**FINANCE WORKING PAPERS | 3 | 2017**
Global Finance Series

transnationalinstitute

# Asia and Finance Capital: From the Japanese bubble to China's financial time bomb

Walden Bello

ideas into movement

## Introduction

Ten years after the 2007-2008 global financial crisis, the US is stuck in an uncertain recovery and Europe is mired in stagnation. The BRICS, the so-called "emerging markets" grouping composed of China, India, Brazil, Russia, and South Africa, have failed to step up to the plate to replace Europe and the United States as the engines of the global economy. The world, it is now becoming clear, is now in the grip of long-term stagnation, with occasional and short-lived sparks of growth of some parts of the global economy.

It seems only yesterday that East Asia had the reputation of being the home of "miracle economies." That era is long gone. Asia was the site of two major financial crises in 30 years, the collapse of the what was called the Japanese "bubble economy" in the late 1980's and early 1990's and the Asian Financial Crisis of 1997-98. In retrospect, these two debacles were key moments of the volatile roller coaster known as "financialization," or global capitalism's increasing recourse to speculative investment rather than productive investment to stave off a crisis of profitability brought about by a global crisis of overproduction

The collapse of the bubble economy in the late 1980s, from which Japan has not recovered, came out of the blue. It was unexpected in a world that was still not used to economic troubles brought on by financial crises. However, when another real estate-led bubble inflated in Asia in the mid-1990s, with features very similar to the Japanese bubble, alarm bells should have sounded. To most investors and government authorities, however, the massive inflation of assets was simply another aspect of the 'Asian miracle'. And when the US economy boomed in the early 2000s, on the strength of credit-financed consumer spending and skyrocketing real estate values, the parallels to the run-up to the Asian Financial Crisis should have led the authorities to take strong action. But again, the danger signs were ignored because it was felt that "this time would be different."

Today, with the world still mired in the stagnation brought about by the global financial crisis, yet another bubble is inflating, this time in China. There are divergent assessments on whether or not China will, in fact, plunge into crisis. But the consensus is that if it does, the global economy into which China has become integrated as the world's "manufacturing center" will not escape the waves triggered by the financial earthquake. Faced with this prospect, will the world respond differently than it did to the three previous crises?

## Japan: From the bubble to Abenomics

Japan poses one of the biggest puzzles in modern economic history. As one leading expert on Japanese economics puts it:

> 'Japan astounded the world with its economic performance not once, but twice. Japan performed its economic 'miracle' from the 1950s through the 1980s, and then it produced an equally stunning descent into crisis in the 1990s. In the former period Japan had the strongest economic performance in the industrialized world; in the latter it had the worst. Japan's transition from hyper-success to hyper-failure presents a compelling puzzle for analysts: What went wrong?'[1]

The puzzle remains. Over a quarter of a century after it began, Japan's long stagnation continues, with a negative impact not only on the Japanese people's quality of life, but also on their morale. A few months that I spent in Kyoto in 2017 left two distinct impressions related to Japan's long stagnation. One was the large number of older people making up the population; people over 65 now comprise over 26 per cent of the population. The second was what can only be described as a state of national depression over the economy, wherein a large part of the population has lost hope in the future and feels rudderless.

The state of the economy is worsening Japan's demographic crisis. A recent national survey found that, as a result of financial insecurity, 69 per cent of males and 59 per cent of females aged 18-22 years had no sexual partner; 30 per cent said they had no 'hope' for such a relationship; and 42 per cent per cent of both sexes said they were virgins. The survey, taken in 2015, also showed that the number of children desired by respondents was smaller than in 2010.[2]

Depression is rife among all age groups, with more and more youth falling prey to it. Among young people, this condition is known as *hikikomori*; it is partly caused, psychologists say, by the prolonged economic stagnation. As one report put it:

> 'Most psychologists believe that one of the root causes of *hikikomori* is the Japanese idea of '*sekentei*', which is basically your reputation in the community and the pressure one feels to impress others. This is an immensely important social construct in Japanese society... After World War II, the post-war generation worked feverishly hard to rebuild Japan, which had been nearly flattened by the worst war in the history of mankind. Through their efforts they turned Japan into an economic powerhouse. You might say they were too successful. The Japanese economy's stagnation in the 1980s meant no future generation could ever hope to aspire to the achievements of their parents or grandparents. Yet, there was still the expectation on them from their parents and grandparents to 'build a better future' ... Most young Japanese people deal with this pressure with varying levels of acceptance, but there is a large minority that cannot. And when they fail, they feel like total failures and begin to pull away. Yet, by pulling away from society, that feeling of losing *sekentei* becomes stronger and the urge to pull away more increases. Thus begins a vicious repeating cycle..'[3]

Poverty in Japan is largely invisible, leading some visitors from crisis-ridden Europe to joke 'if this is stagnation, I'll have it anytime'. Yet poverty is present and growing. The proportion of households living in poverty increased from 13.2 per cent in 1988 to 16.1 per cent in 2012.[4] Japan was once seen as one of the world's most equal societies, but its enduring economic stagnation has left this reputation in tatters. According to the Organisation for Economic Cooperation and Development (OECD), current levels of inequality in Japan are approaching those of the United States: Japan's top quintile (the richest 20 per cent of the population) earns about six times more than the lowest quintile, while in the US, the richest quintile earns 7.8 times more than the lowest quintile.[5]

## Overproduction and stagnation

Many economists have sought to unravel the puzzle of Japan's long stagnation, but no consensus has been reached. This paper does not try to solve the puzzle either, but instead has a modest aim: to understand how finance contributed to the crisis that overtook the Japanese economy, and continues to keep it in thrall.

Perhaps the best place to start is in the late 1970s, when the long period of post-World War II expansion came to an end and a crisis of overproduction and profitability overtook the global economy.

The trend toward global stagnation in the last quarter of the 20th century is clearly illustrated in the figures gathered by the economic historian Angus Maddison, regarded as a reliable source on global economic trends. The annual rate of growth in global gross domestic product (GDP) fell from 4.9 per cent in what is now seen as the post-World War II 'golden age' (1950-1973), to 3 per cent in 1973-89 – a drop of 39 per cent.[6] Confirming this trend, United Nations' figures show that global GDP grew at an annual rate of 5.4 per cent in the 1960s, 4.1 per cent in the 1970s, 3 per cent in the 1980s, and 2.3 per cent in the 1990s.[7]

The fundamental cause of the long downturn was a crisis of profitability. This stemmed from the reduced growth in demand and rising excess industrial capacity, which in turned triggered intense competition among the centre or developed economies. In the immediate post-war period, the US helped revive the economies of Europe and Japan by providing massive aid as well as serving as a market for their goods. By the late 1970s, however, the center economies became less complementary and more competitive. 'In global capitalist production,' notes Japan specialist Bai Gao, 'the success of Japan and Germany in exporting their products to international markets not only went hand in hand with the failing competitiveness of the United States in 1971-1989 but also contributed to overproduction and to the decline of profitability of global capitalism as a whole."[8] In short, the United States, Europe and Japan built up huge industrial capacity at a time when many parts of the world were too poor or too unequal to absorb the industrialized world's output.

The excess capacity – the difference between potential and actual output – of the 1980s was exacerbated by the massive expansion of industrial and manufacturing plants in the newly industrializing countries (NICS) of East Asia, particularly in South Korea and Taiwan. As historian Robert Brenner notes, by 1990, 'the share of world exports of goods held at this point by all of non-OPEC, non-Japanese Asia had risen to 13.1 per cent, higher than that of the US (11.7 per cent), Germany (12.7 per cent), or Japan (8.5 per cent). In the immediately preceding years, the four Asian NICS had not only stepped up their export of heavy industrial capital-intensive outputs, but had also begun to venture into technology-intensive lines'.[9]

## The seeds of the Japanese financial crisis

During Japan's economic ascent, its government was acclaimed for what was regarded as its deft management of economic development. This involved not only the Ministry of Trade and Industry's (MITI) strategy of 'picking winners' or selecting and promoting promising industries, and 'administrative guidance' of the private sector, but also the Ministry of Finance's coordination of the country's banks to support this developmental thrust. What was not appreciated at the time, however, was that the Ministry of Finance's financial strategy would bear the seeds of an overproduction crisis. Essentially, the strategy was to encourage a high savings rate in order to fuel a high investment rate. The Ministry of Finance realized, Asia expert Steven Vogel writes, that:

> 'Japan needed high levels of savings and investment to propel growth but that the private sector would be likely to underinvest unless the government shared some of the risk. The government deployed a wide array of tools to promote savings… Savers subsidized investment by depositing money into savings accounts that earned lower-than-market rates of interest, thus raising the demand for credit and giving the government the leverage to allocate credit to priority sectors. The banks were willing to go along because they could lend to firms at below-market rates and still maintain reasonable spreads (margins between deposit rates and lending rates).'[10]

The strategy worked as long as local and global demand was dynamic and rising. But the rise in local demand was eventually constrained by people's high level of savings, even as intensified international competition slowed the rate of growth of Japanese exports. This leveling off of demand ran counter to corporate planning, which focused on adding capacity in the first half of the 1980's, expecting that exports would continue to rapidly increase under the cheap or undervalued Yen regime..[11] Overproduction and overcapacity was the result, with the consequent downward spiral in profitability leading to an oversupply of capital meant for productive investment 'Japan,' one report underlined, 'has a staggering overcapacity in a vast array of industries dotting the landscape, with more bank branches, gas stations, construction companies, and automakers than the nation and its global customers can support profitably."[12]

Not surprisingly, corporate bankruptcies increased, doubling from 5,292 in 1990 to 10,728 in 1992 and the amount of liabilities quadrupling. These levels stayed roughly the same until the end of the decade.[13] Those that skirted bankruptcy began to reduce their investment, with private sector investment declining at an annual rate of 5.3 per cent in real terms from 1991 to 1994.[14]

With demand for loans from the big industrial firms falling, banks (to maintain their profit levels) increased their lending to real estate and other enterprises engaged in speculative activity. The big corporations themselves, which were able to fund themselves using retained earnings, the stock market, or international financial sources, threw their excess cash into domestic speculative activity – an activity that came to be known *Zaitech* – where industrial corporations generated profits from investment in stocks and bonds. The development of Zaitech, notes Gao:

> '… indicates that, sustained by the liberalization of finance, Japanese corporations began to shift away from their real business to financial speculation. Ironically, when the world praised Japanese corporations for their long-term thinking in business strategy in the 1980s, Japanese corporations had begun to turn to short-term profits at a rapid rate.[15]

The flow of cash into real estate fuelled a massive speculative bubble that reached unimaginable levels. In 1989, all of Japan's land was valued at approximately four times the value of all property in the United States in spite of the fact that Japan's land area was only four per cent that of the US. The Imperial Palace Garden alone was valued as much as all the property in the state of California, or all of Canada.[16] Clearly, by the mid-1980s, the property market was overheating and it was only a matter of time before the bubble was pierced. The Ministry of Finance and Bank of Japan were reluctant to act, and when they did so, the consensus goes, it was too late.

## Inflating the bubble

The reluctance to act stemmed from the fact that the Ministry of Finance and the Bank of Japan were not only aware of the creation of a bubble in stock and real estate prices, but they encouraged it with their policy of 'window guidance' – a practice of signaling to private banks how much credit to create and provide to non-financial firms. As economist Richard Werner writes:

> 'The problem was not that bank lending was out of control. To the contrary, it was controlled almost perfectly by the Bank of Japan's window guidance. Instead, the problem was the policy taken by the Bank of Japan in setting those loan growth quotas. Since the Bank of Japan chose far larger quotas than banks thought necessary, compliance with window guidance meant that banks were forced to peddle their loans to real estate speculators. The Bank of Japan appeared to have been aware that its credit controls were sharply raising the allocation of new money to the real estate sector, thus pushing up real estate prices.'[17]

As one Bank of Japan official admitted: 'All the banks tried to use their loan growth quota to the maximum and did all they could do to give out loans. But the loans did not go to normal corporations, such as steel, automobile construction, but instead to non-bank financial institutions [which engaged in real estate speculation]. This became the bubble.'[18]

The reasons that the Ministry of Finance and Bank of Japan hesitated to tighten up credit but rather loosened it (even as the property bubble reached unprecedented heights) stemmed from a variety of motives, among them fear of triggering a recession, maintaining the profitability of the banks, and deep concern about the unpredictable consequences of the bursting of such a massive bubble.

## Feeble response to the recession

When the bubble did burst and the economy lurched into recession, the response was clumsy and inadequate. Collapse in demand, from both corporations and consumers, required government action. Massive and decisive counter-cyclical policies were the need of the hour. However, monetary policy, in the form of interest rate cuts, was weak, in response to the magnitude of the crisis, consisting of a small cut in interest rates spread over four years. Besides, as economist Richard Woo has noted, in a "balance-sheet recession," or one stemming from the bursting of a bubble, monetary policy has limited effectiveness since corporations and consumers would rather pay off their debts than acquire new debt.[19]

The potentially more effective response – fiscal policy – taking the form of government efforts to raise effective demand through job creation and other means to place money in the hands of consumers, was likewise weak and indecisive. Despite a deepening recession, the government:

> '... undertook only half-hearted stop-start fiscal stimulus in the mid-1990's ... Later, based on the incorrect presumption that the Japanese economy was soon reverting to its previous trend, the Japanese government raised the consumption tax in April 1997 from 3 per cent to 5 per cent. Then everything went wrong for the Japanese economy for the rest of the 1990s. The Asian currency crisis started during the summer of 1997.

> In the fall of the same year, the domestic banking crisis hit the Japanese economy, revealing the seriousness of the non-performing loan problem. In 1998 and 1999, Japan experienced its worst recession since the first oil crisis in the early 1970s. To combat this sharp economic downturn, the government implemented a series of large fiscal stimulus packages. However, all were smaller than advertised, were less than fully implemented, and allowed cuts in public investment.'[20]

Moreover, it was not coordinated with monetary policy. 'No effort was made to coordinate monetary fiscal policies during the lost decades,' says one study, which went further to claim that '... indeed, at times the Ministry of Finance and Bank of Japan appeared to be pursuing completely different objectives. The result was that monetary and fiscal policies often worked at cross-purposes, with expansionary monetary policy offset by tight fiscal policy and vice versa. The unfortunate result was intermittent and inadequate fiscal stimulus.'[21]

## Zombie banks

One of the biggest problems was the government's refusal to address non-performing (NPLs) – loans carried by the banks that totalled around 15 per cent of GDP and that were acting as a brake on the banks' viability as mechanisms for economic resuscitation. The government also prevented banks declaring themselves bankrupt. Indeed, the Ministry of Finance tried to solve the problem of economic stagnation by providing cheap money to the banks so as to get them to produce large current earnings that would allow their writing off NPLs and begin normal lending again.[22] With investment demand low, however, this merely worsened the problem. Economist Kobayashi Keiichiro puts forward an explanation for the authorities' reluctance to deal with the issue of NPLs in the books of what were called 'zombie banks' in the popular parlance:

> 'The peculiar structure of banking regulation and supervision centered on a closed financial community that included Ministry of Finance's Banking Bureau and large private banks. The coziness of the relations in this community reinforced the thinking behind the now-famous 'convoy' system of Japan's banking, in which all the main banks were helped by the government to move forward together; none was allowed to lag behind (or go bankrupt), and external actors had hardly any say. The system helped prevent the tardiness of dealing with NPLs from exposure to outside criticism, a situation that persisted due to an unspoken set of agreements between the Ministry of Finance's Banking Bureau and the financial world.'[23]

This web of ties let the issue drag on, making sustained recovery more and more distant as time went on. The more appropriate response, according to Vogel, would have been the following:

> 'Given the scale of the crisis, the financial authorities should have adopted the approach that had succeeded elsewhere, one that cuts against the very grain of Ministry of Finance tradition. This would have meant publicly disclosing the scale of the problem, using public funds to recapitalize the banks, creating a new debt-collection agency to buy up the bad loans from the banks and sell them off in the market, and pressing the banks to write off or sell off their loans in an efficient manner.'[24]

## Macroeconomic policy versus structural reform

To Keynesian economists such as Paul Krugman and Joseph Stiglitz, the key problem was lack of aggregate demand, and the way around this was through innovative monetary and fiscal policy. This included 'inflation targeting' or deliberately stoking inflation proposed through various radical monetary and fiscal policies in order to ward off the greater danger of deflation and get the economy moving again. Government printing of money was proposed by Joseph Stiglitz to raise effective demand – an idea that was later associated with US Federal Reserve Chairman Ben Bernanke and caricatured as dropping money from helicopters to people who would then move to spend it, thus igniting economic activity.

With monetary and fiscal policies either poorly implemented, poorly timed, or at cross-purposes, by 2000 depression took hold of the national psyche, and deflation (or a downward spiraling of prices), meant deepening recession took hold of the economy. A good description of Japan's condition over the past 17 years is provided by one analyst:

> 'Once deflation took hold, it worked its way through the economy in textbook fashion. Businesses began to hold off on investment and households stepped back from buying big-ticket items, delaying purchases on expectations that prices would decline. Financial strategies adjusted to the deflationary environment... And firms grew reluctant to hire workers on the lifetime contracts ...increasingly opting for 'non-regular workers' with lower basic wages, less job security, fewer benefits, less training, and lower productivity.'[25]

Failure to persuade consumers to spend led to the rise of the so-called structural reform school, members of which saw the solution as being the dismantling of the key institutions that had been associated with Japanese capitalism in the period of catch-up with the western economies, such as the *kereitsu* system, the conglomerate-like collection of enterprises grouped around one bank; administrative guidance by the Ministry of Trade and Industry and window guidance by the Ministry of Finance; and lifetime employment for corporations' core work forces. Deregulation, privatization, and liberalization of trade became the watchwords of the structural reform school, and they received a powerful boost from the support of the United States, which wanted, for its own purposes, to open up the Japanese economy to US imports and the Japanese financial system to US banks.

The position of the structural reform (or 'supply-side' school) was fortified by widespread disenchantment with the institutions of the famous Japanese developmental state that was dedicated to catching up with the West and with the power of bureaucrats whose reputation was tied to the successful past performance of these institutions. This did not necessarily mean, however, that the public had ceased to value the relative equality and strong social solidarity that had been associated with these institutions – conditions that were threatened by the neoliberal structural reforms.

In the mid-1990s, Prime Minister Ryutaro Hashimoto's 'Bing Bang' reform programme promoted financial sector deregulation and liberalization. The policy was implemented unevenly, probably because the economic managers feared that deregulation would have worsened the crisis since it would have weakened the government's role at precisely the time that more effective government intervention was needed. A second wave of reforms came with the ensuing administration of Prime Minister Junichiro Koizumi, the crowning achievement of which was the privatization of a keystone institution, the Japan Postal Bank.

However, demand- and supply-side solutions were not policy options chosen on technocratic grounds alone. Political coalitions were constructed around each approach. Certain sectors, such as big corporations and consumers, benefited more from supply side reforms while others, such as labour, small businesses and farmers, were or would be hurt. Other sectors were indecisive in their response. As a result, these coalitions proved to be unstable, so that policy oscillated between the two poles, with neither being given a chance to be substantially implemented before coalition politics or electoral developments forced a move back to the other pole. As political economist Keichi Tsunekawa writes:

> 'It is inaccurate to argue that the long-term economic stagnation of Japan has been caused by the inadequacy of neoliberal reforms such as trade liberalization and deregulation. The neoliberal encroachment on the developmental, clientelist, and welfare-statist policies has indeed been serious over the last three decades, still the Japanese economy continues to stagnate. The real cause of Japan's trouble is the lack of any consistent policy orientation. Both voters' preference and government policies have switched too easily between neoliberal reforms and expansionary demand-side measures, thereby obstructing any quick and decisive government response to the post-bubble, NPL problem aggravated by the AFC [Asian Financial Crisis] The resultant uncertainty for future market conditions has deterred both investment and consumption, thus prolonging the recession.'[26]

Though Tsunekawa does not mention it, perhaps another big factor was the continuing widespread support of many sectors for the values of relative equality and job security, so that there was reluctance – even on the part of the beneficiaries of structural reforms such as big corporations and consumers – for thoroughly dismantling the institutions that had promoted these.[27]

It was only 15 years after the banking crisis began that a pragmatic mix of measures, including infusing public funds into the troubled banks (something that the authorities did not want to do earlier for fear of public censure), helped the Japanese banking system to get a grip on the NPL issue around 2005. But by then, the mélange of weak expansionary and fiscal policies that were at times working at cross-purposes, and the zigzag between demand- and supply-side approaches, had left the country in policy drift, seemingly unable to get out of stagnation. Japan's financial system was not shattered, but it was severely weakened.

It is said that this situation had one merit: it made the banks and authorities timid about experimenting with the financial innovations coming out of Wall Street in the early 2000s, thus preventing the system from being brought down by the toxic assets that ravaged the US, British, and European financial systems. But that, apparently, is no longer the case. Japanese banks are now engaged in trading in derivatives and other financially engineered products – something that formerly cautious banking experts now support in the name of financial upgrading.[28] Moreover, banks have plunged into Fintech, or the innovative consolidation via the internet of financial services for corporate and individual consumers formerly handled by diverse financial intermediaries.

As one noted economist asserted, the Fintech craze may bring Japanese banking to uncharted, dangerous waters.[29] One suspects that the world may not have heard the last of the troubles of Japan's financial system.

## Enter 'Abenomics'

When the current government of Shinzo Abe came to power in 2012, it unveiled what was applauded as a bold solution to the state of stagnation that combined demand- and supply-side measures. 'Abenomics' as it has come to be known had three so-called 'arrows'. The first was aggressive monetary expansion, essentially providing interest-free money to banks, corporations, and consumers – in short, aggressive 'quantitative easing' as this process came to be known. The second arrow was massive fiscal stimulus, with government spending great amounts on infrastructure and social welfare. The third arrow was more long-term, consisting of supply-side neoliberal reforms, one element of which was Japan's joining of the Trans-Pacific Partnership (TPP), which would provide external pressure on Japan to liberalize its trade, financial, and corporate structures.

After almost five years, however, Abenomics has not produced impressive results. A balanced assessment is provided by the IMF, one of the backers of the approach. Ironically, given its past reputation as a doctrinaire inflation fighter, the Fund approvingly reports that the monetary 'big bang' programme 'raised actual and expected inflation far more effectively than many imagined possible. This has lowered real interest rates and raised asset prices, contributing to stronger consumption, credit demand, and, more recently, investment'. But although there are other tentative, positive indicators, the IMF concludes that 'Japan is not fully back'. It may well be that while it may look good on paper, short-term demand management amidst long-term structural reform may, in fact, be contradictory since the former promotes greater consumer purchasing power while the latter consists of neoliberal measures that would negatively affect this. Moreover, now that President Donald Trump has scrapped the TPP, a key element of Abenomics is gone. Things remain fragile, with the IMF warning that the threat of a relapse into deflation remains a possibility.[30]

Some prominent Japanese economists are bolder in their assessment of Abenomics. Naoyoki Yoshino, dean of the Asian Development Bank Institute, says that Japan's age structure, where over 25 per cent of people are now over 65, renders the usual monetary and fiscal stimulus ineffective, since retired people have a greater propensity to save rather than spend the added liquidity than working-age people.[31] Eisuke Sakakibara, the influential former vice minister of the Ministry of Finance, says Abe's focus on growth is misplaced, since Japan is now a mature economy, for which a 1 per cent GDP growth rate should be considered normal.[32] Another celebrated economist, Noriko Hama of Doshisha University, agrees with Sakikabara that low growth is normal for Japan's status as a mature economy, adding that Abenomics, which she calls 'nonsense economics', is not driven by sound principles but by Abe's politics, which seek to regain Japan's imperial might.[33]

So what can we say of the state of the Japanese economy at this point?

First, the roots of its malaise are intrinsically connected to the overproduction that has overtaken global capital.

Second, the turn to speculative finance, which created the bubble that eventually felled the economy, was driven by the crisis of profitability brought about by overproduction and excess capacity.

Third, macroeconomic, demand-side management has not worked, a major reason being that it was implemented so ineptly by bureaucrats.

Fourth, supply side (neoliberal) reforms have been made, in some areas more than others, but neoliberal transformation has been incomplete, perhaps largely because of the strong value placed on equality and resistance to neoliberal measures that would significantly increase inequality.

Fifth, all institutions that were central to the developmental state in the period of catch-up have been discredited because they have failed to lift Japan from almost 30 years of stagnation. This includes the bureaucracy, banks, and corporations. With the discrediting of the bureaucracy, politicians now have a stronger hand in deciding economic issues and promoting economic solutions.

Sixth, Abenomics has had mixed results, with only the 'arrow' of monetary expansion seeming to work. Economists have thus come up with new explanations for the failure of the economy to respond to the orthodox policies to revive it. These range from Japan's aging population radically reducing the effectiveness of macroeconomic solutions, to the claim that Japan does not have a problem of stagnation but is undergoing a normal transition to maturity that is reflected in a low growth rate.

## The Asian financial crisis

Japan played a key role in the generation of the Asian financial crisis. First of all, the excess capacity that characterized Japan' s industry was transferred to East and Southeast Asia via a wave of Japanese direct investment – the result of a re-valuation of the yen relative to the dollar that made it more expensive to manufacture in Japan.

At least $15 billion of Japanese direct investment flowed into Southeast Asia between 1985 and 1990, with Indonesia receiving $3.1 billion, Thailand $3.7 billion and Malaysia $2.2 billion.[34] The inflow of Japanese capital allowed what had become known as the 'Asian newly industrializing countries' (NICs) to escape the credit squeeze of the early 1980s (triggered by the debt crisis in developing countries); surmount the global recession of the mid-1980s; and move on to a path of high-speed growth. At the heart of the currency re-valuation (called the *endaka*) was the ratio of foreign direct investment inflows to gross capital formation, which leapt spectacularly in the late 1980s and 1990s in Indonesia, Malaysia and Thailand.

It was, however, not just the scale of Japanese investment over this five-year period that had an impact – it was also the strategy that accompanied it. The Japanese government and the keiretsu planned and cooperated closely in the transfer of corporate industrial facilities to Southeast Asia. One key dimension of this process was the relocation of not just big corporations like Toyota or Matsushita, but also the small and medium enterprises that supplied them with services and components. Another key dimension of the process was the functional integration of complementary manufacturing operations that were spread across the region in different countries.

The aim was to create an Asia Pacific platform for re-export to Japan and to third-country markets. This was industrial policy and planning on a grand scale, managed jointly by the Japanese government and corporations and driven by the need to adjust to the post-Plaza Accord world, where, as noted above, the drastic revaluation of the Yen made production in Japan no longer competitive. As one Japanese diplomat candidly said: 'Japan is creating an exclusive Japanese market in which Asia Pacific nations are incorporated into the so-called *keiretsu* system.'[35]

## Japan exports the 'bubble economy'

The process was largely beneficial as long as Japanese foreign direct investment was coming in, but when the growth in Japanese export markets began to slow down owing to the global crisis of overproduction, the chain of events that would eventually lead to the Asian financial crisis began. These countries had built up investment-hungry export machines that needed to be fed with more investment. Japan expert Charles Hughes sums up the arguments of those who blamed Japanese policies for their key role in triggering the crisis:

> 'Japan was seen to have fostered a vulnerable model of growth in the region due to the influx of Japanese portfolio and production DFI [direct foreign investment], which, although it enabled the states of the region to acquire some of the capital and technology necessary to overcome bottlenecks in production and raise their international competitiveness, also encouraged an unhealthy reliance on inward investment to finance current account deficits without resorting to government borrowing. Japan, it is argued, shifted its investment bubble to East Asia, with the states of the region becoming over-dependent on the supply of Japanese capital and vulnerable to any drop in its supply, and the massive flows of Japanese investment working to compound the potential speculative bubbles in the region by creating the impression of economic dynamism which attracted volatile 'hot money' portfolio investments from other developed states taking advantage of the dollar-pegged currencies of East Asia and concomitant lack of exchange risk. In a sense, then, Japanese DFI provided "first hit" which was to turn the East Asian states into… unstable investment "junkies"…'[36]

The process described by Hughes is oversimplified but it is essentially accurate. Japanese investment was the key trigger of Southeast Asia's rapid growth, which, when it declined due to global overcapacity, forced those countries to rely on bank and speculative capital from Japan and the West that was knocking on the door to take advantage of the 'Asian Miracle'. Just as it had earlier been the source of the bulk of foreign direct investment in East Asia, Japan was also the source of much of the speculative capital that flowed in. As analyst Kirsten Nordhaug notes: 'Japan's loose post-bubble monetary policies also created surplus liquidity which 'leaked out' to East Asia. Japanese banks lent large amounts of money to the region at a low interest rate, both to Japanese subsidiaries and to locally owned firms."[37].'

## Southeast Asia: Speculative capital supplants foreign direct investment

In Southeast Asia, the surge in portfolio investment and short-term private bank credit in the early 1990s followed an earlier rise in foreign direct investment that started in the mid-1980s.

As noted earlier, between 1985 and 1990, some $15 billion of Japanese direct investment flowed into the region in one of the largest, swiftest movements of capital to the developing world in recent history. This direct investment was accompanied by billions of dollars more in bilateral aid and bank loans from Tokyo. Moreover, it provoked an ancillary flow of billions of dollars in direct investment from the newly industrialized economies of Taiwan, Hong Kong and South Korea.

It was this prosperity that attracted portfolio investors and banks and, with the collapse of Mexico during that country's financial crisis in 1995, fund managers, who channeled the biggest chunk of their investments and loans for developing world markets to the East Asian region. The interests of speculators seeking better climes than the relatively low-yield capital markets of the North and the risky markets of Latin America coincided with the search by Asian technocrats for alternative sources of foreign capital as infusions of the yen leveled off in the early 1990s.

On the advice of fund managers and the IMF, Thailand followed Mexico's example and formulated a three-pronged strategy. It liberalized the capital account and the financial sector as a whole; maintained high domestic interest rates relative to those in northern money centres to lure portfolio investment and bank capital; and fixed the local currency at a stable rate relative to the dollar to insure foreign investors against currency risk.

Portfolio investments in both equities and bonds rose, and so did credit from international banks to Thai financial institutions and enterprises. The latter actors engaged in what they perceived as the very profitable carry trade, that is, they took advantage of the large differential between the relatively low rates at which they borrowed from northern money-centre banks in Tokyo and New York and the high rates at which they could relend the funds to local borrowers.

In the short term the formula was wildly successful in attracting foreign capital. Net portfolio investment came to around $24 billion in the 3 years before the crises erupted in 1997, while at least another $50 billion entered in the form of loans to Thai banks and enterprises. These results encouraged finance ministries and central banks in Kuala Lumpur, Jakarta and Manila to copy the Thai formula, with equally spectacular results. According to Washington's Institute of International Finance, net private capital flows to Malaysia, Indonesia, the Philippines, Thailand and Korea shot up from $37.9 billion in 1994, to 79.2 billion in 1995, and to $97.1 billion in 1996.[38] Japan was a central source of funds. In 1996 Japanese banks had $265 billion in outstanding loans to East Asian countries, with $83.9 billion in the three countries that eventually became epicentres of the Asian Financial Crisis – Thailand, Indonesia and South Korea.[39] While most foreign portfolio investments came from the United States and Europe, a large proportion of the funding of these portfolio investments actually were sourced in Japan. As Nordhaug notes: 'Investors borrowed at low interest rates in Japan, changed yen into dollars and re-invested those dollars throughout the world. A large amount of the funds went to the East Asian high-growth area. Most East Asian countries (with exceptions such as China and Taiwan) undertook significant capital account liberalization to attract these funds from the early 1990s.'[40]

In retrospect, the experiences of Thailand and its neighbours demonstrated the fatal flaws of a development model based on huge, rapid infusions of foreign capital. First, just as in Mexico, there was a basic contradiction between encouraging foreign capital inflows and keeping an exchange rate that would make the country's exports competitive in world markets. The former demanded a currency pegged to the dollar at a stable rate, in order to draw in foreign investors. But with the dollar appreciating in 1995 and 1996, so did the pegged Southeast Asian currencies. Consequently, international prices of Southeast Asian exports rose.

Second, the bulk of the incoming funds consisted of speculative capital seeking high, quick returns. With little regulation of its movements, foreign capital did not gravitate to the domestic manufacturing sector or to agriculture, which were considered low-yield sectors that would provide a decent rate of return only after a long gestation period. The high-yield sectors with a quick turnaround time to which foreign investment and foreign credit inevitably gravitated were the stock market, consumer finance, and, in particular, real estate development. In Bangkok, at the height of the boom in the early 1990s, land values were higher than in urban California. People who had witnessed the growth of the Japanese real estate bubble in the late 1980s could not but speculate that another bubble had grown and was waiting to burst.

Not surprisingly, a glut in real estate developed rapidly. Bangkok led the way with $20 billion worth of new commercial and residential space unsold by 1996. Foreign banks had competed to push loans on to Thai banks, finance companies, and enterprises in the boom years of the early 1990s; by the middle of the decade, lenders woke up to the realization that their borrowers were loaded with NPLs.

Alarm bells began to sound. The flat export growth rates for 1996 (an astonishing zero growth in both Malaysia and Thailand) and burgeoning current account deficits were worrisome. Since a foreign-exchange surplus earned through the consistently rising exports of goods and services was the ultimate guarantee that the foreign debt contracted by the private sector would be repaid, the slowing of exports was a blow to investor confidence. What the investors failed to realize was that the very policy of maintaining a strong currency, calculated to draw them in, was also the cause of the export collapse. Many also failed to realize that the upgrading of the quality of exports, which could have counteracted the rise in export prices, had been undermined by the easy flow of foreign money into the speculative sectors of the economy. Manufacturers had channeled their investments there in order to harvest quick profits, instead of pouring them into the long, slow process of research and development and of improving the skills of the workforce.[41]

By 1997, it was time to get out. Because of the liberalization of the capital account, there were no mechanisms to slow down the exit of funds. With hundreds of billions of Thai baht chasing a limited number of dollars, the outflow of capital threatened to be highly destabilizing. Many big institutional players and banks began to leave, but what converted a nervous departure into a catastrophic stampede was the speculative activity of the hedge funds and other arbitrageurs. Gambling on the authorities' eventual devaluation of the overvalued baht, they accelerated the process by unloading huge quantities of the Thai currency in search of dollars.

In the Thai debacle, hedge funds played a particularly key role. Hedge funds are essentially investment partnerships that are limited to the very wealthy, are often based offshore, and are little regulated. Specializing in combining short and long (or selling or buying) positions) in different currencies, bonds and stocks in order to net a profit from the combined transactions, the funds had been attacking the baht occasionally since 1995, led by the best known hedge fund operator George Soros. But the most spectacular assault occurred on May 10, 1997, when in just one day, hedge funds are said to have 'bet US$10 billion against the baht in a global attack'.[42] Of the Bank of Thailand's $28 billion forward book (the value of contracts for currency exchange for the future, based on less attractive rates for the local currency than the current rate) at the end of July, according to an IMF report, approximately $7 billion was 'thought by market participants to represent transactions taken directly with hedge funds. Hedge funds may have also sold the baht forward [that is, at less attractive terms for the local currency than the current rate] through offshore counterparties, onshore foreign banks, and onshore domestic banks, which then off-loaded their positions to the central bank'.[43]

Under such massive attacks, the Bank of Thailand lost practically all its $38.7 billion of foreign-exchange reserves between the end of 1996 and mid-1997. On 2 July, the decade-long peg of 25 baht to the dollar was abandoned, and the Thai currency lost over 50 per cent of its value in a few months.

Jakarta and Kuala Lumpur experienced the same conjunction of massive capital flow, property glut, and rise in the current account deficit. The nervousness had existed there, too, but the baht collapse was what triggered the severe anxiety among foreign investors. Political economist Jeffrey Winters describes the deadly dynamics:

> 'Suddenly, you receive disturbing news that Thailand is in serious trouble, and you must decide immediately what to do with your Malaysian investments. It is in this moment that the escape psychology and syndrome begins. First, you immediately wonder if the disturbing new information leaking out about Thailand applies to Malaysia as well. You think it does not, but you are not sure. Second, you must instantly begin to think strategically about how other EMFMs [emerging market financial managers] and independent investors are going to react, and of course they are thinking simultaneously about how you are going to react. And third, you are fully aware, as are all the other managers, that the first ones who sell as a market turns negative will be hurt the least, and the ones in the middle and the end will lose most value in their portfolio – and are likely to be fired from their position as and EMFM as well. In a situation of low systematic transparency, the sensible reaction will be to sell and escape. Notice that even if you use good connections in the Malaysian government and business community to receive highly reliable information that the country is healthy and is not suffering from the same problems as Thailand, you will still sell and escape. Why? Because you cannot ignore the likely behaviour of all the other investors. And since they do not have access to the reliable information you have, there is a high probability that their uncertainty will lead them to choose the escape. If you hesitate while they rush to sell their shares, the market will drop rapidly, and the value of your portfolio will start to evaporate before your eyes.'[44]

Winters comes to a radically different conclusion from Adam Smith, who believed that the invisible hand of the market should bring about the greatest good for the greatest number. 'The chain reaction,' Winters writes, 'was set in motion by currency traders and managers of large pools of portfolio capital who will operate under intense competitive pressures that cause them to behave in such a manner that is objectively irrational and destructive for the whole system, especially for the countries involved, but subjectively both rational and necessary for any hope of individual survival.'[45]

## Speculative capital fells a tiger economy

Unlike in Southeast Asia, South Korea's development had not been based principally on foreign investment. Instead, it rested on capital amassed through monopoly of a domestic market by local capital and on an aggressive mercantilist policy promoted by the state.

A close working relationship between the private sector and the state fostered high-speed industrialization. By 'picking winners', providing them with subsidized credit through a government-directed banking system and protecting them from competition from transnationals in the domestic market, the state nurtured *chaebol*, or industrial conglomerates that it later encouraged to enter the international market.

In the 1980s, the state-*chaebol* combination appeared to be unstoppable in international markets, as the deep pockets of the commercial banks were extremely responsive to government wishes and provided the wherewithal for Hyundai, Samsung, LG Electronics and other conglomerates to carve out market shares in Europe, Asia and North America.

It did not take very long, however, for the tide to turn against the Koreans. Several factors contributed to this, including over-investment resulting in over-capacity, which led to declining profitability. Easy credit by government-controlled banks had been a central reason for the so-called Korean miracle, but by the early 1990s, the credit demands of the *chaebol* to support investment and expansion had become voracious. At the same time, foreign banks and foreign funds were eager to lend to Korea and pressed Washington, the World Bank, and the IMF, in turn, to pressure the Koreans to open up their financial sector. Korea then entered the OECD, which required it to liberalize its capital account, financial sector and foreign investment regime.[46] Although Korea formally adopted a gradualist strategy – embodied in the so-called Reform of the Foreign Exchange System – the inflow of foreign funds was, in fact, anything but gradual. In 1993, the Kim Young Sam government relaxed its controls over cross-border capital flows, allowing both conglomerates and newly created banks greater liberty to borrow abroad. As Ravi Arvind Palat of Binghamton University has pointed out, the 1993 financial liberalization signified the weakening of the state as a buffer between the local economy and the international economy, on the one hand, and the rise of an uncontrolled private sector as the principal mediator between the two arenas, on the other.[47]

The results were disastrous. Korean banks plunged gleefully into the interbank market, 'taking advantage of lower interest rates overseas and passing the funds on to their domestic customers ... [T]his was hardly prudent banking practice since it meant that Korea Inc. was borrowing short-term money abroad – money that had to be repaid in hard currency – and lending it long-term to the expansion-crazed *chaebol.'*[48] But, as always, it took two to tango, and 'foreign banks rushed into this promising new market, led by the Europeans and the Japanese'.[49] South Korea's foreign debt promptly trebled, from $44 billion in 1993 to $120 billion in September 1997, and went on to reach $153 billion in February 1998.[50] Most aggressive among the borrowers of short-term foreign funds were the 30 new merchant banks, which accounted for $20 billion of the $153 billion debt.[51]

The high-profile collapse of some severely indebted *chaebol* early in 1997 and the financial panic in Southeast Asia in the summer of 1997 combined to make the Korean economy a sitting duck.

Exhibiting much the same herd mentality demonstrated by fund managers during the Southeast Asian crisis a few months earlier, the banks began pulling out, paying little attention to the fact that Korea had a more advanced, solid industrial economy than Thailand or Indonesia, and was a member of the OECD. As one IMF staffer recalled:

> 'I was being called by a lot of banks in October and November, and it was amazing how little they knew about Korea. They'd ask, "Has Korea ever defaulted?" Well, the answer is no. They'd ask, "How recent is Korea's miracle? Isn't it all driven by foreign capital flows?" Well, it's not. I remember one indignant guy in New York saying, "We're a responsible bank; we cannot roll over our claims in a nontransparent country." And I thought, "Well, you certainly seem to have been able to *lend* to them!" In a panic situation, once something becomes an issue, no bank wants to be left out on a limb.'[52]

When fund managers began to dump the local currency, the *won*, in early November 1997, the Korean government tried to defend the exchange rate by using its reserves. It promptly lost about $10 billion, or over one third of its foreign currency reserves. The *won* was devalued on November 17, resulting in a 24 per cent loss in value against the dollar by early December 1997, or a 24 per cent hike in the cost of servicing dollar-denominated loans by local borrowers. With Korean banks and firms facing bankruptcy, the IMF negotiated a record $57 billion rescue to enable Korean borrowers to repay their international creditors. This funding did not, however, halt the flight from the *won* by foreign banks – nor did an additional $10 billion provided by the United States and other governments over Christmas week.

Only the looming threat of a bankruptcy that would disrupt the global financial system compelled Washington to pressure bankers to roll over their loans to Korea, which caused the haemorrhaging of money to stop.[53] On January 29, 1998, a consortium of 13 international banks agreed not to take any more money out of the country and to restructure $24 billion of the short-term debt scheduled to be paid in 1998: they would swap these short-term loans for new debt that would not be payable for 1-3 years.[54] In his account of those tense days, *Washington Post* reporter Paul Blustein remarked: 'In a sense, the international banks got away with murder. They had foolishly injected billions of dollars of short-term loans into a country with a shaky financial system, yet they were suffering no losses.'[55] Indeed, as the key architect of the bailout, then Secretary of the Treasury Robert Rubin admitted, not only did the banks emerge unscathed – they 'were paid back in full and ended up receiving a higher rate of interest in the interim'.[56]

## After the fall

In both Mexico and East Asia, creditors and speculative investors got off pretty lightly thanks to rescue packages put together by the IMF. Yet the price was high for the people in these countries. In exchange for rescue funds, governments were forced to adopt IMF policies that emphasized stabilization, which included cutting government expenditures and raising interest rates. Instead of playing a countercyclical role to offset the collapsing private sector, government policy speeded up contraction of the economy. In 1998 the economies affected by the crisis plunged into recession or registered zero growth. Joseph Stiglitz, former Chief Economist of the World Bank, noted: '[A]usterity, the Fund's leader said, would restore confidence in the Thai economy . . . [E]ven as evidence of policy failure mounted, the Fund barely blinked, delivering the same medicine to each ailing nation that showed up on its doorstep'.[57] But as over one million people in Thailand and 22 million in Indonesia sank beneath the poverty line in just a few weeks, not even the IMF could deny the devastating results of its policy. Indeed, the IMF (in a mid-1999 paper) issued what amounted to an admission of guilt, stating that in the East Asian countries it advised during the crisis, 'the thrust of fiscal policy … turned out to be substantially different … because the original assumptions for economic growth, capital flows, and exchange rates … were proved drastically wrong'.[58]

But the price paid by the affected countries was not just their people's suffering. They were forced to yield large tracts of their sovereign authority over their own economies. As the late Asia expert Chalmers Johnson argued, a good case can be made that Washington's opportunistic behaviour during the Asian financial crisis reflected the fact that 'having defeated the fascists and the communists, the United States now sought to defeat its last remaining rivals for global dominance: the nations of East Asia that had used the conditions of the Cold War to enrich themselves'.[59]

The IMF's confession vindicated Malaysia's policy during the crisis. Prime Minister Mohammed Mahathir, as is well known, blamed foreign speculators for the crisis, singling out George Soros, and took precisely those steps that the IMF and western experts had warned against: imposing capital controls and currency controls, including fixing the exchange rate. Mahathir also refused the assistance of the IMF, convinced that the infamous conditionalities of the Fund would provoke a recession and erode national economic sovereignty. As its neighbours saw their currencies abused by speculators and their economies plunging into recession, Malaysia saw its economy recover earlier and more vigorously. Capital controls had a stronger association with a smaller drop in GDP growth, industrial output, and real wages than IMF programmes in the other crisis-hit countries, noted Thomas Pepinsky.[60] He also observed that 'by facilitating macroeconomic expansion and eliminating stock and currency speculation, capital controls appear to have given Malaysian policymakers the breathing room to engineer economic recovery'.[61]

The situation could not have been more different in neighbouring Thailand. There, local authorities agreed to remove all limitations on foreign ownership of Thai financial firms, accelerate the privatization of state enterprises, and revise bankruptcy laws along lines demanded by foreign creditors. As then US Trade Representative Charlene Barshefsky told Congress, the Thai government's 'commitments to restructure public enterprises and accelerate privatization of certain key sectors – including energy, transportation, utilities, and communications – which will enhance market-driven competition and deregulation – [are expected] to create new business opportunities for US firms'.[62]

Likewise, in Indonesia, Barshefsky emphasized 'the IMF's conditions for granting a massive stabilization package addressed practices that have long been the subject of this [Clinton] Administration's bilateral trade policy … Most notable in this respect is the commitment by Indonesia to eliminate the tax, tariff, and credit privileges provided to the national car project. Additionally, the IMF programme seeks broad reform of Indonesian trade and investment policy, like the aircraft project, monopolies and domestic trade restrictive practices, that stifle competition by limiting access for foreign goods and services'.[63] The national car project and the plan to set up a passenger jet aircraft industry had elicited the strong disapproval of Detroit and Boeing, respectively.

In the case of Korea, the US Treasury and the IMF did not conceal their close working relationship, and the Fund clearly played a subordinate role. Not surprisingly, the concessions made by the Koreans – including raising the limit on foreign ownership of corporate stocks to 55 per cent, permitting the establishment of foreign financial institutions, fully liberalizing the financial and capital market, abolishing a restrictive classification system for automobile imports, and agreeing to end government-directed lending for industrial policy goals – coincided closely with Washington's push to liberalize Korea before the crisis. As Barshefsky candidly told members of Congress:

> 'Policy-driven, rather than market-driven, economic activity meant that US industry encountered many specific structural barriers to trade, investment, and competition in Korea. For example, Korea maintained restrictions on foreign ownership and operations, and had a list of market access impediments ... The Korea stabilization package, negotiated with the IMF in December 1997, should help open and expand competition in Korea by creating a more market-driven economy ... [I]f it continues on the path to reform there will be important benefits not only for Korea but also the United States'.[64]

Summing up Washington's strategic goal, Jeff Garten, Undersecretary of Commerce during President Bill Clinton's first term, said: 'Most of these countries are going through a dark and deep tunnel ... But on the other end there is going to be a significantly different Asia in which American firms have achieved a much deeper market penetration, much greater access.'[65]

## Liberalizing Asia: the record

The IMF and western political and economic interests took advantage of the crisis to impose what they described as 'international best practices' in the governance of banks and corporations in crisis-hit countries. The aim was to break up what were branded as 'crony capitalist coalitions' and open up the economy to greater foreign investor presence. This push appears at first glance to have achieved notable success, but as Andrew Walter points out, what government and business interests evolved was a strategy of 'mock compliance'. Mock compliance was formal compliance with the demand of external forces through the passing of new laws reforming the banking system and establishing the independence of regulators, coupled with informal resistance to or noncompliance with these formal strictures by entrenched private sector interests. Explaining why Indonesia registered full compliance with only two out of 25 of the Basle Core Principles forged by the neoliberal global banking establishment, Walter writes:

> 'It is clear that ratification failure has not been the main obstacle to substantive compliance in Indonesia. Although there were delays in legislation and implementation... most of the formal regulatory framework was in place by the end of 1999. Given this, private sector opposition to compliance shifted to less visible forms. It is difficult to judge the relative importance of regulatory forbearance, administrative failure, and private sector compliance avoidance in substantive compliance failures, because all three are often interrelated in the Indonesian case.'[66]

In Thailand, the post-crisis hegemony of neoliberalism was even more short-lived. In 2001, the pro-IMF governing coalition was ousted with the election of a parliamentary contingent dominated by the Thai Rak Thai Party (TRT) led by Thaksin Shinawatra. Thaksin promptly paid off Thailand's debt to the Fund and declared Thailand's 'independence' from the institution. After three stagnant years under governments faithfully complying with the IMF's neoliberal prescriptions, the Thaksin propelled countercyclical, demand-stimulating neo-Keynesian policies to get the economy back on track. The Thai government provided low-interest loans, instituted government-financed universal health care, and gave each village 1 million baht ($40,000) to spend on a special project. Despite dire predictions from neoliberal economists, these measures contributed to propelling the economy onto a moderate growth path.[67]

As for financial and corporate reforms that had been initiated in the aftermath of the crisis, these fell by the wayside, with the government spending little energy in support of them. Indeed, upon taking power, says Allan Hicken:

> 'Thaksin immediately put the brakes on privatization and liberalization. When the privatization effort was finally revived in 2003, shares were generally offered only to domestic stockholders, and where foreign investors were involved, their shares did not carry voting rights. In the area of telecommunications, the setting up of an independent regulatory agency, mandated by law, slowed to a crawl. At the same time, the government worked to keep the sector closed to foreign participation—all to the benefit of Thaksin's companies.'[68]

Ironically, it was Thaksin's reversal of this telecommunications policy to allow the Singapore government-owned Temasek substantial shares in the Thaksin family-owned Shin Corporation (a sale that benefited the Thaksin family to the tune of $2 billion in tax-free profits) that became the undoing of the government, leading to a military coup in September 2006.

Governments throughout Southeast Asia, for the most part, saw IMF reforms as a means by which western interests were prying open their economies under the guise of ending 'crony capitalism'. While they felt compelled to make some concessions because they'd accepted IMF rescue funds, they wanted to yield as little ground as possible, substituting mock compliance for substantive compliance. What they focused on instead were measures to protect their economies from the western financial speculators that had targeted their currencies and brought on the crisis. Never again would they allow this to happen. It is therefore not surprising that all countries geared up their export sectors to earn dollars that could then be stowed away as foreign reserves that could be deployed for future battles against speculators. Reserve accumulation was a form of 'self-insurance' from future crises by countries that had been taught the bitter lesson of relying on the IMF when facing capital account and current account crises. From less than one trillion dollars before the Asian Financial Crisis, East Asian countries accumulated over four trillion dollars by 2008.[69]

Countries in the region also sought to create regional arrangements that would substitute for reliance on the IMF. In September 1997, at the height of the crisis, Eisuke Sakikabara, then Vice Minister of Japan's Ministry of Finance, proposed the creation of an Asian Monetary Fund (AMF), the bulk of whose funding would come from Japan. This was vetoed by the US and China, the former because it feared the emergence of a rival to the International Monetary Fund, which it dominated, and the latter because it might lead to the creation of a 'Yen Bloc' that would enhance Tokyo's geopolitical and geo-economic position. Indeed, the AMF initiative did seem to be one that sought to advance Tokyo's desire to accelerate the region's recovery as well as speed up its integration under Japanese auspices in order to pull Japan out of its stagnation.

More successful was the strategy of forging of a network of bilateral agreements that would promote sharing of reserves among countries if any of them came under attack by currency speculators. This was the ASEAN+3 Network, better known as the 'Chiang Mai Initiative'. Though the bilateral swap amounts agreed were not that substantial, the Chiang Mai Initiative was nevertheless of great significance for the different regional actors, according to Asia specialist Jennifer Amyx:

> 'For a few actors in the region, such as Indonesia and the Philippines, this project represents, foremost, a borrowing facility, allowing these countries to potentially draw on more foreign exchange reserves than each alone possesses. For the 'plus three', which have abundant foreign exchange reserves, it, foremost, provides an opportunity to build political capital with Southeast Asia, as well as some leverage for pressuring international financial institutions such as the IMF to address more seriously their underrepresentation of Asia. For other ASEAN economies, such as Singapore, Thailand, and Malaysia, this project is most useful for the opportunities that its accompanying policy dialogue process provides to exert peer pressure on China. It also offers insights into developments in China at a time when changes in the Chinese financial system and foreign exchange regime could have huge effects on the operations of its neighbours.'[70]

Among all the East Asian economies, Korea was probably the most transformed by the neoliberal push from external powers. While the *chaebol* and the banks did put up strong resistance and were able to slow down some reforms, for the most part the neoliberal push was successful. Perhaps the most salient indicators are in the financial system. About a decade after the crisis, foreign investors now have majority stakes in six out of seven nationwide commercial banks, gaining control of three. Some 33 to 50 per cent of bank assets in the country are accounted for by the foreign-controlled banks. Liberalization of the capital market has led to the share of equity-market capitalization by foreigners reaching 43.3 per cent.[71] Foreign institutional investors have also built up considerable stakes in the bulk of listed Korean blue-chip companies, though they do not yet control them.[72]

Perhaps the most reliable assessment of the state of liberalization of the Korean economy is provided by Jungryn Mo, who argues that foreign capital has made inroads into Korean financial markets and even dominates the banking sector, although 'Korean banks and companies have failed to reach transparency and accountability standards comparable to those of their competitors in advanced economies' and 'the movement of the financial system toward a market-based system has been progressing ... at an uneven pace.'[73]

Indeed, one can even say that in some instances the government has been more lenient with foreign-owned institutions than with domestic ones. In one notorious instance this almost led to another financial disaster: while the government pressured domestic banks to offset their debts with foreign currency denominated assets so as to square their foreign exchange positions, it did not require foreign banks to do the same. As a consequence, the short-term debts of foreign banks piled up very rapidly, exceeding those of domestic banks by 2006. When the 2008 financial crisis hit, the Korean *won* depreciated by almost 30 per cent, leading to a situation where the ratio of international reserves to short-term debt fell rapidly from 200 per cent in 2006 to 126.4

per cent in the third quarter of 2008. What saved Korea from plunging into its second financial crisis in 10 years was a $30 billion currency swap approved by the US Federal Reserve Board in October 2008.[74] The roots of the near disaster, according to Yasonobu Okabe, lay in the post-Asian financial crisis policy of the Korean government, which was 'highly permissive to the entry of foreign capital', leading to 'highly optimistic' government expectations that 'were disappointed by the large capital flight by foreign banks'.[75]

Why was post-Asian financial crisis liberalization so successful in Korea but so limited in its impact elsewhere in East Asia? Part of the answer lies in the strong support from the population that the crisis-era reform government of Kim Dae Jung enjoyed owing to the widespread perception that the reckless borrowing from the international lenders by the *chaebol* or conglomerates created the crisis. But another part of the answer lies in geopolitics. The Korean economy could not be allowed to go under by the US, which saw Korea as its front-line military protectorate. Thus, the US government was directly involved in the rescue programme, not leaving this to the IMF to manage alone. As noted earlier, it was pressure from the US Treasury Department that got international banks to roll over their loans to Korea at a crucial juncture in the crisis. The quid pro quo was firm government action to carry out the neoliberal reorganization of labour, the disciplining of the *chaebol*, and opening up the financial sector to US and other foreign firms. Despite labour protest and resistance from the *chaebol* and the banks, the Kim Dae Jung government and its successors fulfilled their part of the deal. At the end of one decade of reform, the vaunted Korean developmental state had been replaced by a neoliberal state.[76] No longer was Korea the most difficult place to do business in, as US firms were wont to complain before the Asian financial crisis.

## 'Asia's revenge'

The US's gaining of the upper hand in its effort to open up Korea and Asia was not the end of the story. As noted earlier, to protect themselves from further attacks from western speculators, the economies of the region engaged in an export drive that netted them billions of dollars – a great part of which was cornered by the region's central banks. East Asian reserves – excluding Japan's – went from less than $100 billion in 2000 to more than $4 trillion in 2007. The central banks did not, however, keep all of these reserves in a state of hibernation – after all, banks must use money to make money. A large part was recycled back to developed economies through the purchase of assets such as mortgage-backed securities from the private sector in the US, or US Treasury bills. Much of this was then re-lent to private financial institutions that used it to create credit that financed US consumer spending, particularly in housing. While Asian money did not create the global financial crisis, it was, unwittingly, a contributing factor. While the US and European financial systems were savaged by the crisis, Asia's financial institutions escaped, virtually unscathed. Such was 'Asia's revenge'.

## China: Third phase of the global financial crisis?

Despite its integration into the global capitalist economy, China was spared by the Asian financial crisis of 1997-98 and avoided being drawn into the global financial crisis of 2008. But ever since the Shanghai Stock Market cratered in the summer of 2015, the big question being asked by some is: is it China's turn next?

China escaped the 1997-98 Asian financial crisis because it had not liberalized its financial sector. Despite advice from western economists to accelerate the opening up of its financial sector, China had prevented its currency, the *renminbi* or *yuan*, from being convertible, maintained strong controls on capital flows, had a rudimentary stock market, and had very little foreign debt. It had just begun the process of setting up diverse state banks, and their role amounted to little more than providing funds to state-owned enterprises, with little concern about the profitability of these loans. While laws for direct investment were liberalized to encourage foreign firms to relocate to China to take advantage of cheap labour, opening up the financial sector lagged behind, 'mired in the ways of the old planned economy and awash in bad debts'.[77] The banking system, writes James Stent, 'still operated as a fiscal agent of government, as a bursar for the disbursement of government funds'.[78]

## Conflicting lessons from the Asian financial crisis

While it was not caught up in the crisis, China performed a significant service to the regional economy by not devaluing its currency, keeping this at 8.28 yuan to the dollar. Engaging in competitive devaluation with the stricken economies would have worsened the regional situation and prolonged the recession and stagnation that hit its neighbours. With its huge trade surplus, China could afford to essentially do nothing and wait out the crisis. But the Chinese absorbed the hard lesson taught to its neighbours about the volatility of international capital. As China specialist Barry Naughton writes: 'China learned the same broad lessons about more prudent international policy that the most directly affected crisis countries learned: keep the currency low enough to maintain consistent export surpluses, build up foreign exchange reserves, avoid reliance of short-term bank loans, and above all, never allow yourself to become dependent on the IMF for macroeconomic insurance'.[79]

But, paradoxically, the Asian financial crisis also provided the trigger for China's financial sector to become liberalized, modernized, and truly capitalist. As Edward Steinfeld writes, while the key lesson that many developing countries took from the crisis were the dangers posed by global finance, China's key reforming leaders, like Prime Minister Zhu Rongji, saw the crisis as providing the justification for accelerating the process of transforming the country's banking system into a fully capitalist one. The reason for this, says Steinfeld, was the realization that there were deep similarities between China and its collapsing neighbours, that they had 'economies dominated by politically connected industrial behemoths, bank-dominated and heavily state-influenced financial systems devoted to funding such behemoths, and high levels of household savings providing much the liquidity'.[80] Suddenly, terms such as moral hazard, nonperforming assets, and unfunded liabilities appeared 'to apply just as equally, in the minds of the Chinese, to China itself. In essence, it was not capitalism that suddenly fell into doubt, something the Chinese could have treated as a foreign problem, but rather, the East Asian developmental model, something that Chinese unmistakably identified their own country as being part of'.[81] In short, the Chinese absorbed what they thought to be the key lessons of two conflicting paradigms: uncontrolled speculation by foreign capital may have triggered the crisis, but a deeper cause was 'crony capitalism'.

## Reformers liberalize finance

Over the next few years – from the late 1990s into the early 2000s – bringing the financial sector up to date became one of the reformers' priorities. The aim was, as Zhou Xiaochuan, Governor of the People's Bank, put it, the creation of 'comprehensive, enterprise-like, commercial banks without direct administrative controls'.[82] This involved cleaning up the massive amount of non-performing loans that had resulted from the nearly unconditional lending to state enterprises in the previous period. Making the balance sheets of the state banks healthy was essential to Zhu Rongji's goal of having the banks listed on the Hong Kong stock exchange, where underwriting handled by the major western investment banks would force the state banks to bring their corporate governance and accounting systems up to global standards, 'passing muster with international auditors and the scrutiny of foreign securities exchange examiners'.[83] Also central to this process of modernization was the professionalization of bank staff via the recruitment of Chinese citizens trained in financial management in western universities.

Western banking, however, took a big hit when the global financial crisis erupted in 2007-2008. By that time, China's financial upgrading was in motion, but it had been carried out with caution. Though flotations on the Hong Kong stock market resulted in some foreign banks gaining minority ownership in the China Construction Bank, Bank of China, and Industrial and Commercial Bank, Chinese banks had very little exposure to toxic securities such as the sub-prime securities hawked by Wall Street that had led to impairment of bank balance sheets in the US and Europe. The crisis, however, had the effect of slowing down, if not stopping, further measures that reformers, western advisers and western banks had pushed – in particular, privatization of the state banks, interest rate liberalization and widening access to credit to private enterprises.

## Liberalizers versus the export lobby

It is important to underline that the crisis brought to the fore conflicts that had been developing among leaders of the Communist Party and the Chinese state. There were broadly two wings that increasingly came to loggerheads. One was the liberalizers, committed to transforming the economy into a fully fledged capitalist economy marked by a stronger role for market forces, which they believed would promote a more efficient allocation of resources. The other was the set of interests that had developed and coalesced around the export-oriented strategy that had made China the 'world's manufacturer'. The export lobby had developed into a powerful force over time, and its main argument in debates at leadership level was that China's very success as an export superpower meant that economic policy should not harm the interests and policies that had been responsible for this. The lobby included government planning bodies such as the National Development Reform Commission and the Ministry of Finance, both of which had generated the strategy of export-led industrialization; export-oriented state and private enterprises; local government and Communist Party bodies in the coastal provinces; and state-owned construction firms whose infrastructure projects underpinned the export-led strategy.

This is not to say that the liberalizers and the export-led lobby did not share some interests and points of view. Both favored China's cheap labour policy. Both supported the break-up of the institutions of job security of the Mao era, including the withdrawal of state subsidies for loss-making state enterprises that had not adapted to the export-led strategy. Financial policy was, however, another matter. Here the battle lines were drawn. Reformers wanted a more rapid reform of the financial system, pushing for liberalizing the low interest rates on deposits that had subsidized the export lobby as well as ending the virtual monopoly on bank loans enjoyed by the latter. Not only would the allocation of resources be more efficient, they argued, but millions of long-exploited savers would benefit, as would private businesses that had no access to credit from the state banks. The export lobby, however, was able to slow down reforms, and they were helped in no small measure by the conflict between the liberalizers at the People's Bank of China and anti-reformists ensconced in the big state banks. As Eswar Prasad points out: 'The big banks, in tandem with the large state-owned enterprises and provincial governments that they bankroll, have been fierce and powerful opponents of reforms. The system, as it is structured, works well for these groups, which hardly makes them eager for greater liberalization."[84]

The leadership of President Hu Jintao and Premier Wen Jiabao that took over in 2002 tended to accommodate the export lobby but at the same time, it was worried that China's economy had become too dependent on exports and was sensitive to criticisms that the export lobby was cornering most of the nation's real and financial resources, leading to greater inequality in the country and serving as kindling for social protest, to which the Communist Party was extremely sensitive.

## The export lobby hijacks the stimulus

When the Chinese growth rate began to dip as a consequence of the global financial crisis, the Hu-Wen leadership rolled out the $585 billion stimulus programme, which, in relation to the size of the economy, was bigger than the concurrent $787 billion stimulus that the Obama administration injected into the US economy. The aim was not only to serve as a countercyclical instrument to reverse economic contraction. It was also meant to trigger a macroeconomic reorientation of the Chinese economy from export-led to domestic-led growth by increasing the purchasing power of consumers.

Western analysts like Barry Naughton have credited the stimulus programme with saving China from spinning into recession while at the same time faulting it for essentially putting an end to the big push towards economic liberalization that was championed by Zhu Rongji at the turn of the 21st century. Their argument is the stimulus involved a lapse into the 'old socialist ways', where funds were indiscriminately funneled by the banks to the big state enterprises and local governments in order to have an immediate impact, resulting in inefficient, wasteful spending; revived the spectre of nonperforming loans for the big Chinese state banks that the reforms of Zhu Rongji had banished; and brought back the worst features of state management.

These analysts are correct that the focus on rolling out the stimulus froze liberalization initiatives. But what transpired was not a retreat to socialism in the sense of prioritizing the interests of those groups that had been left behind by China's export-led growth. Alongside workers and peasants, these disadvantaged sectors included the small and medium entrepreneurs serving local markets and the general population in their roles as savers and consumers – in short, as economist Hongying Wang put it, all those who have 'suffered from the financial and public finance systems that have deprived them of their fair share of the national wealth'.[85]

Since they controlled the channels through which trillions of *renminbi* could be quickly deployed

– the big state banks, local governments, and big state and private enterprises – the export lobby didn't just neutralize the plan to make domestic consumption the cutting edge of the economy. It was also able to hijack the massive stimulus programme that had been intended to place money and resources in the hands of consumers. According to statistics Wang cites from *Caijing Magazine*, some 70 per cent of the stimulus funds went to infrastructure, while only 8 per cent went to social welfare expenditures such as affordable housing, healthcare, and education.[86]

## Financial repression and the real estate bubble

Major reforms fell by the wayside, including two that would have had a significant impact on income distribution and altering the composition of winners and losers: an end to the policy of 'financial repression', or keeping the interest rate on savings low in order to subsidize the export lobby; and providing greater access to bank loans to private and state enterprises that had been deprived of them thanks to the monopoly on credit enjoyed by the privileged export lobby. Indeed, the persistence of the old policies created new sources of instability for the financial system.

China has had a high rate of national savings, with the national savings rate accounting for 53 per cent of gross domestic product in 2007-2008, up from 38.1 in 1998-2002. Household savings accounted for 22.9 per cent of GDP in 2007-2008, up from 18.5 per cent in 1998-2002. What the policy of financial repression meant was that increasing numbers of Chinese, particularly among the newly emerging middle class, became dissatisfied with the meagre benefits they derived from depositing their money in bank accounts with low state-determined interest rates. Investing in real estate became an attractive alternative. According to economist Nicolas Lardy, data on real estate indicate that the pronounced growth in real estate investment did not stem from a rising rate of home ownership or from accelerated urbanization, but from real estate becoming a preferred type of asset. The key reason for this was a dramatic decline in real returns on bank deposits, with the average return on 1-year deposits becoming negative after 2003. In contrast, returns to newly built residential property rose in real terms from 2.3 per cent in 1998-2003 to 4.6 per cent per annum in 2004-2010.[87]

Thus, with little money to be earned from bank deposits, a great number of the Chinese public gravitated toward the real estate and property markets. This move was encouraged by the authorities, who were worried about the public's discontent with the lack of profitable outlets for their savings. This encouragement included easing lending requirements at state banks to allow people to invest not only their savings but also borrowed cash.

Speculation in property was the investment of choice for many years, with over 18 per cent of all households in Beijing, for instance, owning two or more properties.[88] But as in the United States during the subprime property bubble, the market attracted too many investors, leading to a speculative frenzy that saw real estate trends see-saw crazily as fears spread that the bubble was about to burst. Still, prices in major cities continued to rise, hitting a peak in early 2017 when worried authorities began to take measures to prick the bubble, like the Beijing Municipal Commission of Housing and Urban-Rural Development's raising minimum down-payments from 50 to 60 per cent.[89] Indeed, about 60 Chinese cities have enacted more than 150 restrictive policies on home purchases and prices since March 2017. These measures targeted lower tier cities that had become popular destinations for speculators who were no longer eligible to buy homes in overinvested tier 1 and tier 2 cities, and were eyeing new areas.[90]

Authorities faced a dilemma. On the one hand, workers complained that the bubble had placed owning and renting apartments beyond their reach, thus fueling social instability. On the other hand, the economy had become hooked to the property boom: a sharp drop in prices could bring the rest of the economy with it, and with China's increasingly central role in the global economy as a source of growing demand, take the rest of the global economy along with it as well. According to an authoritative source, since it accounts for 20 per cent of national demand:

> 'The real estate sector is at the heart of the problem because of its wide-ranging and complex interconnections with other sectors. Any slowdown in the real estate sector would adversely affect construction-related industries along its entire supply chain, including steel, cement, and other construction materials. The quality of the loans extended to those related industries will also be affected, leading to higher NPLs.

Shocks to the real estate sector could have an even wider impact on banks' asset quality. Chinese households have more than 40 per cent of their total wealth in the form of housing. Lower property prices impose a negative wealth effect on households and will reduce consumption demand. This will feed back into lower corporate sales and profits, and ultimately, slower GDP growth. Weaker corporate profits and negative household wealth effects will reduce debt-servicing capacity.'[91]

Currently, Chinese authorities are careful to deny that the dynamics of the real estate sector mean a bubble similar to that which developed in the US in the 2000s and Japan in the 1980s has come into being. But one of Japan's foremost authorities on the Chinese economy says that real estate prices have run out of control. 'If you take three indicators and compare them to the US and Japanese indicators during their bubble periods, you have to conclude China is in a bubble. These indicators are housing prices in relation to the average consumer's income, the rate of growth of the economy in relation to the growth rate of loans to real estate, and the rate of real estate loans in relation to the growth rate of total loans. The ratios are as high as those of the US and Japan. The biggest threat to China is asset price inflation.''[92]

## From the real estate bubble to the stock market bubble

Uncertainties in real estate investment, which the government has tried hard to control for over a decade in an attempt to prevent the emergence of a bubble like the sub-prime one seen in the US, has pushed many middle class investors seeking higher returns to the country's fledgling stock market. The result has been a see-saw between real estate and stocks as the preferred investment asset, reflecting shifts in investor sentiment. The stock market has been the more volatile of the two. A good account of this volatility is provided by Nicolas Lardy:

> 'A massive run-up in prices pushed the Shanghai Stock Market A-share market index to a peak of 6,251.5 in October 2007. Subsequently, even before the onset of the global financial and economic crisis, the market [was] sold off, with the index falling by more than half by mid-year 2008. The market then plunged further, with the index hitting a low of about 1,800 at the time of the Lehman collapse in the fall of 2008. Despite China's

> relatively strong economic growth during the global economic crisis and a particularly rapid recovery in corporate profits in 2010, by end-June 2011 the A-market share index stood at only 2,800, less than half its peak level in October 2007. Most Chinese households, having been burned by the stock market, have limited their equity investments.'[93]

But apparently, Chinese households have short memories. Frenzy again gripped the stock market in 2014. With China's stock market value going above $10 trillion and the Shanghai index rocketing upward by 150 per cent between mid-2014 and mid-2015, the market seemed both a safe and highly rewarding bet. Hundreds of thousands of small investors rushed into the casino, many betting with money borrowed from Chinese state banks.

When the Shanghai index reached its highest point in mid-June, a Bloomberg analyst observed that the previous year's gain alone was 'more than the $5 trillion size of Japan's entire stock market. No other stock market has grown as much in dollar terms over a 12-month period'.[94]

A steep, 40 per cent plunge in the Shanghai index followed. Hundreds of thousands of Chinese investors posted huge losses and are now in debt. Many lost all their savings – a significant personal tragedy in a country with a poorly developed social security system. As early as 2001, Wu Jinglian, known as the country's leading academic reform economist, had characterized the corruption-ridden Shanghai Stock Exchange as a 'casino', where investors would inevitably lose money over the long run.[95] Subsequent events proved him right: Shanghai was every bit as much a casino as Macau.

## The rise of shadow banking

The low bank deposit interest rates that favoured the export lobby were one source of financial instability. The virtual monopoly of access to credit by export-oriented industries, state-owned enterprises and the favoured coastal regions produced a second threat: the emergence of a shadow banking sector. A shadow banking sector is perhaps best defined as a network of financial intermediaries whose activities and products are outside the normal, government-regulated banking system. Shadow banking has come to refer to a variety of financial instruments ranging from relatively common financial products such as money market mutual funds, asset-back securities, and real estate investment trusts, to more complex products like hedge funds, structured finance vehicles and leveraged derivative products associated with financial engineering, which are usually funded by investment banks and large institutional investors.[96] Many of the transactions involving the products of shadow banking are not reflected on the regular balance sheets of financial institutions, so that these project an inaccurate picture of their condition. When liquidity crises take place, however, the fiction of independence of the investment vehicles is ripped apart by market actors who factor these off- balance sheet transactions in their assessment of the financial health of the mother institution.

The shadow banking system's emergence in China came about 'to circumvent tight bank lending quotas and interest rate regulations to meet a real sector (especially SMEs) need for access to credit, and a concurrent demand for higher yielding saving/investment products by China's household and corporate savers'.[97] Since the formal banking system was skewed towards short-term lending, the emergence of the shadow banking system responded to enterprises' need for longer-term credit, especially for projects that took a long time to mature. Unable to change the formal banking practices owing to the resistance of the export lobby, reformers at China's Central Bank did not discourage this "financial innovation and development."[98]

By the end of 2013, according to one of the more authoritative studies, the scale of shadow banking risk assets totalled 32.2 trillion RMB, or 51 per cent of GDP.[99] The global average, in contrast, was 120 per cent of GDP, leading to the assessment of some experts that the Chinese shadow banking system was still some distance from a Lehman scenario.

There were, however, some characteristics of the Chinese situation that caused concern. First, many shadow banking creditors had raised their capital by borrowing from the formal banking sector. Should a shadow banking crisis ensue, it was estimated that up to 50 per cent of the NPLs of the shadow banking sector could be 'transferred' to the formal banking sector, thus bringing it down too.[100] As one worried assessment put it:

> 'In the shadow banking system, where regulatory oversight is less intensive, there is insufficient official data on the status of NPLs, provisioning, and CAR [capital adequacy ratio], but they are likely to be worse off than those of the banks. Shadow banks borrow mostly from the banking system, with a relatively small amount of self-financing. If shadow banks went into financial difficulties, their NPLs could spread to the banking system, impairing its asset quality. This means that the NPLs of the whole banking system could be higher than the 1 per cent disclosed in the banks' books, but a more realistic estimate would have to examine the potential credit losses in the shadow banking sector.'[101]

Second was the link between the shadow banking sector and the real estate sector. Over 30 per cent of the total new issuance of combined unit trust products in 2010 and 2011, and 10 per cent of existing trust products at the end of 2013, were accounted for by the real estate sector. Moreover, a large proportion of the loans extended to borrowers had property as collateral.[102] Thus, a sharp drop in property valuations would immediately have a negative impact on the shadow banking sector in the form of a proliferation of NPLs.

Is China, in fact, still distant from a Lehman style crisis? Interestingly, the authoritative study by Sheng and Soon provides worrisome statistics but concludes that 'China's shadow banking problem is still manageable, but time is of the essence and a comprehensive policy package is urgently needed to preempt any escalation of shadow banking NPLs, which could have contagion effects'.[103] As a number of authorities have pointed out, it is the negative synergy between real estate inflation, shadow banking loans to real estate, and formal banks' loans to shadow banks that poses the greatest danger to the Chinese economy.

In terms of its global impact, some claim that a shadow banking crisis in China 'has no direct systemic implications, since China is a net lender to the world and very few foreigners hold Chinese shadow banking assets'.[104] Still, they admit, it could have negative contagion effects on foreign holdings of China's bonds and securities, forcing their sell-off, with the added destabilizing effects on China's financial system.[105] Not mentioned is the fact that a financial crisis would inevitably have an impact on the real economy, forcing lower growth, if not a global recession of the order of that which began in 2008-2009. With China's centrality in global trade, this decline would have a massive impact on an already stagnant global economy.

## Conclusion

China's cautious financial liberalization shielded it from the Asian financial crisis. The minimal exposure of its banks to toxic assets, such as sub-prime-mortgage-based securities, saved its financial system from the crisis that the savaged US and European financial systems. The $585 billion stimulus that the Chinese leadership set in motion in response to the global recession that came on the heels of the financial crisis prevented the country's growth rate from declining significantly. However, its strategic aim of redistributing income and transforming the growth strategy from an export-led to a domestic demand-led process failed, as the powerful export lobby hijacked the bulk of the stimulus funds. This coalition was also able to prevent liberalization of the interest rate on savings deposits and an end to its monopoly on credit from the big state banks. This contributed to people putting their savings into real estate and the stock market, creating speculative bubbles in both. It also created a shadow banking sector whose assets grew rapidly in relation to GDP. Today, the negative synergy between real estate loans, the expansion of the shadow banking system, and the dependence of the shadow banking system on loans from state banks is creating or has already created a speculative bubble that threatens not only the Chinese economy but the global economy. The Chinese bubble could be the third phase of the global financial crisis.

*Walden Bello is currently the International Adjunct Professor at the State University of New York at Binghamton and an associate of the Transnational Institute. He is the author or co-author of 20 books, among the latest of which are *Capitalism's Last Stand?* (London: Zed, 2013) and *Food Wars* (London: Verso, 2009), and *Dilemmas of Domination: The Unmaking of the American Empire* (New York: Henry Holt, 2005).

## Notes


1. Vogel, S. (2006) *Japan Remodeled*. Ithaca: Cornell University Press.
2. Brasor, P. 'There's nothing weird about sexless Japan', *Japan Times*, 1 October, 2016. Available at: http://www.japantimes.co.jp/news/2016/10/01/national/media-national/theres-nothing-weird-sexless-japan/#.WOvlJY7ieRu (retrieved 10 April 2017).
3. 'What is Hikikomori? Could it be one of Japan's most serious problems?' *Japan Info*, 21 November 2016. Available at: http://jpninfo.com/64533 (retrieved 9 April 2017).
4. Wakatabe, M. *Japan's great stagnation and Abenomics*. Basingstoke: Palgrave Macmillan, pp.8-9.
5. Gordon, A. (2015) ' Making sense of the lost decades', in Y. Funabashi, and B. Kushner, *Examining Japan's lost decades*. London: Routledge, p.94
6. Maddison, A., cited in Crotty, J., 'Why there is chronic excess capacity', *Challenge*, November-December 2002, p.25. The usual dating for the "Golden Age" or "Glorious 30 Years" is 1950-1980.
7. Ibid.
8. Gao, B. (2001) *Japan's Economic Dilemma* (Cambridge: Cambridge University Press, p.5.
9. Brenner, R. (1998) 'The economics of global turbulence', special issue of *New Left Review*, No 229 (May-June), p.185.
10. Vogel, p.32.
11. Hiroyasu, U., Yamada, T., and Harada, Y. (2016) 'Regulation approach to Japanese and Asian capitalisms: understanding the varieties of capitalism and structural dynamics', in Yokokawa, N., K Yagi, H Uemura and R Westra (eds.) *The rejuvenation of political economy*. London: Routledge, p.132.
12. Sugawara, S. (1998) 'Excess capacity slowing Japan's recovery', *Washington Post*, 25 December, p.B-9.
13. Mera, K. (2000) 'The linkage of the economy with land price fluctuations: the case of Japan in the 1990s', in K. Mera and B. Renaud (eds.) *Asia's financial crisis and the role of real estate*. Armonk, New York: M.E. Sharpe, p.87.
14. Ibid.
15. Gao, p.169.
16. Werner, R. (2005) *New paradigm in macroeconomics*. Basingstoke: Palgrave Macmillan, pp.135-136.
17. Ibid., p. 292.
18. Ibid., p. 293.
19. Koo, R. (2009) *The escape from balance sheet recession and the QE Trap*. Singapore: John Wiley, p.26.
20. Kenneth Kuttner, IwaisakoTokuo, and Adam Posen, "Monetary and Fiscal Policies during the Lost Decades," in Yoichi Funabashi and Barak Kushner, eds., *Examining Japan's Lost Decades* (London: Routledge, 2015), p. 23-24
21. Ibid., p.29.
22. Ibid., p.89
23. Keiichiro, K. (2015) 'The two 'lost decades' and macroeconomics: changing economic policies', in Y. Funabashi and B. Kushner (eds.) *Examining Japan's lost decades*. London: Routledge, p.43.
24. Vogel, p.50.
25. Schiff, J. (2015) *Can Abenomics succeed?* Washington, DC: International Monetary Fund, p.1.
26. Tsunekawa, K. (2015) 'Japan: the political economy of the long stagnation', in T.J. Pempel and Keiichi Tsunekawa, *Two crises, different outcomes*. Ithaca: Cornell University Press, p.214.
27. Anchorduguy, M. (2005) *Reprogramming Japan: the high-tech crisis under communitarian capitalism*. Ithaca: Cornell University Press.
28. Noroyuki Yoshino, interview with author, Tokyo, 9 June 2017.
29. Noriko Hama, interview with author, Tokyo, 19 June 2017
30. Ibid., p. 8.
31. Interview, Tokyo, June 9, 2017.
32. Interview, Tokyo, June 14, 2017.
33. Interview, Tokyo, June 19, 2017.
34. Figures provided by Japan Ministry of Finance.
35. Okazaki, H. (1992) 'New strategies toward super-Asian bloc'. *This Is* [Tokyo], August. Reproduced in *FBIS Environment Report*, August 1992, p.18.

36. Hughes, C. 'Japanese policy and the East Asian currency crisis: abject defeat or quiet victory?'. *Review of International Political Economy*, Vol 7, No 2, pp.219-253. Available at: http://www.tandfonline.com/doi/abs/10.1080/096922900346956 (retrieved 19 August 2017).

37. Nordhaug, K. 'Asian Monetary Fund Revival', Focus on the Global South, undated. Available at: https://focusweb.org/publications/2000/Asian%20Monetary%20Fund%20revival.htm (retrieved 30 June, 2017).

38. Institute of International Finance. (1998) *Capital flows and emerging market economies* Washington: Institute of International Finance, p.3.

39. Nordhaug, op cit.

40. Ibid.

41. HG Asia (1996) *Communique: Thailand – worth a nibble perhaps but not a bite*. Hong Kong: HG Asia.

42. Kantong, T. (1998) 'The currency war is the information war', Talk at the Seminar Workshop on '*Improving the flow of information in a time of crisis: The challenge of the Southeast Asian media*'. Subic, Philippines, 29-31October.

43. Eichengreen, B., Mathieson, D. (1998) *Hedge funds and financial market dynamics*. Occasional Paper 166. Washington: International Monetary Fund, p.17.

44. Winters, J. 'The financial crisis in Southeast Asia', paper delivered at the Conference on the Asian Crisis, Murdoch University, Fremantle, Western Australia, August 1998.

45. Ibid.

46. Park, AA. (2001) 'Korea's management of capital flows in the 1990s', in S Griffith-Jones, M Montes, and A Nasution (eds.) *Short-term capital flows and economic crises*. Oxford: Oxford University Press, pp.80-81.

47. Arvind Palat, R. (1999). 'Miracles of the day before?: The great Asian meltdown and the changing world economy,' *Development and Society*, vol. 28, no. 1 (June), pp.25-26.

48. Blustein, P. *The Chastening* (2001) New York: Public Affairs, pp.125-26.

49. Ibid, p.126.

50. Palat, p. 25; Grabel, I., 'Rejecting exceptionalism', in J Michie and J Grieve Smith, *Global instability: the political economy of world economic governance*. London: Routledge, 1999), p.52.

51. Grabel, p.52.

52. Quoted in Blustein, p.127.

53. Blustein, pp.196-205.

54. Grabel, p.53.

55. Blustein, p. 202.

56. Rubin and Weisberg, p.241.

57. Joseph Stiglitz, quoted in *The Nation*, 13 May, 2000.

58. International Monetary Fund. (1999) 'IMF-supported programs in Indonesia, Korea, and Thailand', IMF Occasional Paper, no. 178, 30 June, p.62.

59. Johnson, C. (2000) *Blowback: the costs and consequences of American empire*. New York: Henry Holt, p.206.

60. Pepinsky, T. (2008) 'Economic recovery in Indonesia and Malaysia', in A MacIntrye, T.J. Pempel and J Ravenhill (eds.) *Crisis as catalyst: Asia's dynamic political economy*. Ithaca: Cornell University Press, p.235.

61. Ibid.

62. Testimony of Charlene Barshefsky before the Way and Means Subcommittee, US House of Representatives, 24 February 1998.

63. Ibid.

64. Ibid.

65. Quoted in 'Worsening financial flu lowers immunity to U.S. business', *New York Times*, 1 February 1998.

66. Walter, A. (2008) *Governing finance: East Asia's adoption of international standards*. Ithaca: Cornell University Press, p.76.

67. Bello, W. (2007) All fall down: The Asian financial crisis, neoliberalism and economic miracles,' *Asia Pacific Journal/ Japan Focus*, Vol. 5, No. 8, 1August 1. Available at: http://apjjf.org/-Walden-Bello/2486/article.html (retrieved 30 June 2017).

68. Hicken, A. 'The politics of economic recovery in Thailand and the Philippines', in A MacIntyre, T.J. Pempel and John Ravenhill (eds.) *Crisis as catalyst: Asia's dynamic political economy.* Ithaca: Cornell University Press,

69. Allen, F., Yun Hong, J. (2011) 'Why are there large foreign exchange reserves? The case of South Korea', *Korea Social Science Journal,* Vol 38, No 2 (Dec), p.13.

70. Amyx, J. "Regional financial cooperation in East Asia since the Asian financial crisis," in A MacIntyre, T.J. Pempel and John Ravenhill (eds.) *Crisis as catalyst: Asia's dynamic political economy.* Ithaca: Cornell University Press, pp. 127-128.

71. Mo, J. 'The Korean economic system ten years after the crisis," in in A MacIntyre, T.J. Pempel and John Ravenhill (eds.) *Crisis as catalyst: Asia's dynamic political economy.* Ithaca: Cornell University Press, pp.261-262.

72. Ibid., p.264

73. Ibid.

74. Yasonobu Okabe, Y. "'Institutional path dependence in Korea and Thailand," in T.J. Pempel and K. Tsunekawa (eds.) *Two crises, different outcomes: East Asia and global finance*. Ithaca: Cornell University Press, in Pempel and Tsunekawa, pp. 104-105.

75. Ibid., p.106

76. Lim Hyun-Chin and Jang Jin-Ho, p. 22.

77. Stent, J. (2017) *China's banking transformation: the untold* story. Oxford: Oxford University Press, p.76

78. Ibid.

79. Naughton, B. (2015) 'China and the two crises: from 1997 to 2009', in T.J. Pempel and Keiichi Tsunekawa (eds.) *Two crises, different outcomes: East Asia and global finance*. Ithaca: Cornell University Press, , p. 116.

80. Steinfeld, E. (2008) 'The capitalist embrace: China ten years after the financial crisis," in A MacIntyre, T.J. Pempel and John Ravenhill (eds.) *Crisis as catalyst: Asia's dynamic political economy.* Ithaca: Cornell University Press, p.190.

81. Ibid.

82. Quoted in Leo Goostadt, L. (2011) *Reluctant regulators*. Hong Kong: Hong Kong University Press, p.81.

83. Stent, p.85.

84. Prasad, E. (2017) *Gaining currency: the rise of the Renminbi*. Oxford: Oxford University, p.67.

85. Wang, H. (2014) 'Global imbalances and the limits of the exchange rate weapon', in E. Helleiner and J. Kirshner (eds.) *The great wall of money*. Ithaca: Cornell University Press, pp.118-119.

86. Ibid.

87. Lardy, N. (2012) *China's economic growth after the global economic crisis*. Washington, DC: Peterson Institute of International Economics, p.89.

88. Ibid., p.91.

89. Silva, C. (2017) 'China worried about a housing bubble as prices soar', *Newsweek*, 18 March. Available at: http://www.newsweek.com/housing-market-2017-china-real-estate-prices-are-570265 (retrieved 24 June 2017).

90. 'Chinese efforts to stem housing bubble show promise', (2017) *Bloomberg Views*, 12 June. Available at: https://www.bloomberg.com/view/articles/2017-06-12/chinese-efforts-to-stem-housing-bubble-shows-promise (retrieved 24 June 2017).

91. Sheng, A., Chow Soon, N. *Shadow banking in China* (2016) Chichester: John Wiley, pp.151-152.

92. Interview with Japanese economist, identity withheld at request, Tokyo, 9 June 2017.

93. Lardy, p.90

94. "China's stock market value exceeds 10 trillion for the first time," June 15, 2015, https://www.bloomberg.com/news/articles/2015-06-14/china-s-stock-market-value-exceeds-10-trillion-for-first-time. Accessed June 25, 2017.

95. Lardy, p. 90.

96. Sheng and Soon, p.18.

97. Ibid, pp.xxii-xxiii

98. Ibid.

99. Ibid., p.xxiv.

100. Ibid., p.xxv

101. Ibid., p.138

102. Ibid., pp.150-151

103. Ibid., p.xxix

104. Ibid., p.xxiv

105. Ibid.

This paper by Walden Bello dissects the Japanese bubble economy in the late 1980's and early 1990's and the Asian Financial Crisis in 1997-98 and shows how they shaped Asia's capacity to deal with and respond to the 2008 global financial crisis. It looks at how China emerged seemingly unscathed, but warns that the inroads of speculative financial capital into China and East Asia along with ongoing problems of over-production might mean that a future financial crisis is highly probable.

This is the third part of a broader study on global finance, conducted under the auspices of the Transnational Institute (TNI) and the Center for Southeast Asian Studies (CSEAS), Kyoto University. The previous two papers focused on the dynamics of the United States economy and the European Union during the current global economic crisis. The final paper in the series will explore possibilities for an alternative global financial architecture.

Walden Bello is currently the International Adjunct Professor of Sociology at the State University of New York at Binghamton and an associate of the Amsterdam-based Transnational Institute. He has just completed a visiting research fellowship at the Centre for Southeast Asian Studies of Kyoto University.

**AUTHOR:** Walden Bello

**EDITOR:** Angela Burton

**LAYOUT:** Evan Clayburg

Published by Transnational Institute – www.TNI.org



**ACKNOWLEDGEMENTS:**

The author would like to express his deep gratitude to Professor Caroline Hau of CSEAS and to Fiona Dove, Pietje Vervest, Brid Brennan, Satoko Kishimoto and Nick Buxton of TNI for facilitating this study.