Dae Jung Kim, Inauguration Speech (25 February 1998)

Based on this interpretation, Joseph Stiglitz maintains that different post-crisis economic growth among the crisis-affected countries can be explained by how much they took IMF recommendations. According to him, "Malaysia's capital controls allowed it to recover more quickly, with a shallower downturn, and with a far smaller legacy of national debt burdening future growth... Today, Malaysia stands in a far better position than those countries that took IMF advice." [11] Among the three IMF-rescued countries, Korea's better result was attributable to its selective acceptance of IMF's prescription. For example, the government played a key role in financial and corporate restructuring rather than letting market mechanisms solve problems in the sectors. Thailand's adherence to the IMF left the country behind Korea and Malaysia in terms of macroeconomic performance and progress of structural reform. In the case of Indonesia, inappropriate IMF policies worsened the financial crisis and contributed to increasing political and social turmoil.

A closer scrutiny reveals, however, that there was a considerable degree of policy convergence between Korea and Malaysia. At the initial stage of the crisis, both countries employed IMF policy recommendations in a similar way. Although Malaysia did not receive financial assistance from the IMF, Anwar Ibrahim – then Deputy Prime Minister and Finance Minister – followed pro-cyclical macroeconomic policy. In terms of structural reform, both governments committed themselves to financial restructuring and corporate reform. Even after the downfall of Anwar, there was no fundamental change although the speed of reform slowed in order to favour Mahathir's cronies.

This policy convergence has not been as much appreciated in the existing literature on the financial crisis. [12] Instead, much attention has been paid to the policy divergence especially in

[11] Joseph E. Stiglitz, *Globalization and its Discontents* (London: Allen Lane, 2002), p.125.
[12] There are some exceptions. See Donald K. Emmerson, Americanizing Asia?, *Foreign Affairs*, Vol.78, No.3 (May / June 1998); Richard Higgott and Nicola Phillips, Challenging Triumphalism and Convergence: the Limits of Global Liberalization in Asia and Latin America, *Review of International Studies,* Vol.26, No.3 (July 2000); Barry K. Gills, The Crisis of Postwar East Asian Capitalism: American Power, Democracy and the Vicissitudes of Globalization, *Review of International Studies*, Vol.26, No.3 (July 2000); Richard Robison, Looking Back on the Asian Crisis: The Question of Convergence, *Asian Journal of Social Science*, Vol.31, No.2 (2003)

foreign economic policy. The emphasis on the divergence is an obstacle to understanding the whole picture of economic adjustment by over-stating the role of capital controls.

For this reason, this thesis focuses on the policy convergence between Korea and Malaysia in the post-crisis period. The main question is what explains the policy convergence; in other words, what led Korea and Malaysia to adopt neoliberal economic policies? My argument is that economic ideas – in particular, the Washington consensus – was a determining factor that led policy makers in both countries to adopt a similar set of policy prescriptions to the crisis.

Economic ideas can have a causal effect on policy change. [13] Policy failures or paradigm shift lead policy makers to rethink the legitimacy of an economic policy. As a result, policy and theoretical debates take place in the policy-making circles including high-profile bureaucrats and economists in think tanks and academia. In these debates, the role of economic ideas is important because they provide policy-making circles with theoretical frameworks to understand the failures and plausible solutions to them.

The impacts of economic ideas are transmitted to policy-making through discursive practices and social learning. First, discursive practices play a crucial role in shaping the social meaning of economic policies. The socially-constructed meanings influence policy-making by changing public opinion. Second, social learning affect policy preferences. In analysing economic problems, policy makers draw historical lessons from the experiences of other countries and international organisations that have dealt with a similar problem.

By linking economic ideas to policy outcomes, I show how the political power of the Washington consensus had an impact on the post-crisis economic adjustment in Korea and Malaysia. As a matter of fact, the consensus effectively de-legitimised the East Asian development model by attributing the underlying causes of the crisis to domestic economic

[13] Until recently, few IPE studies put stress on the role of economic ideas in policy change in the developing world. Some exceptions are Alice H. Amsden, The Specter of Anglo-Saxonization is Haunting South Korea, in Lee-Jay Cho and Yoon Hyung Kim (eds.), *Korea's Political Economy: An Institutional Perspective* (Boulder: Westview, 1994); Kathryn Sikkink, Development Ideas in Latin America: Paradigm Shift and the Economic Commission for Latin America, in Frederick Cooper and Randall Packard (eds.), *International Development and the Social Sciences: Essays in the History and Politics of Knowledge* (Berkeley: University of California Press, 1997)

vulnerabilities in the financial and corporate sectors. In addition, the consensus provided a well-organised guideline for economic adjustment. This is why the crisis-affected countries accepted IMF style policies, whether they were under the IMF-supported programmes or not.

It should be noted that ideational approaches are complementary to – rather than conflicting with – interest-oriented and institution-oriented approaches. [14] The emphasis on economic ideas is not to deny the influence of interests and institutions in economic adjustment. Even though Korea and Malaysia were influenced by the Washington consensus, the pattern of economic adjustment was not the same. It means that the political influence of economic ideas was constrained, to a varying degree, by vested interests – big business and organised labour – and political institutions. Thus, the policy convergence (and divergence) cannot be properly understood without taking into consideration domestic politics and institutional settings.

In this thesis, I explain the impact of economic ideas on four policy areas – macroeconomic stabilisation, financial restructuring, corporate reform and labour market flexibility – which constitute the principal aspects of the post-crisis economic adjustment. First, macroeconomic stabilisation is aimed to fix immediate economic disequilibrium by using fiscal, monetary and exchange rate policy. Second, financial restructuring is designed to fix weaknesses in the financial sector by reducing non-performing loans (NPLs) and strengthening institutional frameworks for regulations and supervision. Third, corporate reform is intended to remove the underlying problems that caused the financial crisis by upgrading corporate governance system. Finally, labour reform is planned to make labour markets more flexible by changing regulations on (un) employment.

This thesis is aimed to contribute to IPE in two respects. First, there are very few structured comparisons of Korea and Malaysia although there are a large number of single

[14] Peter A. Hall, The Role of Interests, Institutions, and Ideas in the Comparative Political Economy of the Industrialized Nations, in Mark I. Lichbach and Alan S. Zuckerman (eds.), *Comparative Politics: Rationality, Culture and Structure* (Cambridge: Cambridge University Press, 1997)

case studies. [15] A common problem with the literature is that lack of uniformity in terms of period and methodology often fails to offer a balanced comparison among the countries. Another problem is that most literature focuses on a particular policy area (notably capital controls), thereby failing to evaluate economic adjustment as a whole. [16] This thesis attempts to analyse macroeconomic stabilisation and structural reform in a coherent framework.

Second, the role of economic ideas has not been properly appreciated because of the predominance of interest-oriented and institution-oriented approaches in the existing literature on the post-crisis economic adjustment. [17] This thesis fills the void by developing an ideational explanation of policy change. In doing so, it provides an alternative approach to the post-crisis economic adjustment in Korea and Malaysia.

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[15] Iyanatul Islam and Anis Chowdhury, *The Political Economy of East Asia: Post-Crisis Debates* (New York: Oxford University Press, 2000); Wing Thye Woo, Jeffrey D. Sachs, and Klaus Schwab (eds.), *The Asian Financial Crisis: Lessons for a Resilient Asia* (Cambridge: MIT Press, 2000); Greg Noble and John Ravenhill (eds.) *The Asian Financial Crisis and the Architecture of Global Finance* (Cambridge: Cambridge University Press, 2000); Richard Robinson, Mark Beeson, Kanishka Jayasuriya, and Hyuk-Rae Kim (eds.), *Politics and Markets in the Wake of the Asian Crisis* (New York: Routledge, 2000); Peter Drysdale (ed.), *Reform and Recovery in East Asia: The Role of the State and Economic Enterprise* (London: Routledge, 2000); Maria Weber (ed.), *Reforming Economic Systems in Asia: A Comparative Analysis of China, Japan, South Korea, Malaysia, and Thailand* (Cheltenham: Edward Elgar, 2001); Arvid John Lukauskas and Francisco L. Rivera-Batiz (eds.), *The Political Economy of the East Asian Crisis and its Aftermath: Tigers in Distress* (Northampton: Edward Elgar, 2001); Anis Chowdhury and Iyanatul Islam (eds.), *Beyond the Asian Crisis : Pathways to Sustainable Growth* (Northampton: Edward Elgar, 2001); Usha C. V. Haley and Richter, Frank-Jürgen (eds.), *Asian Post-Crisis Management: Corporate and Governmental Strategies for Sustainable Competitive Advantage* (Basingstoke : Palgrave, 2001); Kyung Tae Lee (ed.), *Globalization and the Asia Pacific Economy* (London: Routledge, 2002); Xiaoke Zhang, *The Changing Politics of Finance in Korea and Thailand: From Deregulation to Debacle* (London: Routledge, 2002); Geoffrey R.D. Underhill and Xiaoke Zhang (eds.), *International Financial Governance Under Stress: Global Structures versus National Imperatives* (Cambridge: Cambridge University Press, 2003)

[16] Mohd Nazari Ismail, Foreign Capital and Sovereignty: A Comparative Study of Malaysian and South Korean Experience during the Asian Financial Crisis, *Asian Business and Management*, Vol.1, No. 3 (November 2002); Mahani Zainal-Abidin, Kwanho Shin and Yunjong Wang, Macroeconomic Adjustments and the Real Economy in Korea and Malaysia Since 1997, Working Paper 03-07 (KIEP, 2003); Sangmook Lee, The Politics of the Asian Financial Crisis in Malaysia and South Korea, *Journal of the Asia Pacific Economy*, Vol. 9, No.1 (2004)

[17] Some exceptions are Kanishka Jayasuriya and Andrew Rosser, Economic Orthodoxy and the East Asian Crisis, *Third World Quarterly*, Vol.22, No 3 (2001); Massimo Florio, Economists, Privatization in Russia and the Waning of the 'Washington Consensus', *Review of International Political Economy*, Vol. 9, No.2 (Summer 2002); Yujiro Hayami, From the Washington Consensus to the Post-Washington Consensus: Retrospect and Prospect, *Asian Development Review*, Vol. 20, No. 2 (2003)

2. The Washington Consensus and Policy Convergence: Definitions

Before addressing the main question, it is necessary to define the Washington consensus and policy convergence because the two concepts are often misunderstood or confused. In the first place, John Williamson argues that the consensus should be distinguished from market fundamentalism, free market ideology or neoliberalism. According to him, neoliberalism is an ideology that the Mont Pelerin Society founded to promote the right wing version of a liberal agenda, whereas the consensus was a set of policy recommendations based on empirical research rather than ideology. For example, the consensus did not support key pillars of neoliberalism: i.e., monetarism, low tax rates and the minimal state. [18] Contrary to his complaint, a comparison of neoliberalism, orthodox policies and the Washington consensus reveals that there is no fundamental difference among them in terms of theoretical foundations.

First, neoliberalism is a set of economic ideas that were inspired by Friedrich von Hayek and Milton Friedman.

> [N]eoliberalism has been a political project concerned with institutional changes on a scale not seen since the immediate aftermath of the Second World War and a project that has attempted to transform some of the most basic political and economic settlements of the postwar era, including labor market accords, industrial relations systems, redistributive tax structures, and social welfare programs. Integral to these changes has been a shift away from Keynesian economic ideas, which emphasized the political management of aggregate demand, to a more conservative discourse based on monetarist, supplyside, and rational expectations theories. [19]

Under the political leadership of Ronald Reagan and Margaret Thatcher, the US and the UK transformed its economic structure and macroeconomic management frameworks

[18] John Williamson, From Reform Agenda to Damaged Brand Name, *Finance and Development* (September 2003), p.11.
[19] John L. Campbell and Ove Kaj Pedersen, Introduction, in John L. Campbell and Ove Kaj Pedersen, (eds.), *The Rise of Neoliberalism and Institutional Analysis* (Princeton: Princeton University Press, 2001), p.1.

following the economic ideas. The success of the countries prompted other industrial countries to undertake similar economic reform. Among others, the New Zealand case is widely regarded to be most comprehensive and consistent. [20]

Second, the literal meaning of economic orthodoxy is the predominant set of economic ideas at any particular time. In the debate over economic development, the orthodoxy means a set of market-oriented policies that are reflected in IMF and World Bank conditionality. Orthodox policies consist of "reduction in the fiscal deficit, controls on domestic credit expansion and credit extended to the public sector, and establishment of a realistic exchange rate." [21]

The heterodoxy was developed by (neo) structuralists, most of whom are sympathetic to John Maynard Keynes and Karl Polanyi. Basically, they are very critical of IMF-style stabilisation, believing that market failures are more harmful than government failures. [22] Their policy preferences are: " a higher priority to goals other than achieving external equilibrium in the short run, particularly economic growth and distributional or poverty alleviation goals; a more cautious and selective approach to the use of the market (though market mechanisms are not rejected); a questioning of the legitimacy of detailed, external policy intervention; and a refusal to take the international environment as given, arguing for greater symmetry in adjustment between North and South and for a different resolution of the debt crisis." [23]

Finally, the Washington consensus is a set of economic policy that would be good for developing countries particularly in Latin America in the late 1980s. According to John Williamson, Washington refers to the set of policies endorsed by the principal economic

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[20] Herman Schwartz, Can Orthodox Stabilization and Adjustment Work? Lessons from New Zealand, 1984-90, *International Organization*, Vol.45, No.2 (Spring 1991); Lewis Evans, Arthur Grimes, Bryce Wilkinson and David Teece, Economic Reform in New Zealand 1984-95: The Pursuit of Efficiency, *Journal of Economic Literature*, Vol.34, No.4 (December 1996)

[21] Miles Kahler, Orthodoxy and Its Alternatives: Explaining Approaches to Stabilization and Adjustment, in Joan M. Nelson (ed.), *Economic Crisis and Policy Choice: The Politics of Adjustment in the Third World* (Princeton: Princeton University Press, 1990), p.36. See also Hakim Ben Hammouda, *The Political Economy of Post-Adjustment: Towards New Theories and Strategies of Development* (Aldershot: Ashgate, 2003)

[22] Lance Taylor, Editorial: The Revival of the Liberal Creed: The IMF and the World Bank in a Globalized Economy, *World Development*, Vol.25, No.2 (February 1997)

[23] Kahler (1990), p.52.

institutions located in Washington DC: the US Treasury, the Federal Reserve Board, the IMF and the World Bank.[24] The original version of the consensus consists of ten propositions.[25]

- Fiscal discipline
- A redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education, and infrastructure
- Tax reform (to lower marginal rates and broaden the tax base)
- Interest rate liberalization
- A competitive exchange rate
- Trade liberalization
- Liberalization of inflows of foreign direct investment
- Privatization
- Deregulation (to abolish barriers to entry and exit)
- Secure property rights.

As summarised in Table 1-1, it is hard to deny that there are some considerable differences. For example, neoliberalism emphasises tax cuts whereas the Washington consensus supports a re-direction of public expenditure. However, the differences arise from different historical backgrounds, not from economic philosophy. While neoliberalism emerged from the criticisms of Keynesianism in industrial nations where well-developed social welfare system was in place, the Washington consensus and the orthodoxy evolved from the debate over structuralism in developing countries that lacked sufficient social safety nets. Despite the differences, all of them share the core principles of neoliberalism: fiscal discipline, trade

[24] It is worthwhile to note that all international economic organizations do not support the consensus. By and large, the IMF, World Bank, WTO, and OECD support the liberalisation and deregulation of finance and trade. Meanwhile, the UNDP and ILO express serious concerns about its social and environmental impacts on developing countries and workers. The difference reflects that each organisation has different mandates and provides different policy advices.

[25] John Williamson, What Washington Means by Policy Reform, in John Williamson (ed.), *Latin American Adjustment: How Much has Happened?* (Washington D.C.; Institution for International Economics, 1989)

liberalisation, financial deregulation and privatisation. This is why the Washington consensus has become a synonym for neoliberalism in the developing world.

[Table 1-1] A Comparison of Neoliberalism, the Washington consensus and Orthodoxy

	Neoliberalism	WC	Orthodoxy
Fiscal discipline	O	O	O
Trade liberalization	O	O	O
Privatisation	O	O	O
Anti-inflation	O		O
Financial liberalization	O	O	
Tax reform	O	O	
Flexible exchange regime		O	O
Property rights	O	O	
Social welfare reform	O	O	
Labour market reform	O		

In the meanwhile, the concept of convergence is one of the most controversial issues in the debate over globalisation. Its logic is that free transaction of goods and capital encourages common market rules and structure across nations. For example, many countries introduce a similar set of market-friendly policies – such as tax breaks and lax regulations on environment and labour – to attract foreign direct investment (FDI). Otherwise, multinational corporations (MNCs) would move to other countries that provide more favourable conditions. [26]

In the debate, three different concepts of convergence – economic, institutional and policy – are discussed. [27] The first is economic convergence. Economic historians look at

[26] Suzanne Berger, Introduction, in Suzanne Berger and Ronald Dore (eds.), *National Diversity and Global Capitalism* (Cornell University Press, 1996); Hugo Radice, Globalization and National Capitalisms: Theorizing Convergence and Differentiation, *Review of International Political Economy*, Vol. 7, No.4 (Winter 2000); Suzanne Berger, Globalization and Politics, *Annual Review of Political Science*, Vol.3 (2000); Paul Mosley, Globalisation, Economic Policy and Convergence, *World Economy*, Vol. 23, No. 5 (May 2000); Daniel W. Drezner, Globalization and Policy Convergence, *International Studies Review*, Vol.3, No.1 (2001)

[27] Robert Boyer, The Convergence Hypothesis Revisited: Globalization but still the Century of Nations?, in Suzanne Berger and Ronald Dore (eds.), *National Diversity and Global Capitalism* (Cornell University Press, 1996)

productivity levels and standards of living to understand the real effects of globalisation. For example, Jeffrey Williamson argued that a surge of trade and capital flows in the late 19th and the early 20th century played a part in the convergence of real wage in industrial countries.[28] Second, institutional convergence means the harmonisation of institutional settings: financial system, corporate governance, social welfare, production network etc. Political economists examine similarities and differences among different modes of capitalisms.[29] Finally, policy convergence can be defined as a tendency that increases similarities in a particular policy. A government can introduce a policy that proves to be effective in solving a particular problem in foreign countries. For example, the Thatcher government introduced US-born monetarism, thereby surrendering Keynesian.[30] Similarly, the UK administrative reform in the late 1980s was a benchmark for the Japanese government.[31]

Among them, this thesis is aimed to evaluate the effect of economic ideas on policy convergence. The reason is that it is too early to assess economic and institutional convergence because these types of convergence can be measured on a large time-scale. For example, institutional convergence can be recognised only after an economic idea is embedded in state institutions and thus consolidates institutional stability. In addition, it should be noted that the main focus of the thesis is on policy-making rather than policy implementation. Even though reform policies were introduced, some of them have not yet fully implemented.

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[28] Jeffrey G. Williamson, Globalization, Convergence, and History, *Journal of Economic History*, Vol. 56, No. 2 (June 1996)

[29] Peter A. Hall (ed.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001) For different types of institutional settings, see also Michel Albert, *Capitalism against Capitalism* (London: Whurr, 1993); Paul Hirst and Grahame Thompson, *Globalization in Question: The International Economy and the Possibilities of Governance*, second edition (Cambridge: Polity Press, 1999); Ronald Dore, *Stock Market Capitalism, Welfare Capitalism: Japan, Germany, and the Anglo-Saxon* (Oxford: Oxford University Press, 2000);

[30] Michael J. Oliver and Hugh Pemberton, Learning and Change in 20th-Century British Economic Policy, *Governance*, Vol. 17, No. 3 (July 2004)

[31] Koichi Nakano, Cross-national Transfer of Policy Ideas: Agencification in Britain and Japan, *Governance*, Vol.17, No.2 (April 2004)

3. Research Design and Case Selection

This thesis is a comparative case study. [32] There are three rationales for qualitative methodology. First, practical problems exist in applying quantitative methodology because the quality of data is quite often subject to controversy. [33] In many East Asian countries, political and social statistics are missing or absent and the measurements of some data changed many times. More seriously, there is widespread scepticism over economic and financial statistics. Each nation has its own statistical standards that had been changed during the crisis. In this regard, many analysts in the private sector have reservations over the reliability of the official data on the financial and corporate sectors. [34]

Second, the small N problem is an obstacle to applying quantitative methodology. Small-N studies are vulnerable to selection bias when they choose extreme cases. In addition, it is extremely difficult to draw a statistically-meaningful conclusion from a small number of cases in regression approaches. [35] With respect to the East Asian crisis, there are at best four or five cases. The number is not large enough to generalise the empirical findings.

Finally, the impacts of economic ideas cannot be quantified without any bias because ideas are (inter-) subjective in essence. It is always controversial to assess how much

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[32] For a general overview of methodological issues, see John S. Odell, Case Study Methods in International Political Economy, *International Studies Perspectives*, Vo.2, No.2 (May 2001); Cameron G. Thies, A Pragmatic Guide to Qualitative Historical Research in the Study of International Relations, *International Studies Perspectives*, Vol.3, No.4 (November 2002); John Gerring, What Is a Case Study and What Is It Good for?, *American Political Science Review*, Vol. 98, No. 2 (May 2004)

[33] Thorsten Beck, George Clarke, Alberto Groff, Philip Keefer and Patrick Walsh, New Tools in Comparative Political Economy: The Database of Political Institutions, *World Bank Economic Review*, Vol.15, No.1 (September 2001); Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, Governance Matters III: Governance Indicators for 1996, 1998, 2000, and 2002, *World Bank Economic Review*, Vol. 18, No. 2 (2004)

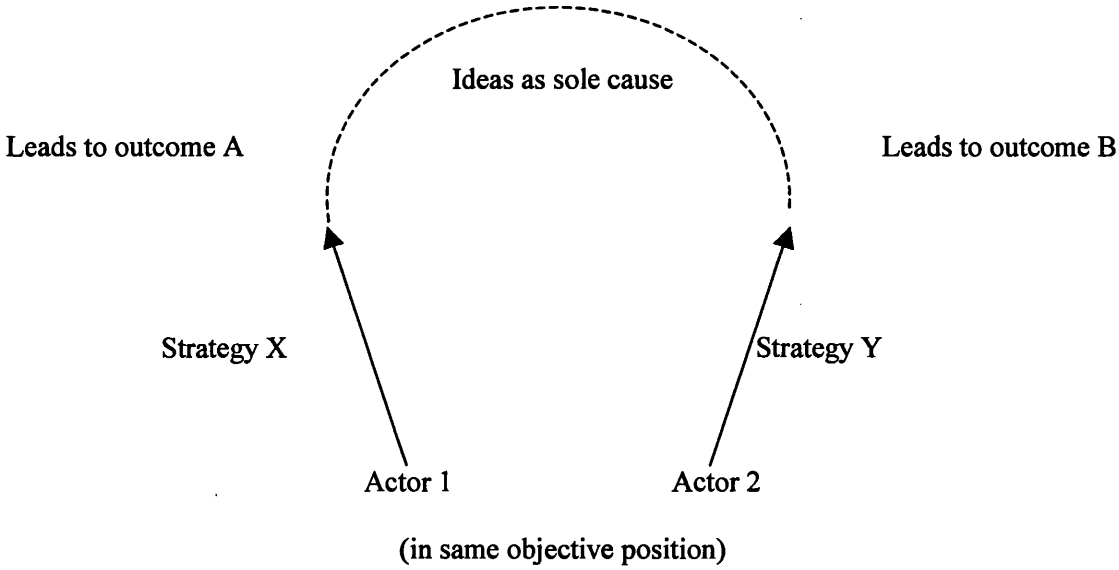
[34] One of the most controversial data is NPLs. For example, the Korean government was suspected of underestimating NPLs to hide the seriousness of financial distress. The same problem existed in Malaysia. In September 1998, the government relaxed the definition of NPLs from 3 months to 6 months, which was regarded as an attempt to save highly-indebted financial institutions from immediate bankruptcy threats. This data problem applies to all of the crisis-affected countries in East Asia.

[35] Gary King, Robert O. Keohane, and Sidney Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research* (Princeton: Princeton University Press, 1994)

economic ideas affect policy change.[36] For this reason, the political influence of economic ideas is often presented in relative – not absolute – terms.

One way to solve these methodological problems is a cross-cutting comparison. As shown in Figure 1-1, for example, Craig Parsons suggests that a comparison of two policy makers (or groups) with similar socio-political backgrounds in a similar position can isolate the effects of ideas from other effects.

[Figure 1-1] How Much Cross-Cutting Ideas Matter[37]



One problem with the cross-cutting comparison lies in the selection of cases. It is very hard to find good examples: i.e., two countries with similar socio-economic background.

[36] This does not imply that quantitative methodology is inappropriate for ideational approaches. For example, see Beth A. Simmons and Zachary Elkins, The Globalization of Liberalization: Policy Diffusion in the International Political Economy, *American Political Science Review*, Vol. 98, No.1 (February 2004)

[37] Craig Parsons, Showing Ideas as Causes: The Origins of the European Union, *International Organization*, Vol.56, No.1 (Winter 2002), p.52.

Another is that its logic is more counter-factual rather than causal because it assumes that if economic ideas were absent, the outcome would be different. [38]

For this reason, I reverse Parsons's cross-cutting approach to avoid the case selection problem. My research strategy is to highlight the political power of economic ideas by showing that two countries with different socio-economic backgrounds adopted a similar set of economic policies. In this respect, the reasoning of this approach is counter-factual. The impact of economic ideas is proved by rejecting the materialist proposition that different countries employ different economic ideas because of differences in socio-political circumstances and in the position in the world economy.

In this thesis, I compare Korea with Malaysia. The main reason for this choice is that the two countries had many differences that could have obstructed policy convergence. First of all, Korea adjusted to the financial crisis under IMF-supported programmes whereas Malaysia overcame it without IMF's intervention. The role of the IMF in economic adjustment was very crucial because it had the authority to impose conditionality on countries that received financial assistance. Korea should follow IMF's policy recommendation, but Malaysia had no legal obligation to accept them.

Second, the initial conditions of economic adjustment in Korea and Malaysia were quite different. Above all, the severity of the economic crises differed across the countries. Among them, Malaysia had favourable economic conditions – among others, relatively low exposure to short-term debt – that enabled the economy to avoid the worst scenario. And it is also important to note that Malaysia's financial regulatory and corporate government systems were more resilient than those of the others.

Finally, regime change also distinguishes Korea from Malaysia. In Korea, the Kim Young Sam administration was replaced with the Kim Dae Jung government in the wake of the financial crisis. This was the first defeat of the candidate of the ruling party in the presidential elections over the past three decades. However, Kim Dae Jung's political power was limited

[38] James D. Fearon, Counterfactuals and Hypothesis Testing in Political Science, *World Politics*, Vol.43, No.2 (January 1991); David Sylvan and Stephen Majesk, A Methodology for the Study of Historical Counterfactuals, *International Studies Quarterly*, Vol.42, No.1 (March 1998)

because his party was not a majority in the National Assembly. Although there were considerable protests against the Mahathir regime in mid-1998, the Malaysian government managed to win the 1999 general election with a comfortable margin.

As shown in Table 1-2, there are several socio-economic differences that could affect policy choice. First, there was a considerable divergence between Northeast Asian capitalism and Southeast Asian capitalism. Prior to the crisis, Korea belonged to Northeast Asian capitalism that is characterised as extensive state intervention in the markets to promote strategic exporting industries. Meanwhile, Malaysia was classified as a rich natural resources model that depends on foreign direct investment (FDI). [39] This difference is reflected in the manner of state intervention. Korea's financial and corporate structures had many similarities to those of Japan, which were under direct and heavy state control. In Malaysia, the legacy of British colonialism was embedded in the financial and corporate sectors even though the government tried to emulate Japan's industrialisation in the name of the 'Look East' policy. [40]

Second, Korea and Malaysia had a quite different government-big business relationship. In Korea, the relationship was confrontational. Although benefiting from industrial policy during the 1970-80s, the chaebol were critical of government policy from the 1990s when various measures were introduced to curb their monolithic power. In Malaysia, the relationship was cooperative because most large conglomerates – especially large bumiputera companies – were under the sponsorship of top political leaders.

Third, Korea had a more democratic decision making process than Malaysia. Since the late 1980s, Korea's pilot agencies were gradually deconstructed with the fall of military authoritarian regimes. At the same time, the influence of civil society substantially increased in some policy area such as labour, social welfare and environment. In contrast, Malaysia's

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[39] Dwight H. Perkins, There are At Least Three Model of East Asia Development, *World Development*, Vol.22, No.4 (April 1994) For discussions about the differences between Southeast Asian and Northeast Asian economies, see Anne Booth, Initial Conditions and Miraculous Growth: Why is South East Asia Different from Taiwan and South Korea?, *World Development*, Vol.27, No.2 (February 1999); Donghyun Park, The Dichotomy between Northeast Asian Capitalism and Southeast Asian Capitalism, *Journal of the Asia Pacific Economy*, Vol. 5, No.3 (2000)

[40] Meredith Woo-Cumings, *Economic Crisis and Corporate Reform in East Asia* (New York: Council on Foreign Relations, 2000)

politics was dominated by the UMNO. Although there were many factions in the ruling party, Mahathir's authority was rarely challenged during his reign.

Fourth, Korea and Malaysia had different social problems. In Korea, politically significant confrontation between two regions (Kyongsang and Cholla Province) had a great impact on domestic politics. In the presidential and general elections, Kyongsang Province supported conservative parties whereas Cholla Province liberal parties (especially led by Kim Dae Jung). Although Korea is a multi-religious country (Buddhism, Protestantism, Catholic and Confucianism), there was no serious conflict between them. In Malaysia, political parties divided by ethnic and religion. Three major ethnics – Malays, Chinese and Indian –have its own political parties. Malays are divided into two groups: moderate Islamic UMNO and radical Islamic PAS. Among them, Malays dominate domestic politics and its religion – Islam – influence economic and social policy. [41]

Finally, organised labour in Korea was strong enough to engage actively in social policy by calling nation-wide general strikes. The role of non-governmental organisations (NGOs) was also very active. In contrast, Malaysia's trade unions were weak and their political power was very limited. And a large number of foreign workers in the manufacturing and construction industries were not fully protected. [42]

[Table 1-2] A Brief Comparison of Korea and Malaysia

	Korea	Malaysia
Type of Capitalism	Northeast Asian (ex-Japanese colony)	Southeast Asian (ex-British colony)
State intervention	Strong	Moderate
Government-big business relations	Confrontational	Cooperative
Political regime	Democracy (presidency)	Semi-democracy (parliament)
Party system	Multi-party	One hegemonic party with minor ones
Labour movement	Strong	Weak
Social problems	Regional rivalry	Ethnic-religious tensions

41 Jungug Choi, Ethnic and Regional Politics after the Asian Economic Crisis: A Comparison of Malaysia and South Korea, *Democratization*, Vol.10, No.3 (Spring 2003)
42 Sarosh Kuruvilla and Christopher L. Erickson, Change and Transformation in Asian Industrial Relations, *Industrial Relations*, Vol. 41, No. 2 (April 2002)

4. Outline of the Thesis

This thesis is organised into two parts. Part I explores with theoretical and historical backgrounds. Chapter II review competing explanations of the post-crisis economic adjustment. In the first place, I review the existing literature on the politics of economic adjustment that provides theoretical foundations to the explanations. To this end, three competing approaches explanations are examined: interest-oriented, institution-oriented and ideas-oriented. Among them, ideational approaches – institutionalist, Neo-Gramscian and constructivist – are analysed in depth to show how economic ideas affect policy change. By synthesising the ideational approaches, I develop an alternative explanation of policy change. To test the framework empirically, I suggest four working hypotheses.

Chapter III discusses why and how the Washington consensus affected policy change in a historical perspective. First, I trace the development of the Washington consensus in a broader perspective. In particular, I emphasise that the spread of the consensus from the developed world to developing and transition economies was accomplished by not only IFIs' conditionality but also discursive practices and social learning. In the wake of the crisis, the Washington consensus was criticised for ill-sequenced capital account liberalisation and its neglect of social dimensions of economic policy. Against this background, I summarise the emergence of the post-Washington consensus as an alternative to the Washington consensus.

Part II is devoted to case studies. Chapter IV, V, VI and VII compare how the political power of the Washington consensus affected four policy areas respectively: macroeconomic stabilisation, financial restructuring, corporate reform and labour market reform. In reality, the four policies were intertwined and mutually affected each other. In particular, progress of structural reform was influenced by the speed of macroeconomic stabilisation. Despite this, I examine them separately for analytical reasons.

These empirical chapters show how different economic ideas affect policy-making by examining theoretical and policy debates in the countries and the IFIs. To test the hypotheses, the role of the IFIs, policy makers and big business in the debates was closely examined. In addition, the chapters look at how the political power of the Washington consensus was affected by political institutions.

In Chapter VIII, I summarise the major findings. First, I account for the policy convergence between Korea and Malaysia. Then I discuss the four hypotheses to appreciate the impact of the Washington consensus on the policy convergence. Finally, I explain the policy divergence between the two countries by examining each country's socio-political settings.

Part I

Theoretical and Historical Backgrounds

Chapter II

The Politics of Economic Adjustment: An Analytical Framework

1. Introduction

This chapter presents an analytical framework to examine the policy convergence (and divergence) between Korea and Malaysia with respect to policy responses to the East Asian financial crisis. The existing literature on the politics of economic adjustment in the crisis-affected countries falls into three categories: interest-oriented, institution-oriented and idea-oriented. Among them, I choose ideational approaches to explain the policy convergence between Korea and Malaysia. The reason is that interest-oriented approaches fail to capture the convergence and institutional approaches pay little attention to it.

In international political economy (IPE), there are three types of ideational approaches: institutionalist, neo-Gramscian and constructivist. Although there are methodological differences, the three approaches agree to the assumptions: (1) economic ideas can be an independent variable in a situation where there is no clear solution to a new problem or policy failures; (2) economic ideas are diffused by discursive practices and social learning; and (3) economic ideas can have an impact on policy change by redefining interests and changing institutional settings.

Four working hypotheses are drawn to put the political power of economic ideas to the empirical test. The dependent variable is the political power of economic ideas and the independent variables are support from external agencies, support from big business, support from top policy makers – particularly finance minister and central banker, and regime type – i.e., democratic or authoritarian.

This chapter starts with an overview of recent literature on the politics of economic adjustment in the post-crisis East Asia. Then it examines three ideational approaches with respect to its implication for economic policy-making and institutional change. By synthesising these ideational approaches, an ideational explanation of policy change is presented. Finally, I suggest four working hypotheses for empirical test.

2. Competing Approaches to Economic Adjustment in the Post-Crisis East Asia

1) Interest-oriented Approaches

Since the 1980s when debt crises engulfed Latin American and East Asian economies, there has been a robust literature on the politics of economic adjustment in the developing world. [43] Implicitly or explicitly, most economic analyses are based on interest-based explanations. They can be divided into two categories in terms of level of analysis; domestic social groups and transnational social forces.

First, interest-based approaches focus on the role of domestic social groups. The basic logic is that domestic social groups respond to economic adjustment by considering how they gain or suffer from it in both absolute and relative terms; political conflicts arise from the fact that the benefits or costs are not evenly distributed both across the social groups and over times. [44] This uneven distribution generates collective action problems, because social groups who were privileged or subsidised by the exiting system do not want to cooperate to achieve economic reform.

[43] For an overview of the literature before the Asian crisis, see Stephan Haggard, Interests, Institutions and Policy Reform, in Anne O. Krueger, *Economic Policy Reform: The Second Stage* (Chicago: University of Chicago Press, 2000)

[44] Jeffrey A. Frieden, Invested Interests: The Politics of National Economic Policies in a World of Global Finance, *International Organization*, Vol.45, No.4 (Autumn 1991). See also Jonathan Crystal, What Do Producers Want? On the Origins of Societal Policy Preferences, *European Journal of International Relations*, Vol.9, No.3 (2003)

> [T]he typical organization for collective action within a society will, at least if it represents only a narrow segment of the society, have little or no incentive to make any significant sacrifices in the interest of the society; it can best serve its members' interests by striving to seize a larger share of society's production for them... The organizations for collective action within societies that we are considering [for example, labour unions], are therefore overwhelmingly oriented to struggles over the distribution of income and wealth rather than the production of additional output – they are "distributional coalitions." [45]

In addition, time-inconsistency between economic adjustment and its consequences creates political conflicts. The so-called J-curve theory explains the problem. In the short term, economic reform is likely to cause transitional costs such as high unemployment, price inflation and the decline of output growth before the promised benefits of economic reform start to materialise. [46] This is why "Good economics does often turn out to be good politics, but only eventually. Policies that work do become popular, but the time lag can be long enough for the relationship not to be exploitable by would-be reformers." [47]

These problems become serious when losers of reform are politically powerful groups (i.e., urban industrialists and organised labour) while gainers (i.e., agricultural workers and small industrialists) are disenfranchised and powerless. In such situation, economic adjustment could be constrained by political and social oppositions at least in the short-term. [48] Thus the success of economic reform depends, in large part, on how domestic social groups' resistance is managed.

When it comes to the Asian crisis, most literature highlighting the role of big business and organised labour are based on interest-oriented approaches. In both countries, vested interests

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[45] Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven: Yale University Press, 1982), p.44.
[46] Joel S. Hellman, Winners Take All: The Politics of Partial Reform in Postcommunist Transitions, *World Politics*, Vol.20, No.2 (January 1998)
[47] Dani Rodrik, Understanding Economic Policy Reform, *Journal of Economic Literature*, Vol.XXXIV, No.1 (March 1996), p.10.
[48] For example, see Hector E. Schamis, Distributional Coalitions and the Politics of Economic Reform in Latin America, *World Politics*, Vol.51, No.2 (January 1999) See also Dani Rodrik, Trade and Industrial Policy Reform, in Jere Behrman and T.N. Srinivasan (eds.), *Handbook of Development Economics*, Vol.III (Amsterdam: Elsevier, 1995)

played a role in economic adjustment. Initially, big business in Korea and Malaysia sought to delay or sidestep corporate governance reform. And trade unions in Korea fiercely resisted the legalisation of redundancy. [49] Despite the opposition, both big business and organised labour reluctantly accepted the Washington consensus during the crisis. For example, big business tried to upgrade corporate governance and trade unions approved massive redundancy. Interest-oriented approaches do not provide a reasonable answer to the question of why they embraced neoliberalism that neither represents nor serves their interests.

The other type of interest-oriented approaches put stress on the role of external pressure from the international financial institutions, trans-national corporations and major industrial countries (especially the US). Its intellectual origin can be traced back to Marxist dependency theories that prevailed in the 1970s in the developing world. [50] Nowadays, however, there is a wide ideological variation from neoclassical economists (Joseph Stiglitz) to developmental state theorists (Robert Wade). The common theme of the explanations is that trans-national capitalists forced the crisis-affected countries to follow the Washington consensus through the international financial institutions (IFIs) to secure their interests in the crisis-affected countries.

The IFIs have various channels to constrain economic policy in developing countries. [51] First, international organisations such as the IMF, the World Bank and the World Trade Organisation have enormous impacts on financial and trade policy. Second, internationally-operated banks and credit rating agencies informally affect financial policy by their impact on

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[49] For a review of crony capitalism, see Linda Y.C. Lim and Aaron Stern, State Power and Private Profit: The Political Economy of Corruption in Southeast Asia, *Asian Pacific Economic Literature*, Vol.16, No.2 (2002) In the case of Korea and Malaysia, see Stephan Haggard, Wonhyuk Lim, Euysung Kim (eds.), *Economic Crisis and Corporate Restructuring in Korea: Reforming the Chaebol* (Cambridge: Cambridge University Press, 2003); Kwame Sundaram Jomo (ed.), *Malaysian Eclipse: Economic Crisis and Recovery* (London: Zed Books, 2001)

[50] Robert Wade, Wheels Within Wheels: Rethinking the Asian Crisis and the Asian Model, *Annual Review of Political Science*, Vol.3 (2000)

[51] Barbara Stallings, International Influence on Economic Policy: Debt, Stabilization, and Structural Reform; Miles Kahler, External Influence, Conditionality, and the Politics of Adjustment, in Stephan Haggard and Robert R. Kaufman (eds.), *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts, and the State* (Princeton: Princeton University Press, 1992)

capital flows and credit ratings on sovereign bonds. [52] Their policy preferences reflect the political and economic interests of creditor countries as well as the IFIs. [53]

In this regard, the 'Wall Street-US Treasury-IMF complex' is a key determinant in explaining patterns of economic recovery across the crisis-affected countries. [54] According to this view, the main objective of IMF-supported programmes was given to protect the interests of the IFIs and creditor countries rather than to assist the crisis-affected countries.

This structural explanation exaggerates the overriding role of the IMF in macroeconomic policy choice. Thus it does not explain why Malaysia introduced many IMF policy recommendations. The government did not have any obligation because it was not under the IMF-supported programmes. Despite this, Anwar implemented an IMF-style polices. Even after his downfall, little change had been made in the frameworks of structural reform. Like the other three countries, Malaysia consolidated the banking sector and upgraded its corporate governance system. It is equally important to note that there is considerable divergence across the three IMF-rescued countries even though the IMF imposed a similar set of policy measures. In terms of financial and corporate reform, for example, Korea's interventionist approach was contrasted with Thailand's market-oriented approach. Structural reform in Malaysia was initiated by the government. In this respect, Korea's structural reform was more similar to Malaysia's than Thailand's. [55]

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[52] Richard Cantor and Frank Packer, Determinants and Impact of Sovereign Credit Ratings, *Economic Policy Review,* Vol.2, No.2 (1996); Robert Brooks, Robert W. Faff, David Hillier and Joseph Hillier, The National Market Impact of Sovereign Rating Changes, *Journal of Banking and Finance*, Vol.28, No.1 (January 2004)

[53] Strom Cronan Thacker, The High Politics of IMF Lending, *World Politics*, Vol.52, No.1 (October 1999); Erica R. Gould, Money Talks: Supplementary Financiers and International Monetary Fund Conditionality, *International Organization*, Vol.57, No.3 (Summer 2003)

[54] Robert Wade and Frank Veneroso, The Asian Crisis: The High Debt Model VS. the Wall Street-Treasury-IMF Complex, *New Left Review*, No.228 (March-April, 1998); Jagdish Bhagwati, The Capital Myth: The Difference between Trade in Widgets and Dollars, *Foreign Affairs*, Vol.77, No.3 (May/June 1998)

[55] Masahiro Kawai, Ira Lieberman and William P. Mako, Financial Stabilization and Initial Restructuring of East Asian Corporations: Approaches, Results, and Lessons, in Charles Adams, Robert E. Litan, and Michael Pomerleano (eds.), *Managing Financial and Corporate Distress: Lessons from Asia* (Washington D.C.: Brookings Institution, 2000); Stijn Claessens, Daniela Klingebiel and Luc Laeven, Financial Restructuring in Banking and Corporate Sector Crises: What Policies to Pursue?, in Michael Dooley and Jeffrey Frankel (eds.), *Managing Currency Crises in Emerging Markets* (Chicago: University of Chicago Press, 2003)

2) Institution-oriented Approaches

The lingering influence of developmental state theory draws attention to the role of political institutions – particularly regime type and state capacity. [56] First, there was a debate on how regime type – democratic or authoritarian – affected economic reform. In the 1980s, the successful economic adjustment in the East Asian newly-industrialised countries seemed to support the hypothesis that authoritarian regimes have an advantage in resolving collective action problems; in other words, authoritarian regimes are likely to implement politically unpopular polices more easily than democratic ones because their weak legislatures make interest groups less influential in shaping economic policy. However, there is no conclusive evidence to support it. [57]

Second, proponents of developmental state theories argued that strong states could reduce distributional conflict by harmonising the interests of individual capitalists and the objectives of national economic development. The minimum requirements of developmental state are the relative autonomy of bureaucracy from special interest groups and high level of state capacity, which is defined as "a combination of internal coherence and external connectedness that can be called embedded autonomy." [58]

Finally, transactions costs analyses underline the institutional environments of economic reform. Their basic assumption is that well-functioning institutions such as property rights and the rules of law reduce transactional costs that tend to increase during economic crisis. "[I]f

[56] For an overview of institutional approach in general, see John L. Campbell and Ove Kaj Pedersen (eds.), *The Rise of Neoliberalism and Institutional Analysis* (Princeton: Princeton University Press, 2001). See also Peter A. Hall and Rosemary Taylor, Political Science and the Three New Institutionalisms, *Political Studies*, Vol. 44, No.5 (December 1996); Lisa Martin and Beth Simmons, Theories and Empirical Studies of International Institutions, *International Organization*, Vol.54, No.4 (Autumn 1998)

[57] Stephan Haggard and Robert R. Kaufman (eds.), *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts, and the State* (Princeton: Princeton University Press, 1992); Stephan Haggard, Jean-Dominique Lafay and Christian Morrisson, *Political Feasibility of Adjustment* (OECD, 1995); Stephan Haggard and Robert R. Kaufman, *The Political Economy of Democratic Transitions* (Princeton: Princeton University Press, 1995)

[58] Peter B. Evans, The State as Problem and Solution: Predation, Embedded Autonomy, and Structural Change, in Haggard and Kaufman (1992), p.178. See also Stephan Haggard and Chung-In Moon, Institutions and Economic Policy: Theory and a Korean Case Study, *World Politics*, Vol.42, No.2 (January 1990); Richard F. Doner, Limits of State Strength: Toward an Institutionalist View of Economic Development, *World Politics*, Vol. 44, No. 3. (April 1992)

market reforms are carried out within a polity where accountability institutions are weak (or even deliberately emasculated to accelerate policy implementation), corruption, collusion, and patronage will ensue and promote disastrous economic crises in the medium term." [59] However, the effects of corruption are ambivalent. As David Kang shows, transaction costs can be reduced even country with weak institutions, "if there is a balance of power among a small and stable set of government and business elites."[60]

With respect to the Asian crisis, there are three kinds of institutional explanations. First, Haggard put forward an institutional explanation on the politics of economic reform. In his account, political uncertainties were a key concept to explain the variations of economic reform in the crisis-affected countries. The sources of the uncertainties include electoral cycles, opposition parties, decision-making process and government-business relations.

Among them, the most important factor is the decision making process. His argument is that democracies – Korea and Thailand – were relatively successful in implementing economic reform without undermining political stability, while pseudo-democracies (or soft authoritarian regimes) – Malaysia and Indonesia – experienced political turmoil in carrying out economic adjustments policies. [61] The reason is that "democracy benefits from popular support, which itself stabilizes expectations, provides the basis for monitoring government and private-sector malfeasance, even if imperfectly, and has a crucial self-corrective mechanism, in the form elections, through which failing governments can be changed. " [62] In Malaysia and Indonesia, autocratic leaders did not surrender cronyism and nepotism, which resulted in further deterioration. By contrast, Korea and Thailand elected new leaders who committed themselves to economic reform.

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[59] Luigi Manzetti, Political Manipulations and Market Reforms Failures, *World Politics*, Vol. 55, No.3 (April 2003)

[60] David C. Kang, *Crony Capitalism: Corruption and Development in South Korea and the Philippines* (Cambridge: Cambridge University Press, 2002), p.3.

[61] Gordon Paul Means, Soft Authoritarianism in Malaysia ad Singapore, *Journal of Democracy*, Vol.7, No.4 (1996); William Case, Malaysia's Resilient Pseudodemocracy, *Journal of Democracy*, Vol.12, No.1 (2001)

[62] Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington D.C.: Institute for International Economics, 2000), p.222.

This explanation accounts well for the relations between regime change and economic reform. However, it has difficulties in explaining the variations across cases. There is little evidence that authoritarian regimes managed the crisis better than democratic ones, and vice versa. [63] In Korea, democratisation helped the Kim Dae Jung government to overcome resistance from big businesses and labour unions. Meanwhile, Mahathir's authoritarianism made it easy for the government to introduce unorthodox policies without significant political side effects.

Second, MacIntyre suggests another formal institutional approach. His argument is that national political architecture – shaped by the interaction of the complex of the rules that make up the constitutional structure and party system – was a key determinant in explaining the differences in crisis management across the four Southeast Asian countries: Thailand, Malaysia, Indonesia and the Philippines.

His approach begins with veto player analysis. A veto player is defined as an individual or collective actor that has the institutionalised power to defeat a proposed law by withholding formal approval. "Veto players are specified in a country by the constitution (the president, the House, and the Senate in the United States) or by the political system (the different parties that are members of a government coalition in Western Europe)." [64] The analysis assumes that the more veto players in a decision-making process, the more decision-making authority is dispersed. Based on the assumption, he proposes a power concentration paradox: "A national political architecture that either severely centralises or severely fragments decision making is likely to produce seriously problematic patterns of governance." [65]

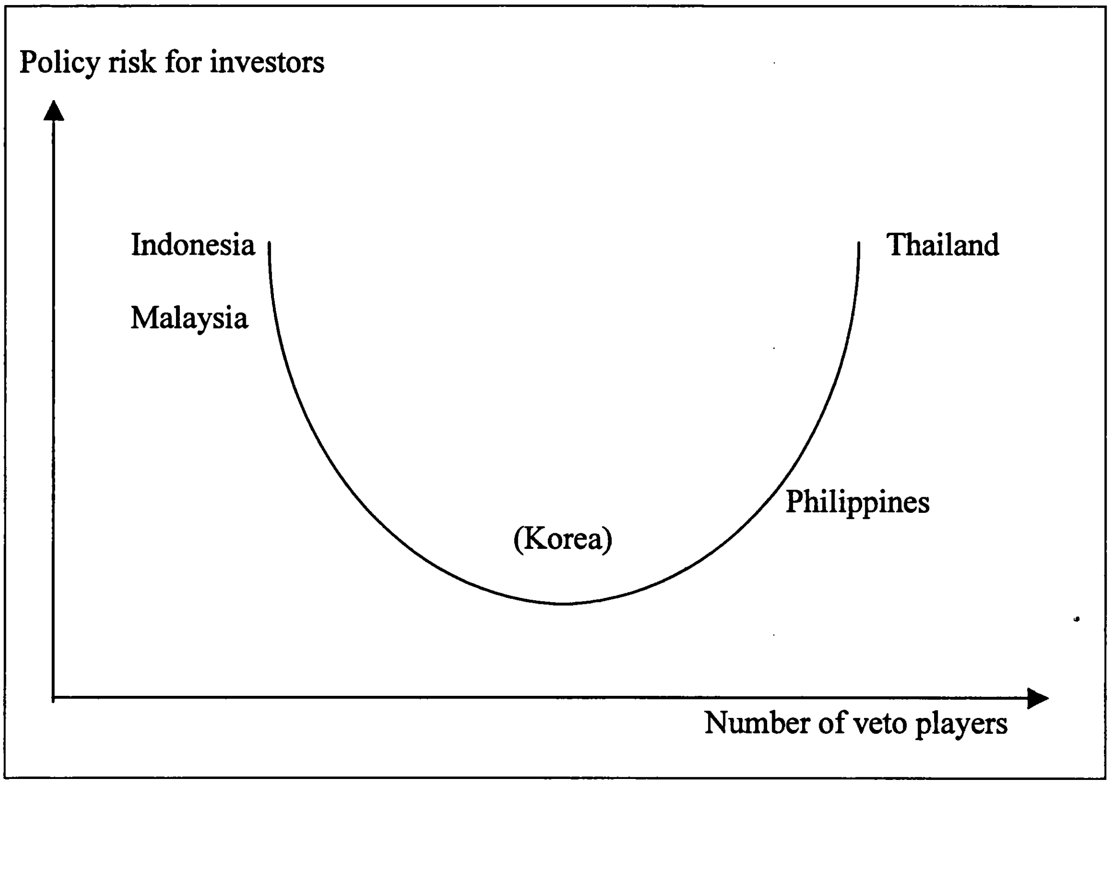
Following the concept, he classifies the crisis-affected countries into three groups. Seen in Figure 2-1, Indonesia and Malaysia had one veto player while Thailand and the Philippines

[63] For a comprehensive discussion, see Valerie Bunce, Democratization and Economic Reform, *Annual Review of Political Science*, Vol.4 (2001). Except the case of post-socialist economic reform, the relationship is statistically insignificant in East Asia and Latin America.
[64] George Tsebelis, *Veto Players* (Princeton: Princeton University Press, 2002), p.2.
[65] Andrew MacIntyre, *The Power of Institutions: Political Architecture and Governance* (Ithaca: Cornell University Press, 2003), p.11

had multiple veto players. Although he does not deal with the Korean case, the country was not either of the two extremes. [66]

This explanation is successful in explaining why Indonesia and Malaysia's policy responses were more politically volatile than the others'. However, its explanatory power is confined to the extent of political risks at national level because it does not look at how policy preference was formed in each policy areas. In other words, it cannot explain why a specific policy was introduced and how it was implemented. As MacIntyre admits, "institutions, by themselves, do not cause these policy outcomes...It is the interests and the ideas that lie behind them that animate politics." [67]

[Figure 2-1] Veto Player and Policy Risk [68]



[66] *Ibid*, p.102.
[67] *Ibid*, p.101.
[68] Andrew MacIntyre, The Politics of the Economic Crisis in Southeast Asia, *International Organization*, Vol.55, No.1 (Winter 2001), p.94. Because he does not look at the Korean case, the original diagram does not include Korea.

Finally, for proponents of developmental state theory, the transformative capacity of the state is a key variable in explain policy choice and outcomes. [69] For this reason, many developmental state theorists attribute the financial crisis to the weakening of state power after financial liberalisation. It was financial liberalisation that substantially reduced the ability to "adapt to external shocks and pressures by generating ever-new means of governing the process of industrial change." [70]

Natasha Hamilton-Hart extends this concept to crisis management. According to her, governing capacity is defined as the government's ability to implement its declared policy in a constant and rule-abiding way. In the financial sector, for example, governing capacity can be measured by how much governments "control and influence financial resources through an active financial policy, state-owned bank, compulsory saving schemes, or compulsory purchases of public debts." [71]

Based on the definition, Hamilton-Hart divide East Asian countries into two groups.

> [T]he national strategies of the high- or moderately high-capacity states of Taiwan, Singapore, Hong Kong, Malaysia and Korea show the variety of policy responses that were viable in the post-crisis environment. They were compelled to react the crisis, but the way each did so reflected primarily national priorities. In contrast, the lower-capacity states of Thailand, Indonesia, and Philippines were more constrained in their policy choices. [72]

This classification is useful in explaining why Indonesia failed to introduce capital control policy while Malaysia successfully implemented. According to her, the Malaysian

[69] Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Stanford: Stanford University Press, 1982); Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (Oxford University Press, 1989); Robert Wade, *Governing the Market: Economic Theory and Role of Government in East Asian Industrialization* (Princeton University Press, 1990); Meredith Woo-Cummings (ed.), *The Developmental State* (Ithaca: Cornell University Press, 1999)
[70] Linda Weiss, State Power and the Asian Crisis, *New Political Economy*, Vol.4, No.3 (1999), p.4. See also Linda Weiss, *The Myth of the Powerless State: Governing the Economy in a Global Era* (Cambridge: Polity Press, 1998)
[71] Natasha Hamilton-Hart, *Asian States, Asian Bankers: Central Banking in Southeast Asia* (Ithaca: Cornell University Press, 2002), p.8.
[72] *Ibid*, pp.155-56.

government had intensive capital-account monitoring regimes in place well before the crisis. In contrast, the Indonesian government had few systems to oversee financial liberalisation. Further, Indonesia's insufficient administrative power explains, to some extent, why Indonesia lagged behind Malaysia in terms of financial / corporate reform.

However, Hamilton-Hart's explanation does not fit into the Korean case. The government had power enough to enforce the top five chaebols to accept its business swap plan (the so-called Big Deal) even though its state capacity was substantially constrained by the IMF. [73] Furthermore, her explanation has difficulties in understanding why Malaysia implemented structural reform. According to her assessment, the Malaysia government should reject neoliberal reform policies. With the exception of capital controls, however, the government followed most elements of IMF-supported programmes. In these respects, the state capacity thesis is not successful in explaining the policy convergence and divergence across the countries.

3) Ideas-oriented Approaches

Interest-oriented and institution-oriented approaches do not provide a convincing explanation of the 'policy' convergence between Korea and Malaysia. For this reason, I turn to ideas-oriented approaches. Until recently, ideational factors have not been seriously considered in the field of mainstream IPE scholars who based their methodologies on rationalist institutionalism. [74] Although rational choice theories and institutional approaches do not completely ignore the role and influence of ideas, ideas are treated, at best, as a mediating or intervening variable. As a result, "an interest in ideas never vanished, but was

[73] It can be said that, compared with Taiwan, Korea's governing capacity shrunk rapidly after the dissolution of the Economic Planning Board in 1994. See Linda Weiss, Developmental States in Transition: Adapting, Dismantling, Innovating, not 'Normalizing', *Pacific Review,* Vol. 13, No. 1 (2000); Elizabeth Thurbon, Two Paths to Financial Liberalization: South Korea and Taiwan, *Pacific Review*, Vol. 14, No. 2 (2001); Hisahiro Kondoh, Policy Networks in South Korea and Taiwan during the Democratic Era, *Pacific Review,* Vol. 15, No.2 (2002); Xiaoke Zhang, Domestic Institutions, Liberalization Patterns, and Uneven Crises in Korea and Taiwan, *Pacific Review*, Vol.15, No.3 (2002)
[74] For the theory, see Robert O. Keohane and Helen V. Milner (eds.), *Internationalization and Domestic Politics* (Cambridge; Cambridge University Press, 1996)

simply sidelined into the bailiwicks of 'reflectivists', neo-Marxists, and other marginal figures in the discipline." [75]

The re-emergence of interest in ideas coincided with a systemic change in the 1990s. Many scholars raised questions over the explanatory power of rationalist approaches in analysing the end of the Cold War. [76] In addition, some IPE scholars raised questions over rationalist and institutionalist approaches because some issues – such as US strategic trade policy – were not explained by rationalist institutionalism. [77]

The literature can be divided into three approaches: institutionalist, neo-Gramscian and constructivist. This classification is distinguished by their methodological foundations and the importance each attaches to ideas relative to interests and institutions. On the one hand, institutionalists – rational and historical – take ideas into consideration to analyse anomalies that are not explained by interest-based or institution-based theories. For institutionalists, ideas are considered, at best, as a mediating or intervening variable that can complement their explanatory power. On the other hand, constructivists regard ideas as an independent variable. Ideas are an endogenous factor that is embedded in languages or discourses. They try to transcend the positivist or empiricist concept of material- ideational divide to emphasise the role of ideational factors. Between them, neo-Gramscians exist. While rejecting the traditional Marxist notion of.base-superstructure, they do not exclude the importance of non-ideological elements in Marxist class analysis.

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[75] John Kurt Jacobsen, Much Ado about Ideas: The Cognitive Factor in Economic Policy, *World Politics*, Vol. 47, No. 2. (January 1995), p.284

[76] For example, see Jeff Checkel, Ideas, Institutions, and the Gorbachev Foreign Policy Revolution, *World Politics*, Vol.45, No.2 (January 1993); Thomas Risse-Kappen, Ideas do not Float Freely: Transnational Coalitions, Domestic Structures, and the End of the Cold War, *International Organization*, Vol.48, No.2 (Spring 1994); Mark Kramer, Ideology and the Cold War, *Review of International Studies*, Vol.25, No.4 (October 1999); Margarita H. Petrova, The End of the Cold War: A Battle or Bridging Ground Between Rationalist and Ideational Approaches in International Relations?, *European Journal of International Relations*, Vol. 9, No.1 (2003)

[77] For example, see Judith Goldstein, Ideas, Institutions, and American Trade Policy, *International Organization*, Vol.42, No.1 (Winter 1988); Judith Goldstein, The Impact of Ideas on Trade Policy: The Origins of U.S. Agricultural and Manufacturing Policies, *International Organization*, Vol.43, No.1 (Winter 1989)

(1) Institutionalist Approaches

Institutionalist approaches take into consideration the role and influence of ideas only when some phenomena are not satisfactorily explained by interest- and institution-based models. There are two kinds of institutionalist approaches: rational and historical. Although their methodological foundations are different, both treat ideas as an exogenous factor.

Rational institutionalist approach has an assumption that social phenomenon are explained by individual actor's interests. Because actors' preferences and causal belief are given and logically prior to any belief, the role of ideas is limited. It is thus no surprise that many rationalists regard ideas as hooks: that is, ideas are merely a tool to legitimise the interests of certain group.

Judith Goldstein and Robert Keohane relax some of the rationalist premise to incorporate the role of ideas into their analytical framework. However, their recognition of ideas does not mean that ideas play a central role, because their underlying motivation is to defend the rationalist perspective from reflectivist or constructivist attack on their theoretical foundations. Their strategy is to employ null hypotheses to reveal the reflectivist's inability to provide empirical evidence.

Ideas are considered only when interest-based explanations encounter empirical anomalies. In other words, "from a game-theoretical perspective, ideas may be important precisely because unique predictions cannot be generated solely through an examination of interests and strategic interactions (utility functions and payoff matrices). Because almost all games with repeated play have multiple equilibria, the ideas held by players are often the key to a game's outcome." [78] Accordingly their focus is on the effects of particular belief shared by large number of people on human action, not on the sources of the belief. In the perspective, ideas are regarded at best as intervening or meditating variables.

[78] Judith Goldstein and Robert O. Keohane (eds.), *Ideas and Foreign Policy: Belief, Institutions and Political Change* (Ithaca: Cornell University Press, 1993), p.17.

Goldstein and Keohane divide ideas into three categories. First, worldviews are an idea that defines the universe of possibilities for action. Embedded in the symbolism of a culture, worldviews deeply affect modes of thought and discourse. Second, principled beliefs are normative ideas that specify criteria for distinguishing right from wrong and just from unjust. Finally, causal beliefs are beliefs about cause-effect relationships that derive authority from the shared consensus of recognized elites. These beliefs provide guides for individuals on how to achieve their objectives.

Then they provide a causal explanation of how and under what condition ideas function in policy-making. "[I]deas influence policy when the principled or causal beliefs they embody provide road maps that increase actors' clarity about goals or ends-means relationships, when they affect outcomes of strategic situations in which there is no unique equilibrium, and when they become embedded in political institutions." [79]

The contribution of rational institutionalism to ideational research programmes is very limited, although Goldstein and Keohane's works played a crucial role in reviving the interest in ideas and thus provide a useful reference for debates. Its limitation lies in the fact that rational institutionalism is not a theory of ideas but a theory of interests and institutions. As Peter Hall points out, their approaches "privilege interests and incorporate ideas into their analyses only in relatively restricted roles, allows for a clear causal analysis but tends to miss many of the respects in which ideas many influence economic behavior." [80]

Unlike rational institutionalism, historical institutionalism starts from the assumption that the perceived interests of political groups are neither fixed nor given by a set of socio-economic conditions because they are influenced, to some degree, by how they interpret their interests in a historical setting. In this regard, "politics is not only a contest for power. It is also a struggle for the interpretation of interests." [81] Furthermore, Hall acknowledges both normative and positive power of ideas. "Ideas are central to politics in two ways. From the competing moral visions put forward by contenders for political power, a sense of collective

[79] *Ibid*, p.3.
[80] Hall (1997), p.185.
[81] *Ibid*, p.197.

purpose is forged; and out of the policy proposals generated by intellectuals and officials alike, solutions to common problems are devised."[82]

His analyses on the spread of Keynesianism across industrial nations illustrates that ideas could be an independent variable when they provide a policy paradigm to politicians. The most important factor is not the logic of the paradigm but their function as a catalyst to resolve institutional stalemates. According to him, the power of ideas as policy paradigm depends on economic viability, political viability and administrative viability. In a similar vein, James Walsh argues that ideas are most likely to be implemented if they do not attract high levels of opposition from society and if institutional arrangements concentrate authority within the state. For example, Thatcher's monetary policy was successful because there was low societal opposition and high concentration of authority. [83]

Kathryn Sikkink applies that approach to the debates on developmental policy in Latin American countries. She distinguishes the role of ideas in the process of adoption, implementation and consolidation. "The adoption of new models is the result of the ideas of top policy makers, who respond to what they perceive as the constraints and opportunities in the international and domestic economic situation. Ideas held by powerful individuals are the key to understanding the adoption of polices... At the level of the implementation and consolidation of developmentalist policies, state institutions and the manner in which ideas are embodied in state institutions are more central to the explanation." [84]

Like rational institutionalism, historical institutionalism introduces ideas to explain empirical anomalies. The focus of historical institutionalism is not ideas per se but the conditions that turn a particular idea to a policy. In this respect, the main difference between them lies in their ontology rather than epistemology. Whereas rationalists look at individual actor's interests, the focus of the institutionalist perspective is on institutional configurations.

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[82] Peter A. Hall, Conclusion, in Peter A. Hall, Introduction, in Peter A. Hall (ed.), *The Political Power of Economic Ideas: Keynesianism across Nations* (Princeton: Princeton University Press, 1989), p. 389.
[83] James I. Walsh, When do Ideas Matter?: Explaining the Successes and Failures of Thatcherite Ideas, *Comparative Political Studies*, Vol.33, No.4 (May 2000)
[84] Kathryn Sikkink, *Ideas and institutions: Developmentalism in Brazil and Argentina* (Ithaca: Cornell University Press, 1991), p.26-27.

In this regard, it is hard to conclude that historical institutionalism provides a systemic analysis of ideas.

In sum, the main criticism of the institutionalist approaches is that it limits the role and influence of ideas on the both epistemological and ontological basis. [85] First, their main interest is not ideas but interests and institutions. "What matters is not the idea's intrinsic force in a given context but whether the idea reconciles the interests of elites within the institutional processes of a state so that a coalition emerges to enact the resulting agenda. The more powerful the sponsors, the more powerful the ideas. Goldstein went a step further in arguing that the 'power of the idea itself explains its acceptance', but her trade policy study consistently retreated into a political sponsorship argument." [86]

Second, this ontological basis gives rise to an epistemological problem. The role of ideas is important only if there exist "empirical anomalies that can be resolved only when ideas are taken into account." [87] As a result, it makes it logically impossible for institutional approaches to realise the power of ideas *a priori*. It only concedes the power *ex post*. At the same time, their emphasis on outcomes prohibits institutional approaches from investigating the sources of interests. This problem is critical if ideas can have an impact on the formation of actors' preferences and causal belief.

Third, economic ideas are tested at the cognitive and normative levels at the same time. As Table 2-1 shows that normative implications are as politically significant as cognitive implications in legitimising economic ideas and gaining public support. [88]

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[85] Jacobsen (1995); Ngaire Woods, Economic Ideas and International Relations: Beyond Rational Neglect, *International Studies Quarterly*, Vol. 39, No. 2 (January 1995); Mark M. Blyth, Any More Bright Ideas?: The Ideational Turn of Comparative Political Economy, *Comparative Politics*, Vol. 29, No. 2 (January 1997)

[86] John Kurt Jacobsen, Duelling Constructivisms: A Post-mortem on the Ideas Debate in Mainstream IR/IPE, *Review of International Studies*, Vol. 29, No.1 (January 2003), p.48.

[87] *Ibid*, p.6.

[88] Martha Finnemore and Kathryn Sikkink, International Norm Dynamics and Political Change, *International Organization*, Vol. 52, No. 4 (Autumn 1998)

[Table 2-1] Types of Ideas and Their Effects on Policy-making [89]

	Concepts and theories in the foreground of the policy debate	Underlying assumptions in the background of the policy debate
Cognitive level	**Programs** Ideas as elite policy prescriptions that help policy makers to chart a clear and specific course of policy action	**Paradigms** Ideas as elite assumptions that constrain the cognitive range of useful solutions available to policy makers
Normative level	**Frames** Ideas as symbols and concepts that help policy makers to legitimize policy solutions to the public	**Public sentiments** Ideas as public assumptions that constrain the normative range of legitimate solutions available to policy makers

Finally, from a perspective of sociology of knowledge, institutionalist approaches – implicitly or explicitly – prohibit the development of alternative ideational approaches by treating ideas as auxiliary hypotheses to solve prior theoretical problems in their own research programs, although it contributed to reigniting the interest in ideas. The dominance of rationalist institutionalism was not seriously challenged until constructivists produced empirical work that provided evidence for their theory. At the same time, neo-Gramscian approaches developed by the British and Canadian scholars were largely overlooked in the US, with the exception of Robert Cox's achievements. In any cases, rationalists consider these alternatives as "sometimes useful as a supplement" to their own theories. [90]

(2) Neo-Gramscian Approaches

Neo-Gramscian approach put special emphasis on the role of ideas or ideology. Unlike traditional Marxists, it tries to transcend a dichotomy of base-superstructure – i.e., ideas and materials – by introducing the concepts of hegemony and discourse. In doing so, ideas become an endogenous – rather than exogenous – factor in the approach. [91]

[89] John L. Campbell, Institutional Analysis and the Role of Ideas in Political Economy, in Campbell and Pedersen (2001), p.166.
[90] Michael C. Desch, Culture Clash: Assessing the Importance of Ideas in Security Studies, *International Security*, Vol.23, No.1 (Summer 1998), p.142.
[91] Stephen Gill (eds.), *Gramsci, Historical Materialism and International Relations* (Cambridge: Cambridge University Press, 1993); Andreas Bieler and Adam David Morton, A Critical Theory Route

For Gramscians, the power of ideas or ideologies begins with the concept of hegemony, which is defined as the persistence of specific social and economic structures that systematically advantage certain groups. [92] Hegemony is maintained and reproduced by persuasive power (consent) rather than coercive power (force). In civil society, ideologies provide legitimacy through the assertion of moral and intellectual leadership and the projection of a particular set of interests as the general interest. The role of ideologies is important because the relative autonomy of civil society from economic structures and state apparatus open the ideological realm that becomes a key site of political struggles. It is the role of 'organic intellectuals' to produce ideas and to propagate them. Because civil society composed of several social groups, there are two types of intellectuals: one is intellectuals serving dominant social forces; another is intellectuals supporting social changes. [93]

Robert Cox develops a neo-Gramscian approach by applying these concepts to IPE. According to him, together with material capabilities and institutions, ideas are one of the components of a historical bloc. He divides ideas into two categories. One is "intersubjective meanings, or those shared notions of the nature of social relations which tend to perpetuate habits and expectations of behavior." The other is "collective images of social order held by different groups of people." [94] The difference between them is that inter-subjective meanings are common throughout a historical bloc and cut across social divisions, whereas collective images are multiple and represent particular social forces. Thus inter-subjective meanings constitute the common ground for social discourses. In contrast, competing collective images are a tool of class conflict.

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to Hegemony, World Order and Historical Change: Neo-Gramscian Perspectives in International Relations, *Capital & Class*, No.82 (2004) For a general overview of Marxist traditions, see Andrew Gamble, Marxism after Communism: Beyond Realism and Historicism, *Review of International Studies*, Vol.25, No.5 (December 1999)

[92] Peter Ghosh, Gramscian Hegemony: An Absolutely Historicist Approach, *History of European Ideas*, Vol.27, No.1 (2001)

[93] Andreas Bieler, Questioning Cognitivism and Constructivism in IR Theory: Reflections on the Material Structure of Ideas, *Politics*, Vol. 21, No.2 (2001), p.73.

[94] Robert W. Cox, Social Forces, States, and World Orders: Beyond International Relations Theory, reprinted in Robert W. Cox with Timothy J. Sinclair, *Approaches to World Order* (Cambridge: Cambridge University Press, 1998), pp.98-99.

Base on this framework, neo-Gramscians analyse how neoliberalism legitimise economic globalisation. According to Stephen Gill, neoliberal globalisation and its ideology "serve to reify a global economic system by large institutional investors and transnational firms which control the bulk of the world's productive assets and are the principal influences in world trade and financial markets."[95] The network of transnational elites includes the IMF, the US Treasury and the Federal Reserve Board, Wall Street, Ivy League universities, think tanks, transnational corporations, and the governments of North Atlantic countries.[96]

The discursive formation of neoliberalism proceeds in two ways. First, it asserts that there is no alternative to the Washington consensus or neoliberal globalisation. This is employed to "justify weaker or lax enforcement of labor laws and regulations on environmental protection as well as the elimination of restrictions on trade and capital movements. "[97] Second, "the equation of free competition and free exchange (global capital mobility) with economic efficiency, welfare, and democracy, and a myth of virtually unlimited social progress, as represented in television advertising and other media, and in World Bank and IMF reports."[98] By constructing these discourses, "Disciplinary neoliberalism is institutionalised at the macro-level of power in the quasi-legal restructuring of state and international political forms...This discourse of global economic governance is reflected in the conditionality policies of the Bretton Woods organisations, quasi-constitutional regional arrangements such as NAFTA or Maastricht, and the multilateral regulatory framework of the new World Trade Organisation. It is reflected in the global trend towards independent central banks, with macroeconomic policy prioritising the 'fight against inflation'."[99]

From this perspective, IMF-supported programmes in the crisis-affected countries involve the imposition of Anglo-American model of capitalism on East Asian economies. "Central to

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[95] Stephen Gill, Globalisation, Market Civilisation, and Disciplinary Neoliberalism, *Millennium,* Vol. 23, No. 3 (1994), p.405.
[96] For a sociological analysis on the network, see Leslie Sklair, Social Movements for Global Capitalism: The Transnational Capitalist Class in Action, *Review of International Political Economy,* Vol.4, No.3 (Autumn 1997)
[97] Daniel Egan, The Limits of Internationalization: A Neo-Gramscian Analysis of The Multilateral Agreement On Investment, *Critical Sociology,* Vol.27, No.3 (2001), p.79.
[98] Gill (1994), p.406.
[99] *Ibid*, p.412.

U.S. strategy is the imposition of a specific neoliberal model of restructuring. In the context of recent crises, state-directed and controlled forms of political economy have been, and are being, pressured to liberalize." [100]

Although there are still controversies over the achievements of the so-called 'Italian School' (including Robert Cox and Stephen Gill), it is hard to deny that the school have developed theories of the power of ideas that has been largely ignored by mainstream IPE scholars. In their approaches, ideas are "recognised as realities in their own right and thus an object of knowledge." [101] Equally important is that its transnational historical materialism contributes to analysing the role of ideas at the international level.

Despite these achievements, neo-Gramscian approaches have some problems. First, the neo-Gramscian definition of ideology does not fit easily into the analysis of global political economy. "The flow and power of ideas, Gramsci should have taught us, is nowhere clear and unambiguous; and outside of where these ideas are firmly grounded within national social formations, their global power must be seen as contingent, open to contestation, and malleable." [102] Second, the link of neoliberalism to transnational networks can be regarded as a return to traditional Marxist dichotomy of base-superstructure. In Gill's definition of disciplinary neoliberalism, there is little room for relative autonomy of ideology – or independent influence of ideas. [103]

[100] Stephen Gill, The Geopolitics of the Asian Crisis, *Monthly Review,* Vol.50, No.10 (1999)
[101] Stephen Gill, Epistemology, Ontology and the 'Italian School', in Gill (1993), p.26.
[102] Randall D. Germain and Michael Kenny, Engaging Gramsci: International Relations Theory and the New Gramscians, *Review of International Studies*, Vol.24, No.1 (January 1998), p.19. See also Craig N. Murphy, Understanding IR: Understanding Gramsci, *Review of International Studies*, Vol.24, No.3 (July 1998); Mark Rupert, Re-engaging Gramsci: A Response to Germain and Kenny, *Review of International Studies*, Vol.24, No.3 (July 1998)
[103] Marieke De Goede, Beyond Economism in International Political Economy, *Review of International Studies*, Vol.29, No.1 (2003), pp.89-90.

(3) Constructivist Approaches

Although there are variants of constructivist approaches in IR, most constructivists are based on post-structuralist or post-modern methodology. [104] First, constructivists are opposed to epistemological positivism that fails to take account of the role of discourses or languages. "What counts as a socially meaningful object or event is always the result of an interpretive construction of the world out there... Our interpretations are based on a shared system of codes and symbols, of languages, life-worlds, social practices. The knowledge of reality is socially constructed." [105] Second, most constructivists criticise ontological individualism in that the evolution and transformation of discourses or languages are inter-subjective. "They exist in the shared meanings of their users and are reproduced through their practices. These practices, in turn, are patterned by the rules embodied in the language. In order to avoid individualist reductionism, structural change cannot be conceived as being the simple aggregation of individual action, but must be conceived as the open reproduction of intersubjective practices following rules on their own." [106]

With respect to the role of ideas in policy-making, there are two kinds of constructivist approaches: epistemic communities and discursive analysis. In the first place, the epistemic communities approach stresses the role of special or technical knowledge. According to Peter Hass, "An epistemic community is a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge

[104] For a comprehensive overview, see John G. Ruggie, What Makes the World Hang Together? Neo-utilitarianism and the Social Constructivist Challenge, *International Organization*, Vol.52, No.4 (1998); Emanuel Adler, Constructivism and International Relations, in Walter Carlsnaes, Thomas Risse and Beth A. Simmons (eds.), *Handbook of International Relations* (London: Sage, 2002). Although Alexander Wendt is one of the pioneers of constructivism, I do not include Wendt's works – especially *Social Theory of International Politics* (Cambridge: Cambridge University Press, 1999) – because his methodology is half-constructivist. As his critics point out, he bases his theory on positivist epistemology and post-positivist ontology. This criticism arises from the fact that his intention is to bridge between rationalists and reflectivists. For the debate, see Steve Smith, Wendt's World; Robert Keohane, Ideas Part-Way Down; and Alexander Wendt, On the Via Media: A Response to the Critics, *Review of International Studies*, Vol.26, No.1 (January 2000) Cf. Ted Hopf, The Promise of Constructivism in International Relations Theory, *International Security*, Vol. 23, No.1 (Summer 1998)
[105] Stefano Guzzini, A Reconstruction of Constructivism in International Relations, *European Journal of International Relations*, Vol. 6, No.2 (2000), pp.159-160.
[106] *Ibid*, p.164.

within that domain or issue-area." [107] The influence of epistemic communities on policy-making is made by communicative actions. "Epistemic communities can help define the self-interest of a state or factions within it. The process of elucidating the cause-and effect relationships of problems can in fact lead to the redefinition of preconceived interests or to the identification of new interests." [108]

This approach is epistemologically constructivist in that it accepts the concept of inter-subjectivity. Reality is socially constructed; ideas inform policies; actors' understanding of the world and the formulation of alternative actions are shaped by belief systems, operational codes, and cognitive maps. In terms of ontology, however, it is not free from positivist or empiricist legacies. The reservation over inter-subjectivity prevents them from recognising the power of languages or words. In this respect, Peter Hass and Emanuel Alder argue, "learning may occur through reflection on empirical events rather than through their representation." [109]

One good example is Richard Cockett's analysis of the role of monetarists in the formation of Thatcherism. [110] The analysis shows that several economists under the intellectual leadership of Friedrich von Hayek developed and propagated neoliberal economic ideas. In the UK, the Institute for Economic Affairs (IEA) was at the heart of their intellectual networks. The IEA was also closely linked to American and European economists via Mont Pelerin Society, whose member included Milton Friedman and George Stigler.

In a similar vein, compliance theories also assume that economic ideas are diffused or transferred by social learning: "a process whereby agent interests and identities are shaped through and during interaction".[111] In the process, argumentative persuasion can change policy preference through debate in the absence of coercion. The existence of epistemic communities is also important because "Learning can take the form of simple copying of ideas or solutions,

[107] Peter M. Hass, Introduction: Epistemic Communities and International Policy Coordination, *International Organization*, Vol.46, No.1 (Winter 1992), p.4.
[108] *Ibid*, p.14.
[109] *Ibid*, p.371.
[110] Richard Cockett, *Thinking the Unthinkable: Think-Tanks and the Economic Counter-Revolution, 1931-1983* (London: HarperCollins, 1993)
[111] Jeffrey T. Checkel, Why Comply? Social Learning and European Identity Change, *International Organization*, Vol.55, No.3 (Summer 2001), p.516.

or more sophisticated adaptation of ideas to the particular problem in focus." [112] Among others, international organisations, international negotiations and international conference are major arena for social learning.

The epistemic communities approach has many limitations. Its empiricist tendency regards technical or instrumental knowledge as given, making it impossible for them to raise a question of how the knowledge is constructed. In addition, the impact of ideas is confined to self-contained groups of specialists, experts or top policy makers. There are not many issue areas on which allow technical advices to exert crucial influence. This is why the existing literature is confined, largely, to environmental, research and development (R & D) and nuclear policies. [113] Finally, the approach is not clear about whether ideas per se or experts affect policies. In this regard, it can be criticised that "the causal effects of ideas on policies are displaced onto the political effects of experts." [114]

Unlike the epistemic communities approach, which looks at the power of technical or special knowledge, the discursive analysis puts emphasis on the linguistic construction of subjects. "Discourse is a system of meaning that orders the production of conceptions and interpretations of the social world in a particular context. In this view, ideas are always embedded in discourses and become meaningful only by being interpreted as part of a particular discursive system of meaning." [115]

Discursive practices generate narrative structures that constitute the social meaning of politics and economics. [116] The socially-constructed meanings have an impact on decision-making.

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[112] Arild Underdal, Explaining Compliance and Defection: Three Models, *European Journal of International Relations,* Vol.4, No.1 (1998), p.21.
[113] De Goede (2003), pp.86-87.
[114] Albert S. Yee, The Causal Effects of Ideas on Policies, *International Organization*, Vol. 50, No. 1. (Winter 1996), p.86.
[115] Peter Kjaer and Ove K. Pedersen, Translating Liberalisation: Neoliberalism in the Danish Negotiated Economy, in Campbell and Pedersen (2001), p.220.
[116] Jennifer Milliken, The Study of Discourse in International Relations: A Critique of Research and Methods, *European Journal of International Relations,* Vol. 5, No.2 (1999)

> As a set of ideas, discourse offers both cognitive arguments about the logic and necessity of a particular policy programme and normative arguments about its appropriateness. As an interactive process, discourse involves both a coordinative discourse among key policy actors focused on constructing a policy programme and a communicative discourse between political actors and the public focused on informing and deliberating about such a programme. [117]

In this process, ideational power converts into material power. As a result, "struggles about meaning are struggles about power." [118]

The primary contribution of constructivism lies in its role in flourishing ideational research programmes in the field of international relations and international political economy. "Whereas realism and liberalism tend to focus on material factors such as power or trade, constructivist approaches emphasize the impact of ideas... They pay close attention to the prevailing discourse(s) in society because discourse reflects and shapes beliefs and interests, and establishes accepted norm of behaviour." [119] It regards ideas as an independent variable by emphasising the role of epistemic communities and discourses.

The main criticism of constructivists is the underdevelopment of empirical studies to test their theories. [120] This criticism can be applied to extreme versions of constructivism supposing that causality is hardly a testable concept. "Postmodern analyses usually regard a causal focus as misdirected because in a world of ambiguity, indeterminacy, and multiplicity, causal connections are unstable, impermanent, and obscure." [121] However, conventional constructivists do not agree to the proposition. In this sense, the criticism is due, in part, to the misunderstanding of constructivist methodology. "Some ideational factors simply do not

[117] Vivien A. Schmidt, How, Where and When does Discourse Matter in Small States' Welfare State Adjustment?, *New Political Economy,* Vol. 8, No. 1 (2003), p.134.
[118] John Kurt Jacobsen, Duelling Constructivisms: A Post-mortem on the Ideas Debate in Mainstream IR/IPE, *Review of International Studies*, Vol. 29, No.1 (January 2003), p.48. Cf. Jutta Weldes, *Constructing National Interests: The United States and The Cuban Missile Crisis* (Minneapolis: University of Minnesota Press, 1999)
[119] Stephen M. Walt, International Relations: One World, Many Theories, *Foreign Policy*, No.110 (Spring 1998), pp.40-41.
[120] Ronen Palan, A World of Their Making: An Evaluation of the Constructivist Critique in International Relations, *Review of International Studies*, Vol. 26, No.4 (October 2000)
[121] Yee (1996), p.102.

function causally in the same way as brute facts or the agentive role that neo-utilitarianism attributes to interests. As a result, the efficacy of such ideational factors is easily underestimated." [122] In other words, it would be illogical to assess constructivist analyses only in the prism of positivism or empiricism.

Another problem is that discursive analysis has a danger of over-emphasising the importance of political rhetoric and underestimating the role of interests and institutions. For example, Vivien Schmidt defines the vehicles of discourses as politicians' speeches, party platforms, government pronouncements, opposition positions, public debates, and media commentary. [123] In many cases, it is very difficult to draw on meaningful implications from politicians' addresses and official documents because they tend to reiterate moral causes of their actions without revealing their interests or motivations.

For example, Linda Lim argues that "Asian economic success is the product simply of the application of orthodox Western text book economic principles – external 'openness' to trade and foreign investment on the one hand, and domestic 'good government' with small, balanced, or surplus government budgets and conservative monetary policy leading to low inflation and high saving rates, on the other." [124] Discursive analyses of official addresses and documents might provide some evidence in support of her argument, because few policy makers and politicians do not endorse protectionism and state intervention at least in public. However, institutional- and interest- oriented approaches can successfully reject the claim by showing that their economic system was not an application of Western orthodoxy in many aspects: for example, extensive state intervention in the financial and corporate sectors. For this reason, discursive analysis can be meaningful only after examining whether their rhetoric is consistent with their real behaviour. In this respect, ideational approaches should be accompanied by interest- and institution- oriented analyses.

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[122] Ruggie (1998), p.869.
[123] Vivien A. Schmidt, Does Discourse Matter in the Politics of Welfare State Adjustment?, *Comparative Political Studies*, Vol. 35, No. 2 (2002), p.169.
[124] Linda Y.C. Lim, Whose Model Failed? Implication of the Asian Economic Crisis, *Washington Quarterly*, Vol.20, No.3 (Summer 1998), p.25.

3. An Ideational Explanation of Policy Change

Each of these explanations provides some insights. Institutional approaches show that economic ideas can be a causal factor in building, consolidating and maintaining institutions. Neo-Gramscian approaches demonstrate that the formulation of class interests at both national and international level is constrained by economic ideas. And constructivist approaches develop key concepts – discursive practices, social learning and epistemic communities – that are useful in comprehending how economic ideas affect interests and institutions. But none of them alone can answer the research question of this thesis because they do not specify under what condition and how much economic ideas affect policy change. For this reason, I synthesise the three approaches to draw an explanatory framework.

The starting point is to define under what condition economic ideas matters. All the three approaches agree that economic crises increase the significance of economic ideas. However, not all crises generate an ideational shift. In other words, economic crisis is a necessary condition for economic reform. [125] For this reason, Wesley Widmaier makes a distinction between material and ideational crisis. What is important is not whether an economic crisis takes place but the crisis ignites theoretical and policy debates over economic models (or systems).

> [C]rises are defined as events that agents *interpret* as undermining not material relations, but rather some set of shared understandings... As a form of practice, the social construction of crises specifically involves efforts to fix or to define events as the temporal beginnings of some 'crises' at certain *initial points* in ways that run counter to some set of views. The successful reframing of a policy problem can then legitimate new intersubjective frameworks and the provision of governance for revised purposes in the *reversal* of the pre-crisis state. Over time, the successive

[125] Javier Corrales, Do Economic Crises Contribute to Economic Reform? Argentina and Venezuela in the 1990s, *Political Science Quarterly*, Vol. 112, No. 4. (Winter 1997-1998); Allan Drazen and William Easterly, Do Crises Induce Reform?: Simple Empirical Tests of Conventional Wisdom, *Economics and Politics*, Vol.13, No.2 (July 2001)

construction of particular types of crises can gradually transform state and societal interests, engendering the institutionalisation of new self-fulfilling prophecies regarding behaviour. [126]

In a similar vein, Mark Blyth introduces a concept of 'Knightian uncertainty', where contemporary agents know neither what their interests actually are nor how to realise them. [127] Under the uncertainty, economic ideas can become an endogenous factor. First, economic ideas reduce uncertainty by helping policy makers to interpret the causes and consequences of economic crises or policy failures. Second, economic ideas enable political parties to co-operate by redefining the perception of existing political costs and benefits regarding alternative course of action. Third, economic ideas may be effective in transforming existing institutions by de-legitimising the existing political and economic institutions in the struggle over existing institutions. Fourth, following the de-legitimation of existing institutions, new economic ideas help to construct the form and content of the institutions that should be designed to resolve a given economic crisis. Finally, such economic ideas are institutionalised over time by generating conventions that result in institutional coordination of agents' expectations. [128]

The political power of economic ideas is wielded through two mechanisms. First, discursive practices generate narrative structures that construct the social meaning of economic policies. The socially-constructed meanings affect decision-making through theoretical and policy debates. Second, social learning is an important process that causes policy preferences. For example, compliance with international standards or "best practice" helps politicians and policy makers to legitimise the economic ideas. This point is very

[126] Wesley W. Widmaier, Constructing Monetary Crises: New Keynesian Understandings and Monetary Cooperation in the 1990s, *Review of International Studies*, Vol.29, No.1 (January 2003), p.65. See also Collin Hay, The "Crisis" of Keynesianism and the Rise of Neoliberalism in Britain: An Ideational Approach, in Campbell and Pedersen (2001)

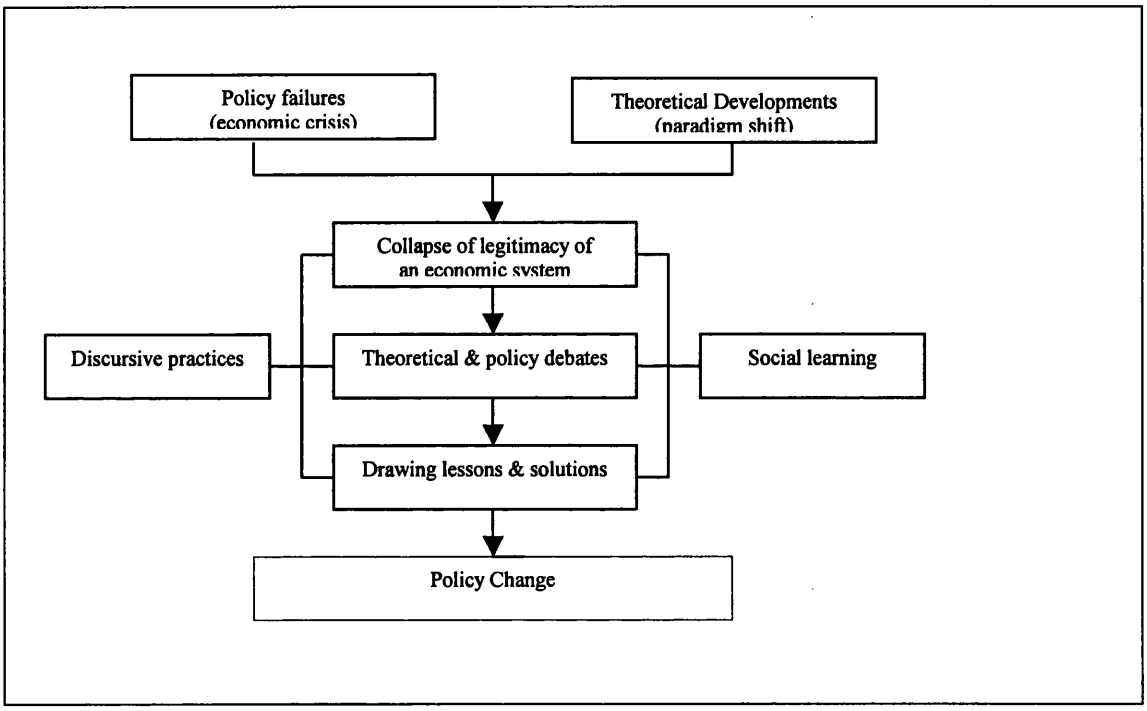
[127] Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge: Cambridge University Press, 2002), p.10.

[128] *Ibid*, pp.37-41.

instructive in analysing the role of economic ideas in developing countries that have been often importers– rather than exporters – of economic ideas. [129]

Figure 2-2 summarises the conditions, mechanisms and functions of economic ideas in policy change.

[Figure 2-2] An Ideational Model of Policy Change



This model provides the theoretical basis for an ideational explanation of policy convergence, because policy convergence is a particular kind of policy change that increases similarity or uniformity. According to Collin Bennett, 'policy' convergence takes place through four processes: emulation, elite networking and policy communities, harmonisation through international regimes, and penetration by external actors and interests. [130]

[129] There are few case studies on developing countries. Some exceptions are Kathryn Sikkink, *Ideas and institutions: Developmentalism in Brazil and* Argentina (Ithaca: Cornell University Press, 1991); Anil Hira, *Ideas and Economic Policy in Latin America: Regional, National and Organizational Case Studies* (Westport: Praeger, 1998); Hilary Appel, The Ideological Determinants of Liberal Economic Reform: The Case of Privatization, *World Politics,* Vol.52, No.4 (July 2000)
[130] Colin J. Bennett, What Is Policy Convergence and What Causes It?, *British Journal of Political Science*, Vol. 21, No. 2. (April 1991)

Ideas play a crucial role in the processes except penetration. First, policy ideas inspire policy emulation (or transfer) by providing benchmarks. To solve a problem, a government can copy a policy that is successful in managing the same problem in other countries. Second, networking in epistemic communities is a channel of policy transfer. Policy makers can import new policy ideas that are learned from international conferences and seminars. For policy makers in developing and transition economies, international gatherings provide a good opportunity to exchange their experiences and to get advice from world-class experts. Finally, international regimes play a crucial role in policy convergence by leading countries to comply with international agreements, conventions and accords. This policy harmonisation is legitimised in the name of global standards or best practices. Even though some of clauses in international agreements are not in their interests, governments do not reject (or at least pretend to follow) them. The reason is that "government face reputational consequences that cast doubt on their approach to the economy and potentially the legitimacy of their governance."[131]

The concept of confidence game clearly explains how these ideational factors affect economic policy.

> Market confidence is then an intersubjective construction that has a tenuous relationship to market fundamentals but does not have any precise, calculus metric... Market behaviour therefore rests on the coordination of agent's expectations through the maintenance of conventions. So long as such intersubjectively held conventions regarding the economy are adhered to, then the economy will perform within the parameters of the expected "conventional judgement". [132]

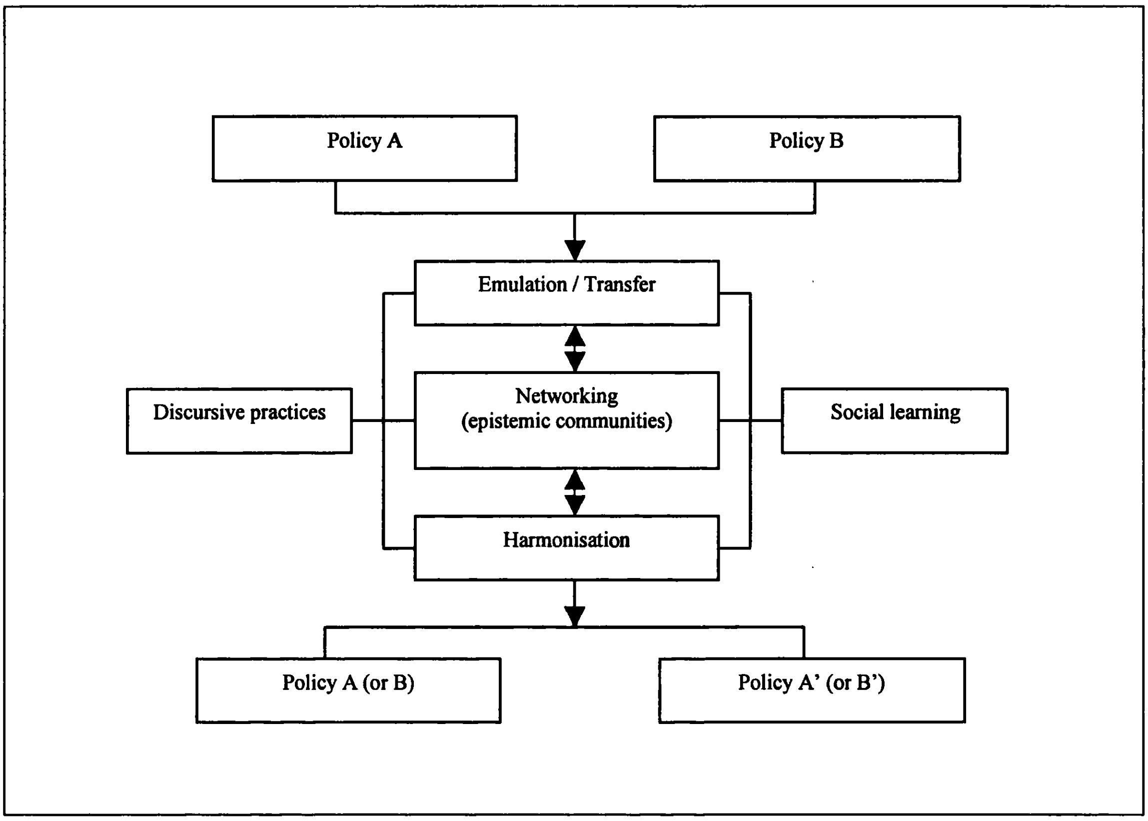
Figure 2-3 summarises an ideational explanation of how different policies converge to a policy. It should be noted that policy convergence does not always mean that policy B (or A)

[131] Beth A. Simmons and Zachary Elkins, The Globalization of Liberalization: Policy Diffusion in the International Political Economy, *American Political Science Review*, Vol. 98, No.1 (February 2004), p.173.

[132] Mark Blyth, The Political Power of Financial Ideas: Transparency, Risk and Distribution in Global Finance, in Jonathan Kirshner (ed.), *Monetary Orders: Ambiguous Economics, Ubiquitous Politics* (Ithaca: Cornell University Press, 2002), p.257.

is replaced with policy A' (or B'); and it is difficult to distinguish the three processes in real policy-making because they are intertwined.

[Figure 2-3] An Ideational Model of Policy Convergence



4. Conclusion

This chapter has reviewed the existing literature on the politics of the East Asian financial crisis. Because interest-oriented and institution-oriented approaches do not provide a convincing explanation of the policy convergence between Korea and Malaysia, I have turned to ideas-oriented approaches: institutional, neo-Gramscian and constructivist.

The common assumptions of ideational approaches are: (1) economic ideas can be a causal factor when a new problem or policy failures that are not clearly understood take place; (2) discursive practices and social learning play a crucial role in the diffusion of economic ideas; and (3) economic ideas can re-define interests and change institutional settings.

It should be noted that discursive practices and social learning are an inter-subjective process. In other words, ideas are not merely diffused but translated. As Blyth points out, "Translation is a process whereby concepts and conceptions from different social contexts come into contact with each other and trigger a shift in the existing order of interpretation and action in a particular world." [133] In a similar vein, Sikkink argues that "The same ideas do not take on the same meanings in all settings. Meanings emerge through a process of interpretation, in which certain actors play a more privileged role as interpreters". [134] To understand the settings, it is necessary to note that "the meaning and acceptance of new ideas derive not only from the content but also from; (1) powerful symbolic issues; (2) the nature of the political and ideological context into which ideas they are introduced; (3) the nature of who interprets or carries the ideas."[135]

To assess the political power of economic ideas in different socio-political environments, I deduct four operational hypotheses from the existing ideational approaches.

1) The political power of economic ideas is likely to increase if external agencies support the ideas.

This hypothesis is designed to test to what extent the IFIs affected the political power of the Washington consensus. The international financial institutions import their policy preferences in two ways: by attaching policy conditionality to their financial assistance and by dispersing them by discourse practices. International organisations including the IMF and World Bank have its own research departments that Robert Wade calls the 'controllers of ideas'. [136] Think thanks such as Institute for International Economics (IIE), Brookings Institution, American Enterprise Institute (AEI) in US and Institute of Economic Affairs (IEA)

[133] Kjaer and Pedersen (2001), p.219.
[134] Kathryn Sikkink, *Ideas and institutions: Developmentalism in Brazil and* Argentina (Ithaca: Cornell University Press, 1991), p.254.
[135] *Ibid*, p.252.
[136] Robert H. Wade, US Hegemony and the World Bank: The Fight over People and Ideas, *Review of International Political Economy,* Vol.9, No.2 (Summer 2002), p.220.

in UK also affect policy-making. [137] Their modus operandi includes publishing reports and journals, hosting conferences and seminars and using the media (i.e., contributing articles and giving interviews). These discourse practices have a constraining impact on economic policy-making through various mechanisms. Their analyses affect major powers' foreign economic policy, investment banks' portfolio and credit rating agencies' assessments. In developing countries, policy makers and economists learn economic ideas when training at academic institutions, working at international organisations and participating in bi- or multi-lateral negotiations.

2) The political power of economic ideas is likely to increase if big business supports the ideas.

This hypothesis is designed to evaluate the impact of big business on the political power of the Washington consensus. Big business has financial and organisational resources to promote its policy preferences through various political activities: for example, raising political funds, providing information and building constituency. [138] Big business does not only buy policy by contributing political donations but also provide information to policymakers to project its policy preferences to policy-making process. [139] An Information strategy includes reporting research and survey results, commissioning research projects, testifying as expert witnesses and in hearings, and supplying decision makers with position papers or technical reports. To this end, business associations and conglomerates own or fund think tanks and media that promote pro-business policy agendas. For example, umbrella organisation – the Federation of Korean Industries (FKI) – has the Korea Economic Research

[137] For the US case, see Andrew Rich and R. Kent Weaver, Think Tanks in the U.S. Media, *Press/Politics*, Vol.5, No.4 (2000)

[138] Wendy L. Hansen and Neil J. Mitchell, Disaggregating and Explaining Corporate Political Activity: Domestic and Foreign Corporations in National Politics, *American Political Science Review*, Vol. 94, No. 4. (December 2000)

[139] John M. De Figueiredo, Lobbying and Information in Politics, *Business and Politics,* Vol. 4, No. 2 (2002) See also Susan K. Sell and Aseem Prakash, Using Ideas Strategically: The Contest Between Business and NGO Networks in Intellectual Property Rights, *International Studies Quarterly*, Vol.48, No.1 (2004)

Institute and top four Korean chaebols – Samsung, Hyundai, Daewoo and LG – have its own economic research centres. [140]

3) The political power of economic ideas is likely to be greater if top policy makers – particularly finance minister and central banker – support the ideas.

This hypothesis is to assess the role of policy makers in introducing and implementing the Washington consensus. Ideological orientations of technocrats are an important factor in policy-making. [141] This is more important in the East Asian NICs where policy makers have embedded autonomy. Highly selective meritocratic procedure and recruitment and long-term career compensations enable policy makers to deliver collective goods without becoming captive to vested interests. [142] Policy makers use government-affiliated institutions to promote the economic ideas that they support. In Korea, for example, the Korea Development Institute (KDI) has played a key role in economic policy-making since the early 1970s. In Malaysia, although not controlled by the government, the Institute of Strategic and International Studies (ISIS) and the Malaysian Institute of Economic Research (MIER) are well connected to key policy makers in finance ministry and the central bank.

4) The political power of economic ideas is likely to be greater in democratic regimes than authoritarian regimes.

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[140] The role of business associations in the developing world, see Mick Moore and Ladi Hamalai, Economic Liberalisation, Political Pluralism and Business Associations in Developing Countries, *World Development*, Vol.21, No.12 (December 1993); John Lucas, The Politics of Business Associations in the Developing World, *Journal of Developing Areas*, Vol.32, No.1 (1997); Richard E. Doner and Ben R. Schneider, Business Associations and Economic Development: Why Some Associations Contribute More than Others, *Business and Politics*, Vol.2, No.3 (December 2000); Paola Perez-Aleman, A Learning-centered View of Business Associations: Building Business--Government Relations for Development, *Business and Politics*, Vol.5, No.2 (August 2003)

[141] Stephan Haggard, The Politics of Adjustment: Lessons from the IMF's Extended Fund Facility, *International Organization*, Vol. 39, No. 3 (Summer 1985), p.531-32.

[142] Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton: Princeton University Press, 1995)

This hypothesis is intended to examine how much regime types affect the political power of the Washington consensus. The impact of regime types on policy debates draws much attention as many developing and transition economies shifted from authoritarian regimes to democratic ones. Although there is no conclusive evidence, an emerging consensus is that democracy encourages policy debates more than authoritarianism. [143] The logic is as follows. In democratic regimes, policy debates tend to give rise to a political controversy because elections intensify the polarisation of economic ideas among political parties or vested interest groups. High possibility of regime change increases the political significance of economic ideas. In authoritarian regimes, policy debates are confined to elite factions because opposition to the incumbents' policies face significant sanctions. In addition, elections under authoritarian rulers are less relevant for policy-making because there is very little possibility of regime change. [144]

In the next part, I test these hypotheses against the cases of Korea and Malaysia, which examines the role and influence of economic ideas in the process of crisis management. In doing so, I show how economic ideas bring about policy convergence between the two countries in four policy areas: macroeconomic adjustment, financial reform, corporate reform, and social and labour policy.

[143] Karen L. Remmer, Democracy and Economic Crisis: The Latin American Experience, *World Politics*, Vol. 42, No.3 (April 1990); Peter A. Gourevitch, Democracy and Economic Policy: Elective Affinities and Circumstantial Conjunctures, *World Development*, Vol.21, No.8 (August 1993); John Williamson, Democracy and the "Washington Consensus", *World Development*, Vol.21, No.8 (August 1993); Hilton L. Root, What Democracy can do for East Asia, *Journal of Democracy*, Vol. 13, No.1 (January 2002)

[144] Geoffrey Garrett and Peter Lange, Internationalization, Institutions and Political Change, *International Organization*, Vol.49, No.4 (Fall 1995), pp.641-43; Stephan Haggard, Inflation and Stabilization, in Gerald M. Meier (ed.), *Politics and Policy Making in Developing Countries: Perspectives on the New Political Economy* (San Francisco: ICS Press, 1991), pp.238-39.

Chapter III

The Political Power of the Washington Consensus: A Historical Background

1. Introduction

This chapter aims to explain the political power of the Washington consensus in a historical perspective. In the 1990s, the influence of the consensus steadily increased in the developing world. After a series of debt crises, the consensus was introduced in many Latin American countries by international financial institutions' policy conditionality. In East Asia, policy makers cautiously embraced neoliberal policies including financial liberalisation.

The East Asian financial crisis opened a window of opportunity for the Washington consensus. By attributing the primary cause of the crisis to domestic weaknesses in the financial and corporate sectors, the consensus effectively de-legitimised the East Asian development model. In such circumstances, liberal policy makers and economists were given more scope to push ahead with neoliberal economic policies. In the latter stage of the crisis, however, the political power of the consensus decreased as the negative effects of the consensus on growth and equality gave rise to political and social instabilities.

This chapter begins with an explanation of the rise of the Washington consensus from an ideational perspective that highlights the mechanism of discursive practices and social learning. Then it discusses how the consensus prevailed in the theoretical and policy debates on the causes and consequences of the financial crisis. I then analyse how the negative side effects of the consensus contributed to decreasing its political power and the emergence of the post-Washington consensus. Finally, the two ideas are compared in the context of the post-crisis economic adjustment.

2. Ideological Shift from Keynesianism to Neoliberalism in Industrial Countries

The emergence of neoliberalism in industrial countries had an enormous impact on the development of the Washington consensus. Neoliberalism provided theoretical foundations for the consensus that were effective in criticising the Keynesian consensus – inward-looking development and active state intervention. [145] More importantly, the revival of the US and British economies under Ronald Reagan and Margaret Thatcher and the collapse of communism helped the international financial institutions including the World Bank and the International Monetary Fund to convince developing and transition countries to accept the consensus. [146]

The core principles of neoliberalism are: (1) securing macroeconomic stability by low inflation and small fiscal deficits; (2) opening their economy to international competition by trade and capital account liberalisation; and (3) liberalising their markets through deregulation and privatisation.

In terms of macroeconomic policy, neoliberalism bases itself on monetarism.[147] Until the late1960s, the predominant macroeconomic policy framework in most industrial countries was Keynesianism. In the framework, top priority is given to full employment on the ground that it brings both economic growth and socio-political stability. To reduce unemployment, Keynesians support active policy instruments including fiscal deficits and redistributive taxes. The success of Keynesianism underpinned the post-World War 'embedded liberalism'. [148] Monetarists led by Milton Friedman challenged the Keynesian orthodoxy by criticising that fiscal stimulus policies made economic equilibrium unstable and caused chronic inflation. For this reason, they put special emphasis on price stability rather than full employment. In the

[145] H. W. Singer, Editorial: The Golden Age of the Keynesian Consensus – The Pendulum Swing Back, *World Development*, Vol.25, No.3 (March 1997)
[146] Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: the Battle between Government and the Marketplace that is Remaking the Modern World* (New York: Simon & Schuster, 1998)
[147] Gérard Duménil and Dominique Lévy, Costs and Benefits of Neoliberalism: A Class Analysis, *Review of International Political Economy*, Vol.8, No.4 (Winter 2001)
[148] For the concept, see John Gerard Ruggie, International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order, *International Organization*, Vol. 36, No. 2 (Spring 1982)

1970s, monetarism became popular among policy makers as well as academic economists who sought for solutions to solve stagflation. Although the theory was refuted in academic debates, some of its policy ideas such as control of monetary aggregates and independence of central bank were widely accepted in many industrial countries. [149]

With regard to foreign economic policy, monetarists do not agree with Keynesians either. Basically, Keynesians are sceptical over the efficiency of financial markets – both domestic and international – because they think that financial transactions are affected by psychological factors – such herding behaviour – as well as economic calculation. For this reason, Keynes – as one of the founding fathers of the Bretton Woods system – supported national governments' right to impose restrictions on capital flows. [150] In contrast, neoliberal economists argue against capital controls on the basis that market mechanisms allocate financial resources effectively. Milton Friedman also made a case for free floating regime, believing that the Bretton Wood system – a dollar-pegged regime – distorted free capital transactions. [151]

When it comes to structural reform, "Monetarists generally favor free market policies." [152] The core of their policy ideas is to reduce the role of government in the economy through liberalisation, deregulation and privatisation. These policy ideas were popularised by Friedrich

[149] Friedman's policy ideas is summarised in Milton Friedman, The Role of Monetary Policy, *American Economic Review*, Vol.58, No.1 (March 1968). For their impact on policy-making over the past decades, see Andrew F. Brimmer, The Political Economy of Money: Evolution and Impact of Monetarism in the Federal Reserve System, *American Economic Review*, Vol. 62, No. 1/2. (1972); David Laidler, Monetarism: An Interpretation and an Assessment, *Economic Journal*, Vol.91, No.361 (March 1981); J. Bradford De Long, The Triumph of Monetarism?, *Journal of Economic Perspectives*, Vol.14, No.1 (Winter 2000)

[150] Eric Helleiner, *States and the Re-emergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994); Jonathan Kirshner, Keynes, Capital Mobility and the Crisis of Embedded Liberalism, *Review of International Political Economy*, Vol.6, No.3 (Autumn 1999); André Cartapanis and Michel Herland, The Reconstruction of the International Financial Architecture: Keynes' Revenge?, *Review of International Political Economy*, Vol. 9, No.2 (Summer 2002)

[151] Milton Friedman, The Case for Flexible Exchange Rates, in Milton Friedman, *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953). However, not all monetarists support free floating regimes.

[152] Thomas Mayer and Patrick Minford, Monetarism: A Retrospective, *World Economics*, Vol. 5, No.2 (April–June 2004), p.171.

von Hayek and Milton Friedman that attacked the costs of state intervention in socialist economies. [153]

Anne Krueger elaborated on the theoretical grounds for neoliberal reform. According to her, government is defined as a multitude of actors, who are concerned with their self-interests as well as public ones. This pluralist definition of government implies that decision-makers do not always behave as a benevolent social guardian. "Even when it appears that government action would actually be effective, there is something of a presumption in favour of policies and programmes requiring a minimum of administrative and bureaucratic input." [154] Put simply, the less the state intervenes, the better markets work.

Based on the definition, Krueger criticises three fallacies of the Keynesian concept of government.[155] First, the problem of imperfect information is not confined to market actors. Like individual firms, government cannot free itself from the information asymmetry since it is impossible to forecast the future performance of all economic actors. Thus state intervention is not costless. Second, the capture theory by George Stigler shows that public regulators tend to serve the interests of the regulated to secure their own self-interests such as promotion and rewards. In particular, this kind of capture, like an iron triangle, lasts as long as bureaucrats benefit from regulation. Thirdly, Mancur Olson's collective action dilemma occurs when small but powerful interest groups lobby to influence decision-making process without considering public interests.

From the late 1980s, the influence of neoliberalism spread from the policy-making circles in industrial countries to their counterparts in developing and transition economies. The IMF and World Bank played a key role in the policy diffusion. [156] The Bretton Woods institutions demand member states to follow their policy guidelines in order to avail itself of financial

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[153] Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944); Milton and Rose Friedman, *Free to Choose: A Personal Statement* (London: Secker and Warburg, 1980)
[154] Anne O. Krueger, Government Failures in Development, *Journal of Economic Perspective*, Vol.4, No.3 (Summer 1990), p.20.
[155] Anne O. Krueger, Economists' Changing Perceptions of Government, *Weltwirtschaftliches Archiv*, Vol.126 (1990)
[156] Thomas J. Biersteker, Reducing the Role of the State in the Economy: A Conceptual Exploration of IMF and World Bank Prescriptions, *International Studies Quarterly*, Vol.34, No.4 (December 1990)

assistance from them. Initially, policy conditionality was concerned with macroeconomic policy because most balance-of-payments crises were caused by large fiscal deficits. However, macroeconomic stabilisation programmes were not successful so that the IFIs turned their attention to structural weaknesses in the developing world. [157]

Ideational factors contributed to the spread of the Washington consensus. [158] First, there were epistemic communities that helped the transfer of the new economic ideas at an international level. [159] One of the best examples is the "Chicago Boys" in Chile. As one of the US aid programmes, American economists selected by the economics department of Chicago University were dispatched to train Chilean students. Initially the Chicago faculty contacted National University of Chile (NUC), but the programme was awarded to Catholic University in 1953. The reason is that the NUC faculty were dominated by structuralists – or followers of Raul Prebisch – of the Economic Commission for Latin America and the Caribbean did not want to follow Chicago-style curriculum. As a result, the Chilean protégés of Chicago economists led by Friedrich von Hayek, George Stigler, Milton Friedman and Arnold Harberger imported their mentors' doctrines; market-oriented development, monetarism and rationality in economic policy. Until Augusto Pinochet's military coup in 1973, however, the Chicago Boys did not have a significant influence in economic policy-making, even though they were linked to the business community. In the 1970s when monetarists succeeded in challenging Keynesianism in the US academic world, Pinochet gave the Chicago Boys a good opportunity to convert their ideas into economic policies. With the exception of foreign exchange rate policy, they implemented key neoliberal policies: austere macroeconomic stance, trade liberalisation and privatisation. [160]

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[157] Jacques J. Polak, The Changing Nature of IMF Conditionality, *Essays in International Finance*, No.184 (International Financial Section, Department of Economics, Princeton University, 1991)
[158] Stephan Haggard and Steven B. Webb (eds.), *Voting for Reform: Democracy, Political Liberalization, and Economic Adjustment* (Oxford: Oxford University Press, 1994), pp.27-29.
[159] Kathryn Sikkink, Development Ideas in Latin America: Paradigm Shift and the Economic Commission for Latin America, in Frederick Cooper and Randall Packard (eds.), *International Development and the Social Sciences: Essays in the History and Politics of Knowledge* (Berkeley: University of California Press, 1997)
[160] Juan Gabriel Valdes, *Pinochet's Economists: The Chicago School in Chile* (Cambridge: Cambridge University Press, 1995); Patricio Silva, Technocrats and Politics in Chile: From the Chicago Boys to the

> The Chilean state was able to carry out its program, not because it was more repressive, personalistic, or patrimonial than other states, but because it had a coherent political economic project and a talented, ideologically motivated bureaucracy capable (despite some costly policy errors) of designing new legal and economic institutions. [161]

Second, social learning is important in the ideological shift. Some developing countries undertook neoliberal reform as a pre-emptive measure not to be marginalised from the world economy. International conferences and negotiations hosted by the IFIs including the OECD and the GATT (later the WTO) played a part in persuading them to accept the Washington consensus. [162] Research departments in the IFIs have been led by chief economists, most of whom are sympathetic to neoliberalism. This is why the US influence on the recruitment of key positions in the departments has intensified the tendency.

> Ever since the US began, in the early 1980s, to assert its neoliberal foreign economic policy unilaterally in multilateral organizations, and since the Bank at the same time became involved not just in projects but in structural adjustment of whole economies, the US Treasury has been keenly interested in the appointment of the chief economist. It has exercised a *de facto* veto. [163]

CIEPLAN Monks, *Journal of Latin American Studies*, Vol.23, No. 2 (May 1991); William J. Barber, Chile Con Chicago: A Review Essay, *Journal of Economic Literature*, Vol.33, No.3 (December 1995) The political power of neoliberalism was strong in other Latin American countries. See Catherine M. Conaghan, James M. Malloy and Luis A. Abugattas, Business and the "Boys": The Politics of Neoliberalism in the Central Andes, *Latin American Research Review*, Vol. 25, No. 2. (1990); David E. Hojman, The Political Economy of Recent Conversions to Market Economics in Latin America, *Journal of Latin American Studies*, Vol.26, No.1 (February 1994); William R. Nylen, Selling Neo-liberalism: Brazil's Instituto Liberal, *Journal of Latin American Studies*, Vol.25, No.2 (May 1993)

[161] Rhoda Rabkin, How Ideas Become Influential: Ideological Foundations of Export-Led Growth in Chile (1973-90), *World Affairs*, Vol.156, No.1 (Summer 1993), p.10.

[162] Thomas J. Bierstecker, The "Triumph" of Neoclassical Economics in the Developing World: Policy Convergence and Bases of Governance in the International Economic Order, in James Rosenau and Ernst-Otto Czempiel (eds.), *Governance Without Government* (Cambridge: Cambridge University Press, 1992)

[163] Robert H. Wade, US Hegemony and the World Bank: The Fight over People and Ideas, *Review of International Political Economy*, Vol.9, No.2 (Summer 2002), p.220.

Finally, IFIs' discursive practices contributed to championing the Washington consensus in the developing world. The IFIs publish numerous theoretical papers, journal reports and policy reviews to sell their policy recommendations. Although there is no obligation, many developing countries follow (or pretend to listen to) IFIs' recommendations not because their recommendations are always good advice but because they set the boundaries of conventions of economic policy. If one country does not follow the conventions, it would be criticised by the IFIs. In the current international financial system, IFIs' criticism has a negative impact on credit ratings of sovereign debts and thus the allocation of international portfolio because their criticism is a signal that foreign investors should leave the country. In other words, the IFIs can punish a country when it does not meet their expectations. [164]

Against this background, Paul Krugman argues that the emerging market phenomenon was as much ideational as materialist.

> [B]y 1993 or so "emerging market funds" were being advertised on television and the pages of popular magazines. At the same time that this self-reinforcing process was under way in the financial markets, a different kind of self-reinforcing process, sociological rather than economic, was taking place in the world of *affairs* – the endless rounds of meetings, speeches, and exchanges of communiqués that occupy much of the time of economic opinion leaders. Such interlocking social groupings tend at any given time to converge on a conventional wisdom, about economics among many other things. People believe certain stories because everyone important tells them, and people tell those stories because everyone important believes them. Indeed, when a conventional wisdom is at its fullest strength, one's agreement with that conventional wisdom becomes almost a litmus test of one's suitability to be taken seriously. [165]

[164] Ilene Grabel, The Political Economy of 'Policy Credibility': The New-Classical Macroeconomics and the Remaking of Emerging Economies, *Cambridge Journal of Economics*, Vol.24, No.1 (January 2000); Juan Martinez and Javier Santiso, Financial Markets and Politics: The Confidence Game in Latin American Emerging Economies, *International Political Science Review*, Vol.24, No.3 (2003)
[165] Paul Krugman, Dutch Tulips and Emerging Markets, *Foreign Affairs*, Vol.74, No.4 (July /August 1995), p.36

In the early 1990s, many East Asian developing countries embraced some policy recommendations of the Washington consensus. In the region, more attention was paid to financial and trade liberalisation because their macroeconomic management was relatively prudent, compared with Latin American countries. In the name of financial globalisation, many restrictions on capital account transaction were lifted to attract foreign investment and to enhance the efficiency of domestic financial markets. [166] For example, Korea implemented – though incompletely and gradually – liberalisation policies to become a member of the OECD in 1996. Malaysia also established an offshore tax heaven for foreign financial institutions in Labuan in 1990, which was intended to be a regional financial centre such as Hong Kong and Singapore. [167]

3. The East Asian Financial Crisis and the Triumph of the Washington Consensus

As Richard Higgott argues, "The Asian Crisis is a contest of ideology between Asian and Anglo-American ways of organising capitalist production." [168] The triumph of the Washington consensus was not only achieved by IMF's financial resources but also by its ideological warfare against the East Asian developmental model. The predominance of neoliberalism in the theoretical and policy debate over the causes of the crisis enhanced the legitimacy of the Anglo-American economic model on which IMF-supported programmes is based.

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[166] Financial globalisation can be defined as "the broad integration of national markets associated with both innovation and deregulation in the postwar era and is manifested by increasing movements of capital across national frontiers." Benjamin J. Cohen, Phoenix Risen: The Resurrection of Global Finance, *World Politics*, Vol. 48, No. 2 (January 1996), p.269.

[167] Stephan Haggard and Sylvia Maxfield, The Political Economy of Financial Internationalization and the Developing World, *International Organization*, Vol. 50, No.1 (Winter 1996); Michael Loriaux, Meredith Woo-Cumings, Kent E. Kalder, Sylvia Maxfield and Sofia Perez (eds.), *Capital Ungoverned: Liberalizing Finance in Interventionist States* (Ithaca: Cornell University Press, 1997); Arvid Lukauskas and Susan Minushkin, Explaining Styles of Financial Market Opening in Chile, Mexico, South Korea, and Turkey, *International Studies Quarterly*, Vol.44, No.4 (December 2000)

[168] Richard Higgott, The Asian Economic Crisis: A Study of the Politics of Resentment, *New Political Economy*, Vol.3, No.3 (1998), p.349.

To understand the debates in a broader context, it is necessary to examine theories of currency / financial crisis. [169] There are three models in neoclassical economics. The first-generation model highlights fiscal indiscipline. Under fixed exchange regimes, loose fiscal policy is likely to create a balance-of-payments crisis by putting downward pressure on the currency in the long run. In the second-generation model, self-fulfilling speculative attack is the main trigger of currency crisis. Irrational behaviour such as herding, contagion or adverse selection can bring even an economy with sound macroeconomic fundamentals to currency crisis. Finally, the third-generation model emphasises the role of moral hazard, which makes the financial and corporate sectors vulnerable to external shocks. [170]

There is little doubt that the first-generation model does not fit into East Asia. [171] As the IMF says, "The Asian crisis differed from previous financial crises in which the IMF's assistance has been needed... Conventional fiscal imbalances were relatively small; and only in Thailand were significant real exchange rate misalignments evident." [172] Thus economists turned to the second and third generation models. In the debate, supporters of the Washington consensus – including the US government and the IMF – emphasised domestic weaknesses in the financial and corporate sectors, whereas its critics highlighted speculative attacks and herding behaviours. This theoretical difference had a far-reaching political implication. In the second- generation model, the crisis-affected countries were victims of the flawed international financial system. In contrast, the countries themselves were to blame for the crisis in the third-generation model. Against this background, the underlying motivation of

[169] For an overview of financial crises in historical perspective, see Charles P. Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises*, fourth edition (New York: John Wiley & Sons, 2000); Barry Eichengreen, *Financial Crises and What to Do About Them* (Oxford: Oxford University Press, 2002)

[170] Paul Krugman, Currency Crises (1997), available at http://web.mit.edu/krugman/www/crises.html ; What Happened to Asia? (1998), available at http://web.mit.edu/krugman/www/DISINTER.html

[171] Graciela L. Kaminsky and Carmen M. Reinhart, Financial Crisis in Asia and Latin America: Then and Now, *American Economic Review*, Vol. 88, No. 2 (May 1998); Jenny Corbett and David Vines, Asian Currency and Financial Crises: Lessons from Vulnerability, Crisis and Collapse, *World Economy*, Vol.22, No.2 (March 1999); J. Bradford DeLong, Financial Crises in the 1890s and the 1990s: Must History Repeat?, *Brookings Papers on Economic Activities*, No.1 (1999); Lawrence H. Summers, International Financial Crises: Causes, Prevention, and Cures, *American Economic Review*, Vol.90, No.2 (May 2000)

[172] Timothy Lane, Atish R. Ghosh, Javier Hamann, Steven Phillips, Marianne Schulze-Ghattas, and Tsidi Tsikata, *IMF-Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment*, Occasional Paper No.178 (IMF, 1999), p.17.

IMF's support for the third-generation model was a strategy to de-legitimise the East Asian model, thereby making it easy for the Fund to impose its own programmes on the region.

To this end, neoliberal economists attacked World Bank's *The East Asian Miracle* that made the case for industrial policy and strategic trade policy. [173] This was of political and theoretical significance because the report was published under the sponsorship of the Japanese government that wanted to legitimise and promote its economic model. [174]

Their strategy to blame systemic problems with the East Asian development model for the financial crisis was two-fold: positive and normative. First, neoliberal economists attempted to show that the development model was neither productive nor efficient. This argument was suggested by Paul Krugman's *The Myth of Asia's Miracle*. [175] Theoretically, Krugman's analogy between the East Asian miracle and Stalin's industrialisation in the Soviet Union was based on the theory of total factor productivity (TFP) that is defined as the ratio between real product and real factor inputs. The theory is used to measure the contribution of technological change in economic growth. Some empirical studies found out that economic growth in East Asia was driven by more capital and labour than technology. [176] The underlying implication of the finding was that the East Asian model was neither efficient nor sustainable in the long run. In other words, East Asian NICs' economic growth was not a miracle and their development model was not superior to Western model. For this reason, some Western commentators

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[173] World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Oxford: Oxford University Press, 1993). Some economists and journalists also praised the economic model, urging the US government to use industrial policy and strategic trade policy. For example, see Robert B. Reich, *The Work of Nations: Preparing Ourselves for 21st Century Capitalism* (Alfred A. Knopf, 1992); James M. Fallows, *Looking at the Sun: The Rise of the New East Asian Economic and Political System* (New York: Pantheon Books, 1994)

[174] Robert Wade, Japan, the World Bank, and the Art of Paradigm Maintenance: The East Asian Miracle in Political Perspective, *New Left Review*, No. 217 (May-Jun 1996)

[175] Paul Krugman, The Myth of Asia's Miracle, *Foreign Affairs*, Vol.73. No.6 (November / December 1994)

[176] Jong-Il Kim and Lawrence J. Lau, The Sources of Economic Growth of the East Asian Newly Industrialized Countries, *Journal of the Japanese and International Economics*, Vol.8, No.3 (1994); Alwyn Young, The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience, *The Quarterly Journal of Economics*, Vol. 110, No.3 (August 1995); Susan M. Collins and Barry P. Bosworth, Economic Growth in East Asia: Accumulation Versus Assimilation, *Brookings Papers on Economic Activity*, No.2 (1996) For criticisms of this approach, see Jesus Felipe, Total Factor Productivity Growth in East Asia: A Critical Survey, EDRC Report Series NO. 65 (ADB, 1997); Edward K. Y. Chen, The Total Factor Productivity Debate: Determinants of Economic Growth in East Asia, *Asian-Pacific Economic Literature*, Vol. 11, No. 1 (May 1997); Chang-Tai Hsieh, Productivity Growth and Factor Prices in East Asia, *The American Economic Review*, Vol.89, No.2 (May 1999)

suggested that the crisis-affected countries would ultimately adopt Anglo-American style capitalism by surrendering Japanese-style capitalism. [177]

Second, neoliberal economists developed a theory of crony capitalism to criticise the model from a normative perspective. The concept was originally invented to describe Ferdinand Marcos's behaviour that gave oligopoly rights to group of businessmen and various political supporters to maintain his power in the Philippines. Sang Jin Wei generalises the concept in a broader perspective. "Crony capitalism refers to an economic environment in which relatives and friends of government officials are placed in positions of power and government decisions on allocation of resources and judicial judgement on commercial disputes are distorted to favour these friends and relatives." [178]

The core of the theory is that the primary cause of the crisis is moral hazard problem inherent in the East Asian development model. [179] The moral hazard thesis had three points. First, industrial policy was accused of breeding cronyism in the corporate sector. Before the crisis, close-government relationship was an advantage that allowed the crisis-affected countries to achieve rapid industrialisation. Second, deposit insurance was criticised for generating moral hazard in the financial sector. Excessive risky lending of financial institutions arose from their expectation that their liabilities were under government guarantee.

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[177] For critics of Japanese (or East Asian) model, see Ron Bevacqua, Whither the Japanese Model? The Asian Economic Crisis and the Continuation of Cold War Politics in the Pacific Rim, *Review of International Political Economy*, Vol.5, No.3 (Autumn 1998); Ronald Dore, Asian Crisis and the Future of the Japanese Model, *Cambridge Journal of Economics*, Vol.22, No.6 (November 1998); Rosemary Foot and Andrew Walter, Whatever Happened to the Pacific Century?, *Review of International Studies*, Vol. 25, No.5 (December 1999); Steven K. Vogel, The Crisis of German and Japanese Capitalism: Stalled on the Road to the Liberal Market Model?, *Comparative Political Studies*, Vol. 34, No.10 (December 2001); Shahid Yusuf, Remodeling East Asian Development, *ASEAN Economic Bulletin*, Vol.19, No.1 (April 2002)

[178] Shang-Jin Wei, Domestic Crony Capitalism and International Fickle Capital: Is There a Connection?, *International Finance*, Vol.4, No.1 (Spring 2001), p.21.

[179] In economics, moral hazard refers to actions of economic agents in maximising their own utility to the detriment of others, in situations where they do not bear the full consequences or, equivalently, do not enjoy the full benefits of their actions due to uncertainty and incomplete or restricted contracts which prevent the assignment of full damages (benefits) to the agent responsible. Y. Kotowitz, Moral Hazard, in *The New Palgrave Dictionary of Economics* (London: Macmillan, 1987), p.549.

Finally, political corruption delayed the development of good governance system. The countries lacked sufficient regulatory agencies that could prevent moral hazard problem. [180]

The crony capitalism thesis was very effective because it de-privileged the model from a normative perspective. [181]

> [T]he successful discursive attacks on Asian model practices coupled with the severe economic effects of the crisis generated a normative environment for policy formation that severely constrained resistance to the radical restructuring of the institutional and legal framework of the Korean economy than would otherwise have been expected. Defense of these practices became untenable when these practices had been successfully discursively reconstructed as corruption, while a move to market-based outcomes and decision-making had been successfully discursively reconstructed as ethical and authoritative. The major mechanism by which ideas are transmitted into the policy arena is through discourse, or arguments. In this context, discourse is high politics.[182]

The crony capitalism thesis paved the way for the IMF to intervene in governance issues as well as monetary and financial policies. Structural reform became one of the key pillars of IMF-supported programmes in East Asia on the ground that the roots of crony capitalism could not be solved without transforming the economic system as a whole. IMF's emphasis on structural reform were criticised in two ways. First, many of them – especially labour market reform, privatisation and trade liberalisation – have nothing to do with the financial crisis,

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[180] For criticisms of the thesis, see Chalmers Johnson, Economic Crisis in East Asia: The Clash of Capitalisms, *Cambridge Journal of Economics*, Vol.22, No.6 (November 1998); Ha-Joon Chang, The Hazard of Moral Hazard: Untangling the Asian Crisis, *World Development*, Vol.28, No.4 (April 2000); Joel S. Kahn and Francesco Formosa, The Problem of 'Crony Capitalism': Modernity and the Encounter with the Perverse, *Thesis Eleven*, No.69 (May 2002)
[181] There is little empirical evidence that supports the thesis. See Michael T. Rock and Heidi Bonnett, The Comparative Politics of Corruption: Accounting for the East Asian Paradox in Empirical Studies of Corruption, Growth and Investment, *World Development*, Vol.32, No.6 (June 2004)
[182] Rodney Bruce Hall, The Discursive Demolition of the Asian Development Model, *International Studies Quarterly*, Vol.47, No.1 (March 2003), p.71.

although they are helpful to lay the foundation for long-term economic growth.[183] Second, there were suspicions that these measures were inserted to serve the national interests of IMF's major shareholders. For example, import diversification was a priority of the Japanese government, while the liberalisation of financial service reflected the US demand. Nevertheless, the thesis enabled the IMF to disguise the hidden agenda of structural reform successfully.

Furthermore, the crony capitalism thesis protected the IMF and major creditor countries from the accusation that they should bear responsibility for their mistakes: for example, its failure to deliver early warnings and negligence in reforming the international financial architecture.[184]

> Laying the blame on homegrown causes protects the current international financial regime behind an ideational shield. Ironically, it even legitimizes arrangements for international financial players that are similar to the crisis-affected countries' arrangements that those same international players identify as the main cause of the crisis and in need of reform: if no blame rests with international financial players or the international financial system, but does rest with *irresponsible* governments in the crisis-affected countries (who did not insist on full "transparency" in company accounts, for example), then the international private financiers are entitled to be protected from private losses just as they are entitled to keep the private profits. And the homegrown causes explanation also legitimizes the use of the IMF to subject the governments, banks, and firms of developing countries to the kind of discipline demanded by private international capitalists (who saw themselves shut out by "cronyism"), but not to subject those capitalists to the kind of discipline that might operate to the advantage of developing countries.[185]

[183] For a defence of the IMF policy, see Nancy Brune, Geoffrey Garrett and Bruce Kogut, The International Monetary Fund and the Global Spread of Privatization, *IMF Staff Papers*, Vol.51, No.2 (2004)

[184] At that time, the IMF was criticised for its bailout policy. For example, see George P. Shultz, William E. Simon and Walter B. Wriston, Who Needs the IMF?, *Wall Street Journal* (3 February 1998); Timothy Lane and Steven Phillips, Does IMF Financing Result in Moral Hazard?, Working Paper No. 00/168 (IMF, 2000)

[185] Robert Wade, *Governing the Market: Economic Theory and Role of Government in East Asian Industrialization*, second edition (Princeton University Press, 2003), p.xxiii.

4. The Emergence of the Post-Washington Consensus after the Financial Crisis

Although the Washington consensus effectively attacked the East Asian development model in both positive and normative ways, its policy recommendations were far from perfect. As heated debates on policy responses to the crisis shows, IMF-supported programme were criticised in many ways. As a result, the IMF conceded that some of their policy recommendations proved to be ineffective. [186]

First, fiscal contraction contributed to deepening of a recession rather than a restoration of investors' confidence. At the time of the crisis, as most crisis-hit countries maintained a sound fiscal stance during the 1990s, there was room for expansionary budgets.

> Fiscal targeting in IMF-supported programs...are typically projections based on current policies and assumptions together with measures adopted under the programs: in the Asian crisis countries, these assumptions were proved drastically wrong... [P]rogram revisions accommodated a substantial part of the expansionary effect of changing economic conditions on the fiscal positions from the start of 1998. [187]

Second, the successful revival of the Malaysian economy disproved the IMF's scepticism. Irrespective of whether capital controls contributed to economic recovery, the policy was not as dangerous as the Fund had envisaged.

> [P]reliminary evidence suggests that the controls have been effective in realizing their intended objective of reducing the ringgit's internationalisation and helping to contain capital outflows by eliminating the offshore ringgit market and by restricting the outflows of capital by residents and

[186] A self-critical assessment is undertaken by the Independent Evaluation Office at the IMF. See IMF, *IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil* (IMF, 2003)
[187] Lane et al. (1999), p.62.

non residents. The wide-ranging nature, and strict enforcement, of the controls prior to the partial relaxation of the control regime in early 1999 certainly play a role. [188]

Third, it is a moot point whether structural reform contributed to economic recovery. [189] IMF supporters argue that structural reform played a significant role in the restoration of investors' confidence. However, critics points out,

> Most of the serious structural problems that were identified as the main causes of the crisis in Indonesia, Korea, Malaysia and Thailand could not have been resolved over a span of two years... Since the crisis countries are not even half-way there in restructuring their financial institutions and corporations, it would be presumptuous to argue that the reform efforts have established a foundation for sustainable growth in East Asia. [190]

These mistakes that the IMF conceded provided a rare window of opportunity to rethink the advantages and disadvantages of the Washington consensus in a broader perspective. [191] Before the East Asian crisis, empirical studies on Africa and Latin America cast doubt on the legitimacy of the Washington consensus, pointing out the poor results from IMF and World Bank conditionality.[192] However, this scepticism was not seriously regarded among policy makers and mainstream (or neoclassical) economists. It is the East Asian crisis that provoked profound debates on IMF-supported programmes. From the early stage of the crisis, some

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[188] Akira Ariyoshi, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Ivan Canales-Kriljenko, and Andrei Kirilenko, *Capital Controls: Country Experiences with Their Use and Liberalization*, Occasional Paper No.190 (IMF, 2000), pp.104-05.

[189] *Wall Street Journal*, Korean Comes Back, Suggesting Reform Isn't the Only Answer (17 May 1999)

[190] Yung Chul Park and Jong-Wha Lee, Recovery and Sustainability in East Asia, Working Paper No.8373 (NBER, 2001), p.31. See also Jong-Wha Lee and Changyong Rhee, Macroeconomic Impacts of the Korean Financial Crisis: Comparison with the Cross-country Patterns, *World Economy*, Vol. 25, No. 4 (April 2002)

[191] Barry Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda* (Washington D.C.: Institute for International Economics, 1999); Kenneth Rogoff, International Institutions for Reducing Global Financial Instability, *Journal of Economic Perspectives*, Vol.13, No.4 (Fall 1999)

[192] Barry Gills and George Philip, Editorial: Towards Convergence in Development Policy?: Challenging the 'Washington Consensus' and Restoring the Historicity of Divergent Development Trajectories, *Third World Quarterly*, Vol. 17, No. 4 (1996); Lance Taylor (eds.), *After Neoliberalism: What Next for Latin America?* (Ann Arbor: University of Michigan Press, 1999)

prominent economists – who once held high-profile positions in the international financial institutions or US government – criticised the IMF. [193] Their point was that IMF's austere macroeconomic policy would worsen economic recession; and capital account liberalisation would make the crisis-affected countries more vulnerable to external shocks. Although these criticisms were echoed by some policy makers in the crisis-affected countries, they could not be immediately implemented because the Washington consensus overwhelmingly prevailed at that time. [194]

These critical assessments resulted in the post-Washington consensus. When it comes to macroeconomic stabilisation, the consensus prefers Keynesian stimulus policies to monetarist's anti-inflation policies. Its advocates argue that fiscal deficits should be allowed to cope with economic recession because they are an effective measure to spur output and to reduce social costs of unemployment. In terms of structural reform, the consensus supposes that government intervention makes markets function better. In this regard, it suggests gradualist approaches to liberalisation, deregulation and privatisation.[195]

Among others, the post-Washington consensus warns the danger of ill-sequenced financial liberalisation. It has three rationales. First, financial liberalisation is likely to make domestic financial markets vulnerable to volatile capital flows at least in the short term. [196] Second,

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[193] Among others, Martin Feldstein was Chairman of Council of Economic Advisers in the Reagan administration. Joseph Stiglitz was Chairman of the Council in the Clinton administration and Vice President and Chief Economist of the World Bank at that time of the crisis. Jeffrey Sachs has participated in various IMF and World Bank missions in developing and transition economies since the 1980s.

[194] For example, many Japanese economists had a dissent view, which is different from that of the IMF and the US. A major difference lies in the prescriptions to the crisis. The Japanese government seems to hold the view that there are few reasons to reform the whole financial system since the crisis stemmed from a liquidity problem. This difference was reflected in the New Miyazawa Initiative that did not attach any IMF-style conditionality to financial assistance. See Yoshitomi Masaru, The Asian Crisis and the IMF's Medicine, *Japan Echo* (April 1998)

[195] Joseph E. Stiglitz, More Instruments and Broader Goals: Moving toward the Post-Washington Consensus, *WIDER Annual Lecture* (Helsinki: 7 January 1998)

[196] Carlos Diaz-Alejandro, Good-Bye Financial Repression, Hello Financial Crash, *Journal of Development Economics*, Vol. 19, No. 1/2 (1985); John Williamson and Molly Mahar, A Survey of Financial Liberalisation, *Essays in International Finance*, No.211 (International Financial Section, Department of Economics, Princeton University, 1998), p.53. See also Asli Demirguc-Kunt and Enrica Detragiache, Financial Liberalization and Financial Fragility, Working Paper No. 98/83 (IMF, 1998); Paul Wachtel, Growth and Finance: What Do We Know and How Do We Know It?, *International Finance*, Vol.4, No.3 (2001); Lance Taylor, The Consequences of Capital Liberalization, *Challenge*, vol.43, No.6 (November / December 2000) This criticism is confirmed by IMF economists. See Eswar

there is no conclusive evidence to prove positive correlation between financial liberalisation and economic performance. [197] Third, the correlation between liberalisation and growth is fragile and tenuous at least in the short term. [198]

As a matter of fact, the East Asian financial crisis and its spread to emerging economies in Eastern Europe and Latin America undermined one of the key doctrines that the IMF has pursued: capital account liberalisation. As Joseph Stiglitz points out, "[W]hen there is a single accident on a highway, one suspects that the driver's attention may have lapsed. But when there are dozens of accidents at the same bend in the same highway, one needs to re-examine the design of the road." [199] Even neoliberal newspapers as well as mainstream economists seriously consider that the affected countries have good reason to limit capital outflows in order to prevent further depreciation of their currencies. [200]

Table 3-1 shows that the crisis-hit five Asian economies (Indonesia, Korea, Thailand, Malaysia and Philippines) received a net private capital inflow of 65.8 billion dollars in 1996. However, the next year witnessed a net outflow of 20.4 billion dollars. Compared with FDI and portfolio investment, bank loans were very volatile. There are a couple of reasons why foreign capital flowed to the region at that time. First, low interest rates in industrial countries led institutional investors to divert their portfolio to emerging markets. From 1990 to 1996,

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S. Prasad, Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, Occasional Paper No.220 (IMF, 2003)

[197] Dennis Quinn, The Correlates of Change in International Financial Regulation, *American Political Science Review*, Vol.91, No.3 (September 1997);

[198] Dani Rodrik, Who Needs Capital-Account Convertibility?, *Essays in International Finance*, No.207 (International Financial Section, Department of Economics, Princeton University, 1998); Barry Eichengreen, Capital Account Liberalization: What do the Cross-Country Studies Tell Us?, *World Bank Economic Review*, Vol.15, No.3 (2001); Hali Edison, Michael Klein, Luca A. Ricci, and Torsten M. Slok, Capital Account Liberalization and Economic Performance: Survey and Synthesis, Working Paper No. 02/120 (IMF, 2002); Eichengreen, Barry and David Leblang, Capital Account Liberalization and Growth: Was Mr. Mahathir Right?, *International Journal of Finance and Economics*, Vol.8, No.3 (July 2003)

[199] Joseph E. Stiglitz, Capital Market, Liberalization, Economic Growth, and Instability, *World Development*, Vol.26, No.6 (June 2000), p.1075. See also Maurice Obstfeld, The Global Capital Market: Benefactor or Menace?, *Journal of Economic Perspective*, Vol. 12 (Fall 1998); Frederic S. Mishkin, Global Financial Instability: Framework, Events, Issues, *Journal of Economic Perspective*, Vol.13, No.4 (Fall 1999); Pierre-Richard Agénor, Benefits and Costs of International Financial Integration: Theory and Facts, *World Economy*, Vol. 26, No.8 (August 2003)

[200] For example, see Martin Wolf, Asia: Ins and Outs of Capital Flows, *Financial Times* (16 June 1998); David Wessel and Bob Davis, Currency Control are Getting a Hearing Amid Asian Crisis, *Wall Street Journal* (4 September 1998)

net capital flows to emerging economies surged seven-fold. Second, there was a wave of financial liberalisation in developing countries. Many East Asian countries removed restrictions on capital accounts that provided many channels for flow foreign capital. [201]

[Table 3-1] Net Private Capital Flows to Emerging Markets [202]

	92	93	94	95	96	97	98	99
Emerging markets								
Total net private capital inflows	112.6	172.1	136.3	226.9	215.9	147.6	75.1	80.5
Net FDI	35.4	59.4	84.0	92.6	113.2	138.6	143.3	149.8
Net portfolio investment	56.1	84.4	109.6	36.9	77.8	52.9	8.5	23.3
Bank loans and other	21.0	28.3	-57.3	97.4	24.9	-44.0	-76.7	-92.5
Asia								
Total net private capital inflows	20.8	57.4	63.6	104.9	104.1	-1.4	-42.6	-27.0
Net FDI	15.7	33.9	47.1	46.6	53.1	55.5	58.3	49.9
Net portfolio investment	9.0	21.8	11.8	14.2	12.9	3.5	-17.9	-5.6
Bank loans and other	-3.9	1.7	4.7	44.1	38.1	-60.4	-82.9	-71.3
Five crisis-affected Asian countries*								
Total net private capital inflows	29.0	31.8	36.1	74.2	65.8	-20.4	-25.6	-24.6
Net FDI	7.3	7.6	8.8	7.5	8.4	10.3	8.6	10.2
Net portfolio investment	6.4	17.2	9.9	17.4	20.3	12.9	-6.0	6.3
Bank loans and other	15.3	7.0	17.4	49.2	37.1	-43.6	-28.2	-41.1

* Indonesia, Korea, Malaysia, Philippines and Thailand
** Unit: Billions of US dollar

This massive reversal of capital flows, including the flight of domestic capital, pressured them to depreciate their currencies to nearly 40 percent below pre-crisis values.[203] In short, "countries with a large number of controls on capital inflows tend to be less prone to a

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[201] Takatoshi Ito, Capital Flows in Asia, Working Paper No. 7134 (NBER, 1999); Dani Rodrik and Andres Velasco, Short-Term Capital Flows, Working Paper No. 7364 (NBER, 1999)

[202] IMF, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (IMF, 2000), p.46.

[203] Tony Makin, The Great East Asian Capital Flow Reversal: Reasons, Responses and Ramifications, *World Economy*, Vol. 22, No. 3 (May 1999); Andrew Elek and Dominic Wilson, The East Asian Crisis and International Capital Markets, *Asian-Pacific Economic Literature*, Vol. 13, No. 1 (May 1999); Stephen Grenfell, Capital Flows and Crises, *Asian-Pacific Economic Literature*, Vol. 13, No. 2 (November 1999) It is still debatable which actors - hedge funds or international banks – initiated the reversal. For the debate, see Thomas D. Willett, Aida Budiman, Arthur Denzau, Gab-Je Jo,Cesar Ramos and John Thomas, The Falsification of Four Popular Hypotheses About the Asian Crisis, *World Economy*, Vol.27, No.1 (2004)

currency crash, perhaps, by limiting the amount of funds that could leave a particular country should foreign investors' sentiments change." [204]

According to Paul Krugman, financial liberalisation policy is attributable to IFIs' obsession with market confidence. [205] Their emphasis on market sentiment reflects the interest of portfolio investors rather than that of crisis-affected countries. Indeed, a substantial amount of IMF's loans were used to advance creditor interests rather than to regaining economic growth. "The Fund-led bailouts impose few net costs on the industrialized countries, since the Fund has always been repaid." [206] For this reason, the Fund has been accused of "creditor community's enforcer" or "chief debt collector for international banks." In other words, the Fund is more concerned about the policy objectives of its chief shareholders – i.e., the industrial countries – than about rescuing currency crisis-affected countries.

The case of Korea illustrates how Western banks imposed severe conditions and burdens on crisis-hit countries.

> There is little question that the rollover was critical to Korea's relatively rapid turnaround. Creditors, for their part, came out better *after* the rollover than before: there was no writedown, the new loans carried higher interest rates than the original loans, plus they carried a Korean government guarantee. Korea had certain advantages that may not be present for other reschedulings: its political importance brought strong pressure from the Unites States to get a deal done, the Korean government negotiated on behalf of the banks, and there were a relatively small number of creditors (mainly U.S. banks). [207]

With respect to corporate reform, supporters of the post-Washington consensus have some reservations over IFIs' encouragement of governance reform. First, they are opposed to a mere imposition of an Anglo-American model in the disguise of global standards or "best practice".

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[204] Marco Rossi, Financial Fragility and Economic Performance in Developing Economies: Do Capital Controls, Prudential Regulation and Supervision Matter?, Working Paper No.99/66 (IMF, 1999), p.16.
[205] Paul Krugman, The Confidence Game, *New Republic* (5 October 1998)
[206] Devesh Kapur, The IMF: A Cure or a Curse?, *Foreign Policy*, No.111 (Summer 1998), p.125.
[207] Steven Radelet, Orderly Workout of Cross Border Private Debts, Working Paper (Harvard Institute for International Development, 1999), p.10.

A series of corporate scandals in the US – including Enron, Tyco and World Com – show that the Anglo-American system is far from perfect. [208]

> The term *crony* capitalism, as loosely applied today by Western technocrats, editors and sundry commentators, denotes corruption or favoritism...Explanations centered on a *crony capitalism* variant as the cause of the Asian crisis tend to induce moral satisfaction. They help confirm mostly hidden prejudice among Europeans and Americans about non-Western governments not being able to govern well. They also encourage the state of deep denial in which the technocracies of international organizations and Western governments find themselves today. [209]

Second, they suspect that IFIs' ultimate objective does not lie in the development of corporate governance itself but in the protection of foreign investors.

> [D]espite the claim that good corporate governance embodies 'universal principles', the definition advanced by the IFIs intentionally draws on the Anglo-American variant. This imposed standardisation of corporate governance serves two overlapping goals. First, it attempts to stabilise the international financial system by ensuring that emerging markets adapt to the exigencies of the neoliberal open market economy. Second, by placing greater emphasis on 'shareholder value' rather than on other variants of corporate governance, the interests of foreign capitals are protected.[210]

These criticisms of the Washington consensus gave rise to a critical review of democratic accountability in the IFIs. [211] In principle, the executive board of the IMF should represent the

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[208] Franklin R. Edwards, Hedge Funds and the Collapse of Long-Term Capital Management, *Journal of Economic Perspective*, Vol.13, No.2 (Spring 1999); Paul M. Healy and Krishna G. Palepu, The Fall of Enron, *Journal of Economic Perspective,* Vol.17, No.2 (Spring 2003)

[209] Karel Van Wolferen, The Global Conceptual Crisis, *New Perspectives Quarterly*, Vol.16, No.1 (Winter 1999)

[210] Susanne Soederberg, The Promotion of 'Anglo-American' Corporate Governance in the South: Who Benefits from the New International Standard?, *Third World Quarterly*, Vol.24, No.1 (2003), pp.8-9. See also Ewald Engelen, Corporate Governance, Property and Democracy: A Conceptual Critique of Shareholder Ideology, *Economy and Society,* Vol.31, No.3 (August 2002)

[211] Ngaire Woods, Making the IMF and the World Bank More Accountable, *International Affairs*, Vol. 77, No. 1 (January 2001); Leo Van Houtven, Governance of the International Monetary Fund: Decision

finance ministers of all of the member countries. The reality, however, is the predominance of the major industrial countries since the voting weight of the US, Europe and Japan is sufficient to pass any decision. In particular, the US Treasury has wielded significant power over the Fund with sufficient votes to veto. In this regard, the Fund has been accused of being a rubber stamp of the Treasury whose constituency is – in Dam's words – Wall Street. [212]

> [T]the Fund too often pursues policies that serve the interests of Wall Street and the US Treasury Department rather than the world as a whole... [T]he IMF is too responsive to the agendas of national governments (the governments of its principal shareholders in particular)...The US government's prominence in international financial markets and large voting share in the Board enable it to exercise a disproportionate influence over decision-making in the Fund. [213]

One way to solve the dominance of the major countries is to update the distribution of voting rights, which has not reflected the growing significance of emerging economies. [214] Based on an analysis of each country's wealth and economic performance, the IMF sets the amount of the quota the member will contribute. Quotas are reviewed every five years and can be raised or lowered. However, the Quota Formula Review Group commissioned by the IMF shows that the existing quota formula failed to reflect the rapidly-changing world economy. There is no doubt that East Asia is under-represented in the Fund by many standards as Table 3-2 demonstrates. [215]

Making, Institutional Oversight, Transparency and Accountability, Pamphlet No. 53 (IMF, 2002); Rethinking IMF Governance, *Finance and Development* (September 2004); Vijay Kelkar, Vikash Yadavl and Praveen Chaudhry, Reforming the Governance of the International Monetary Fund, *World Economy*, Vol.27, No.5 (2004)

[212] Kenneth W. Dam, *The Rules of the Global Game: A New Look at US International Economic Policymaking* (Chicago: Chicago University Press, 2001), p.198.

[213] Jose De Gregorio, Barry Eichengreen, Takatoshi Ito and Charles Wyplosz, *An Independent and Accountable IMF: Geneva Reports on the World Economy 1* (London: Centre for Economic Policy Research, 1999), pp.1-4.

[214] Even at current exchange rates, China and Brazil have already surpassed Canada in terms of GDP. And Korea, Russia, India, Argentina and Mexico are bigger than small G-10 countries including Switzerland, Belgium and Sweden. See Jeffrey Frankel and Nouriel Roubini, The Role of Industrial Country Policies in Emerging Market Crises, in Feldstein (2003)

[215] Raghbendra Jha and Mridul K. Saggar, Towards a More Rational IMF Quota Structure: Suggestions for the Creation of a New International Financial Architecture, *Development and Change*, Vol. 31, No. 3 (June 2000); David P. Rapkin and Jonathan R. Strand, Is East Asia Under-represented in the

[Table 3-2] IMF Quotas and the Shares of the World Economy

Country	Quota ('99)	GDP ('94)	PPP-based GDP ('94)	Trade (Average of '90-'94)	Reserves ('94)
US	17.5	27.0	21.2	15.2	7.0
Germany	6.1	7.9	4.8	10.6	7.8
France	5.0	5.1	3.6	6.7	2.6
UK	5.0	3.9	3.4	6.1	3.6
Netherlands	2.4	1.3	0.9	3.5	3.2
Belgium	2.1	0.8	0.6	2.8	1.3
Switzerland	1.6	1.0	0.5	1.9	3.2
Japan	6.2	18.3	8.2	8.2	10.4
China	2.2	2.1	9.8	1.6	3.4
Korea	0.7	1.4	1.5	1.8	2.0
Indonesia	0.9	0.6	2.2	0.7	1.0
Malaysia	0.7	0.2	0.5	0.9	2.8
Thailand	0.5	0.5	1.3	0.9	2.4

Source: IMF, Report to the IMF Executive Board of the Quota Formula Review Group (2000)

Another way is to change IFIs' modus operandi. An over-emphasis on confidentiality hinders transparency and accountability in the decision-making process. Indeed, the secrecy of the IMF makes it difficult to evaluate the appropriateness of its operations. In addition, the Fund tends to be intolerant of its critics. It is widely believed that the Fund persuaded the US Treasury to expel Joseph Stiglitz from the Bank before his term of office had finished. [216]

In a broader perspective, it was the anxiety about neoliberalism that posed a serious challenge for the Washington consensus. [217]

International Monetary Fund?, *International Relations of the Asia-Pacific*, Vol.3, No.1 (February 2003) This view is shared by European policy makers. See Lorenzo Bini Smaghi, A Single EU Seat in the IMF?, *Journal of Common Market Studies*, Vol. 42, No, 2 (2004)

[216] *Washington Post*, Outspoken Economist to Leave World Bank (25 November 1999); *New York Times*, World Bank Economist Felt He Had to Silence His Criticism or Quit (2 December 1999)

[217] For criticisms of the consensus, see Robin Broad and John Cavanagh, The Death of the Washington Consensus?, *World Policy Journal* (Fall 1999); Charles Gore, The Rise and Fall of the Washington Consensus as a Paradigm for Developing Countries, *World Development*, Vol.28, No.5 (May 2000); Moises Naim, Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion?, *Third World Quarterly*, Vol.21, No.3 (2000); Eduardo Lora and Ugo Panizza, The Future of Structural Reform, *Journal of Democracy*, Vol.14, No.2 (April 2003) For a defence, see T. N. Srinivasan, The Washington Consensus a Decade Later: Ideology and the Art and Science of Policy Advice, *World Bank Research Observer*, Vol.15, No.2 (August 2000); Richard Higgott, Contested Globalization: The Changing Context and Normative Challenges, *Review of International Studies*, Vol. 26, No.5 (December 2000)

> The window of opportunity had closed and the first real backlash against 'globalization' was fully in train. At the very least, US and IMF dreams of even more open capital markets had to be put on the back burner, replaced by fears that the anti-globalization sentiments, strong in many emerging markets and growing in the USA, could spread to other liberalized OECD countries... the recent financial crises, and responses to them in Asia and Latin America, represent less the final ideological triumph of liberalism in a post-Cold War era than a further spur to rethinking significant aspects of the neoliberal project. [218]

The distributional impacts of economic globalisation have serious political implications because the benefits and costs of economic globalisation are not even across countries and across classes within countries. Internationally, the gap between developed countries and less-developed ones is not narrowed. Domestically, globalisation reduces the capacity of government to redistribute wealth by forcing them to adopt more business-friendly economic policy at the expense of social welfare. [219]

Public discontents with neoliberal globalisation prevailed in advanced world as well as developing world. [220] At the WTO conference in Seattle in 1999, even well paid workers in advanced countries aggressively expressed their concerns about a 'race to the bottom' – losing their jobs against low-paid workers in developing countries. A widespread perception is that globalisation reduced the relative wage of unskilled workers in industrial countries, thus leading to uneven income distributions. In Davos in January 2000, where the World Economic Forum takes place annually, anti-globalisation activists protested that globalisation would increase inequality between nations. In Washington D.C. in April 2002, many non-governmental organisations (NGOs) called for the reform of the Bretton Woods institutions that were under criticism for the lack of transparency and democratic accountability. The

[218] Richard Higgott, Economics, Politics and (International) Political Economy: The Need for a Balanced Diet in an Era of Globalisation, *New Political Economy*, Vol.4, No.1 (1999), p.360.
[219] This argument is subject to much controversy. For a general overview, see Jeffrey G. Williamson, Winners and Losers over Two Centuries of Globalization, *WIDER Annual Lecture* (Copenhagen: 5 September 2002); Geoffrey Garrett, The Distributive Consequences of Globalization (2001), available at http://www.international.ucla.edu/cms/files/conseall.pdf
[220] For example, see *Business Week*, Backlash: Behind the Anxiety Over Globalization (24 April 2000) Cf. Gary Burtless, Robert Z. Lawrence, Robert E. Litan, and Robert J. Shapiro, *Globalphobia: Confronting Fears about Open Trade* (Washington, D.C.: Brookings, 1998)

resistance to globalisation, which have developed over the past decade, are not confined only to economic issues, but also political, social and environmental ones. [221]

Against this backdrop, the post-Washington consensus moves beyond the technocratic recommendations of the Washington consensus, highlighting the socio-political dimensions of globalisation. [222] The Washington consensus is not enthusiastic about increasing social spending because of negative effects on social expenditures on economic growth. First, social welfare system tends to reduce national savings that provide capital to industries. Second, social expenditures are one of the sources of inflation, which sometime lead to a large devaluation of the currency. Finally, social policy can weaken the incentive to seek employment. For these reasons, neoliberalism suggests a business-friendly social policy: cutbacks in welfare benefits due to fiscal constraint, a reduction in the share of the employer's contributions in the social security revenues, increase of human capital investment and labour market flexibility. [223]

Supporters of the post-Washington consensus argue that globalisation increases the importance of social insurance and the role of government in providing cover against external risk. The reason is that the neoliberal policy can provoke a backlash against economic globalisation itself because international economic integration can cause domestic social disintegration. Unless the adverse effects of globalisation on those who do not benefits from

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[221] Duncan Green and Matthew Griffith, Globalization and its Discontents, *International Affairs*, Vol.78, No.1 (January 2002); Nick Crossley, Global Anti-corporate Struggle: A Preliminary Analysis, *British Journal of Sociology* Vol. 53, No. 4 (December 2002); Alan V. Deardorff, What Might Globalisation's Critics Believe?, *World Economy*, Vol. 26, No. 5 (May 2003); Eric Helleiner, Economic Liberalism and Its Critics: The Past as Prologue?, *Review of International Political Economy,* Vol.10, No.4 (November 2003)

[222] This concern is recently acknowledged by the proponents of the Washington consensus. See John Williamson, What Should the World Bank Think about the Washington Consensus?, *World Bank Research Observer*, Vol.15, No.2 (August 2000); Pedro-Pablo Kuczynski and John Williamson (eds.), *After the Washington Consensus* (Washington D.C.: Institute for International Economics, 2003)

[223] Dong-Myeon Shin, Economic Policy and Social Policy: Policy-Linkages in an Era of Globalisation, *International Journal of Social Welfare*, Vol.9, No.1 (2001) For the impacts of globalisation on welfare policy in the developing world, see Layna Mosley, Room to Move: International Financial Markets and National Welfare States, *International Organization*, Vol. 54, No.4 (Autumn 2000); Robert Kaufman and Alex Segura-Ubiergo, Globalization, Domestic Politics, and Social Spending in Latin America, A Time-Series Cross-Section Analysis, 1973–97, *World Politics*, Vol.53, No.4 (July 2001); Brian Burgoon, Globalization and Welfare Compensation: Disentangling the Ties that Bind, *International Organization*, Vol. 55, No.3 (Summer 2001); Nita Rudra, Globalization and the Decline of the Welfare State in Less-Developed Countries, *International Organization*, Vol. 56, No. 2 (Spring 2002)

globalisation are well managed, it is very difficult to gain political support for financial and trade liberalization, which is a serious threat for open economic system. Thus "the need for social insurance does not decline but rather increases as global integration increases." [224]

In industrial economies, organised labour resists liberalisation and privatisation because the policy is likely to result in a reduction of social welfare. [225] In East Asia, decades-long economic growth was not accompanied by the growth of social welfare system. As Table 3-3 shows, their social welfare was not better placed to cope with economic hardship than Central European countries that are in the similar stage of economic development.

[Table 3-3] Welfare State around 2000 [226]

	Former communist countries		Western OECD countries	East Asian countries	Developing countries
	Central Europe	Others			
Universal or near universal provision of pensions	Yes	Very low replacement rates	Yes; high replacement rates	For civil servants only	For civil servants only
Universal or near universal provision of family benefits	Yes	Limited	Yes, except in the United States	No	No
Unemployment insurance	Yes	No	Yes	Limited	No
Socialized health	Yes	No	Yes, except in the United States	Limited	No (in practice)
Socialized education	Yes	Limited	Yes	Yes	Yes (Limited)
Score	5	2	5	2.5	1.5

224 Dani Rodrik, *Has Globalization Gone Too Far?* (Washington D.C.: Institute for International Economics, 1997), p.79.
225 For example, see Elmar Rieger and Stephan Leibfried, Welfare State Limits to Globalization, *Politics & Society*, Vol.26, No.3 (September 1998)
226 Ethan B. Kapstein and Branko Milanovich (eds.), *When Markets Fail: Social Policy and Economic Reform* (New York: Russell Sage Foundation, 2002), p.19.

5. Conclusion

This chapter has traced the development of the Washington consensus in the context of the theoretical and policy debates on the East Asian financial crisis. By analysing the spread of neoliberalism from industrial countries to developing and transition countries, it has shown how ideational factors – epistemic communities, social learning and discursive practices – affected the spread of the Washington consensus.

From a perspective of neoliberalism, the financial crisis was a good opportunity to vindicate the Washington consensus. To this end, neoliberal economists de-legitimised the East Asian development model with the TFP theory and crony capitalism thesis. The ideological triumph of the consensus helped the IMF to push ahead with neoliberal economic policies in the crisis-affected countries.

As the negative side effects of IMF-supported programmes – such as prolonged economic recession, massive unemployment and the rise of income inequality –, the influence of the Washington consensus decreased. For these reasons, the post-Washington consensus emphasised pro-cyclical macroeconomic policy, institutional frameworks for prudent regulation / supervision, and social safety nets. [227]

It should be noted that the emergence of the post-Washington consensus does not necessarily mean the decline of the Washington consensus. As Table 3-4 demonstrates, the PWC is no absolute denial of the WC. In other words, the PWC is neither anti-global not anti-liberal. The PWC supports trade liberalisation by supporting the WTO disciplines and prudent macroeconomic management by establishing independent central banks. Furthermore, the PWC endorses a transparent corporate governance system and labour market reform. In this sense, Dani Rodrik calls the PWC an "augmented Washington consensus".

[227] John Williamson, Costs and Benefits of Financial Globalisation: Concepts, Evidence and Implications, in Geoffrey R. D. Underhill and Xiaoke Zhang (eds.), *International Financial Governance under Stress: Global Structures versus National Imperatives* (Cambridge: Cambridge University Press, 2002)

[Table 3-4] A Comparison of the Washington Consensus and the Post-Washington Consensus [228]

Original Washington Consensus	Augmented Washington consensus
• Fiscal discipline • Reorientation of public expenditure • Tax reform • Interest rate liberalization • Unified and competitive exchange rate • Trade liberalization • Openness to DFI • Privatization • Deregulation • Secure property rights	• Corporate governance • Anti-corruption • Flexible labor markets • Adherence to WTO disciplines • Adherence to international financial codes and standards • "Prudent" capital-account opening • Non-intermediate exchange rate regimes • Independent central banks / inflation targeting • Social safety nets • Targeted poverty reduction

In the next part, I analyse how the political power of the Washington consensus affected the post-crisis economic adjustment in Korea and Malaysia. To this end, I examine four policy areas respectively: macroeconomic stabilisation, financial restructuring, corporate reform and labour market reform. Although the policies were intertwined, I explore them separately for analytical reasons.

[228] Dani Rodrik, Growth Strategies, Working Paper No.10050 (NBER, 2003), p.44.

Part II

Case Studies

Chapter IV

Macroeconomic Stabilisation

1. Introduction

This chapter examines how much the political power of the Washington consensus affected macroeconomic adjustment in Korea and Malaysia. When it comes to macroeconomic policy, the consensus preaches the importance of fiscal discipline, a competitive exchange rate and market-determined interest rates, which became the key features of IMF-supported programmes. The IMF gave top priority to exchange rate stabilisation – consisting of high interest rates and fiscal tightening – on the basis that price stability is the foundation for sound macroeconomic policy. [229]. At the same time, the IMF emphasised the need for radical restructuring of the financial and corporate sectors. The rationale is that the macroeconomic imbalances could not be fixed without structural reform because the financial crisis arose from microeconomic weaknesses as well as macroeconomic mismanagement. [230]

On the other hand, critics of the Washington consensus – for example, Joseph Stiglitz and Jeffrey Sachs – put stress on economic growth rather than price stability. For this reason, they recommended a counter-cyclical policy: i.e., low interest rates and fiscal expansion. With respect to structural reform, they claimed that financial and corporate restructuring should be implemented after economic recovery on the ground that structural reforms would be likely to defer economic growth at least in the short-term. For example, high interest rate policy

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[229] Morris Goldstein, *The Asian Financial Crisis: Causes, Cures, and Systemic Implications* (Washington, DC: Institute for International Economics, 1998); Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, Paper Tigers? A Model of the Asian Crisis, *European Economic Review*, Vol.43, No.7 (June 1999)
[230] The IMF privileged the fundamentalist view. See Stanley Fischer, In Defense of the IMF: Specialized Tolls for a Specialized Task, *Foreign Affairs*, Vol.77, No.4 (July-August 1998); Jack Boorman, Timothy Lane, Marianne Schulze-Ghattas, Ales Bulir, Atish R Ghosh, Javier Hamann, Alexandros Mourmouros, and Steven Phillips, Managing Financial Crises: The Experience in East Asia, *Carnegie-Rochester Conference Series on Public Policy*, Vol.53 (2000)

worsened non-performing loans (NPLs) by increasing the financial burden of highly-indebted companies.[231]

Table 4-1 presents the two competing views on the causes of the crisis and policy remedies to it.

[Table 4-1] Competing Views on the Financial Crisis [232]

		Fundamentalist	Non-fundamentalist
Analysis	Definition	Financial (or illiquid) Crisis	Currency (or liquid) Crisis
	Causes	Moral Hazards in Financial Sector	Volatility of Financial Markets
		Vulnerable Financial Structure Inflexible Exchange Rate	Un-hedged Liberalisation Large Short-term Borrowing
Policy Responses	Capital Account	Liberalisation	Control
	Exchange Rates	Free Floating	Fixed / Managed Floating
	Monetary Policy	Tightening	Easing
	Fiscal Policy	Austerity	Expansion

Whether the IMF intervened or not, Korea and Malaysia adopted a pro-cyclical policy at least from October 1997 to the first half of 1998. Both governments raised interest rates and reduced fiscal spending to slow capital outflows and to prevent rapid depreciation of the currency.

The rest of the chapter is organised as follows. Each section of Korea and Malaysia begins with an overview of the debate on the causes of the financial crisis. In the sections, attention is paid to how the IMF, policy makers and big business interpreted the crisis. Then I analyses how their interpretations affected the making and implementation of policy prescriptions. The final section draws a conclusion from the case studies.

[231] Martin Feldstein, Refocusing the IMF, *Foreign Affairs*, Vol.77, No.2 (March-April 1998); Jeffrey D. Sachs and Steven Radelet, The East Asian Financial Crisis: Diagnosis, Remedies, Prospects, *Brookings Papers on Economic Activity*, No.1 (1998); Jason Furman and Joseph E. Stiglitz, Economic Crises: Evidence and Insights from East Asia, *Brookings Papers on Economic Activity*, No.2 (1998); Roberto Chang and Andres Velasco, A Model of Financial Crises in Emerging Markets, *Quarterly Journal of Economics*, Vol.CXVI, No.2 (May 2001)

[232] The distinction is drawn from Giancarlo Corsetti, Paolo Pasenti, and Nouriel Roubini, What Caused the Asian Currency and Financial Crisis?, *Japan and World Economy*, Vol.11, No.3 (1999)

2. Korea

1) The Causes and Consequences of the Financial Crisis

In the mid-1990s, the Korean economy had few symptoms of financial crisis. Except looming current account deficits, most macroeconomic indicators appeared sound, compared with other developing countries. This assessment proved to be wrong when the Thai crisis spread to the Northeast Asian region. A series of bankruptcy of chaebols including Hanbo Steel and Kia Motor in the first half of 1997 reminded both foreign investors and policy makers that the underlying weaknesses at the micro level were disguised by apparently sound 'macro' economic indices. [233]

The health of the economy got worse in the second half of 1997. The corporate failures spilled over the banking sector by generating an unprecedented level of NPLs. In response to the growing concern over the fragility of domestic financial institutions, the government issued a public statement that it would guarantee the payment of foreign debt liabilities by Korean financial institutions on 29 August 1997. This measure failed to stabilise financial markets because market participants suspected that the government did not have sufficient foreign exchange reserves to support the institutions. As a matter of fact, the government did not have correct information about the total obligation of overseas borrowing by Korean institutions because it relied on IMF's residence-based debt data that did not include offshore borrowing by overseas branches of domestic banks. [234]

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[233] For a historical background, see Donald Kirk, *Korean Crisis: Unraveling of the Miracle in the IMF Era* (New York: St. Matin's Press, 2000); Tat Yan Kong, *The Politics of Economic Reform in South Korea: A Fragile Miracle* (London: Routledge, 2000); Heather Smith (ed.), *Looking Forward: Korea after the Economic Crisis* (Canberra: Asia Pacific Press, 2000); Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas* (Washington D.C.: Institute for International Economics, 2000); Robert F. Emery, *Korean Economic Reform: Before and Since the 1997 Crisis* (Aldershot: Ashgate, 2001); Brian Bridges, *Korea after the Crash: The Politics of Economic Recovery* (London: Routledge, 2001)

[234] IMF, *IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil* (IMF, 2003), pp.188-89.

Politically-motivated exchange rate policy worsened the situation.[235] In the second half of 1997, a widespread consensus among economists was that the won should be depreciated to reduce trade deficits.[236] However, the Bank of Korea (BOK) actively intervened in currency markets to defend the currency. Behind the intervention lay political considerations. It is believed that President Kim Young Sam ordered his cabinet to maintain a strong won policy to accomplish GDP per capita 10,000 dollars by the end of his tenure.[237] As a result of the policy, foreign exchange reserves were quickly depleted. Between June and November 1997, foreign exchange reserves fell by nearly 10 billion dollars. Despite this intervention, the currency was devalued below the psychological barrier W 1,000: $ 1 on 17 November 1997 (the 1996 averaged rate is W 802: $ 1). According to Stanley Fischer, "Negotiations began in Seoul on 26 November, and concluded on December 3, by which date Korea was virtually out of reserves."[238]

To prevent a balance-of-payments crisis, Finance Minister Kang Kyung Shik sent his deputy to Tokyo on 11 November 1997. However, the Japanese government refused to provide any financial assistance on a bilateral basis.[239] To make matters worse, the government not take any action to stop Japanese banks from withdrawing 7 billion dollars loans from Korean banks. This lukewarm attitude was due to US Treasury's diplomatic pressure on its Japanese counterpart not to bypass the IMF. Korea's negative reaction to the

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[235] The mistakes made by policy makers were clearly stated by the Board of Audit and Inspection. See Board of Audit and Inspection, G*amsa Yeongam 1998* [*BAI Annual Report 1998*] (Seoul: Board of Audit and Inspection, 1998), pp.110-119.

[236] Sang-Woo Nam and Se-Jong Kim, Evaluation of Korea's Exchange Rate Policy, in Ito Takatoshi and Anne O. Krueger (eds.), *Changes in Exchange Rates in Rapidly Developing Countries: Theory, Practice, and Policy Issues* (Chicago: University of Chicago Press, 1999) See also Dong-A Ilbo, *Ilgeobeorin Sibnyeon Kalguksueseo IMFkkaji: YS Munmin Jeongbu 1800il Bihwa* [*Lost Five Years from Noodle to the IMF: The Secret behind the Kim Young Sam Government*] (Seoul: Dong-A Ilbosa, 1999), pp.215-237.

[237] Woo Sik Moon and Yeong Seop Rhee, Foreign Exchange Market Liberalization Policies in South Korea: Past Assessment and Future Options, in Kyung Tae Lee (ed.), *Globalization and the Asia Pacific Economy* (London: Routledge, 2002), p.121.

[238] Stanley Fischer, The International Financial System: Crises and Reform, The Lionel Robbins Lecture (London School of Economics, 29-31October 2001), pp.14-15.

[239] Paul Blustein, *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* (New York: PublicAffairs, 2001), p.128.

Asian Monetary Fund (AMF) proposal in September 1997 also made Japanese officials unenthusiastic about financial aid to Korea. [240]

In addition to the policy mistakes, social and political instability contributed to aggravate the crisis. To enhance flexibility in the labour markets, the government proposed new labour bills in December 1996. However, the bills backfired because the New Korea Party (NKP: the ruling party) tried to pass them secretly in the National Assembly without giving opposition parties and trade unions any notice. After a general strike organised by the Korean Confederation of Trade Unions (KCTU) and the Federation of Korean Trade Unions (FKTU), the government made substantial concessions to them. Furthermore, the implementation of many laws was deferred in two years. [241]

Second, high-profile corruption scandals weakened President Kim Young Sam's political leadership. In particular, the collapse of Hanbo Steel in early 1997 had an enormous impact on domestic politics. The company provided bribes to key politicians and policy makers who exerted influence on banks to extend credit to the company. Among them, Kim Hyun Chol, a son of the President, was the most notorious case. His arrest severely damaged the moral and political authority of President Kim. The decline of his political power was accelerated by the presidential election due in December 1997. [242]

Finally, the presidential election aggravated both political and economic uncertainty. Under authoritarian regimes, it had not been hard to predict who would be the next president because the ruling party supported by the military and the chaebol won presidential elections with a comfortable margin. Democratisation changed the rules of the game, making the election an unpredictable competition. [243]

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[240] Jung Hun Lee and Chung in Moon, Responding to Japan's Asia Policy: The Korean Calculus, in Takashi Inoguchi (ed*.), Japan's Asia Policy: Revival and Response* (Houndmills: Palgrave Macmillan, 2002), pp.154-58. See also Do Hyung Kim, East Asia's Economic Crisis and Korea-Japan Cooperation, *Korea Focus* (November / December 1998)

[241] Park, Se-il, *Managing Labor Reform Lessons from the Korean Experience*, 1996-97 (KDI, 2000)

[242] Sung Deuk Hahm and Kwang Woong Kim, Institutional Reforms and Democratization in Korea: The Case of the Kim Young Sam Administration, 1993-1998, *Governance*, Vol.12, No.4 (October 1999)

[243] For the role of democracy in the crisis, see Jongryn Mo and Chung-in Moon, Epilogue: Democracy and the Origins of the 1997 Korean Economic Crisis, in Jongryn Mo and Chung-in Moon (eds.),

In the presidential race, the prospects for Lee Hoi Chang, the candidate of the Grand National Party (GNP: the ruling party) were not promising.[244] One reason is that he was caught out by a scandal that his two sons had intentionally evaded mandatory military service. The revelation was a severe setback to him because the former Justice of the Supreme Court had earned a reputation as an anti-corruption campaigner. The decline of Lee Hoi Chang's popularity did not automatically increase that of his main rival. Although Kim Dae Jung – the candidate of the National Congress for New Politics (NCNP) – was respected for his life-long struggle for democracy and human rights, his radical platform was an obstacle to broadening his political base. It was the power struggle in the ruling party that helped Kim Dae Jung to become a front-runner in the race. Lee Hoi Chang's popularity fell substantially after expelling President Kim Young Sam from the party. This prompted Rhee In Je, former Governor of Kyonggi province to leave the party and established himself as a serious contender. Consequently Kim Dae Jung won the election on 19 December 1997.[245]

The end of the presidential election did not alleviate political uncertainty at all. As Table 4-2 shows, Kim Dae Jung won the election with a very narrow margin. In addition, the ruling coalition (NCNP-ULD) was in a minority in the National Assembly. Thus his political power was much more limited than his predecessors. Moreover, there was a concern about his economic policy among market participants because he was not regarded as a pro-market politician.[246]

Democracy and the Korean Economy (Stanford: Hoover Institution, 1999); Sunhyuk Kim, The Political Origins of South Korea's Economic Crisis: Is Democratization to Blame?, *Democratization*, Vol.7, No.4 (Winter 2000)

[244] The GNP succeeded the NKP after Lee expelled President Kim Young Sam in November 1997.

[245] Won-Taek Kang and Hoon Jaung, The 1997 Presidential Election in South Korea, *Electoral Studies*, Vol.18, No.4 (December 1999); Byung-Kook Kim, Electoral Politics and Economic Crisis, 1997-1998, in Larry Diamond and Byungkook Kim (eds.), *Consolidating Democracy in South Korea* (Boulder: Lynne Rienner, 2000)

[246] *Washington Post*, Opposition Leader Wins S. Korean Vote (19 December 1997)

[Table 4-2] Presidential Election Results (December 1997)

Candidate	Political party	Share of the vote (%)
Kim Dae Jung	NCNP- ULD	40.3
Lee Hoi Chang	GNP	38.7
Rhee In Je	NPP	19.0
Others		2.0

Source: National Election Commission

2) The Collapse of Developmentalism and the Triumph of Neoliberalism

It is well-known that Park Chung Hee's developmental strategy was heavily influenced by Japan's industrialisation strategy. According to Bai Gao, Japanese economic ideas consist of three general principles: viewing the economy strategically; restraining excessive competition; and rejecting the profit motive in management.[247] These policy ideas were imported by the Park regime. Park Chung Hee was a graduate of the Japanese Military Academy and his key policy makers such as Tae Wan Son and Chang Ki Yong worked at Japanese banks during the colonial period (1910 – 1945). In addition, few economists had economic ideas about economic development and industrialisation in less-developed economies at that time. Although American-trained economists such as Nam Duck Woo frequently advised President Park, their influence was very limited until the late 1970. In this regard, Robert Wade points out that those neoclassical economists did not play a crucial role in the government.

> The activities of such an agency are likely to be uncongenial to economists trained to believe that targeting by officials will generally fail. That is one good reason for curbing number and influence of economists in the industrial policy-making process, as was done in Japan, Korea and Taiwan. The other reason is that neoclassical economics has little to say about the issues raised by the

[247] Bai Gao, *Economic Ideology and Japanese Industrial Policy: Developmentalism from 1931 to 1965* (Cambridge: Cambridge University Press, 1997)

present shift of technoeconomic paradigm, of how to exploit the opportunities opened by the new information technologies. [248]

Since the 1980s, the number of economists educated in American rapidly grew in the government and academic institutions. During the 1980s, almost six hundred Koreans received PhD from US academic institutions. The number is nearly three times more than that of Japan. [249] Many American-trained economists joined government-affiliated institutions including the Korean Development Institute (KDI) and chaebol's research centres which influenced policy-making through various channels.

The inflow of the American-trained economists generated a profound intellectual shift. Because most economics departments in American universities taught neoclassical economic theories that were drawn from the experience of American capitalism, their policy preferences were market-oriented rather than state-led development. More importantly, some economists witnessed the monetarist revolution led by Friedrich von Hayek and Milton Friedman in the 1970s. The intellectual shift in the US had an enormous impact on Korean economists.

The Korean Development Institute (KDI) was at the heart of the intellectual shift. The KID was established as a think tank in March 1971 under the Second Five-Year Development Plan. Its influence rapidly increased among policy makers as its economists were recruited by President Park particularly after Nam Duck Woo was appointed as the Minister of Economic Planning Board (EPB) in the mid-1970s.

The theoretical foundation for the KDI was neoclassical economics that was predominant in American universities at that time. Some neoliberal American economists including Anne Krueger collaborated with KDI economists. Their collaborations were concerned about

[248] Wade (1991), p.372.
[249] Alice H. Amsden, The Specter of Anglo-Saxonization is Haunting South Korea, in Lee-Jay Cho and Yoon Hyung Kim (eds.), *Korea's Political Economy: An Institutional Perspective* (Boulder: Westview, 1994), pp. 91-96.

financial and trade liberalisation. Although some works admitted the advantages of interventionist policies, most KDI publications promoted market-oriented reform. [250]

This tendency was intensified by its recruitment policy. From the begging, the institution employed Korean economists graduated from top American academic institutions. [251] For example, ten out of eleven presidents of the KDI were American-trained economists: UC Berkeley (2), Minnesota (2), University of Pennsylvania, Missouri, Pittsburgh, Vanderbilt, Wisconsin- Madison and Syracuse. One exception was Kang Bong Kyun who had a typical bureaucrat career in the EPB but did master degree at Williams College. It should be noted that major Chaebol's research centres also started to recruit American-trained economists at that time.

The political power of KDI economists was not fully realised until the early 1980s. One reason is that Park Chung Hee wanted to continue his ambitious industrial policy, although he recognised many negative consequences of the policy.

> Although Korea's economic policy has been broadly outward oriented, the thinking of its top economic policymakers has departed in a number of ways from economic orthodoxy. During the 1970s, two contending policy lines coexisted. A number of officials in the economic bureaucracy argued for a more market-oriented style of economic management. The top political leadership and advocates of an activist industrial policy supported a more dirigist approach, emphasizing exports but also industrial planning and the use of a variety of controls and direct interventions in order to deepen the industrial sector in heavy and chemical industries. [252]

[250] Some exceptions were Leroy P. Jones and Sakong Il, *Government, Business, and Entrepreneurship in Economic Development: The Korean Case* (Cambridge: Harvard University Press, 1980); David C. Cole and Yung Chul Park, *Financial Development in Korea, 1945-1978* (Cambridge: Harvard University Press, 1983)
[251] Like US universities, the KDI has recruited research fellows through job fairs at annual conference of the American Economic Association. Confidential interview with KDI economists (Seoul, July 2002)
[252] Stephan Haggard, Richard N. Cooper, and Susan Collins, Understanding Korea's Macroeconomic Policy, in Stephan Haggard, Richard N. Cooper, Sung-Tae Ro, and Susan Collins (eds.), *Macroeconomic Policy and Adjustment in Korea, 1970-1990* (Cambridge: Harvard Institute for International Development, 1994), p.5.

After the assassination of President Park Chung Hee in October 1979, the Chun Doo Hwan regime recruited young economists to replace old bureaucrats who were accused of corruptions. As a result, several KDI economists – Kim Jae Ik, Kim Ki Hwan, Sakong Il and Kim Mahn Je – and their supporters such as Kang Kyung Shik in the bureaucracy held the key posts in the Presidential Office and the EPB in the early 1980s. The core of their ideas was stabilisation by liberalisation (especially, interest rates and trade) and the restructuring of heavy and chemical industries. Although the Ministry of Finance and the Ministry of Commerce and Industry opposed their policy initiatives, the KDI economists pushed ahead with the policies. [253]

The ascent of Kim Jae Ik was the best example to show how liberal economists dominated economic policy-making. He started his career as an economist at the Bank of Korea. After doing Ph.D. at Stanford University, he was hired by Nam Duck Woo – Minster of Economic Planning Board (EPB) in 1974 and worked at the Presidential Office until the death of President Park. However, his policy ideas were not fully implemented until he became a senior economic adviser to President Chun Doo Hwan in 1980. His policy preferences were to achieve price stability, to liberalise trade regimes and to refrain growth in wages and tax rates. At the same time, he pushed ahead with radical structural adjustments. He was the key architect of the Investment Reorganisation of the Heavy and Chemical Industries in August 1980. [254]

Against this background, financial liberalisation in the early 1990s was motivated by neoliberal ideas.

> The quest for liberalize Korean finance was carried out by transnational elites now ensconced as economic technocrats... all experts on finance, all with American Ph.D.s, and all professing

[253] For the debate on stabilisation package, see Heunggi Kim (ed.), *Yeongyokui Hanguk Gyeongje: Bisa Gyeongjegihoegwon 33 Nyeon* [*Up and Down in the Korean Economy: The Secret behind the Economic Planning Board 33 Years*] (Seoul: Maekyung, 1999), pp.275-314.

[254] Kihwan Kim, Kim Jae-Ik: His Life and Contributions, in Lawrence B. Krause and Kim Kihwan (eds.), *Liberalization in the Process of Economic Development* (Berkeley: University of California Press, 1991); Yun Tae Kim, Neoliberalism and the Decline of the Developmental State, *Journal of Contemporary Asia*, Vol.29, No.4 (1999), pp.444-46.

> allegiance to the goal of liberalization, as well as the entire panoply of thirty five men at the Korean Development Institute, every last one of them a Ph.D. from American universities. Ideological osmosis could not have more complete. [255]

Despite the increasing influence of liberal economists, many of their policy initiatives were not popular among policy makers and some of his initiatives – for example, real name deposit system and stronger anti-monopoly laws – were not implemented. One of the reason is that there were little consensus over the liberal policy ideas. The political power of Kim Jae-Ik was based on his close relationship with President Chun Doo Hwan. [256] Although there were several supporters in the EPB, very few senior bureaucrats in the Ministry of Finance were sympathetic towards liberalisation. In fact, state intervention was pervasive in some policy areas including exchange rate management and financial market policy until the late 1980s.

To overcome the opposition, Kim Jae-Ik persuaded President Chun to appoint his lieutenant Kang Kyung Shik as the Minster of Finance. More importantly, politicians supported Kim Jae-Ik's structural reform not because they believed in liberal economic thoughts but because they regarded it as a useful tool to control the chaebols. In other words, "the new military dictatorship adopted a policy of 'liberalization', one intent of which was to mitigate monopolistic abuses by strengthening freer markets as a particular form of discipline over big business." [257]

American-trained economists contributed to supporting economic liberalism in the private sector. In the 1990s, top five chaebols – Samsung, Hyundai, Daewoo, LG and SK –expanded research centres to encourage their policy preferences: liberalisation and deregulation policy. However, they rarely expressed their dissatisfactions with government policies because

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[255] Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991), pp.190-191.
[256] Janggyu Lee, *Gyeongjeneun Dangsini Daetongryeoniya: Chun Doo Hwan Sidaeui Gyongje Bisa* [*You are the President in charge of Economic Affairs: The Secret behind the Chun Doo Hwan Era*] (Seoul: Joongang Ilbosa, 1991); Stephan Haggard and Susan Collins, The Political Economy of Adjustment in the 1980s, in Stephan Haggard, Richard N. Cooper, Sung-Tae Ro, and Susan Collins (eds.), *Macroeconomic Policy and Adjustment in Korea, 1970-1990* (Cambridge: Harvard Institute for International Development, 1994)
[257] Amsden (1989), p.120.

officials frequently complained them about negative assessments on government policies. [258] To avoid this kind of intervention, the Korean Economic Research Institute (KERI) funded by the Korean Federation of Industries (KFI) – chaebol's umbrella organisation – established the Center for Free Enterprise (CFE) in 1997. The main aim of the centre is to promote liberal economic ideas: minimal state intervention and free market principles. To this end, the CFE has published the works of neoliberal economists including Friedrich von Hayek and Milton Friedman.

Against this background, President Kim pursued the entry of the Organisation of Economic Cooperation and Development (OECD), " which in turn became the symbol of Kim's new liberal vision for Korea and his intention to push ahead with liberalisation as the government's main policy priority." [259] In the name of the *Segyehwa* policy, further liberalisation of the economy was undertaken. Its ultimate objective was to enhance national competitiveness by overhauling the old politico-economic system. To this end, the Presidential Commission of *Segyehwa* Promotion, set up on 21 January 1995, proposed a broad agenda of six major reforms: education, law and economy, politics and mass media, national and local administration, environment, and culture. [260]

The ambitious projects were hardly implemented because many of them were a political marketing tool rather than a serious policy initiative. [261] Nevertheless, the policy had a significant impact on the ideological shift toward neoliberalism by emphasising the need for liberalisation.

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[258] Liberal economists in government-affilated institutions moved to chaebol's think tanks, but vice versa is very rare. Personal interview with Yoon Jong Wang (Seoul, 19 August 2002); Confidential interview with SERI economist (Seoul, December 2004)

[259] Elizabeth Thurbon, Ideational Inconsistency and Institutional Incapacity: Why Financial Liberalisation in South Korea Went Horribly Wrong, *New Political Economy,* Vol.8, No.3 (November 2003), p.352.

[260] The term *Segyehwa* means internationalisation or globalisation in Korean. See Samuel S. Kim, Korea and Globalization (*Segyehwa*): A Framework for Analysis, in Samuel S. Kim (ed.), *Korea's Globalization* (Cambridge: Cambridge University Press, 2000) For socio-cultural aspects of the policy, see Kong (2000), Ch.5; James Lewis and Amadu Sesay (eds.), *Korea and Globalization* (London: RoutledgeCurzon, 2001)

[261] Barry K. Gills, Economic Liberalisation and Reform in South Korea in the 1990s: A 'Coming of Age' or a Case of 'Graduation Blues', *Third World Quarterly,* Vol.17, No.4 (1996); Barry K. Gills and Dong-Sook S. Gills, South Korea and Globalization: The Rise to Globalism?, in Samuel S. Kim (ed.), *East Asian and Globalization* (Lanham: Rowman & Littlefield Publishers, 2000)

The chaebol supported the *Segyehwa* policy. However, its priority was a bit different from the government's policy objectives. The chaebol focused on financial liberalisation and labour market flexibility. First, the government maintained strict regulation on chaebol's ownership of commercial banks because commercial banks could become piggy banks for the chaebol. For this reason, the chaebol wanted to reduce government intervention in the financial markets. Second, the chaebol demanded the government to increase labour market flexibility to reduce labour costs. Many chaebol companies except Samsung experienced violent labour disputes from the late 1980s.

The financial crisis accelerated the ideological shift. Massive criticisms of crony capitalism led policy makers and economists to convince that close government-business relationship was a major source of political corruption; the relationship should be changed to end a vicious circle of cronyism between political elites and business leaders. This is why the vast majority of Korean economists agreed to IMF's interpretations that the crisis was caused by domestic weaknesses in the financial and corporate sectors.[262]

Some economists challenged the dominant interpretation, arguing that external factors such as speculative attacks were more important than internal ones in explaining the cause of the crisis.[263] Furthermore, Chung Un Chan, one of the most influential economists, criticised IMF's stabilisation policy from a perspective of Keynesianism. However, this view was not shared by mainstream economists. [264]

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[262] For example, See Deakeun Park and Changyong Rhee, Currency Crisis in Korea: How was it Aggravated?, *Asian Development Review*, Vol.16, No.1 (1998); Sung Hee Jwa and Huh Chan Guk, Korea's 1997 Currency Crisis: Causes and Implications, *Korea Journal* (Summer 1998); Hak K. Pyo, The Financial Crisis in South Korea: Anatomy and Policy Imperatives, in Karl D. Jackson, *The Asian Contagion: The Causes and Consequences of a Financial Crisis* (Boulder: Westview Press ,1998); Joon-ho Hahm and Frederic S. Mishkin, The Korean Financial Crisis: An Asymmetric Information Perspective, *Emerging Markets Review*, Vol.1, No.1 (May 2000); Dongchul Cho and Kiseok Hong, Currency Crisis of Korea: Internal Weakness or External Interdependence, in Takatoshi Ito and Anne O. Krueger (eds.), *Regional and Global Capital Flows: Macroeconomic Causes and Consequences* (Chicago: University of Chicago Press, 2001)

[263] Ha-Joon Chang, Korea: The Misunderstood Crisis, *World Development*, Vol.26, No.8 (August 1998)

[264] Un-Chan Chung, *Hanguk Gyeongje Ajikdo Meoreotda* [*There is still a long way to go to reform the Korean Economy*] (Seoul: Namu wa Sup, 1999) See also Un-Chan Chung, The Korean Economy before and after the Crisis, in Duck-Koo Chung and Barry Eichengreen (eds.), *The Korean Economy beyond the Crisis* (Cheltenham: Edward Elgar, 2004).

The triumph of the crony capitalism thesis is reflected in the Korea Development Institute (KDI)'s assessment.

> [T]he Korean economic crisis arose from international creditors' loss of confidence in the Korean economy's insolvent corporate and financial sectors, negligent financial supervision and an inherently unstable international money market. However, it should be kept in mind that these fundamental causes are rooted in the accumulation of structural economic weaknesses. Over the past thirty years of accelerated economic growth, former governments were deficient in developing the rules and principles of a market economy, failing to implement structural reform policies consistent with changes in the international environment. [265]

The political power of the Washington consensus was enhanced by IMF's intervention. On 11 December, Kim Dae Jung hinted that some clauses of the IMF-supported programmes could be revised if he were elected. His intention was not to reject the agreement but to renegotiate some clauses in the conditionality. Nevertheless, his remark disturbed financial and currency markets because foreign observers understood that he would not implement the economic reform that the Fund demanded. To restore market confidence, the IMF warned the three presidential candidates that it would cancel its financial assistance unless all of them commit themselves to the programmes. Although this was a clear violation of national sovereignty, they could not help accepting IMF's demand because of the crisis. [266]

This incident restrained, to some extent, economists as well as bureaucrats from discussing – let alone criticising – the appropriateness of the programme in public. [267] Even after the election, Kim Dae Jung as President-elect invited high-profile foreign investors including George Soros to assure his commitment to economic reform. At the same time, he included liberal economists and policy makers – among others, You Jong Keun and Lee Hun

[265] KDI, *Djnomics: A New Foundation for the Korean Economy* (Seoul: KDI, 1999), p.10.
[266] *Asiaweek*, Biting the IMF Bullet - Seoul was Close to a 'Financial Catastrophe' (12 December 1997); *Economist*, Panic in South Korea (13 December 1997)
[267] Joseph E. Stiglitz, *Globalization and its Discontents* (London: Allen Lane, 2002), pp.42-43.

Jai – in the Committee for Emergency Economic Countermeasures that functioned as a cabinet before his inauguration. [268]

The success of the crony capitalism thesis in the theoretical battles shaped Kim Dae Jung's economic policy. The persuasive influence of the Washington consensus was so enormous that all the opposition parties committed themselves to economic reform, irrespective of their ideological orientations. [269] It is equally important that Kim Dae Jung's economic philosophy had an important impact on the rise of the Washington consensus. He was one of the most ardent critics of the chaebol system. [270] According to him, the crisis was caused by the collusion between the government and business. For this reason, Kim argued that economic reform could not be accomplished without political democratisation. [271]

As seen in Figure 4-1, the primary objective of economic reform in the Kim Dae Jung administration was to transform the state-led economic system into a market-friendly economic system. To this end, the administration embraced key principles of the Washington consensus: financial liberalisation, corporate restructuring, labour market flexibility and privatisation.

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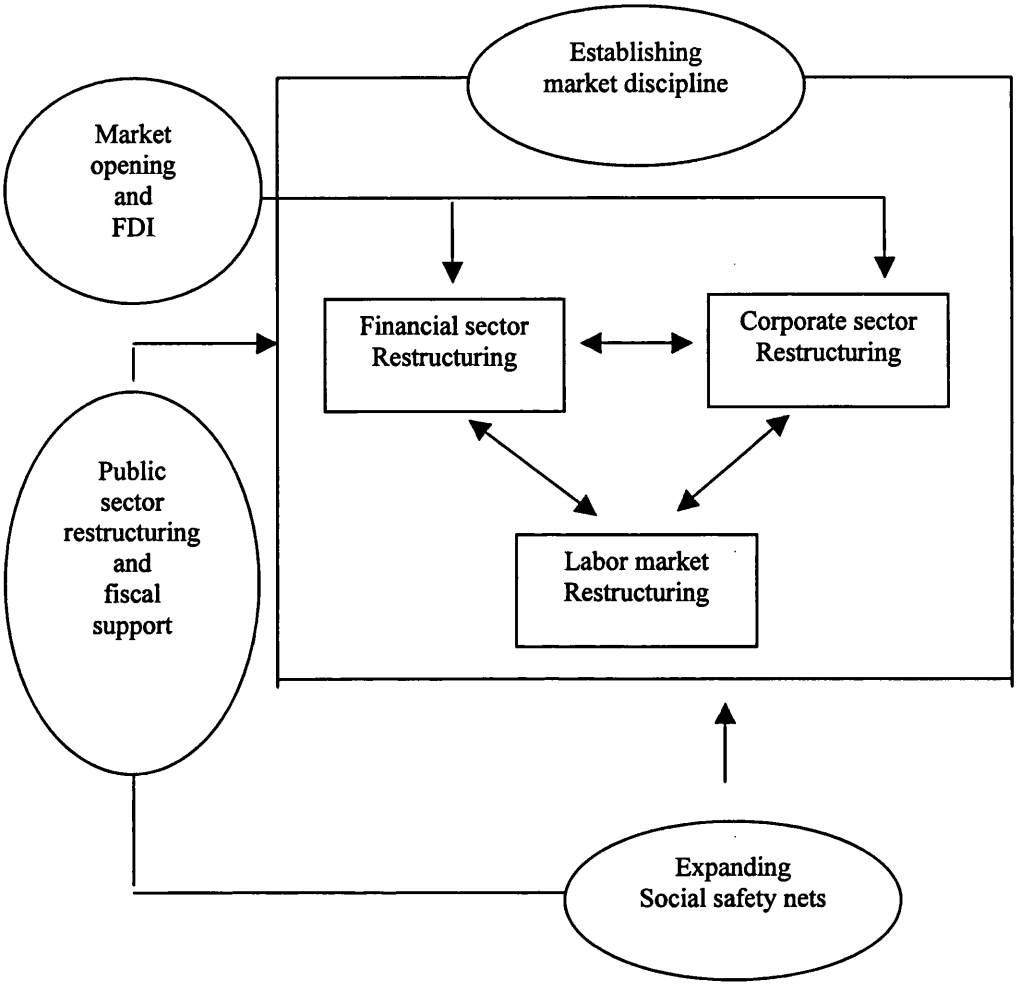
[268] There was a concern that veteran policy makers such as Kim Yong Hwan in the committee might not give up government control over the financial sector. See *Business Week*, The Battle for Kim's Economic Soul (26 January 1998)

[269] In terms of policy priority, there was a significant difference between the NCNP and the GNP. The ruling party gave top priority to corporate reform to overhaul the old economic system. In contrast, the opposition party put more emphasis on deregulation and privatisation than corporate reform because of their closeness to the chaebol.

[270] Dae Jung Kim, *Mass-Participatory Economy: Korea's Road to World Economic Power*, revised and updated Edition (Lanham: Center for International Affairs, Harvard University and University Press of America, 1996)

[271] Sunhyuk Kim, The Politics of Reform in South Korea: The First Year of the Kim Dae Jung Government, 1998-1999, *Asian Perspective*, Vol. 24, No. 1 (2000)

[Figure 4-1] Blueprint for Economic Restructuring [272]



3) Macroeconomic Adjustment

Despite the widespread consensus over the need for fundamental transformation of the economic system, there was a significant disagreement over the speed and sequence of economic reform. On the one hand, many policy makers and economists in government-affiliated research institutes preferred a radical approach. Their priority was given to structural reform rather than macroeconomic stabilisation. They supported a pro-cyclical policy on the ground that a counter-cyclical policy might provide some breathing space to unhealthy companies, thereby making structural reform incomplete.

[272] KDI (1999), p.46.

This was a significant shift in policy preferences. Because nearly double-digit growth rate over the past decades made even five percent growth look a recession, policy makers were very negative on pro-cyclical macroeconomic policy. Since the 1960s, pro-stability policy seldom prevailed over pro-growth policy. One exception was the 1979-80 recession when Kim Jae Ik – Chief Economic Advisor to President Chun Doo Hwan – presided over economic policy-making.[273] Against this background, it was no surprise that some policy makers were hesitant to accept IMF's stabilisation package. This negative attitude was not changed until Michel Camdessus intervened in the negotiation process.[274]

On the other hand, most economists in chaebol's research institutes favoured a gradual approach. Their argument was that structural reform should be implemented only after economic recovery become solid. In the short term, structural reform tends to aggravate economic recession. Thus, they demanded a Keynesian policy to boost economic growth. At the same time, they warned that government involvement in structural reform would violate the ultimate objectives of economic reform: a transformation of the state-led system to a market-oriented one.[275]

As a matter of fact, highly-leveraged chaebol companies suffered from high interest rates policy due to companies suffered from rising burdens of interest payments. In the first quarter of 1998, the bankruptcy rate was nearly triple its level a year earlier. For this reason, the chaebol called for the IMF to decrease interest rates. For example, Kim Woo Choong – then chairman of Daewoo and President of the FKI – sent an open letter to the IMF managing director on 9 February 1998.[276]

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[273] For his policy, see Lawrence B. Krause and Kim Kihwan (eds.), *Liberalization in the Process of Economic Development* (Berkeley: University of California Press, 1991)
[274] IMF (2003), p.170.
[275] KERI, *Choegeun Gyeongje Hyeonangwa Daechaek* [*Current Economic Problems and its Remedies*] (KERI, 1998). Top four chaebol's research centres – Samsung, Hyundai, LG and Daewoo – participated in the making of this policy paper.
[276] Sung Hee Jwa, *A New Paradigm for Korea's Economic Development: From Government Control to Market Economy* (New York: Palgrave, 2001), pp.214-19.

In the debate, the pro-cyclical policy prevailed over the counter-cyclical policy. This made it easy for the IMF to implement its stabilisation package effectively. Table 4-3 is a summary of IMF's policy recommendation.

[Table 4-3] Changes in the IMF's Macroeconomic Projections [277]

	Monetary policy	Fiscal policy (%)	Growth rate (%)	Inflation (%)	Current account *
97.12. 3	Raise call rates from 12.5 % to 21 %	A minimum balance and preferably small surplus	- 3	5	
97.12.24	Raise call rates, reaching about 30 %				
98. 2. 7	Cautiously allowed to ease in line with continued exchange rate stabilization	- 0.8	-1	Slightly below double digits	2
98. 5. 2	Call rates continued to be lowered	-1.75	-1	One digit	7
98. 7.24	Further gradual reduction in interest rates	-4	-4	9	11
98.11.13	Easy monetary stance	-5		5	7
99. 3.10	Flexible monetary policy	-5	2	3	Narrow significantly but remain substantial
99.11.24	Low interest rate policy	-4	8-9	3	Narrow but remain in surplus
00. 7.12	Adjusted to address possible inflationary pressures	-1.5 – 2	8 – 8.5	Below 2.5	Narrow but remain in surplus

* Percent of GDP

The most urgent task was the stabilisation of the currency rate. On the brink of default, the government borrowed 21 billion, 10 billion and 4 billion dollars from the IMF, the World Bank and ADB, respectively. As a second line of defence, 13 countries made a commitment to lend 23.3 billion dollars, if necessary. The total amount of the package was 58.35 billion dollars. Following the Manila Framework in November 1997, the country was offered 13.5

277 Based on Letters of Intent. Available at http://www.imf.org/external/country/KOR/index.htm

billion dollars of Supplemental Reserve Facility (SRF) in addition to the 7.5 billion dollars in stand-by loans.

The rescue package failed to improve foreign exchange liquidity quickly. One of the reasons is that the debts of Korean banks were not rolled over due to its negative economic outlook. To resolve the problem, the IMF and the US Treasury and the Federal Reserve System organised special meeting in New York in January 1998. As a result, 13 representatives of the foreign commercial banks agreed to extend the maturity dates of 23 billion dollars short-term credits to Korean banks on 28 January 1998. [278] Following the agreement, 96.5 percent of Korean commercial banks' short-term debt – 21.8 billion dollars – was converted to longer-term loans with a maturity of one to three years. The success of rescheduling offered a breathing space for the wrecked economy to launch wide-ranging reforms.

In April 1998, the government succeeded in issuing 4 billion dollars worth of Foreign Exchange Equalisation Bonds with the help of the US Securities and Exchange Commission.[279] The global bond issuance allowed Korean financial institutions and corporations in the private sector to regain access to international capital markets. However, this did not imply the return of foreign investor confidence. At that time, the country's creditworthiness remained below investment grade.

To stabilise the currency markets, short-term interest rates – which fluctuated around 12 percent prior to the crisis – rose to over 30 percent by 24 December 1997. Nonetheless, the won fell to its lowest point of won 1,965 per dollar – more than 50 percent below its pre-crisis level. For this reason, some policy makers and the chaebol asserted that the policy worsened credit crunch in the financial sector. The IMF defended its policy on the basis that there was no realistic alterative to it although the duration of the policy might be too long. [280] In May

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[278] Woochan Kim and Yangho Byeon, Restructuring Korean Banks' Short-Term Debts, in David T. Coe and Se-Jik Kim (eds.), *Korean Crisis and Recovery* (IMF & KIEP, 2002)
[279] *Euromoney*, Koreans Dig in their Heels (June 1998)
[280] For the debate, see Dongchul Cho and Kenneth D. West, The Effect of Monetary Policy in Exchange Rate Stabilization in Post-Crisis Korea, in Inseok Shin (ed.), *The Korean Crisis: Before and After* (Seoul: KDI, 2000)

1998, interest rates were lowered to levels well below those prior to the crisis. The three-month interest rate fell to its pre-crisis level of around 11 percent by August, and further to 6 percent in March 1999.[281]

Ironically, the high interest rate policy resulted in consolidating the dominance of the five largest chaebols in the financial markets.[282] The top five chaebols borrowed money at a cheaper rate by getting their successful subsidiaries to guarantee the debts of others. In contrast, even small- and medium-sized enterprises (SMEs) with high creditworthiness had to pay extra costs in raising funds. As a result, only the corporate bonds issued by the top five were traded in bond markets.[283] As shown in Table 4-4, the predominance of the top four chaebols was enhanced after the collapse of Daewoo.

[Table 4-4] Concentration of Top Four Chaebols: Hyundai, Samsung, LG & SK

		96	97	98	99
Assets	Top Thirty Chaebol (a)	348.3	435.3	472.7	422.7
	Top Four Chaebol (b)	166.5	220.0	232.7	243.7
	Ratio (b/a)	47.8%	50.5%	49.2%	57.6%
Sales	Top Thirty Chaebol (a)	385.2	441.4	479.3	445.4
	Top Four Chaebol (b)	220.8	257.8	295.2	303.9
	Ratio (b/a)	57.3%	58.4%	61.5%	68.2%

* Unit: Trillion Won
Source: Fair Trade Commission

When it comes to fiscal policy, the IMF's prescription was a budget balance or small surplus in 1998. With the benefit of hindsight, there is little question that the policy was flawed. First, it did not consider Korea's conservative stance in the pre-crisis years. In fact, the budget surplus consolidated during 1993-97 was about 0.3 percent of GDP. As a result, the national debt was just only 8.8 percent and 11.1 percent of GDP in 1996 and 1997. This figure is much lower than the average of the OECD countries of 70 percent. Thus, there was room for fiscal deficits. Second, the 1998 recession was far more severe than the IMF projected. The

[281] See IMF (2003), p.177.
[282] *Economist*, The Chaebol that Ate Korea (14 November 1998)
[283] Dong Won Kim, Young Soo Lee, and Kyung Suh Park, Credit Crunch and Shocks To Firms: Korean Experience under the Asian Financial Crisis, *Emerging Markets Review*, Vol.3, No.2 (June 2002); IMF, Korea: Selected Issues, Country Report No.01/101 (2001), Ch.IV.

Fund initially estimated – 1 percent of economic growth, but the real GDP contracted by 6 percent in 1998. According to the IMF, the optimistic projection was due to the Korean government's opposition to a growth projection lower than 2.5 percent in 1998. [284]

To counter the recession, the IMF allowed the government to widen the deficit target to 1 percent of GDP in May 1998, and to 4 percent in July 1998. A rationale for accommodative fiscal policy was that because public debt was only 6 percent of GDP, the government could have drawn on its spare borrowing capacity to offer its obligations in exchange for those of the countries' troubled financial sector. [285]

This expansionary policy also had a political motivation. The local election in 1998 was regarded as a vote of confidence for Kim Dae Jung's economic policy. In addition, outcomes of the elections had a far-reaching implication for next general election due by April 2000. If the ruling party failed to win the election, the GNP would have pursued a pro-chaebol policy agenda in the National Assembly. In this respect, the NCNP pushed the government to expand fiscal spending.

Following the introduction of a supplementary budget in July and September 1998, the deficit objective was raised to 5 percent of GDP. Public expenditure was used 1) to assist small and medium-sized enterprises, which were most affected by a lack of credit; 2) to finance financial intermediaries ridden with a huge amount of NPLs; and 3) to finance the unemployment problem. In the last quarter, however, the decline in interest rates, lay-offs and a pay cut in the public sector reduced government spending. Consequently, the government deficit shifted from a small surplus in 1997 to a deficit of 3.2 percent of GDP in 1998. As Table 4-5 shows, the shift to counter-cyclical policy contributed to impressive economic recovery in 1999 and 2000. [286]

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[284] IMF (2003), p.178.
[285] *Ibid*, p.179.
[286] OECD, *Economic Surveys: Korea* (1999), pp.9-10.

[Table 4-5] Changes in the Major Economic Index (year-end basis) [287]

	1997	1998	1999	2000
Economic Growth Rate**	5.0	-6.7	10.9	8.8
Unemployment Rate (%)	2.6	6.8	6.3	4.1
Interest Rate (%) Overnight Call Rate Corporate Bond	 31.32 28.98	 6.48 8.00	 4.74 9.95	 6.01 8.13
Stock Price Index (p)	376.31	562.46	1,028.07	504.62
Total External Liabilities* Ratio of Short-term Debt (%)	159.2 39.9	148.7 20.6	137.1 28.6	136.3 32.4
Foreign Investment*	7.0	8.9	15.5	15.7
Foreign Exchange (won/dollar)	1,695	1,204	1,138	1,264.5
Foreign Exchange Reserves Available*	8.9	48.5	74.0	96.2

* Unit: $ billion **Percentage change year-on-year

In the meanwhile, the impact of political institutions was ambivalent. On the one hand, the 1997 presidential election contributed to strengthening the political power of the Washington consensus by drawing public attention to economic policy debates. On the other hand, a series of elections had a constraining effect on the pro-cyclical policy by exposing policy makers to political pressures.

[287] Drawn from MOFE, *IMF Wigiihu 4 Nyeonei Seonggwawa Gwaje* [Achievements and Tasks after the IMF Crisis] (3 December 2001), p.15.

3. Malaysia

1) The Causes and Consequences of the Financial Crisis

Following the collapse of the Thai baht in July 1997, Malaysia underwent one of the worst financial crises in recent history. Its currency, the ringgit, depreciated by 44 percent and the Kuala Lumpur Stock Exchange (KLSE) Composite Index lost nearly 50 percent between mid-1997 and January 1998. As NPLs rose to 8.7 percent by February 1998, some domestic financial institutions became virtually insolvent.

Despite the economic hardship, the Malaysian government did not call for any financial assistance from the IMF. Its low exposure to foreign currency loans and sound macroeconomic fundamentals helped the government to manage the crisis in its own way. Above all, its macroeconomic fundamentals were sound in relative terms. In the first half of 1997, real GDP grew at 8 percent. Fiscal policy was prudent, registering a surplus for the previous four years. Further, inflation remained at its lowest level. Although the current account deficit – which was 9.0 and 5.5 percent of GDP in 1995 and 96 respectively – was a cause for concern, it continued to decline in the first half of 1997. Moreover, the financial sector was relatively well-regulated. As of the end of June 1997, the average risk weighted capital ratio (RWCR) of the banking system was 12 percent, well above the internationally-recommended minimum level of 8 percent. And net NPLs were 2.2 percent of total loans. [288]

However, there were some serious imbalances in the economy. First, rapid credit expansion led to deterioration in the asset quality of financial institutions. A large portion of foreign capital flowed in the early 1990s was disbursed to non-productive sectors (i.e., property and stock). While its robust macroeconomic indices helped to disguise the underlying imbalances, it was estimated that the currency was overvalued by approximately 25 percent

[288] This figure was based on the pre-crisis classifications of NPLs. The classifications were revisited twice. In January 1998, Anwar shortened the six-month standard to a three-month one. After his downfall, the old standard was restored due, in part, to pressures from the business community. See Mohamed Ariff and Syarisa Yanti Abubakar, The Malaysian Financial Crisis: Economic Impact and Recovery Prospects, *Developing Economies*, Vol. XXXVII, No.4 (December 1999), p.428.

and stocks were overpriced by roughly 30 percent.[289] Second, heavy dependence on electronic products left the exporting sector prone to economic downturns of its major trading partners. Further, the devaluation of the Chinese currency and the depreciation of the Japanese yen against the US dollar eroded Malaysia's competitiveness particularly in the US market.[290]

Policy mistakes aggravated these vulnerabilities. First, the initial attempt to defend the ringgit in July 1997 failed to stop the depreciation of the currency. The loss of 1.5 billon dollars forced Bank Negara Malaysia (BNM) to float the currency. Despite this, the authorities denied the possibility of a full-scale financial crisis, thus missing the opportunity to take pre-emptive actions. It was not until the collapse of the currency and stock market that macroeconomic adjustments and structural reforms were seriously considered. Second, some temporary measures in the stock market did more harm than good. In December 1997 when the KLSE index plunged to its lowest level, trading restrictions were imposed on five of the 60 brokerage companies without any concrete reason.[291] This unexpected suspension clearly shook investors' confidence. The injection of public funds was not successful in boosting the stock market index either. The reason is that many investors exploited the intervention as a last chance to sell out their stocks at a reasonable rate.[292]

The economic turmoil gave rise to political instability. In the wake of the crisis, the Malaysian leadership carefully observed Indonesia's crisis because of the geographical proximity, close politico-economical relations and ethnic/ religious similarities. 'Reformasi' – the catchphrase of Indonesian activists – started to be circulated among anti-Mahathir groups, who hoped to emulate the Indonesian movement. In particular, the resignation of Suharto sent an alarming warning to Mahathir.

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[289] Mohamed Ariff, Fixing Malaysia's Fixed Exchange Rate Regime: Some Options, *Kajian Malaysia*, Vol.XVII, No.2 (Disember 1999), p.2.

[290] Anita Doraisami, Trade Causes of the Asian Crisis: The Malaysian Experience, *World Economy*, Vol.27, No.5 (2004). See also Enzo Grilli, The Asian Crisis: Trade Causes and Consequences, *World Economy*, Vol. 25, No. 2 (February 2002); Rupa Duttagupta and Antonio Spilimbergo, What Happened to Asian Exports During the Crisis?, *IMF Staff Papers*, Vol.51, No.1 (2004)

[291] *Wall Street Journal*, Malaysian Exchange Restricts Five Firms (1 December 1997)

[292] *Wall Street Journal*, Malaysia Pledges Funds to Assist banks: Plan Unnerves Stock Market, and Ringgit (6 March 1998)

2) Legacies of the New Economic Policy

The financial crisis led policy makers to rethink Mahathir's economic policy framework seriously. At the heart of the framework lies the New Economic Policy (NEP) that was launched in the early 1970s. The key principle of the NEP was the harmony between economic growth and ethnic equality.

- Eradicating poverty by raising income levels and increasing employment opportunities for all Malaysians, irrespective of race
- Accelerating the process of restructuring Malaysian society to correct imbalances, to reduce and eventually eliminate the identification of race with economic function. [293]

To reduce the gap among the three main ethnic groups (Malays, Chinese and Indian), many preferential treatments were given to the bumiputera. Due to the socio-political implications, the legitimacy of the policy was rarely challenged even when some NEP measures had negative impacts on economic growth. [294]

Against this background, the Look East policy was launched to emulate the East Asian countries (particularly Japan and Korea) rather than Western European countries. To achieve the nationalist industrialisation programme, the government established the Heavy Industries Corporation of Malaysia (HICOM) which subsidised large industrial projects: for example, Kedah Cement and Perak Hanjoong, Perwaja Steel and Proton.

The policy was tested by the 1985 economic crisis that was aggravated by the declining of major exporting goods (especially petroleum, tin, rubber and palm oil). Facing one of the worst recession, there was little room for fiscal expansion because the government over-invested heavy industrialisation projects. Therefore, Mahathir and Daim turned their attention

[293] Samuel Bassey Okposin, Abdul Halim Abdul Hamid and Ong Hway Boon, *The Changing Phases of Malaysian Economy* (London: ASEAN Academic Press, 1999), p.44.
[294] R. S. Milne, The Politics of Malaysia's New Economic Policy, *Pacific Affairs*, Vol. 49, No. 2 (Summer 1976); Malaysia-Beyond the New Economic Policy, *Asian Survey*, Vol. 26, No. 12. (December 1986) For the pre-NEP era, Kwame Sundaram Jomo, *A Question of Class: Capital, the State, and Uneven Development* (New York: Monthly Review Press, 1988)

to foreign and non-bumiputera investors. On the one hand, the Investments Promotion Act was introduced to encourage foreign investment in 1986. On the other hand, the Industrial Coordination Act was revised to support non-bumiputera investment. These liberal policies relaxed regulations on ownership and employment – especially in manufacturing industries – that were intended to promote the share of the bumiputera in the economy. [295]

It is hard to conclude that these liberal policies were inspired by the Washington consensus. The reason is that the government did not surrender the NEP. Mahathir used the policies not to transform the policy framework but to cope with the downturn in business cycle. In this regard, it is fair to say that his policy shift was motivated by neoliberalism (or the Washington consensus) but by pragmatism. [296]

The legacy of the NEP was clearly imbedded privatisation. The original objective of the policy was to downsize inefficient public companies. However, this objective was not completely accomplished. The main reason is that "Most of the deregulation and market-oriented reforms have avoided directly encroaching on bumiputera ethnic interests in the economy. On the contrary, an important condition for privatization efforts is that they should conform to NEP objectives, meaning that bumiputera interests should be enhanced in the process. " [297] As a matter of fact, bumiputera were awarded eight projects during the 1986-1989 when 14 public enterprises were privatised. In the process, key bumiputera politicians – namely, Mahathir, Daim and even Anwar – took advantage of the policy by awarding government contracts their protégés. Ironically, the policy provided the economic and financial basis for cronyism. [298]

In the early 1990s, several liberal policies were gradually undertaken by liberal policy makers. Although there was no defining moment of policy shift, the 'National Development

[295] For the causes and consequences of the crisis, see K.S. Jomo, Ling How Kong and Ku Ahmad Shamsulbahriah (eds.), *Crisis and Response in the Malaysian Economy* (Kuala Lumpur: Malaysia Economic Association, 1987)
[296] Rajah Rasiah and Ishak Shari, Market, Government and Malaysia's New Economic Policy, *Cambridge Journal of Economics*, Vol.25, No.1 (January 2001), p.65.
[297] Kwame Sundaram Jomo, Whither Malaysia's New Economic Policy?, *Pacific Affairs*, Vol. 63, No. 4 (Winter 1990-1991), p.478.
[298] Edmund Terence Gomez and Kwame Sundaram Jomo, *Malaysia's Political Economy: Politics, Patronage and Profits*, second edition (Cambridge: Cambridge University Press, 1999), Chapter 4.

Policy (NDP: 1991-2000) and 'Wawasan 2000 (Vision 2020)', explicitly or implicitly, embraced some features of neoliberalism.[299]

The policies defined nine challenges that the government should tackle to become an advanced economy by 2020. Among them, three challenges were very close to neoliberal economic ideas.

- An entrepreneurial economy that is self-reliant, outward-looking and enterprising
- An economy characterised by low inflation and a low cost of living
- An economy that is subjected to the full discipline and rigour of market forces.[300]

Both political considerations and economic rationales lay behind the shift towards neoliberal economic ideas.[301] Although bumiputera businessmen were protected and subsidised by the NEP, they complained that government protections and subsidies were not sufficient to accomplish the original target (i.e., 30 percent share of the economy). However, this complaint was not accepted by the government. As a matter of fact, Mahathir thought that bumiputera businessmen demanded more and more government interventions rather than making efforts to develop technology and improve productivity.

> We should not dismiss the infant industry argument, but we should not bow to illegitimate pressure... productive liberalisation ensures that our private sector will be less reliant on artificial profits and on protection, which benefits some producers at the expense of consumers and other producers. Infants must grow up. They must grow up to be sturdy and strong. And this cannot be done if they are over-protected.[302]

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[299] Abdul Hamid Ahmad Sarji (ed.), *Malaysia's Vision 2020: Understanding the Concept, Implications and Challenges* (Petaling Jaya: Pelanduk Publications, 1993); Mei Ling Sieh Lee, *Taking on the World: Globalization Strategies in Malaysia* (Kuala Lumpur: McGraw-Hill, 2000)
[300] Okposin et al, (1999), p.46.
[301] For political purpose, Mahathir sometimes chose non-liberal policies such as capital controls despite severe opposition from liberal policy makers at the Treasury and the central bank. Personal interview with Tan Siok Choo (Kuala Lumpur, 14 March 2002)
[302] Mohamad Mahathir, Malaysia: The Way Forward, Presented at the Inaugural Meeting of the Malaysian Business Council (Kuala Lumpur, 28 February 1991)

Malaysia's way to liberalisation was different from its neighbours because of its special emphasis on the social objectives of economic development. An underlying consensus among political leaders was that the political / social objective of economic development should not be surrendered. [303] The consensus had far-reaching implications for the Mahathir regime that based its raison d'être on class harmony. If he failed to manage it, he could not justify his authoritarian or pseudo-democratic regime. In this regard, the reform plans did not embrace all aspects of the Washington consensus that paid very little attention to social policy.

The financial crisis raised a significant question over the consensus by increasing the tension between economic efficiency and social objective. On the one hand, Mahathir attributed the crisis to external factors. [304] Indeed it was the Thai crisis that put the ringgit into a downward spiral. In anticipation of a large devaluation, currency traders undertook a series of speculative attacks on the currency in the offshore ringgit market. Consequently, offshore ringgit interest rates rose well above domestic rates. This created a vicious cycle of massive capital outflows and financial / corporate distress. [305]

From Mahathir's point of view, IMF-supported programmes were unacceptable.

> Many expected us to go to the IMF for loans to tide over our crisis. But we did not do that. Calling in the IMF would have been a disaster for the Malaysian *ummah*, as the NEP policies are not in keeping with the IMF's idea of free unfettered competition in which the strongest would take all. Equity is not of concern to the IMF. Efficiency, maximising profit for the already rich is. [306]

[303] Bridget Welsh, Malaysia and Globalization: Contradictory Currents, *Asian Perspective*, Vol. 23, No. 4 (1999); Mark Beeson, Mahathir and the Markets: Globalization and the Pursuit of Economic Autonomy in Malaysia, *Pacific Affairs*, Vol. 73, No. 3 (Fall 2000); Bruno Trezzini, Embedded State Autonomy and Legitimacy: Piecing Together the Malaysian Development Puzzle, *Economy and Society*, Vol. 30, No.3 (August 2001)
[304] For a conspiracy theory, see Kok Wing Lim, *Hidden Agenda* (Petaling Jaya: Limkokwing Integrated, 1998) Cf. Linda Y. C. Lim, Crisis and Conspiracy, *Far Eastern Economic Review* (19 March 1998)
[305] Kwame Sundaram Jomo (ed.), *Malaysian Eclipse: Economic Crisis and Recovery* (London: Zed Books, 2001)
[306] Mohamad Mahathir, Malaysia's Experience: Lessons for the *Ummah*, in Hashim Makaruddin (ed.), *Islam and the Muslim Ummah: Selected Speeches of Dr Mahathir Mohamad* (Selangor Darul Ehsan: Pelanduk Publications, 2000), p.55.

This interpretation had political origins. [307] Among others, rising ethnic tension was one of the key factors than policy makers and politicians had to take into consideration. In Malaysia, the economic inequality between the Malays and Chinese was the major source of political problems. Until the early 1970s, bumiputera (the literal meaning is sons of the soil) accounted for approximately 60 percent of the total population, but the economy was under the control of the Chinese. [308] The ethnic rioting on 13 May 1969 alarmed politicians into concluding that the economic inequity was a destabilising factor. To prevent ethnic conflicts, multi-ethnic political coalitions – the Alliance (1954-74) and Barisan Nasional (1974- present) – reached an agreement that non-Malay ethnics should tolerate pro-Malay policies. [309] They regarded it as a sort of insurance securing them a safer business environment. To achieve equitable development among the diverse ethnic groups, the New Economic Policy (NEP) gave preferential treatment to the Malays in order. As a result, the stake of the Malays in the economy over the decades increased faster than that of the Chinese and Indian. [310]

In terms of foreign economic policy, Mahathir was more pro-Japan than any other East Asian leader. [311] A 'Look East' policy and 'East Asian Economic Caucus' proposals reflect his preference. The Look East policy was designed to emulate Japan's industrialisation rather than that of Western countries. And the East Asian Economic Group (later renamed the East Asian Economic Caucus) aimed at building a Japan-led regional framework to cope with economic blocs such as the European Union (EU) and the North American Free-Trade Agreement

[307] For example, see Mohamad Mahathir and Shintaro Ishihara, translated by Frank Baldwin, *The Voice of Asia: Two Leaders Discuss the Coming Century* (Tokyo: Kodansha International, 1995) See also Boo Teik Khoo, *Paradoxes of Mahathirism: An Intellectual Biography of Mahathir Mohamad* (Kuala Lumpur: Oxford University Press, 1995)
[308] The majority of the population is Malay (54 percent). Minorities consist of Chinese (35 percent) Indian (10 percent) and others (1 percent). Politics have reflected this ethnic division. Political parties have organised along ethnic lines and thus their objectives are to promote a particular ethnic group. See Harold A. Crouch, *Government and Society in Malaysia* (Ithaca: Cornell University Press, 1996)
[309] John Funston, Malaysia, in John Funston (eds.), *Government and Politics in Southeast Asia* (Singapore: Institute of Southeast Asian Studies, 2001)
[310] For the historical background of the policy, see Mohamad Mahathir, *The Malay Dilemma* (Singapore: Federal Publication, 1970)
[311] Kit G. Machado, Malaysian Cultural Relations with Japan and South Korea in the 1980s: Looking East, *Asian Survey*, Vol. 27, No. 6 (January 1987); Ho Khai Leong, Malaysia's Conceptions of Security: Self-Resilience, Sovereignty and Regional Dynamics, *Asian Perspective*, Vol. 22, No. 3 (1998)

(NAFTA). In this regard, it is not surprising that Mahathir was one of the most outspoken supporters of the Asian Monetary Fund (AMF) proposal.

On the other hand, Anwar sympathised with the IMF, implying that it was not fair to ascribe the causes of the crisis solely to external determinants since Malaysia had weaknesses in the financial and corporate sectors. Following this logic, he introduced IMF policy recommendations in December 1997. His case for the policy was economic efficiency. This means that the principle of the NEP – a harmony between development and equality – could be reserved to regain foreign investor confidence in the short run and to prepare institutional frameworks for further economic growth in the long run. As a result, "Anwar's choice projected him as pro-IMF and pro-West, especially in the light of the parameters of public discourse that had already been established." [312]

It is not easy to explain why Anwar took the pro-IMF stance because his political supporters in poor agricultural areas suffered most from the IMF-style policy. Before the crisis, he earned nation-wide reputation as a defender of Islamic Malays. Moreover, as a devoted Muslim, he criticised Western culture in defence of Asian and Islamic culture. [313] For these reasons, his conversion to pro-Western values cannot be explained without considering his political ambitions. Since the 1995 general election, younger members of UMNO anticipated that Anwar would succeed to Mahathir, hoping that leadership change would provide them with greater opportunities for promotion. [314]

Despite this, it appeared that the relationship between Mahathir and Anwar was benign. Whenever asked about disagreement between them, both leaders dismissed it as an unfounded rumour. [315] On departing for a two-month leave of absence abroad in 1997, for example, Mahathir had appointed Anwar both Acting Prime Minister and Acting President of the UMNO. In this respect, Anwar's succession to Mahathir seemed to be a matter of time.

[312] Christine B. N. Chin, The State of the 'State' in Globalization: Social Order and Economic Restructuring in Malaysia, *Third World Quarterly*, Vol.21, No.6 (2000), p.1050.
[313] Ibrahim Anwar, *The Asian Renaissance* (Singapore: Times Books International, 1996)
[314] Hari Singh, Tradition, UMNO and Political Succession in Malaysia, *Third World Quarterly*, Vol.19, No 2 (1998)
[315] *Sunday Times*, Anwar Denies Contradicting Mahathir's Financial Statements (5 October 1997)

The financial crisis offered Anwar a window of opportunity to challenge Mahathir's leadership. The Prime Minister was attacked by the failure of his policy responses to the crisis. In addition, external environment were not favourable for him. Implicitly or explicitly, the disgraceful downfall of Suharto negatively affected his authority because there were many similarities between the two leaders: for example, intolerance of dissent and pervasive cronyism. [316]

This uneasy relationship came to the surface when Anwar announced a new policy package on 5 December 1997. [317] The package was a political challenge to Mahathir in two ways. First, it was initiated by the Treasury and the central bank, not the Prime Minister. Some measures introduced by the Prime Minister – including interventions in the stock markets and the bailout of Renong – worsened the crisis. Thus Anwar had a chance to project his view into economic policy. His priority was given to restore foreign investor confidence and IMF-style macroeconomic policy was adopted. Second, some of Mahathir's pet projects were deferred as a result of budget tightening: for example, the Bakun hydroelectric dam, the Kuala Lumpur Linear City project, the Northern Region International Airport, the mountain resort highway, and Phase 2 of the new administrative centre in Putrajaya. [318]

The package was welcomed by the international financial community. For example, Michel Camdessus praised Anwar's policy package. [319] Implicitly or explicitly, this endorsement encouraged Anwar to distance himself slightly from Mahathir's policies. When visiting Canada, he said that the pursuit of economic growth without democracy might

[316] R. S. Milne and Diane K. Mauzy, *Malaysian Politics under Mahathir* (London: Routledge, 1999), pp.156-57. See also Peter Searle, Coping with Corruption and Cronyism, in Gerald Segal and David S. G. Goodman, *Towards Recovery in Pacific Asia* (London: Routledge, 2000)
[317] *Wall Street Journal*, Intimate Enemies: How Malaysia's Rulers Devoured Each Other and Much They Built (30 October 1998)
[318] Helen E. S. Nesadurai, In Defence of National Economic Autonomy? Malaysia's Response to the Financial Crisis, *Pacific Review*, Vol.13, No.1 (2000)
[319] IMF, Camdessus, Welcomes Malaysia's New Package of Economic Measures, New Brief No.98/9 (25 March 1998) Since late 1997 when Anwar introduced IMF-style policy, foreign investors and commentators regarded him as a sincere reformer. For example, *Wall Street Journal*, Malaysia's Finance Chief Gains in Stature (22 September 1997)

encourage cronyism and corruption. It was an implicit challenge to Mahathir who preached that economic development should be achieved even at the expense of civil rights. [320]

Despite the international recognition of his policy, only Ahmad Don – the Governor of the central bank – was on Anwar's side among senior policy-makers. [321] There are two reasons why the IMF's endorsement did not contribute to strengthening the political power of the Washington consensus in the government. First, the bumiputera business community supported Mahathir's interpretation of the crisis. "This not only drew attention away from any past business mistakes that these companies may have made that contributed to their problems, it also meant that state assistance may be forthcoming. Alternative views and interpretations were therefore generally downplayed or ignored." [322]

Second, relatively small short-term foreign borrowings helped Malaysia to survive the financial crisis without the IMF's financial assistance. Nevertheless, the surge of capital flights, trade deficits and fiscal deficits required the government to seek extra funding resources. Table 4-6 summarises a plan for refinancing.

[Table 4-6] Refinancing Plan [323]

Funding requirements		Possible sources of funds	
Asset management company	RM 25 b	World Bank	US $ 300m disturbed US $ 700m to be disturbed before year end
Special purpose vehicle	RM 16 b		
Social development	RM 7 b	AMC bond	US $ 2 b (maximum)
Infrastructure development	RM 5 b	Japan	US $ 300 m (seeking 1-2 b)
Credit facilities for exporters	RM 4 b	Taiwan EXIM Bank	US 1 b (under consideration)
Low-cost housing	RM 2 b	Asian Development Bank / International Islamic Bank	No figure disclosed

One option was the issuing of sovereign bonds in international financial markets. This option was postponed since the downgrade of its sovereign credit rating substantially

[320] John Hilley, *Malaysia: Mahathirism, Hegemony and the New Opposition* (London: Zed Books, 2001), pp. 65-77 & 106-111.
[321] *Straits Times*, Malaysia's Interest Rates Take Centre Stage (1 June 1998)
[322] Nesadurai (2000), p.87.
[323] *Business Times*, Topping More Loans from the World Bank for 1999 (24 July 1998)

increased the cost of foreign borrowing. An international road show scheduled in July 1998 was cancelled. [324] Moreover, the introduction of capital controls isolated Malaysia from the international financial community. The delay of the World Bank's loan was a serious setback.[325] Despite this, Malaysia did not accept the offer of a 4 million dollars loan from Singapore due, in large part, to the uneasy relationship between the two countries. [326]

It was Japan that rescued the country from the danger of a balance-of-payments crisis. Since 1994, Malaysia had never asked Japan for loans because the appreciation of the yen substantially increased its debt burden. However, the rapid depletion of its foreign currency reserves led the country to be a recipient of the New Miyazawa Plan. On 11 December 1998, Malaysia issued five-year government bonds (74 billion yen), 90 percent of which was guaranteed by Japan's Ministry of International Trade and Industry (MITI). Besides, Japan's Export-Import Bank provided the Malaysian government with a 500 million dollars loan. [327]

Against this background, Malaysia strongly supported Japan-centred regional co-operation. This pro-Japanese stance has a historical origin. A 'Look East policy' and 'Buy British Last' campaign was aimed at emulating Eastern (Japanese) capitalism rather than Western capitalism. And Japan's ODA and FDI were the main sources of its industrialisation projects.

> Japanese investment has helped raise our level of prosperity and standard of living. Such genuine support stands in stark contrast to the dubious 'investment' more recently undertaken by currency and stock-market speculators, coming to Malaysia after the country had 'taken off', not to assist in the building of a nation, but merely to reap instant profits. [328]

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[324] *Wall Street Journal*, Malaysia Shelves Bond Offering After Moody's Downgrades Debt (27 July 1998)

[325] *Straits Times*, Controls Disrupt World Bank's Plans for $ 3b Loan (24 September 1998)

[326] EIU, Country Report: Malaysia (1st quarter 1999), p.26.

[327] *Asiamoney*, The Real Message in Miyazawa's Plan (February 1999)

[328] Mohamad Mahathir, *A New Deal for Asia* (Selangor Darul Ehsan: Pelanduk Publications, 1999), p.90. For a critical review of the policy, see Kwame Sundaram Jomo (ed.), *Japan and Malaysian Development: In the Shadow of the Rising Sun* (London: Routledge, 1994)

Despite Japan's assistance, the funding problem was not completely resolved until the issue of a 1 billion dollars global bond in May 1999. To fill the gap, the government organised political campaigns to mobilise domestic savings.[329] At the same time, the government requested twelve foreign banks operating in the country to lend 1.3 billion dollars at a very cheap rate in December 1998.[330]

The general framework of crisis management was presented by the National Economic Action Council (NEAC), which was established as a consultative organisation to the cabinet on 7 January 1998. The primary task of the NEAC was to provide a comprehensive framework for crisis management and to coordinate ministries at the stage of implementation. Its 26 members included the Prime Minister, Finance Minister, Governor of the central bank, and representatives from industry, banking and finance, trade unions and consumer associations. In character, it functioned as an emergency cabinet.[331] The NEAC announced the National Economic Action Plan on 23 July 1998.

As Table 4-7 shows, the plan was a compromise between the Washington consensus and the NEP principles.

[Table 4-7] National Economic Action Plan[332]

Objectives	Measures
Stabilising the ringgit	• Appropriate Choice of Exchange Rate Regime • Reduce Over-Dependence on the US Dollar • Increase External Reserves • Adopt a Balanced Interest Rate Policy
Restoring market confidence	• Improve Transparency and Regulatory Environment • Establish Rules for Assisting Industries and Companies in Trouble • Increase Consistency of Policies • Adopt Liberal and Market-Based Policies • Improve Public Relations • Improve the Dissemination of Economic Information

[329] *Straits Times*, KL Halts US $ 2b Bond Plan (28 July 1998); KL to raise RM 60b Locally (7 October 1998)
[330] *Business Times*, 12 Foreign Banks to Lend US $ 1.35 b at Below Market Rate (30 December 1998)
[331] For a comprehensive overview of the NEAC, see Zainal-Abidin Mahani, *Rewriting the Rules: The Malaysia Crisis Management Model* (Petaling Jaya: Prentice Hall, 2002)
[332] NEAC, *National Economic Recovery Plan: Agenda for Action* (NEAC, 1998), p.45.

Maintaining financial market stability	• Preserve the Integrity of the Banking System • Establish Agencies Along the Lines of FDIC/RTC • Recapitalise the Banking Sector • Monitor Closely Overall Credit Expansion • Improve the Capital Market • Develop the PDS Market
Strengthening economic fundamentals	• Increase the Quality of Investments • Improve the Balance of Payments • Maintain a Balanced Public Sector Financial Position • Maintain an Appropriate Monetary Policy • Maintain Price Stability • Increase Labour Competitiveness
Continuing the equity and socio-economic agenda	• Ameliorate the Hardship from Poverty • Address the issues on Bumiputera Equity Ownership • Expand Employment Opportunities • Meet the Challenge of Expanding Tertiary Education • Address the Problem of Graduate Unemployment • Control the influx of Foreign Workers • Gear up State Corporations to Face the Crisis • Revamp Cooperatives and Cooperative Banks • Protect the Environment for Sustainable Development
Restoring adversely affected sectors	- Primary Commodities and Resource-Based Industries - Manufacturing - Information Technology and the Multimedia Super Corridor - Motor Industry - Construction - Property - Infrastructure - Transportation - Freight Forwarding - Tourism - Insurance and Reinsurance - Industrial Development Finance Institutions

From a political perspective, the creation of the NEAC reflected a growing cleavage between Mahathir and Anwar. Indeed there was a cause for concern that the rivalry between the Finance Ministry and the NEAC might complicate a coherent and transparent policy-making process. Furthermore, the appointment of Daim Zainuddin as the executive director had political implications. The former Finance Minster had been a close ally of Mahathir in the cabinet (Finance Minister) and party (UMNO Treasurer) from the early 1980s. Thus Daim's comeback meant that the Prime Minister did not trust his deputy as before.

More importantly, Daim's political background was the bumiputera business community. He was one of the most outspoken politicians who supported the NEP principles: i.e., affirmative actions should be maintained until bumiputera to achieve the 30 percent share of the economy. In this regard, he was critical of Anwar's policy that allowed non-bumiputera investors to increase their share. Further, he argued that this policy would undermine the political dominance of Malays in the end. [333]

3) Macroeconomic Adjustment

Under Anwar's leadership, Malaysia's responses were not different from those of the countries under the IMF-supported programmes. [334] Anwar's policy package was very similar to IMF-supported programmes: reductions in government spending by postponing large-scale infrastructure projects, curbing capital outflows by raising interest rates, and reforming the financial sector by upgrading the regulatory framework.

With respect to fiscal policy, Malaysia maintained a prudent stance. For five years in a row (1992-97), the economy registered a sizeable amount of surplus. A fiscal surplus of 2.7 percent was envisaged in the 1998 budget plan announced in October 1997. In the middle of the regional crisis, the need for reducing current account deficits led the government to revise the original plan. To show its commitment to sound macroeconomic management, Anwar announced a new budget plan in December 1997. Its highlight was an 18 percent reduction in the 1998 budget allocations. [335] To repress domestic demand, major infrastructure projects and privatisation programmes were deferred or cancelled. In addition, operational costs in the public sector were slashed as a result of downsizing government agencies. For example, cabinet ministers / their deputies and senior civil servants took a voluntary 10 and 3 percent pay cut respectively, while the others' salaries were frozen. [336]

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[333] *New Straits Times,* Daim Tells Why Malays Still Need Privileges (19 December 2000)
[334] Mohd. Yaacob Abdul Aziz, Towards a Sustainable Financial System: The Malaysia Situation, in Ramesh Adhikari and Ulrich Hiemenz (eds.), *Achieving Financial Stability in Asia* (OECD, 2000)
[335] BNM, *Annual Report 1997* (1998), pp.82-84.
[336] *Wall Street Journal,* Malaysia Unveils More of Austerity Plan as Stock Surge 11 % in Reaction to Idea (9 December 1997)

Hindsight reveals that this austere stance was inappropriate. At that time, an active fiscal policy was needed to cope with an impending recession. Malaysia's strong fiscal position could have provided considerable scope for counter-cyclical measures. Nevertheless, Anwar did not surrender the conservative stance until crisis-hit countries including Thailand and Korea increased fiscal deficits to fund social safety nets and financial restructuring.

To mitigate the negative impact of economic recession, some measures were taken to support job mobility programmes. In August 1998, the Employment Act of 1955 was amended to bring more flexibility to labour markets. The financial crisis increased the unemployment rate from 2.6 percent in 1997 to 3.9 percent in 1998. Compared with the other crisis-affected countries, its social impact was modest. First, most companies reduced foreign workers rather than Malaysian ones. Second, pay cuts were preferred to lay-offs because the economic recession was expected to disappear. [337] As a result, labour unrest was not of major political concern.

When it comes to monetary and exchange rate policy, massive capital inflows in the early 1990s created symptoms of asset and equity bubbles in the economy. Thus, BNM attempted to reduce the inflationary pressure. To this end, ceilings on lending to the property sector and for the purchase of shares were introduced as pre-emptive measures.

In the wake of the crisis, BNM adopted a low interest rate policy to protect highly-indebted companies from insolvency. However, this policy was not sustainable due to the depreciation of the ringgit and trade deficits. In particular, the depreciation of the currency made it more difficult for the central bank to pursue a coherent monetary policy. Before the crisis, the ringgit was floating in a narrow band of between RM 2.36 and RM 2.51 to the US dollar. This parity became unstable in March 1997, and depreciated to an average of 2.57 in July. The central bank attempted to maintain the value of the currency by intervening in foreign exchange markets on 8 July 1997. However, after wasting an estimated 1.5 billion dollars, the central bank gave up the policy, allowing the currency to devalue. On 7 January 1998, the currency plunged to its lowest level – RM 4.88 – but recovered to an average of 3.73

[337] IMF, Malaysia: Recent Economic Developments, Staff Country Report No. 99/85 (IMF, 1999), p.6.

in April 1998. This disappointing result left the monetary authorities with no choice but to raise interest rates. [338]

The market-based solution brought serious side effects to the economy. [339] Many highly-leveraged companies faced financial difficulties because they could not serve surging interest on their debts, let alone the principal. In October 1997, for example, Renong – one of the largest and best-connected companies – was forced to restructure its debts. Corporate distress gave rise to the surge of non-performing loans (NPL), which adversely affected the commercial banks. In addition, new regulations that were intended to strengthen the financial system aggravated corporate distress. For example, the shortening of the NPL classification period from six months to three months made financial institutions more cautious about new lending. This vicious circle eventually endangered the integrity of the domestic financial markets.

In this situation, Mahathir called for a reduction of interest rates. However, Anwar did not respond to the Prime Minister's plea. Instead, the Finance Minister maintained a high interest rates policy on the basis that the reversal of the policy would delay structural reform by giving unprofitable companies easy access to bank loans. The debate was not easily resolved because the confrontation between the Prime Minister and the Vice Prime Minister was not only confined to economic policy. [340]

To overcome the isolation, Anwar launched a political campaign against nepotism and corruption in early May 1998. The campaign was assisted by young UMNO members. Despite warnings from senior UMNO members, Anwar's supporters openly demanded that the government curb cronyism. [341] The campaign reached its highest point at the UMNO's annual

[338] *Business Times*, Malaysia Forced to Keep Interest Rates High (6 May 1998)
[339] Wee Beng Gan, Lee Ying Soon and Chee Chee Soh, The Ringgit and the Malaysian Financial Crisis: An Interpretation, *Malaysian Journal of Economic Studies*, Vol.XXXVI, No.1 (June 1999); Wee Beng Gan and Lee Ying Soon, Credit Crunch during a Currency Crisis: The Malaysian Experience, *ASEAN Economic Bulletin*, Vol.18, No.2 (August 2001)
[340] K.S. Jomo argued that the confrontation between them was exaggerated by Western media at that time. According to him, there was little disagreement between them at least macroeconomic policy until mid-May. It was Western newspapers that led Mahathir to suspect his deputy seriously. K. S. Jomo, Personal interview (Kuala Lumpur, 14 March 2002)
[341] *Straits Times*, Subversives Using Cronyism Charge (16 June 1998)

general assembly where UMNO Youth Chief, Ahmad Zahid Hamidi, criticised government assistance to state-owned Petroliam Nasional that had rescued the companies of Mahathir's eldest son. [342]

Although the cause of the campaign was correct, the timing was very tricky. At that time, Indonesia's President Suharto was forced to resign amid nationwide demonstrations. After the resignation of the region's longest-serving elected leader, Mahathir was believed to fear that the political instability in this neighbouring country would be contagious to his country. [343]

To gain support from the business community, Mahathir disclosed the names of companies and their principal shareholders that received beneficial contracts in the privatisation of state-run companies. Among the list of nearly 300 companies were Anwar's supporters as well as Mahathir's cronies. Furthermore, Mahathir emphasised that the affirmative action was designed to promote bumiputera business. [344]

Anwar's attempt to attack Mahathir was not successful because his economic policy failed to stop economic recession. The economy contracted by - 7.4 percent in terms of real GDP. Senior UMNO leaders did not support his painful strategy, worrying about the next election which was held due by April 2000. Thus his challenge to the Mahathir leadership intensified his isolation in the party.

The winner of the power struggle was Mahathir. This does not mean that all his policies proved to be correct; on the contrary, most of them still remain the subject of much debate. In this respect, Anwar's defeat was more political rather than theoretical. Although Anwar's macroeconomic policy was praised by the international financial community, he failed to gain enough support to push ahead with it. His allies were gradually isolated in the cabinet, the central bank and the ruling party [UMNO].

With hindsight, the policy rift between Mahathir and Anwar became politically serious when the National Economic Action Council (NEAC) was created in January 1998. In fact, NEAC had no raison d'être because its functions were, to a considerable extent, overlapped by

[342] For the assembly, see *Malaysian Business*, Show Stoppers (16 July 1998)
[343] *Wall Street Journal*, Malaysia Hit by Problems in Indonesia (27 March 1998)
[344] EIU, Country Report: Malaysia (3rd quarter 1998), p.14.

those of the Ministry of Finance and the central bank. The appointment of Daim as its executive director signalled the decline of Anwar's authority in the policy-making circle. Second, Daim's return to the cabinet as special functions minister "entrusted with the tasks relating to economic development" in June 1998 confirmed the speculation that Anwar had been excluded from Mahathir's inner circle. Third, the elimination of Anwar's supporters accelerated after young UMNO leaders accused Mahathir of cronyism. An Anti-Anwar pamphlet – *Fifty Reasons Why Anwar Shouldn't Be Prime Minister* – was widely circulated within the UMNO. In late August, Ahmad Don and his deputy Fong Weng Phak had to resign because both supported Anwar's policies. [345] It is also widely believed that Mahathir pressured two influential newspaper editors (*Utusan Malaysia* and *Berita Harian*) and a director of TV3 – all of whom were regarded as Anwar's supporters – to resign. [346] The final step was the dismissal of Anwar as Deputy Prime Minister and Minister of Finance on 2 September 1998.

The removal of political opponents paved the way for Keynesian policy. Although the policy shift was swift and decisive, the timing was too late to re-ignite economic growth. And the introduction of capital controls had an ambivalent impact on economic recovery. On the one hand, capital controls allowed the authority to regain monetary autonomy by insulating the economy from external pressures. On the other hand, capital controls left the economy isolated from international financial markets, thereby making it difficult to attract foreign capital that is required to finance fiscal deficits and structural reform.

When it comes to fiscal policy, the main obstacle to expansionary budget was Anwar's resistance. As the economy contracted by 4.8 percent in the first half of 1998, he rethought his policy. On 24-25 March 1998, the budget plan was revised to allow a fiscal deficit of 2.6 percent of GDP. Additional expenditures were allocated on social spending. [347] Because external conditions became favourable, the policy reversal continued in the second half of 1998. The current account was in surplus in the second quarter of the year. This meant that

[345] *Wall Street Journal*, Malaysian Central Bank Officials Quit (31 August 1998)
[346] *Sunday Times*, KL 'Won't' Restrict Flow of Capital' (30 August 1998)
[347] *Business Times*, KL Ready to Run Budget Deficit to Keep up Social Spending: Anwar (12 May 1998)

one of the obstacles to using fiscal stimulus disappeared. In addition, there was need for an extra budget for banking sector restructuring. To this end, a supplementary budget amounting to RM 7 billion was announced in July 1998. In addition, an Infrastructure Development Fund was launched to boost economic activity. Consequently, the 1998 budget resulted in a deficit of 3.7 percent of GDP. [348]

The impact of fiscal expansion on economic growth was not as strong as expected because the original budget was so tightened and the policy shift took place well after economic activity slowed. [349] This recognition led the government to expand its fiscal deficit to 6.1 of GDP in 1999. Economic recovery in the first half of 1999 increased government revenues and there was more room for expenditure on financial restructuring and social spending. As a result, real expenditure was raised by RM 9.5 billion while the original deficit rate (6.0 percent of GDP) was not violated. To finance the deficit, government bonds were issued. Not to place extra burdens on financial institutions, the bonds were sold to the Employees Provident Fund (EPF) and insurance companies. [350] Table 4-8 summarises the projection and result of fiscal operations.

[Table 4-8] Fiscal Operations (Percentage of GDP)

Year	Original plan	Result
1997	1.6	2.5
1998	2.7	-3.7
1999	-6.0	-6.1
2000	-5.0	-4.1

Source: Ministry of Finance, Annual Report (various issues)

There was political controversy over who initiated the policy shift. According to Mahathir, Anwar stuck to the economic orthodoxy supported by the IMF and thus refused to relax this

[348] Ministry of Finance, *Economic Report 1998/99* (1999), p.47.
[349] Kanitta Meesook, Il Houng Lee, Olin Liu, Yougesh Khatri, Natalia Tamirisa, Michael Moore, and Mark H. Krysl, *Malaysia: From Crisis to Recovery*, Occasional Paper No. 207 (IMF, 2001), p.40.
[350] BNM, *Annual Report 1999* (2000), pp.87-89.

fiscal stance despite the impending economic recession. [351] On the other hand, K. S. Jomo argues that Anwar had already planned to change the macroeconomic policy framework in May 1998. Nonetheless, there is no convincing evidence that Anwar acted on his own initiative. At that time, the IMF already allowed its loan recipients to increase their budget deficits.

With respect to monetary policy, Mahathir ordered the NEAC to consider a low interest rate policy on 21 April 1998. His point was that high interest rates increased debt-serving burden of highly-leveraged firms. When interest rates rose to an average of 11 percent in June 1998, financial and corporate distress was at its peak. And he urged the government to rescue some strategic firms for the sake of economic recovery and the national interest. However, Anwar refused to change the policy, arguing that low interest rates would encourage capital flight, thereby putting more downward pressure on the currency.

[Table 4-9] Changes to BNM Intervention Rate and Statutory Reserve Requirement (SRR) [352]

Period		Liquidity	Date	Intervention Rate	SRR
1998	Jan-Feb	Tightening	End-97	8.70	13.5
			9 Jan	9.00	
			20 Jan	10.00	
			6 Feb	11.00	
	Mid Fed-July	Stable	16 Feb		10
			1 July		8
	Aug-Dec	Easing	3 Aug	10.50	
			10 Aug	10.00	
			27 Aug	9.50	
			1 Sep		6
			3 Sep	8.00	
			16 Sep		4
			5 Oct	7.50	
			9 Nov	7.00	
1999	Jan-Aug	Continued Easing	5 Apr	6.50	
			3 May	6.00	
			9 Aug	5.50	

The confrontation turned bitter when Singaporean banks started to sell highly lucrative ringgit deposits (up to 40 percent returns). As Table 4-9 shows, the statutory reserve

[351] Mohamed Mahathir, *The Malaysian Currency Crisis: How and Why It Happened* (Selangor Darul Ehsan: Pelanduk Publications, 2000)
[352] BNM, *The Central Bank and the Financial System in Malaysia* (BNM, 1999), p.595.

requirement (SRR) was lowered from 10 percent to 8 percent from 1 July 1998.[353] The shift to a fixed exchange regime made it easy for the authorities to relax monetary policy because they would no longer have to consider the potential exchange rate consequences.[354]

Despite consecutive interest rate reductions, money circulation did not grow. Many banks were still very passive in lending due to tight regulations on NPLs and to economic uncertainty.[355] To encourage bank lending, some regulations were relaxed on 23 September 1998 that was effective from January 1999.[356] First, the default period for classifying a loan as non-performing by banking institutions would be increased from three to six months. Second, banking institutions would no longer be automatically required to provide a 20 % specific provision on sub-standard loans. Finally, for non-performing loans that were restructured or rescheduled, such loans could be reclassified as performing loans when the repayments under the rescheduled terms were complied with for a continuous period of six months, instead of the current practice that required 12 months of continuous payment.[357]

Table 4-10 demonstrates that the problem was resolved in 1999 and the economy was successful in regaining economic growth in 1999 and 2000.

[Table 4-10] Changes in the Major Economic Index

	1997	1998	1999	2000
Gross official reserves (US $ billion)	21.7	26.2	30.9	29.9
Exchange rate (ringgit/dollar)	2.8	3.9	3.8	3.8
Three month inter-bank rate (%)	8.6	6.5	3.2	3.3
Federal budget balance (% of GDP)	2.5	-1.5	-4.1	-4.2
Stock Price Index (end of period)	594	586	812	680
Real GDP Growth	7.3	-7.4	6.1	8.3

Source: IMF

353 EIU, Country Report: Malaysia (3rd quarter 1998), p.20.
354 IMF, Malaysia: Recent Economic Developments, Staff Country Report No. 99/85 (IMF, 1999), p.16.
355 *Straits Times*, Mahathir Calls for Easier Bank Borrowing (9 November 1998); *Business Times*, Ultra-Conservative Bankers Seen Hurting Malaysia Recovery (24 April 2000)
356 *Straits Times*, KL to Ease Classification of 'Bad Loans' (2 September 1998)
357 Ministry of Finance, *Economic Report 1998/99* (1999), p.42.

4. Conclusion

This chapter have analysed the political impact of the Washington consensus on economic policy. The cases of Korea and Malaysia have shown that the consensus played a crucial role in leading the two countries to adopt a similar set of economic policy. This is why both introduced IMF-style economic adjustment policies, whether the IMF involved or not.

The Korean case shows that the Washington consensus played a crucial role in interpreting the causes of the crisis and designing policy prescriptions. It is hard to deny that IMF's policy conditionality lay behind the supremacy of the consensus. However, it would be a big mistake to overlook the transformation of ideological terrain. As President Kim Yong Sam's *Segyehwa* policy shows, a growing number of policy makers and economists were supportive of market-oriented reform from the early 1990s. The chaebol were also enthusiastic about the ideas of liberalisation, deregulation and privatisation because they wanted to reduce government intervention. In this regard, the financial crisis was a catalyst for accelerating the speed of structural reform.

The Washington consensus also had a significant effect on Malaysia's economic adjustment particularly under Anwar. From October 1997 to June 1998, Anwar introduced IMF-style policy packages, even though the government did not have any legal obligation to do so. Despite the opposition from the bumiputera business community, pro-cyclical policy was implemented at the early stage of economic adjustment. Although the policy was reversed by Mahathir in September 1998, it should be noted that the other three crisis-affected countries also shifted to counter-cyclical policy at that time. Even after the dismissal of Anwar, the Basel core principles of bank supervision and the OECD principles of corporate governance were applied to the financial and corporate sector, albeit sometimes superficially.

Some unorthodox policies employed by Mahathir show that the political power of the Washington consensus was not strong enough to reject the legacies of the NEP. The main reason is that there was an ideational division among policy makers and big business. On the one hand, Anwar's supporters in the Treasury and BNM followed IMF policy recommendations. On the other hand, Mahathir, Daim and senior bumiputera business leaders were strongly opposed to Anwar's policy in the name of the NEP principles. This disagreement led Mahathir to establish the NEAC to decrease the power of Anwar's supporters in the Treasury and the central bank. More importantly, it should be noted that not all pro-Anwar policy makers believed in neoliberalism. Some of them supported Anwar for political reasons. In other words, their commitment to IMF-style stabilisation policies was not strong enough to reject the legacies of the NEP.

> Despite the presence of domestic political constraints, the government has liberalized some aspects of the ethnic-based distributive policy in a move to accommodate global market forces and restore growth. Nevertheless, these limited liberalizing tendencies do not signal any ideological or policy shift towards full acceptance of neoliberal norms and practices. This was demonstrated by the clearly illiberal move in September 1998 to impose capital controls and insulate the domestic economy from a harsh external environment in order to regain some monetary independence. It suggests that the commitment to free markets in Malaysia is instrumental or tactical rather than ideological. [358]

The differences between Korea and Malaysia can be explained by socio-political factors that affected the political power of the Washington Consensus. In Korea, IMF's conditionality was a key factor that made the consensus predominant. Equally important, policy makers agreed to IMF's policy recommendations, realising that the existing economic model was no longer appropriate for the economy. Although big business was unenthusiastic about some IMF policies – especially high interest rate policy –, their opposition was of less political importance because the chaebol's legitimacy was seriously damaged by the crony capitalism thesis. The presidential election in December 1997 contributed to reminding voters of the importance of economic reform and thus to increasing the political influence of the consensus.

[358] Nesaradui (1999), p.106.

In Malaysia, the political power of the Washington consensus was not robust. There was a clear tension between the NEP principles – a harmony between racial equity and economic development – and neoliberalism that champions economic efficiency. This tension divided policy makers into two groups. While Anwar's supporters the Treasury and BNM preferred orthodox policy measures, Mahathir's followers in the NEAC adhered to the NEP principles. As the National Economic Recovery Plan demonstrates, its economic adjustment programme was a political compromise between the two economic ideas.

It was the bumiputera business community that gradually shifted the swing of the pendulum toward the NEP principles. The community was very critical of it because high interest rates and the cancellation of big infrastructure projects had negative impacts on their business. Mahathir exploited this discontent to protect his political authority and to rescue his cronies from bankruptcy.

It should be noted that Mahathir's policy shift in September 1998 was an anti-IMF policy. In mid-1998, the IMF allowed the crisis-affected countries under the IMF programmes to use Keynesian stimulus measures. As a matter of fact, the Korean government lowered interest rates aggressively from April 1998 and introduced supplementary budgets in July and September in the year. In this regard, it is hardly surprising that there was not much difference between the two countries in terms of the pattern of economic recovery.

Chapter V

Financial Reform

1. Introduction

This chapter explores to what extent the political power of the Washington consensus affected financial reform in Korea and Malaysia. Financial liberalisation is one of the most important doctrines of the consensus. Many of the consensus's policy agendas are, directly and indirectly, related to the policy doctrine: i.e., interest rate liberalization, liberalization of inflows of foreign direct investment, a competitive interest rate and deregulation (to abolish barriers to entry and exit) and privatisation.

Prior to the crisis, the East Asian financial system was widely believed to be a bank-based system. [359] To finance rapid industrialisation, the state frequently and extensively intervened in the financial markets with various policy tools: for example, interest ceilings, credit rationing and debt guarantees. Strong government intervention was effective in mobilising scarce capitals to invest large projects such as economic infrastructure. [360]

As Figure 5-1 indicates, this system is close to a Japanese system rather than an Anglo-American one. In the US and the UK, stock and bond markets are crucial for the allocation of financial resources. In the financial market-based system, hostile takeovers are allowed and market competitions are fierce. In France and Germany, banks play a bigger role in financial markets. In the bank-based system, the relations among them are generally stable because

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[359] For cross-national comparisons of the system across the region, see Robert Wade, East Asian Financial Systems as a Challenge to Economics: Lessons from Taiwan, *California Management Review*, Vol.27, No.4 (Summer 1985); Stephan Haggard, Chung Lee, and Sylvia Maxfield (eds.), *The Politics of Finance in Developing Countries* (Ithaca: Cornell University Press, 1993); Stephan Haggard and Chung H. Lee (eds.), *Financial Systems and Economic Policy in Developing Countries* (Ithaca: Cornell University Press, 1995)
[360] Joseph E. Stiglitz and Marilou Uy, Financial Markets, Public Policy, and the East Asian Miracle, *World Bank Research Observer*, Vol. 11, No.2 (August 1996); Dimitri Vittas and Yoon Je Cho, Credit Policies: Lessons from Japan and Korea, *World Bank Research Observer*, Vol. 11, No.2 (August 1996)

there is little chance of hostile M & As. The Japan system is located between them, but it is more close to the bank-based system rather than the financial-based system.

[Figure 5-1] Comparing Financial Systems of Major Countries [361]

	United States	United Kingdom	Japan	France	Germany
Financial Markets	Central	Central	Developed	Fairly unimportant	Unimportant
External corporate governance	Hostile takeovers	Hostile takeovers	Main bank system		Hausbank system

According to John Zysman, the divergence between market-based system and bank (or credit)-based system arises from different industrialisation strategies. "A capital market-based financial system [i.e., the US and the UK] would be linked to company-led growth, a credit-based system with administrated price [i.e., France and Japan] would be linked to state-led growth, and a credit-based system with bank domination [i.e., Germany] would be linked to negotiated change." [362]

The financial crisis led East Asian policy makers to rethink the bank-based financial system in a fundamental way. Supporters of the Washington consensus argued that interventionist policy tools were the source of moral hazard problem that caused unsustainable levels of non-performing loans (NPLs). [363] For this reason, they recommended deregulation and liberalisation of financial markets. This policy was supported by some empirical studies

[361] Based on Franklin Allen and Douglas Gale, *Comparing Financial Systems* (Cambridge: MIT Press, 2000), p.4.
[362] John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca: Cornell University Press, 1983), p.286.
[363] Carl-Johan Lindgren, Tomás J.T. Baliño, Charles Enoch, Anne-Marie Gulde, Marc Quintyn, and Leslie Teo, *Financial Sector Crisis and Restructuring: Lessons from Asia*, Occasional Paper No. 188 (IMF, 1999)

showing that there is a positive correlation between financial liberalisation and economic growth. [364]

Critics of the IMF pointed out that ill-sequenced liberalisation were the main cause of the crisis, suggesting more cautious approach to liberalisation. Before liberalisation, appropriate institutional frameworks for prudent regulation / supervision should be in place. Further, some economists argued that capital controls could be useful in stabilising currency and financial market. [365]

In the post-crisis era, Korea and Malaysia used a similar set of measures. To address financial distress, both governments established asset management companies (AMCs) that purchased NPLS and consolidated the financial sector by encouraging M & As. At the same time, they re-organised their supervisory agencies and revised regulations to prevent moral hazard problem. In the meanwhile, there was a stark contrast in terms of capital account liberalisation. Malaysia used capital controls whereas Korea liberalised capital account. However, the capital control policy was quickly removed after solid economic recovery. [366]

The remainder of this chapter is divided into three sections. In the next two section sections, I trace the development of the financial system in Korea and Malaysia respectively. The focus of the chapters is on how the Washington consensus had an influence on policy choice and implementation. The final section compares the two cases to evaluate the impact of the IFI, policy makers, big business and political institutions on the political power of the consensus.

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364 World Bank, *Finance for Growth: Policy Choices in a Volatile World* (Oxford: Oxford University Press, 2001) See also Ross Levine, Financial Development and Economic Growth, Views and Agenda, *Journal of Economic Literature*, Vol. 35, No.2 (June 1997); Mohsin S. Khan and Abdelhak S. Senhadji, Financial Development and Economic Growth: An Overview, Working Paper No.00/209 (IMF, 2000)
365 Robert Wade, The Coming Fight Over Capital Flows, *Foreign Policy*, No.113 (Winter 1998-9); Richard N. Cooper, Should Capital Controls Be Banished?, *Brookings Papers on Economic Activities*, No.1 (1999); Benjamin J. Cohen, Capital Controls: The Neglected Option, in Geoffrey R. D. Underhill and Xiaoke Zhang (eds.), *International Financial Governance under Stress: Global Structures versus National Imperatives* (Cambridge: Cambridge University Press, 2002)
366 Malaysia's capital control policy could be explained in the previous chapter because its main objective was macroeconomic stabilisation rather than microeconomic reform. Nonetheless, I include Malaysia's capital control policy in order to compare it with Korea's capital account liberalisation policy.

2. Korea

1) Financial Liberalisation in the Early 1990s

Prior to the financial crisis, the Korean financial system was bank-dominated rather than market-oriented. Major commercial banks were under state control, whether nationalised or not. For example, the government used to handpick executives of the commercial banks and set credit quotas. Since the early 1970s when the government promoted some strategic industries such as heavy and chemical industry, state intervention was pervasive in the financial sector. Interest rate controls and quantitative credit targets were used to finance the favoured industries. In this regard, financial policy was considered as a means of industrial policy. [367]

The bank-based financial system was relatively successful in overcoming two weaknesses of the economy: insufficient domestic savings and lack of foreign investment. At the early stage of industrialisation, domestic capital markets were not developed enough to finance large industrial projects. Moreover, it was difficult to attract foreign investment since international organisations as well as foreign investors were sceptical over the prospects of the economy. Under such circumstances, the government mobilised financial resources to fund the projects. Except for two economic recessions following the oil crises in the 1970s, the system was relatively successful.

There were negative aspects of the bank-based system. Pervasive state involvement hindered domestic financial institutions from developing efficient and competitive financial markets. As a result, the financial sector was one of the most underdeveloped parts of the economy. At the same time, strong government interventions generated moral hazard problem in the financial sector.

[367] For an overview of the financial system, see David Cole and Yung Chul Park, *Financial Development in Korea, 1945-78* (Cambridge: Council on East Asian Studies, Harvard University Press, 1983); Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991); Chongwoo Choe and Imad A. Moosa, Financial System and Economic Growth: The Korean Experience, *World Development*, Vol. 27, No. 6 (June 1999)

In the early 1980s, many policy-makers and economists recognised that strong state intervention in the financial sector did more harm than good. Liberalisation of the financial sector was undertaken in the mid-1980s. [368] Key changes included the privatisation of the commercial banks, the reduction in the dispersion of regulated interest rates, and the relaxation of entry barriers to non-bank financial markets. [369]

The first wave of liberalisation remained slow and limited. [370] The reason is that was part of macroeconomic stabilisation to cope with the recessions that followed the second oil crisis and the assassination of President Park Jung Hee in 1979. Thus, the opening of capital accounts was postponed on the basis that financial institutions lacked both sufficient resources and techniques to compete with foreign counterparts. [371] For this reason, many restrictions on capital account transactions remained untouched until the late 1980s when the economy recorded current account surpluses. [372]

The second wave of liberalisation was launched in the early 1990s. As Table 5-1 shows, a five-year plan, *Blueprint for Financial Liberalisation and Market Opening*, was introduced in July 1993. Its objective was to give greater autonomy to domestic financial intermediaries to determine their interest rates on loans and deposits. Major changes included a gradual liberalisation of long and short-term international capital flows and the deregulation of interest rates on lending and deposits.

These measures were not enough to meet the OECD entry requirements. In 1992, for example, restrictions on the items in the OECD code for capital account liberalisation were 89 percent, while the average for all OECD countries was 17 percent. [373] To accelerate the speed

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[368] Sang-Woo Nam and Chung H. Lee, Korea, in Haggard and Lee (1995)
[369] For details, see Appendix 5-1.
[370] Alice H. Amsden and Yoon-Dae Euh, South Korea's 1980s Financial Reform: Good-bye Financial Repression (Maybe), Hello New Institutional Restraints, *World Development*, Vol.21, No.3 (March 1993) Nonetheless, Korea maintained a cautious approach compared with other developing countries.
[371] Sangwoo Nam, Korea's Financial Reform since the Early 1980s, in Gerard Caprio Jr., (ed.), *Financial Reform: Theory and Experience* (Cambridge: Cambridge University Press, 1994)
[372] Sung Hee Jwa, Capital Mobility in Korea Since the Early 1980s: Comparison with Japan and Taiwan, in Ito and Krueger (1994)
[373] OECD, *Economic Surveys: Korea* (1994), p.118.

of liberalisation, the Presidential Commission for Financial Reform was established in 1995. [374]

[Table 5-1] Third-Stage Blueprint for the Liberalisation & Opening of the Financial Sector [375]

Schedule	Items
Phase I (1993)	• Liberalise all bank and non-bank lending rates (except for policy loans) and long-term deposits over tow-year maturity • Issue Monetary Stabilisation Bonds and government bonds of close to market interest rates • Operate M2 targets flexibly • Liberalise call markets • Widen the daily won-dollar trading margin from 0.8 to 1.0 percent • Switch to the notification system for foreign direct investment into Korea
Phase II (1994-5)	• Liberalise all lending rates and rate for short-term marketable instruments • Establish indirect monetary controls • Deregulate loans to large conglomerates • Develop short-term financial markets • Further widen the daily won-dollar trading margin • Further ease requirements for underlying documentation prior to foreign exchange transactions • Expand limits on foreign investment in the stock market • Allow foreign participation in primary markets for some bonds • Ease requirements for opening branches of foreign securities companies
Phase III (1996-7)	• Liberalise all deposit rates except for demand deposits (allow money market certificates and money market funds) • Utilise open market operations as main monetary policy tool • Operate the Loans Management System as a prudential regulation • Introduce free-floating exchange rate system • Eliminate requirements for underlying documentation for the usual foreign exchange transactions • Allow foreign borrowing through commercial loans • Allow foreign financial institutions to hold stock of domestic banks

374 Moon-Soo Kang, Financial Deregulation and Competition in Korea, in Takatoshi Ito and Anne O. Krueger (eds.), *Deregulation and Interdependence in the Asia-Pacific Region* (Chicago: University of Chicago Press, 2000)
375 Won-Am Park, Financial Liberalisation: The Korea Experience, in Takatoshi Ito and Anne O. Krueger (eds.), *Financial Deregulation and Integration in East Asia* (Chicago: University of Chicago Press, 1996), p.252.

In December 1995, the *Foreign Exchange System Reform* Plan was proposed. In the plan, most significant is the elimination of restrictions on foreign investment. [376] The government expanded the scope for short-term foreign currency borrowing, while restrictions on long-term overseas borrowing were maintained. [377] As a result, the approval of the Ministry of Finance and Economy (MOFE) was no longer required to borrow short-term loans. Meanwhile, liberalisation of outward flows was faster than that of inward flows to prevent rapid appreciation of the Korean won, which would be likely to increase inflationary pressure and to lower export competitiveness. [378]

With hindsight, the plan proved to be a critical mistake. First, the sequence of liberalisation was poorly designed. The liberalisation of short-term interest rate before long-term interest rates resulted in a rapid expansion of short-term debts in financial institutions and the corporate sector. Second, there were loopholes in the regulatory framework. Banks remained under tight regulation, while restrictions on non-banking financial institutions (NBFIs) were relaxed or lifted. The regulatory asymmetry allowed the NBFIs to deal in much riskier foreign exchange transactions. Third, liberalisation was not accompanied by appropriate supervisory frameworks. One of the reasons is that a long-standing confrontation between the MOF and the BOK hindered the establishment of an independent supervisory institution. [379]

These problems played a role in the build-up of short-term debt denominated in the US dollar. Between 1994 and 1996, the authorities granted 24 finance companies a merchant bank licence. The newly-licensed merchant banks took advantage of financial liberalisation with very profitable 'carry trades': that is, borrowing foreign currencies from Japan or the US at a low interest rate, converting them to the US dollar, and using it to invest in the Southeast

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[376] OECD, *Economic Surveys: Korea* (1996), Ch. II.
[377] OECD, *Economic Surveys: Korea* (1999), p.30.
[378] Moon and Rhee (2002), p.125.
[379] Yoon Je Cho, The Role of Poorly Phased Liberalization in Korea's Financial Crisis, in Gerald Caprio, Jr., Patrick Honohan and Joseph E. Stiglitz (eds.), *Financial Liberalization: How Far, How Fast?* (New York: Cambridge University Press, 2001); *Financial Repression, Liberalization, Crisis and Restructuring: Lessons of Korea's Financial Sector Policies*, Research Paper No.47 (Asian Development Bank Institute, 2002)

Asian region. However, a massive reversal of capital flows in the mid-1990s left them with a huge amount of loss. [380] In addition, commercial banks were allowed to open new foreign branches. Their performance was very poor and a large amount of the official foreign currency reserves was used to finance the repayment of the short-term debts of the offshore branches. [381]

These problems with rapid liberalisation were not totally unforeseen. Some economists had urged the government to delay entry into the OECD, fearing that financial liberalisation would result in a disaster without appropriate institutional frameworks. [382] Nevertheless, the pace and scope of liberalisation was not decelerated. Why did the government push so vigorously for financial liberalisation in the early 1990s? The answer to the question is not simple, since external and internal factors are intertwined. [383]

The third wave of financial liberalisation reflected an ideological shift on a global scale. Since the early 1980s, neoliberal policies were introduced by neoclassical economists educated in US and UK academic institutions. Because Reaganomics and Thatcherism flourished in the countries, most of them were familiar with – though not necessarily supportive of – neoliberalism. In particular, research institutes of the chaebol such as the Korea Economic Research Institute (KERI) were increasingly filled with those who were sympathetic to the idea. This phenomenon also affected bureaucrats, many of whom had studied in the institutions or worked for international financial institutions. Consequently, the influence of Keynesianism gradually faded among policy-makers as well as academics. [384]

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380 David Gillen, Yoolim Lee and Bill Austin, J.P. Morgan's Korean Debacle, *Bloomberg* (March 1999), pp.24-30.

381 Wonsik Sul, On the Performance of the Foreign Subsidiaries of Korean Banks: Are Securities investments Really Profitable?, *Journal of Asian Economics*, Vol.11, No.2 (Summer 2000)

382 Stephen L. Harris, South Korea and the Asian Crisis: The Impact of the Democratic Deficit and OECD Accession, in Underhill and Zhang (2003) See also *Euromoney*, Korea: Living in the Sham of a Free Market (September 1996)

383 For the political economy of financial liberalisation in the 1990s, see Panicos O. Demetriades and Bassam A. Fattouh, The South Korean Financial Crisis: Competing Explanations and Policy Lessons for Financial Liberalization, *International Affairs*, Vol.75, No.4 (1999); Henry Laurence, Financial System Reform and the Currency Crisis in East Asia, *Asian Survey*, Vol.39, No.2 (March / April 1999)

384 Yeon-ho Lee, The Failure of the Weak State in Economic Liberalization: Liberalization, Democratization and the Financial Crisis in Korea, *Pacific Review*, Vol.13, No.1 (2000), pp.125-129

Pressure from the US government also played a crucial role in opening up the financial markets. Since the US is its key trading partner as well as military ally, the Korean government could not sidestep the bilateral pressure. [385] One problem with the pressure was that the US government demanded some policies that would bring negative side effects to the Korean economy.

> [N]owhere in the memo's three pages is there a hint that South Korea should improve its bank regulation or legal institutions, or take similar stems. Rather, the goal is clearly to use the [pending Korean application to join the OECD] as a way of prying open Korean markets – in part to win business for American banks and brokerages. "These are all of interest to the US financial services community," the memo reads. [386]

The external pressure coincided with the chaebol's interests. [387] The chaebol complained that a substantial gap between domestic and foreign interest rates reduced their profitability. In fact, internationally-recognised chaebols such as Samsung, Hyundai and Daewoo with good credit ratings were keen to attract foreign capital by issuing corporate bills and convertible bonds in international financial markets. In addition, removal of outward capital flows would enable them to expand their overseas investment. From the early 1990s, many chaebols considered moving product lines to Southeast Asian countries to reduce labour costs. [388] However, financial liberalisation was not always good for the chaebols because the opening of domestic capital markets would deprive them of their privileged position.

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[385] For the role of the US government, see Meredith Woo-Cumings, Slouching Toward the Market: The Politics of Financial Liberalization in South Korea, in Loriaux, Woo-Cumings, Kalder, Maxfield and Perez (1997)
[386] *New York Times*, How U.S. Wooed Asia To Let Cash Flow In (16 February 1999)
[387] Byung-Sun Choi, Financial Policy and Big Business in Korea: The Perils of Financial Regulations, in Stephan Haggard, Chung Lee, and Sylvia Maxfield (eds.), *The Politics of Finance in Developing Countries* (Ithaca: Cornell University Press, 1993); Chung H. Lee, Keun Lee and Kangkoo Lee, Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea, Working Paper No.31 (Institute of Economic Research, Seoul National University, 2000)
[388] Duk Choong Kim and Dong Suk Suh, Financial Liberalization and Korean Corporations' Financing Policy for Globalization, *Journal of Asian Economics*, Vol.9, No.1 (1998)

2) Financial Restructuring after the Financial Crisis

Korea's approach to financial liberalisation was gradualist rather than big bang. This gradualist approach provoked a debate over financial reform. On the one hand, proponents of the Washington consensus argued that radical liberalisation could have prevented moral hazard problem arising from heavy state intervention. Their solution to the problem was further deregulation and liberalisation of financial markets. [389] On the other hand, critics of the consensus asserted that the countries failed to protect themselves from volatile capital flows because neoliberal liberalisation policy did not take into consideration relevant safeguards against negative aspects of liberalisation. Thus they suggested that liberalisation should be delayed until well-functioning regulatory frameworks are in place. The debate had no real impact on policy-making because the IMF imposed a comprehensive liberalisation plan on the government. [390]

Financial reform proceeded in two stages. The first stage was aimed at easing the capital crunch in the financial and corporate sectors and restoring a sophisticated regulatory system: re-capitalisation of weak financial intermediaries, the establishment of prudential supervisory frameworks, and further liberalisation and opening up of the financial markets. In the second stage, market-based restructuring was increased to reduce the role of government. At the same time, most restrictions on capital account transactions were lifted.

One of the most urgent tasks was to resolve financial distress. The rapid increase in NPLs threatened the integrity of the sector. As Table 5-2 demonstrates, NPLs surged sharply particularly in non-banking financial institutions.

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[389] This view was shared by the Presidential Committee on Financial Reform that suggested a bold reform plan before the crisis. For details, Buhmsoo Choi, Financial Reform in Korea, in Lee-Jay Cho, Yoon Hyung Kim and Chung H. Lee (des.), *Restructuring the National Economy* (KDI, 2001)

[390] In this context, some economists argue that the crisis is the result of under - not over- regulation. See Ha-Joon Chang, Hong-Jae Park and Chul Gyue Yoo, Interpreting the Korean Crisis: Financial Liberalisation, Industrial Policy and Corporate Government, *Cambridge Journal of Economics*, Vol.22, Vol.6 (November 1998); Jin-Wook Choi, Regulatory Forbearance and Financial crisis in South Korea, *Asian Survey*, Vol.42, No.2 (March-April 2002)

[Table 5-2] NPL Breakdown by Financial Sector (Ratio of NPLs / Total loans) [391]

	Dec 1997	Dec 1998	Dec 1999	Dec 2000
Bank	6.1	7.6	8.4	8.0
Commercial	6.0	7.4	8.3	8.9
Special & development	6.2	8.1	8.4	6.1
Non-Banking financial institutions	9.3	19.9	23.2	23.6
Merchant banks	4.1	20.0	15.4	37.1
Insurance companies	9.3	8.8	13.9	8.5
Mutual savings & loans	11.7	24.1	32.6	36.9
Credit unions	10.2	22.3	21.6	12.6
Leasing companies	NA	30.2	36.3	43.1
Securities companies	13.2	26.0	34.0	52.6
Total	6.7	10.4	11.3	10.4

Two approaches were employed to address the problem. On the one hand, a purchase and acquisition (P & A) approach was applied to healthier institutions. The authorities encouraged strong banks to merge with weaker ones by providing public funds to dispose of bad debts. In exchange for public funds, acquired banks reduced the number of staff and closed branches. On the other hand, a much harsher approach was employed with unhealthy institutions. Most of them were closed down or suspended. As a result, 11 commercial banks, 26 merchant banks, 9 leasing companies, 7 securities houses, 13 insurance companies and 10 investment trusts disappeared from January 1998 to March 2001. Table 5-3 is a summary of the result.

[Table 5-3] Financial Institutions (as of March 2001) [392]

	Dec 97	Mar 01	Jan 1998 – Mar 2001			Newly Created Co.
			Mergers	Relocation of Licence / Liquidations	Total	
Banks	33	22	6	5	11	-
Merchant Banks	30	5	3	23	26	1
Leasing Co.	25	19	1	8	9	3
Securities Co.	36	43	1	6	7	14
Insurance Co.	50	40	6	7	13	3
Investment Trust Co.	31	29	1	9	10	8
Mutual Savings & Finance Co.	231	146	25	72	97	12
Credit Unions	1666	1311	101	258	359	4
Total	2102	1615	144	388	532	45

391 Based on OECD, *Economic Survey: Korea* (2001), p.155. It should be noted that there were changes in the classification of NPLs during the crisis. At the end of March 1998, the classification was shortened from loan in arrears of 6 months or more to loans in arrears of 3 months or more. In December 1999, financial institutions introduced forward-looking criteria to make a more realistic assessment of loan risks. See Chan-Hyun Sohn, Korea's Corporate Restructuring since the Financial Crisis, Policy Analyses No.02-04 (Korea Institute for International Economic Policy, 2002), p.26.
392 FSC, *Financial Reform and Supervision in Korea* (FSC, 2001), p.9.

The government injected public funds to re-capitalise weak financial institutions. By the end of 1999, public funds were allocated to purchase NPLs worth 20.5 trillion won (17.1 billion dollars) from banks and secondary financial institutions, and to provide 43.5 trillion won (36.2 billion dollars) in re-capitalisation and deposit repayment support. Despite this, the soundness of the financial institutions did not improve quickly. Thus the government injected additional funds in 2001.

As Table 5-4 shows, the total amount of funds that used to rescue the financial institutions was a 134.7 trillion won (26 percent of GDP). As a result of the rescue package and economic recovery, nearly all major banks officially met or exceeded the 10% BIS capital adequacy ratio as of 30 June 1999, with some as high as 13%.

[Table 5-4] Expenditures on Financial Sector Restructuring [393]

	First programme (through Aug 2000)	Second programme (As of Mar 2001)	Total
Expenditure by type of institution			
Banking sector	70.3	10.4	80.7
Investment trusts	12.2	3.7	15.9
Merchant banks	11.9	4.6	16.5
Insurance companies	10.5	2.0	12.5
Mutual savings & loans/ credit cooperatives	4.7	4.4	9.1
Total	109.6	25.1	134.7
Sources of financing			
Government-guaranteed borrowing	4.0	19.8	83.8
Recycled funds	18.6	8.6	27.2
Other public funds	20.7	-3.3	23.7
Total	109.6	25.1	134.7
Percent of GDP (2000)	21.2	4.8	26.0
Net outlays			
Total minus recycled funds	91.0	16.5	107.5
Percent of GDP (2000)	17.6	3.2	20.8

* Unit: 1 trillion won

393 OECD, *Economic Surveys: Korea* (2001), p.152.

In the process of financial restructuring, some financial institutions resorted to politics. [394] Local banks that failed to meet the BIS minimum capital adequacy ratios tried desperately to organise political campaigns for survival. On the one hand, directors of the banks attempted to persuade policy-makers on the basis that the closure of local banks might destroy the local economy. On the other hand, local businesses lobbied politicians whose constituencies might be adversely affected. For example, directors of Kyungki Bank offered bribes of more than 80,000 dollars to Lim Chang-yuel, the then Governor of Kyungki Province and a former Finance Minister. This attempt failed to save the bank, which was merged into KorAm Bank in June 1998. The Governor and his wife were prosecuted for taking bribes from the bank in 1999. [395]

The closure and M &A of financial institutions resulted in massive unemployment and wage cuts. As Table 5-5 illustrates, no less than 20 percent of bank branches were closed and one third of staff in the banking sector was made redundant to decrease operational costs. The FKTU and the KCTU collaborated to minimise the number of redundancies. However, their protests did not succeed in reducing the scale of restructuring since the government linked its assistance to their self-rescue plans.

[Table 5-5] Numbers of Branches and Staff, and Operational Expenses [396]

		Domestic commercial banks	Nation wide	Regional	Top 3
1997	No. of Branches	6,177	4,872	1,305	1,010
	No. of Staff	113,994	94,065	19,929	25,710
	Operational expenses	6.1	-	-	-
June 2001	No. of Branches	4,784	4,039	745	1,828
	No. of Staff	73,401	64,759	8,642	31,019
	Operational expenses	0.3	25	22	11
Change (%)	No. of Branches	-22.6	-17.1	-42.9	81.8
	No. of Staff	-35.6	-31.2	-56.6	20.6
	Operational expenses	-95.3	-	-	-

[394] For relations between politicians and banks, see James C. Schopf, An Explanation for the End of Political Bank Robbery in the Republic of Korea: The T + T Model, *Asian Survey*, Vol.41, No.5 (September - October 2001)
[395] *Korea Herald*, Prosecutors Seek Arrest Warrant for Gov. Lim in Bribery Case (17 July 1999)
[396] IMF, Korea: Selected Issues, Country Report No.01/101 (2001), p.98.

In the meanwhile, the government revised institutional frameworks for regulation and supervision. To this end, 15 major pieces of financial reform legislation – including the General Banking Law and the Financial Industry Restructuring Act – were enacted on 29 December 1997. Two pieces of legislation were revised to enhance procedures for restructuring financial institutions in September 1998. [397]

The objective of the institutional change was to upgrade its regulatory and supervisory frameworks to comply with international standards. Table 5-6 summarises key features of the reform.

[Table 5-6] Standards in Prudential Regulations and Supervision [398]

Objectives	Measures	Schedule
Mark-to Market for security	• Introduction of mark-to-market for securities • Change in securities' classifications from categorisation by currency (domestic / foreign) to maturity (investment / marketable securities)	June 1998 - completed
Banking sector disclosure	• More information to be disclosed to meet the international accounting standards	December 1998 - completed
Loan classification & provisions	• Revision of lain classification procedures to fully reflect capacity to repay and not simply past performance	June 1999 Effective from December 1999
Improvement in BIS capital ratio calculation	• Deduction form tier 2 capital of all provisions except those with respect to assets classified as normal and precautionary	January 1999 - completed
Prudential rules for foreign exchange liquidity and exposure	• Risk management for short-term foreign currency risk (short-term assets of less than 3-month maturity of at least 60 percent of short-term liabilities) • Report maturity mismatched for sight to 7 days; 7 days to 1 month, 1 to 3 months, 3 to 6 months; 6 months to 1 year; and over 1 year • Management of country exposures (set exposure limits for each country based on international credit ratings)	July 1998 - completed
Trust accounts	• Introduction of rules providing full disclosure to trust beneficiaries and precluding any possibility of payment by managing banks to make good or guarantee any loss • Introduction of restrictive rules to be applied to all trust accounts ensuring segregation for management as well as accounting purposes	January 1999 - completed January 2000

[397] FSC, *Financial Reform and Supervision in Korea* (FSC, 2000), pp.39-41.
[398] OECD, *Economic Surveys: Korea* (1999), p.85.

To strengthen the capacity of prudent supervision and regulation, government agencies were reshuffled.[399] One of the most remarkable changes was the downsizing of the Ministry of Finance and Economy (MOFE), created from the merger of the Economic Planning Board and the Ministry of Finance in December 1994. Despite its comprehensive policy instruments and organisations, the MOFE was blamed for failures to predict and prevent the crisis.[400] Following the recommendation of the Presidential Committee on Financial Reform, the Ministry transferred its authority to supervise and regulate to new independent agencies. In addition, the creation of the Budget and Planning Commission deprived the MOFE of one of its most powerful resources in maintaining its supremacy among ministries.[401]

Before the crisis, the BOK was caricatured as a branch of the MOFE because the ministry had more power to control monetary policy than the central bank. However, the crisis shifted the balance of power between the two institutions. An amendment to the Bank of Korea Act in April 1998 enhanced the independence of the BOK. For example, the governor of the BOK replaced the Minister of the MOFE as the Chair of the Monetary Board consisting of seven members. In accordance with this organisational change, the management system of the BOK moved from direct control, exercised by fixing ceilings on bank loans, to indirect intervention, exerted by changes in reserve requirements, open market operations and rediscount policy.[402]

In addition to the organisational change, there was a significant shift in its modus operandi. Inflation targeting was introduced to define its primary objective clearly and thus to make

[399] Kwang-woong Kim, A Critical Reflection on the Reform of the Kim Dae-jung Government, Korea *Journal*, Vol.39, No.2 (Summer 1999)

[400] From January to February 1999, the Special Investigation Commission on the Causes of the Economic and Currency Crisis organized in the National Assembly conducted in-depth inspections of related institutions. As a result, Kang Kyung Shik, the then Minister of Finance and Economy, and Kim In Ho, Chief Presidential Secretary for Economic Affairs, were charged with negligence of duty and abuse of power. See National Assembly, *Gukhoebo* [National Assembly Review] (February 1999), pp.34-39.

[401] *Wall Street Journal*, Power Fades Korea's Financial Ministry (28 June 1999), p.14. However, in order to coordinate conflicting interests among ministries, the Minister of the MOFE was promoted to Deputy Prime Minister on 29 January 2001.

[402] Independent monetary institution is a key feature of neoliberalism. See Ilene Grabel, Ideology, Power and the Rise of Independent Monetary Institutions in Emerging Economies, in Jonathan Kirshner (ed.), *Monetary Orders: Ambiguous Economics, Ubiquitous Politics* (Ithaca: Cornell University Press, 2002)

itself freer from external pressures.[403] And its target changed from M2 to M3, a measure of total liquidity including the liability of non-bank financial institutions. This shift was nothing more than an acceptance of the criticism that the narrow definition did not properly capture monetary expansion in the process of financial restructuring.

Meanwhile, the BOK lost some of its functions.[404] The Financial Supervisory Commission (FSC) took the place of the central bank as the principal supervisor of banks. Although being placed under the Office of the Prime Minister, the FSC was supposed to be an independent watchdog, free from direct government control. Its mandate includes: the resolution of issues relating to financial supervision, the instruction of supervisory authorities, and the implementation of restructuring plans. In addition, the Commission has the authority to issue and revoke licences to financial institutions.

In January 1999, its executive body (the Financial Supervisory Service: FSS) was launched as a single regulator unifying four existing supervisory agencies: the Banking Supervisory Authority (BSA), the Security Supervisory Board (SSB), the Insurance Supervisory Board (ISB) and the Non-bank Supervisory Authority (NSA). The FSS is responsible for the inspection and examination of all financial institutions. In addition, it acts as an arbitrator in resolving disputes between financial institutions and their customers. This integrated supervisory approach allows the FSC to monitor various types of financial institution.[405]

The FSC oversaw corporate and financial governance reform as the regulator of the country's banks. It took charge of various tasks: organising with banks a list of companies to be liquidated, closing financial institutions, drafting plans to restructure corporations and negotiating the sale of two nationalised banks to foreign investors. In particular, the FSC played a crucial role in corporate reform. At its peak, the Chairman of the Commission, Lee

[403] Alexander W. Hoffmaister, Inflation Targeting in Korea: An Empirical Exploration, *IMF Staff Papers*, Vol.48, No.2 (2001) Monetarism that was the theoretical basis for the policy has been dominant since the late 1980s in the central bank. Confidential interview with BOK official (London, September 2002 & Seoul, November 2004)
[404] BOK's trade union initially opposed the creation of the FSC because they were concerned that the new regulatory body would be under the control of the MOFE.
[405] FSC, *Financial Supervisory System in Korea* (FSC, 2001)

Hun Jai, was ranked as the second most-powerful economic policy-maker after the President Kim Dae Jung. [406]

As a result, a new division of labour emerged among government agencies. The MOFE, which had control of the specialised banks and non-bank financial institutions, lost almost all its authority on supervision. The Ministry managed to retain the right to draft legislation related to financial supervision and to coordinate financial sector policy. In the meanwhile, the BOK transferred its responsibility for bank supervision to the FSC, while retaining a few of its previous supervision functions such as checking prudential requirements for banks. However, its functions are limited. At best, the central bank as a lender of last resort for banks has the power to inspect banks to which it extends liquidity support. And the Monetary Board of the BOK can call for a reconsideration of any FSC decision that may include measures directly related to monetary policy.

The reorganisation of the economic ministries had political implications. The disgrace of the pilot agencies did not mean the end of state intervention. Instead, the FSC replaced the MOFE as a policy co-ordinator. Hence the emergence of the FSC can be seen as an important change in state intervention: from industrial to financial policy. [407]

As Figure 5-2 demonstrates, two state-own institutions played a crucial role in the restructuring of the financial sector. The Korea Depository Insurance Corporation (KDIC) is a special juridical entity with no capital established in June1996. In cases where liquidation in the insurance sector is needed, or where the FSC and the MOFE conclude that re-capitalisation using public funds of any such company is the appropriate action, the KDIC provides the funds and oversees the enforcement of the terms and conditions. Its main governing body is the Policy Committee which comprises the President of the KDIC, the Vice Minister of Finance and Economy, the Deputy Governor of the BOK, the Vice Chairman of

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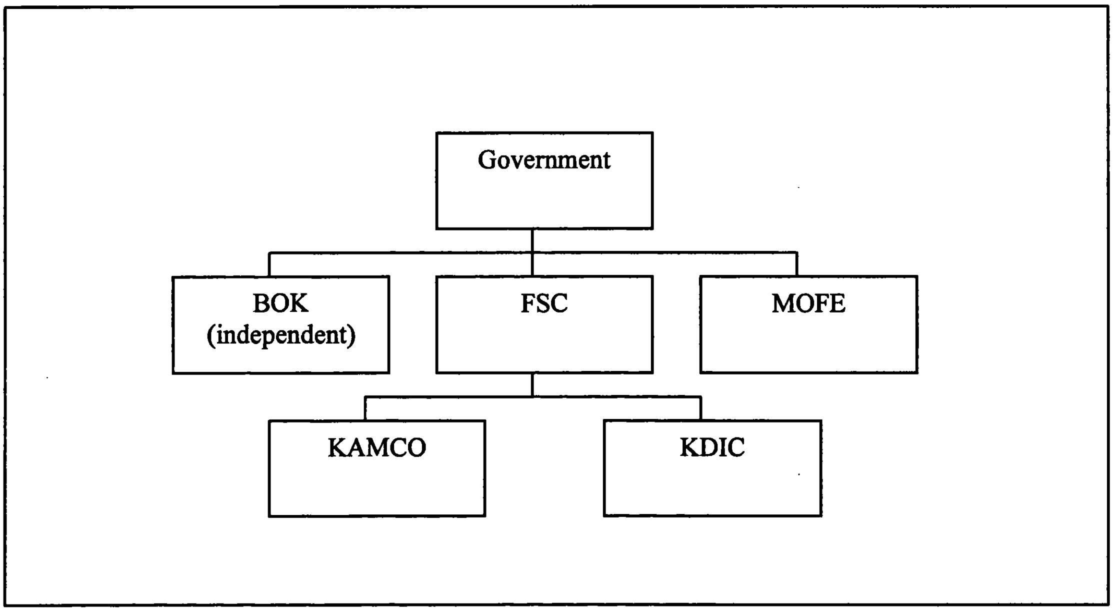
[406] Before the crisis, he was regarded as an interventionist because he started his career in the Ministry of Finance. In fact, his approach to corporate restructuring (especially, the so-called Big Deal) was not market-oriented. Confidential interview with MOFE officials (Seoul, August 2002)

[407] Ha-Joon Chang and Chul Gyue Yoo, The Triumph of the Rentiers?, *Challenge*, Vol.43, No.1 (January / February 2000)

the FSC and the heads of the associations representing banks, insurance companies and other financial institutions.

[Figure 5-2] Re-organisation of Regulatory Framework [408]



The Korea Asset Management Corporation (KAMCO) is equivalent to the Resolution Trust Corp (RTC) in the US. Its original mandate was the management and disposal of non-performing assets (NPAs) in the financial sector and state-owned properties. In November 1997, the KAMCO was formally re-established to enhance and expand its role: management and operation of the Non-performing Loans Management Fund; acquisition and resolution of NPAs from financial institutions; implementation of work-out programmes for acquired distressed companies; and the management of state-owned properties and the resolution of tax arrears. [409]

The chaebol was not satisfied with the ways of financial restructuring. [410] First, implementation of the BIS capital adequacy ratio was too strict to increase sufficient liquidity.

[408] Based on Charles Enoch, Gillian Garcia and V. Sundararajan, Recapitalizing Banks with Public Funds, *IMF Staff Papers*, Vol.48, No.1 (December 2001), p.106.
[409] Dong He, The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea, Working Paper No.04/172 (IMF, 2004)
[410] KERI, *Choiguen Choigeun Kyeongje Hyeonankwa Daechaek* [*Current Economic Problems and its Remedies*] (KERI, 1998), pp.79-110.

The government ordered public-funds-injected banks not to expand lending until they met the ratio. As a result, even top five chaebols had difficulties in borrowing money from their main banks. This situation did not quickly improve even after economic recovery.

Second, the chaebol were worried that the *de facto* nationalisation of some commercial banks might lead to enhance state intervention in financial markets. Public fund injections into the financial sector resulted in a substantial increase of government ownership. Before the crisis, the equity shares of the government in commercial banks were no more than 18 percent of total banking sector capital. As of mid-2000, they accounted for 56 percent. [411] As of the end of 2000, the government held a 49 percent interest in Korea First, 80.1 percent in Cho Hung, 74.7 percent in Hanvit, 100 percent in Seoul and 35.9 percent in Korea Exchange. And many ex-MOFE and ex-BOK officials on the boards of directors of financial institutions were generally supportive of government policy.

Finally, the chaebol complained that the government discriminated against national capitalists in favour of foreign ones. Since the chaebol were prohibited from holding a controlling stake (4 or 8 percent) in any commercial bank, the chaebol could not increase their influence on the banking sector. To overcome this problem, Kim Woo Choong – chairman of the FKI and Daewoo – proposed that a chaebol consortium (Hyundai, Samsung, Daewoo and LG) sponsored by the FKI could bid for one or more banks or create a mega-bank with foreign partners. The government dismissed it as wishful thinking on the basis that the chaebol might use it as their 'piggy bank'. [412]

3) Capital Account Liberalisation

As Table 5-7 demonstrates, capital count liberalisation proceeded in two stages. The first stage (implemented by 1 April 1999) was designed to liberalise foreign exchange transactions by corporations and financial institutions related to their external activities. To maintain a

[411] IMF, Korea: Selected Issues, Country Report No.01/101 (2001), p.88.
[412] Donald Kirk, *Korean Crisis: Unraveling of the Miracle in the IMF Era* (New York: St. Matin's Press, 2000), p.134.

level of prudence, an ex post facto reporting was required. In April 1999, the new Foreign Exchange Transaction Act replaced the positive list system with a negative list, which permits all capital account transactions except those expressly forbidden by law and presidential decree. At the second stage (implemented by the end of 2000), the focus shifted to the liberalisation of capital account transactions by individuals.

[Table 5-7] Two Stage of Foreign Exchange Liberalisation [413]

	Objectives	Features
First phase (April 1999)	• Upgrade the foreign exchange system to international standards • Facilitate the flow of foreign capital • Further promote overseas business activities of the private sector in the current open market environment	• Converting regulations on capital account transactions into a negative system • Revising regulation on foreign exchange institutions • Establishing Safeguard measures
Second phase (January 2001)	• Liberalize foreign exchange and capital account transactions for individuals • Streamlined remaining restrictions on corporations and financial institutions regarding their foreign exchange transactions	• Alleviating obligatory repatriation of overseas claims • Eliminating ceiling on overseas payments and monetary possessions when leaving the country for residents • Easing the regulation on purchase and sale of foreign exchange • Relaxing the limitation on deposits and trusts • Greater allowance for overseas borrowing and Korean won lending • Further liberalization of securities investment • Allowing acquisition of overseas real estates • Expanding foreign exchange businesses • Expanding methods of corporate settlement

Capital account liberalisation helped the economy to attract record levels of foreign investment. According to Jin Nyum, Finance Minster, the economy received at least 50 billion dollars of FDI from 1998 to 2001. This was quite exceptional, considering that the total

[413] MOFE, *Je 2 Dangye Oehwan Jayuhwa Sebuchujin Bangan* [The Second Stage of Foreign Exchange Liberalization] (15 December 2000)

amount of inward FDI was only 24 billion dollars from the beginning of industrialisation to 1997.[414]

Some safeguards were put in place to protect domestic financial markets from extremely unfavourable market conditions. For example, restrictions on trading the won on overseas markets by non-residents were not lifted because the authorities wanted to keep its influence on the currency's movement.

At the same time, the government improved its institutional frameworks for crisis prevention. Central to these measures were various limits on short-term capital flows by unsound financial institutions. As Table 5-8 shows, the nature of the measures is pre-emptive actions rather than direct controls because the authorities want to enhance market mechanisms by avoiding interventionist policies.

[Table 5-8] Measures to Prevent a Foreign Exchange Crisis [415]

Area	Measures
Establishment of a monitoring system	• Creation of a computer system to monitor speculative transactions in the foreign exchange, stock, bond and future markets • Establishment of an "International Financial Centre" to provide an early warning system against a foreign currency crisis
Precautionary measures	• Restrictions on short-term overseas borrowing by financially unsound companies • Restrictions on foreigners' borrowing of more than W 100 million at a maturity of less than one year • Requirement that securities with less than one-year maturity issued domestically by foreigners be approved by MOFE
Emergency measures	• Partial or complete freeze on foreign exchange transactions • Concentration of foreign currency in the central bank • Capital transaction authorisation system • A variable deposit requirement on capital inflows

Further opening of the financial markets allowed foreign investors to purchase some troubled banks. Nevertheless, few banks drew attention from them. Huge amounts of NPLs were a major obstacle to attracting foreign investment. Thus, the government injected public

[414] *Financial Times*, Seoul Warns Tension May Scare Investors (7 February 2002)
[415] OECD, *Economic Surveys: Korea* (1999), p.63.

funds into two of the weakest banks: Seoul Bank and Korea First Bank. In 1999, Hong Kong Shanghai Banking Corporation (HSBC) had an interest in Seoul Bank. However, differences over takeover conditions were so big that the deal was not finalised. In April 2000, the government commissioned Deutsche Bank to draw up a rationalization programme for the bank after the sale of the bank to foreign investors was not realised.

The failure of the Seoul Bank sale prompted foreign observers to question the government's commitment to financial liberalisation. [416] Thus, the government hurried the sale of its 51 percent stake in Korea First Bank for 500 billion won (442 million dollars) to Newbridge Capital, an American investment fund in December 1999. This sale was criticised for fire sale because the deal was very favourable to the buyer.

Besides, Commerzbank of Germany purchased 29.8 % of Korean Exchange Bank for 267 million dollars. And Goldman Sachs invested 500 million dollars in Kookin Bank, which consisted of shares (300 million dollars) and convertible bonds (200 million dollars). ING Group also acquired 10 percent of Housing and Commercial Bank. As a consequence, total foreign ownership reached approximately 30 percent of total banking sector assets as of the end of 1999. [417]

To sum up, the Korean experience illustrate that financial reform was clearly influenced by the Washington consensus. Prior to the crisis, most policy makers and economists in the chaebol's research institutes recognised the need for liberalisation and deregulation. This ideological shift toward market-friendly policy coincided with external pressures from the IFIs and the US government. It is also important that big business was supportive of liberalisation and deregulation. In this regard, Kim Woo Choong's resort to nationalist rhetoric was not a challenge to the principle of financial reform but a political tactic to gain special treatments from the government to save his companies.

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[416] Lonestar (a US fund) and Hana Bank bid for the bank, and Hana Bank was allowed to merge it in September 2002. See Chungwon Kang, From the Front Lines at Seoul Bank: Restructuring and Reprivatization, Working Paper No.03/235 (IMF, 2003)
[417] IMF, Korea: Selected Issues, Country Report No.01/101 (2001), p.90. For more details, see Appendix 5-2.

Political considerations did not play a role in financial reform, even though the government injected a huge amount of public fund. One reason is that, as a result of liberalisation and deregulation, its influence on the financial sector was not as strong as before. It is thus hardly surprising that there were much fewer corruption scandals in the process of financial sector restructuring.

3. Malaysia

1) Financial Liberalisation in the 1990s

Before the New Economic Policy (NEP), most financial institutions were owned and run by foreign and Chinese capitalists. In order to increase the role of Malay capitalists, various affirmative actions were used to set up banks and to encourage commercial banks to lend more to bumiputera entrepreneurs. As a result, the size and number of Malay financial institutions gradually increased during the 1970s. [418]

In the meanwhile, there were strict regulations on foreign banks. Since 1983, new foreign banks had not been allowed to open new branches. And the '60/40 borrowing guideline' – requiring foreign firms to raise not less than 60 percent of their finance with local banks – remained intact. And foreign equity investment in financial institutions was limited to 30 percent. As a result, the share of total bank deposits held by foreign banks decreased from more than 70 percent in the early 1980s to approximately 30 percent in the mid-1990s. [419]

The recession in the mid-1980s offered an opportunity to re-consider the pro-Malay strategy because the policy generated moral hazard problem in the banking sector. [420] A notable example is Bank Bumiputra (Malaysia). Because the bank was set up to provide credit to the Malay business community, it was regarded as a piggy bank by many Malay politicians who patronised bumiputera companies. As a result, political considerations played a more significant role in making loans than cost-benefit analysis. When the 1985-86 economic recessions aggravated NPLs, the bank was rescued twice in 1985 and 1989 on the basis that

418 Peter Searle, *The Riddle of Malaysian Capitalism: Rent-seekers or Real Capitalists?* (St Leonards: Allen & Unwin, 1999), pp. 73-75.
419 Prema-chandra Athukorala, *Crisis and Recovery in Malaysia* (Cheltenham: Edward Elgar, 2001), p.52.
420 Adek Hussein Awang, Financial System, in Kwame Sundaram Jomo (ed.), *Malaysia's Economy in the Nineties* (Petaling Jaya: Pelanduk Publications, 1994)

the collapse of the country's second-largest bank might undermine the integrity of the financial markets.[421]

This experience led the authorities to deregulate the financial sector to expose Malay banks to market disciplines, thereby enhancing their competitiveness. For example, controls on the base lending rate (BLR) were removed in 1991 to advance competition among commercial banks. At the same time, the regulatory and supervisory frameworks were tightened. For instance, a two-tier system was introduced in 1994, extending to finance companies and merchant banks in 1996. The objective of the system was to offer incentives to well-managed banking institutions.[422] Despite these efforts, old habits of political favouritism continued. Thus, a potential danger of moral hazard emerged when the economic situation deteriorated.

The early 1990s witnessed more radical liberalisation of financial markets. From January 1990, Malaysian firms no longer registered on the Stock Exchange of Singapore (SES). To deal with this change, the Securities Commission (SC) was set up to take over stock market regulation and supervision from the Capital Investment Committee under Bank Negara Malaysia. The institution provided the foundation for a more flexible operational framework. The ceiling of foreign shareholding of local brokerage companies was extended from 30 percent to 49 percent.

To promote Kuala Lumpur as a regional financial centre, an international offshore financial centre was opened in the Federal Territory of Labuan in October 1990. The main objective of the Labuan centre was to attract foreign investors who wanted to set up their office outside Europe and the Caribbean. To this end, offshore banks were permitted to

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[421] Alasdair Bowie, The Dynamics of Business-Government Relations in Industrialising Malaysia, in Andrew MacIntyre (ed.), *Business and Government in Industrialising Asia* (Ithaca: Cornell University Press, 1994), p.183; Edmund Terence Gomez and Kwame Sundaram Jomo, *Malaysia's Political Economy: Politics, Patronage and Profits*, second edition (Cambridge: Cambridge University Press, 1999), pp.60-66.

[422] The system turned out to be ineffective in encouraging "best practice" and was abolished in April 1999. See IMF, Malaysia: Selected Issues, Staff Country Report No.99/86 (1999), p.70.

operate under a more liberal and relaxed regime regulated by the Labuan Offshore Financial Service Authority since February 1996. [423]

The independence from the regulatory institution brought about negative side effects. Many domestic financial companies used the offshore centre as a loophole to avoid regulations. For example, 868 million dollars loans to Renong and its business partner Hottick Investments (Hong Kong) by Malaysian banks remained unnoticed for a long time. The main reason was that the centre was outside the purview of the central bank. [424]

As Table 5-9 illustrates, Malaysia's approach to financial liberalisation was generally gradual and cautious. [425] This approach enabled Malaysia not to be exposed to large short-term currency borrowings compared with other crisis-affected countries. Malaysia's outstanding debt at the end of 1997 was equivalent to 160 percent of GDP, but most of them were denominated in ringgit, not foreign currency.

Three factors contributed to reducing short-term capital flows. First, prudential regulations by BNM discouraged Malaysian companies from borrowing foreign currency loans. In the mid-1990s, rapid loan growth and its exposure to securities and property generated bubbles. BNM managed to tackle the problem by taking pre-emptive measures: improving credit allocation and strengthening prudential regulation. Stricter controls were imposed on loans to property and share financing. And the minimum capital requirement for Tier-1 banking institutions was increased. [426]

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423 Labuan Offshore Financial Service Authority, Labuan Offshore Financial centre, in Low Chee Keong (ed.), *Financial Markets in Malaysia* (Singapore: Butterworths, 2000)
424 *Far Eastern Economic Review*, Clouded Version (2 April 1998)
425 Zainal Aznam Yusof, Awang Adek Hussin, Ismail Alowi, Lim Chee Sing, and Sukhdave Singh, Financial Reform in Malaysia, in Gerard Caprio Jr., (ed.), *Financial Reform: Theory and Experience* (Cambridge: Cambridge University Press, 1994); Anwar Nasution, 'Big Bang' versus 'Go Slow': Indonesia and Malaysia, in J. M. Fanelli and R. Medhora (eds.), *Financial Reform in Developing Countries* (New York: St. Martin's, 1998)
426 BNM (1999), pp.188-191.

[Table 5-9] Financial Liberalisation and Deregulation [427]

	Items	Year
Financial Deregulation	• Removing regulation on interest rate of fixed deposits placed with commercial banks for maturities four years	1971
	• Lifting administrative control on all deposit rates of finance companies and fixed deposit rates (exceeding one year maturity) of commercial banks	1973
	• Freeing interest rates for deposits of 12 months and less and prime lending rates of commercial banks	1978
	• Introducing new interest rate system to boost competition	1990
	• Enacting the Future Industry Act to facilitate financial innovations	1992
Institutional & Regulatory Reform	• The Banking Act – setting the legal and financial requirements for compliance by banking institutions	1973
	• New provision of the Central Bank of Malaysia Ordinance of 1958 to resolve NPLs	1986
	• The Bank and Financial Institution Act (BAFIA) – increasing minimum amount for capital funds (foreign banks should meet higher minimum capital adequacy ratio than domestic ones	1989
	• Establishment of the Securities Commission as a single regulatory agency	1992
Foreign Exchange & Capital Account Liberalisation	• Transition to an IMF article VIII country	1968
	• Replacing the pound sterling with the US dollar in defining the exchange rate parity of the ringgit	1973
	• Establishing the Labuan Offshore Financial Service Authority (LOFSA)	1996
	• Expanding access to ringgit business	1997

Second, the authorities preferred FDI rather than portfolio investment. The first is less volatile than the latter. [428] At its peak in 1992-93, FDI accounted for 8.7 percent of GDP. In the first half of the 1990s, nearly 70 percent of foreign capital flows were related to FDI. [429]

Finally, capital controls were used to tame the volatility of capital flows. In 1988/89 and 1992, the authorities introduced restrictions on swap transactions to discourage non-trade related currency trade. In the early 1990s when massive capital inflows resulted in inflationary

[427] Drawn from UN Economic and Social Commission for Asia and the Pacific, *Financial Sector Reform, Liberalisation and Management for Growth and Stability in the Asia and the Pacific Region: Issues and Experiences* (UN, 1998)
[428] Prema-chandra Athukorala and Jayant Menon, Foreign Investment and Industrialization in Malaysia: Export, Employment and Spillovers, *Asian Economic Journal*, Vol.10, No.11 (1996) See also Graham Bird and Ramkishen S. Rajan, Does FDI Guarantee the Stability of International Capital Flows? Evidence from Malaysia, *Development Policy Review*, Vol. 20, No. 2 (June 2002)
[429] Prema-chandra Athukorala, Capital Account Regimes, Crisis, and Adjustment in Malaysia, *Asian Development Review*, Vol.18, No.1 (2000), p.20.

pressure, the authorities tried to sterilise short-term capitals using monetary tools. However, this measure was not effective and temporary capital controls on portfolio investment were introduced. In 1995 when its objectives were achieved, they were quickly removed. [430]

2) Financial Restructuring after the Financial Crisis

As Table 5-10 shows, the authorities took pre-emptive measures to safeguard the financial sector from the contagious effect of the Thai crisis. [431] From January 1998, financial institutions were required to submit more detailed financial statements and loan classification and provision were tightened. To discourage short-term borrowings, any new capital injection by shareholders of banking institutions had to be funded through non-debt sources or very long-term debt instruments. To contain the possibility of connected lending, the central bank prohibited banks from lending to their shareholders. Furthermore, CEOs and directors of banking institutions were subject to biennial performance reviews. Finally, financial restrictions were tightened on the provision of bridging finance for the development of residential properties, shop houses valued in excess of RM 250.000 per unit and commercial properties. [432]

Despite these measures, many financial companies suffering from the downturn in real estate and equity markets were still in danger of default. In January 1998, BNM announced a plan to consolidate finance companies: (1) merger of small companies with the six identified anchor finance companies; (2) absorption by parent commercial banks; and (3) strategic alliance. To smooth the process, six major companies (four Tier-1 and two large-sized finance companies) were given anchor status and were recommended to find merger partners by the end of March 1998. Before the crisis, there were 39 finance companies, but the top three

[430] For details, see Appendix 5-3.
[431] For the supervisory system prior to the crisis, see Lin See Yan, The Institutional Perspective of Financial Market Reform: The Malaysian Experience, in Shakil Faruqi (ed.), *Financial Sector Reforms in Asian and Latin American Countries: Lessons of Comparative Experience* (World Bank, 1993)
[432] Low Chee Keong, Strengthening the Banking Sector, in Keong(2000)

companies (MBf, Mayban Finance, and Arab-Malaysian) had over 60 percent of the market share. [433]

[Table 5-10] Preventive Measures undertaken in 1997-98 [434]

	Measures
Supervision	• The level of transparency in the annual financial statements of banking institutions • All banking institutions would be subjected to a more intensive and rigorous supervision, including stress testing their positions each month • Banking institutions is required to report and publish key indicators of financial soundness every financial quarter not later than six weeks after the closure of the financial quarter • Loan classification and provisioning standards is streamlined to be consistent with international best practices
Risk management	• The default period for classifying a loan as non-performing by banking institutions is reduced from six months to three months • Banking institutions is required to maintain general provisions for bad and doubtful debts of at least 1.5 % of total loans net of specific provision and interest-in-suspension • Banking institutions are required to comply with the consolidated minimum risk-weighted capital ratio (RWCR) of 8 % on a quarterly basis • To expand the current capital adequacy framework to incorporate market risks • The minimum capital funds for finance companies is raised from RM 5 million to RM 300 million by end-June 1999 and RM 600 million by the end of year 2000 • The limits of single customer exposure were reduced from 30 % to 25 percent of total capital funds

Initially, the plan received a negative response from the financial markets. [435] In particular, the choice of United Merchant Finance (UMF) as an anchor company provoked suspicions because it was not a non-tier 1 company. At that time, it was widely believed that this decision had been taken to help its parent company, United Merchant group, which had political

[433] *Malaysian Business*, Marriages of Convenience (16 January 1998)
[434] Drawn from Ministry of Finance, *Economic Report 1998 / 99* (1999), pp.39-40. It should be noted that some measures ware reversed to boost monetary expansion in September 1998. For more details, see Soo-Nam Oh, Towards a Sustainable Banking Sector-Malaysia, in ADB, *Rising to the Challenge in Asia: A Study of Financial Markets*, Vol.8 Malaysia (ADB, 1999)
[435] The IMF did not support the merger plan. See *Far Eastern Economic Review*, Taking its Medicine (2 April 1998)

connections with Daim and Anwar.[436] In addition, minority shareholders opposed the merger plans, claiming that the price paid for them did not reflect the market value.[437] To meet the deadline, the government had to exert pressure on them. After all, 15 small and medium-sized firms were merged with 6 anchor firms, and 14 firms were absorbed by their parent banks.[438]

The systemic nature of the banking crisis highlighted the need for more radical approaches. To this end, the authorities prepared a more comprehensive financial sector restructuring plan. Figure 5-3 presents the whole structure of the plan. It did not only include short-term measures to resolve all NPL problems in the banking sector but also long-term tasks to enhance the financial system by institutional reform.

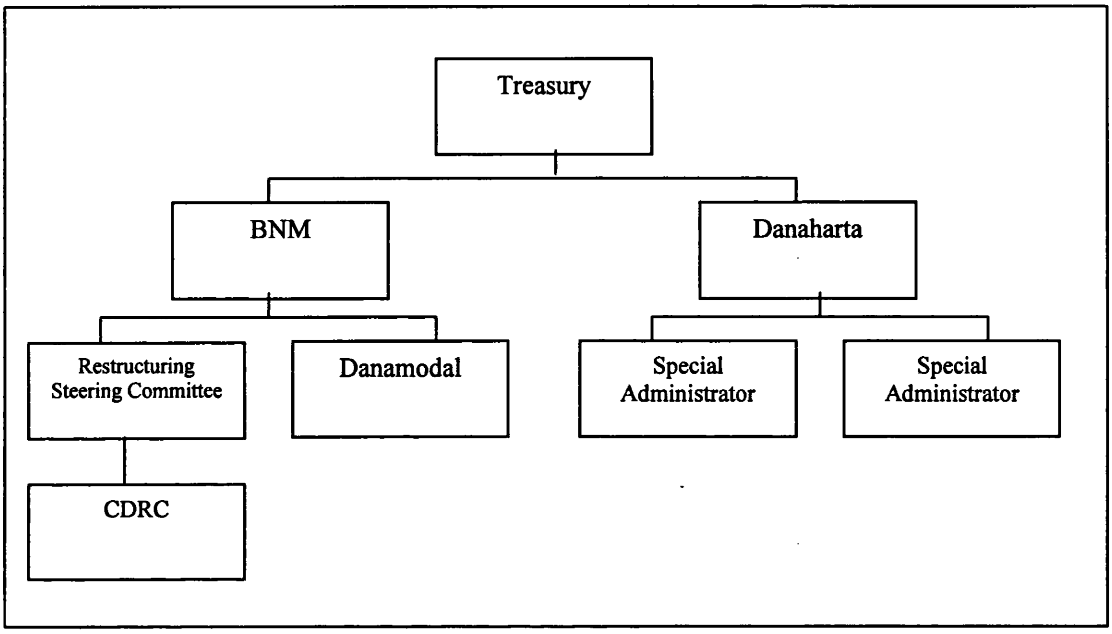
[Figure 5-3] Objectives of the Banking Sector Restructuring Plan[439]

Short term	Long term
Halt the vicious cycle Stimulate economic recovery ↓ Encouraging banks to lend ↓ Manage NPLs: Danaharta, CDRC, Rehabilitation Unit Capital: Danamodal Funding: Special Unit	• Create resilient banking system to withstand future shocks • Developing efficient & competitive banking sector to support economic growth & contribute as sector of growth • Provide foundation to broaden & deepen financial markets & strengthen financial infrastructure to meet future challenges ↓ • Financial companies merger programme • BNM to initiate mergers and use Danamodal to facilitate consolidation of the banking sector and to rationalise and revamp management where necessary • Asset-backed securitisation • Plan to chart the direction of the banking sector

436 *Malaysian Business*, A Merger Wager (April 16 1998)
437 *Straits Times*, KL Merger Plan Hurts Finance Stocks (6 January 1998)
438 *Business Times*, All 39 M'sian Finance Firms Say Yes to Consolidation (1 April 1998)
439 BNM, *Annual Report 1998* (1999), p.145.

To this end, the authorities established special agencies to address the problem under the Treasury and the central bank. Figure 5-4 illustrates demonstrates the relationship between government agencies.

[Figure 5-4] Re-organisation of Regulatory Framework [440]



In the first place, Pengurusan Danaharta Nasional Berhad (hereafter Danaharta) was established on 20 June 1998. Danaharta aimed to purchase NPLs below their book value (in other words, at fair market value) from financial institutions, which were given government-guaranteed bonds in exchange for the purchase of their NPLs. The removal of NPLs was very important because financial institutions were reluctant to resume their lending activities. The initial share capital of Danaharta was RM 10 billion and it increased its paid-up capital to RM 250 billion in January 1999. The government had full ownership of the institution, but the board of directors included former senior government officials as well as representatives from the private sector. In addition, Danaharta could appoint a special administrator without having to go to court. [441]

[440] Based on Enoch, Garcia and Sundararajan (2001), p.106.
[441] Pengurusan Danaharta Nasional Berhad, Pengurusan Danaharta Nasional Berhad, in Keong (2000)

Danamodal Nasional Berhad (hereafter Danamodal), founded on 10 August 1998, also contributed to restructuring the financial / corporate sector.[442] Its main objective was to re-capitalise debt-ridden banks. The asset management company did not only lend loans to weak banks, but also played a part in mergers and acquisitions (M & As) for the banks. By assessing their prospects, Danamodal provided funds to viable banks and monitored their operation to prevent a moral hazard problem. Its seed capital for Danamodal – RM 3 billion – was raised by the central bank. The funds for recapitalisation were financed by common shares, irredeemable Non-Cumulative Convertible Preference Shares (INCPS) and subordinated loans. These instruments were designed to minimise the use of public funds and to base its *modus operandi* on market principles.

The bank recapitalisation agency had acquired RM 37.5 billion (in terms of book value), which represent 44 percent of the NPLs in the sector. As a result, the net NPL ratio of the sector reduced to 6.3 percent based on the 6- month classification from its peak of 9 percent in November 1998. To finance the operation, the agency issued bonds amounting to RM 11.1 billon. The performance of Danaharta is summarised in Table 5-11.

[Table 5-11] Performance of Danaharta (As of the end of 2000)[443]

	Loan outstanding*	Expected recovery *	Expected recovery rate
Performing loans	2.57	2.57	100
Plain loan restructuring	7.06	6.54	93
Settlement	6.34	4.86	77
Scheme of arrangement	6.08	5.07	83
Special administrators	2.50	1.54	62
– scheme approved	7.63	2.12	28
Foreclosure	2.02	1.10	55
Legal action	1.63	-	-
Total	35.83	23.80	66

* Unit: RM billion

[442] Danamodal is under greater influence of the central bank than Danaharta.
[443] BNM, *Annual Report 2000* (2001), p.133.

Despite Danaharta and Danamodal's efforts, NPLs rose rapidly because the austere macroeconomic policy deepened the economic recession. In 1998, two large banks – Bank Bumiputera Malaysia and Sime Bank – registered huge losses. The injection of RM 1.1 billion to Bank Bumiputera was not enough to stop a bank run, and the authorities took over 65 percent of its NPLs. In June and September 1999, Bank Bumiputera Malaysia and Sime Bank were taken over by Bank of Commerce (M) and RHB Bank respectively.

The sale of Sime Bank to RHB Bank was under attack because the RHB Bank was controlled by Rashid Hussain who had been a close friend to Mahathir and Daim. Among the major shareholders of RHB Bank was Malaysian Resources Corporate Berhad controlled by Anwar's cronies and the UMNO co-operative. [444]

To avoid any likelihood of systemic failure, BNM took over control over the operation of four banking institutions in 1999: Kewangan Bersatu, MBf Finance, Sabah Finance and Sime Merchant Bankers. The central bank intervened in merging two of the weakest banks with stronger ones. As a result, Kewangan Bersatu and Sabah Finance were consolidated with Mayban Finance and Multi-Purpose Bank respectively in September 1999. Meanwhile, Sime Merchant Bankers was subjected to an open tender exercise. And RM 2 billion was injected into MBf Finance through Danamodal. [445]

Furthermore, BNM initiated a radical plan on 29 July 1999. The central bank selected six banking groups from all 58 domestic financial institutions: Malaysian Banking Group, Multi-Purpose Banking Group, Bumiputera Commerce Group, Public Bank Group, Perwira Affin Bank Group and Southern Bank Group. The requirement for anchor bank was minimum shareholders' funds of RM 2 billion and an asset base of at least RM 25 billion. [446]

This plan drew criticism of its criteria of anchor banks. [447] It was suspected that Daim tried to save under-performing banks under the control of his cronies. For example, RHB Bank and

[444] *Malaysian Business*, Facing the Music (16 January 1999)
[445] BNM, *Annual Report 1999* (2000), p.130.
[446] BNM, *Annual Report 2000* (2001), p.123.
[447] *Malaysian Business*, Merger by Decree (16 October 1999) Daim's intervention in the financial sector had a long history. Anwar was no exception because he also used to exert his influence on the banking sector by proxy. For details, see Hamilton-Hart (2002), Ch.5.

Hong Leong Bank controlled by associates of Anwar were excluded, while Perwira Affin Bank and Multi-Purpose Bank run by cronies of Daim were included. [448]

The central bank maintained that the selection of anchor banks was based on an economic rationale, not political considerations. However, there is little doubt that Bumiputera Commerce Bank, Multi-Purpose Bank and Perwira Affin Bank had poor performance records. As Table 5-12 shows, only two banks –Southern Bank and Public Bank – were allowed to survive among non-state or non-UMNO-associated banks. [449]

[Table 5-12] Malaysia's Commercial Banks by Asset Size (1997) [450]

Bank	Rank in Malaysia	Rank in Asia	Founders' Ethnic origin	Major shareholder
Malaysian Banking	1	59	Chinese	Government
Bank Bumiputra Malaysia	2	109	Malay	Government
RHB Bank	3	127	Malay	Rashid Hussain
Public Bank	4	141	Chinese	Teh Hong Piow
Sime Bank	5	224	Malay	Sime Darby
Bank of Commerce (M)	6	237	Chinese	Renong
Hong Leong Bank	7	252	Chinese	Quek Leng Chan
Perwira Affin Bank	8	271	Malay/Pakistan	Affin Holdings

After the announcement of the plan, some banks attempted to mobilise their political networks to save their businesses. [451] In particular, the Chinese community expressed strong opposition to the plan because many Chinese employees in the banking sector were made redundant in favour of their Malay counterparts. In August 1999, 11 ethnic Chinese groups demanded more equal treatment in an open letter. On 3 October 1999, the plan was abandoned by Prime Minister Mahathir, fearing that the opposition could lead to political moves against

[448] *Business Times*, Bank Negara Gives Nod for 10 Anchor Banks (15 February 2000)
[449] *Asiamoney*, The Humbling of Daim Zainuddin (November 1999)
[450] Drawn from *Malaysian Business*, Winning the Race (16 November 1997) and the homepages of each bank.
[451] *Malaysian Business*, Mixed Response (1 April 1999)

him. Eventually anchor bank status was given to four other banks: RHB Capital, Arab-Malaysian Merchant Bank, Hong Leong Bank and EON Bank. [452]

In addition, Daim's intervention provoked political controversies. [453] For example, Daim played a key role in permitting the International bank of Malaysia which was previously controlled by himself to acquire the merchant-banking arms of Bank Bumiputera Malaysia at a very low price. He also blocked the Hong Leong Bank's bid for Bank Simpanan Nasional Merchant Bankers to favour Perwira Affin Bank. These interventions were opposed by Ali Abul Hassan Sulaiman, then governor of BNM. After his retirement in April 2000, he sent a confidential letter to Mahathir that described Daim's extensive involvement. [454] The letter gave rise to the decline of Daim's power by convincing the Prime Minister to suspect that Daim was violating the original principle of economic reform to support his political funding machine. Eventually Mahathir used the same tactic to remove Daim as he had to eliminate Anwar. Nor Mohamed Yakop, the architect of the capital controls policy, replaced Daim as his special adviser. [455]

A revised plan of banking sector consolidation was announced on 14 February 2000. [456] The objective was to establish large financial holding companies to compete with foreign banks. Various incentives were granted, including exemption from stamp duty and real property gain tax and recognition of the losses of the acquired institutions for tax purposes. To accelerate the process, the government made these incentives available by 30 August 2000. [457]

Nevertheless, only six of the ten anchor banks met the deadline. In particular, Utama Bank resisted any merger plan, arguing that Sabah and Sarawak – the states on the western part of the Island of Borneo – needed a bank to support the local economy. Its resistance led to the

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[452] *Far Eastern Economic Review*, Merger delayed (4 November 1999); *Malaysian Business*, Merger Challengers (16 February 2000)

[453] According to an opposition leader, Daim's cronies were very concerned about Anwar's succession to Mahathir because Anwar's followers would take over their vested interests. See Syed Husin Ali, The Changing Faces of Politics and Repression in Malaysia, *Inter-Asian Cultural Studies*, Vol.2, No.1 (2001)

[454] *Far Eastern Economic Review*, Behind Daim's Fall (27 June 2002)

[455] *Business Times*, Dr M Picks New Adviser on Financial Issues (11 May 2000); Will Daim Stay on as Finance Minister? (12 May 2000)

[456] *Malaysian Business*, The Main Players (16 February 2000) See also Meesook (2002), p.79.

[457] *Straits Times*, KL Bank Mergers to Get Tax Breaks (1 August 2000)

deadline being extended twice. Finally, behind-the-scenes match-making by the Prime Minister led the bank to agree to merger terms with RHB Bank in February 2002.[458] The outcome of the restructuring is summarised in Table 5-13.

[Table 5-13] Result of Bank Restructuring

Number	97	98	99	00	01
Commercial Banks	36	36	33	31	25
Finance companies	39	33	23	19	12
Merchant banks	12	12	12	12	10
Islamic banks	NA	NA	2	2	2
Total	87	81	70	64	49

Source: Bank Negara Malaysia, Annual Report (various issues)

In 2001, BNM proposed a far-reaching plan to overhaul the banking sector.[459] The main objective was the dispersion of the ownership structure to prevent controlling shareholders from abusing their power. To this end, the central bank announced that Section 46 of the Banking and Financial Institutions Act 1989 (Bafia) would be strictly enforced. Section 46 defines the ceiling of shareholdings in banking institutions: not more than 10 percent for any one individual and 20 percent for any one corporation. This regulation is in favour of institutional investors rather than individual ones.[460]

The success of banking sector consolidation convinced the authorities to push ahead with the integration of other sectors. In 2000, the Securities Commission urged 66 stock-broking firms to form about 15 universal brokers, whose requirements were minimum paid-up capital of 250 million ringgit and at least three merger partners. Because only three firms met the condition at that time, the deadline was extended beyond the end of 2000. In addition, Bank Negara Malaysia put forward a plan to restructure the insurance industry. To do so, the minimum paid-up capital requirement of issuers was increased twofold in November 2000. The target was to reduce the number of firms to around 40 by 2003 (down from 67 at the end

[458] EIU, Country Finance: Malaysia (March 2002), p.11.
[459] For details, see Appendix 5-4.
[460] For the impact of the plan on the banking sector, see *Malaysian Business*, Bankers Going Bonker (1 April 2001), pp. 24-33.

of 2000).[461] From 2001, Dananharta did not acquire NPL form the financial sector and it was scheduled to close its operation in 2005. As of the end of 2002, the average recovery rate achieved was 57 percent.[462]

3) Capital Controls

Until the late 1960s, Malaysia had a currency board system under which the Malaysian dollar was fixed to the British pound sterling. In 1967, the system was replaced with a more flexible regime and the new Malaysian currency, the ringgit, was issued. In June 1972, the US dollar replaced the pound sterling as the intervention currency. Just after the Bretton Woods system collapsed in 1973, the ringgit was allowed to float. From October 1978 onwards, the ringgit was *de facto* pegged to a trade-weighted basket of currencies. With the exception of the 1986 depreciation, the managed floating system successfully stabilised the exchange rate.

Cross-border transactions in ringgit remained liberal from the time of independence. Malaysia was the fourth East Asian country that accepted the obligation of Article VIII in 1968 after Hong Kong, Japan and Singapore. In 1973, many regulations on foreign exchange transactions were lifted. Few restrictions on portfolio inflows by non-residents resulted in the development of an active offshore ringgit market in Singapore.[463]

Compared with its neighbouring countries, Malaysia maintained a liberal regime of foreign exchange transactions.[464] Restrictions on non-resident holdings were, however, briefly used in the early 1990s when massive capital inflows brought inflationary pressures to the economy.[465] The financial crisis led the government to rethink its liberal attitude toward

[461] EIU (2002), pp.16-18.
[462] BNM, *Annual Report 2002* (2003), p.116.
[463] IMF, Malaysia: Recent Economic Developments, Staff Country Report No. 99/85 (IMF, 1999), p.84.
[464] Prema-chandra Athukorala and Jayant Menon, Outward Orientation and Economic Development in Malaysia, *World Economy*, Vol. 22, No. 8 (November 1999); Jayant Menon, How Open is Malaysia? An Analysis of Trade, Capital and Labour Flows, *World Economy*, Vol. 23, No. 2 (February 2000); S.K. Goh, M. H. Alias, and N. Olekalns, New Evidence on Financial Openness in Malaysia, *Journal of Asian Economics*, Vol.14, No.2 (April 2003)
[465] Latifah Merican Cheong, Capital Flows and Capital Controls: The Malaysian Experience, in Kyung Tae Lee (ed.), *Globalization and the Asia Pacific Economy* (London: Routledge, 2002)

capital account liberalisation. Mahathir's condemnation of hedge funds in September 1997 signalled a policy change. However, his attack backfired and the depletion of the country's foreign exchange reserves was accelerated. Worse, economic recession drove foreign investors out of the economy.

Against this background, capital controls were widely tipped as a policy option from April 1998. [466] The architect of the policy was Nor Mohamed Yakcop – a special adviser to the Prime Minister and member of the NEAC – who masterminded the design and implementation of the policy. [467] His policy preference was close to Mahathir rather than Anwar. Basically, he was sceptical of financial liberalisation on the ground that neoliberalism is more beneficial to developed countries than developing ones.

> In today's unipolar world, the so-called neo-liberal order is the dominant one, with its agenda of a trading and capital flows architecture that favors large trans-national corporations (TNCs) and capital providers from the developed countries. We see current WTO initiatives including TRIPs (Trade-Related Intellectual Property) and TRIMs (Trade Related Investment Management) provisions and the current international financial institutions, such as the IMF, very much favoring developed countries' TNCs, creditors and investors. [468]

Not all policy makers supported capital controls. At that time, the governor and deputy governor of the central bank – both of whom were regarded as Anwar's allies – opposed the policy, fearing that the policy would isolate Malaysia from the international financial community. Their opposition was very critical because the central bank should take responsibility for the implementation of capital controls. This is why it took several months to carry out the policy. [469]

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[466] Zainal-Abidin Mahani, Implications of the Malaysian Experience on Future International Financial Arrangements, *ASEAN Economic Bulletin*, Vol.17, No.2 (August 2000)
[467] Thanks to his strong commitment to Mahathir's policy, he was promoted to Deputy Finance Mister later. Personal interview with K.S. Jomo (Kuala Lumpur, 14 March 2002)
[468] Nor Mohamed Yakcop, The Remaking of Malaysia Inc., *New Strait Times* (22 February 2002)
[469] *Straits Times*, Mahathir: Central Bank Opposed Controls (2 September 1998)

The final decision was made on 6 August 1998 and announced on 2 September 1998. The policy shift consisted of three measures.

- Freezing the external ringgit accounts of non-residents in Malaysia, which aimed at eliminating the offshore ringgit market in Singapore and stopping currency traders from accessing to ringgit funds
- Introducing a 'twelve-month rule' that prohibits the repatriation of portfolio capital inflows
- Fixing the exchange rate at RM 3.8 to the US dollar. [470]

It should be noted that Malaysia's capital controls policy was a temporary measure with a very limited time span. As Table 5-14 distinguishes, the main target of the policy was short-term capital flows. Thus, there was no restriction on long-term capital flows and current account transactions. In addition, the policy was designed to discourage outflows rather than inflows.

[Table 5-14] Selective Capital and Foreign Exchange Controls [471]

Transaction subject to control	Transaction not subject to control
Ringgit-denominated transactions with non-residents	Current account transactions • trade transactions denominated in foreign currency
Outflow of short-term capital • One-year withholding period until 30 August 1998 • A three-tier tax (10%, 20%, 30%) on profit remittance between September 1998 and February 1999	Repatriation of profits, interests, dividends, capital gains and rental income from FDI and similar forms of ringgit assets owned by non-residents
Import and export of ringgit (carriage on person)	
Export of foreign currency by citizens (carriage on person)	General payments by residents including those for education abroad
Outflow of Malaysian investment abroad	FDI inflows and outflows

470 For more details, see Appendix 5-5.
471 Prema-chandra Athukorala, *Crisis and Recovery in Malaysia* (Cheltenham: Edward Elgar, 2001), p.77.

The switch from the managed float to a pegged system was also exceptional. While other crisis-affected countries gave up their *de facto* pegged regimes following the IMF's recommendation, Malaysia alone pegged its currency to the US dollar. Three questions were raised with regard to the exchange regime change. First was the appropriateness of fixed regimes in East Asia. Traditionally East Asian countries preferred managed floating regimes, which gave them some room for devaluation to increase exports. The adoption of a fixed exchange regime made it difficult to manipulate exchange rates. Second, the exchange rate mattered. Unless the rate was uncompetitive, it could not be sustained because large trade deficits put downward pressure on the currency. The average rate for the previous two months was RM 4.18, while the pre-crisis rate was RM2.4. [472] Third, it was also important to choose which foreign currency the ringgit should be pegged to. In most cases, currencies of major trading partners are selected as anchor currencies. Well before the switch, rumours were circulating that the Japanese yen was being seriously considered as the anchor. However, the choice turned out to be the single currency peg to the US dollar. This decision is understandable because more than three quarters of Malaysia's trade was settled in the US dollar. [473]

The initial reaction to Malaysia's capital controls was very unfavourable. At that time, very few economists and policy-makers dared to support the policy. The international financial community regarded it as unorthodox "not because it was unheard of or unthinkable before, but because it ran counter to the IMF prescriptions adopted by other crisis-hit countries." [474] Only exception was Paul Krugman who recommended the policy as a temporary measure. [475]

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[472] It is not clear that this measure meant either appreciation or depreciation. Before the crisis, the currency had been traded at around 2.5 RM per $ 1. According to Kaplan and Rodrik, it was the approximately 10 percent appreciation relative to the level at which the ringgit had been trading immediately before the controls. However, Dwight Perkins and Wing Thye Woo point out that the rate left it undervalued against the other major currencies in the region. Considering the rise of its trade surplus afterwards, it is de facto devaluation.
[473] BNM, *Annual Report 1999* (2000), pp.107-11.
[474] Ariff (1999), p.2.
[475] Paul Krugman, Saving Asia: It's Time to Get Radical, *Fortune* (7 September 1998)

Foreign investors withdrew their funds from the country, even though the repatriation of principal and profits from direct investments was unaffected by the policy. Subsequent outflows pushed the stock market to fall by 13.3 percent to its lowest level in 1998. At the same time, major investment banks removed Malaysia from their investment indices, which were used as investment benchmarks for fund mangers. On 4 September 1998, for instance, Morgan Stanley Capital International announced that Malaysia was excluded from the MSCI Developed Market series, effective as of the close of 30 September 1998. Furthermore, all international rating agencies including Moody's, Thompson Bank Watch and Fitch IBCA, downgraded Malaysia's credit and sovereign risk ratings. As a result, Malaysia's risk premium rose substantially even above those of Korea and Thailand. [476] On 23 September 1998, the World Bank postponed its aid plan (300 million dollars) which was designed to improve social safety nets, suggesting that the Bank needed some time to analyse the impact of the capital controls on the plan.

The backlash made it virtually impossible for Malaysia to borrow funds from the international financial markets. However, the government managed not to go to the IMF because some East Asian countries gave financial assistance to the economy. In July 1998, Taiwan pledged soft loans of 1 billon dollars. In October, Japan's New Miyazawa Initiative relieved the shortage of foreign investment. [477]

In the meanwhile, domestic responses were not negative. The unexpected policy shift generated confusion in the financial markets. And there was concern about black markets and bureau de change fraud. [478] Nevertheless, the business sector – including the Federation of Malaysian Manufacturers (FMM) – welcomed the new policy. First, the pegging to the US

[476] Akira Ariyoshi, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Ivan Canales-Kriljenko, and Andrei Kirilenko, *Capital Controls: Country Experiences with Their Use and Liberalization*, Occasional Paper No.190 (IMF, 2000), p.100-102.
[477] EIU, Country Report: Malaysia (4th quarter 1998), pp.20-21.
[478] *Straits Times*, Black Market in Currency Begins (10 September 1998); 20 Money Changers under Probe (13 November 1998)

dollar released them from the burdens and costs of hedging. Second, its undervalued rate helped them to improve their competitiveness significantly. [479]

Just after the policy was implemented, the KLSE index started to rebound. However, it is hard to say whether capital controls and the pegged exchange regime lifted the index. It was state-controlled institutional funds that purchased stocks. However, non-resident investors, intentionally or unintentionally, contributed to the recovery because restrictions on capital outflows required them to re-invest their funds in the economy. [480]

There is little doubt that the main objective of the policy was achieved. [481] First, the restrictions on the internationalisation of the ringgit blocked offshore ringgit trading, thus containing the outflows of the currency. For a month, RM 11 billion of an estimated 20 billion ringgit in offshore holdings was returned to Malaysia from Singapore, where the ringgit was traded in foreign exchange markets. [482] Second, there were no more speculative attacks on the currency, even after the relaxation of fiscal and monetary policy. Finally, the turnaround of the economy gave a breathing space to press ahead with structural reform.

According to the IMF, the success of the policy can be ascribed to many factors.

> (1) The wide-ranging nature of the controls that has covered essentially all the potential loopholes in the system; (2) strict implementation and enforcement of the measures by Bank Negara Malaysia and a disciplined banking system, which strictly interpreted the measures and has not sought out potential loopholes; and (3) Bank Negara Malaysia's efforts to disseminate information on the nature of the exchange control rules to promote greater transparency and under-standing of the measures. [483]

Solid economic recovery enabled the government to relax the restriction on capital outflows in February 1999. As Table 5-15 shows, outright prohibition on the repatriation of

[479] *Malaysian Business*, Positive Effects (16 September 1998)
[480] IMF, Malaysia: Selected Issues, Staff Country Report No.99/86 (1999), p.9.
[481] David Cook and Michael B. Devereux, Capital Controls in Malaysia: Effectiveness and Side Effects, *Asian Economic Papers*, Vol. 1, No. 1 (January 2002)
[482] *Straits Times*, RM 11b Moved Back into Malaysia (18 September 1998)
[483] Ariyoshi et al. (2000), p.105.

portfolio investment for a 12-month holding period was replaced with a market-based measure of a system of exit levies.

[Table 5-15] Malaysia's Exit Tax on Foreign Capital (15 February 1999)

Funds brought in before 15 February 1999	
Principal withdrawn	Tax (percent)
Within 7 months	30
Within 7 to 9 months	20
Within 9 to 12 months	10
After 12 months	0
Profits withdrawn	
During 12 month holding period	0
After 12 month holding period	10
Funds brought in on or after 15 February 1999	
Principal	No Tax
Profits	
Withdrawn within 12 months	30
After 12 months	10

Source: Asian Wall Street Journal (5-6 February 1999)

Despite the high levy, some fund managers cleared up their holdings on the Kuala Lumpur Stock Exchange (KLSE). Thus stock prices fell sharply after the introduction of the new system. Nevertheless, this change was regarded as a positive signal. The IMF board of directors said, "the regime of capital controls – which was intended by the authorities to be temporary – had produced more positive results than many observers had initially expected." [484] Investment banks embraced Malaysia in their investment indices and upgraded Malaysia's credit ratings. Subsequently in May 2001, the 10 percent exit levy on repatriated profits from portfolio investment of less than a year was abolished and the restrictions on the purchase of property by foreigners were eased. Since then there is no restrictions on all foreign investment in Malaysia, including the equity market. [485]

Although the capital control policy achieved its own objective, it is still controversial how much the policy contributed to economic recovery. Supporters hold the view that the pressures

[484] Available at http://www.imf.org/external/np/sec/pn/1999/pn9988.htm
[485] For details, see Appendix 5-6.

on the ringgit in offshore markets could not have been halted without the policy. Moreover, capital controls provided some breathing space to take reform measures without putting downward pressure on the currency. [486] On the other hand, critics claim that the effects of capital controls should not be exaggerated. At that time, there were few incentives for capital outflows because substantial capitals had already left the country and the ringgit was subsequently depreciated. [487] The unexpected controls might have – even though unintentionally – punished "the investors who had also shown greater commitment to Malaysia." [488]

Considering that capital controls were a supplementary part of the Keynesian stimulus policy package, it is difficult to identify the effects of the policy. [489] And the scope of the capital controls was selective, not comprehensive. Its main target was to the offshore ringgit market in Singapore. "The exchange controls introduced by the government on 2 September 1998 do not affect the operation of long-term investors in the manufacturing and related service sectors... The measures, which are applicable mainly to short-term portfolio investments, are aimed at containing speculation on the ringgit and minimising the impact of short-term capital inflows on the domestic economy. "[490] In addition, the policy did not last

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486 Hali J. Edison and Carmen M. Reinhart, Capital Controls during Financial Crises: The Case of Malaysia and Thailand, International Financial Discussion Paper (Board of Governors of the Federal Reserve System, 2000); Dwight Perkins and Wing Thye Woo, Malaysia: Adjusting to Deep Integration with the World Economy, in Wing Thye Woo, Jeffrey D. Sachs, and Klaus Schwab (eds.), *The Asian Financial Crisis: Lessons for a Resilient Asia* (Cambridge: MIT Press, 2000); Ethan Kaplan and Dani Rodrik, Did the Malaysian Capital Controls Work?, Working Paper No. 8142 (NBER, 2001); Rawi Abdelal and Laura Alfaro, Capital and Control, Lessons from Malaysia, *Challenge*, Vol. 46, No. 4 (July/August 2003); Gan Wee Beng and Soon Lee Ying, Current Account Reversal during a Currency Crisis: The Malaysian Experience, *ASEAN Economic Bulletin*, Vol.20, No.2 (August 2003); Anita Doraisami, From Crisis to Recovery: The Motivations for and Effects of Malaysian Capital Controls, *Journal of International Development*, Vol.16, No.2 (March 2004)

487 Ron Hood, Malaysian Capital Controls, Working Paper No.2536 (World Bank, 2001); Rudiger Dornbusch, Malaysia's Crisis: What was Different?, in Sebastian Edwards and Jeffrey Frankel, *Preventing Currency Crises in Emerging Markets* (Chicago: University of Chicago Press, 2002); Robert Dunn, Jr., The Misguided Attractions of Foreign Exchange Controls, *Challenge*, Vol. 45, No.5, (September / October 2002); Masahiro Kawai and Shinji Takagi, Rethinking Capital Controls: The Malaysian Experience, Discussion Paper No.03A-05 (Policy Research Institute, Ministry of Finance, 2003); Natalia T. Tamirisa, Do Macroeconomic Effects of Capital Controls Vary by Their Type? Evidence from Malaysia, Working Paper 04/3 (IMF, 2004)

488 Kwame Sundaram Jomo, Capital Controls: The Experience of Malaysia, *World Economics*, Vol.3, No.1 (January-March 2002), p.131.

489 For details of the package, see IMF, Malaysia: Recent Economic Developments, Staff Country Report No. 99/85 (IMF, 1999)

490 EIU, Country Finance: Malaysia (March 2000), p.22.

more than six months. The restriction on a one-year holding period for repatriation of portfolio capital inflows was replaced in February 1999 with a system of graduated exit levies, and further relaxed in September 1999.

The capital control policy had political implications because of its distributional effects. Simon Johnson and Todd Mitton argue that it resulted – intentionally or unintentionally – in protecting Maharthir's clients from economic difficulties. According to their analysis, politically-connected firms, suffering from an estimated 60 billion dollars loss in market value from July 1997 to August 1998, gained an estimated 5 billion dollars in market value during September 1998. [491] However, the evidence is far from perfect. Above all, the classification of Mahathir's cronies is flawed. Due to their decades-long alliance, the political patronage structures of Mahathir, Anwar and Daim were overlapped. [492] In addition, there is no evidence that Anwar was opposed to the policy.

[Figure 5-5] Different Effects of Capital Controls on the Manufacturing Sector [493]

High exports, low imports	**High exports, medium-high imports**
- Rubber products - Palm oil processing - Wood products - Petroleum products	- Electronics - Electrical products - Textiles and clothing - Chemical products
Low exports, low imports	**Low exports, high imports** - Transport equipment

As Figure 5-5 demonstrates, the distributional impact of the policy was uneven across industries. Resource-based industries benefited from the policy because of improved terms of trade. And electronics, apparel and chemical industries also enhanced their competitiveness to a considerable extent. In contrast, the surge in prices of imports was disadvantageous to the

[491] Simon Johnson and Todd Mitton, Cronyism and Capital Controls: Evidence from Malaysia, *Journal of Financial Economics*, Vol.67, No.2 (February 2003)
[492] Their classification of ownership is based on Gomez and Jomo (1999). However, Jomo admitted that some parts of the data were outdated and incorrect. Personal interview with K. S. Jomo (Kuala Lumpur, 14 March 2002)
[493] BNM, *Annual Report 1999* (2000), p.109.

transport equipment industry. The distributional effects on Mahathir's cronies were not uniformly favourable.

There is a controversy over whether capital controls can be regarded as a political tactic to remove Anwar from the cabinet because of a coincidence between the downfall of Anwar and the capital control policy. Moreover, the resignation of Ahmad Don and Fon Weng Phak – Anwar's key allies – before the implementation of the policy implied that Anwar was in opposition to the policy. [494] There were rumours that the capital control policy was announced hours before the dismissal of Anwar to prevent speculation on the currency because he was regarded as a pro-market politician among foreign investors.

According to Mahathir, however, only Fon Weng Phak strongly argued against the policy.[495] This is confirmed by Jomo's explanation.

> This earlier imposition of controls—while Anwar Ibrahim was already Finance Minister (from 1991) and soon after Ahmad Don became central bank governor—suggests that the two were not as opposed to such measures as they have been made out to be after Ahmad Don's (forced) resignation in August 1998 and Anwar Ibrahim's sacking on 2 September 1998. [496]

Anwar's popularity did not enhance his political power because Mahathir deliberately hinted that Anwar was not loyal to his nation. The suspicion escalated after the arrest of Anwar. The US government urged Mahathir to release him. When visiting Kuala Lumpur to attend the annual summit of the Asia-Pacific Economic Co-operation (APEC) forum on 16 November 1998, Vice President Al Gore expressed his support for Anwar in front of Mahathir. This comment provoked a very fierce reaction from Malaysia's political and business elites since they regarded it as arrogant. Even several foreign delegates criticised the Vice President, suggesting that his comment might be regarded as inappropriate

[494] *Sunday Times*, KL 'won't Restrict Flow of Capital' (30 August 1998); *Business Times*, Anwar Brands Forex Controls as Jingoistic Outburst (8 September 1998)
[495] Mohamad Mahathir, Controls Have Proven Successful in Bringing About Quick Recovery, *New Straits Times* (4 August 1999)
[496] Jomo (2002), p.129.

interference.[497] Mahathir gained momentum, portraying Anwar as a puppet of foreign powers. On December 9, the Dewan Negara, the upper house of parliament, approved a call for the resignation of Michel Camdessus. In such circumstances, it is not surprising that there were rumours that the US Central Intelligence Agency (CIA) had sponsored Anwar's supporters when Al Gore condemned the government for repressing democracy. [498]

After being dismissed as Deputy Prime Minister, Finance Minister and Vice President of the UMNO, the police charged Anwar with allegations of sexual misconduct and corruption (section 377 of the Criminal Act). On 20 September 1998, he was under house arrest under the Internal Security Act, which permits detention without trial. On that day, thousands of his supporters marched to the national mosque and then to Merdeka (Freedom) Square in central Kuala Lumpur. The protest was so big that riot police used tear gas and water cannon to break up the demonstrations. Large-scale protests against the arrest of Anwar continued across the country until the end of the year.

The controversial trial was a catalyst for the consolidation of anti-Mahathir groups. On 27 September 1998, 18 parties and organisations formed GAGASAN [Coalition for People's Democracy]. And Islamic NGO groups led by PAS also made a political alliance called GERAK [Movement for People's Justice Council]. These opposition coalitions were merged into ADIL [the Movement for Social Justice] led by Anwar's wife Wan Azizah Ismail. In April 1999, ADIL developed into a multi-ethnic political party, KeADILan [National Justice Party]. [499]

During the trial, Anwar claimed that the charges of obstruction of justice and sodomy were fabricated by lieutenants of Mahathir to remove him from the government, and that the policemen who interrogated him beat him several times in order to force him to admit to the charges. His defence was not successful, although he managed to refute the charges of sodomy.

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497 *Wall Street Journal*, Gore's Support of Malaysian Protester's Disturbs Reformers Who Fear Backlash (18 November 1998) Even after the completion of his trial, seven US congressmen filed a resolution to give Anwar a new trial on 27 October 2000. See *New Straits Times*, American Lawmakers File Anwar Resolution (2 November 2000)
498 EIU, Country Report: Malaysia (1st quarter 1999), p.20.
499 Jason P. Abbott, Bittersweet Victory: The 1999 Malaysian General Election and the Anwar Ibrahim Affair, *Round Table*, Vol. 354, No. 1 (April 2000)

In April 1999, he was sentenced to six years in jail for abuse of power. Nine years for sodomy charges were eventually added in August 2000. [500]

Afterwards, his supporters were expelled from key positions in the government and the ruling party. In a cabinet reshuffle in January 1999, Mahathir appointed outgoing Foreign Minister Abdullah Badawi as Deputy Prime Minister. This appointment eliminated the political uncertainty over the succession to Mahathir. Furthermore, the result of the general election in November 1999 confirmed that Mahathir's leadership was strong enough to overcome the challenge of Anwar and his supporters.

This harsh and controversial case drew world-wide criticisms. Even ASEAN leaders as well as Western governments expressed deep concern. For example, Indonesian President B. J. Habibie, a long-time friend of Anwar, cancelled a state visit to Malaysia in October 1998. And Philippine President Joseph Estrada considered boycotting the Asian Pacific Economic Cooperation (APEC) forum hosted by Malaysia in November 1998. [501]

However, it is very tricky to evaluate the case of Anwar Ibrahim. There is little doubt that his campaign against corruption, cronyism and nepotism was correct in principle. And Mahathir's treatment of him at his trial was a disgrace. However, it is hard to deny that his political struggle was motivated by his ambition to succeed to Mahathir. Furthermore, he was not perfectly free from cronyism because he also patronised many Malay and Chinese businessmen during his tenure as Finance Minister. As Hari Singh pointed out, his *reformasi* movement includes this contradiction. [502]

To summarise, Malaysia's general framework of financial sector restructuring was similar to Korea's: establishment of AMCs, purchase of NPLs, and the consolidation of the banking sector by M & As. At the same time, there was a re-organisation of supervisory / regulatory institutions. Despite this, Malaysia's financial reform was believed as very unorthodox mainly

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[500] Patricia Martinez, Malaysia in 2000, *Asian Survey*, Vol.41, No.1 (January - February 2001). The sodomy charge was overturned by the high court on 2 September 2004 but his appeal to the corruption charge was rejected. See *International Herald Tribune*; Anwar is Released by Court in Malaysia (8 September 2004); Malaysia Court Refuses to Hear Anwar Appeal (16 September 2004)
[501] *Wall Street Journal*, Fired Malaysian Official is Transferred from Solidarity (October 15 1998)
[502] Hari Singh, Democratization or Oligarchic Restructuring? The Politics of Reform in Malaysia, *Government and Opposition*, Vol.35, No.4 (Autumn 2000)

because of capital controls policy. Although it was a temporary measure that lasted for just two years, the policy was regarded as a revolt against the IMF. This is not because the policy was revolutionary but because the other crisis-affected countries followed the quite opposite policy: i.e., capital account liberalisation. Moreover, Mahathir's fierce criticism of Western hedge funds made Malaysia's policy look more conventional.

The legacy of cronyism in the process of banking sector consolidation reinforced the impression. Some financers – both bumiputera and Chinese – lobbied their political sponsors – especially Mahathir and Daim – to save their banks. These attempts – successful or not – weakened the political power of the Washington consensus.

4. Conclusion

This chapter has discussed the political influence of the Washington consensus on financial reform. The experiences of Korea and Malaysia have demonstrated that the consensus had a substantial impact. However, its impact varied across policies. In terms of financial sector restructuring, both countries used a similar policy framework: i.e., market-friendly London approach. With respect to capital account liberalisation, there was a fundamental difference between them.

In Korea, the political power of the Washington consensus was visible since the early 1990s. Financial liberalisation was undertaken by liberal policy makers. Their logic was that financial globalisation made it hard for the government to maintain the state-controlled system. In addition, external pressures from the US and the IFIs (particularly the OECD) were crucial for financial opening. Big business also supported the policy for two reasons. First, chaebol's dependence on policy loans decrease as it could borrow funds at a discounted rate. Second, its business expansion to foreign countries led the chaebol to lobby policy makers to relax regulations on foreign exchange transactions. However, financial reform was not in favour of the chaebol because the IMF and the authorities tightened regulations on chaebol-owned financial institutions to prevent them to become chaebol's piggy banks.

In Malaysia, the political power of the Washington consensus was weak due to the legacies of the NEP principles. Although the IFIs and some liberal policy makers in the Treasury and BNM supported Anwar's reform plan, their political power did not overwhelmed Mahathir's. This led to two unorthodox policies. First, the bumiputera business community exerted political influence on banking sector restructuring. As a result, the process of the restructuring was distorted by vested interests of bumiputera businessmen and their political sponsors. Second, foreign economic policy such as capital controls was also unconventional. It should be noted, however, that the policy was designed to slow capital outflows, not to reverse the whole process of financial liberalisation. In fact, there was no control on FDI and the restrictions on outward capital flows were lifted after economic recovery. In this regard, the impact of the policy should not be exaggerated.

[Appendix 5-1] Korea: Financial Liberalisation and Deregulation during the 1980s [503]

	Items	Year
Financial Liberalisation	• Introduction of corporate paper	1981
	• Privatisation of nationwide commercial banks	1981-3
	• Abolition of beneficial interest rates on policy loans	1982
	• Alleviation of government intervention un the internal operation of	1984
	banks	1984
	• Introduction of negotiable CDs	1984
	• Introduction of a band for bank loan rates	1984
	• Indirect opening of the stock market through the Korean Fund	1987
	• Introduction of cash management accounts by short-term finance	1987
	companies	1988
	• Introduction of bond management funds by securities companies	
	• Relaxation of entry barriers to financial industry, including banks,	1988
	life insurance, lease, and investment trust	1988
	• Opening of the life insurance industry to foreign firms	1991
	• Announcement of phased deposit and loan rate deregulation	1991
	• Opening of the life securities industry to foreign firms	1991
	• Announcement of a four-step interest rate liberalisation plan	
	• Conversion of short-term finance companies to securities companies	1992
	or banks	
	• Opening of purchase of individual equity stocks on the Korean	
	• Stock Exchange to foreign investors	
Foreign Exchange & Capital Account Liberalisation	• Switch to a basket-peg exchange rate system from a dollar-peg	1980
	• Foreign exchange forward transaction implemented	1981
	• Interest rate swap allowed	1984
	• Switch to a negative system in foreign direct investment policies	1984
	• Insurance of convertible bonds (CBs), warrant bonds (WBs), and	1985
	depository receipts (DRs)	
	• Financial future allowed	1987
	• Transition to an IMF article VIII country	1988
	• Foreign exchange call market established	1989
	• Switch to the Market Average Exchange Rate System	1990
	• Switch to a negative system in foreign exchange management	1992

[503] Park (1996), p.250.

[Appendix 5-2] Korea: Equity Participation in Domestic Banks by Foreigners [504]

Bank	1997		2000	
	Weight of foreign shareholders	Major shareholders	Weight of foreign shareholders	Major shareholders
Korean Housing & Commercial	41.2	Government (22.4%)	65.4	Bank of New York (US, 13.1%) ING Group (Europe, 10%)
Kookmin	37.0	Government (15.2%) Bank of New York (8.4%)	58.2	Goldman Sachs (US, 11.1%)
Korea First	0.1	Korea Life Insurance (4.9%)	Over 51.0	New Bridge Capital (US, 51%)
Regent Securities	4.6	Daeyu Group (31.8%)	51.4	RPGL (Malaysia, 37.8%)
KGI Securities	0.0	Chohung Bank (59.7%)	Over 51.0	KGI Group (Taiwan, 51%)
Good Morning Securities	9.4	Ssangyong Group (27.4%)	52.1	H&Q AP (US, 20.6%) Lombard APIC (US, 13.8%) GIC (Singapore, 9.19%)
Seoul Securities	0.6	Daelim Group (36.2%)	51.8	Quantum Emerging (US, 30.9%)
Meritz Securities	0.2	Hanjin Group (43.6%)	25.3	Prudential (US, 25.3%)
Mirae Asset Securities	0.0	Mirae Asset Venture Capital (16.8%)	Over 11.35	CDIB (Taiwan, 11.35%)
Ileun Securities	0.0	Korea First Bank (49.0%)	36.7	SWKOL (Malaysia, 29.2%) Regent Securities (Subsidiary of RPGL, 19.6%)

504 Kyeong-won Kim (ed.), *Three Years after the IMF Bailout: A Review of the Korean Economy's Transformation since 1998* (Seoul: Samsung Economic Research Institute, 2001), pp.39-40.

[Appendix 5-3] Malaysia: Merger Programme for Domestic Banking Institutions [505]

Original Anchor Banking Group	Merged with	Resultant Entity After Merger
Affin Bank Berhad Group Perwira Affin Bank Berhad Asia Commercial Finance Berhad Perwira Affin Merchant Bank Berhad	BSN Commercial Bank (M) Berhad BSN Finance Berhad BSN Merchant Bankers Berhad	Affin Bank Berhad Affin ACF Finance Berhad Affin Merchant Bank Berhad
Alliance Bank Berhad Group Multi-Purpose Bank Berhad	International Bank Malaysia Berhad Sabah Bank Berhad Sabah Finance Berhad Bolton Finance Berhad Amanah Merchant Bank Berhad Bumiputra Merchant Bankers Berhad	Alliance Bank Berhad Alliance Finance Berhad Alliance Merchant Bank Berhad
Arab-Malaysian Bank Berhad Group Arab-Malaysian Bank Berhad Arab-Malaysian Finance Berhad Arab-Malaysian Merchant Bank Berhad	MBf Finance Berhad	Arab-Malaysian Bank Berhad Arab-Malaysian Finance Berhad Arab-Malaysian Merchant Bank Berhad
Bumiputra Commerce Bank Berhad Group Bumiputra Commerce Bank Berhad Bumiputra Commerce Finance Berhad Commerce International Merchant Bankers Berhad		Bumiputra Commerce Bank Berhad Bumiputra Commerce Finance Berhad Commerce International Merchant Bankers Berhad
EON Bank Berhad Group EON Bank Berhad EON Finance Berhad	Oriental Bank Berhad City Finance Berhad Perkasa Finance Berhad Malaysian International Merchant Bankers Berhad	EON Bank Berhad EON Finance Berhad Malaysian International Merchant Bankers Berhad
Hong Leong Bank Berhad Group Hong Leong Bank Berhad Hong Leong Finance Berhad	Wah Tat Bank Berhad Credit Corporation (Malaysia) Berhad	Hong Leong Bank Berhad Hong Leong Finance Berhad
Malayan Banking Berhad Group Malayan Banking Berhad Mayban Finance Berhad Aseambankers Malaysia Berhad	**The Pacific Bank Berhad** PhileoAllied Bank (M) Berhad Sime Finance Berhad Kewangan Bersatu Berhad2	Malayan Banking Berhad Mayban Finance Berhad Aseambankers Malaysia Berhad
Public Bank Berhad Group Public Bank Berhad Public Finance Berhad	Hock Hua Bank Berhad Advance Finance Berhad Sime Merchant Bankers Berhad	Public Bank Berhad Public Finance Berhad Public Merchant Bankers Berhad
RHB Bank Berhad Group RHB Bank Berhad RHB Sakura Merchant Bankers Berhad	Delta Finance Berhad Interfinance Berhad Bank Utama *	RHB Bank Berhad RHB Delta Finance Berhad RHB Sakura Merchant Bankers Berhad
Southern Bank Berhad Group Southern Bank Berhad	Ban Hin Lee Bank Berhad United Merchant Finance Berhad Perdana Finance Berhad Cempaka Finance Berhad Perdana Merchant Bankers Berhad	Southern Bank Berhad Southern Finance Berhad Southern Investment Bank Berhad

* The merger was completed at the end of 2002.

[505] BNM, *Annual Report 2001* (2002), p.111.

[Appendix 5-4] Malaysia: Change in Capital Account Regulations in 1994-97 [506]

Date	Type of transaction	Measure
1/17/94	Bank transactions	A ceiling was placed on the net external liability position of domestic banks (excluding trade-related and direct investment inflows). (Removed on January 20, 1995)
1/24/94	Portfolio investment	Residents were prohibited to sell the following Malaysian securities to non residents: banker's acceptances; negotiable instruments of deposit; Bank Negara bills; treasury bills, government securities (including Islamic securities) with a remaining maturity of up to one year, and Cagamas bonds and notes (whether or not sold or trade on a discount basis) with a remaining maturity of up to one year. (Removed on August 12, 1994)
2/7/94	Portfolio investment	Residents were prohibited to sell to non residents all forms of private debt securities (including commercial papers, but excluding securities convertible into ordinary shares) with a remaining maturity of one year or less. The restriction on the sale of Malaysian securities to non residents was extended to both the initial issue of the relevant security and the subsequent secondary market trade.
2/23/94	Banking system transactions	Prohibition of forward transactions (on bid side) and non trade-related swaps by commercial banks with foreign customers to curtail the speculative activities of offshore agents seeking long positions in ringgit (Lifted on august 16, 1994)
8/19/94	Portfolio investment	Restrictions on the sale of Malaysian securities were lifted. Residents were permitted to sell to non residents any Malaysian securities.
12/1/94	Borrowing & lending in domestic & foreign currency	Non resident-controlled companies were allowed to obtain credit facilities, including immovable property loans, up to RM 10 million without specific approval, provided that at least 60 percent of their total credit facilities from banking institutions were obtained from Malaysian-owned banking institutions. Short-term trade facility, guarantee, and forward foreign exchange facility were excluded from the computation o f the RM 10 million limits in December 1994, while 60:40 rule continued to apply to total short-term trade facilities. Non residents with valid work permits may obtain domestic borrowing to finance up to 60 percent of the purchase price of residential property for their own accommodation; Residents many borrow in foreign currency up to total of the equivalent of RM 5 million from non residents and from commercial and merchant banks in Malaysia.
6/27/95	Portfolio investment	Corporate residents with a domestic credit facility were allowed to remit funds up to the equivalent of RM 10 million for overseas investment purposes each calendar year.
2/1/96	Payments for invisible transactions	The threshold for the completion of the statistical forms for each remittance to or receipt of funds from, no residents were raised from amounts exceeding RM 50,000 to 100,000 or its equivalent in foreign currency.

[506] IMF, Malaysia: Selected Issues, Staff Country Report No.99/86 (1999), p.21

[Appendix 5-5] Malaysia: Capital and Exchange Control Measures in 1997–99 [507]

Measure	Motivation
August 4, 1997: Controls were imposed on banks to limit outstanding noncommercial- related ringgit offer-side swap transactions (i.e., forward order/spot purchases of ringgit by foreign customers) to \$2 million per foreign customer (hedging requirements of foreigners for trade related and genuine portfolio and foreign direct investments were excluded).	To delink the offshore ringgit market from its onshore counterpart and reduce the upward pressure on domestic onshore interest rates.
September 1, 1998: A number of selective exchange control measures were introduced, including the following. • A requirement was introduced to repatriate all ringgit held offshore (including ringgit deposits in overseas banks) by 10/1/98 (Bank Negara Malaysia approval thereafter); approval requirement was imposed to transfer funds between external accounts (freely allowed previously); and licensed offshore banks were prohibited to trade in ringgit assets (allowed up to permitted limits before). • A limit was introduced on exports and imports of ringgit by resident and nonresident travelers, effective 10/1/99 (no limits existed before). • Residents were prohibited from granting ringgit credit facilities to nonresident corresponding banks and stockbroking companies (subject to a limit previously). • Residents were prohibited from obtaining ringgit credit facilities from nonresidents (subject to limits previously). • All imports and exports were required to be settled in foreign currency. • Malaysian banks were prohibited from conducting transactions in offer-side swaps with nonresident banks (effectively reducing the previous swap limit to zero), and from engaging in reverse repo transactions collateralized by ringgit instruments with nonresident banks. • All purchases and sales of ringgit financial assets can only be transacted through authorized depository institutions; trading in Malaysian shares on Singapore's Central Limit Order Book over-the-counter market became de facto prohibited as a result of a strict enforcement of the existing law requiring Malaysian shares to be registered in the Kuala Lumpur Stock Exchange and other authorized trades prior to trade.	Aimed specifically at eliminating the offshore ringgit market and restricting the supply of ringgit to speculators that can be used to take positions against the ringgit.
September 1, 1998: A number of additional measures were introduced, including the following. • Approval requirement for nonresidents to convert the ringgit held in external accounts into foreign currency, except for purchases of ringgit assets (no such restrictions previously). • A 12-month waiting period (from September 1, 1998 or the date of	Aimed at preventing heavy capital outflows by residents and nonresidents.

[507] Ariyoshi et al. (1999), p.98.

entry of funds, which-ever comes later) for nonresidents to convert ringgit proceeds from the sale of Malaysian securities held in external accounts (excludes foreign direct investment flows, repatriation of interest, dividends, fees, commissions, and rental income from portfolio investment).There were no such restrictions previously. • A prior approval requirement beyond a certain limit for all residents to invest abroad in any form (previously applied only to corporate residents with domestic borrowing). • A specific limit on exports of foreign currency by residents and up to the amount brought into Malaysia for nonresidents (previously, export of foreign currency required approval with no specific limit).	
February 15, 1999: The 12-month holding period rule for repatriation of portfolio capital was replaced with the following. • A graduated system of exit levy on repatriation of the principal of capital investments (in shares, bonds, and other financial instruments, except property investments) made prior to 2/15/99, with the levy decreasing in the duration of investment, and thus penalizing earlier repatriations (the levy is 30 percent if repatriated in less than 7 months after the date of entry (or September 1, 1998, whichever comes later), 20 percent if in 7–9 months, and 10 percent if 9–12 months); no levy on principal if repatriated after 12 months and no levy on profits, interest, dividend, or rental income; • A graduated exit levy on the repatriation of the profits from investments made after 2/15/99 in shares, bonds, and other financial instruments, except property investments, with the levy decreasing in the duration of investment; no levy on principal and no levy on interest, dividend, or rental income (the levy is 30 percent if repatriated in less than 12 months after the investment was made and 10 percent if repatriated after 12 months).	To encourage existing portfolio investors to take a longer-term view of their investments in Malaysia, attract new funds to the country, discourage destabilizing short-term flows, and allow for a smoother outflow of funds.
February 18, 1999 and April 5, 1999: Property investments and investors in MESDAQ (where growth and technology shares are listed) were exempted from the exit levy.	To exclude from the controls certain types of investments that are either difficult to liquidate or resemble foreign direct investments.

[Appendix 5-6] Malaysia: Modifications to the Exchange Control Rules in 2000 [508]

Date	Subject
14 Mar 00	**The Central Limit Order Book** The original non-resident holders of the Central Limit Order Book (CLOB) securities were freely allowed to repatriate all funds arising from the sale of such securities purchased by them without the payment of exit levy.
29 Jun 00	Administrative procedures were issued to facilitate the classification of proceeds from the sale of the CLOB securities as being free from levy.
24 Apr 00	**Private Debt Securities (PDS)** In line with the objective of promoting the development of the domestic bond market, resident companies in Malaysia would be freely allowed to issue PDS for permitted purposes without prior written approval from BNM. Non-Resident Controlled Companies (NRCCs) raising domestic credit facilities by way of Private Debt Securities would be exempted from the RM10 million limit and the 50:50 requirement for issuance of PDS on tender basis through the Fully Automated System for Tendering (FAST).
30 Jun 00	Guidelines on PDS were issued to the Lead Arrangers.
27 Jul 00	**Import and Export of Currency** Resident and non-resident would not be required to make a declaration in the Travellers Declaration Form (TDF) as long as they carry currency notes and/or traveller's cheques within the permissible limits. For non-residents, the declaration has been incorporated into the Embarkation Card issued by the Immigration Department.
30 Sep 00	**Licensed Offshore Banks in Labuan International Offshore Financial Centre** Licensed Offshore Banks in the Labuan International Offshore 2000 Financial Centre would be allowed to invest in ringgit assets/ instruments in Malaysia for their own accounts only and not on behalf of their clients. The investments must not be financed by ringgit borrowing
23 Nov 00	**Domestic Credit Facilities extended by Resident Banking Institutions to Non-Resident Controlled Companies** Effective 1 December 2000, foreign-owned banking institutions 2000 in Malaysia may extend up to 50% of the total domestic credit facilities to Non-Resident Controlled Companies (NRCCs), in the case of credit facilities extended by resident banking institutions. This is to fulfil Malaysia's commitment under the General Agreement on Trade and Services (GATS). Previously, foreign-owned banking institutions could only extend up to a maximum of 40% funding.
15 Dec 00	**Ringgit Credit Facilities to Non-Residents** Effective 20 December 2000, licensed commercial banks and 2000 2000 Bank Islam Malaysia Berhad in Malaysia were freely allowed to extend in aggregate an intra-day overdraft facility of not exceeding RM200 million and an overnight facility of not exceeding RM10 million to non-resident stockbroking companies and non-resident global custodian banks. In addition, they can also enter into short-term currency swap arrangement to cover payment for purchase of shares on the Kuala Lumpur Stock Exchange subject to certain conditions.
	Exit Levy System As announced in the Budget 2001, the exit levy system was liberalised.

[508] BNM, *Annual Report 2000* (2001),p.11-12.

Chapter VI

Corporate Reform

1. Introduction

This chapter explores how much the political power of the Washington consensus affected corporate reform in Korea and Malaysia. The original version of the Washington consensus does not shed light on corporate governance system. [509] One reason is that there was no serious debate on the role of corporate governance in economic development. Before the crisis, few studies shed light on corporate governance in developing countries. [510] Another is that decades of economic growth misled both foreign and domestic investors to overlook the issue. On the face of it, the performance of East Asian firms in the mid-1990s was not bad. For example, returns on assets (ROA) of East Asian companies were high even compared with those of the US and Germany. [511] In the wake of the crisis, the crony capitalism thesis made corporate reform one of the most important policy agendas. For this reason, the IMF included many corporate reform policies in its programmes for the first time although its mandates have nothing to do with the issue. [512]

As Table 6-1 presents, corporate governance system can be divided into two categories: relationship (German and Japanese) and arm's length (Anglo-American).

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[509] Corporate governance is referred to as the rules, standards, and organisations that govern the behaviour of corporate owners, directors and managers and their duties and accountability to outside investors. See Oliver Hart, Corporate Governance: Some Theory and Implications, *Economic Journal*, Vol.105 (May 1995)

[510] Some exceptions are Ajit Singh and J. Hamid, Corporate Financial Structures in Developing Countries, International Finance Corporation Discussion Paper No.1 (1992); Ajit Singh, Corporate Financial Patterns in Industrializing Economies, International Finance Corporation Discussion Paper No. 2 (1995) According to them, there are some significant differences between developed and developing countries. First, corporations in developing world tend to depend very heavily upon external finance while their counterparts of advanced economies prefer internal finance. Second, they use equity finance rather retained profits to fund new investment projects.

[511] Stijn Claessens, Simeon Djankov, and Lixin Colin Xu, Corporate Performance in the East Asian Financial Crisis, *World Bank Research Observer,* Vol.15, No.1 (February 2000)

[512] The OECD has developed a guideline for good governance system since the OECD council meeting in April 1998. See OECD, *OECD Corporate Governance Guidelines* (OECD, 2004)

[Table 6-1] Characteristics of Relationship-based and Market-based System [513]

	Relationship	Arm's-length
Share of control-oriented finance	High	Low
Financial markets	Small, less liquid	Large, highly liquid
Share of all firms listed on exchanges	Small	Large
Ownership of debt and equity	Concentrated	Dispersed
Investor orientation	Control-oriented	Portfolio-oriented
Shareholder rights	Weak	Strong
Creditor rights	Strong for close creditors Weak for arms length creditors	Strong
Dominant agency conflict	Controlling vs. minority investors	Shareholders vs. management
Role of board of directors	Limited	Important
Role of hostile takeovers	Very limited	Potentially important
Role of insolvency	Potentially important	Potentially important

It was widely believed that there is no clear answer to the question of which is the best since each system has weaknesses and strengths. [514] According to Rajan and Zingales, the arm's length system is suitable for an economic environment where exists both high contractability and high capital opportunity, whereas the relationship-based system has been developed in a condition of low contractability and low capital opportunity. [515]

In the 1980s when the Japanese and German economies flourished, the relationship model was widely regarded to be better than the Arm's length one. After the financial crisis, the pendulum of public opinion swung back. The crony capitalism thesis privileged the Anglo-

[513] Juzhong Zhuang, Some Conceptual Issues of Corporate Governance, EDRC Briefing Notes, No. 13 (June 1999), p.12.
[514] See Mark J. Roe, Some Differences in Corporate Structure in Germany, Japan, and the United States, *Yale Law Journal*, Vol.102, No.8 (June 1993); Stephen Prowse, Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms among Large Firms in the United States, the United Kingdom, Japan and Germany, BIS Economic Papers No.4 (July 1994); John Kay and Aubrey Silberston, Corporate Governance, *National Institute Economic Review*, No.153 (August 1995); Andrei Shleifer and Robert W. Vishny, A Survey of Corporate Governance, *Journal of Finance*, Vol. LII, No.2 (June 1997); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, Law and Finance, *Journal of Political Economy*, Vol. 106, No. 6 (December 1998)
[515] Raghuram G. Rajan and Luigi Zingales, Which Capitalism? Lessons from the East Asia Crisis, *Journal of Applied Corporate Finance*, Vol.11, No.3 (Fall 1998)

American model on the ground that the crisis-affected countries had the relationship model, which is more prone to moral hazard problem than the Arm's length one. [516]

Despite the differences in legal and institutional settings, the corporate governance system of Korea and Malaysia had much in common. First, the separation of ownership and management was blurred. Second, the degree of concentration of ownership was very high. Third, big business was under the control of a few families and politicians. These allowed owners to treat their companies as family fiefdoms rather than publicly-listed companies. [517]

To fix the problem, the IMF recommended the crisis-affected countries to adopt so-called global standards. The core of corporate reform was to enhance transparency and accountability. This objective could not be accomplished without changing the government-business relationship. The reason is that preferential treatments were given to politically-connected companies in return for their investment in strategic industries and political support for the ruling parties. In this respect, corporate reform required a systemic transformation from the Japanese model to the Anglo-American model.

The rest of this chapter is organised as follows. Each case study of Korea and Malaysia outlines the evolution of the corporate governance system. Then it examines how the Washington consensus impinged on the patterns of corporate finance restructuring and governance system reform after the crisis. The final section assesses the role of the IFIs, policy makers, big business and political institutions in corporate reform in a comparative perspective.

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[516] Martin N. Bailey and Eric Zizewitz, Extending the East Asian Miracle: Microeconomic Evidence from Korea, *Brookings Papers on Economic Activity: Microeconomics* (1998); Stephan Haggard, Governance and Growth: Lessons from the Asian Economic Crisis, *Asian-Pacific Economic Literature*, Vol. 13, No. 2 (November 1999); Thomas Clarke, Haemorrhaging Tigers: The Power of International Financial Markets and the Weaknesses of Asian Modes of Corporate Governance, *Corporate Governance*, Vol.8, No.2 (April 2000); Simon Johnson, Peter Boone, Alasdair Breach, and Eric Friedman, Corporate Governance in the Asian Financial Crisis, *Journal of Financial Economics*, Vol.58, No.1-2 (October / November 2000); Todd Mitton, A Cross-firm Analysis of the Impact of Corporate Governance on the East Asian Financial Crisis, *Journal of Financial Economics*, Vol. 64, No.2 (May 2002)

[517] Stijn Claessens, Simeon Djankov and Larry H. P. Lang, The Separation of Ownership and Control in East Asian Corporations, *Journal of Financial Economics*, Vol.58, No.1-2 (2000)

2. Korea

1) The Chaebol System

The chaebol system is the offspring of decades-long industrial policy. Heavy and chemical industries promotion policy in the 1970s was critical in the emergence of the chaebol system. Preferential treatment such as credit access, tariffs and tax benefits were also offered to several companies. In the system, close government-business relationships enabled them to strengthen their competitiveness in exporting markets. It is indisputable that the chaebol contributed to transforming one of the poorest countries into an industrial nation. [518]

In a sense, the chaebol system might be a rational choice for a late industrialising country. According to Khanna and Palepus, business groups in developing countries are a way to overcome the underdevelopment of market mechanisms that facilitate efficient allocation of finance and resources. [519] Nevertheless, the system has many problems. At the firm-level, internal markets in the groups can be abused as a tunnel for controlling shareholders to transfer the wealth from a company to another. [520] At the national level, pro-chaebol industrial policy prohibited the development of small and medium-sized companies.

As Table 6-2 shows, there were several attempts to reform the chaebol system since the introduction of the Fair Trade Act of 1980. One of the most important measures was tight restriction on the bank ownership structure. In 1982 when the banking sector was privatised,

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518 For the development of the chaebol system, see Myung Hun Kang, *The Korean Business Conglomerate: Chaebol Then and Now*, Korea Research Monograph, No. 21 (Berkeley: Institute of East Asian Studies, 1996); Eun Mee Kim, *Big Business, Strong State: Collusion and Conflict in South Korean Developments, 1960-1990* (New York: State University of New York Press, 1997); Edward M. Graham, *Reforming Korea's Industrial Conglomerates* (Washington D.C.: Institution for International Economics, 2003); Sea-Jin Chang, *Financial Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebols* (Cambridge: Cambridge University Press, 2003). For a comparison with Japan and Taiwan, see Marcus Noland and Howard Pack, *Industrial Policy in an Era of Globalization: Lessons From Asia* (Washington D.C.: Institute for International Economics, 2003)

519 Tarun Khanna and Krishna Palepu, The Right Way to Restructure Conglomerates in Emerging Markets, *Harvard Business Review* (July / August 1999); Tarun Khanna, Business Groups and Social Welfare in Emerging Markets: Existing Evidence and Unanswered Questions, *European Economic Review*, Vol.44, No.4-6 (May 2000)

520 Kee-Hong Bae, Jun-Koo Kang, and Jin-Mo Kim, Tunneling or Value Added? Evidence from Mergers by Korean Business Groups, *Journal of Finance*, Vol.LVII, No.6 (December 2002)

no single shareholder was allowed to own more than 8 percent of commercial banks. The ceiling was reduced to 4 percent in 1994. [521]

[Table 6-2] Industrial Restructuring and Rationalisation [522]

Policy	Measures
Company rationalization (1969-71)	• Implemented in three phases 1) Readjustment of about 30 companies in the fields of PVC, auto-making, steel & chemical fibres 2) Denomination & adjustment of 56 insolvent companies 3) Denomination & adjustment of 26 insolvent companies
Industrial rationalization (part of the 3 August 1972 measures)	• Carried out on 3 August 1972 to ease the financial distress of companies caused by the severe won devaluation and stringent monetary policy that had been implemented following IMF recommendations • Designated 61 industries for industrial rationalization - 30 heavy industries including the steel, nonferrous metals, shipbuilding & electronics - PVC, fertilizer & petrochemicals Financial & tax support given to industries that undertook capacity adjustment, business specialization, subcontract system improvement, M & As, financial re-capitalisation, and R & D - Financial support by the industry rationalization fund - Exemption of corporate tax and acquisition tax in M & A, and depreciation rate increase - Fiscal subsidy to capacity investment
Investment adjustment of heavy industries (late 1970s –early 1980s)	• Downsizing and readjustment of the over-capacity of heavy industries, caused by the policy of heavy industry development through the 1970s • Support for investment readjustment through M & A and production specialization - Government support through bailout funds • Interest rates lowed in 1982 to ease the financial costs to firms
Core business (early 1990s)	• Indirect inducement policy aimed at reducing the level of chaebol business diversification • Bank credit limits lifted and other preferential treatments given exclusively to the two or three main companies which each chaebol designated as their core

[521] Heather Smith, The State, Banking and Corporate Relationship in Korea and Taiwan, in Peter Drysdale (ed.), *Reform and Recovery in East Asia: The Role of the State and Economic Enterprise* (London: Routledge, 2000), p.68.
[522] Jae-Woo Lee, Corporate Restructuring in Korea: Experience and Lessons, *Korea Journal* (Autumn 1999), p.252.

These policies did not have a serious impact on the chaebol system. Although some chaebols went bankrupt or were acquired by others, the system remained intact. First, the chaebol had become too large to be allowed to fail. In 1995, the share of the 30 largest chaebol accounted for 16 percent of GDP, 41 percent of manufacturing GDP (up from 20 percent a decade ago), 5 percent of employment, about half of all exports, and 14 percent of total commercial bank loans.[523] A chaebol's bankruptcy might have a negative impact on the national economy as a whole by reducing exports and increasing unemployment.[524]

Second, the political influence of the chaebol grew as their economic size expanded. For example, Chung Ju Yung, the founder of Hyundai, formed a political party to run for the 1992 presidential election. Although his attempt was unsuccessful, the unprecedented challenge illustrated that the chaebol's economic supremacy could turn into political power.[525]

Third, the chaebol developed various channels to deliver its policy preferences to policy-makers and politicians.[526] Traditionally, they provided the ruling party with campaign donations in exchange for their support for pro-chaebol policies. Business interest groups including the Federation of Korean Industries, Korean Employers' Federation and the Korean Chamber of Commerce and Industry played a key role in promoting chaebol's policy agenda.[527] In addition, informal networks – alumni networks and arranged marriages – were employed to consolidate the links between politicians and big business. The financial scandals

[523] IMF, Republic of Korea: Selected Issue, IMF Staff Country Report, No.98/74 (1998), p.6.
[524] Chung-in Moon, Changing Patterns of Business-Government Relations in South Korea, in Andrew MacIntyre (ed.), *Business and Government in Industrialising Asia* (Ithaca: Cornell University Press, 1994)
[525] Chang-Hee Nam, South Korea's Big Business Clientelism in Democratic Reform, *Asian Survey*, Vol. 35, No. 4. (April 1995); Won-Taek Kang, The Rise of a Third Party in South Korea: the Unification National Party in the 1992 National Assembly Election, *Electoral Studies*, Vol.17, No.1 (March 1998)
[526] David C. Kang, Bad Loans to Good Friends: Money Politics and the Developmental State in South Korea, *International Organization*, Vol. 56, No.1 (Winter 2002) See also Kyong-Dong Kim, Political Factors in the Formation of the Entrepreneurial Elite in South Korea, *Asian Survey*, Vol.16, No. 5 (May 1976); Yeon-ho Lee, *The State, Society and Big Business in South Korea* (London: Routledge, 1997)
[527] Euiyoung Kim, The State's Authority in the Organizing of the World of Business: Corporatist Business Interest Representation in South Korea, *Asian Perspective*, Vol.23, No.2 (1999)

of two ex-Presidents, Chun Doo Hwan and Roh Tae Woo are a good example to reveal how the chaebol supported plutocracy. [528]

In contrast to previous authoritarian regimes, the Kim Dae Jung administration had many advantages in overhauling the chaebol system. First of all, his economic philosophy was very critical of chaebol-oriented development and suggested a pro-small and medium enterprises (SMEs) policy. [529] In relative terms, President Kim distanced himself from the chaebol because the chaebol's donations to opposition parties were very small. In addition, there was nationwide consensus that the crisis arose from chaebol's over-investment and poor corporate governance. For example, some non-governmental organisations (NGOs) – such as People's Solidarity for Participatory Democracy (PSPD) and Citizens' Coalition for Economic Justice (CCEJ) – promoted shareholder activism against the chaebol system.

In addition to these political advantages, the IMF supported President Kim's tough measures to reform the chaebol system. In its conditionality, top priority was given to corporate reform, because the IMF thought that chaebol's reckless expansion was a major cause of the financial crisis. As Table 6-3 illustrates, the IMF suggested a comprehensive reform packages. Furthermore it imposed a strict time schedule on the government. According to the schedule, all the measures should be accomplished no later than 2000.

These tasks can be classified into two categories. One is refinancing that was intended to rescue ill-liquid companies from bankruptcy. The other is institutional restructuring that was aimed to overhaul the existing governance system. Although there is some overlapping between them, I analyse this separately for analytical reasons.

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[528] Byeong-Seog Park, Political Corruption in South Korea: Concentrating on the Dynamics of Party Politics, *Asian Perspective*, Vol.19, No.1 (Spring 1995); Kelly K. Hwang, South Korea's Bureaucracy and the Informal Politics of Economic Development, *Asian Survey*, Vol.36, No.3 (March 1996)

[529] Dae Jung Kim, *Mass-Participatory Economy: Korea's Road to World Economic Power*, Revised and Updated Edition (Lanham: Center for International Affairs, Harvard University and University Press of America, 1996)

[Table 6-3] Five Principles for Corporate Reform [530]

Objective	Measures	Schedule
Enhancing transparency in corporate management	Adoption of consolidated financial statements	FY 1999
	Adoption of international accounting principles	Oct 1998
	Strengthening the voting rights of minority shareholders	May 1999
	Compulsory appointment of outside directors	Feb 1998
	Establishment of external auditors' committee	Feb 1998
Clearance of all cross-debt guarantees	Resolution of existing cross guarantees	Mar 2000
	Prohibiting new cross guarantees between subsidiaries	Apr 1998
	Prohibiting demand for cross guarantees from financial institutions	Apr 1998
Improvements in capital structure	Agreement with banks to improve the capital structure	Apr 1998
	Removal of restriction on capital infusion with consideration	Feb 1998
	Exclusion of income tax deduction on interest payments of excessive borrowings	FY 2000
	Introduction of asset-backed securities	Sep 1998
Concentration on core businesses	Adoption of corporate- split system	Jun 1998
	Improving M & A procedures	Jun 1998
	Liberalisation of foreign ownership of real estate	Jun 1998
	Full liberalisation of M & As	May 1998
	Streaming bankruptcy procedures	Feb 1998
Strengthened responsibility & accountability	Strengthening the legal liability of controlling owners	Jun 1998
	Allowing voting rights to institutional investors	Sep 1998
	Introduction of cumulative voting system	Dec 1998

2) Restructuring of Corporate Finance

Well before the crisis, the high leverage of the chaebol was a cause for concern. [531] Just prior to the crisis, the problem went from bad to worse. The average debt-equity ratio of the 30 largest chaebols (as determined by the Fair Trade Commission) was 347.5 percent in 1995, reaching 518.9 percent in 1997. [532] Compared with the other crisis-affected countries, the ratio

[530] Sung Hee Jwa, *A New Paradigm for Korea's Economic Development: From Government Control to Market Economy* (New York: Palgrave, 2001), p.228.

[531] The chaebol-affiliated firms were much more leveraged than non-chaebol companies. See Jong-Wha Lee, Young Soo Lee and Byung-Sun Lee, The Determination of Corporate Debt in Korea, *Asian Economic Journal*, Vol.14, No.4 (December 2000)

[532] Bonchun Koo, Corporate Restructuring and Financial Reform in Korea, in Le-Jay Cho, Yoon Hyung Kim, and Inseok Shin (eds.), *Restructuring the Korean Financial Market in a Global Economy* (Seoul: KDI, 2002), p.249.

was exceptionally high. The average of the ratio from 1988 to 1996 was 346.7 in Korea, 112.9 percent in Malaysia, 195.1 percent in Indonesia, and 200.8 percent in Thailand. [533]

To make matters worse, many of them did not earn sufficient profits to cover the interest payments on their debts, let alone repay the principal. As Table 6-4 shows, the manufacturing sector recorded a net loss in 1997.

[Table 6-4] Profitability of Manufacturing Companies [534]

	1994	1995	1996	1997
Operating Profit to Net Sales	7.7	8.3	6.5	8.3
Normal Profit to Net Sales	2.7	3.6	1.0	-0.3
Return on Equity	7.6	11.0	2.0	-4.2
Return on Assets	1.9	2.8	0.5	-0.9

Despite their high leverage ratio and low profitability, the chaebol's cross-holding system enabled them to have easy access to credit. This is the so-called 'too big to fail' logic. Because their debts were guaranteed by other heavily-indebted subsidiaries, default of an affiliate was highly likely to result in the collapse of the holding company. Under such circumstances, it was virtually impossible for financial institutions to stop lending to even an unprofitable affiliate. [535]

To address the problem, the authorities introduced tough regulations that were designed to discourage commercial banks from lending to the chaebol. To this restriction, the chaebol developed various channels to finance their investment. As Table 6-5 demonstrates, the chaebol established or acquired non-bank financial intermediaries (NBFIs). Being less regulated than commercial banks, the chaebol's NBFIs were able to circumvent government controls.

[533] Claessens, Djankov and Xu (2000), p.28.
[534] Inseok Shin and Joon-Ho Hahm, The Korea Crisis: Causes and Resolution, in Cho, Kim and Shin (2002), p.111.
[535] Sung Wook Joh, Korean Economic Crisis and Corporate Governance System, in Takatoshi Ito and Anne O. Krueger (eds.), *Governance, Regulation and Privatization in the Asia-Pacific Region* (Chicago: University of Chicago Press, 2004)

[Table 6-5] Number of NBFIs Owned by Top 70 Chaebols (as of the end of 1997) [536]

	Top 5	Top 6-30	Top 31-70	Non-chaebols
Merchant bank (29)	3	7	4	14
Securities (26)	6	5	1	12
Investment trust company (14)	2	2	1	5
Life insurance (31)	2	4	8	14
Fire & Marine Insurance (13)	2	3	0	5
Instalment Credit (26)	2	7	3	12
Mutual saving & finance (219)	1	5	12	18
Venture investment (56)	3	4	6	13
Card (7)	3	1	0	4
Finance & Factoring (46)	3	4	5	12
Total (477)	27	42	40	109

* Unit: number of firms

The chaebol also had internal channels to maintain the cross-holding system through various forms of internal business transaction: purchasing their subordinated bonds at unreasonably high prices, making deposits for equity transactions at lower interest rates than the market rate, and participating in paid-in capital increases. [537] From the perspective of chaebol-owners, this intra-group transaction was a way to protect them from any hostile M & A. In some cases, internal capital markets permitted some chaebols to invest in capital-intensive industries like semiconductors. In terms of the national economy, however, it was likely to distort the efficient allocation of capital, and could eventually make healthy subsidiaries insolvent through the channel of cross-debt guarantees. [538]

The financial crisis made the chaebol's tricks ineffective. Deepening economic recession reduced their profits. Highly-leveraged companies became very vulnerable to high interest rate policy. As a result, many chaebols such as Hanbo, Kia and Daewoo went bankrupt. To deal

[536] Il Chong Nam, Joon-Kyung Kim, Yeongjae Kang, Sung Wook Joh, and Jun-Il Kim, Corporate Governance in Korea, the OECD Conference on Corporate Governance in Asia: A Comparative Perspective (Seoul: 3-5 March 1999), p.53.
[537] Bong Joon Yoon, The Korean Financial Crisis, the Chaebol, and Economic Reform, *Korean Observer*, Vol.XXX, No.3 (Autumn 1999)
[538] S. J. Chang and S. J, Hong, Economic Performance of Group-Affiliated Companies in Korea: Intra-group Resource Sharing and Internal Business Transactions, *Academy of Management Journal*, Vol. 43, No.3 (June 2000). See also Hyun-Han Shin and Young S. Park, Financing Constraints and Internal Capital Markets: Evidence from Korean 'Chaebols', *Journal of Corporate Finance*, Vol. 5, No.2 (June 1999)

with corporate distress, the government suggested principles of corporate finance restructuring based on the London Approach. [539] The case for the approach was that it can ensure common action and thus can prevent precipitate moves to start insolvency proceedings. To this end, it supposes equality of all lenders, the central lender acting as a neutral arbitrator, standstill on loan facilities, pending agreement and consideration given to the position of other creditors and shareholders. [540]

According to the principles, each creditor bank set up a Decision Committee for Insolvent Enterprises (DCIE) in May 1998. Through comprehensive investigations, the Financial Supervisory Commission (FSC) announced in June 1998 a corporate "black list" naming 55 firms, which were classified as insolvent and non-viable (including 20 affiliates of the top 5 chaebols and 32 affiliates of the top 6 to 64 chaebols). Non-viable corporations, regardless of their size, were forced to restructure their operations or leave the market. As for the viable ones, there were various supports from creditors and the government.

In order to facilitate efficient corporate restructuring, many restrictions on M & As and FDI were either revised or lifted. As a result of the liberalisation of M & As in May 1998, domestic M & As increased by 16 percent to 486 in 1998. More significantly, pro-FDI policy encouraged foreign investors to participate in corporate restructuring. As a result, the share of foreign companies accounted for a fifth of M & A deals in 1998. [541]

Different approaches were applied to the top five chaebols and the 6-64th largest chaebols. The top five chaebols (Daewoo being later excluded) and their affiliates were regarded as having sufficient resources to hedge their losses. Thus they were permitted to carry out 'self-

[539] Pen Kent, *Corporate Workouts: A U.K. Perspective* (Bank of England, 1997) available at http://www.bankofengland.co.uk/londapp.htm. Besides it, there are US (deposit insurance) and Spanish (guarantee fund) approaches. Cf. Ma. Socorro Gochoco-Bautista, Soo-Nam Oh, and S. Ghon Rhee, In the Eye of the Asian Financial Maelstrom: Banking Sector Reforms in the Asia-Pacific Region, in ADB, *Rising to the Challenge in Asia: A Study of Financial Markets*, Vol.1 (ADB, 1999)

[540] Strictly speaking, it might be misleading to say that the Korean workout programmes used the London approach, since government involvement was so pervasive. See Gerald E. Meyerman, The London Approach and Corporate Debt Restructuring in East Asia, in Charles Adams, Robert E. Litan, and Michael Pomerleano (eds.), *Managing Financial and Corporate Distress: Lessons from Asia* (Washington D.C.: Brookings Institution, 2000)

[541] OECD, *Economic Surveys: Korea* (1999), pp.108-09.

directed business restructuring', though the government provided a clear time schedule and guidelines. As shown in Table 6-6, all of them met the target (200 percent debt-equity ratio).

[Table 6-6] Business Restructuring Plan for the Top Five Chaebols [542]

	Hyundai	Samsung	Daewoo	LG	SK
Core Industries	Automobiles, Electronics, Heavy and Chemical industries, Financial Services	Electronics, Financial Services, Trade, Other Services	Trade, Construction, Automobiles, Heavy industry, Financial Services	Chemicals, Energy, Electronics, Telecommunications, Financial Services	Chemicals, Energy, Financial Services Information and Telecommunications, Construction, Distribution
No of affiliates Before Reduction After Reduction	 63 32	 66 40	 41 10	 53 32	 49 22
Target of debt-equity ratio (%) *	199.7	184.0	196.0	199.8	199.7
Non-core affiliate sold off **	1,172	1,466	1,906	903	495
Induced foreign investment	79.8	35.8	40.3	47.2	14.6

* By the end of 1999 ** Unit: Ten Billion Won ** Unit: $ 100 Million

Middle-sized chaebols (the 6- 64th) were orchestrated to enter into 'workouts' with their creditors. Many of them (the Daewoo Group companies later included) were subject to debt workouts with their respective creditor banks based on the principle of fair burden or loss sharing. Creditor banks took the lead in the workout plans by converting debt into equity, short-term loans into long-term loans, and allowing exemptions on interest payments. Table 6-7 shows that the progress of the workout was modest.

542 Dohyung Kim, IMF Bailout and Financial and Corporate Restructuring in the Republic of Korea, *Developing Economies*, Vol.XXXVII, Vol.4 (December 1999), p.504.

[Table 6-7] Corporate Workout Programme (as of the end of 2000) [543]

	Nominated (A)	Excluded				Graduated (C)	Remaining (A-B-C)
		total	Dropped out	Merged	Ejected		
Daewoo	12	1	0	0	1	1	10
6-64 chaebols	49	22	5	12	5	12	15
Middle-sized firms	43	11	3	3	5	23	9
Total	104	34	8	15	11	36	34

In the meanwhile, strong measures were employed to prevent the chaebol from using non-banking institutions as financial vehicles. In October 1998, a requirement on financial institutions was imposed to ease the concentration of capital. Commercial banks and investment trusts could not hold more than 10 and 15 percent (respectively) of bonds issued by the top five chaebols of their total corporate bond holdings. And a tough stance toward the chaebols in the area of the privatisation of commercial banks remains intact. Further the government ordered them to dispose of excessive holdings of their bonds by the end of 2000. Nevertheless, the dominance of the top five chaebols in capital markets did not diminish. [544]

For all these efforts, there were limits to reduce their debts because many of their affiliates registered huge losses, in large part, over-investment. The government pressed the chaebols to reduce surplus capacity with business swaps, or the so-called 'Big Deal'. [545] The case for the policy is that chaebol's diversification did not raise productivity through synergies of managerial know-how and technical expertise. [546]

On 3 September 1998, the top five chaebols – Hyundai, Samsung, Daewoo, LG, and SK – agreed to restructure themselves by swapping businesses in industries. According to the plan, they chose two or three areas as their core business where they would focus their competence. The final arrangement was approved by the 7 December 1998 agreement between the FKI,

543 OECD, *Economic Surveys: Korea* (2001), p.135
544 MOFE, *Chaebol Gaehyeok Husok Jochi Bangan* [Additional Measures for Chaebol Reforms] (25 August 1999)
545 Behind the decision lay the government, which saw it as a litmus test for their willingness to reform. See *Far Eastern Economic Review*, Give Me Your Sick (2 July 1998)
546 World Bank, *Republic of Korea: Establishing a New Foundation for Sustained Growth* (1999), p.44.

creditor banks and the government. For the purpose of prudential regulation of the financial sector, a monitoring role was assigned to the FSC.

The chaebol and the GNP (main opposition party) opposed the policy on the ground that the policy clearly contradicts the underlying principle of economic reform: enhancing market mechanisms and reducing state intervention.

> The government again interferes in the market by telling the chaebol what to do, only this time with the stated purpose of allowing the market to work properly. It is ironic to see Kim Dae Jung, the former dissent, using the heavy-handed tactics of dictator Park Chung Hee in order to dismantle the very economic infrastructure Mr. Park built.[547]

Despite the opposition, the government pushed ahead with the policy. In the Big Deal, the top five chaebols used two different approaches. One was to sell off their subsidiaries to more competitive companies (i.e., semiconductors, oil refining, and power generation facilities). The other was to spin off the subsidiaries to independent companies (i.e., aircraft, rolling stock, petrochemicals, and vessel engines). The business swap was completed in nine core sectors by the end of December 1999. One-third of their total liabilities (8.9 trillion won) were lowered by the elimination of overlapping assets, swapping debts to equities, and attracting foreign investment. [548]

As Table 6-8 indicates, the result of corporate finance restructuring appeared to be successful. Cross debt guarantees decreased substantially. And strict enforcement of combined financial statements made it difficult for the chaebols to guarantee the debts of their affiliated companies. [549] It should be noted, however, that the recovery of stock markets contributed, to a considerable degree, to the reduction of the debt-equity ratio. In addition, there was scepticism that this achievement was helped by accounting tricks such as asset revaluation and the payment of equity issues by non-monetary means.

[547] *Wall Street Journal*, The Chaebol Weight-Loss Plan (8 December 1998)
[548] For more details, see Appendix 6-1.
[549] IMF, Korea: Selected Issues, Country Report No.01/101 (2001), p.119.

[Table 6-8] Cross Debt Guarantee [550]

	96.4	97.4 (A)	98.4	99.12(B)	B/A (%)
Top 1-5	13.4	11.8	11.1	0.9	92.4
Top 6-30	21.8	21.8	15.8	3.4	84.4
Total	35.2	33.6	26.9	4.3	87.2

* Unit: trillion won

3) Overhaul of the Ownership Structure

As far as the chaebol is concerned, there were few mechanisms to monitor and check the activity of boards of directors. [551] Most directors of boards were *de facto* appointed by chaebol owners, which had sufficient shares to bloc any voting against their interests. Further, chaebol owners could avoid legal liability because they were not registered as the chief executive officer (CEO). The lack of a disciplinary turnover also protected the chaebol system. There was a very weak relationship between the turnover of the top executives of the chaebols and their performance. [552]

The opaque cross-holding system made it possible for chaebol owners to abuse their power without considering the interests of other shareholders. For example, the top ten chaebol owners held a mere 1.30% of the equity of all the groups as of July 2001, but exercised virtually 100% control over group management. [553] It should be noted that their real stakes might be bigger than that because chaebol owners distributed some of their stakes to their relatives, friends and employees who could not challenge their ownership. [554]

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550 Fair Trade Commission, *Gongjeong Geolae Jeongchaegui Seonggwawa Vison* [Fair Trade Policy: Achievements and Vision] (29 February 2000)

551 Joongi Kim, Recent Amendments to the Korean Commercial Code and their Effects on International Competition, *University of Pennsylvania Journal of International Economic Law*, Vol.21, No.2 (Summer 2000)

552 Terry L. Campbell and Phyllis Y. Keys, Corporate Governance in South Korea: the C*haebol* Experience, *Journal of Corporate Finance*, Vol.8, No.4 (October 2002)

553 Korea Stock Exchange, 10 *Dae Group Siga Chongaek Mit Hoejang Boyu Jusik Hyeonhwang* [TopTen Chaebol Market Value and Owner's Share: Recent Survey], (18 July 2001)

554 Kon Sik Kim, Corporate Governance in Korea, *Journal of Comparative Business and Capital Market Law*, Vol.8, No.1 (March 1986), p.23.

Regulatory obstacles also prohibited outsider investors – both institutional and individual – from influencing corporate affairs. The Commercial Code restrained hostile M & As. Institutional investors' influence was very limited because they could only execute shadow voting for customer accounts. And there were few legal protections to favour minority shareholders. For example, external shareholders with less than 5 percent of a company's shares could not exercise their rights. [555]

The backwardness of the corporate governance system had its origins in a family ownership structure. [556] Family ownership has disadvantages as well as advantages. On the one hand, it can allow the board of directors to make quick decisions, and thus reduces so-called principal-agent problems between owner, directors and managers. On the other hand, it discriminates against minority shareholders. In extreme cases, the concept of corporate governance is not relevant, since majority-holders can make all the decisions at will. [557]

The family ownership structure was a major obstacle to overhauling the corporate governance system. Even on the brink of bankruptcy, the chaebols were reluctant to accept any offer that would be likely to affect their family ownership. "The chaebol, when in need, welcomed the foreign investment, but management control... remained in the hands of mysterious family groupings whose inner workings and power relationships, rivalries, and trade-offs were largely hidden." [558]

Samsung, the flagship of Korean capitalism, was no exception. After the financial crisis, the biggest and most globalised chaebol was a main target for shareholder activists and

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[555] Jill Solomon, Aris Solomon, and Chang-Young Park, The Evolving Role of Institutional Investors in South Korean Corporate Governance: Some Empirical Evidence, *Corporate Governance*, Vol.10, No.3 (2002)

[556] Meredith Woo-Comings, All in the Family: Reforming Corporate Governance in East Asia, *Current History* (December 1998) See also see Dong-Woon Kim, Interlocking Ownership in the Korean Chaebol, *Corporate Governance*, Vol.11, No.2 (April 2003)

[557] There is no systemic correlation between ownership and performance. See Harold Demsetz and Belén Villalonga, Ownership Structure and Corporate Performance, *Journal of Corporate Finance*, Vol.7, No.3 (September 2001)

[558] Donald Kirk, *Korean Crisis: Unraveling of the Miracle in the IMF Era* (New York: St. Matin's Press, 2000), p.232.

foreign investors. [559] First, the role and status of the chairman was not clearly defined. In the group, the chairman retained unrestricted power but took no legal liability. By law, key decision should have been made by the board of directors. In practice, however, the board was nothing more than a rubber stamp. The failure of Samsung Motors was a good example. In the early 1990s, most directors were sceptical over the project because the car industry faced an over-capacity problem. Despite the warning, chairman Lee Kun Hee pushed ahead with his original plan until the car company was sold to Renault Motors in the wake of the crisis. However, the chairman was never punished for his misjudgement.

Second, chairman Lee gave considerable amounts of stock to his only son – Lee Jae Yong – using various methods to evade inheritance and transactions taxes. [560] Later, the National Tax Service imposed fines on him. At the same time, rules and regulations on inheritance and gift tax evasion were more strictly enforced.

Third, Lee Jae Yong was appointed as Vice President in charge of the strategic planning office of Samsung Electronics Co. in March 2001. His promotion was designed to pass the wealth and control of the Samsung group to him. The company defended the chairman's decision, noting that he had been on its payroll for 10 years. This explanation backfired because he did not work at Samsung during that period but took an MBA at Keio University and a DBA course at Harvard University. Moreover, the successor-in-waiting had no serious management experience in such a high position, only experience of running an e-business company for a year. When the bubble of the internet boom burst, his company having lost many billion of won was sold to the parent company at an above-market price. [561] In this respect, some minority shareholders were opposed to his appointment at the annual shareholders meeting in March 2000. [562]

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[559] Hasung Jang and Joongi Kim, Nascent Stages of Corporate Governance in an Emerging Market: Regulatory Change, Shareholder Activism and Samsung Electronics, *Corporate Governance*, Vol.10, No.2 (2002)
[560] *Far Eastern Economic Review*, Spinning its Wheels (19 November 1998)
[561] *Financial Times*, Samsung Heir in 'Sweetheart' Deal over Internet Companies (28 March 2001)
[562] *Wall Street Journal*, Samsung Electronics is Criticized for Promotion (12 March 2001)

Hyundai was the largest chaebol before the crisis in terms of asset value. However, its governance system was one of the poorest. Before his death, Chairman Chung Ju Young chose his fifth son – Chung Mong Hun, chairman of Hyundai Engineering & Construction and Hyundai Electronics Industries – as his successor. The problem was that the decision was made by the Chairman alone, not the board of directors. It means that he regarded the succession as a family affair rather than a management decision. In other words, their main concern was the distribution of the family assets rather than the shareholders' interests.

Because the decision was not made at a formal meeting of board of directors, it provoked a power struggle between Chung Mong Hun and Chung Mong Ku, his elder brother and chairman of Hyundai Motor. After a series of infighting, Chung Mong Hun succeeded in securing his position as the chairman of the group in 2000. As a result, key affiliates – especially Hyundai Motor – were separated from the group because Chung Mong Ku did not want to stay in the group. The battle for succession between the two sons had a very negative impact on investor confidence. After failing to attract new capital to sustain their reckless investments, key companies – including Hyundai Engineering & Construction – of the group went bankrupt in 2000. [563]

With respect to transparency and accountability, the collapse of Daewoo in August 1999 was one of the most notorious corporate scandals. [564] Daewoo's collapse (with debts of 65 billion dollars) was the largest ever bankruptcy in Korea's history. This was a result of chairman Kim Woo Choong's reckless expansion strategy. Even when high interest rates substantially increased the liquidity problem of the group, he acquired another highly-indebted company – i.e., Ssangyong Motor Co. He pushed this deal on the assumption that special loans would be available from the government. However, his idea was not realised because the government did not prepared to commit itself unreservedly to the 'too big to fail' privilege any longer.

[563] *Far Eastern Economic Review*, Will Hyundai Find A Lifeline? (23 November 2000)
[564] Dong Gull Lee, The Restructuring of Daewoo, in Stephan Haggard, Wonhyuk Lim, Euysung Kim (eds.), *Economic Crisis and Corporate Restructuring in Korea: Reforming the Chaebol* (Cambridge: Cambridge University Press, 2003) For a defence of Chairman Kim, see *Fortune*, Wanted: Kim Woo Choong (22 January 2003)

After the bankruptcy, chairman Kim was charged with accounting fraud; inflating the books through asset swaps within the group and double-counting sales. Nineteen Daewoo executives and accounting firms were convicted of falsifying company assets in July 2001. In responses to the charges, he maintained that 'window dressing' – a euphemism for accounting tricks – was common at the time. However, the Daewoo case was exceptional in that the chairman diverted some funds to his secret accounts (Daewoo's so-called British Finance Centre) in London.

To prevent these problems, the corporate governance system was comprehensively overhauled. As Table 6-9, top priority of the reform was given to three issues: enhancing transparency by introducing combined financial statement; strengthening minority shareholder rights; and toughening the role of directors.

[Table 6-9] Corporate Governance Reform [565]

	Measures
Improving transparency	• Introduction of consolidated financial statements • Obligation of establishing election committee for the assignment of outside auditors for listed companies and affiliates of the chaebols
Strengthening financial market discipline	• Regulation in bank loans - Debt-equity ratio 200% became a *de facto* limit in provision of loans - Prohibition of new loans with guarantee by affiliated firms - Establishing a system for constant assessment of corporate credit risk, including introduction of forward looking criteria (FLC) • Liberalization of M & A market - Permitting hostile takeovers - Abolition of regulations on foreigners' shareholding
Strengthening internal governance	• Outside director system - One fourths of the board of directors should be outside directors • Responsibility of major shareholders - Registration of the controlling shareholder as the representative director of leading affiliates - The removal of the chairman's office • Right of Minority shareholders - Loosening conditions for the inspection of accounting books, and request for

[565] Chan-Hyun Sohn, Korea's Corporate Restructuring since the Financial Crisis, Policy Analyses No.02-04 (Korea Institute for International Economic Policy, 2002), p.97. See also Jill Solomon, Aris Solomon, and Chang-Young Park, A Conceptual Framework for Corporate Governance Reform in South Korea, *Corporate Governance*, Vol.10, No.1 (2002)

	the dismissal of directors and auditors by shareholders - Introduction of a cumulative voting system when appointing directors • Right of institutional investors - Allowing voting rights for shares in funds managed by investment trust companies and bank trust accounts
Prohibiting inappropriate intra-group relations	• Strengthening punishment on unfair internal transactions • Revival of regulation on the amount of investing in related firms to 25 % of net assets of a business group • Abolition of cross debt guarantee

Despite the reform, corporate restructuring remained deadlocked due to chaebol resistance. [566] The chaebol's strategy was two-fold. One is nationalist rhetoric. For example, Kim Woo Choong claimed that the IMF was the gunboat of foreign investors who wanted to impose Anglo-American corporate governance to undermine national competitiveness. [567] Chaebol think-tanks echoed his argument that the only interest of foreign investors was to remove their competitors in global markets by destroying the industrial base of the chaebols. [568] This appeal to nationalist sentiment was very effective in capturing public attentions. In the general election, the GNP exploited the logic to criticise the government's economic policy. But this kind of propaganda, implicit or explicit, backfired. For example, GM's plan to acquire Daewoo Motors was blocked by this hostility from employers as well as trade unions.

On the other hand, some chaebols exploited the political weaknesses of the Kim Dae Jung administration. A notable case is Samsung Motors. The company was originally destined to close its Pusan factory after the failure of the negotiations with Daewoo. Since this was a region over which former President Kim Young Sam and the GNP (main opposition party)

[566] Scepticism over the corporate reform has persisted among foreign observers. For example, see *Business Week*, Showdown in Korea: Can President Kim Get the Chaebol to Change? (14 December 1998); *Economist*, The Chaebol Spurn Change (22 July 2000)

[567] Hahn-koo Lee, *IMF Sidaeui Misin* [Fallacies of the IMF Era], *Joongang Ilbo* (7 April 1998). The author was the president of the Daewoo Economic Institute, and chaired the policy committee of the opposition party [GNP].

[568] *Washington Post*, Big Korean Firms Set for Fight (10 June 1998) For a case for the chaebol, see Byong-Ho Gong, Hyeon Jeongbuui Gaehyeog Inyeom? [What is the Reform Ideas for Kim Dae Jung' Government?], *Wolgan Chosun* (November 1999); Ie Dong Bae, Corporate Korea in Perspective, *Far Eastern Economic Review* (23 July 1998) This debate was reproduced between Japanese and American economists. See Kenichi Ohmae, Japanese Scholar Sparks Heated Debate over Korea's Reforms, *Korea Herald* (12 August 1999): Rudiger Dornbusch, Ohmae's Charges Lack Credibility, *Korea Herald* (20 & 21 September 1999)

had political influence, President Kim Dae Jung had to surrender the original plan to build electoral support in the 2000 general election. [569]

In response to the chaebol resistance, President Kim declared in his address on Liberation Day, "I am determined to go down in Korea's history as a President who first accomplished corporate reforms and straightened things out in the economy for the middle and working classes." [570] At the same time, his advisors such as Kim Tae-Dong (former senior presidential secretary for economic affairs and head of the Presidential Commission on Policy Planning) and Hwang Tai-Youn (member of the commission) called for more radical reform of the chaebol system. [571]

After the address, three complementary principles of corporate governance reform were introduced.

- To ensure the independent function and expertise of the board of directors, an external recommendation committee will name board members. At listed large corporations, up to 50% of all board members are to be named from the outside.
- Institutional investors will be given a greater role to monitor corporate management.
- Shareholder meetings, board meetings and auditor systems have been taking place practically in name only. These meetings will take on greater roles to achieve proper checks-and-balances.

Following these principles, comprehensive measures were introduced to reduce the power of the chaebol owners, eventually leading to the dissolution of family-dominated ownership. The details of the additional measures is summarised in Table 6-10.

[569] Yeon-ho Lee, The Failure of the weak State in Economic Liberalization: Liberalization, Democratization and the Financial Crisis in Korea, *Pacific Review*, Vol.13, No.1 (2000), pp.120-124.
[570] Dae Jung Kim, Address by President Kim Dae Jung on the 54th Anniversary of National Liberation: To Open a New Millennium of Hope and Prosperity (15 August 1999)
[571] *Korea Herald*, Public Confused over President Kim's Attitude toward Reform of Chaebol (20 August 1999)

[Table 6-10] Additional Measures for Chaebol Reforms (August 1999) [572]

	Measures
Improvement of Corporate Governance of Non-Banking Financial Institutions	• Increasing the role and number of outside directors • Reinforcement of Firewalls • Enhancement of Management Transparency • Reinforcement of Accountability
Improving Corporate Governance	• Code of Best Practices of Corporate Governance • Government's Regulatory Improvement Related to Corporate Governance • Revision of Other Relevant Laws and Regulations
Prevention of Inheritance and Gift Tax Evasion	• The eligibility criterion for inheritance and gift taxes will be broadened and tax rates will be adjusted upward. • High-income earners will be closely monitored to prevent them from evading taxes. • Measures will also be implemented to prevent tax evasion achieved through both legal grey areas and loopholes created by evolving financial systems technology. • Non-profit foundations established by *chaebol* will be prohibited from owning stakes of related *chaebol* affiliates.
Curbing Indirect Cross Ownership	• Introduction of Limitation of Total Investment into Stocks • Reduction of Debt Ratio by Demanding Consolidated Financial Statements from the Conglomerates • Reinforcement of Monitoring the Agreement on Financial Structure Improvement
Cut Unfair Intra-Group Transactions	• System Improvement for the Prevention of Unfair Intra-Group Transaction • Official Specifications of Types of Unfair Intra-Group Transactions • Reinforcement of Investigation for Early Abolishment of Unfair Intra-Group Transaction Practices

In governance reform, the Fair Trading Commission (FTC) played a key role. [573] In February 1999, the revision of the Fair Trade Act granted the Commission more power to regulate financial transactions. However, there were limitations on the scope of the FTC's activities because extensive intervention might have provoked a controversy over the principle

[572] MOFE, *Cheabol Gaehyeo Husok Jochi Bangan* [Additional Measures for Chaebol Reforms] (25 August 1999)

[573] Following the Monopoly Regulation and Fair Trade Act of 1980, the FTC was established as an office in the former Economic Planning Board (EPB), became independent in December 1994, and was made a ministerial agency in 1996. However, Anti-monopoly laws were not adequate to restrain the monopoly position of the chaebol. See Peter M. Beck, Revitalizing Korea's Chaebol, *Asian Survey*, Vol.38, No.1 (November 1998)

of economic reform: to transform the state-directed economy into a market-regulated economy.

It is civil activism that filled the void. The minority shareholders' rights movement led by the People's Solidarity for Participatory Democracy (PSPD) and the Citizens' Coalition for Economic Justice (CCEJ) won full support from both foreign and domestic investors. [574] The PSPD's Participatory Economy Committee organised small shareholders to curb the arbitrary management of the chaebol owners. At the 1998 annual shareholders meeting of SK Telecom, the cash cow of the fourth largest chaebol, the PSPD demanded that the company have its books independently audited. In addition, they claimed that 270 million dollars used to support unprofitable affiliates should be returned to the company. This movement was backed by foreign funds owning 10 percent share of the company. [575] Samsung, the largest chaebol, faced their criticisms. Chairman Lee was accused of orchestrating unfair stock transactions to evade inheritance taxes at the 1999 annual shareholders' meeting of Samsung Electronics. At the same time, they also opposed the promotion of his son Lee Jae Yong as a director of board, pointing out his lack of management experience. [576]

These challenges had a positive impact on corporate governance reform. However, the evaluation of the role of outside directors should be more cautious. Because more than 80 percent of outside directors were still appointed by the chaebol owners or by their management, they tended to confirm decisions made by the management. In this respect, their role in monitoring management decisions on behalf of minority shareholder was not developed yet. [577]

It is also controversial whether the government implemented these measures consistently. One example is the Hyundai case. The Kim Dae Jung administration gave special treatments

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[574] Ha-sung Jang, Corporate Governance and Economic Development: The Korean Experience, in Farrukh Iqbal and Jong-il Yoo (eds.), *Democracy, Market Economics, and Development: An Asian Perspective* (Washington, D.C. : World Bank, 2001); Woon-Youl Choi, Sung Hoon Cho, Shareholder Activism in Korea: An Analysis of PSPD's Activities, *Pacific-Basin Finance Journal*, Vol.11, No.3 (July 2003) Cf. Hyuk-Rae Kim, The State and Civil Society in Transition: the Role of Non-governmental Organizations in South Korea, *Pacific Review*, Vol.13, No. 4 (2000)

[575] *Asiaweek*, Revolt of the Investor: Korean Conglomerates May Never be the Same (3 April 1998)

[576] For more details, see Appendix 6-2.

[577] OECD, *Economic Surveys: Korea* (2001), pp.140-45.

to Hyundai group in exchange for its support for the so-called sunshine policy – i.e., positive engagement with North Korea. In October 1998, the group won the third auction for control over Kia Motors and its sister company, Asia Motors even though it did not meet the government guideline for corporate governance: i.e., 200 % of debt-equity ratio.

To summarise, the Korean case demonstrates that the Washington consensus had a considerable effect on corporate reform. The crony capitalism thesis was an effective weapon that de-legitimised the chaebol system. Because corporate governance reform requires legal and institutional changes, the IFIs had a limitation in impinging its policy agendas on the country in a direct way. Nevertheless, their support for corporate reform made it easier for policy makers to overcome chaebol's resistance in the name of compliance with global standards or "best practice".

There is little doubt that the Kim Dae Jung government was less connected to the chaebol system than the previous governments. This allowed policy makers to undertake a more radical approach. It is also undisputable that pro-reform NGOs' support was instrumental in reducing the power of chaebol's nationalist rhetoric.

3. Malaysia

1) The Bumiputera Business Community

Malaysia's existing corporate governance system was widely regarded as a UK system because it based its legal principles on the British one. A closer look reveals that it was more Japanese than British in many ways. The corporate sector was dependent on bank rather than stock or bond markets and the development of the sector was heavily influenced by government's industrialisation projects. [578]

The New Economic Plan (NEP) was intended to support Malay businessmen at the expense of other ethnic groups. To this end, the UMNO took control over the Ministries of Trade & Industry and of Finance that had been under the influence of the Malaysian Chinese Association (MCA). Unlike other Asian countries, the bridge between them was the ruling party (the UMNO) rather than government agencies. [579]

To improve the income and wealth of bumiputera, the Industrial Co-ordination Act was introduced in 1975. For example, bumiputera were given privileges such as job quotas in the public service, reservation of certain economic activities and guaranteed land rights. At the same time, special agencies were established to assist bumiputera business activities. For example, policy loans from Majlis Amanah Rakyat (MARA: Council of Trust for the Indigenous People), the Urban Development Authority (UDA), and the State Economic Development Corporations (SEDCs) were channelled to bumiputera businessmen. Foreign investment projects were approved only if the investors agreed the allocation of a proportion of equity to bumiputera. And Malaysian banks were required to offer loans at reasonable cost to priority sectors: i.e., all bumiputera groups, low-cost housing and small-scale enterprises.

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[578] Kean Ow-Yong and Cheah Kooi Guan, Corporate Governance Codes: A Comparison between Malaysia and the UK, *Corporate Governance*, Vol.8, No.2 (April 2000)

[579] Kwame Sundaram Jomo, *Southeast Asia's Misunderstood Miracle: Industrial Policy and Economic Development in Thailand, Malaysia and Indonesia* (Boulder: Westview, 1997) See also Kwame Sundaram Jomo, *Industrializing Malaysia: Policy, Performance, Prospects* (London: Routledge, 1993)

As a result, bumiputera businesses had grown for the past two decades. [580]

As Table 6-11 shows, however, the original target (30 percent of corporate assets) was not met by 1990 despite these efforts. First, the short-termism of many bumiputera entrepreneurs discouraged them from developing big businesses. In many cases, they sold their companies to the Chinese businesses after exploiting rental income (the so-called get-rich-quick mentality). Second, the Chinese business community adjusted to the policy: establishing Multi-Purpose Holding (MPHD), and hiring Malay politicians as functional directors to deal with the government. [581] Third, economic liberalisation in the 1980s led the government to introduce FDI-friendly policies and encourage Chinese investment. Accordingly, many favourable measures were withdrawn when the NEP was replaced with the National Development Policy (NDP) in 1990.

[Table 6-11] Ownership of Share Capital (at par value) of Listed Companies (percent) [582]

Ownership Group	1985	1990	1992	1995	1998
Bumiputera	18.5	19.2	18.2	20.6	19.4
Individual and institutions	11.3	14.1	15.9	18.6	17.7
Trust funds	7.2	5.1	2.3	2.0	1.7
Non- Bumiputera	49.5	46.8	40.0	43.4	41.1
Chinese	48.2	45.5	37.8	40.9	38.5
Indians	0.9	1.0	1.1	1.5	1.5
Other	0.4	0.3	1.1	1.0	1.0
Foreigners	24.0	25.4	32.4	27.7	31.8
Nominee companies	8.0	8.5	9.5	8.3	7.7
Total Value of Share capital (RM Billion)	83.1	108.4	130.9	179.8	294.6

While the industrial policy contributed to rapid industrialisation and a reduction in the economic disparity between bumiputera and the Chinese, it generated moral hazard and thus

580 Mei Ling Sieh Lee, The Transformation of Malaysian Business Group, in Ruth T. McVey (ed.), *Southeast Asian Capitalists* (Ithaca: Southeast Asia Program, Cornell University, 1992)
581 Peter Searle, *The Riddle of Malaysian Capitalism: Rent-seekers or Real Capitalists?* (St Leonards: Allen & Unwin, 1999)
582 IMF, Malaysia: Selected Issues, Staff Country Report No.99/86 (1999), p.75. It should be noted that the proportion of Malay could be exaggerated by so-called 'Ali-Baba schemes': i.e., some Malay directors are appointed by Chinese owners who want to disguise their companies as Malay-owned. See David Seah, Malaysia: Dilemmas of Integration, *Parliamentary Affairs*, Vol. 53, No. 1 (January 2000), p.194.

discouraged entrepreneurship. [583] Because politically-linked businessmen were awarded government contracts, political connections were regarded as a necessary part of business in the Malay community. "Government leaders have used Malaysia preferences from the NEP to justify the awarding of contracts to UMNO-linked enterprises and individuals, creating in the process a large and influential group of domestic, bumiputera companies that are in fact the vehicles for ensuring continued UMNO political dominance." [584]

The privatisations of the mid-1990s underlined the political patronage system. In the cause of the promotion of bumiputera ownership, major privatisation contracts were allocated to Malay capitalists who acted as proxies for political patrons. [585]

> [A]s the boundaries between business, politics and the state have become increasingly blurred in the process of creating Malay entrepreneurs, so the distinction between other important categories of analysis have also become less clear. In the Malaysian context, as indeed elsewhere in Southeast Asia, it is no longer easy in many cases to distinguish between 'rent-seeking' and true 'productive' capitalism, between pariahs and entrepreneurs or between patrons and clients. [586]

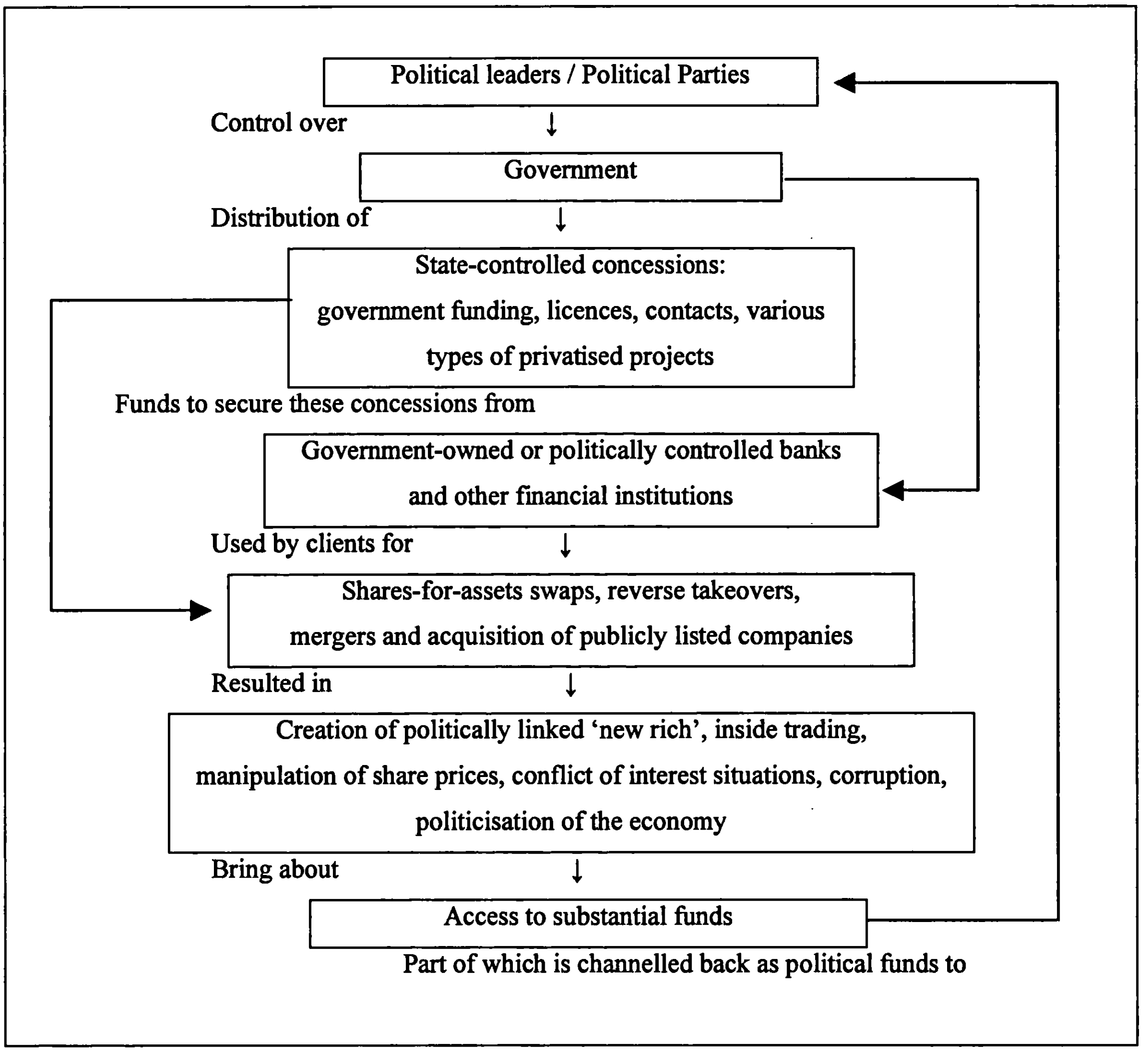
The ruling party (the UMNO) involved in various business activities through its holding company (Fleet Holding). Particularly after the appointment of Daim as chairman of the company in 1982, its size and influence rose substantially. In 1990, the company was taken over by Renong, which became the largest conglomerate.

Figure 6-1 is helpful in understanding the complex network between government, business and politicians. The network is relied upon mutual interests between politicians and their protégés in the business sector. The relationship is (re) produced when political leaders can give various favours to their protégés in the business sector in return for political

[583] For an empirical research, see Megumi Suto, Capital Structure and Investment Behaviour of Malaysian Firms in the 1990s: A Study of Corporate Governance before the Crisis, *Corporate Governance*, Vol.11, No.1 (January 2003)
[584] Bowie (1994), p.182.
[585] Kwame Sundaram Jomo (ed.) *Privatizing Malaysia: Rents, Rhetoric, and Reality* (Boulder: Westview, 1994)
[586] Searle (1999), p.1.

donations. In the network, the government does not play an independent role because the government is a mere tool that politicians and businessmen use for their own interests rather than public interests.

[Figure 6-1] Political Patronage in Malaysia [587]



Under the system, senior politicians owned shares of leading companies as a means of political funding. This system was criticised for encouraging political favouritism rather than economic innovation. Even Megat Najmuddin Khas – President of Malaysian Institute of Corporate Governance (MICG) and the Federation of Public Listed Companies (FPLC) –

[587] Edmund Terence Gomez and Kwame Sundaram Jomo, *Malaysia's Political Economy: Politics, Patronage and Profits*, second edition (Cambridge: Cambridge University Press, 1999), p.190.

conceded that the corporate government was very poor because of easy money, irresponsible diversification, over-expansion, weak supervision, over-heating and crony capitalism. [588]

Table 6-12 shows that non-bumiputera businessmen also benefited from the network. Among others, some Chinese tycoons had close relations with key Malay politicians as well as Chinese leaders in the MCA.

[Table 6-12] Key Corporate Elites Closely Linked to UMNO [589]

	Main shareholder	Selected corporate interests
Bumiputra	Wan Azmi Wan Hazmah	Land & General, R. J. Reynolds
	Halim Saad	(Renong), United Engineers (M) Bhd
	Samsudin Abu Hassan	Aokam Perdana Bhd, Landmark Bhd
	Tajudin Ramli	Technology Resources Ind., Malaysian Airlines (MAS)
	Yahya Ahmad	(HICOM Holdings Bhd), Gadek Bhd
	Ahmad Sebi Abu Bakar	Advance Synergy Bhd
	Azman Hashim	(Arab Malaysian Group)
	Ibrahim Mohamed	(Uniphoenix Corp. Bhd)
Non-Bumiputra	Vincent Tan Chee Yioun	(Berjaya Group), Sport Toto (M) Sdn Bhd
	T. Ananda Krishnan	(Pacific State Investments), MAI Holdings, Usaha Tegas, Tanjong
	Dick Chan	Metroplex Bhd
	T. K. Lim	Kamunting Bhd
	Ting Pek Khiing	Ekran Bhd
	Quek Leng Chan	(Hong Leong Group)
	Loy Hean Heong	(Malaysian Borneo Finance Bhd)

The MCA's holding company was Multi-Purpose Holdings Bhd (MPHB). [590] The establishment of MPH was a political response to the Industrial Coordination Act (1975), which threatened the Chinese business community by providing special treatment to Malay entrepreneurs. The company aimed to mobilise human resources and funds to compete with Malay capitalists. However, it failed to gain support from Chinese big business that preferred personal networks with UMNO politicians to the MCA. In addition, a power struggle in the MCA and corruption scandals in the early 1980s reduced the authority of the company in the

[588] *Straits Times*, KL 'to Blame for its Own Woes' (7 June 2000)

[589] John Hilley, *Malaysia: Mahathirism, Hegemony and the New Opposition* (London: Zed Books, 2001), p. 64. For more details, see Appendix 6-3.

[590] For the political status of the Chinese community, see Amy L. Freedman, The Effect of Government Policy and Institutions on Chinese Overseas Acculturation: The Case of Malaysia, *Modern Asian Studies*, Vol. 35, No. 2 (2001)

Chinese community. More importantly, the Malay business community and senior Malay politicians were concerned about its growing influence as MPHB conflicted with bumiputera interests. As a result, MPHB did not evolve into a big conglomerate like Renong, whereas Hong Leong, Berjaya and MUI under Malay patronage rapidly expanded their business.[591] In this regard, there were few fundamental differences between the Malays and Chinese in terms of politician-business relationship.

2) Restructuring of Corporate Finance

Many big conglomerates depended much more on banks than capital markets. Thus their indebtedness was generally high. In the early 1990s, the indebtedness became much higher due to massive inflows of capital and low interest rates.[592] In such circumstances, the collapse of the stock market in 1997 put a number of big conglomerates in danger of bankruptcy.[593] To deal with corporate distress, the government allowed non-bumiputera and foreign investors to buy bumiputera shares although the first option to purchase them was given to other bumiputera or bumiputera agencies. As a result, bumiputera's share in the corporate sector fell below the 1995 level.

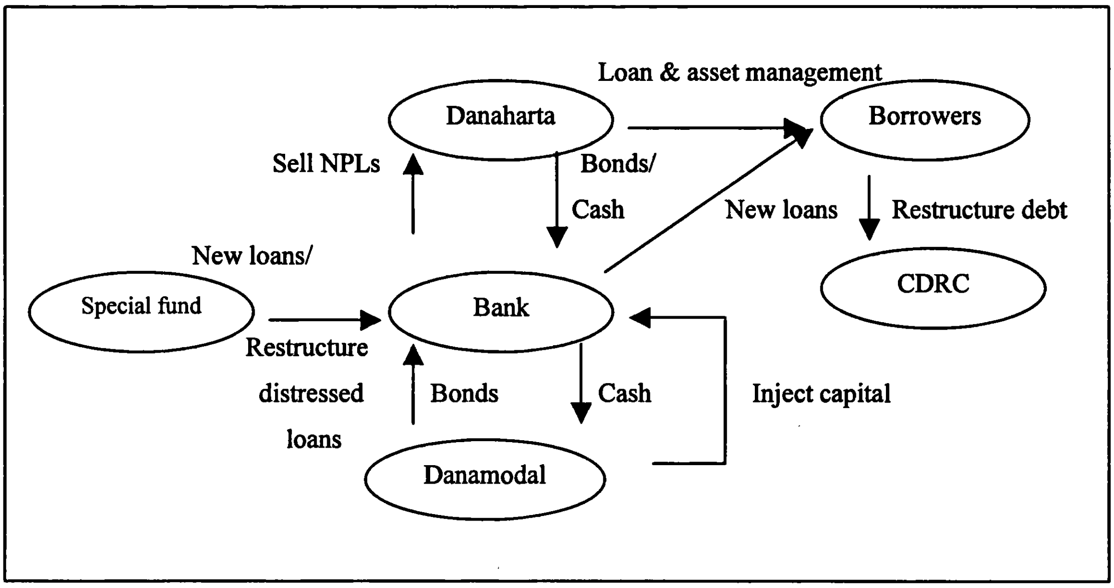
Fearing that the policy change would lead to the decline of bumiputera's influence in the business community, the government, explicitly or implicitly, supported troubled bumiputera companies by urging public-contributed funds such as *Perbadanan Nasional Berhad* (PNB) to buy the shares of the companies. In addition, the government supported the stock market by injecting public funds (notably Khazanah Nasional). In addition, short-selling of 100 blue-chip stocks was prohibited from 28 August 1997. However, these temporary measures did not stop

[591] For the influence of the Chinese in the business community, see also *Malaysian Business*, Clan Power (1 June 2001), pp.24-31.
[592] IMF, Malaysia: Selected Issues, Staff Country Report No.99/86 (1999), pp.77-86.
[593] Yougesh Khatri, Luc E. Leruth, and Jenifer Piesse, Corporate Performance and Governance in Malaysia, Working Paper No. 152 (IMF, 2002)

the downward spiral of the stock market index because many investors – both foreign and domestic – saw it as a chance to sell their shares. [594]

These poor results required the authorities to seek more radical solutions. To speed up debt restructuring by large borrowers (over RM 50 million), the Corporate Debt Restructuring Committee (CDRC) was established under the sponsorship of BNM in July 1998. [595] As Figure 6-2 shows, the committee based its modus operandi on the London Approach, providing a platform for both creditors and borrowers to work out debt restructuring without having to resort to legal proceedings. After independent consultants examined the companies that voluntarily applied for CDRC assistance and drafted a restructuring proposal, the CDRC made a final decision based on the unanimity principle. If a creditor refused to accept the proposal, the CDRC requested Danaharta or Danamodal to take over the debt from the creditor. [596]

[Figure 6-2] Mechanisms of Corporate Restructuring [597]



[594] Prema-chandra Athukorala, *Crisis and Recovery in Malaysia* (Cheltenham: Edward Elgar, 2001), p.64.
[595] To resolve the NPL problem in SMEs, Enterprise Programme was launched in June 2000.
[596] *Malaysian Business*, CDRC in Action (16 January 1999)
[597] BNM, *Annual Report 1998* (1999), p.147.

As Table 6-13 shows, the performance of the CDRC was unsatisfactory.[598] Compared with financial reform, the speed and extent of corporate restructuring was at best modest. It is not fair to attribute its poor performance solely to the CDRC because there were many obstacles in the way of its operations. Above all, the political patronage system made it difficult for the CDRC to restructure companies run by politicians' cronies. In the name of the national interest, for example, companies that were involved in a large infrastructure project or had a large number of Malaysian employees would be rescued even if they failed to meet the minimum requirements for survival.[599] Second, a lack of legal obligations was another limitation. The CDRC did not have any legal powers to push through management changes because it was a mere facilitator between creditors and debtors.

[Table 6-13] Performance of CDRC (as of the end of 2000)[600]

	No. of cases	Amount (RM billion)
Received	75	47.2
Withdrawn / rejected	21	7.8
Resolved	42	27.3
Transferred to Danaharta	9	1.8
Completed & being implemented	33	25.5
Outstanding	12	12.1

To accelerate corporate restructuring, Azman Yahya – former managing director and then chairman of Danaharta – was appointed as chairman of the CDRC in August 2001.[601] After then, the CDRC aggressively pushed ahead with restructuring plans. Before the closure in August 2002, the CDRC resolved 47 cases with total debts amounting to RM43.971 billion, which represented around 65 percent of the cases under its auspices. 11 cases (RM 2.47 billion) were transferred to Danaharta. While 14 cases (RM 8.67 billion) were withdrawn, 14 cases (RM 3.95) were rejected.[602]

598 *Far Eastern Economic Review*, Slow off the Mark (8 April 1999)
599 *Malaysian Business*, The Better Solution (16 January 1999)
600 BNM, *Annual Report 2000* (2001), p.13.
601 *Malaysian Business*, They Get Younger (16 December 2001)
602 CDRC, Press Statement (15 August 2002)

3) Overhaul of Corporate Governance

Regulations on corporate governance were upgraded to restore investors' confidence. The authorities amended many clauses of the Companies Acts in October 1998.[603] The focus of the amendments strengthened the responsibilities of disclosure and extended the power of the Securities Commission as the main regulator of capital markets in its investigative and enforcement roles. [604] At the same time, the Ministry of Finance set up the High Level Finance Committee on Corporate Governance on 24 March 1998. The Committee, consisting of government and industry representatives, proposed a new Code of Corporate Governance in February 1999. [605] Based on this, the Malaysian Securities Commission published the *Finance Committee Report on Corporate Governance* in March 1999. The core of the report is the *Malaysian Code on Corporate Governance* as a set of principles and best practice for good governance. [606]

- Clarifying the responsibilities of key corporate participants;
- Enhancing obligations of key corporate participants, especially in related party transactions;
- Improving the accuracy and timeliness of disclosures;
- Enhancing the value of general meetings;
- Enhancing the efficiency of shareholder redress for grievances; and
- Enhancing enforcement of good corporate conduct. [607]

Furthermore, the Securities Commission revised the rules on listing, reverse take-overs and back-door listings on the KLSE in April 1999. The revision was aimed to upgrade the

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[603] *Malaysian Business*, Extraordinary Measures to Fit the Times (16 November 1998)
[604] Ong Hong Cheong, Evolution of the Malaysian Financial System beyond the Financial Crisis, in Seiichi Masuyama, Donna Vandenbrink, and Chia Siow Yue (eds.), *East Asia's Financial System: Evolution and Crisis* (Singapore: Institute of Southeast Asian Studies, 1999)
[605] Low Chee Keong, Corporate Governance in Malaysia, in Keong (2000)
[606] Jeyapalan Kasipillai, Insights in Corporate Governance in Malaysia, in N. Balasubramaniam, *A International Perspective on Corporate Boards and Governance* (Kuala Lumpur: Malaysian Insurance Institute, 1999)
[607] Securities Commission, *Annual Report 2000* (2001), 2-3

quality of assets and the capitalisation level of listed companies. Although there were complaints that the new rules were too restrictive, the tightening of the regulations was broadly accepted as a necessary step toward a full disclosure-based regulatory system.[608]

Despite these improvements, scepticism prevailed over the enforcement of the new governance system. On the face of it, many complaints from the corporate sector appear to imply that the enhanced standards were strictly enforced.[609] In reality, however, the authorities did not follow the rules they set up when dealing with politically well-connected companies. In particular, minority shareholders' rights remained unprotected in large conglomerates. In June 1998, for example, when some minority shareholders tried to change old customs in the annual general meetings of Chase Perdana and Instangreen Corporation, the government had enforced bailouts of some politically well-connected firms to the detriment of minority shareholders.[610] In addition, large institutional investors were *de facto* state-controlled and played a passive role in corporate governance issues.[611]

In terms of asset size and political significance, UEM-Renong Group was the most important case. The Renong group was one of the biggest conglomerates, consisting of more than 100 companies. Its 17 subsidiaries covered key industries from construction, telecommunications to banking. What distinguished the group from its competitors was its political prestige. Its political sponsors were Mahathir and Daim. Due to the political connection, the group was the biggest beneficiary of the NEP and privatisation policy.

This privileged status had a historical origin. Renong was an offspring of Fleet Group that was set up by Tengku Razaleigh Hamzah on behalf of Prime Minister Abdul Razak in 1972. Its primary objective was to drive out foreign media companies. To this end, the Group acquired New Strait Times Press (M) with the financial assistance of Bank Bumiputra Malaysia. After Daim Zainuddin had been inaugurated as chairman in the early 1980s, the

[608] *Malaysian Business*, Appropriate Measures? (1 June 1999); KLSE Cracks the Whip (16 February 2001)
[609] *Malaysian Business*, On the Alert (16 March 2000)
[610] *Malaysian Business*, Boardroom Moves (1 August 1998)
[611] R. Thillainathan, Corporate Governance and Restructuring in Malaysia: A Review of Markets, Mechanisms, Agents and the Legal Infrastructure, paper prepared for the Joint World Bank / OECD Survey of Corporate Governance (1999)

group expanded into publications, telecommunications, banking and insurance. The aftermath of the 1985 recession stopped the highly-leveraged group from expanding its business. In 1990, Renong – another UMNO investment arm – took control over the group in exchange for shares. Under the control of Halim Saad – Daim's business partner – the group became one of the largest conglomerates in the 1990s. [612]

Despite its special position in the economy, Renong could not avoid to fall victim to the financial crisis. High interest rates and the cancellation of large infrastructure projects raised the group's debts burden, estimated to be 20 billion ringgit, or approximately 8 percent of all loans made by the banking sector. [613] To save the group, the government forced United Engineers (M) (UEM) – one of Renong's subsidiaries – to take over a 32.6 percent stake of its holding company on 17 November 1997. The shares were purchased for RM 2.34 billion cash (almost 550 million dollars at the time) because no approval from shareholders was required in the case of an acquisition in cash. To complete the deal, UEM had to borrow short-term loans to pay the amount although it had cash-cow companies including Projek Lebuhraya Utara Selatan Sdn (PLUS).

This deal was criticised for several reasons. First, UEM overvalued Renong's share price. At that time, one Renong's share was traded at RM 2.90. But UEM paid an average RM 3.26 per share. Second, the company was granted by the Foreign Investment Committee (FIC) a waiver from providing a general offer to the other minority shareholders at an optimum rate. In principle, a waver was permitted only in the defence of the national interest. For this reason, Anwar opposed the deal. Daim intervened to give the waiver to UEM on the condition that Halim Saad offered a put option to UEM and its shareholders (i.e., buying their shares in three years' time at cost plus interest). Third, the disciplinary action was very soft although the companies violated many regulations on corporate governance: just a fine of RM 100,000 on the failure to give notice of change in a substantial shareholder's interest. [614]

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[612] *Malaysian Business*, Coming Full Circle (16 August 2001)
[613] *Wall Street Journal*, Renong Plans to Offer Proposal to Settle Debts (9 October 1998)
[614] Kathryn Hanes, The Rescue of Renong, *Global Finance*, Vol. 12, No. 6 (June 1998)

All in all, this was nothing short of a bail-out of Renong and its major shareholder, Halim Saad, at the expense of minority shareholders of UEM. Thus the market response to the deal was thus very negative. Disappointed investors – both foreign and domestic – sold the stocks of both companies. Within a day of the announcement, the share price of UEM and Renong fell by 38 and 20 percent respectively. As a result, the KLCI index recorded a 7 percent decline. [615]

In 1999, UEM and Renong proposed a new restructuring plan because UEM's interest burden for short-term borrowings sharply increased due to high interest rates. One of the key feature of the plan was the issue of bonds by PLUS. The government helped the company by allowing the CDRC to arrange its rescue plans and making concessions to PLUS. [616] UEM issued RM 8.37 billion PLUS bonds and financial institutions exposed to Renong took up the zero coupon bonds with a yield of 9.4 percent. In other words, Renong debts were converted into PLUS bonds. [617]

These measures were not enough to save the heavily-indebted group. Despite solid economic recovery, the share prices of UEM and Renong remained below the pre-crisis level. It meant that Halim Saad could not keep his promise to buy the put option (32.6 percent stake in Renong) from UEM by 14 February 2001. Thus he could not help deferring it. This led the share prices of Renong and UEM to collapse by 13 and 11 percent respectively in December 2000. [618]

In July 2001 when it became evident that the group could not survive without additional funds, Khazanah Nasional – the government's investment arm – announced that it would take over a 32 percent stake in UEM using the Employees Provident Fund (EPF). [619] Because UEM held 32.6 percent stake in Renong that owned a 38 percent stake in UEM, Renong was under the control of KNB. The deal cost the EPF approximately RM 3.8 million (1 billion

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[615] *Asiamoney*, Malaysia's Brokers Get the Blues (April 2001)
[616] *Malaysian Business*, Breaking up is Hard to Do (1 April 1999)
[617] *Malaysian Business*, Attractive Bonds (1 October 1999)
[618] *Far Eastern Economic Review*, A Question of Honour (21 December 2000)
[619] *Malaysian Business*, Handing it to the State (16 August 2001)

dollars).[620] Nevertheless, the deal drew some support from investors. The reason is that the bid price of RM 4.50 was well above the market value and Halim Saad was ousted from the group.

There are few better examples than Mahathir's family to show how political considerations overwhelmed corporate governance principles. [621] The Prime Minister had three sons, all of whom were involved in business. Mirzan, the eldest son, owned Konsortium Perkapalan Berhad (KPB) that consisted of shipping and trucking companies. Even though his qualifications – a MBA degree from the University of Pennsylvania's Wharton School and work experience at Salomon Brothers – were good enough to enable him to become a successful CEO, it was widely acknowledged that state-run companies such as Petronas and Proton helped him to expand his business by awarding favourable contracts. [622]

The debt restructuring arranged by government-controlled companies reinforced this impression. When the share price of KPB fell to RM 3.78 (at its peak of RM 17.30 in March 1997), MISC controlled by Petronas acquired KPB's subsidiaries at an overvalued price. This politically-motivated bailout succeeded in saving Mirzan's business empire. But it let investors' confidence down, prompting further falls of the KL Stock Exchange Index. [623]

Mokhzani, the second son, was the owner of Tongkah Holdings, whose subsidiaries provided services for 19 government-owned hospitals and supplied granite panels for Kuala Lumpur's new international airport. In addition, he was one of the major shareholders of PhileAllied Bank. In the original plan of banking sector consolidation, the bank was to be merged into Multi-Purpose Bank controlled by Daim's cronies after the downfall of Anwar. However, the bank strongly withstood the plan. According to Terence Gomez, Mokhzani persuaded his father to assign it to government-controlled Malayan Banking in order to avenge Daim's opposition to the rescue of Mirzan's business. [624]

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[620] *Asiamoney,* Malaysia Inc moves in for Renong (September 2001)
[621] Gomez and Jomo (1999), pp.192-99.
[622] *Wall Street Journal,* Premier's Son Reins in Business Ambitions in Malaysia (30 December 1998)
[623] *Far Eastern Economic Review,* Read the Figures (14 May 1998)
[624] Terence Gomez, Why Mahathir Axed Daim, *Far Eastern Economic Review* (5 July 2001)

Concerned about a political backlash against the bailouts, Mahathir's family steadily reduced their exposure to the business sector. In October 1998, for example, a 200-million-ringgit (52 million dollars) contract to implement the first phase of Malaysia's smart-schools project was not awarded to Mirzan's company. [625] In April 2001, Mokhzani sold his stake in two listed companies at a discounted price. The main reason was to defend his father and himself from criticism of nepotism.[626]

One of the most controversial figures in the corporate sector is Daim, who had been Mahathir's key lieutenant since the 1980s. Overseeing the whole process of corporate restructuring, he was accused of putting his private interests before the public interests. In addition to his intervention in the selection of anchor banks, he violated the principles of corporate governance reform to assist his business associates who suffered from the financial crisis. Daim's rescue of his cronies such as Halim Saad (UEM-Renong) and Tajudin Ramli (Malaysian Airlines) were criticised even by senior UMNO members.

Considering the close partnership between Mahathir and Daim, it is not fair to put the blame solely on Daim. Some of controversial bailouts could not be executed without Mahathir's consent – implicit or explicit. However, on many issues – the selection of anchor banks, the choice of the governor of BNM, the control of New Strait Times and the sale of Time DotCom – Daim had different opinions. [627] One of the most important cases is the rescue of MAS. Rumours were circulated that Mahathir was very angry when Daim ordered state-run funds to over-pay for ailing companies. For example, government funds were used to pay Tajudin 1.8 billion ringgit for his 29 percent stake in 2000 and to buy a substantial stake of a Renong's telecommunications unit in 2001. [628] The rift with Mahathir was a catalyst for the

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[625] *Far Eastern Economic Review*, Sharing the Wealth (22 October 1998)
[626] *Far Eastern Economic Review*, Final Sacrifice: Daim Bows Out (14 June 2001)
[627] *Far Eastern Economic Review*, Parting ways? (25 May 2000) But Mahathir officially denied the rift between him and Daim. See *New Straits Times*, Talk of Rift with Daim not New, says Dr Mahathir (12 May 2000)
[628] *Far Eastern Economic Review*, Behind Daim's Fall (27 June 2002)

exit of Daim in June 2001. His declining reputation among Malay voters left Mahathir with no alternative but for the Finance Minister to resign from all the position he held. [629]

The departure of Daim had a positive effect on corporate restructuring. Most delayed restructuring plans including UEM-Renong and MAS were put back on course by ousting Daim's protégés. In addition, the participation of young technocrats – notably Azman Yahya (head of CDRC) and Nor Mohamad Yacob (special economic adviser to Mahathir) – made it easy for Mahathir to erase the legacy of Daim's cronyism. [630]

To conclude, the Malaysian experience shows that the Washington consensus had some effect on corporate governance reform. Although the corporate sector was not severely hit by the crisis, the government upgraded institutional frameworks for corporate governance in the cause of compliance with global standards or "best practice".

However, its political power was not strong enough to implement all the reform policy consistently. First, the division among top leaders prohibited policy makers from pursuing reform policies in a constant way. At the initial stage, Anwar's supporters prepared a blueprint for governance reform. After his downfall, Mahathir and Daim did not follow it to save their cronies – especially large bumiputera companies – although they did not overturn key reform measures.

Second, lack of regime change made it much more difficult for policy makers to implement the measures because the decades-long nexus between key politicians and big business withstood despite Anwar's challenge. It is equally important that there were no NGOs – equivalent to the CCEJ and PSPD – that helped policy makers to offset the power of the bumiputera business community.

4. Conclusion

[629] *Far Eastern Economic Review*, Surviving a Change of Guard (19 July 2001)
[630] *Asiamoney*, Change at last in Malaysia (December 2001/January 2002)

This chapter have examined the political impact of the Washington consensus on corporate reform. In the wake of the financial crisis, the consensus extended its policy agenda to corporate reform that was ignored in the original version. By attributing the main cause of the crisis to crony capitalism, the consensus made it imperative for the crisis-affected countries to improve its corporate governance system.

In Korea, the chaebol resisted corporate reform in two ways. First, the chaebol employed nationalist rhetoric. A hidden agenda of corporate reform is that foreign competitors manipulated the IMF into reducing their capacities. Second, the chaebol accused the policy of anti-market-friendly policy. In particular, the Big Deal policy was criticised for heavy state intervention by them.

Nevertheless, corporate reform was implemented with relative success. IMF's presence was instrumental in forcing the chaebol to accept corporate reform. It was equally important that President Kim Dae Jung was critical of the chaebol system. His economic philosophy was to give more favour to small- and medium-sized companies to check the monopolistic position of the chaebol. Policy makers also recognised that chaebol's monolithic power was an obstacle to fair trade. Minority shareholders' rights activities strengthened the legitimacy of anti-chaebol policy.

In Malaysia, policy makers were divided into two groups. On the one hand, Anwar's supporters in the Treasury and the central banks supported the Washington consensus. In the wake of the crisis, Anwar withdrew many preferential treatments that privileged the bumiputera business community. On the other hand, Mahathir and Daim's protégés in the NEAC minimised the change of corporate governance system on the ground that its change would de-stabilise racial harmony by widening the gap between Malays and the other ethnic communities. The bumiputera community also criticised Anwar's policy for serving foreigners' interests rather than Malaysia's interests.

The debate was finished not by a theoretical competition but by a power struggles. Mahathir removed Anwar from the cabinet and Daim took charge of economic policy. Although the government introduced upgraded sets of regulation to comply with international standards, there were many irregularities in the stage of implementation to protect Mahathir and Daim's cronies. In this regard, the political power of the Washington was limited in Malaysia.

This divergence result can be explained by different government-business relationship. As Andrew MacIntyre points out, "in the Northeast Asian NICs... the formulation and implementation of economic policy has not been greatly constrained in a direct (or instrumental) way by the preferences of business... Southeast Asian bureaucracies have not been as insulated from distributional pressures or, apparently, as coherent or high calibre." [631] In other words, the government confronted with the chaebol in Korea, big business was an integral part of the ruling party in Malaysia. This institutional difference can explain why Korean policy makers had a much tougher stance toward big business than Malaysian counterparts.

[631] Andrew MacIntyre, Business, Government and Development: Northeast and Southeast Asian Comparisons, in Andrew MacIntyre (ed.), *Business and Government in Industrialising Asia* (Ithaca: Cornell University Press, 1994), p.6 & 7.

[Appendix 6-1] Korea: The Big Deal - Business Swap Agreements between Top Five Chaebols [632]

Industry	Plan	Controlling Body
Semiconductor	Samsung Electronic Co. Hyundai Electronic Ind. LG Semiconductor Co.	Samsung Electronic Co. Hyundai Electronic Ind. (July 07)
Power-generating equipment	Hyundai Heavy Industries Co. Korea Heavy Industries & Construction Co. Samsung Heavy Industries Co.	Korea Heavy Industries & Construction Co (November 30)
Petrochemicals	SK, LG, Daelim, Lotte, Hanwha Hyundai Petrochemical Co. Samsung General Chemical Co.	SK, LG, Daelim, Lotte, Hanwha New Entry (December 18)
Aircraft manufacturing	Samsung Aerospace Industries Co. Daewoo Heavy Industries Co. Hyundai Space & Aircraft Co.	New entry (October 1)
Railroad vehicles	Hyundai Precision & Ind. Co. Daewoo Heavy Industries Co. Hanjin Heavy Industries Co.	Third-party professional manager (July 1)
Ship engines	Hyundai Heavy Industries Co. Korea Heavy Industries & Construction Co. Samsung Heavy Industries Co.	Hyundai Heavy Industries Co. Korea Heavy Industries & Construction Co. (November 30)
Oil refining	SK, LG, Ssangyong Hyundai Oil Co. Hanwha Energy Co.	SK, LG, Ssangyong Hyundai Oil Co. (May 30)
Cars*	Hyundai Motors Daewoo Motors ** Samsung Motors	Hyundai Motors (+ Kia Motors) Renault (April 27, 2000)
Electronics*	Daewoo Electronics ** Samsung Electronic Co.	Samsung Electronic Co.

* Car and electronics added in December 1998.
** Under court receivership, the government negotiated with foreign creditors to workout its debts.

[632] Compiled from OECD, *Economic Surveys: Korea* (1999), p.128; Kyeong-won Kim (ed.), *Three Years after the IMF Bailout: A Review of the Korean Economy's Transformation since 1998* (Seoul: Samsung Economic Research Institute, 2001), p.107.

[Appendix 6-2] Korea: Minority Shareholders and Foreign Investors in Major Companies [633]

Companies	Major requirements	Results
Korea First Bank	Filed a suit for the compensations for losses in regard to bad loans to Hanbo Steel (June 1997)	Four current and former directors were ruled to recompense 40 billion won (June 1998) by the court
SK Telecom	Presentation of shareholder proposal by the Tiger Fund (January 1998) - Claimed compensation for losses created illegal internal transactions with other SK affiliates - Claimed the guarantee of rights to recommend outside directors - Claimed the promise to get approval when the company deals with other SK affiliates and makes overseas investment	Acceptance of shareholders' proposal - Donation of 300 thousand shares of Daehan Telecom to SK telecom - The right to recommend three outside directors and one inspector was given to the Fund - Giving up of purchase of the new stock issuance of SK Securities
	Opposition movements by the Tiger Fund and People's Solidarity for Participatory Democracy on new stock issuance (January 1999)	Approval of new stock issuance in the shareholders' special meeting after the company's purchase of shares owned by the Tiger Fund
Samsung Electronics	Request to impose penalty on managers who refused to show record of the proceedings of the board of directors (March 1998)	A penalty of 3 million won was imposed by the court
	Shareholders' proposal by foreign funds (January 1999) and People's Solidarity for Participatory Democracy	The bill of revised corporate charters was submitted to the general shareholders' meeting in 1999
Korea Telecom	Filed a suit to compensate for losses created by interfering in the participation in the general shareholders' meeting (March 1998)	Still pending in the Seoul District Court
Hyosung	Opposition of the merger between affiliates (July 1998)	Hyosung's purchase of shares owned by the Appaloosa Fund (a US hedge fund)

[633] K. W. Kim (2001), p.96.

[Appendix 6-3] Malaysia: Politically-connected Companies [634]

Company Name	Primary Connected Major Shareholder/Director	Primary Political Connection
Advance Synergy Bhd	Ahmad Sebi Abu Bakar	Daim, Anwar
Antah Holdings Bhd	Negeri Sembilan Royalty	Mahathir
Aokam Perdana Bhd	Samsudin Abu Hassan	Daim
Arab Malaysian Corporation Bhd	Azman Hashim	UMNO
Austral Amalgamated Bhd	Samsudin Abu Hassan	Daim
Ban Hin Lee Bank Bhd	Quek Leng Chan	Anwar
Bandar Raya Developments Bhd	Mca	Mca
Berjaya Group Bhd	Vincent Tan Chee Yioun	Daim
Berjaya Sports Toto Bhd	Vincent Tan Chee Yioun	Daim
Cold Storage (Malaysia) Bhd	Basir Ismail, Samsudin Abu Hassan	Daim
Construction And Supplies House	Joseph Ambrose Lee, Abdul Mulok Awang Damit	Daim
Cycle & Carriage Bintang Bhd	Basir Ismail	Daim
Damansara Realty Bhd	Koperasi Usaha Bersatu Bhd	UMNO
Datuk Keramat Holdings Bhd	Koperasi Usaha Bersatu Bhd	UMNO
Diversified Resources Bhd	Yahya Ahmad, Nasaruddin Jalil	Anwar, Mahathir
Ekran Bhd	Ting Pek Khiing	Daim, Mahathir, Abdul Taib Mahmud
Faber Group Bhd	UMNO	UMNO
Gadek (Malaysia) Bhd	Yahya Ahmad, Nasaruddin Jalil	Anwar, Mahathir
George Town Holdings Bhd	Tunku Abdullah	Mahathir
Golden Plus Holdings Bhd	Ishak Ismail, Mohamed Sarit Haji Yusoh	Anwar
Granite Industries	Samsudin Abu Hassan	Daim
Hicom Holdings Bhd	Yahya Ahmad	Anwar, Mahathir
Ho Hup Construction Company Bhd	Halim Saad	Daim
Hong Leong Bank Bhd	Quek Leng Chan	Anwar
Hong Leong Credit Bhd	Quek Leng Chan	Anwar
Hong Leong Industries Bhd	Quek Leng Chan	Anwar
Hong Leong Properties Bhd	Quek Leng Chan	Anwar
Hume Industries (Malaysia) Bhd	Quek Leng Chan	Anwar
Idris Hydraulic (Malaysia) Bhd	Ishak Ismail	Anwar
Kamunting Corporation Bhd	T.K. Lim	Daim
Kfc Holdings (Malaysia) Bhd	Ishak Ismail	Anwar
Kinta Kellas Public Limited Co	Halim Saad	Daim
Kretam Holdings Bhd	UMNO Youth, Wan Azmi Wan Hamzah	Daim
Kumpulan Fima Bhd	Basir Ismail	Daim
Land & General Bhd	Wan Azmi Wan Hamzah	Daim
Landmarks Bhd	Samsudin Abu Hassan	Daim
Magnum Corporation Bhd	T.K. Lim	Daim
Malakoff Bhd	Malaysian Resources	UMNO
Malaysian Airline System Bhd	Tajudin Ramli	Daim
Malaysian Resources Corporation	Wan Azmi Wan Hamzah	UMNO, Anwar
Metroplex Bhd	Dick Chan	Unspecified
Multi-Purpose Holdings Bhd	T.K. Lim	Daim
Mycom Bhd	Mohd Tamrin Abdul Ghafar	Ghafar Baba
Nanyang Press (Malaya) Bhd	Quek Leng Chan	Anwar
New Straits Times Press (Malaysia)	Unspecified	Anwar
O.Y.L. Industries Bhd	Quek Leng Chan	Anwar
Pacific Chemicals Bhd	Ting Pek Khiing, Robert Tan	Daim, Mahathir, Abdul Taib Mahmud
Pengkalen Holdings Bhd	Joseph Ambrose Lee, Abdul Mulok Awang Damit	Daim
Prime Utilities Bhd	Ahmad Sebi Abu Bakar	Daim, Anwar
Promet Bhd	Ibrahim Mohamed	Mahathir
R.J. Reynolds Bhd	Wan Azmi Wan Hazmah	Daim
Rashid Hussain Bhd	Wan Azmi Wan Hamzah	Daim
Renong Bhd	Halim Saad	Daim
Sapura Telecommunications Bhd	Unspecified	Mahathir
Setron (Malaysia) Bhd	Penang Bumiputera Foundation, Kamaruddin Jaafar	Anwar
Sistem Televisyen Malaysia Bhd	UMNO Companies	UMNO
Star Publications (Malaysia) Bhd	Vincent Tan Chee Yioun	Daim
Taiping Consolidated Bhd	Vincent Tan Chee Yioun	Daim
Tanjong Public Limited Company	T. Ananda Krishnan	Mahathir
Technology Resources Industries	Tajudin Ramli	Daim
Time Engineering Bhd	Halim Saad	Daim
Tongkah Holdings Bhd	Mokhzani Mahathir	Mahathir
Uniphoenix Corporation Bhd	Ibrahim Mohamed	Mahathir
Uniphone Telecommunications Bhd	Shamsuddin Bin Abdul Kadir	Mahathir
United Engineers (Malaysia) Bhd	Halim Saad	Daim
United Merchant Group Bhd	Ahmad Sebi Abu Bakar	Daim, Anwar
United Plantations Bhd	Basir Ismail	Daim

634 Simon Johnson and Todd Mitton, Cronyism and Capital Controls: Evidence from Malaysia, *Journal of Financial Economics*, Vol.67, No.2 (February 2003), pp.378-79.

Utusan Melayu (Malaysia) Bhd	UMNO	UMNO
Wembley Industries Holdings Bhd	Ishak Ismail	Anwar
Ytl Cement Bhd	Yeoh Tiong Lay	Unspecified
Ytl Corporation Bhd	Yeoh Tiong Lay	Unspecified
Ytl Power International Bhd	Yeoh Tiong Lay	Unspecified

Chapter VII

Labour Market Reform and Social Policy

1. Introduction

This chapter examines to what extent the political power of the Washington consensus affected labour market reform and social policy in Korea and Malaysia. The consensus argues that labour market rigidities are one of the underlying causes of the crisis. In this regard, the IMF recommended the crisis-affected countries to improve flexibility. First, competitive labour markets help to enhance productivity by improving the allocation of human capital of workers. Second, flexibility in the labour sector facilitates structural reform by lowering wage costs and allowing large-scale redundancy. [635]

The post-Washington consensus points out that the pursuit of economic efficiency can be harmful for economic equality by causing various types of negative side effects: unemployment, increasing wage differences and worsening employment conditions. To mitigate these effects, labour market reform is accompanied with social policy such as unemployment insurance, public work and training programmes and minimum wages. [636]

Traditionally, IMF-supported programmes were hardly helpful in addressing the problems. First, pro-cyclical policy constrained government's capability to increase social spending. Second, structural reform increased unemployment at least in the short-term. For these reasons, critics of the IMF urged the crisis-affected countries to adopt expansionary fiscal policy and to postpone some reform policies until strong economic recovery. [637]

[635] Chris Manning, Labour Markets in the ASEAN-4 and the NIEs, *Asia-Pacific Economic Literature*, Vol.13, No.1 (1999)
[636] T. Paul Schultz, Labor Market Reforms: Issues, Evidence, and Prospects, in Anne O. Krueger (ed.), *Economic Policy Reform: The Second Stage* (Chicago: University of Chicago Press, 2000)
[637] Giovanni Andrea Cornia, Richard Jolly and Frances Stewart (eds.), *Adjustment with a Human Face. Vol.1, Protecting the Vulnerable and Promoting Growth* (Oxford: Clarendon, 1987); Giovanni Andrea Cornia, Social Funds in Stabilization and Adjustment Programmes: A Critique, *Development and Change*, Vol.32 (2001); James Raymond Vreeland, *The IMF and Economic Development* (Cambridge:

Nevertheless, the consensus pays little attention to the social dimension of economic development. The underlying rationales are two-fold: economic growth resolve poverty and income inequality; and social policy such as redistribution taxes can be harmful to economic efficiency. As Michel Camdessus said, "Reducing poverty depends on expanding employment, particularly among the less skilled. And this, in turn, requires an adaptable labor market that encourages mobility and keeps labor costs in line with labor productivity, as well as sustained efforts to improve workers' skills." [638]

In East Asian developing countries, labour / social policy were subordinated (and often sacrificed) to economic / industrial objectives. [639] In the name of economic development and industrialisation, the governments repressed trade union movement and wage increases. In return, it imposed on strict regulations on lay-offs in order to guarantee job security. Over the past decades, this system was successful because rapid economic growth kept unemployment rate low. In 1996, for example, unemployment rate in the crisis affected countries ranged from 1.5 to 2.8 percent. In this respect, the East Asian social welfare regime is called a productivist model. [640]

The dominance of the productivist model can be explained by three factors. First, income distribution was generally egalitarian although economic growth increased gradually inequality. The average Gini Coefficient of the crisis countries was lower than that of Latin American countries. [641] Second, the absence of strong social democratic / labour parties explains partly the underdevelopment of social safety nets. Except Korea, there were few remarkable labour movements in the region because authoritarian regimes repressed industrial

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Cambridge University Press, 2003) Despite this criticism, the IMF did not take social issues into serious consideration until recently. See Ke-young Chu and Sanjeev Gupta (eds.), *Social Safety Nets: Issues and Recent Experiences* (Washington DC: IMF, 1998); Sanjeev Gupta, Louis Dicks-Mireaux, Ritha Khemani, Calvin McDonald, and Marijn Verhoeven, *Social Issues in IMF-Supported Programs*, Occasional Paper No.191 (IMF, 2000)

[638] Michel Camdessus, Making Globalization Work for Workers, Address to the 24th Congress of the World Confederation of Labor (Bangkok: 2 December 1997)

[639] Frederic C Deyo, *Beneath the Miracle: Labor Subordination in the New Asian Industrialism* (Berkeley: University of California Press, 1989); Richard A. Higgott and Helen E. S. Nesadurai, Rethinking the Southeast Asian Development Model: Bringing Ethical and Governance Questions in, *ASEAN Economic Bulletin,* Vol.19, No.1 (April 2000)

[640] Ian Holliday, Productivist Welfare Capitalism: Social Policy in East Asia, *Political Studies*, Vol.48, No.4 (2000)

[641] ADB, *Asian Development Outlook* (2000), p.118.

actions.[642] Finally, informal safety nets such as family-based assistances supplemented formal safety nets. In some cases, large conglomerates provided social and health benefits to their employees.[643]

The financial crisis exposed weaknesses of the productivist model.[644] First, the downfall of currency value increased the price of importing goods such as food and fuel. This price inflation led to a low standard of living. Second, economic recessions froze labour markets and put downward pressure on real earnings. In particular, vulnerable groups including women, children, disabled, old age, ethnic minority and foreign workers were not fully protected from severe poverty. Finally, many households were victims of the collapse of asset and stock markets. This meant a massive reduction in the real value of household saving. Furthermore, high interest rates limited their access to credit.[645]

The remainder of this chapter is structured into three sections. In the next two sections, I examine labour market reform and social policy in Korea and Malaysia respectively. The focus of each section is on how the Washington consensus and the post-Washington consensus shaped labour market reform and social policy. Although the two policies are closely related, I discuss them separately for analytical reasons. The final section assesses the influence of the international financial institutions, policy makers, big business and political institutions on the political power of Washington consensus.

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[642] Nancy Birdsall and Stephan Haggard, After the Crisis: The Social Contract and the Middle Class in East Asia, in Ethan B. Kapstein, and Branko Milanovich (eds.), *When Markets Fail: Social Policy and Economic Reform* (New York: Russell Sage Foundation, 2002)
[643] Shahid Yusuf, *Innovative East Asia: The Future of Growth* (World Bank, 2003), pp.36-38.
[644] James C. Knowles, Ernesto M. Pernia and Mary Racelis, Social Consequences of the Financial Crisis in Asia, Economic Staff Paper No.60 (ADB, 1999); Emanuele Baldacci, Luiz R. De Mello Jr. and Maria G. Inchauste Comboni, Financial Crises, Poverty, and Income Distribution, Working Paper No. 02/4 (IMF, 2002) Cf. Raymond K.H. Chan, The Sustainability of the Asian Welfare System after the Financial Crisis, *Asian Journal of Social Science*, Vol.31, No.2 (2003)
[645] For a general overview of social issue in East Asia, see Yun-Peng Chu and Hal Hill, *The Social Impact of the Asian Financial Crisis* (Cheltenham: Edward Elgar, 2001); Sanjeev Gupta, Calvin McDonald, Christian Schiller, Marijn Verhoeven, Z. Bogetic and Gerd Schwartz, Mitigating the Social Costs of the Economic Crisis and the Reform Programs in Asia, Papers on Policy Analysis and Assessments No.98/7 (IMF, 1998); Eddy Lee, *The Asian Financial Crisis: The Challenge for Social Policy* (ILO, 1998); Anne Booth, The Social Impact of the Asian Crisis: What Do We Know Two Years On?, *Asian-Pacific Economic Literature*, Vol.13, No.2 (November 1999)

2. Korea

1) Labour Market Reform

From the early 1990s, labour market reform emerged as one of the most significant issues in economic policy. Big business argued that high wages and costs of industrial actions reduced their competitiveness in exporting markers. Foreign investors also complained that strong trade unions were one of the major obstacles to invest in the economy. In fact, some labour-intensive industries moved product lines to Southeast Asian and China to reduce their labour costs. [646]

Against this background, policy makers had a fundamental reassessment of industrial relations. To reform the labour sector, the government proposed a draft for new labour law in December 1996. [647] Although they were approved in the National Assembly, the bills did not take effect due to nation-wide backlash against them. First, there was a procedural flaw in the way of legislation because the New Korea Party (NKP: the ruling party) passed them secretly in the absence of opposition parties: the National Congress for New Politics (NCNP) and the United Liberal Democrats (ULD). Second, the bills legalised lay-off for managerial reasons, which trade unions opposed thoroughly. For the first time, two rival trade unions – the Federation of Korean Trade Unions (FKTU) and the Korean Confederation of Trade Unions (KCTU) – co-operated to organise a two-day general strike in January 1997.

To ease the hostile response, the government suggested a new proposal that contained two important concessions to the unions: immediate legalisation of the KCTU and a two-year postponement of lay-offs for managerial reasons. At the same time, the government made some concessions for employers: 1) more than one union at a given workplace would not be permitted until 2002; 2) companies no longer have to pay striking workers; and 3) from 2001,

[646] Hagen Koo, The Dilemmas of Empowered Labor in Korea: Korean Workers in the Face of Global Capitalism, *Asian Survey*, Vol.40, No.2 (April / March 2000); Jonhgseok Bae, Dongwon Kimand Changwon Lee, Globalization and Labor Rights, in Young-Ki Choi, Social Dialogue and Economic Recovery in Korea, in Wonduck Lee (ed.), *Labor in Korea* (KLI, 2002)
[647] Se-il Park, *Managing Labor Reform Lessons from the Korean Experience, 1996-97* (KDI, 2000)

full-time union officials will not be paid. Although the new bills were passed in March 1997, these even-handed concessions satisfied neither employers nor employees. [648]

This fierce reaction from the trade unions could not be understood without considering the history of trade union movements. Until the late 1980s, the government repressed trade unions. Only one nationwide umbrella organisation (the FKTU) was allowed and its political activities were completely forbidden. Many chaebol companies also obstructed their employees from organising into trade unions. In particular, Samsung was notorious for prohibiting trade unions in its all subsidiaries. Democratisation in the mid-1980s made the repressive system unsustainable. [649] In many chaebol companies, trade unions were organised and there were remarkable labour movements in the late 1980s. By political and economic struggles, trade unions achieved big increases in wages and allowances.

In return for these suppressive policies, strict regulations were maintained to protect job security. Among others, lay-off was strictly prohibited by the Labor Standards Act without "right causes". However, the real effect of the regulations was not significant because demand always exceeded supply in the labour markets. In this circumstance, lifetime employment became a social norm. [650]

Against this background, the outbreak of the financial crisis changed the balance of power between big business and organised labour. There were two approaches to reform the labour sector. On the one hand, neoliberal economists in the Korea Development Institute (KDI) and chaebol's research institutes including the Korea Economic Research Institute (KERI) preferred an Anglo-American model that give priority to labour flexibility. On the other hand,

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[648] Yong Cheol Kim, Industrial Reform and the Labor Backlash in South Korea, *Asian Survey*, Vol.38, No. 12 (December 1998)

[649] For an overview, see Byung-Kook Kim and Hyun-Chin Lim, Labor against Itself: Structural Dilemmas of State Monism, in Larry Diamond and Byungkook Kim (eds.), *Consolidating Democracy in South Korea* (Boulder: Lynne Rienner, 2000); Paul G. Buchanan and Kate Nicholls, Labour Politics and Democratic Transition in South Korea and Taiwan, *Government and Opposition*, Vol.38, No.2 (April 2003)

[650] Ju Ho Lee and Dae Il Kim, Labor Market Developments and Reforms in Korea, Working Paper, No.9703 (KID, 1997)

economists in the Korea Labor Institute (KLI) were interested in European models – particularly Dutch – that stresses on social stability. [651]

In the wake of the crisis, the Anglo-American approach prevailed over the European one. Neoliberal economists argued that market-oriented labour policy enabled the US and the US to achieve low unemployment and high labour productivity. [652] This argument coincided with IMF's policy recommendation that gave top priority to labour market flexibility.

It is worthwhile to note that President Kim Dae Jung relatively well-placed to pursue this reform agenda. First, his cabinets were not tainted by the failures of the previous Kim Young Sam government. [653] Second, his pro-labour stance would be an advantage in persuading the trade unions to accept labour market flexibility. [654]

The government revised the Labour Standards Act on 14 February 1998. As Table 7-1 presents, the most important thing in the New Act was the legalisation of lay-off. It is equally significant that temporary worker agencies were also allowed to operate and regulations on private job placement agencies were lessened.

[Table 7-1] Employment Policies [655]

Topic	Measures
Increase the flexibility of employment	• Employment flexibility increased under new law • Temporary worker agencies allowed since July for 26 occupations
Taxes and transfers	• Coverage of Employment Insurance System has been extended to 70 percent of employees, while the duration of benefits has been lengthened • Training programmes and public works jobs have also been used to provide income support

[651] For the debate, see KLI (ed.), *Models of Industrial Relation: An International Comparison* (KLI, 2003). This book is written in Korean. For the model, Visser, Jelle and Hemerijck, Anton, *A Dutch Miracle: Job Growth, Welfare Reform and Corporatism in the Netherlands* (Amsterdam: Amsterdam University Press, 1997)
[652] For example, KDI, *Djnomics: A New Foundation for the Korean Economy* (KDI, 1999), p.115. However, its evidence is controversial. See Stephen Nickell, Unemployment and Labor Market Rigidities: Europe versus North America, *Journal of Economic Perspectives*, Vol.11, No.3 (Summer 1997)
[653] David I. Steinberg, Korea: Triumph amid Turmoil, *Journal of Democracy* Vol.9, No.2 (1998)
[654] Chung-in Moon and Song-min Kim, Democracy and Economic Performance in South Korea, in Larry Diamond and Byungkook Kim (eds.), *Consolidating Democracy in South Korea* (Boulder: Lynne Rienner, 2000)
[655] OECD, *Economic Surveys: Korea* (1999), p.152.

	• Livelihood protection has been expanded
Active labour market policies	• Deregulation of private-sector job placement agencies • The Public Employment Service has been expanded and integrated with other services to make it a "one-stop shop" • The number of unemployment being trained at public expense has increased from 42,000 to 340,000.
Enhance product market competition	• Almost half of the 11,000 existing regulations have been eliminated by the new administration • The Import Diversifications Programme was abolished at the end of June 1999

In return for the lay-off legalisation, trade unions demanded that employers share the economic hardship. In a meeting with the personnel officers of the 30 largest chaebols, Labour Minister Lee Ki Ho threatened that the government would impose a penalty on companies that abused the lay-off policy. However, this was nothing more than a lip service. As Table 7-2 shows, the number of dismissal increased from January and July 1998. However, it should be noted that these figures might not reflect the whole effect of lay-off because some companies preferred a so-called honorary retirement to lay-off to avoid trade unions' protest.

[Table 7-2] Unemployment by Reason [656]

	January 98	July 98	July 99	July 00
No. of Unemployed	669 (100.0)	1,381 (100.0)	1,209 (100.0)	631 (100.0)
Personal reason	179 (26.8)	289 (20.9)	335 (32.6)	285 (45.2)
Closing of business	123 (18.4)	173 (12.5)	65 (6.3)	36 (5.7)
Dismissal	97 (14.5)	234 (16.9)	123 (12.0)	38 (6.0)
Business deterioration / end of contract	199 (29.7)	602 (43.6)	306 (29.7)	175 (27.7)
Other reasons	71 (10.6)	83 (6.0)	199 (19.3)	98 (15.5)

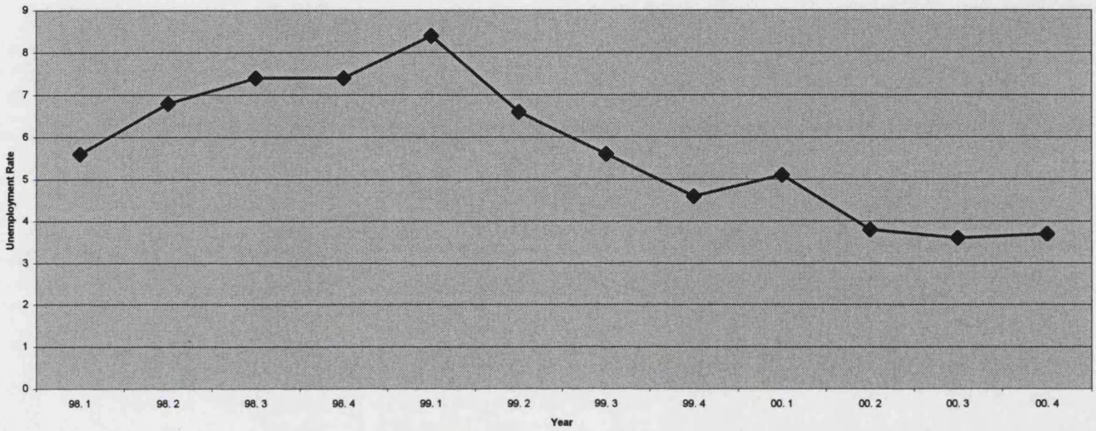
* Unit: thousands, %

In addition to the legalisation of lay-off, the default of small- and medium-sized firms aggravated the unemployment problem. As result, the number of dismissal increased more than times in the first half of 1998. Against this background, the IMF was dubbed the

656 Jai-Joon Hur, Economic Crisis, Income Support, and Employment Generating Programs: Korea's Experience, *Quarterly Journal of Labor Policy*, Vol.2, No.4 (2002), p.42.

abbreviation for "I'M Fired." As Figure 7-1 shows, the yearly average unemployment rate soared to 6.8 percent in 1998. This figure is the highest ever since 1966. [657]

[Figure 7-1] Unemployment Trend [658]



Source: Bank of Korea, Quarterly Bulletin (various issues)

Trade unions accused the government of pretending to force the chaebol to minimise lay-offs. Two umbrella organisations – the FKTU and KCTU – co-operated in calling for nationwide industrial action. Among others, the case of Hyundai Motors is worthy of note. First, the company was the largest company to declare massive lay-offs. Second, its union was one of the most militant unions. Thus, the case was a first litmus test for the new industrial relations. After the employers announced 1,500 redundancies in June 1998, the workers occupied the plant and built huge barricades alongside it in the next month. The government deployed riot police to disperse them. In August, a last-minute mediation by the NCNP (the ruling party) MPs managed to prevent violent conflict. The company and the unions agreed to reduce the number of compulsory redundancies from 1,500 to 277. Instead, 1,261 took

[657] The annual aggregate unemployment rate reduced from 8.1% in 1963 to 2.0% in 1996. The trend was reversed briefly during the 1979–1980 recession caused by the second oil shock and the political unrest after the assignation of President Park Jung Hee. See Yongsung Chang, Jaeryang Nam and Changyong Rhee, Trends in Unemployment Rates in Korea: A Search-matching Model Interpretation, *Journal of the Japanese and International Economies*, Vol.18, No.2 (June 2004)

[658] It should be noted that, unlike the OECD standards, these statistics do not include those who are self-employed and whose business has gone bankrupt. Thus, the real rate might be higher.

voluntary unpaid leave on condition that the company would re-hire them in 18 months' time. All in all, this settlement was an uncomfortable compromise, not a victory for either employers or workers: on the one hand, its significance lay in the fact that it was the first case of lay-offs for managerial reasons; on the other hand, the union achieved some concessions from the government as well as employers. However, this was not repeated in other cases. [659]

Mounting discontent over labour reform led policy makers to rethink the Anglo-American approach. To manage socio-political backlash, they took into consideration the European experience of social pact more seriously. Against this background, Kim Dae Jung proposed a Tripartite Commission on 26 December 1997. [660] To develop a social consensus of economic reform, it consisted of trade unions (the FKTU and the KCTU), the chaebols' umbrella organisations (the Federation of Korean Industries and the Korean Employers Federation), and government ministries and representatives of four major political parties.

At first, the chaebol suspected that the Commission was a vehicle to realise Kim's pro-labour policy because trade unions' support helped him to win the presidential election. The largest trade union (the FKTU) formed a policy coalition with the NCNP even though political activities by trade unions were forbidden. For the first time in its history, the FKTU officially supported the opposition leader. Ironically, however, this strong support led him to persuade them to accept labour market reform.

Nevertheless, it was not easy to persuade trade unions to accept labour market reform because they suspected that neoliberal labour policies would be favourable for employers rather than employees. For this reason, they initiated public campaigns against neoliberalism. [661] Under such circumstances, Michel Camdessus met with leaders of the FKTU and the

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659 Michael Neary, Hyundai Motors 1998-1999: The Anatomy of a Strike, *Capital & Class,* No.70 (2000)

660 This was inspired by the Dutch model.

661 Some scholars warned of the plausible outcomes of neoliberal policies. See Byung-young Ahn, Kim Dae Jung Jeongbuga Ppajilsu Inneun Hamjeong [Beware the Trap of Neoliberalism], *Shindonga* (April 1999); Yeonho Lee, DJ Gaehyeokui Sinjayuuijeog Hangye [Limitations of Kim Dae Jung's Neoliberal Economic Reform], *Sasang* (Summer 2001); Martin Hart-Landsberg and Paul B. Urkett, Economic Crisis and Restructuring in South Korea, Beyond the Free Market-Statist Debate, *Critical Asian Studies,* Vol.33, No.3 (2001); Hyun-chin Lim and Joon Han, The Social and Political Impact of Economic Crisis in South Korea: A Comparative Note, *Asian Journal of Social Science*, Vol.31, No.2 (2003)

KCTU on Kim Dae Jung's request.[662] However, his attempt was fruitless because they were not convinced that the neoliberal reform would undermine their rights and interests.

Through concessions from each of the social partners, they made the 'Social Agreement for Overcoming the Economic Crisis' on 6 February.[663] In return for the legalisation of lay-offs and temporary workers, some concessions were given to trade unions. The election law revision bill in April 1998 lifted the restrictions on trade unions' political activities. Civil servants were allowed to form workplace associations from 1999, and teachers' unions were legalised in July 1999. In addition, the Labour Standards Law extended coverage to those who work for a company with four or fewer employees. More significantly, the militant KCTU, established in November 1995, was legalised. A minimum wage and industrial accident insurance were extended to all workplaces with more than five employees. Finally, the government promised not to use violence in response to industrial action. These concessions were not enough to meet their demand of the trade unions because they believed that the lay-off legalisation and workers' dispatch system could not be compensated by any concessions.

Many concessions were finalised before the local election scheduled on 4 June 1998. To secure a national mandate for reform, the election was crucial for the incumbent ruling coalition. Although President Kim Dae Jung enjoyed a high rate of job approval, his party was in alliance with foe-turned-ally Kim Jong Phil's party to form a workable majority in the National Assembly. In the election, his ruling coalition won 10 out of 16 governorships and mayoralties. This good result encouraged the administration to push ahead with its reform agenda.[664]

The policy shift was reflected in the activities of the Tripartite Commission. In the second-term, beginning on 13 June 1998, the Commission focused on the strengthening of the social safety net. To this end, unemployment insurance coverage and job training, and increasing

[662] IMF, IMF Survey (26 January 1998), p.18.
[663] The Commission was granted legal status by a presidential decree on 28 March 1998. To execute the Tripartite Accord more efficiently, several committees and subcommittees were formed. On 1 July 1998, the Committee for Financial Industry Development and an Ad Hoc Committee for Controlling Illegal Labour Practices were set up. See Young-Ki Choi, Social Dialogue and Economic Recovery in Korea, in Wonduck Lee (ed.), *Labor in Korea* (KLI, 2002)
[664] *Far Eastern Economic Review*, A Vote for Reform (18 June 1998)

welfare benefits to the unemployed were expanded. For example, employment insurance coverage was extended to more than two-thirds of employees. For those who are not eligible for such benefits, a large-scale public works programme was established, and opportunities for vocational training were greatly increased. In 1998, about 444,000 public works jobs (equivalent to 1.2 percent of the working-age population) were created. [665]

During the second-term sessions, two labour organisations boycotted the Commission, accusing the government and the employers of forcing workers to bear unilateral sacrifices. In February 1999, the militant KCTU withdrew itself from the Commission, demanding direct negotiations with the government on many issues: suspending economic restructuring, reducing working hours and replacing enterprise-level with industrial-level bargaining. Two months later, the moderate FKTU also decided not to participate in the Commission. Their demands included an end of lay-offs, the introduction of a job sharing system and a legal guarantee allowing unions to participate in management. In response, representatives of the chaebol also stepped down from the Commission, accusing the government of sidelining the chaebol in revising labour policies on compensation for full-time unionised workers and making cuts in legal work hours in favour of trade unions' demands.

After the return of FKTU in September 1999, the Commission started its third term. The power of the commission was strengthened by the Act on Establishment and Operation of the Tripartite Commission enacted in May 1999. Unlike its first and second terms, the government was obligated to consult the Committee before announcing major economic policies that would affect workers' job security and working conditions. Nevertheless, their dissatisfaction with the government led the FKTU to break with the policy alliance with the NCNP in December 1999. This was a serious political setback for the ruling party.

[665] For details, see Appendix 7-1.

2) Productive Welfare

Labour market reform was not only the adverse impact of the financial crisis. Economic recession in the post-crisis brought a vicious circle to the economy: rapid appreciation of the currency, rising inflation and declining real income. Pro-cyclical policies worsened – not relieved – the vicious circle, which gave rise to many social problems. [666]

In 1998, for example, urban household income fell 8 percent in real terms in the year. This was the first decline since 1970. [667] Income distribution also worsened. As Table 7-3 demonstrates, Gini coefficient – zero implies perfect income equality and 1 means perfect inequality – rose to 0.32 in 1998, up from 0.28 in 1997. This was the highest level since the government recorded the index in 1979. It means that mid- and low-income earners suffered more than high-income earners. [668]

[Table 7-3] Changes in the Income Distribution [669]

	97	98	99/ H1	99/ H2
Upper 20 percent	37.2	39.8	40.4	40.0
Lower 20	8.3	7.4	7.3	7.4
Upper 20 percent / Lower 20 percent	4.49	5.38	5.54	5.41
Gini Co efficient	0.28	0.32	0.32	0.31

Compared with the other crisis-affected countries, Korea was believed to have a relatively better social welfare system. [670] Besides a livelihood security system, four social insurance systems including the National Pension, Medical insurance, Employment Insurance and Industrial Accident Compensation Insurance were in place. However, these were not sufficient

[666] Hyungpyo Moon, Hyehoon Lee and Gyeongjoon Yoo, *Economic Crisis and its Social Consequences* (KDI, 1999); Joung-Woo Lee, Social Impact of the Crisis, in Duck-Koo Chung and Barry Eichengreen (eds.), *The Korean Economy beyond the Crisis* (Cheltenham: Edward Elgar, 2004)
[667] OECD, *Economic Surveys: Korea* (1999), pp.141-42.
[668] *Ibid*, p.150.
[669] Drawn from Ajai Chopra, Kenneth H. Kang, Meral Karasulu, Hong Liang, and Henry P. Ma, From Crisis to Recovery in Korea: Strategy, Achievements, and Lessons, Working Paper No.01/154 (IMF, 2001), p.30.
[670] For an overview of the welfare system, see Huck Ju Kwon, *The Welfare State in Korea: The Politics of Legitimation* (New York: St. Martin's, 1999); H. K. Lee, Globalization and the Emerging Welfare State: the Experience of South Korea, *International Journal of Social Welfare*, Vol.8, No.1 (January 1999)

to deal with the social consequences of the crisis. For example, the Employment Insurance System (EIS) – introduced in July 1995 – did not cover two-thirds of employees, because it was confined only to workers in firms with more than thirty employees. Moreover, the duration of benefits was very short: just one month for workers under 25, and up to seven months for workers over 50. Worse, benefits were not available to those who voluntarily left their jobs. "The gap between state-provided welfare and actually-received welfare was filled by a sort of neo- Confucian family politics." [671]

To address the problems, many measures were undertaken. As Table 7-4 shows, the EIS was extended to all companies regardless of their size in 1998. In addition, the National Pension broadened its coverage from firms with 10 or more employees to all firms in April 1999. To provide living expenses for poverty-level households, the National Basic Livelihood Security Law was enacted in August 1999.

[Table 7-4] Extension of EIS Coverage [672]

Date	Unemployment insurance	Job retention & occupational training
July 1995	30 employees	70 employees
January 1998	10 employees	50 employees
March 1998	5 employees	50 employees
July 1998	5 employees	5 employees
October 1998	1 employee	1 employee

In April 1999, a supplementary budget was arranged to finance the policy. The government raised subsidies to firms that kept workers. For large companies, this subsidy was the equivalent of just under 70% of such workers' salaries, while for smaller companies it was equivalent to 75%. At the same time, state-own companies such as Korea Telecom and Korea Electric Power Corporation invested in infrastructure projects to create jobs.

These efforts were not very effective in reducing the inequality in income distribution. Social economic indices show that the lack of social safety nets made the poor, less educated,

671 Kyung-Sup Chang, Compressed Modernity and Its Discontent: South Korean Society in Transition, *Economy and Society*, Vol.28, No.1 (February 1999), p.46.
672 Hur (2002), p.52.

female and young workers more vulnerable. [673] Considering its good record of relatively even distribution of income, this deterioration posed a serious problem in terms of destabilising social cohesion.

Against this background, President Kim Dae Jung proposed a 'productive welfare' policy in August 1999. [674] As Table 7-5 shows, the policy had three main elements: the improvement of the income distribution system by ensuring fair market discipline, such as equal job opportunities and fair compensation; the adoption of a redistribution programme to help those who lose in the market competition to maintain a basic quality of life; and support for the rehabilitation of the beneficiaries of this redistribution through job-creation and vocational training. [675]

[Table 7-5] Productive Welfare [676]

Target of the measures	Major contents
Reinforcement of the social insurance system	• Protection for all workers from unemployment • Protection for all workers from industrial accidents
Job creation and job securing	• Job creation and employment maintenance • Preventing unemployment and assisting prompt job placement • Job training in accordance with industrial demand • Offering fair opportunities for job training and expanding voluntary job training
Enhancement of the quality of life through the expansion of basic welfare infrastructure	• Legislation of the Basic Welfare of Workers Law • Shortening working hours and enhancing working conditions • Overhauling protection measures for the low-income class
Promotion of work-participation welfare and realization of industrial democracy	• Developing various worker-participation programs • Co-operation of Labor/ Corporate/ Government for job securing and less unemployment • Building a social partnership through the Tripartite Commission

[673] Jong-Wha Lee and Changyong Rhee, Social Impacts of the Asian Crisis: Policy Challenges and Lessons, UN Human Development Programme, Occasional Paper No. 33 (1999)
[674] For details, see Tai-youn Hwang, Saengsanjeok Bokjireul Wihan Wonchig [Economic-Financial Principles of Korea's 'Productive Welfare'], *Hankook Ilbo* (5 July 1999); Young-Hwa Kim, Productive Welfare: Korea's Third Way?, *International Journal of Social Welfare*, Vol.12, No.1 (2003)
[675] MOFE, *IMF 2 Nyeon, Gujo Gahyeok Noryeokgwa Geu Seonggwa* [Structural Reform since the IMF Crisis: Efforts and Achievements] (December 1999), p.40.
[676] Kyeong-won Kim (ed.), *Three Years after the IMF Bailout: A Review of the Korean Economy's Transformation since 1998* (Seoul: Samsung Economic Research Institute, 2001), pp.124-25.

The initiative did not bring direct results. Its clumsy definition of the role of government notwithstanding, budgetary tightening constrained the materialisation of the whole agenda. As the economy bounced back, the need for the policy dwindled. Thus the policy was regarded as a political tactic to ease labour discontent. [677]

In conclusion, the Washington consensus had a strong impact on labour market policy. IMF's inclusion of labour reform in its conditionality clearly strengthened the political power of the consensus. In particular, its emphasis on labour market flexibility helped the government to legalise lay-offs and temporary worker agencies in spite of ferocious resistance from trade unions. Chaebol's support for the reform also increased its political power. Before the crisis, the chaebol press the government to deregulate the labour sector.

Nonetheless, it is hard to say that labour reform was entirely neoliberal. As the Tripartite Commission shows, policy makers introduced European models of industrial relations. One reason is that the social consequences of the crisis led them to rethink the IMF-style policies. To ease socio-political backlash against neoliberal labour reform, the government established the Tripartite Commission. This gave rise to the productive welfare policy that shifted from neoliberalism to social democracy or social corporatism. [678]

The policy shift was attributable, in part, to Kim Dae Jung's political weaknesses. First, he could not disregard trade unions' demands because the FKTU officially endorsed him in the presidential election. Second, his party did not have a majority in the National Assembly. Thus there were electoral constraints on economic policy. The productive welfare policy was announced six months before the general election. [679]

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[677] Jae Jin Yang, The Rise of the Korean Welfare State amid Economic Crisis, 1997-99: Implications of the Globalisation Debate, *Development Policy Review*, Vol.18, No.3 (September 2000); Soonman Kwon, Economic Crisis and Social Policy Reform in Korea, *International Journal of Social Welfare*, Vol.10, No.2 (2001) However, there is a dissent that the crisis did not play a critical role in expanding social safety nets; it contributed to accelerating the implementation of the existing roadmap. See Huck-Ju Kwon, Advocacy Coalitions and the Politics of Welfare in Korea after the Economic Crisis, *Policy and Politics*, Vol.31, No.1 (January 2003)

[678] Tat Yan Kong, Neo-liberalization and Incorporation in Advanced Newly Industrialized Countries: A View from South Korea, *Political Studies*, Vol.52, No.1 (2004)

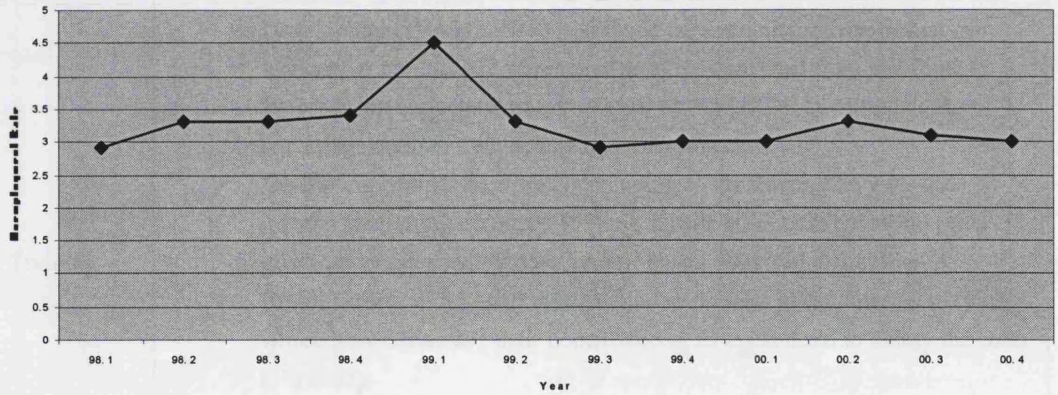
[679] Tat Yan Kong, Power Alternation in South Korea, *Government and Opposition*, Vol.35, No.3 (2000)

3. Malaysia

1. Employment Policy

The contraction of the economy led to a surge in the unemployment rate. As Figure 7-2 shows, it reached to 4.5 percent in the first quarter of 1999 from 2.5 percent in 1996 and 2.6 percent in 1997. The rise of unemployment was unprecedented in recent history. Because of labour shortages in export-oriented and agricultural industries, Malaysia was a labour import country before the crisis.

[Figure 7-2] Unemployment Trend [680]



Source: Ministry of Treasury, Annual Report (various issues)

Table 7-6 presents various policies that were employed to address the problem. Financial and tax incentives were provided to companies to encourage investment and job training programmes that helped unskilled workers. At the same time, regulations on labour markets were relaxed to increase mobility in labour markets.

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680 It should be noted that the official statistics did not reflect the reality, because it did not include foreign and illegal workers. This omission was considerable particularly in the construction sector where approximately one fourths of the workforce was foreign labour and many of them did not hold work permits. See Ishak Shari, The 1997-98 Financial Crisis in Malaysia and its Social Impact: Some Lessons, in Chris Nyland, Wendy Smith, Russell Smyth and Antonia Marika Vicziany (eds.), *Malaysian Business in the New Era* (Cheltenham: Edward Elgar, 2001)

[Table 7-6] Employment Policy

Objective	Measures
Increasing employment	• Encouraging the corporate sector to increase investment in import-substituting and export-oriented industries, thereby generating additional employment opportunities • Setting up a graduate entrepreneur scheme to provide basic training to develop entrepreneurs among unemployed graduates. This scheme provides attachment in large corporations and loans to trainees to set up businesses
Institutional reform	• Amendment of the Employment Act 1955, to encourage employers to institute part-time employment or flexible working hours and introducing guidelines on retrenchment which included pay cuts and reduction of working hours/days and shifts as alternatives to retrenchment • Strengthening the labour market mechanism to facilitate mobility through the setting up of an electronic labour exchange for the registration, monitoring and placement of workers
Training	• Provision of a special fund of RM5.0 million under the Human Resource Development Fund (HRDF) to finance the retraining of retrenched workers. A total of 572 retrenched workers benefited from this fund • Re-crediting unclaimed training funds by the HRDF to companies to encourage them to train and retrain their workers • Exempting companies from contributing to the training levy for six months, beginning February 1998. A further six-month exemption was given to companies in industries still facing financial difficulties • Establishment of a RM40 million fund to provide initial funding to firms which have exhausted their contributions, to assist them to defray the costs of training • Expansion of existing and establishment of new skill training institutes and polytechnics • Increasing accessibility to skill training through the setting up of the Skill Training Loan Fund of RM500 million

Source: Economic Planning Unit, White Paper: Status of the Malaysian Economy (EPU, 2000)

It should be noted that Malaysia's labour market policy was employer-friendly before the crisis. [681] For example, the country did not ratified ILO Convention that protects freedom of association. The Promotion of Investments Act 1986 made negotiations of working conditions more than the minimum standards illegal in pioneer industries. To attract FDI, increase of

[681] There was little change in Malaysia's business-friendly policy. This is contrasted with other Asian countries. See Stephen J. Frenkel and David Peetz, Globalization and Industrial Relations in East Asia: A Three-Country Comparison, *Industrial Relations*, Vol. 37, No. 3 (July 1998)

wages and benefits in exported-oriented industries were repressed by the government. As a result, tread unions had very little power to challenge government policies. [682]

Against this background, it is hardly surprising that there was no remarkable resistance to the banking reform from the trade unions. [683] Even the National Union of Banking Employees (NUBE) did not protest against it, which resulted in laying off more than 10 percent of employees in the sector. Only compensation was Voluntary Separation Schemes (VSS) and the ban on the retrenchment of employees for two years after the merger exercise. [684]

There is another reason that made industrial relations stable. The repatriation of foreign workers contributed to relieving the political burden of the government to push the policy. After the crisis, regulations on foreign workers – particularly unskilled and semi-skilled – were tightened. Many of immigrants whose formal contracts were expired and who were made redundant were repatriated. Moreover, many illegal immigrants voluntarily left the country. In the early stage of the crisis, for example, more than 500,000 Indonesian workers forced to return to their country. Most of them were employed in the construction sector that suffered from the withdrawal or expiration of government contracts.

The repatriation of foreign labour was effective in reducing Malays unemployment. Malaysia was among labour importing countries prior to the crisis. It was estimated that there were 700,000 (legal) and 500,000 ~ 1,000,000 (illegal) foreign workers in Peninsular Malaysia. Most of them came from Indonesia (around 70 percent), Philippines and Bangladesh. Their share of the total work force was 10 ~ 15 percent. [685]

This kind of retrenchment of foreign workers was not criticised by Malaysian workers in many ways. First, the NEP guaranteed the privileged status of Malays in labour markets. Second, there was a perception that foreign workers increased social crimes. Finally some

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682 Patricia Todd and David Peetz, Malaysian Industrial Relations at Century's Turn: Vision 2020 or A Spectre of The Past?, *International Journal of Human Resource Management*, Vol. 12, No.8 (December 2001)

683 *Malaysian Business*, The People Factor (16 February 2000); Lay-off Poser (16 February 2001)

684 *Sunday Times*, 'No Layoffs' for Two Years After Bank Mergers (27 February 2000)

685 Chris Manning, Structural Change, Economic Crisis and International Labour Migration in East Asia, *World Economy*, Vol.25, No.3 (March 2002), p.365.

foreign workers were illegal immigrants and thus were not under proper legal protection. [686] From late 1999 when economic recovery was well under way, the demand for foreign workers rose, especially in the manufacturing sector. Thus the government relaxed the regulations on work permits. [687]

2) Social Policy for Bumiputera

Malaysia did not have well-developed social safety nets to mitigate the social costs of economic reform because the basic strategy was 'redistribution through growth'. [688] The need for social protection was recognised by policy makers at the initial stage of crisis management. Many companies forced their employees to accept pay cuts to avoid redundancy. The price increase of key commodities such as foods also had a negative impact on standard of living. And the deterioration of public services such as education and heath care adversely affected the livelihood of the poor. In the National Economic Recovery Plan, the social agenda was one of the top priorities. However, the spending on poverty reduction, unemployment, health and education were limited by tight fiscal policy until the second half of 1998.

One of the most important social safety nets is the Employees' Provident Fund (EPF) established in 1951. The EPF as a publicly managed mandatory savings scheme provides the main source of retirement income. It is compulsory for private sector employees aged 16 and over earning up to a maximum of RM 2000 a month to join the EPF. Public sector workers are covered by the EPF in the first 10 years of public sector employment. However, it covers

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[686] Bridget Welsh, Malaysia and Globalization: Contradictory Currents, *Asian Perspective*, Vol. 23, No.4 (1999), pp.279-30.

[687] Azizah Kassim, Malaysia, in OECD, *Migration and the Labour Market in Asia: Recent Trends and Policies* (OECD, 2002) In Korea, foreign workers were not protected by laws. See Timothy C. Lim, The Fight For Equal Rights: The Power of Foreign Workers in South Korea, *Alternatives*, Vol.24, No.3 (July / September 1999)

[688] Ishak Shari, Globalisation and Economic Insecurity: A Need for a New Social Policy in Malaysia, *Asian Journal of Social Science*, Vol.31, No.2 (2003)

about half of the work force, because agricultural workers (approximately on third of the work force) and casual workers are excluded from the scheme. [689]

[Table 7-7] Social Safety Nets

Objective	Measures
Poverty reduction	• Retaining the original 1998 budget allocation for the Development Programme for the Hardcore Poor (PPRT) • Making smaller cuts to the 1998 budgets of ministries involved in the provision of social programmes, rural development and agriculture programmes which are mainly targeted for the poor and low-income group as well as ensuring that the budget for 1999 is sufficient to meet programme objectives • Allocating an additional RM100 million to *Amanah Ikhtiar Malaysia* for the provision of interest-free loans to more hardcore poor • Allocating RM200 million for a new micro-credit scheme to provide assistance to petty traders and hawkers in urban areas.
Bumiputera ownership	• Allowing individual Bumiputera facing difficulties as a result of the financial crisis and economic slowdown to sell their shares or part of their interests to non-Bumiputera or foreign investors. However, other Bumiputera or Bumiputera agencies and institutions will be given the first option to purchase them • Encouraging Bumiputera agencies and institutions to evaluate and consolidate their investment as well as develop and maintain a more selective portfolio of investment, particularly in more strategic industries and viable companies • Providing necessary assistance to strategic companies, including companies controlled by Bumiputera that were well-managed and profitable before the economic downturn • Encouraging Bumiputera investors and entrepreneurs to participate and invest in companies established by foreigners to ensure that Bumiputera also benefit from FDI. At the same time, foreign investors will be persuaded to accept Bumiputera partners and transfer knowledge and technology to them.
Education	• Increasing the allocation for the National Higher Education Loan Fund to cater for more students and thus, facilitate their access to higher education in public and private institutions. • Providing loan for students from the low-income group, which covers tuition fees, books, subsistence and other allowances.

Source: Economic Planning Unit, White Paper: Status of the Malaysian Economy (EPU, 2000)

[689] Norma Mansor and Halimah Awang, The Role of Social Safety Nets in Malaysia: Trends and Prospects, in OECD (eds.), *Labour Migration and the Recent Financial Crisis in Asia* (OECD, 2000)

The EPF alone could not address the problems. As Table 7-7 presents, the government used various policy measures. Funds for poverty reduction were established and many education programmes were launched to unskilled job seekers.

Among others, support for bumiputera ownership reflected the legacy of the NEP. This policy was designed to deal with the unevenness of the impacts on different ethnic groups. Although the NEP's affirmative actions were effective in reducing the gap between bumiputera and non-bumiputera, most bumiputera in the rural areas lived under the poverty line. The financial crisis widened the gap by worsening income distribution. [690]

Bumiputera ownership had a political significance because it was a key foundation for political and economic stability. The pro-Bumiputera stance was enhanced by racial conflicts in Indonesia in 1998 that plunged the country into economic recession and political turmoil. These concerns had its origin in the NEP, because its primary objective was to achieve inter-racial harmony by equitable economic development. To this end, many preferential treatments were offered to Bumiputera at the expense of other ethnics (especially Chinese).

In sum, there is no clear influence of the Washington consensus. Before the financial crisis, the government introduced an employer-friendly policy to attract FDI and to promote bumiputera entrepreneurs. Thus there was no significant change in the policy in the post-crisis period.

Meanwhile, social safety nets were strengthened to help vulnerable groups. The focus of the policy was on bumiputera, most of whom lived in dire policy. When Anwar challenged his authority, Mahathir reinforced a pro-bumiputera social policy to consolidate his power base. This strategy enabled Mahathir to manage social turmoil after the dismissal of Anwar and to win the general elections in November 1999.

[690] Zainal Aznam Yusof, Income Distribution in Malaysia, in Colin Barlow (ed.), *Modern Malaysia in the Global Economy: Political and Social Change into The 21st Century* (Cheltenham: Edward Elgar, 2001)

4. Conclusion

This chapter have reviewed the development of labour market reform and social policy after the financial crisis. The cases of Korea and Malaysia have showed that the political power of the Washington consensus was not resilient. The main reason is that the consensus had not paid attention to the social dimension of economic policy and its influence was limited by political considerations. As economic recession deteriorated, the post-Washington consensus gradually gained political support from policy makers.

In Korea, the influence of the Washington consensus was robust just after the outbreak of the crisis. The IMF included labour market reform in its conditionality. In addition, the chaebol endorsed the policy very enthusiastically. Despite this, policy makers did not push the reform agenda because of political backlash against the legalisation of lay-off. Equally important, they recognised that social safety nets were not sufficient to cope with the adverse consequences of the radical change of labour markets.

It was the Tripartite Commission that led big business and organised labour to reach a social pact. The commission was based on a consensual (European) approach rather than a confrontational (Anglo-American) one. The adoption of the European approach means that the political power of the Washington consensus diminished.

In Malaysia, the government maintained a pro-employer stance to attract FDI in Malaysia. In the post-crisis era, there was no significant change in the policy stance. If any, the government encouraged the repatriation of foreign workers to protect Malay workers from unemployment. This policy was supported by the bumiputera business community as well as policy makers.

This pro-bumiputera stance was visible in social policy. The government gave top priority to the bumiputera community that were more vulnerable to the financial crisis than other ethnic communities. This policy preference is embedded in the NEP principles that are conflicted with the Washington consensus.

[Appendix 7-1] Korea: Accomplishments of the Tripartite Commission

(as of 31 December 1998) [691]

	Completed	In Progress	Remarks
	Transparency of management Consolidated financial statements Bigger voice to minor shareholders Some outside board members Cross-debt guarantees banned	Funding for venture and new businesses (414.2 billion won as of 12/'98)	
	Unemployment measures Expansion of unemployment fund Expansion of insurance Loans to the unemployed Payment guarantees for wage bonds	Studying ways to cut workdays to hire more workers	
Government Tasks	*Labour unions* Political activities allowed Teachers' union legalized Limited labour action allowed for civil servants	Cracking down illegal labour practices (886 business investigated)	
	Labour flexibility assured Lay-offs allowed Manpower outsourcing allowed	Revision of four insurance laws	
	Other Medical insurance unified National pension improved Imprisoned labour activists released	Including labour and management representatives in government commissions and councils	
71 cases	51 cases	20 cases	72% completed
	Strengthened accountability of controlling shareholders and management	Labour to exercise greater role in management	
Labour - Management Tasks	Planning departments of 30 conglomerates disbanded Top managers liable for company	Controlling shareholders to use personal wealth to pay off company debts	
	Laid-off workers must be hired first	Strategic alliances between big and small businesses Enhanced export competitiveness	
17 cases	2 cases	15 cases	12% completed

[691] Office of the President, Overcoming a National Crisis, The Republic of Korea Rises Up Again: A Year of Trials and Challenges for President Kim Dae Jung (February 1999)

National Assembly Tasks	Held public hearings on the economy	Political parties to share the pain High-cost, low-efficiency Politics to be reformed	
2 cases	1 case	1 case	50% completed

Chapter VIII

Conclusion

1. Main Argument

This thesis has pursued two primary objectives. Empirically, it has examined a popular perception that Korea's economic adjustment was orthodox whereas Malaysia's was unorthodox. Detailed comparisons of the four policy areas have shown that the perception exaggerates the differences between the two countries, thereby downplaying the similarities. With the exception of capital controls, both countries employed a similar set of macroeconomic stabilisation and structural reform policies and experienced a similar pattern (i.e., V-shaped) of economic adjustment.

Theoretically, this thesis is a challenge to the dominance of interest-oriented and institution-oriented approaches in the literature on the East Asian financial crisis. There is no doubt that vested interests and political institutions played a role in choosing and implementing policy options. However, those approaches do not provide a convincing explanation of why Korea and Malaysia adopted a similar set of policy measures despite many differences in domestic politics and economic conditions. To answer the question, the thesis sheds light on the role of economic ideas in policy-making.

My argument is that the policy convergence between the two countries is attributable, in large part, to the political power of economic ideas. To prove the argument, I have advanced an ideational model of policy change that is drawn from the recent scholarship on ideas-oriented approaches in IPE: institutionalist, neo-Gramscian and constructivist. Based on the model, I have shown how the neoliberal economic ideas affected policy-making in Korea and Malaysia.

In this chapter, I summarise the impact of the Washington consensus on the post-crisis economic adjustment in Korea and Malaysia. Then, I evaluate the policy convergence in the four policy areas. Finally, I discuss the effects of interests and institutions on ideas to explain the divergence between them

2. The Political Power of the Washington Consensus and Policy Convergence

To explain how economic ideas affect policy-making, I have suggested an ideational model of policy convergence. The core of the model is that the impacts of economic ideas are transmitted to policy-making through discursive practices and social learning. These ideational factors generate policy emulation, diffusion and harmonisation. In the aftermath of the financial crisis, the Washington consensus effectively de-legitimised the East Asian development model and offered a well-organised guideline for economic adjustment. This is why the crisis-affected countries accepted IMF style policies, whether they were under the IMF-supported programmes or not.

Before the crisis, Korea and Malaysia pursued a similar set of economic policies that were close to the Japanese model of economic development: export-oriented strategy and strong state intervention such as financial repression and industrial policy. This model enabled them to achieve rapid industrialisation in a short period. However, the model had some fundamental weaknesses because close government-business relations generated moral hazard problem in the financial and corporate sectors. This problem was not seriously considered because of decades-long economic growth.

In the wake of the financial crisis, the de-legitimisation of the East Asian development model in the 1990s paved the way for neoliberal economic reform in the region. One the one hand, the East Asian development model was criticised by neoclassical economic theories, especially total factor productivity (TFP) theory. Among others, Paul Krugman's review about the World Bank's report played a key role in rethinking the advantages of the model. On the other hand, the crony capitalism thesis effectively criticised the normative foundation of the model.

It should be noted that neoliberalism was imported by liberal policy makers well before the crisis. In the 1980s, a growing number of liberal economists who were educated in American universities, implicitly or explicitly, affected the transformation of economic policy framework in Korea. The role of the Korean Development Institute (KDI) was crucial in formulating liberal economic policies in the 1980s: liberalisation of the banking sector and trade regimes. In particular, Kim Jae Ik and his colleagues in the Economic Planning Board (EPB) introduced monetarist macroeconomic policies and trade and financial liberalisation. However, their policy ideas were not fully accepted because interventionist policy makers in the Ministry of Finance and the Ministry of Commerce and Industry were fiercely opposed to them. As a result, further liberalisation of the financial sector was not realised until the early 1990s. Korea's entry to the OECD in 1996 was a critical momentum that led the government to comply with global standards or best practices.

In Malaysia, liberal economic ideas gained momentum in the mid-1980s when the economy faced economic recession. Even though the government stuck to the New Economic Policy (NEP), liberal foreign direct investment (FDI) regimes and privatisation were undertaken to deal with the recession. As a matter of fact, some regulations that protected bumiputera workers were relaxed to attract foreign investors and trade unions were prohibited in foreign companies. The influence of liberal economic ideas was more visible in the National Development Policy (NDP) and Wawasan 2000 (Vision 2020) that replaced the NEP as a development plan.

Compared with Korea, there was no defining momentum of policy change in Malaysia. One reason was that the legitimacy of the NEP was not seriously challenged even during economic downturn because of its political and social implications. In addition, the Malaysian government did not have a liberal think tank like the KDI. Unlike Korea, moreover, there was no well-organised group of liberal economists in the government, although some policy makers had postgraduate degree in the US and UK. This is why Malaysia's embrace of liberal economic ideas was pragmatic rather than dogmatic.

The political power of the Washington consensus was enhanced in the post-crisis period, because the consensus provided a set of policy alternatives to the East Asian development model. Against this background, it is much easier to understand why the crisis-affected countries followed IMF-style economic stabilisation programmes whether the IMF intervened or not.

When it comes to macroeconomic stabilisation, the political power of the Washington consensus was strong in Korea and Malaysia at the early stage of economic adjustment. The IFIs and policy makers supported a pro-cyclical policy. Although big business did not totally agree to the policy, they did not strongly oppose to it either. In September 1998, there was a policy reversal in Malaysia. After Anwar was expelled from the cabinet, Mahathir introduced a Keynesian stimulus package including temporary capital controls. It should be noted that Korea also shifted to a counter-cyclical policy in the second half of 1998.

In terms of financial restructuring, the Washington consensus had a strong impact on policy choice. The IFIs, policy makers and big business preferred a market-oriented solution (i.e., London approach) to resolve financial distress. In Korea, the focus of financial reform was on the whole overhaul of the financial system. In Malaysia, top priority was given to banking sector consolidation.

With respect to corporate reform, there was some remarkable difference between the two countries. In Korea, the legitimacy of the chaebol system was shattered by the crony capitalism thesis. The IFIs and policy makers pressed big business to comply with international standards or "best practice". This strategy was very effective in transforming the corporate governance system. In Malaysia, the IFIs and policy makers tried to introduce a more transparent and accountable governance system. Apparently, their efforts yielded some positive results because regulations on the corporate sector was upgraded and strengthened. However, politically-well connected companies sought for special treatments by lobbying their political patrons (particularly Mahathir and Daim). In this respect, it is hard to say that the new regulations were strictly implemented.

Finally, regarding labour market reform, the political impact of the Washington consensus differed across the countries. In Korea, the IFIs, liberal policy makers and big business supported a radical approach to increase flexibility in labour markets. However, this approach backfired because the outcome of the reform, directly or indirectly, deteriorated unemployment and poverty without sufficient social safety nets. To cope with the backlash, the government presented the productive welfare policy. In Malaysia, there was not much pressure on labour market reform because its policy stance was already employer-friendly, particularly in exporting industries. Although the social consequences of the financial crisis were severe due to insufficient social safety nets, the government managed to control political backlash. Malaysian workers were protected from unemployment by repatriating foreign workers.

Despite the substantial degree of policy convergence, Malaysia's economic adjustment policy is widely regarded as very unorthodox. There are three reasons. First, Mahathir's anti-Western rhetoric reinforced the perception. The Prime Minister frequently accused currency speculator of the main cause of the crisis and very critical of IMF-supported programmes. His accusations had two elements: religion and racism. Malaysia's official religion – Islam – affects Malaysia's politics on a wide range of issues. [692] Since the ethnic riots in 1969, the dominance of ethnic Malays has played a critical role in making religion a serious diplomatic issue. When Palestine and Afghanistan were attacked by Israel and the Soviet Union

[692] It should be noted that there are fundamental differences between modernists (i.e., UMNO) and fundamentalist (i.e., PAS) in terms of the role of religion in state and civil society. Before joining UMNO in 1982, Anwar was a leader of Malaysian Muslim Youth Movement (*Angkatan Belia Islam Malaysia*—ABIM), which supported PAS's election campaigns. See David Camroux, State Responses to Islamic Resurgence in Malaysia: Accommodation, Co-Option, and Confrontation, *Asian Survey*, Vol. 36, No. 9 (September 1996); Jan Stark, The Islamic Debate in Malaysia: The Unfinished Project, *South East Asia Research*, Vol.11, No. 2 (2003) Since the September 11 terrorist attack, PAS was criticised for its support for *al-Qaeda and its* influence of the PAS diminished quickly. See Joseph Chin Yong Liow, Exigency or expediency? Contextualising political Islam and the PAS challenge in Malaysian Politics, *Third World Quarterly*, Vol. 25, No. 2 (2004); The Mahathir Administration's War against Islamic Militancy: Operational and Ideological Challenges, *Australian Journal of International Affairs,* Vol. 58, No. 2 (June 2004)

respectively, the government expressed its support for the Islamic forces. [693] Some transactions with Israel require approval from Bank Negara. [694] And Mahathir frequently maintained that Jewish financiers in Western countries had manipulated speculative attacks in the recent financial crises. When the financial crisis took place, Mahathir insisted on a conspiracy theory whereby Jewish hedge funds deliberately set out speculations to destroy East Asian capitalism. [695]

A closer look reveals that his rhetoric was targeted at Anwar rather than Western capitalism. Mahathir's discourse was intended to convince Malay nationalists and Islamic organisations that Anwar's IMF-style policy measures would serve the interests of the US and IMF rather than Malaysia. This accusation was overstated by senior bumiputera business leaders who were estranged from Anwar. Their point was that market-oriented reform could not co-exist with the NEP that allowed special treatments of bumiputera at the expense of other ethnic groups (i.e., Chinese and Indian).

Second, there is an exaggeration of the role of capital controls. This is caused by several factors. Above all, the introduction of a fixed exchange regime and capital controls in Malaysia was in contrast with its neighbours who moved to free floating regimes. In addition, Mahathir's provocative style made his policies look more unconventional. The coincidence of Anwar's downfall with the introduction of capital controls drew more attention. Further, the IMF and the international financial community were very sceptical about the policy. Against this background, the modest success of the policy was hailed as a setback to the Fund and its policy. However, it should be noted that the policy was frequently used in the 1990s while removing restrictions on capital account transactions. More importantly, capital controls were imposed to reduce interest rates, not to reverse financial liberalisation.

Finally, Western observers regarded Anwar as a reformer. This perception gives rise to a conclusion that the downfall of Anwar means an end of economic reform. In a similar vein,

[693] Shanti Nair, *Islam in Malaysian Foreign Policy* (London: Routledge, 1998)
[694] EIU, Country Profile 1990-2000 (1999), p.36.
[695] One underlying purpose of his anti-Semitism is to prevent Islamic fundamentalists from accusing his outward-looking development of pro-Western one. See Clive S. Kessler, A Malay Diaspora? Another Side of Dr Mahathir's Jewish Problem, *Patterns of Prejudice*, Vol. 33, No. 1 (January 1999)

Mahathir's reform is dismissed as a corrupted attempt to save his cronies. It is hard to deny that political considerations played a part in restructuring the financial and corporate sectors. However, it is worthwhile to note that Mahathir was not opposed to all of the structural reform. In fact, some progress has been made in reforming institutional frameworks for prudential supervision and regulation especially after Daim's departure. [696]

3. Explaining Divergence between Korea and Malaysia: Ideas, Interests and Institutions

Although the Washington consensus had a great impact on policy-making in Korea and Malaysia, it did not generate policy convergence in all the policy area. In fact, there was some considerable divergence in foreign economic policy. One of the most significant reasons is that Korea embraced neoliberalism dogmatically, while neoliberal economic policies were driven, in large part, by pragmatism. This difference in terms of the influence of neoliberalism confirms that policy ideas are translated, not copied. In other words, translation is a path-dependent process. To understand the difference, it is necessary to examine how ideas interact with interests and institutions. To this end, I have evaluated the four hypotheses suggested in Chapter 2.

1) The political power of economic ideas is likely to increase if external agencies support the ideas.

IMF's intervention substantially increased the political power of the Washington consensus among policy makers and politicians in Korea. High-ranking officials of the IMF and US Treasury visited the country to promote the IMF-supported programme. Michel Camdessus met with the leaders of trade unions to persuade them to accept labour market reform. Foreign investors also reminded the government that its commitment to economic

[696] For a pro-government assessment, see Ramon V. Navaratnam, *Malaysia's Economic Recovery: Policy Reforms For Economic Sustainability* (Selangor Darul Ehsan: Pelanduk Publications, 2000)

reform was one of the most significant factors in their investment considerations. These external pressures were instrumental in consolidating the legitimacy of economic reform in the bureaucracy.

In Malaysia, external pressures generated a mixed result. On the one hand, IMF's endorsement of Anwar's economic reform package was helpful in enhancing the authority of his reform policy package. On the other hand, it constrained his political power when his critics – particularly senior bumiputera business leaders – manipulated a nationalist backlash among the community that was dissatisfied with Anwar's policies. Mahathir (and Daim) exploited this nationalist sentiment to remove Anwar from the cabinet by describing the IMF's praise for Anwar as an imperialist attempt to colonise the economy.

2) The political power of economic ideas is likely to increase if big business supports the ideas.

Chaebol's support for market-oriented reform clearly enhanced the political power of the Washington consensus in Korea. Their pursuit for liberalisation, deregulation and privatisation is in line with IMF-supported programmes. However, their endorsement was not unreserved. Among others, big business opposed two policy measures. One is high interest rate policy that increased their interest burden substantially. Because most chaebol companies were heavily indebted, they demanded the authorities to lower the rates. The other is corporate governance reform, which ultimately limits chaebol owners' rights by strengthening minority shareholders' right. Their opposition was not powerful enough to avert the policies. The main reason is that the legitimacy of the chaebol system was effectively criticised by the consensus that attributes the main causes of the crisis to chaebol's reckless investment. Consequently, the chaebol had no alternative to comply with international standards or "best practice".

In Malaysia, the bumiputera business community did not give up the NEP-style development model so that the political power of the Washington consensus was fairly modest. IMF-style policies would conflict with the NEP principles on the ground that its emphasis on economic efficiency is not compatible with the NEP's objective: i.e., a harmony between racial equality and economic development. Their disagreement with the consensus did not lead to resistance to institutional reform. The reason is that they could manage the adverse impacts of structural reform by seeking for special treatments from their political sponsors – especially Daim.

3) The political power of economic ideas is likely to be greater if high-ranking policy makers – particularly finance minister and central banker – support the ideas.

The existence of liberal policy makers was instrumental in building up the political support for the Washington consensus in Korea. It was also noteworthy that economists in government think tanks (notably the KDI) and the chaebol's research centres such as the KERI and the SERI were sympathetic toward the consensus. The financial crisis gave them a chance for them to persuade politicians that were worried about the socio-political consequences of neoliberal policies: especially financial liberalisation and labour market reform.

In Malaysia, the division among policy makers limited the political power of the Washington consensus. Anwar's supporters in the Treasury and BNM agreed to IMF's interpretation of the crisis, whereas Mahathir's followers did not accept it. After the establishment of the National Economic Action Council (NEAC) that were under control of Daim, the swing of the pendulum shifted from Anwar to Mahathir.

4) The political power of economic ideas is likely to be greater in democratic regimes than authoritarian regimes.

The impact of elections was ambivalent in Korea. On the one hand, the 1997 presidential election was crucial in generating a political consensus over economic reform by making economic policy one of the most important issues. On the other hand, a host of elections between 1998 and 2000 had a constraining effect on the Washington consensus. The government retreated from its pledge to fundamental reform to deal with backlashes against neoliberal economic policies.

In Malaysia, the rise and decline of the Washington consensus was closely related to Anwar's political power. This means that elections had very little impact on the policy debates. One reason is that the tradition of consensus-based decision-making process was an obstacle to the politicisation of debates. For this reason, the rift between Mahathir and Anwar did not attract much public attention.

In sum, the political power of the Washington consensus is likely to increase when the IFIs, policy makers and big business support the consensus. Among them, the most important is policy makers' attitude because their policy preferences were critical in designing and implementing economic adjustment policies. The IFIs also had a considerable impact on policy-making. However, their influence was limited in the policy areas that were of political sensitivity. In addition, their endorsement was sometimes unhelpful for reform-minded policy makers and politician because it was described as illegitimate interventions. Finally, the role of big business was critical. In Korea, the chaebol backed market-friendly reform that made it easier for the authorities to push ahead with structural reform. In contrast, bumiputera business community's objection to economic reform substantially decreased the consensus over neoliberal reform. In the meanwhile, there is no meaningful correlation between regime type and the political power of the consensus.

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