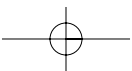
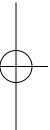
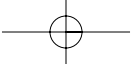


KAS-Schriftenreihe Korea  
콘라드 아데나워 재단 정기간행물

# Global Financial Crisis and Its Impacts on Asia





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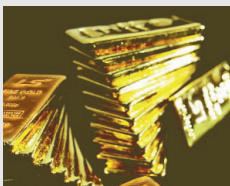
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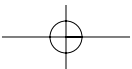
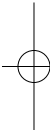
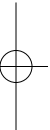
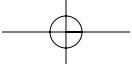
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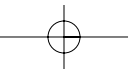
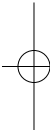
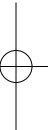
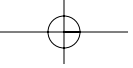
### A Twenty Year Crisis for Northeast Asia? The impact of liberal economic failure upon regional security

Konrad Adenauer Stiftung Global Financial Crisis and its  
Impact on Asia (Da Nang/Vietnam, April 2009)

**Brendan Howe**

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### *Abstract*

*E. H. Carr, writing at the end of an era dominated in both theoretical and practical international relations by liberal internationalism which he termed the 'Twenty Year Crisis,' contrasted the impractical philosophical aspirations of the liberal internationalists with what was 'really' happening in the world. His critique was particularly targeted at the period in the wake of the Wall Street Crash and the previous global financial crisis, when the rise of economic and then expansionistic political nationalism led to a series of conflicts that destroyed the League of Nations and the ideology behind it. Liberal idealists and statesmen were effectively blind to the 'real' nature of the interaction between states by initial post-Great War optimism and a post-war economic boom. There are a number of dangerous parallels between the twenty-year crisis of the European led liberal world system of the early twentieth century, and the crisis of the current American-led system, particularly with regard to Northeast Asia. This paper assesses the degree to which liberal optimism may again be seen as misplaced in times of economic crisis.*



## A Twenty Year Crisis for Northeast Asia? The impact of liberal economic failure upon regional security

### I. Introduction

E. H. Carr (1939), writing at the end of a period dominated in both theoretical and practical international relations by liberal internationalism which he termed the ‘Twenty Year Crisis’, emphasised that the failure to universalise the democratic norm doomed the fledgling international society to conflict. For him, perpetual peace can be achieved only if republican governments were thrown up by domestic societies rather than artificially imposed upon them. ‘When the theories of liberal democracy were transplanted, by a purely intellectual process, to a period and to countries whose practical needs were utterly different from those of Western Europe in the nineteenth century, sterility and disillusionment were the inevitable sequel.’<sup>1)</sup>

Carr contrasted the impractical philosophical aspirations of the liberal internationalists with what was ‘really’ happening in the world (he was hence credited as one of the founders of the realist paradigm), particularly in the wake of the Wall Street Crash and the previous global financial crisis, the rise of economic and then expansionistic political nationalism led to a series of conflicts that destroyed the League of Nations and the ideology behind it. Liberal idealists and statesmen were effectively blind to the ‘real’ nature of the interaction between states by initial post-Great War (or ‘the war to end all wars’) optimism and a post-war economic boom. There are a number of dangerous parallels

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1) Carr, EH 1939[1964], *The twenty years’ crisis, 1919-1939: An introduction to the study of international relations*, Macmillan, London, p27.



between the twenty year crisis of the European-led liberal world system of the early twentieth century, and the crisis of the current American-led system, particularly with regard to Northeast Asia.

## II. Modernism, Development, Interdependence and Econophilia

Writing towards the end of the Cold War, Walter Carlsnaes (1986) noted that since the ‘Realist’ dominance of the 1950s and 1960s, thoughts about international order reform and its influence upon the domestic policies of constituent states have experienced a resurgence, ‘to such an extent that we might be tempted to equate the intellectual mood of the present time with the utopian impulse of the post-1918 decade.’<sup>2)</sup> This process picked up speed following the fall of communism with a second chance to secure the post-First World War utopian aims of liberal internationalism. Resurgent liberal optimism spilled over into analysis of the Northeast Asian subset, with attempts to trace the evolution of a liberal ‘virtuous triangle’ of democratisation, economic interdependence, and international organisation following the apparently successful processes in Europe. Given the phenomenal growth of economies in the region, it is not surprising that many commentators focus on the promise for peace held out by economic interdependence, what Barry Buzan and Gerald Segal have termed the ‘remarkable econophilia’ of East Asia and the Pacific, where all problems are seen as surmountable through development and growth.<sup>3)</sup> This optimism is based on the liberal view that mutual dependencies in trade,

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2) Walter Carlsnaes, 1986. *Ideology and Foreign Policy: Problems of Comparative Conceptualism*. Oxford: Basil Blackwell, p. 8.

3) Barry Buzan and Gerald Segal, 1998. ‘Rethinking East Asian Security’ in Michael T. Klare and Yogesh Chandrani eds. *World Security: Challenges for a New Century*, New York: St. Martin's Press, p. 103.



finance and technology raise the cost of conflict and lower the incentives for war. Economic interdependence is a function of mutual dependence between two or more states, the costs of which are exacerbated by conflict. The basic formulation is: [1] ‘that war becomes irrational under interdependence, because it would endanger and in all probability destroy not only the adversary, but one’s own interests and investments in his country as well: it would serve no rational purpose;’ [2] ‘that increasing cooperation and an increase in mutual dependency (in short, interdependence) will inevitably lead to an increase in the number of conflicts;’ [3] ‘that under interdependence, the strategies of dealing with these conflicts will be restricted to non-violent and non-military ones.’<sup>4)</sup>

The rationale for the crucial third hypothesis is that the costs of war resulting from the disruption to markets, investments, and flow of goods are exacerbated through interdependence as each dependent state is that much more vulnerable than it is under more autarkic conditions, while at the same time a culture of communication and compromise is fostered between mutually dependent dyads through repeated incidents and processes of cooperation. Furthermore, incentives for conflict are lower because ‘in a relatively open liberal international economy, access to raw materials, finance, and markets is obtained at less cost and on a greater scale than would be possible via military control of territory or spheres of influence.’ Thus: ‘A liberal economic order divorces wealth and welfare from control over territory, and thereby removes one of the main reasons for the use of force.’<sup>5)</sup>

The process of interdependence is seen to operate at three levels: the global level, whereby the various processes of globalisation have made all industrialised states

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4) Hylke Tromp, 1989. (3-12) ‘Interdependence, Security, and Peace Research’ in James N. Rosenau and Hylke Tromp eds. *Interdependence and Conflict in World Politics*, Aldershot: Avebury, pp. 9-10

5) Buzan and Segal, op. cit. 1998, p. 103.



interdependent; the regional level, whereby certain regions of the world are seen to represent zones of economically induced peace; and the dyadic level, whereby mutual dependence between pairs of states is seen as reducing the likelihood, or even possibility of them going to war. Mark Gasiorowski and Solomon Polacheck (1982) found ‘a strong, inverse relationship between trade and conflict.’<sup>6)</sup> Their results indicated that international conflict could be eased considerably by ‘engaging a hostile nation in interactions that are beneficial to it.’<sup>7)</sup>

With regard to the first level of interdependence, that of globalisation and economic development, Edward Morse contended as early as 1970, that: ‘Foreign policy has been radically transformed by the revolutionary process of modernisation not only in the societies composing the Atlantic region, but wherever high levels of modernisation exists.’<sup>8)</sup> There is no doubt that high levels of modernisation are being achieved throughout the Asian region, with first Japan, then the Asian Tigers, (South Korea, Hong Kong, Taiwan and Singapore) and finally China itself and the Asian Tiger Cubs (Thailand, Malaysia, Indonesia, and, debatably, the Philippines) becoming increasingly integrated into the international economy.

A recent Central Intelligence Agency (CIA, 2000) publication that analyses global trends leading to a world vision of 2015, sees the process of globalisation picking up speed, and exceeding prior predictions. It notes international economic dynamics, including the development of the World Trade Organisation, and the spread of information technology, as having much greater

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6) Mark J. Gasiorowski and Solomon William Polacheck, 1982. ‘Conflict and Interdependence: East-West Trade and Linkages in the Era of Détente.’ *Journal of Conflict Resolution* 26(4): 709-29. p709.

7) *Ibid.* p. 728.

8) Edward Morse, 1970. ‘The Transformations of Foreign Policies: Modernization, Interdependence and Externalization.’ *World Politics* 22(3): 371-92, p. 371.



influence than previously anticipated, and predicts: ‘The networked global economy will be driven by rapid and largely unrestricted flows of information, ideas, cultural values, capital, goods and services, and people’ and that ‘this globalised economy will be a net contributor to increased stability in the world.’ In particular, ‘Emerging Asia’ is highlighted as the fastest growing region, led by breakout candidates China and India, whose economies already comprise roughly one-sixth of global Gross Domestic Product (GDP).<sup>9)</sup> Table 1 addresses the modernisation and globalisation of Northeast Asia.

**Table 1. Modernisation and Globalisation<sup>10)</sup>**

	2007 gross national income [GNI] per capita dollars	2007 PPP gross national income per capita dollars	World Bank classification (GNI/PPP) <sup>11)</sup>	Globalisation Ranking <sup>12)</sup>
United States	46,040	45,850	H	7
Russia	7,560	14,400	UMC	62
China	2,360	5,370	LMC	66
Japan	37,670	34,600	H	28
Mongolia	1,290	3,160	LIC	N/A
North Korea	N/A	N/A	LIC	N/A
South Korea	19,690	24,750	UMC	35
Taiwan	N/A	N/A	N/A	37

9) Central Intelligence Agency, December 2000. *Global Trends 2015: A Dialogue About the Future With Nongovernmental Experts*. pp. 5-25. <http://www.cia.gov/cia/publications/globaltrends2015/index.html>

10) Primarily extracted from The World Bank, Gross national income per capita 2007, Atlas method and PPP <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf> last accessed 27 February, 2009.

11) H stands for High income (>\$37,566/36,100), UMC for upper middle income (>\$6,987/11,868), LMC for lower middle income (>\$1,887/4,543), and LIC for low income (<\$578/1,494). GDP = Gross Domestic Product. PPP means adjusted for purchasing power parity.

12) Globalization Index Rankings for 2007 [http://www.foreignpolicy.com/story/cms.php?story\\_id=4030](http://www.foreignpolicy.com/story/cms.php?story_id=4030) last accessed February 28, 2009.



However, the table shows mixed results. America and Japan are modern industrialised developed states. South Korea is close to achieving the same status. China's phenomenal recent growth indicates it may catch up, but it remains far from the objective. Russia has just broken into the upper middle income bracket. Mongolia and North Korea remain severely under-developed (with data not even available on the latter) and Taiwan is not listed in much of the data as it is not recognised as an independent state. Furthermore, globalisation rankings for all the countries, including even the US, are very low, especially when only economic indicators are considered. Clearly we need to consider the role of interdependence in the tighter, region-wide setting, or between dyads, rather than the global context.

Asian trade has risen according to both trade in goods as a percentage of purchasing power parity (PPP) gross domestic product (GDP), and trade in goods as a percentage of goods GDP. Likewise, foreign direct investment as a percentage of PPP GDP has risen through the timeframe considered. However, these measurements still lag behind those found in Europe. Exports within the region have increased and, within the Asia Pacific Economic Cooperation (APEC) bloc, now exceed the percentage of total exports of those shipped within the borders of the European Union. Yet those within the East Asian Economic Caucus (EAEC) remain lower. This is explained by the absence of the US from the EAEC but its presence in APEC. Even the inclusion of China in the EAEC figures, while it is excluded from APEC measurements, is not enough to overcome this omission.

For most of regional economies, trade within Asia is becoming increasingly important. However, the exception of China is a large one. Furthermore, for a single country, the U.S. exerts an inordinate degree of control over the trading patterns of all these states. Rather than the true mutual dependence between equals we find in Europe, Asia is faced with a much more lopsided system with



overreliance on the U.S market, unequal bilateral trading relationships between industrialised and emerging Asia, and also between the Chinese mega-economy and other states. Table 2 [below] brings the degree to which this is the case into sharper relief.

**Table 2. Regional Trade and Economic Integration<sup>13)</sup>**

(share of the direction of exports in 2006 and changes from 1990 in parentheses.)

	Directions					
		Emerging	Industrial			Rest of
	Asia	Asia	Asia	NAFTA	EU15	the World
Asia	<b>51.9</b> (9.2)	<b>42.1</b> (11.7)	<b>9.9</b> (-2.5)	<b>20.7</b> (-6.9)	<b>14.2</b> (-4.1)	<b>13.2</b> (1.9)
Emerging Asia	<b>51.6</b> (4.1)	<b>40.8</b> (9.8)	<b>10.8</b> (-5.7)	<b>20.1</b> (-4.6)	<b>14.6</b> (-2.2)	<b>13.6</b> (2.7)
Industrial Asia	<b>53.1</b> (16.2)	<b>46.5</b> (16.9)	<b>6.6</b> (-0.7)	<b>22.5</b> (-8.7)	<b>12.8</b> (-7.4)	<b>11.6</b> (-0.1)
NAFTA <sup>1</sup>	<b>19.5</b> (-5.8)	<b>13.5</b> (1.0)	<b>6.0</b> (-6.8)	<b>52.5</b> (11.9)	<b>14.6</b> (-7.4)	<b>13.4</b> (1.3)
EU15 <sup>2</sup>	8.2 (0.7)	6.1 (1.7)	2.2 (-1.0)	9.6 (1.2)	<b>59.2</b> (-6.7)	23.0 (4.8)

Source: IMF Direction of Trade Statistics, and staff calculations.  
 Note: Numbers in the parentheses are changes in the shares from 1990 to 2006.  
 Shaded cells are those of intra-regional trade flows.  
<sup>1</sup>NAFTA = North American Free Trade Agreement.  
<sup>2</sup>EU15 = Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Rather than interdependence, Asia is faced with a lopsided system of economic dependence upon the US, meaning that: [1] the pacific effects of intra-regional interdependence are not felt; [2] as rapidly developing countries fight for a share

13) Paul Gruenwald and Masahiro Hori, 'Intra-regional Trade Key to Asia's Export Boom' *IMF Survey Magazine* February 6, 2008 <http://www.imf.org/external/pubs/ft/survey/so/2008/CAR02608A.htm> last accessed 27 February, 2009.





of the American market, relations between them have the potential to deteriorate; [3] power relations are likely to reassert themselves. In Northeast Asia, the situation is further exacerbated by a lack of free trade initiatives and economically interdependent dyads between any of the regional great powers. Indeed, despite Japan and Korea signing free trade pacts with Chile and China with Singapore and ASEAN as a whole, countries in the region have far fewer cooperative economic arrangements than is the norm for economies of their scale and development, and the trading models of each of these countries are more tied to economic nationalism and protectionism than the liberal capitalist model designed to boost integration and peace.

### III. A Twenty Year Crisis?

Although Japan had democratic institutions forced upon it, for the most part, liberal internationalists have relied upon the appeal of democracy by convergence whereby the most fundamental question concerns ‘how an almost universal wish to imitate a way of life associated with the liberal capitalist democracies of the core regions (the wish for modernity) may undermine the social and institutional foundations of any regime perceived as incompatible with these aspirations.’<sup>14)</sup> By refraining from forcing people to be free, the hope was that a repeat of Carr’s scenario could be avoided.

The great liberal hope for the region is that as China continues its phenomenal economic progress, a natural and inevitable bi-product will be the emergence of a true Chinese civil society that in turn will press for political liberalisation. Lowell Dittmer predicts ‘under such circumstances, previous experience

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14) Whitehead, L. 1996. *The International Dimensions of democratization; Europe and the Americas*. New York: Oxford University Press, p. 21.



suggests that a full-blown civil society - albeit still with distinctive Chinese cultural characteristics - is apt to emerge as quickly as bamboo shoots after a spring rain,' while Zbigniew Brzezinski agrees: 'It is impossible to envision a long-term process of increasing economic pluralism without the appearance of civil society in China that eventually begins to assert its political aspiration.'<sup>15)</sup> With the United States, Japan and Korea already consolidated democracies, a politically transformed China would not only lead to more democratic than conflictual dyads but would also defuse the potential flash point with democratic Taiwan.

Nevertheless, in many ways, the international environment in contemporary Northeast Asia bears a closer resemblance to that of the interwar twenty year crisis of liberalism than it does to that of the post-World War II integration project in Europe. Thus, at least in this region, such liberal optimism may be seen as, at best, premature. In the current political and economic climate, the consensual process of democratic convergence is under considerable threat. The Western way of life only exerts a positive attraction as long as it is perceived to be desirable and preferable to other alternatives. With the western capitalist democratic world system entering a pronounced downturn, this may no longer be the case, particularly if increased inter-regional competition should lead to a new wave of protectionism and shrinking global trade. Other models of governance may be seen as preferable, resulting in ongoing transitions being undermined, authoritarian 'developmental' regimes being propped up, and actually leading to fewer democratic dyads.

In China, economic liberalisation has not been matched by political liberalisation, and in many ways the process of democratisation can be seen as

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15) Cited in Henry R. Nau, 2002. *At Home Abroad: Identity and Power in American Foreign Policy*. Ithaca: Cornell University Press, p. 165.



going backwards. The Tiananmen Square massacre is but the most glaring symptom of democratisation in retreat. Tentative steps taken in Hong Kong under British rule were abruptly reversed when the territory returned to Beijing's direct control. In 2002, the government launched an attack on the Internet, attempting to restrict access and block sites. Crackdowns against the Falun Gong and other groups under Jiang Zemin's old guard have continued under the new leadership. Economic development in China may only have led to the strengthening of authoritarian forces.

Joshua Ramo (2004) has identified a 'Beijing Consensus' 'defined by a ruthless willingness to innovate and experiment, by a lively defence of national borders and interests, and by the increasingly thoughtful accumulation of tools of asymmetric power projection' which may ultimately hold more appeal than the political and economic reforms advocated by the Washington consensus, particularly in the light of the current collapse of the US-led international economic system.<sup>16)</sup> Indeed, given the perceived failure of the International Monetary Fund (IMF) and US indifference during the 1997-8 Asian financial crisis, the Chinese process of modernisation "groping for stones to cross the river," instead of the IMF model of one big, shock therapy leap may seem more palatable during the present crisis.<sup>17)</sup> This is perhaps understandable given that as Mark Beeson points out, China's own developmental experiences are much closer to those of the ideal-typical, East Asian developmental state.<sup>18)</sup>

When Europe experienced its twenty year crisis, it was already a continent characterised by a high degree of development and interdependence, but

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16) Joshua C. Ramo, *The Beijing Consensus* (London: The Foreign Policy Centre, 2004), p. 4.

17) Ibid.

18) Mark Beeson, 'Hegemonic transition in East Asia? The dynamics of Chinese and American power' *Review of International Studies* (2009), 35, 95-112 p 103.



nevertheless was brought to a state of devastating conflict by the collapse of the liberal economic system and the re-emergence of economic nationalism in the wake of the Wall Street Crash and the contraction of global trade. Likewise, during the early years of the inter-war period democratisation had made great strides on the European continent, with Britain and France consolidated democracies, and all other powers transitioning, yet such was the impact of the financial crisis and the dependence of public support upon economic performance that Hitler and Mussolini were elected in Germany and Italy respectively, Republican Spain fell to Franco, and the prospects for democratic peace withered along with the shrinking number of democratic dyads. Ian Bremmer, Choi Sung-Hong and Yoriko Kawaguchi (2005) claim that the absence of a regional security forum means that the parallels of rising regional powers, territorial conflicts and troubled bilateral relations could see Northeast Asia following a model analogous to Europe early in the twentieth century which set the continent on the road to ‘50 years of catastrophic violence.’<sup>19)</sup>

While the world as a whole is experiencing an economic meltdown of a similar magnitude to that of the Wall Street Crash, the region is now entering its second such crisis within a generation. Japan, the economic powerhouse of the region has only just recovered from a decade-long slump following the 1997-1999 Asian financial crisis, only to be faced with an export collapse of 46% in January 2009 and a stock market flirting with 26 year lows.<sup>20)</sup> Asian stock markets are plummeting again recording the lowest levels for years.<sup>21)</sup> Perhaps most

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19) Ian Bremmer, Choi Sung-Hong and Yoriko Kawaguchi, ‘Northeast Asia: Defusing a dangerous region’ International Herald Tribune December 30, 2005. <http://www.iht.com/articles/2005/12/29/opinion/edbremmer.php?page=1>

20) Ambrose Evans-Pritchard, ‘Japan's exports collapse as crisis deepens in Asia’ <http://www.telegraph.co.uk/finance/financetopics/recession/4807231/Japans-exports-collapse-as-crisis-deepens-in-Asia.html> and BBC News Japanese stocks skirt 26-year low <http://news.bbc.co.uk/2/hi/business/7920253.stm>



worrying is that intra-Asian trade is described as ‘entering free-fall’ and therefore unable to contribute further to the pacific effects of economic interdependence.<sup>22)</sup> The benign era of liberal ‘econophilia’ in the region may be at an end and regional, if not global, stability now hangs by a thread as it did in Europe in the 1930s.<sup>23)</sup> The collapse of the Doha Round of the world trade talks and the responses to the crisis of major economies such as the ‘Buy America’ clause in the US financial stimulus package (even in its more diluted form) could lead to a new round of economic national and further shrinkage of global trade, and thereby a rise in conflictual forces.<sup>24)</sup> Nationalism is on the rise in Northeast Asia. All states in the region feel resentment towards and fear of the historical role of Japan, the current primacy of the United States, and the future rise of China. However, due to its explicitly revisionist mantra and phenomenal growth, China is seen as posing the gravest threat to regional security.

Learning from the 1990-91 Gulf War, China embarked on a major military modernisation programme, acquiring from Russia or developing itself, in-flight refuelling technology, modern weapons, aircraft carriers, new destroyers, attack submarines, and ballistic missile submarines, new radar and radar-guided missiles, a new multi-role fighter, stealth technology, and is expanding and improving its strategic nuclear missile force. Steven Mosher (2000) feels that China deserves a reputation for bellicosity, finding that that although the People's

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21) Malcolm Moore, ‘Financial crisis: Asian shares slump again’ <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3156286/Financial-crisis-Asian-shares-slump-again.html>

22) Ambrose Evans-Pritchard, ‘Asian trade in ‘free fall’ as exports to West dry up’ <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3692255/Asian-trade-in-Free-Fall.html>

23) Ambrose Evans-Pritchard, ‘World stability hangs by a thread as economies continue to unravel’ [http://www.telegraph.co.uk/finance/comment/ambroseevans\\_pritchard/3537362/World-stability-hangs-by-a-thread-as-economies-continue-to-unravel.html](http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/3537362/World-stability-hangs-by-a-thread-as-economies-continue-to-unravel.html)

24) Liam Halligan, ‘Doha failure denies the world economy a much-needed boost’ <http://www.telegraph.co.uk/finance/comment/liamhalligan/2794184/Doha-failure-denies-the-world-economy-a-much-needed-boost.html>



Republic of China (PRC) is not as well-known for militarism as Islamic states, it has far more often resorted to violence in settling international disputes (76.9 percent of the time in its international crises, compared to 53.5 percent for Muslim states, 28.5 percent for the Soviet Union, and 17.9 percent for the United States).<sup>25)</sup>

Furthermore, after a decade of rapprochement, North and South Korea are once more confronting each other over the demilitarised zone (DMZ). South Korea's elevation to office of a conservative president from the Grand National Party, Lee Myung-bak, in 2008 led to an end of the 'Sunshine Policy' of constructive engagement and unconditional economic aid for the North. In response, North Korea has announced that: "The group of traitors has already reduced all the agreements reached between the North and the South in the past to dead documents," relations have reached "the brink of war" and that therefore the North no longer considers itself bound by such agreements.<sup>26)</sup> In the wake of what appears to have been a second, and far more successful North Korean nuclear weapon test on May 25, 2009 and the test-firing of more missiles the following day, South Korea and the United States have upgraded the threat level and readiness of their forces (to the second highest level), the UN Security Council has issued concerned statements and is searching for language acceptable to China with which to frame a resolution condemning North Korea, and South Korea has announced it will join the Proliferation Security Initiative leading to the prospect of South Korean personnel boarding North Korean vessels. Pyongyang has responded with belligerent statements including that it would consider any search or seizure of its vessels an act of war to which North

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25) Steven W. Mosher, 2000. *Hegemon: China's Plan to Dominate Asia and the World*. San Francisco: Encounter Books, pp. 58-59.

26) BBC News, 'Uncertain Future for Fractious Koreas' <http://news.bbc.co.uk/2/hi/asia-pacific/7861114.stm>



Korea will respond with a military strike, and on May 27 announced it was abandoning the truce that ended the Korean War. Spokespersons on both sides have described the threats of the other as constituting more than the usual sabre rattling, and even being tantamount to a declaration of war.

With regard to Japan, Alan Dupont (2005) has noted that Japan is not only moving away from its pacifist past towards a more hard-headed and outward-looking security posture characterised by a greater willingness to use the Self Defense Forces in support of Japan's foreign policy and defence interests, but this shift is also gaining momentum, representing a watershed in Japan's postwar security policy, and is palpable, irreversible and broadly based. In support of this contention, he cites recent polls, including one conducted by the authoritative *Asahi Shimbun* newspaper, that 'show a clear majority of Japanese people and parliamentarians are now in favor of constitutional revision (*Kaiken*), and nearly half want to abandon the prohibition on collective self-defense.'<sup>27)</sup> There is also a danger that Japan is potentially forming a nascent regional conflictual 'bigemony' with the People's Republic of China. Indeed current Sino-Japanese relations have been compared with the Anglo-German rivalry prior to World War I.<sup>28)</sup>

#### IV. A Socially Constructed Peace?

However, in the modern globalised world, many of the problems facing Northeast Asia are likewise global rather than regional in nature. Global multi-faceted complex interdependence rather than regional economic interdependence has changed the playing surface. Economic malaise, terrorism, weapons

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27) Dupont, Alan 2005, 'The schizophrenic superpower', *The National Interest*, No. 79, Spring, pp 43-44.

28) Kent E. Calder, "China and Japan's Simmering Rivalry," *Foreign Affairs*, vol. 85 (March/April 2006).



proliferation (both nuclear and conventional) drug and human trafficking, environmental degradation, climate change, AIDs, SARS, avian influenza, contaminated food products, smuggling, counterfeiting and piracy all play a role in the rational cooperative action of modern states.

Repeated economic and strategic interaction, and the recognition by ruling elites of the permanence and importance of these processes, can lead to the evolution of rules for avoiding unwanted conflicts and for facilitating desired exchanges. Failure to do so would mean an enormous inconvenience and, more seriously, potential loss of competitive advantage for those who failed to take this step when others had done so. So rationally, international order could evolve functionally in Northeast Asia from the logic of anarchy without pre-existing cultural bonds found in Europe, but in direct reaction to the challenges posed by an increasingly integrated European and Atlantic bloc.

The geopolitical codes (the practical output of geopolitical reasoning) of states in the region reflect this rational imperative to come to some sort of accommodation with one another in order best to deal with the challenges they face. Despite severe economic pressures, all states in the region have so far resisted the siren calls of economic nationalism and protectionism, and have worked hard at providing a united front in the face of the crisis.

This is the fundamental assertion of China's 'peaceful rise' paradigm which asserts that China can thrive economically in a peaceful environment and also serve as a catalyst for global peace - a kind of virtuous cycle intended to maximise China's economic benefit. Nowhere has China's attempt to project its peaceful rise paradigm been more apparent than in Asia. Economic and trade relations with every country in the region have increased dramatically, and China has now surpassed the United States as the largest trading partner of both South Korea and Japan. Since the turn of the century China has peacefully resolved nearly all its border disputes and while maintaining traditional strong





ties with Pakistan it has also reached rapprochement with former adversaries Russia and India. Since the 1997 crisis, when Beijing refused to devalue its currency, which would have exacerbated devaluations in Thailand and Indonesia, China has been playing the role of a responsible and even benevolent regional great power.

In Japan, the Yoshida Doctrine placing the highest national priority on economic development, while simultaneously keeping a low diplomatic profile worked well until the end of the Cold War. Recent polls (Nikkei Shimbun Opinion Polls, December 2007 & January 2008) found only 39% supported the renewal of the law (which initially expired November 1, 2007) permitting the dispatch of the Maritime Self Defense Forces to the Indian Ocean in support of antiterrorism measures in Afghanistan; and only 35% in favor of allowing the Self Defense Forces to be dispatched overseas. Yet there *is* continued support for the Japanese government to play a more active role in non-traditional areas of foreign and security policy. 92% thought that Japan should be forceful in diplomatic efforts to persuade other countries to reduce emissions of carbon dioxide and other gases. (Yomiuri Shimbun Opinion Polls 19 & 20 May 2007).

Despite sabre-rattling on the Korean Peninsula, even this part of the region can be seen as a rationally constructed zone of peace. North Korean leader Kim Jong-il clearly desires reunification of Korea, but knows he cannot expect to achieve the unification dream through an invasion which if not immediately halted, would soon be reversed by South Korea and her allies. The only unification achieved as a result of such tactics would be under a Seoul based regime over the bodies of tens of thousands of Koreans from both sides. Kim himself would be killed, or worse, taken to stand trial, vilified as a war criminal and then executed. In fact Kim Jong-il has repeatedly asked for a non-aggression pact and recently won a significant diplomatic victory by having North Korea removed from the US list of terrorist sponsoring states, and is interested in



learning from past mistakes and changing for the better.<sup>29)</sup>

Likewise, no matter how harsh the rhetoric, the current South Korean regime could never contemplate reunification by force. While much is made of the dangers posed by North Korea's missile and nuclear programs, it would be far easy, quicker, and cheaper to reduce Seoul, the capital of South Korea and situated uncomfortably close to the border, to smouldering ruins using the huge conventional artillery batteries currently massed in easy range of the target. Any victory achieved by the South would be at best a Pyrrhic one. In fact the political and economic difficulties facing any attempt to reunify the Korean Peninsula mean that an uneasy status quo is likely to endure for some time to come. Lee Myung-bak's aggressive stance has in fact contributed to his recording some of the lowest opinion poll ratings in history for a Korean president, which in turn have made it harder to take any definitive action.

The external challenges and internal rational payoffs in Northeast Asia have thus contributed to a socially constructed rational peace quite different from that which emerged in Europe in the twentieth century. It may be that the peace regime is neither as consolidated nor as stable as its contemporary European counterpart, but it is still more entrenched than the liberal peace of the twenty-year crisis in Europe. Indeed it could be argued that any security regime that is able to deal with so many conflictual forces, face countless skirmishes and instances of sabre-rattling, and yet for five decades prevent the outbreak of serious hostilities between social and political entities harbouring historical grudges and outright hostility towards one another, may be considered durable indeed.

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29) Don Gregg, 'My Turn: Kim Jong Il - The Truth Behind the Caricature' Newsweek February 3, 2003  
<http://stacks.msnbc.com/news/863858.asp>

## Global Financial Crisis and Its Impacts on Asia



# The Global Financial Crisis and its Impact on Political and Performance Legitimacy in Singapore

**Narayanan Ganesan**

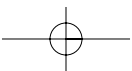
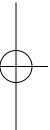
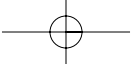
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## The Global Financial Crisis and its Impact on Political and Performance Legitimacy in Singapore\*

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The People's Action Party (PAP) has ruled Singapore from the time of its first victory in the local legislative assembly in 1959. Whereas the early years of rule in the 1960s were often subjected to challenges from left-leaning parties and their allies in the labour movement and grassroots organisations, the PAP skillfully consolidated its power by controlling organised labour, the mass media and community organisations. It also introduced legislation to outlaw strikes and created omnibus unions that were managed by the government. These measures served to strengthen the PAP's control of the domestic agenda by the 1970s. Interestingly, the PAP also depoliticised the state and couched development in administrative rather than value laden political terms. Accordingly and over time, political performance also came to be viewed in economic rather than political terms - what is popularly referred to in the academic literature as performance-based criteria. The political opposition became emasculated and fragmented, and

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\* Paper originally delivered at the international workshop on "The Global Financial Crisis and its Impact on Asia", Hoi An, Vietnam, 23 - 25 April 2009.



offered the PAP little by way of electoral challenges after the *Barisan Sosialis* boycotted parliament in 1966. The introduction of Group Representation Constituencies (GRCs) in 1988 and their subsequent enlargement also meant that many constituencies were often uncontested by the opposition and many Members of Parliament (MP) entered parliament without having gone through the baptism of actual political contestation.<sup>1)</sup> The opposition often chose to contest a number of seats that would not threaten the return to power of a PAP-led government at the close of nomination in order to encourage the citizens to vote more liberally. This so-called by-election strategy was meant, at least in part to ward off criticisms by the incumbent government that its loss to a less experienced and able team may well derail the country's economic and political future. It was also meant to entice the citizenry to check the potential excesses of the PAP while allowing the party to run the country.

The PAP has generally performed rather well in ensconcing itself in power. For the most part, the population appears satisfied with the performance criteria that have been adopted by the PAP. Typically these include the reliable provision of utilities and services in critical areas like health, education and housing. It has also managed the economy rather well with low levels of unemployment and inflation while maintaining high growth rates that, over time, has resulted in the accumulation of substantial reserves. The maintenance of high growth rates for Singapore does however come with a number of intrinsic and structural problems. The first of these is that Singapore is almost entirely dependent on imports for all its necessities including almost all its food and half of its potable water. Secondly, given the small size of the domestic population, growth has to be generated on the basis of manufactured products for export. On both these

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1) For a discussion of the early evolution of domestic politics see N. Ganesan, "Democracy in Singapore", *Asian Journal of Political Science* 4:2 (December 1996): 63-79.



counts, Singapore is extremely vulnerable to cyclical booms and busts in the international economy. The relatively high cost of land and labour also means that the country will have to continually move up the ladder of abstraction in the manufacturing process. In other words, the country can only manufacture products that are sufficiently specialised and have a high value-added component like pharmaceuticals, electronic goods, petroleum and petrochemical products. Consequently, in order to avoid unemployment as technologies change, training and retraining of older workers becomes important.

Singapore is also firmly committed to employing large numbers of foreign workers to keep the cost of production low and remain economically competitive. Such policies also lower the cost of social reproduction and recent migrants, especially those from the region, are far less likely to challenge the tone and temper of domestic politics and policies, having often come from much worse situations. This development has led to some resentment among locals to the extent that the government has consciously tried to provide more economic rights to its own citizens to deflect criticisms. Nonetheless, in order to blur some of the distinction between foreigners who have been granted permanent resident status and citizens, the government now conveniently uses the term “residents” as an umbrella category. It is also making greater efforts at getting recent migrants to integrate better with the local population and has just now gone on to unveil a National Integration Council (NIC).<sup>2)</sup>

Notwithstanding its achievements and high levels of trust, there have been a number of recent developments that have indicated significant levels of unhappiness and sheer disbelief at government policies. Such feedback is readily

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2) See “Panel to aid integration”, *Straits Times*, 6 February 2009.



available from some of the leading local internet websites like mrbrown.com and talkingcock.com. Additional feedback may be gleaned from the forum postings on major websites of the local newspapers. The government's sensitisation to the internet postings are reflected in its greater attempts to engage internet users and detailed explanations regarding policies that have been questioned. A discussion of three such incidents will serve to prove the point.

## The case studies

In late February 2008, the government reported that Mas Selamat Kastari, the Singapore head of the *Jemaah Islamiah* (JI - a regional terrorist network) had escaped from custody at the high security Whitley Road detention centre. He had earlier been arrested in Indonesia and extradited to Singapore where he had been detained under the Internal Security Act (ISA) that provides for detention without trial. Initially there was some shock within the country that such a high profile detainee could have escaped and many expressed security concerns. The government mobilised the resources of many enforcement agencies as well as the army to capture the fugitive. However, he was never found despite the posting of police personnel at all entry and exit points out of the country for many months afterwards.

The disbelief regarding the government's version of the escape (that the prisoner had escaped through a toilet window) surfaced shortly after the announcement. Most of the internet postings questioned the authenticity of the story. There was general disbelief that a fugitive could have escaped from a high security facility in Singapore and that such a large dragnet in a small and developed country for him afterwards failed to produce him. Naturally, over time, the level of cynicism increased and interestingly enough, many from the





educated younger generation were those left unpersuaded. A number of different versions of the story circulated in the country. The first of these was that Mas Selamat had died while being held in custody after aggressive interrogation. A second version of the story was that the Singapore authorities had colluded with American security agencies and interrogated the suspect robustly. He subsequently died and the escape story was meant to cover up what had actually occurred. While these different versions of the story may well sound the farthest thing from the truth, the important point to note is that there was widespread disbelief with the government's version of the story. And as the saga unfolded and a number of personnel manning the security detail were punished, there were also calls for the Minister of Home Affairs, Wong Kan Seng, to take some of the blame for what had happened. Both of these developments, like some of the others cited below, have implications for public perceptions of governance and performance.

More recently, in April 2009, it was disclosed that Mas Selamat had been captured by the Malaysian police after Singapore shared intelligence information with the neighbouring country.<sup>3)</sup> It was reported that he was detained in the town of Skudai in the southernmost state of Johor. It was also revealed that Mas Selamat had used an improvised floatation device to leave the country and swim across the Strait of Singapore to Johor. There he had hidden in a small village with the help of a couple of his previous contacts. Fortunately, for the Singapore government, Mas Selamat's arrest provided sufficient evidence to corroborate the state's earlier version of actual developments although criticisms about its handling of the entire episode, including the belated announcement regarding his capture continued to attract negative publicity.

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3) "Mas Selamat captured", *Straits Times*, 8 May 2009.



The second major development that is directly related to the ongoing global financial crisis involved the Singapore government investment and holding company, Temasek Holdings. The firm had a high profile given the amount of assets that it held and for its large stakes in the Government-Linked Companies (GLCs). Additionally, since 2004, it had been headed by Ho Ching, wife of the present Prime Minister, Lee Hsien Loong. In the last few years, Temasek Holdings had also attracted much negative publicity for its regional investments. In 2006 it bought the entire stake of then Prime Minister Thaksin Shinawatra's family holdings of Shin Telecommunications. The deal that was valued at US\$ 1.8 billion drew much criticism on two counts. Firstly, there was a general feeling among Thais that an important national asset had been sold to a foreign company. Secondly and more importantly, there was disbelief that the entire deal was pursued such that Thaksin's family escaped paying taxes on the sale altogether. This development was actually the proverbial straw that broke the camel's back and led to mounting calls and demonstrations for Thaksin to leave office that were in turn coordinated by the People's Alliance for Democracy (PAD). Temasek Holdings' second regional venture that drew flak was its investments in the Indonesian telecommunication industry. A Jakarta district court ruled that Temasek had violated business competition laws by owning indirect stakes in telecommunication firms Telkomsel and Indosat through its subsidiaries, ST Telemedia and SingTel, respectively. The ruling required Temasek Holdings to sell off all its holdings in one of the companies or pare both holdings by half. Subsequently, the entire 40.8 percent stake in Indosat was sold to Qatar Telecom (QTel) for US\$ 1.8 billion, yielding Temasek Holdings a handsome profit from its earlier purchase price of US\$ 634 million.

In February 2009, in the midst of the global financial crisis, it was revealed that Temasek Holdings had lost a total of US\$ 39.61 billion between March and November 2008. The declared amount meant that the state holding company had



effectively lost 31 percent of its capital from March 2008.<sup>4)</sup> Much of the losses were due to an aggressive expansion of its activities outside its core Asian markets and in the financial sector. Temasek Holdings was especially badly affected by the significant downgrading of its investments in banks like Barclays and Merrill Lynch. Subsequently, it was revealed that Ho Ching would step down and be replaced by Charles Goodyear, the former chief executive of BHP Billiton in October 2009. Additionally, the Finance Ministry press statement noted that Ho's resignation was not performance related and that it was too early to tell if losses would actually be incurred on the investments. Internet postings to the news expressed surprise at the quantum of the losses and the seemingly cavalier manner in which it was announced by Temasek Holdings and the Finance Ministry in parliament. Ho Ching herself was not involved in any of the press briefings or statements and was perceived as having gotten off rather lightly. There was also widespread disbelief that Ho's resignation was not linked to the losses. More recently, newspaper reports that that Temasek Holdings had sold off its entire share portfolio in the Bank of America for a loss of about \$4.6 billion also attracted much negative comments and publicity.<sup>5)</sup>

The final incident that demonstrated a high level of disbelief had to do with the government's decision to utilise some of the financial reserves that had been accumulated from the past. Since this episode is related to Singapore's elected Presidency, some amount of background information is required. In 1993 Singapore introduced a new elected President with a six year term whose major function was to protect the country's accumulated reserves from a government in the future that might be tempted to freely use it for populist policies. The office also carried with it the scrutiny of other important appointees in public service

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4) "Temasek's investment portfolio fell 31 percent", *Agence France Presse*, 10 February 2009.

5) "Temasek Counts the Cost of Merrill Stake", *Asian Wall Street Journal*, 18 May 2009.



and the maintenance of racial harmony. The current president, S. R. Nathan who is in his second term of office, was initially elected for a period of six years in 1999.

As the economic situation showed signs of significant deterioration by 2008, the government announced that it would utilise the interest obtained from its reserves as well as the capital appreciation of its holdings in order to stimulate the economy. However, over time, the decision was made to draw down the reserves in order to mount a significant stimulus package for the new financial year in 2009. Under the rules of engagement of the reserves, the President has to be satisfied that there was indeed a need for its use independently. In fact, the office was often identified as wielding a second independent key to unlock the reserves. Hence, when the actual draw down decision was announced, the President's permission was constitutionally required for it to be implemented. As a result of this requirement, the local daily newspapers went to great lengths on a number of days on how the President had been informed and consulted before the money was obtained.<sup>6)</sup> Large and catchy articles with photographs and charts explaining the procedure were carried in the local media. However, notwithstanding these gestures, the overwhelming postings on the internet surmised that the two keys were actually one. In other words, the prevalent opinion was that the PAP government could do whatever it wanted and that there was no such thing as a second key or checks and balances on the incumbent government.

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6) See for example, "How the President's assent was secured", *Business Times*, 9 February 2009; "Why I said yes", *Straits Times*, 9 March 2009 and "President gives formal approval for draw on past reserves", *Ibid.* 13 March 2009.



## Interpreting the responses and its impact on legitimacy

As mentioned at the outset, the PAP government has long prided itself in its democratic mandate and high levels of political legitimacy albeit this legitimacy has increasingly derived from performance criteria. Since 2008, the global financial crisis has hit the Singapore economy hard with an envisaged domestic economic contraction of up to 10 percent in 2009. Consequently, its government has gone out of the way to assist those in need. Performance is easily achieved during normal times but is understandably difficult during a global recession. Among the policies that it has unveiled is a very generous package of tax and welfare incentives. The latter is often couched in terms of training subsidies or wage supplements in order to distinguish it from welfare that the PAP has never really endorsed as an appropriate policy to pursue for fear that it will lead to a couch mentality. Nonetheless, the S\$ 20 billion economic stimulus package drawn from the reserves was both large and unprecedented.

The three incidents cited in this paper reflect aspects pertaining to the governance of Singapore. All the incidents - the escape of Mas Selamat, the significant losses suffered by Temasek Holdings and the resignation of Ho Ching, and the procedures involved in the release of government reserves - point in the direction of disbelief, for want of a better word. In other words, most of the internet postings on these three incidents indicate an unwillingness to accept the government's version of what transpired at face value. The next logical question that may be asked is: Why is this the case? Whatever the reasons may be, the perception of many bloggers appears to be one of incredulity. Typically, such responses indicate that the audience is not convinced by the official explanations offered and think that a different scenario is more than likely. In other words, the audience is basically unprepared to accept the government's version of what had happened. Naturally, such a response is detrimental to the government as well as



governance in general. It is detrimental because the compact achieved between the public and the government has been undermined. More importantly, if the trend continues unchecked or is not remedied, it will impact on the credibility of the government. As a result, over time, the legitimacy of the government will be eroded with all the attendant consequences.

A recent and regional example will illustrate the argument perfectly. The incumbent Malaysian Prime Minister has a credibility problem. There are widespread perceptions within the country that he is in some way connected to the death and disposal of the Mongolian model, Altantuya Sharibu. The reasons for this public perception are numerous. Firstly, one of the key accused was a known confidant of the Prime Minister and implicated in the murder. The deceased was known to both persons and was involved in a weapons deal that went sour in that the model was not paid her share of the commission. The private detective who swore that the Prime Minister knew the model and has evidence to prove it has gone missing. Then, there is the mobile phone conversation between the Prime Minister and his confidant that was recorded and came up as testimony in which the former assures the latter that a chat with the Inspector General of Police will solve the problem. And finally, when the confidant was released from custody, he migrated with his entire family to the United Kingdom. In the face of such evidence, one can logically conclude that public perceptions of the new appointee will indeed be tainted. Consequently, regardless of how strongly the party that he represents supports him, political legitimacy at the popular level will remain suspect until the nagging questions regarding the case are answered and the matter brought to a close.

Returning to the Singapore case, the three incidents then reflect a general disbelief among the likely younger and more educated blogging community to accept the government's pronouncements at face value. As mentioned earlier, such cumulative disbelief is injurious to public trust in government. And since



political legitimacy derives in part from trust, it is therefore eroded from deteriorated trust. A related issue in the area of governance is transparency. Just like in the Malaysian example cited, the general public perception is that the model's murder has not been dealt with in a transparent and satisfactory manner. The issue of transparency is also important in governance since opaque situations are always interpreted to the detriment of a government. And the reason for this response is quite simply because the thinking public believes that the government has something to hide, and worse still, something to gain by hiding the truth.

Two of the three incidents touch on another important aspect of governance - accountability or responsibility. The former concept is a much broader one that includes fiscal prudence as well as general acceptance of the consequences of policy output. The latter concept is much narrower in scope and quite simply refers to ownership over policies as well as outcomes. Central to both these concepts in governance is the public expectation that governments are liable for bad decisions. And to reflect this expectation as an acceptable fact of governance, public officials often resign or accept a forfeit of sorts as punishment for a bad decision. Since governments do not only make good decisions all the time, a margin of error is normally permitted. Such margins are meant to compensate for the task of being entrusted with so many decisions in the public interest. Another twist to this accepted rule is that the highest ranking person in an organisation often bears the brunt of pressure to resign. Judging from the incidents involving Mas Selamat's escape and Temasek Holdings' very large losses in its investment portfolio, there were clearly public perceptions that some responsibility should be borne by those leading the institutions involved in the incidents. In the case of Wong Kan Seng, he was the Minister for Home Affairs and the detention centres came under the purview of his Ministry. In the case of Temasek Holdings, the public perception appears to be that Ho Ching



resigned in order to take responsibility for the losses, or worse still, was relieved of her position, regardless of what the government's pronouncements on the issue were.

## Concluding remarks

The Singapore government has already attempted to be much more consultative in public policy formulation through white papers, public discussions, widespread dissemination of information and maintaining close linkages with grassroots leaders in public housing estates that accommodate approximately 85 percent of the local population. Nonetheless, the internet has thrown up new challenges that it is slowly facing up to. In this new environment, it is unable to regulate or censure content and opinions. This development is something that the government is unaccustomed to since it has previously had a near monopoly on print and broadcast outlets within the country. The internet savvy younger generation is much more educated, much more likely to obtain information from alternative sources and also be much more reflective than the earlier two generations since political independence in 1965. Accordingly, they are much more likely to challenge the norms of governance as it previously existed. Hence, the Singapore government has to prepare itself for much more robust engagement with younger citizens and evolve over time a much more interactive policy environment. Failure to do so will simply sap the government's credibility and legitimacy.



## Global Financial Crisis and Its Impacts on Asia

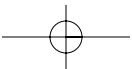
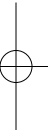
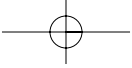


# Been There, Done That: Southeast Asian Response to the Global Financial Crisis?

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## Been There, Done That: Southeast Asian Response to the Global Financial Crisis?

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*My sense is that one consequence of this Asian crisis is an increasing awareness in the region that market capitalism, as practiced in the West, especially in the United States, is the superior model; that is, it provides greater promise of producing rising standards of living and continuous growth.*

Chairman Allan Greenspan  
Testimony before the US Senate  
March 13, 1998

At the height of the Asian Financial Crisis from 1997 to 1998, US Federal Reserve Board Chair Allan Greenspan boldly predicted that the resolution of the crisis would result in two outcomes: the end of crony capitalism and the triumph of western form of free-market capitalism (Hamilton 1999). More than a decade since the financial tsunami swept the Asian region; the world is again in the

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\* Paper presented at the *Workshop on Global Financial Crisis and Its Impact on Asia*, held April 23-25, 2009 in Hoi An, Vietnam under the auspices of the Asian Political and International Studies Association (APISA) and the Konrad Adenauer Stiftung (KAS).



throes of another crisis. But this time the epicentre has shifted from Asia to the United States and Europe (Khor and Kee 2008). Ironically, the US Subprime Crisis that triggered the current global financial distress is rooted in the same “moral hazards”<sup>1)</sup> that Greenspan and other Western economists, analysts, and commentators so condescendingly accused most Southeast Asian governments of committing.

Indeed, the Asian Financial Crisis was a fitting exclamation point to American triumphalism in the 1990s. The US had won the Cold War; Japan fell into a decade long recession; and, European social democracy suffered from high unemployment and low growth. This triumphalism was underscored by an ideological orthodoxy that prescribed to the rest of developing and transitional economies: “Liberalize and privatize, and copy the Anglo-American institutions of legal, financial and corporate governance” (Bardhan 2006).

However, in a few momentous weeks in September and October of 2008, the US financial market was shaken by the successive collapse of five major investment banks. At the heart of this financial debacle is the risky practice of subprime mortgage lending. The Subprime Crisis was triggered by the sudden rise of delinquencies and foreclosures of mortgages which, in turn, wreaked havoc to financial institutions in the US and the world (Torbat 2008). Unlike the 1997 Asian Financial Crisis, the ongoing Global Financial Crisis threatens to bring the world into another major depression. As Beja (2009) astutely noted, the “current global crisis emerged from the heart of the world. It did not occur in some developing economy with faulty financial institutions or broken politics, but in the United States, the richest country with the most advanced financial system in the world.” And this time Southeast Asia is at the receiving end of the crisis.

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1) Greenspan (1998) defined *moral hazard* as “situations in which someone can reap the rewards from their actions when events go well but do not suffer the full consequences when they go badly.”



This paper is an exposition of the initial response of political and economic leaders of Malaysia, Indonesia, Thailand and the Philippines to the ongoing Global Financial Crisis. Specifically, it seeks to explore two crucial areas: 1) the institutional path dependencies created by the Asian Financial Crisis and its influence on current effort to address the Global Financial Crisis; and, 2) the current institutional constraints faced by these countries as a result of challenges and/or instability within domestic politics.

## Varieties of Southeast Asian Capitalism

In the current literature of comparative political economy, there is “an increased appreciation of the fact that countries have different political contexts and the bargaining powers of the different stakeholders in the economic system - owners, managers, and workers - vary. ‘One - Anglo-American - size fits all’ is no longer the prevailing perception.” (Bardhan 2006: 2). The “varieties of capitalism” (VoC) approach is a new framework for understanding the institutional similarities and differences, among developed, as well as developing, economies.<sup>2)</sup> From the VoC perspective, the political economy is a terrain of multiple actors that include individuals, firms, producer groups, or government - each seeking to advance its interest in a rational way through strategic interaction with others. National political economies can be distinguished according to the manner by which firms resolve coordination problems: Liberal Market

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2) The *varieties of capitalism* framework emerged from the seminal and groundbreaking volume edited by Peter A. Hall and David Soskice in 2001, entitled “Varieties of Capitalism: The Theoretical Foundations of Comparative Advantage.” The introductory chapter written by Hall and Soskice outlined the general arguments of the framework. A follow-up volume was edited by David Coates in 2005, entitled “Varieties of Capitalism, Varieties of Approaches.”



Economies (LMEs), notably the United States and the United Kingdom; and, Coordinated Market Economies (CMEs), notably Germany, France, and Japan.<sup>3)</sup> In LMEs, “firms coordinate their activities primarily via hierarchies and competitive market arrangements;” while in CMEs, “firms depend more heavily on non-market relationships to coordinate their endeavors with other actors and construct their core competencies” (Hall and Soskice 2001: 8).

Each of these models relies on a fundamental production regime that functions on an entirely different logic of company economic competition. For CMEs, the institutionalised information exchange and consensus building enhance competitive positions. Thus, they encourage government intervention to contribute to expansion of skills (i.e. high levels of social protection and policies that promote cooperative labour relations) in order to compete in high skills market niches. On the other hand, in LMEs such as the US, such coordination strategy is absent. In fact, labour-management relations are often contentious; there are no incentives for workers nor employers to invest in skills; and, a highly skilled, productive workforce is often discouraged. Thus, the VoC literature which suggests a dualistic world in which strategies that make sense for one model may not be applicable to the other. The “institutional stickiness of the past” prevents countries that attempt reforms from deviating from their historical

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3) At the level of the firm, coordination problems are more pronounced since the capabilities of actors are relational, “internally, with its own employees, and externally, with a range of other actors that include supplier, clients, collaborators, stakeholders, trade unions, business associations, and government.” (Hall and Soskice 2001: 6). Five spheres of relational interact within the firm are susceptible to coordination problems, namely: 1) *industrial relations* or how to coordinate wages and working conditions with the labor force; 2) *vocational training* and education in which firms face the problem of securing a workforce with suitable skills and the workers faced with the question of how much to invest in what skill; 3) corporate governance involves the manner by which firms access finance and the assurance of returns given to investors; 4) *inter-firm relations* or how a company relates with other enterprises that include its suppliers and clients; and, 5) the *employees* themselves where the central problem is to ensure that they have the requisite competencies and cooperate well to realise the objectives of the firm.



model. Institutional complementarities reinforce strategies and solidify path dependencies (Martin 2005).<sup>4)</sup>

While the dualism of the VoC framework lends itself to elegance, parsimony and analytical clarity, the dualistic distinction between LMEs and CMEs can also seem restrictive, thus, creating the impression the “(only) two can play at that game” (Hay 2005: 113). The past success of the East Asian model, the recent phenomenal growth of capitalism in China and Vietnam, and even the high growth success of India in South Asia, are instructive counterfactuals to the economic orthodoxy of privatisation, deregulation or fiscal deficit management (Bardhan 2006; McNally 2007). Edo Andriesse (2008) proposed investigating varieties of capitalism from the perspective of a continuum, from radical market capitalism to radical state capitalism, rather than limiting analysis to a dichotomy between LMEs and CMEs. He also applied the VoC to “semi-peripheral and peripheral countries” where government role and goals are substantially different from core countries, such that economic policies may be oriented toward nation-building efforts rather than profits and firm value. His case studies of two municipalities in Thailand and Malaysia is a pioneering adaptation of the VoC framework to the study of Southeast Asia.

Southeast Asian countries have looked up to the development experience of Northeast Asia, particularly Japan. As Pranab Bardhan (2006: 2) noted,

“[f]or the developing countries, the East Asian model has not yet lost its influence. This model is characterized by initial relative equality, following upon land reforms and mass expansion of education, which helps in smoothing the wrenching conflicts and readjustments of early

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4) According to Hall and Soskice (2001: 17), “two institutions can be complementary if the presence (or efficiency) of one increases the returns from (or efficiency of) the other.”



industrialization. In addition, state-guided coordination of private enterprise and the use of export performance to discipline firms strengthen, rather than stifle, the market process.”

East Asia, in general, and Southeast Asia, in particular, can contribute much to the enhancement of the VoC framework. Thirty years of high economic growth in the Asia-Pacific region gave rise to the so-called Asian model of development, dubbed the “East Asian Miracle” by the World Bank (1993).<sup>5</sup> Generally, Asian capitalism can be differentiated from other forms of capitalism on three major accounts, namely: culture, state, and networks. Simply put, the Confucian cultural tradition and authority structure have rendered some East Asian countries with strong state machinery and organic social networks. However, the dark side of the Asian model had been the blurred lines between political and economic power that breeds exclusionary politics, nepotism, and corruption. It is also important to distinguish between the *Northeast* Asian “developmental state” approach with the *Southeast* Asian experience. Indeed, Malaysia, Indonesia, Thailand and the Philippines have not institutionalised “developmental market economies” found in Japan, South Korea, and Taiwan (Robison et al 2000).

A different set of historical, political and cultural factors helped shape the characteristic of Southeast Asian capitalism. The role of cultural institutions in Southeast Asian capitalism help explain why it is different from its Anglo-Saxon counterpart; while the variance in political institutions help explain the differences within the region (Samphantharak 2007). Emerging from

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5) The World Bank lumped the second tier NICs (Malaysia, Indonesia, and Thailand) with the Original Five (Japan, South Korea, Taiwan, Hong Kong, and Singapore) but argued that there are actually two East Asian models composed of Northeast Asia (the Original Five) and Southeast Asia (the second-tier NICs). The Bank then indicated its preference for the Southeast Asian model given its orientation towards free markets (Jomo 2002; Huber 2003)





decolonisation, newly drawn borders and independence after the Second World War, “institutional relations between the public and the private sector are often attractive for rent seeking behavior and forms of *ersatz* capitalism, i.e. taking advantage of governmental projects and marginal technological improvements rather than entrepreneurship based on new products, services, private consumption and innovation” (Andriessse 2008: 49).

During the period of economic take-off from the 1980s onward, Southeast Asian countries like Malaysia, Indonesia, and Thailand have undertaken a neoclassical, export-led growth model, that has relied heavily on foreign capital and transnational capital’s relocation of productive capacities in the region (Jomo 2002). Samphantharak (2007: 2) identifies three elements that have intertwined to shape the modern corporate sector of Southeast Asian capitalism, namely: overseas Chinese business, business groups and government-business relations. He analysed eight salient characteristics of Southeast Asian capitalism (See Table 1), and observed that “relation-based transactions have been, and still are, common in the region, partly due to the Chinese beliefs embedded in the founders of the business that characterized the modern corporate sector of the region” (Samphantharak 2007: 21).

**Table 1 Characteristics of Southeast Asian Capitalism**

Characteristic	Malaysia	Indonesia	Thailand	Philippines
<b>Overseas Chinese Business*</b>	High 60%	High 70%	High 75%	High 55%
<b>Policies towards Chinese Entrepreneurs</b>	Restrictive	Restrictive	Assimilation	Assimilation
<b>Business Groups as Corporate Organisation</b>	Prevalent	Prevalent	Prevalent	Prevalent
<b>Extended Business Families</b>	High 57.5%	High 68.6%	High 56.5%	Moderate 42.1%



Characteristic	Malaysia	Indonesia	Thailand	Philippines
<b>Coordinated Resource Allocation Decisions***</b>	High 0.785	High 0.687	High 0.941	High 0.819
<b>Mixture of Family-Business Concerns</b>	Prevalent	Prevalent	Prevalent	Prevalent
<b>Conflicting Role of State-owned Corporation</b>	Prevalent	Prevalent	Prevalent	Prevalent
<b>Expansive Political Connections****</b>	24.95%	29.87%	23.29%	5.27%

Source: Adapted from Samphantharak 2007

\* % control of Chinese over Private Corporate, Domestic Capital (1996)

\*\*% of Family Owned Firms (1996)

\*\*\*Average Cash-Flow Right to Voting Right Ratio

\*\*\*\*% Firms with Political Connections (2006)

Lee Kuan Yew of Singapore and Mahatir Mohammad of Malaysia trumpeted the so-called “Asian values” as the primary key to the “East Asian Miracle.” The Asian crisis, however, brought three decades of East Asian development experience and the Asian values discourse into question. Malaysia caught both the financial and democratic contagion, and narrowly prevented regime change (Teehankee 2007). In the midst of a bigger crisis, more than a decade since the Asian contagion, it remains to be seen whether past crisis experience have made Southeast Asia better prepared to face the impending global financial meltdown.

## Asian Financial Crisis and Subprime Crisis Compared

At the first glance, the Asian Financial Crisis and the Subprime Crisis seem different from each other. The former revolved around issues of currency pegs, excessive corporate borrowing, and foreign debt; while the latter involved



controversies regarding securitisation, subprime mortgages, and collateralised debt obligations. Nevertheless, the underlying causes of both crises are the same - “each was triggered by investor panic in the face of uncertainty over the security and valuation of assets, and each featured a liquidity run and rising insolvency in the banking system” (Khor and Kee 2008: 19). The Asian Financial Crisis was the consequence of international liberalisation and increased easily reversible, international capital inflows into developing economies; while the Global Financial Crisis (that spun out of the Subprime Crisis) underscored the continuing dangers of financial imbalances as global capital flowed heavily into the US. The current crisis originated from the securitisation of debt - hybrid instruments that were created through the recombination of financial instruments and then resold as conventional instruments. (Muchhala 2007; Beja 2009)

The Asian Financial Crisis began in early July 1997, with the floating of the Baht in a desperate attempt by Thailand to defend its currency. Upon release from its dollar peg, regional currencies plunged in value, increasing foreign debts, and spreading a potent contagion from Thailand to South Korea, Indonesia, the Philippines, and Malaysia. By mid-January 1998, the currencies of these countries practically lost half of their pre-crisis value against the US dollar. Most analysts traced the crisis to a self-reinforcing spiral of panic triggered by the inherent volatility of financial globalisation and weak financial systems in East Asia. The last stages of the Asian crisis infected the global economy, as Russia experienced a financial crisis in 1998, Brazil in 1999, Argentina and Turkey in 2001 (Muchhala 2007).

The Global Financial Crisis that threatens to plunge the world economy into a deep and prolonged recession began with the housing price crisis in the US. The crisis had its roots in flawed fiscal, monetary, and regulatory policies. Three crucial policy decisions precipitated the outbreak of the Subprime Crisis: 1) the repeal of the 1933 Glass-Steagall Act in 1999; 2) the introduction of mortgage



backed securities by the US Department of Housing and Urban Development in 1970; and, 3) the decision by Federal Reserve Chairman Allen Greenspan to lower interest rates in 2001.

The Glass-Steagall Act was an antitrust legislation that emerged as one of post-depression era reforms in the US. Its repeal, after 75 years, lifted the legal separation between commercial and investment banks. The lifting of the ban spurred bank mergers and acquisitions that culminated in the formation of financial oligopolies (Torbat 2009). By the 1990s, a number of firms like J.P. Morgan invented financial devices to sell debt associated with securitised mortgages. These devices were called derivatives, more popularly known as mortgage backed securities (MBS), credit default swaps (CDS), or collateralised debt obligation (CDO). The introduction of derivatives opened the floodgates of speculation, especially in the real estate and housing market (Caldararo 2008). The US economy entered into recession in 2001 after a series of unfortunate events that included the dot-com bubble burst, stock market crash, current account deficits, and the 9/11 terrorist attacks. To stimulate demand, Chairman Greenspan reduced the Federal Fund rate, thereby increasing demand for housing and fuelling speculations in the financial market. The increase of “cheap” money allowed banks to offer loans to homebuyers who mostly took loans on adjustable rates. When short term interest rates were raised in 2006 to prevent inflation, a multitude of borrowers began defaulting on their mortgage payments. As banks foreclosed the mortgaged defaulted homes, they were also forced to absorb the losses. The burst of the real estate bubble cascaded into the first global economic crisis of the 21st century (Felton and Reinhart 2008; James et al 2008; Torbat 2009).

Certain elements form the backdrop for both crises (See Figure 1), namely: 1) abundant liquidity and excessive, imprudent credit expansion; 2) lax credit standards; 3) increase in property asset prices; 4) principal-agent problem and, 5)



moral hazards. In both instances, the influx of “hot money” led to a sharp rise in bank lending and corporate borrowings. The search for yield by lenders and the abundant liquidity led to lax credit standards. Easy credit, then in turn, fueled real estate bubbles that eventually burst, collapsing the financial market like a deck of cards. At the heart of both crises is the principal-agent problem demonstrated by the credit imprudence of lenders in both crises. Lastly, the moral hazards that most western multilateral agencies accused East Asian financial institutions of committing also reared its ugly head in the bastion of capitalism that is the US. Reminiscent of classic cases of moral hazards, lenders and borrowers faced little or no risks from their activities. The problems of agency and moral hazard are recurring problems in all economic and financial crises, pointing to systematic causes (Khor and Kee 2008) .

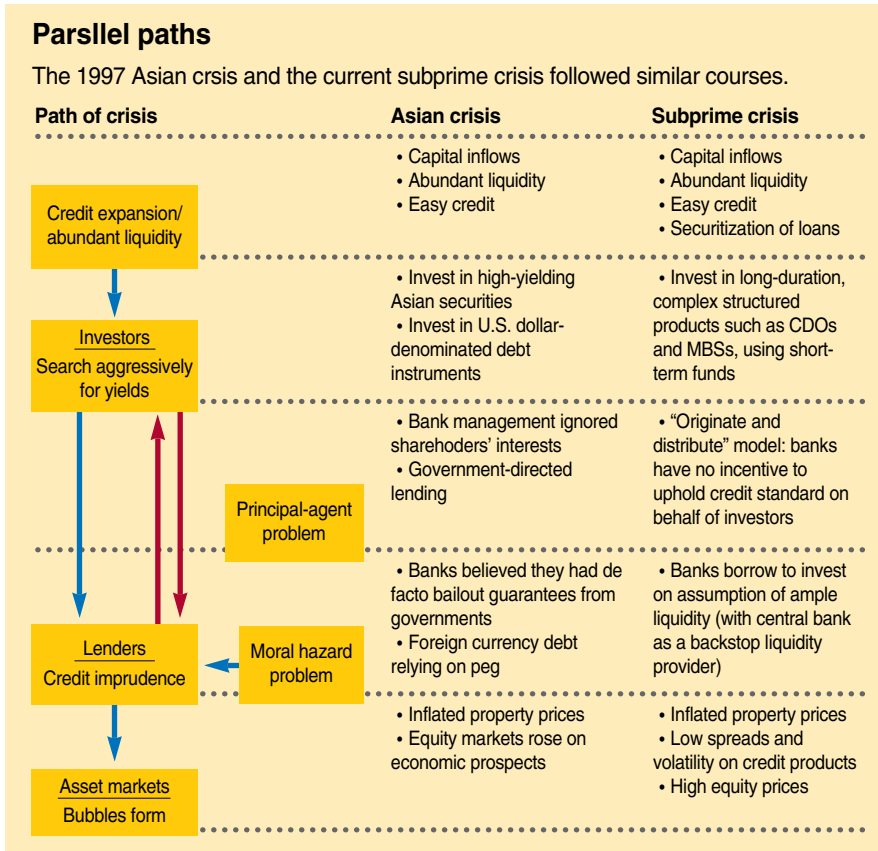
Although financial markets have only existed for a few centuries, the Lehman Brothers itself estimates that there have been more than 60 market crashes since 1622.<sup>6)</sup> It was in the 20th century, however, which produced the most turbulent array of financial storms. Foremost among these crises are the bank run of 1907; the stock market crashes of 1929 and 1987; the crash of the London Stock Market in 1974; the US savings and loan crisis and the Latin American Financial Crisis in the 1980s; the Japanese bank turmoil that resulted in a decade-long recession in the 1990s; the Asian Financial Crisis in 1997 that spread through Russia, Brazil, Argentina, and Turkey; and, the dot-com bubble burst of 2000 (Muchhala 2007; Tett 2007; Torbat 2008).

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6) According to the Lehman Brothers, the first financial crash in the Western world can be dated back to 1622, when the Holy Roman Empire debased its coins, triggering the equivalent of a modern banking panic (Tett 2007).



**Figure 1 Comparison of Asian Financial Crisis and Subprime Crisis**



Source: Khor and Kee 2008: 21

According to a recent Asian Development Bank (ADB) study, historical crisis episodes such as recessions and financial downturns are more frequent, longer lasting and more severe in Asian economies than in OECD countries (See Table 2). The analysis, which covered historical crisis episodes for 21 developing Asian economies over 1961-2007, also revealed that “the severity of a recession tends to increase when it is associated with financial crises, such as credit crunches and stock market crashes. The probability of an Asian recession is 19%



conditional on stock price decline, and jumps to 52% conditional on a stock market crash” (Kiseok et al. 2009: 23). The study also found strong links between Asian economies and the global economy. Likewise, severe financial downturns or recessions in advanced economies are closely associated with the same in Asia.

**Table 2 US and Asian Real GDP Per Capita Disasters**

Country	Peak	Trough	Duration (Years)	GDP Decline (%)
United States	1906	1908	2	10.5
	1913	1914	1	9.5
	1918	1921	3	11.8
	1929	1933	4	29.0
	1944	1947	3	16.5
Average			2.6	15.5
Indonesia	1930	1933	3	11.4
	1940	1945	5	54.5
	1997	1999	2	15.8
Malaysia	1902	1904	2	10.0
	1929	1935	6	19.3
	1936	1937	1	11.7
	1939	1941	2	23.5
	1942	1947	5	36.1
Philippines	1903	1904	1	15.8
	1913	1915	2	11.6
	1929	1935	6	13.4
	1939	1946	7	57.2
	1982	1985	3	18.7

Source: Based on Barro and Ursua 2008 (cited from Kiseok et al 2009: 20)



## Southeast Asian Crises Response

Financial crises often underscore the view that “markets do not exist in isolation from state power, and are not timeless, universal essences but the creations of government and politics” (Beeson and Robison 2000). National economies cannot simply create the optimal conditions for the operation of global industries since national politics reflects conflicts of group and regional interest over tariffs and trade; and national economies have distinct trajectories in the development of financial systems that mould investment decisions by local firms. This is particularly true in the Southeast Asian experience, in which weak and often changing politically motivated domestic coalition face severe problems in implementing long term policies (Andriess 2008). Government-business ties in Southeast Asia, while often have been close, rarely approximated the “governed interdependence model” of their Northeast Asian counterpart (Weiss and Hobson 2000).<sup>7)</sup>

Nonetheless, the 1997 financial crisis was indeed regional, in the sense that no single country was spared from its damaging extent. The extent of the damage, however, varied depending on whether economic deterioration was sudden or more gradual in each country. Respective countries like Thailand, Indonesia, Malaysia and South Korea were drawn in early and suddenly, thereby, experienced the most devastating effects; while others like Singapore, the Philippines, Vietnam, Taiwan, Burma and even China were gradually battered. The key difference did not merely lie on the extent of exposure to international currency, capital flows, and transaction, but the presence of “circuit-breakers and

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7) Under the Northeast Asian mode, a skilled and relatively insulated economic bureaucracy institutionalises a negotiating relationship with well organized industrial groups in pursuit of transformative projects (Weiss and Hobson 2000).





surge protectors” that could dampen the ruinous effects of highly mobile capital controllers (Winters 2000). Thus, it was not an accident that India and China were generally spared from the crisis, since both resisted capital market liberalisation, Furthermore, the Malaysian experience show that even for those that have liberalised their financial sector, certain policy tools (i.e. capital controls or regulation) can still be mobilised to manage capital flows (Muchhala 2007).

Economic crises often raise the intractable link between politics and economics since governments can respond to crises in more effective or less effective ways. Thus, it is imperative at explicating the role of domestic politics in aggravating or mitigating economic downturns. The key element lies in the political structure and institutional configuration that can facilitate or hinder decisiveness in economic policy management. Domestic political intervention can capture rents from liberalisation flow on behalf of vested interests and political elites; or it can be channelled into national economic development (MacIntyre 1999; Robertson 2008). Haggard (2000) identifies three factors that act as political constraints to crisis management, namely: 1) electoral and non-electoral challenges to incumbent governments; 2) inefficiencies in the government’s decision-making process; and, 3) features of business-government relations that might impede a government’s ability to act (See Table 3).

**Table 3 Political Constraints on Crisis Management: Asian Financial Crisis**

	Thailand	Philippines	Malaysia	Indonesia
<b>Government in office, dates in office (onset of crisis*)</b>	Prime Minister Chavalit Yongchaiyut, 11/1996-11/1997 (7/1997)	President Fidel Ramos, 6/1992-6/1998 (Peso depreciated 7/1997)	Prime Minister Mohammed Mahathir, first assumed office 7/1981, re-elected 4/1995 and 11/1999	President Suharto, first assumed office 3/1966, indirectly elected 3/1993 and 3/1998, resigned 5/1998 (widened exchange rate band 7/1997, floated 8/1997)



	Thailand	Philippines	Malaysia	Indonesia
<b>Political Challenges</b>				
<b>Electoral</b>	Six-party coalition government with recurrent threat of defection	Dominant administration party in control of national and local positions; presidential election on 5/1998	Substantial electoral victory for ruling coalition in 1995; general election on 4/2000; UMNO party election on 6/1998	Indirect presidential election on 3/1998
<b>Non-electoral</b>	Antigovernment demonstration in 11/1997	Efforts by administration to revise the Constitution to lift presidential term limit	The political challenge of Anwar Ibrahim	Student demonstrations in 2/1998; protests against price increase and large-scale riots in Jakarta 5/1998; mounting social violence 1-5/1998
<b>Decision-making process</b>	Parliamentary, six-party coalition	Presidential, multiparty coalition, but Lakas dominant	Parliamentary, coalition government, but UMNO dominant	Authoritarian, highly centralised
<b>Government link to business</b>	Close links of all parties and business	Some evidence of corruption	Close to politically favored groups	Close links between executive and cronies and family business

Source: Adapted from Haggard 2000

\*Onset of crisis is the date the currency is allowed to float

Thailand, along with Indonesia and Malaysia, was among the primary recipients of Japanese direct investment that swept the Southeast Asian region between



1985 and 1990 (Bello 2000). At that time, one major weakness that Thailand shared with the rest of the region was the liberalisation of financial markets minus the requisite prudential regulation (MacIntyre 1999). Thai politics exerted a strong influence over both the onset and initial management of the crisis. Accordingly, Thailand's combination of multiple weak parties within a parliamentary structure was prone to policy paralysis. Hence, intra-coalitional politics delayed the passage of the emergency budget and politicians with direct and indirect links with troubled financial firms obstructed the effective resolution of the impending crisis. Moreover, the failure of the government to decisively confront the mounting financial implosion, weakened confidence in the Thai financial sector and reinforced the uncertainty about the government's capacity to mitigate the crisis. After spending billions of dollar reserves, in a vain attempt to defend the Thai Baht, the government moved slowly to introduce key reforms. The crisis brought down Chavalit's government in November 1997 and was replaced by the comeback of Chuan Leekpai. It was at this time that Thailand accepted the International Monetary Fund (IMF) rescue package that imposed stringent austerity measures (MacIntyre 2000; Haggard 2000).

While Thailand was politically immobilised by too many veto points, Indonesia suffered from the lack of it. The massive centralisation of power in the hands of President Suharto left government vulnerable to deep credibility problem due to unreliable policy commitments (MacIntyre 2000). The case of Indonesia was the most dramatic among the countries that were swept up by the Asian Financial Crisis, as the economic crisis unexpectedly spurred a regime change that ended 32 years of authoritarian rule. Key macroeconomic indicators provided few early warnings of economic collapse. In fact, most analysts observed that Indonesia's economy was in a better shape than Thailand. There were no telltale signs of capital flight, speculations on the currency; nor were there any indication of asset bubbles or overinvestment. Nonetheless, the Indonesian Rupiah suffered the



steepest depreciation among the crisis currencies; and its real economy faced the largest fall in output (Haggard 2000). The fall of investor confidence in Indonesia can be understood within the context of its political-institutional structure at the time of the crisis. Ironically, the same authoritarian structure that allowed government to act decisively in the early stages of the crisis became a liability as local and foreign investors lost their confidence in Suharto's capacity to provide the policy environment demanded by the market. Consequently, "extreme decisiveness comes at the price of a highly changeable policy environment . . . there were no institutional checks at all on executive action" (MacIntyre 2000:161).

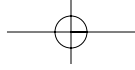
Indonesia's deep economic troubles appeared more puzzling since Suharto's initial crisis response was more coherent and decisive than Chavalit's government; and more cooperative than the cantankerous policy pronouncements of Prime Minister Mahathir of Malaysia (Haggard 2000). Prior to the crisis, Indonesia and Malaysia were the prime exponents of economic nationalism in the Southeast Asian region. Both countries embarked on economic nationalist projects (Indonesia's New Order and Malaysia's New Economic Policy) by promoting industrial upgrading the development of a national capitalist class. However, domestic capital tended to be concentrated in non-tradeable sectors (i.e. distribution, construction, and privatised utilities) since foreign direct investment played a bigger role in the technological export sectors. Despite the fact that both countries were open to FDI prior to the crisis, there were also sectors reserved for the politically well-connected domestic business. These government-business linkages were the subject of market concern during the crisis, and these linkages have been altered by the crisis, but not eliminated (Haggard 2000; Thirkell-White 2008).

Malay nationalism was a crucial element in understanding Malaysia crisis response under Prime Minister Mahathir. Economic nationalist policy in



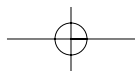
Malaysia did not only promote modernisation and technological upgrading, but also promoted economic opportunity for the indigenous population (*Bumiputra*) over the Chinese and Indian immigrants. As the crisis reached Malaysia, the Mahathir government was torn between a broadly market-friendly policy, on the one hand, and a populist anger with foreign speculators on the other. In the initial stages of the crisis, Mahathir combined shrill and inflammatory economic nationalist rhetoric with a ‘virtual IMF policy’ response. But the perceived failure of the policy and its negative impact on politically-connected corporations led to a series of policy reversals - gradually easing fiscal and monetary policy, and eventually instituting capital controls, designed to stem the further flight of capital. At the same time, he sacked his deputy Anwar Ibrahim, who championed a more neoliberal approach toward the crisis. Capital controls allowed Mahathir to institute modestly expansionary macroeconomic policy and bail-outs for politically connected corporations (Haggard 2000; Thirkell-White 2008).

Among the four Southeast Asian countries, the Philippines is the most curious case. Generally considered “the sick man of Asia” during the halcyon days of the East Asian Miracle, its laggard performance shielded its economy from the full impact of crisis. This can be traced to the strong private sector conservatism nurtured by the domestic economic crises of the 1980s and the early 1990s (Hutchcroft 2000). The Philippines’ experience with market-based democracy is characterised by a recurring boom-bust cycle in an economy that corresponds with a similar pattern of political development and decay. The economy has weathered a number of crises since the Philippines’ independence in 1947. Furthermore, these economic crises have been preceded by, or were the result of, repeated institutional breakdowns that historically ruptured into full blown crises of legitimacy. Intense intra-elite competition, contested elections and the threat of armed revolution characterise the four major political crises in 1953, 1969, 1986



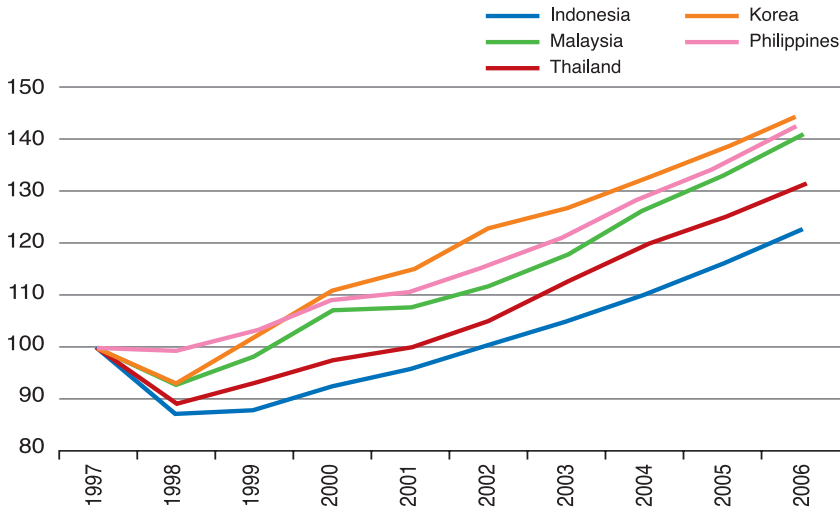
and 2004. Except for a brief period in the mid-1990s, when economic growth coincided with positive political development, elitist politics has continued to hinder the institutionalisation of effective social and political reforms.

More than a decade since the Asian Financial Crisis, the affected countries have demonstrated what many specialists have labeled as a remarkable “V-shaped recovery” (See Figure 2). Instead of embracing the stringent policy prescriptions imposed by the International Monetary Fund (IMF) which further exacerbated the social-effects of the crisis; the affected countries pursued Keynesian reflationary fiscal policies. Present macroeconomic indicators of the region show an average GDP recovery of 4 to 6 percent annual growth between 1999 and 2005 (Muchhala 2007). Two important lessons can be drawn from the Asian Financial Crisis that is important in addressing the Global Financial Crisis: 1) reduction of leverage for the class of borrowers whose problems were painfully exposed by the crisis; and, 2) the correction of macroeconomic imbalances. In 1997, the borrowers were the corporate entities and banks; while in 2007, they were the US household sector, commercial and investment banks, and hedge funds. Stimulus programmes were the key in bringing crisis economies back to recovery and stability. Indeed, the macroeconomic fundamentals are much healthier at present and the corporate balance sheets in Asia have improved (See Figure 3) (Khor and Kee 2008).





**Figure 2 Recovery Rates Based on Real GDP Rates**



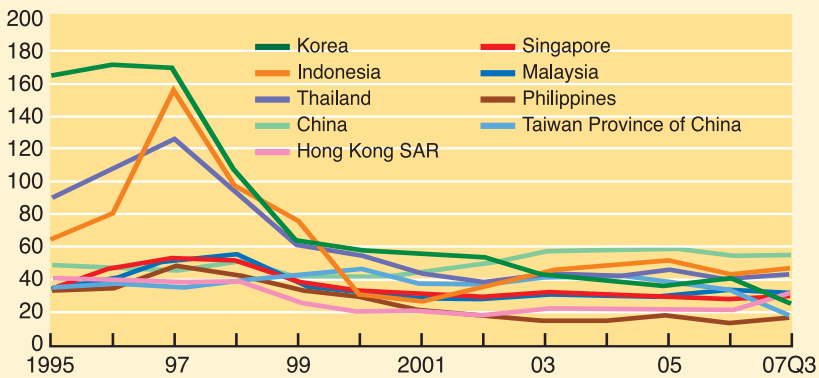
Source: International Monetary Fund 2007 (cited from Burton 2007)

**Figure 3 Corporate Balance Sheets**

### Improving balance sheets

Corporate debt-to-equity ratios have improved dramatically in many Asian countries since the 1997 financial crisis.

(debt to equity, percent)



Source: Thomson International (cited from Khor and Kee 2008)



**Table 3 Political Constraints on Crisis Management: Global Financial Crisis**

	Thailand	Philippines	Malaysia	Indonesia
<b>Government in office, dates in office (onset of crisis*)</b>	Prime Minister Somchai Wongsawat, assumed office 9/2008, 9/2008-12/2008; Prime Minister Abhisit Vejjajiva, 12/2008 (9/2008)	President Gloria Macapagal Arroyo, first ascended to power, 1/2001, elected 5/2004 (9/2008)	Prime Minister Abdullah Ahmad Badawi, assumed office 10/2003, 10/2003-3/2009; Prime Minister Najib Tun Razak, assumed office 3/2009 (9/2008)	President Susilo Bambang Yudhoyono, first directly elected president, elected 10/2004, first five year term will end in 10/2009 (9/2008)
<b>Political Challenges</b>				
<b>Electoral</b>	Six-party coalition government led by People Power Party; replaced by Five-party coalition led by Democrat Party	Dominant administration party in control of national and local positions; presidential election on 5/2010	Ruling Barisan Nasional faced a series of electoral setbacks in 2008 elections when it lost its two-thirds majority and lost 5 out of 12 state legislatures	Ruling Democratic Party has consolidated power and won majority of seats in legislative elections held 4/2009; presidential election scheduled for 7/2009
<b>Non-electoral</b>	Antigovernment demonstration in 8/2008 (yellow shirts); and in 4/2009 (red shirts)	Efforts by administration to revise the Constitution to lift presidential term limit	The political challenge of Anwar Ibrahim	Growing influence of Islamist Parties, such as Prosperous Justice Party (PKS)
<b>Decision-making process</b>	Parliamentary, five-party coalition	Presidential, multiparty coalition, but Lakas dominant	Parliamentary, coalition government, but UMNO dominant	Presidential, multiparty coalition, Democratic Party ascendant over Golkar
<b>Government link to business</b>	Close links of all parties (yellow shirts and red shirts) and business	Some evidence of corruption	Close to politically favoured groups	Weakened links after modest success of reform and anti-corruption policy

\*Onset of crisis is the date the month of successive failure, merger, and conservatorship of several US Banks





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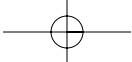
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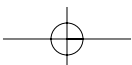
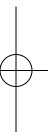


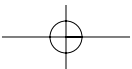
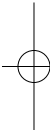
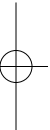
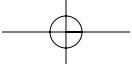
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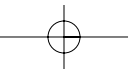
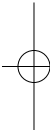
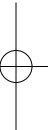
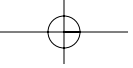
## Global Financial Crisis and Its Impacts on Asia



### Social Implications Economic Crises in Southeast Asia

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## Social Implications Economic Crises in Southeast Asia

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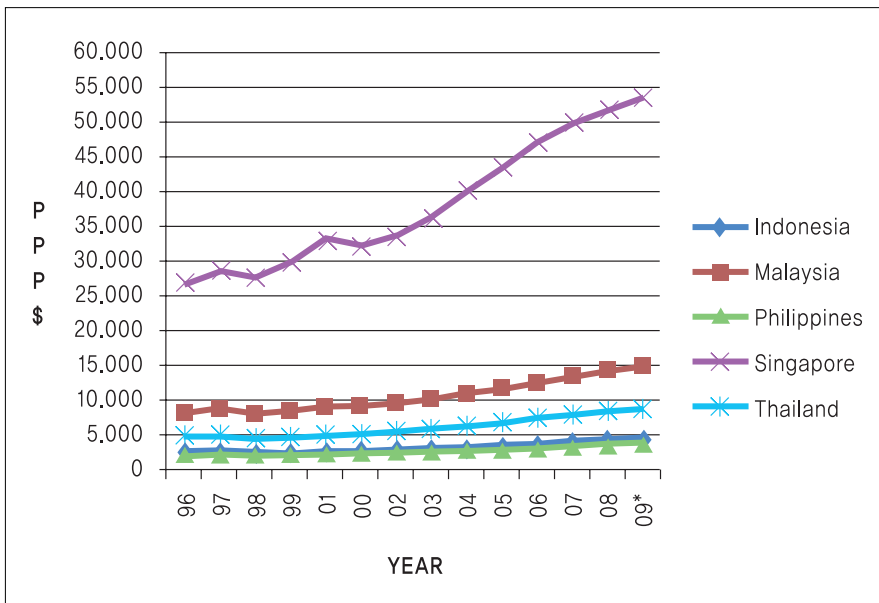
The paper will examine the economic crisis and its social effects in Indonesia, Malaysia, the Philippines, Singapore and Thailand. It will argue that the lack of social protection system in the region when the crisis erupted in 1997 put the population at risk of a social catastrophe due to lack of an adequate social protection system. The catastrophe was averted only after the governments hurriedly expanded their social protection with substantial help from international organisation. The current crisis is yet again confirming the need for social protection mechanisms, as governments are in the process of devising a response. It is unfortunate that not all governments in the region used the lessons of the 1997/98 to establish a comprehensive social protection system to face the current and future crises. With the frequency and intensity of crises increasing, governments need to establish a social protection system that automatically springs into action in the event of widespread decline in income, regardless of the cause. The essence of such a system will be similar to the measures societies have in place to protect themselves against fire, natural disasters, and bank failures.



Asia has been struck by economic crisis twice within just over a decade: 1997 and 2008. The causes of the two crises are different and they have affected different countries differently. What both crises, indeed all economic crises, have in common is that the poor and the vulnerable are disproportionately affected by economic downturns.

There are vast differences in the income levels of the five countries covered here. Singapore is one of the richest countries in the world, with per capita income exceeding ten times that of Indonesia and the Philippines, the two lowest income countries in the group. Malaysia is an upper middle income country while Thailand is a mid middle income country.

### 1. GDP Per Capita, purchasing-power-parity

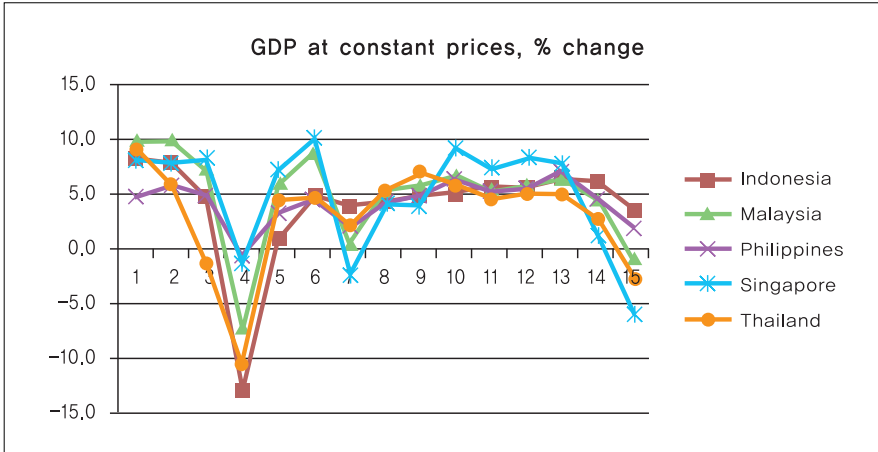


IMF, *World Economic Outlook*, <http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/index.aspx>



The current economic crisis is characterised by growth patterns somewhat different from a decade ago. During the previous crisis, Indonesia and Thailand were worst affected while the Philippines and Singapore were only slightly affected. In 1998, Gross Domestic Product (GDP) shrunk by 13 percent in Indonesia, 10.5 percent in Thailand, 7.4 percent in Malaysia, followed by negligible decline in Singapore and the Philippines. In terms of severity, the decline in Indonesia and Thailand have few contemporary parallels. The latest economic forecast issued by the International Monetary Fund (IMF) in April 2009 is a significant downgrade from the one issued at the end of January which itself was a major downgrade from one issued only two months earlier. In a reverse image of the preceding crisis, Singapore is expected to be most severely affected while Indonesia has the best performing economy.

## 2. Economic Growth



<https://sdb.s.aib.org/sdb.s/index.jsp>; <http://www.singstat.gov.sg/stats/themes/economy/hist/gdp1.html> ;  
[http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/550192-1238574864269/5976918-1239010682147/update\\_april09\\_appendices.pdf](http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/550192-1238574864269/5976918-1239010682147/update_april09_appendices.pdf)  
 MITI, 14 Apr 2009 . <http://www.singstat.gov.sg/news/news/advdp1q2009.pdf>



Unlike the 1997/98 crisis which had multiple domestic and international causes, the current crisis in Asia is rooted largely in shrinking global economy and the related decline in exports and investment. The more a country depends on exports, the more adversely it is affected by the current crisis. In early 2009, exports dipped by as much as 41 percent in these countries. The exception is Thailand, where exports declined by a more modest 28 percent but the decline in growth was severe due to political turmoil in the country. In the case of Indonesia and the Philippines, however, the decline in exports has not been accompanied by a similar decline in growth rate due to their relatively smaller dependence on exports. The current situation is very different from the earlier crisis when exports actually grew in 1998 in all countries except Indonesia without which they would have been in an even worse situation.

### 3. Exports, annual % growth

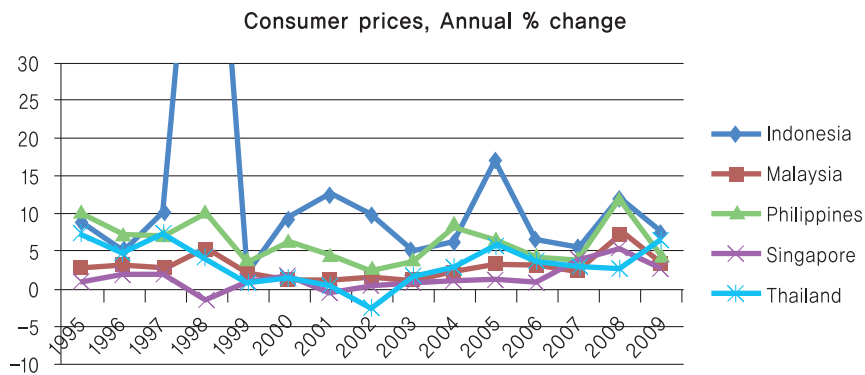


Source: <https://sdfs.adb.org/sdfs/index.jsp>



The effects of declining growth rate are aggravated if accompanied by rising prices. The effects of the 1997/98 crisis were aggravated by the increase in consumer prices in Southeast Asia. Indonesia was particularly affected, where it increased by 77 percent in 1998, followed by the Philippines where it increased by 10 percent. Prices have not increased by the same margin during the current crisis, though it is substantial. The substantial increase in consumer prices in 2008 - of as much as 12 percent in Indonesia and the Philippines and of 6-7 percent in Malaysia and Singapore - was the result of historically high petroleum and food prices that year. Both petroleum and food prices have fallen substantially this year and so inflationary pressures are likely to be low during the rest of the current crisis.

#### 4. Inflation Rate



Source: <http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/index.aspx>

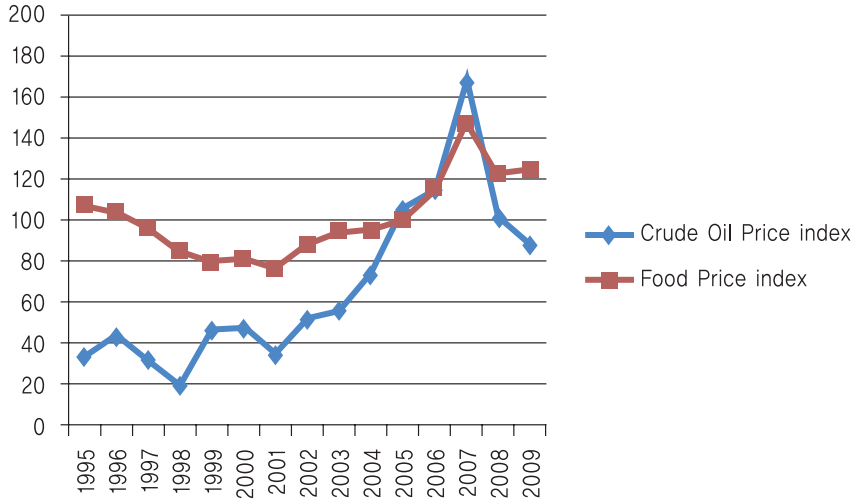


Source: <https://sdfs.adb.org/sdfs/index.jsp>

The current economic crisis follows in the heels of energy and food crisis. Prices of fossil fuels -- oil, natural gas, coal -- and electricity rose steeply in 2006-2008, imposing tremendous stress on government and household budgets. Inflation adjusted the price of a barrel of crude oil on New York Mercantile Exchange (NYMEX) to more than double to \$60 between 2003 and 2005 and then climbed above \$140 in July 2008. But they began to decline as signs of economic slowdown erupted and within a few months was trading below \$50. Oil prices have a disproportionate impact on the economy because it is an intermediate product to a range of agricultural, industrial, and infrastructure industries: the effects of significant price fluctuations in oil prices are typically felt throughout the economy. The recent decline in prices is undoubtedly helpful but its beneficial effects are offset by the prevailing financial crisis.



### 5. Petroleum and Food Prices, 2005 = 100



<http://indexmundi.com/commodities/?commodity=food-price-index&months=180>

Food is the largest expenditure item for the poor and, as such, food prices have disproportionate effect on their living standards. In Indonesia, food prices rose by 81 percent in 1998 and 25 percent in the following year, thus severely affecting the already suffering poor population. The increase was far less steep in other countries, where food prices went up by less than 10 percent in 1998. These are devastating increases in societies suffering from declining employment and income. The current crisis was preceded by massive increase in global food prices. Between 2004 and 2008, price of wheat, maize and especially rice increased steeply, but have declined by as much as 40 percent in recent months. Nevertheless, they remain high relative to longer term trends and are subject to severe fluctuations.

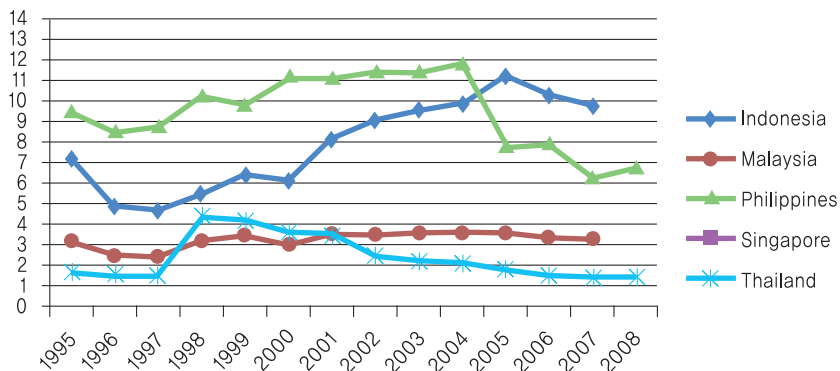
The recent decline in petroleum and food prices is one of the bright spots in the current economic horizon. In the middle of 2008, when both prices had reached



historic highs, there were fears that the high price of the two essential commodities would push millions into poverty. Unfortunately, the decline in food and oil prices in late 2008 was associated with, and indeed triggered by, slowing economy.

Decline in economic growth is, expectedly, accompanied by increase in unemployment. Southeast Asian countries, except for the Philippines, have had low or negligible unemployment rate which rose during the crisis. In 1998 unemployment rose by 17 percent over the preceding year in Indonesia and the Philippines, 31 percent in Malaysia and 189 percent in Thailand. The decline in Thailand was particularly dramatic, which had nearly full employment in 1997. Little is known about the current unemployment situation in Asia, though with declining growth rate, it would be reasonable to expect significant rise in unemployment. However, Singapore, which is by far the most severely affected by the current crisis, has a substantial (amounting to as much as a quarter of the total) foreign labour force and so has some cushion against massive rise in unemployment.

### 6. Unemployment Rate, %



Source: <https://sdb.sdb.org/sdb/index.jsp>; *Coping with the Asian Financial Crisis: The Singapore Experience*





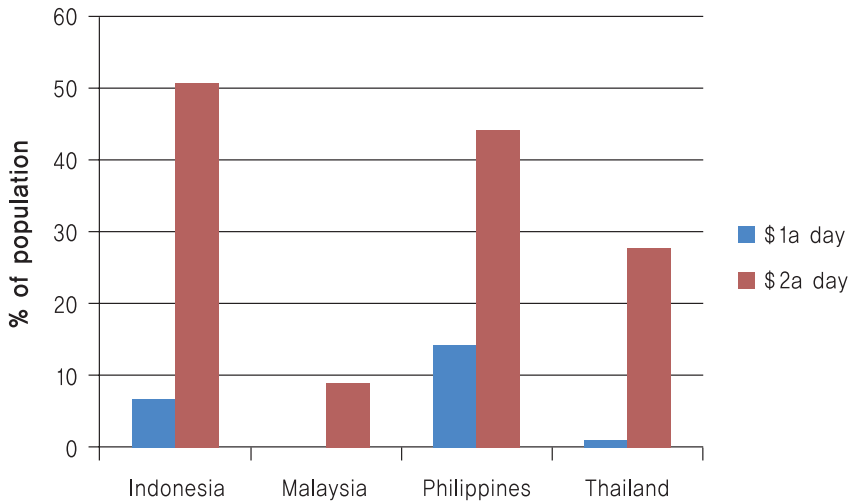
What is not captured in the unemployment data is under-employment. It is believed that due to the absence of unemployment benefits, in difficult economic times many laid off workers in the affected countries simply reduce the hours they work or shift to the informal sector on a part-time basis. This is believed to be particularly true in countries with large agricultural sectors, such as Indonesia and Thailand. In Indonesia, underemployment rose from 37 percent of labour force in 1996 to approximately one-half in 1998, whereas in Thailand it rose from 1.7 per cent in 1998 to 3.6 percent in 1999.

(<http://www.jri.co.jp/english/thinktank/research/aer/2000/AERe200003unemplo.html>).

The economic slowdown during the 1990s crisis was accompanied by increase in poverty, with the \$1/day poverty headcount index increasing from 15.1 to 15.9 in developing East Asia between 1996 and 1999 (Atine, 2003). However, the most significant impact is discernible in \$2/day poverty headcount index: by this measure, poverty increased from 50.9 to 51.2 in developing East Asia and from 43.6 to 52.8 in Southeast Asia over the 1996-1999 period. This confirms that there were a lot of people in the adversely affected countries living just above the poverty line who were pushed under it by the crisis. It is estimated that between 1997 and 1998 poverty rate increased from 11.3 to 18.2 percent in Indonesia, from 8 to 10 percent in Malaysia, and from 10 to 13 percent in Thailand (<http://www.mof.go.jp/english/if/if022h5.pdf>). Even after the recovery from the 1990s crisis, there were a lot of vulnerable people in the region, as the table below shows.



### 7. Poverty headcount ratio (PPP) 2003 (% of population)



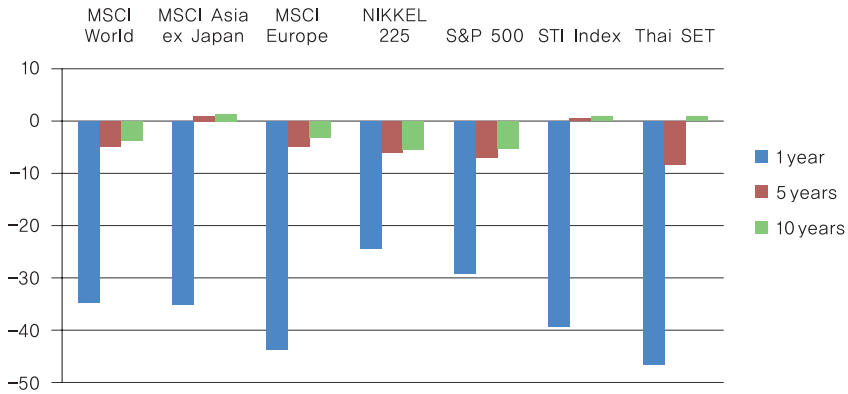
Source: <http://sdfs.adb.org/>

It is still early to estimate the effects of the current crisis on the poor. In the recent forecast issued in February 2009, the World Bank estimated that as many as 53 million additional people could be trapped in poverty due to the economic crisis (World Bank, News & Broadcast, February 12, 2009). It further predicted that 200,000 - 400,000 more babies could die each year between now and 2015 if the crisis persists. In Southeast Asia, Cambodia, Indonesia, Laos, and the Philippines are particularly vulnerable to increased poverty. Singapore does not publish poverty data and so it is impossible to estimate the poverty situation in the island state during the previous or the current crisis.

There has a sharp deterioration in the stock and property market indices and has led to seriously pessimistic consumer sentiments. Foreign investors have been fleeing the region and inflow of foreign equity, loan, and bond have more than halved since their peak in 2007 (<http://www.imf.org/external/pubs/ft/fandd/2008/12/miniane.htm>).

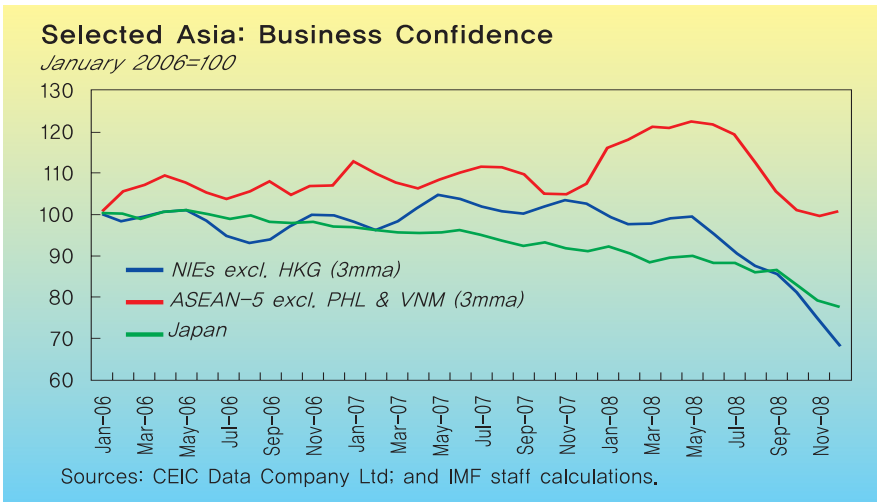


### 8. Stock Index Performance as of 21 April 2009, % Annual Average Change



Source: [www.fundersupermart.com](http://www.fundersupermart.com)

The decline in asset prices and consumer confidence has undermined business confidence, as shown in the following graph, which will further aggravate economic woes.



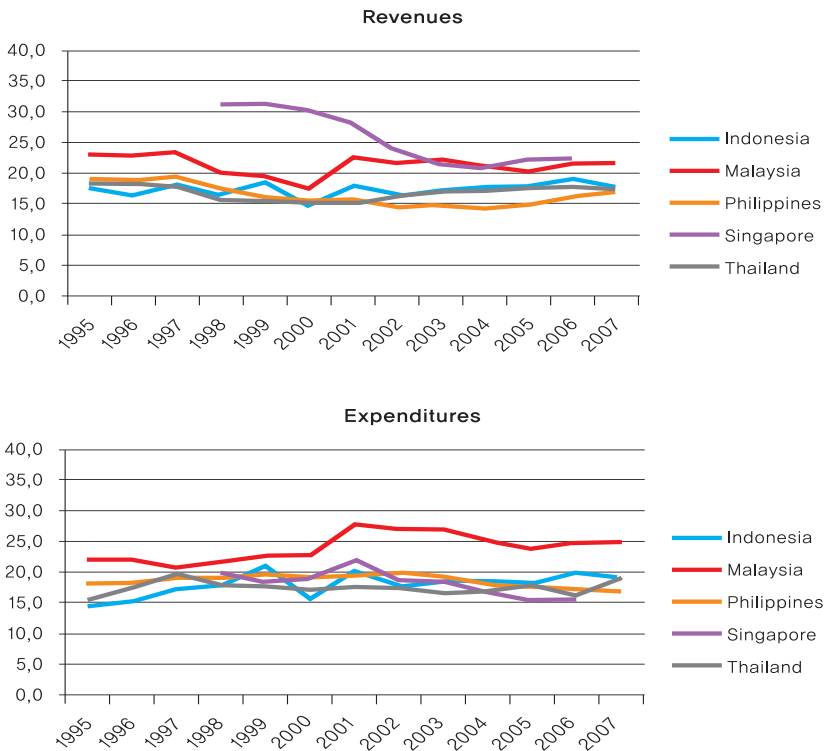
Source: Kato, 2009



Weak business confidence is self-fulfilling: if businesses do not feel confident, they withhold investments, which adversely affects production and income. Current economic conditions are unlikely to improve until businesses feel more optimistic about the near future.

Decline in economic activity in 1998 was accompanied by shrinking government revenues, as total public revenues as a percentage of GDP declined in Indonesia, Malaysia, the Philippines and, especially, Thailand (and probably also Singapore, though comparable data is not available). However, public expenditures declined only in Thailand, while it increased in others, leading to budget deficits of varying magnitudes.

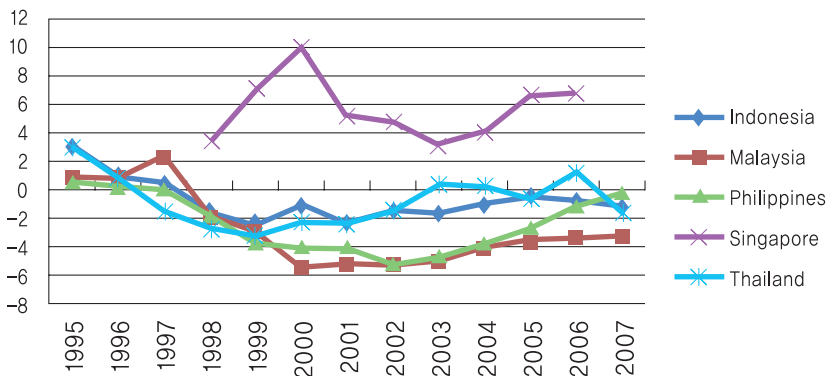
### 9. Public Revenues and Expenditures, Total, % of GDP





In Indonesia and Malaysia, where public expenditures' share of GDP remained stable or increased slightly despite declining revenues, budget deficit increased precipitously during the crisis years. The rise in budget deficit was particularly large in the case of Malaysia.

**10. Overall budgetary surplus/deficit, central government as % of GDP**

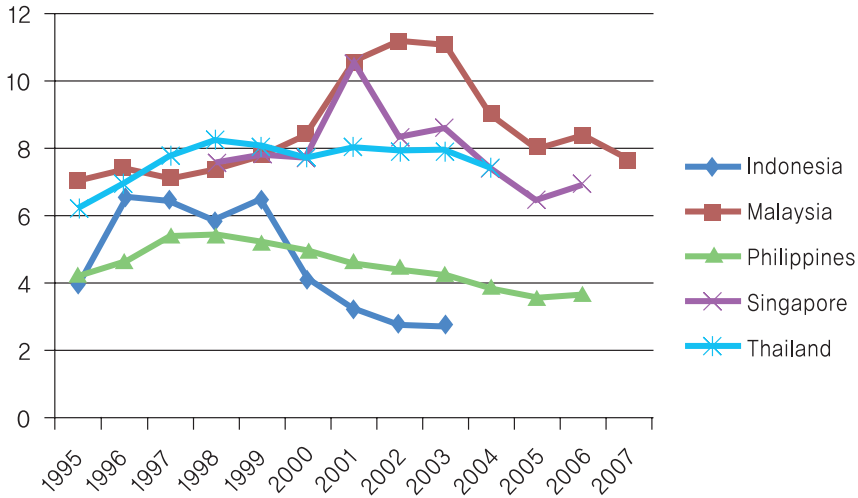


Source: <http://sdfs.adb.org/>

Increasing unemployment and declining income due to economic slowdown are typically associated with increased poverty and higher spending on social protection. However, this did not occur in the crisis-struck countries in Asia: in 1998, social policy expenditures as percentage of GDP remained largely unchanged, increasing slightly in Malaysia and Thailand and declining slightly in Indonesia. In Indonesia, there was a noticeable increase in 1999, more than a year after the onset of crisis, before falling again in the subsequent years. Only in Malaysia was there a substantial increase between 1997 and 2003, when it began to decline. In other countries, social policy expenditures' share of GDP has consistently declined since 2000, reflecting improvement in economic conditions.



### 11. Public Expenditure on Education, Health, Housing & Community Services, and Social Security and Welfare, % of GDP



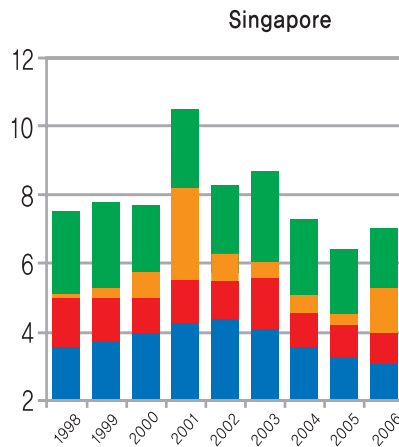
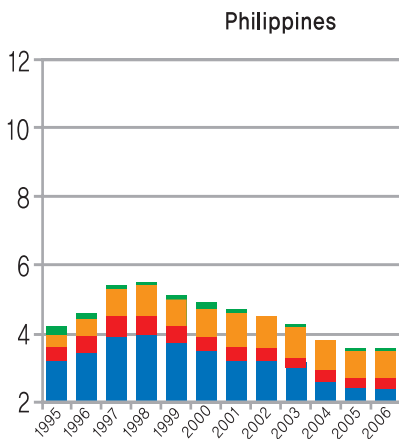
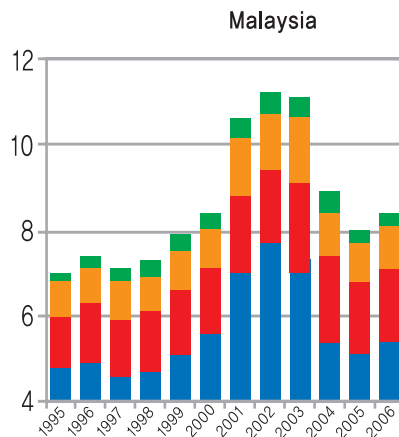
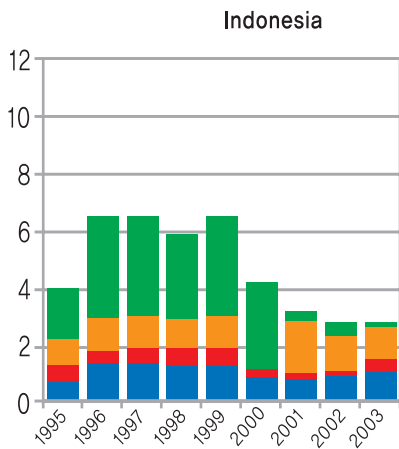
Source: <http://sdfs.adb.org/>; IMF, Government Finance Statistics 2008.

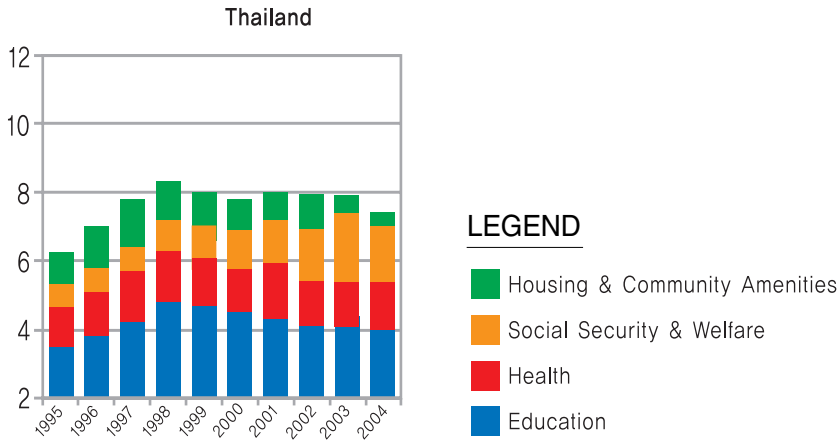
There are substantial differences across Southeast Asian countries not only in terms of the financial resources they devote to social policies but, more significantly, how they are apportioned. The only common feature is the largest proportion that is typically devoted to education, which is unsurprising given the region's youthful demographics. In Indonesia, social welfare has typically been the second largest expenditure item, but in the crisis years it was community amenities (much of it related to public works projects with income generation purpose) that attracted the largest proportion. The small share devoted to health in Indonesia is noticeable. In contrast, in Malaysia, health attracts the second largest share, while housing receives a very small proportion. The Philippines is a small spender on social policy overall and much of it is devoted to education and social welfare. Singapore is remarkable not only for the small sum it spends



on social policy when its income level is taken into account, but for the large share it devotes to housing and the small share to social welfare. Similar to Malaysia, Thailand is remarkable for the large share it devotes to healthcare and the small share to housing.

### 12. Public Expenditures on Social Policy, % of GDP





Source: <http://sdbs.adb.org/>; IMF, *Government Finance Statistics 2008*.

When the crisis started, all efforts were concentrated on the economic dimensions. Micro level surveys in Indonesia and Thailand carried out in early 2008 pointed to the social havoc the crisis was causing: children were being pulled out of schools, nutrition level was declining, health care access was shrinking, and so on. The findings, albeit patchy and cursory, painted a very grim picture of the emerging social reality, galvanising governmental and non-governmental organisations, both domestic and international, into action. By mid-1998, social protection programmes had been established or expanded, with much of funding from international organisations and Japan, in Indonesia, Malaysia, and Thailand. The social indicators stabilised and eventually improved as the programmes began to have their intended effects.

## Conclusion





The current economic crisis is posing difficult challenges for governments and households in Asia. As a result of economic slowdown, jobs have been lost and household income has declined, resulting in diminished public revenues at the same time as the need for greater public spending has increased. In a last ditch effort to shore up their economy, governments around the world are pumping in trillions of dollars through looser fiscal and monetary policies.

Governments have good reason, both economic and social, to take bold action in the face of the unprecedented economic crisis. The experiences of 1997-1998 should serve as reminder of how rapidly poverty can rise under recessionary conditions. And when poverty rises and public finance is tight, there is higher likelihood of increased infant mortality, child malnutrition, and school dropout rate (Mendoza, 2009).

There are sound economic reasons for providing social protection to those adversely affected. Poor families consume less, thus aggravating economic downturn. Social protection serves vital macroeconomic functions by acting as stabilisers that are automatically activated when income and demand are falling.

Economic crises also have broad psychological impacts with long-term deleterious consequences. Evidence shows a strong association between the 1997 economic crisis and suicide rate, which increased sharply in Hong Kong, Japan, Korea, and Thailand, the countries most severely affected by the crisis (Chang et al, 2009). There was no increase in Singapore and Taiwan - it is notable that these were also the countries that remained relatively unscathed by the crisis.

Economic crisis does not only cause economic and psychological hardships, it also causes political unrest, as governments in Indonesia, South Korea and Thailand found out at their own expense in 1997-1998. The economy-first strategy works only as long as economic growth is forthcoming and its benefits reach most people. When economic growth stops, governments that stake their



claim to office on the basis of their economic record - as is the case in many countries in Asia -- have little to fall back upon to legitimise their rule. Social safety nets by protecting against the adverse impact of economic downturn cushion the despair and anguish that lead people to turn against their government. Expansion of social programs to strengthen the government's position has been used from Bismarck in the nineteenth century to Thaksin Shinawatra in recent years.

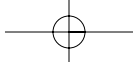
The most immediate reason for providing social protection is that such measures strengthen poor households' capacity to cope with the crisis. As Mendoza (2009) puts it: "For a variety of reasons, the poor are often the least equipped to weather the impact of aggregate shocks on their income?they have few assets which they could sell or use as a buffer, limited or no access to formal credit and insurance markets to help smooth income shocks over time, and often lack the education and marketable skills which are necessary for successful migration to other areas with economic opportunities." Their margin for financial survival is so small that even a small increase in expenditures or decline in income wrecks havoc on their lives. A sudden need for a family member's medical treatment, for instance, is often catastrophic for poor households' finances.

Without social protection, the poor often cope with financial crisis in ways that cause long-term damage to themselves and their communities. To sustain themselves financially, the poor may send their children to work, undermining the children's long-term future. Younger children are especially vulnerable to long-term hardships during economic recessions. Saving resources for family by skimping on children's food or education expenses, and rationing of food for mothers and young children leaves long-term deleterious effects because mal- and under-nutrition for children and pregnant mothers adversely affects children learning skills and increased risk of disease in later life.



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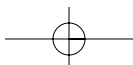
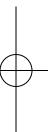


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## Global Financial Crisis and Its Impacts on Asia

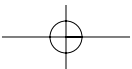
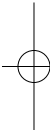
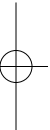
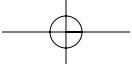


# Impacts of the Global Financial Crisis to Vietnam

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# IMPACTS OF THE GLOBAL FINANCIAL CRISIS TO VIETNAM

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## Introduction

The crisis that is raging globally does not spare Vietnam. The adoption of the export-oriented strategy of economic development has been mostly successful. Vietnam has gradually been integrating into the regional and global economy, adopting market principles, joining what is called the ‘labour division’ in regional and global scales, based on its comparative advantages. As a result, the country has achieved sustained economic growth, ensured external assistance to the national efforts toward modernisation and industrialisation in terms of Foreign Direct Investment (FDI) and Overseas Development Aid (ODA), and improved the people’s livelihood. That is the main outcome of economic reforms for Vietnam.<sup>1)</sup>

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\* Views are author’s own.

1) Exchanges between Nobel Prize winner Paul Krugman and Vietnamese high-level officials in Hanoi (May 22, 2009).



A higher level of exposure of the national economy to the rest of the world, however, also has a negative side. When the regional and global economy enters the recession phase, Vietnamese economy also suffers. In 1997, when the financial crisis hit Asia Pacific region, Vietnam was negatively affected. But this time around, the severity is higher in scope and scale for at least two reasons. Vietnam has been more exposed to the rest of the world than it was 10 years ago.<sup>2)</sup> And unlike the last crisis, the developed countries - which have been the sources of fund and market for other countries - have all been in deep trouble. At the same time, inherent problems of the Vietnamese economy including weak physical infrastructures, underdeveloped legal and financial systems as well as serious corruption are contributing to the graveness of the economic difficulties that Vietnam is facing today.

In term of timing, economic difficulty hit Vietnam earlier. In mid-2008, the country was hit by inflation which was recorded at 25 percent in aggregate term for 2008. The Vietnamese Dong (VND) was depreciated against the US Dollar (USD) as the exchange rate was up to 18,500 VND for one USD from 17,300 VND/USD rate. At the same time, the stock market was down to 1,200 points by the end of 2007 to 1,000 in the beginning of 2008 and 300 points in March while the real estate market was frozen. According to one estimate, the country's nascent stock market, which was one of the world's top performers in 2007, proved to be one of the worst in 2008, losing nearly 70 percent of its value.<sup>3)</sup>

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2) Vietnam, one of the 10 new countries included in the index, debuted at 48 and ranked 10th in terms of trade. Vietnam is ranked for trade (10th), overseas remittance (15th), economic growth (19th), Internet users and Internet hosts (66th and 71st), and peacekeeping (69th). Singapore continues to hold the top position; Malaysia ranks 23rd, falling by four grades. The Philippines also drops by seven grades to 38th; Thailand's position reduces by 8 grades to 53rd; Indonesia is even down by 9 grades, to rank 69th.

3) In May 2008, inflation topped 25 percent, the highest level since at least 1992, while the trade deficit more than tripled over the first five months of the year and Vietnam's stock exchange plunged 55%. "Vietnam's Economy: In Need of Some Snake-Blood," March 5th 2009, *The Economist* electronic edition





The efforts by the government to curb inflation (including higher interest rates and cut of government spending, especially for big projects) further affected key sectors of the economy including banking, real estate, stock markets as well as businesses for money was less available or more expensive to borrow. This then shows that weaknesses of the Vietnamese economy are from within. They have been multiplied by difficulties from outside when the crisis hit the world. The rest of this paper will examine the aspects of the impacts to the Vietnamese economy by what has been happening outside Vietnam.

## Reduced Growth Indicators

The growth rate for 2008 was 6.23 percent, the lowest as compared to the last five years. Vietnam targeted a Gross Domestic Product (GDP) growth rate of 6.5 percent. Yet, the government expected it to be 5 percent for 2009,<sup>4)</sup> when other estimates fluctuated from 0.3 percent (by the Economist Intelligence Unit [EIU]) and 5 percent by the World Bank, Asian Development Bank and International Monetary Fund. In the first quarter of 2009, public sector outputs decreased by 3.2 percent (6.2 percent at the provincial and 2.3 percent at the central level).<sup>5)</sup> Outputs by the FDI sector rose 2.9 percent and private sector to 5 percent. Vietnam's industrial production fell 8.6 percent in January 2009 from the month before. The drop resulted in a 4.4 percent lower industrial output than in January

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4) The government may have to ask the National Assembly to reduce the target by 1.5 percentage points from the existing 6.5 percent for this year, *VnExpress news* website quoted Prime Minister Nguyen Tan Dung as saying.

5) The 3.1-percent growth seen in the first quarter is a “floor level” and the economy should pick up, *VnExpress* on March 15 quoted Le Duc Thuy, head of the National Financial Supervision Committee, as saying. Thuy said gross domestic product (GDP) growth of 5 percent at the end of the year would be good.



2008, according to data from the Planning and Investment Ministry.

Vietnam may lower its 2009 economic growth forecast to 5 percent after posting its weakest first quarter expansion in a decade, as indicated by a report quoting the prime minister. A 7.4 percent growth was initially reported in the first quarter of 2008. The General Statistics Office subsequently trimmed Vietnam's full-year 2008 growth figure to 6.18 percent, its lowest level in almost a decade.<sup>6)</sup> But statistics by the Ministry of Planning and Investment showed that the GDP growth rate for the first quarter of 2009 was 3.1 percent, as compared to 7.4 percent in first quarter of 2008. Industrial and construction output rose 1.5 percent, while that of agriculture, forestry, and aquaculture was 0.4 percent in the first quarter of 2009.<sup>7)</sup>

Growth rate of Hanoi was 3.1 percent, lowest for the last 10 years. The statistics for Ho Chi Minh City was 4 percent while figure for the previous year was 11 percent. The output of industry and construction grew 1 percent while 12 out of 27 industries including paper, textile, shoe leather, machinery and steel were facing stronger competition from abroad and suffering from decline. Electronics shops say that the Tet new year holiday sales were down by as much as 50 percent compared to the previous year. The carmakers' trade association reports that sales tumbled by 68 percent year-on-year in January.<sup>8)</sup>

## Exports Reduction

Vietnam's export-oriented strategy also means a heavy dependence on the

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6) Source: AFP.

7) Vietnam News Briefs, (Tuesday, April 21, 2009.)

8) "Vietnam's Economy: In Need of Some Snake-Blood," March 5th 2009, from *The Economist* electronic edition



overseas markets. The exposure of Vietnamese economy to the rest of the world is relatively high, with total exports and imports accounting for between 150 and 170 percent of the GDP and exports account for about 70 percent of GDP. Therefore, a reduction of external demands for Vietnamese exports, especially from the United States, Japan and European Union (EU), which consume about 50 percent of Vietnamese exports, means a decrease in exports revenues.

Exports slowed since after September 2008. In January 2009, exports incomes reached USD 3.8 billion, a 19 percent reduction as compared to December 2008 and 24.2 percent as compared to January 2008. According to EIU, exports fall 31 percent in 2009. In addition, the fall in prices of main export items including crude oil and rice also contribute to the decrease in export earnings. “The sectors that fell the furthest [in January] were exports, like textiles, garments, and shoes,” said Phan Chi Dung, head of the Trade Ministry's Industrial Consumer Product Department. “They all decreased between 25 and 30 percent. In the domestic market, purchasing power also decreased.” At the same time, China - which accounts for 7 percent of exports and 20 percent of imports - is reducing imports from Vietnam and is more competitive in its exports to Vietnam.<sup>9)</sup> In October 2008, export earnings decreased 3.3 percent, then 4.8 percent in the next month, and 18.6 percent in January 2009 while import volume decreased 44.8 percent for the same period. Export incomes for the first two months of 2009 reached USD 8 billion, a 5.1 percent decrease as compared to the 2008 figures.

Decrease in exports also means decreased imported materials and machinery needed for production of exported goods. In March, the Vietnamese government reported a record trade surplus. But local economists said they were more worried than pleased. The state-run newspaper *Vietnam News* quoted Vietnam's

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9) The fear is that stimulus package by Vietnamese government would benefit Chinese imports. *Thanh Nien (Youth) Newspaper*, February 20, 2008.



General Statistics Office (GSO) as saying the country spent just 11.8 billion dollars on imports, down 45 percent from the same period last year, while earning 13.5 billion dollars from exports, a slight increase of 2.4 percent year-on-year. The 1.7 billion dollar trade surplus for the first quarter was a record. The last time in which Vietnam showed a trade surplus was 1992.<sup>10)</sup>

But experts said it reflected an abrupt slowing of the economy. “This is not a welcome signal,” said economist Tran Duc Nguyen, former head of the Prime Minister's Research Commission, an economic advisory council. GSO said the volume and value of imports dropped sharply, including those of raw materials and equipment for domestic production. Much of Vietnam's export economy involves outsourcing, meaning the country must import components such as electronic and mechanical parts. Meanwhile, several import products for domestic production, including steel and iron, fertiliser and fabric saw decreases of between 28 and 65 percent compared to the same period last year. “The drop in materials and equipment imports has adversely influenced domestic production,” said Nguyen. In addition, Nguyen Tran Bat, chairman of Vietnamese consulting firm InvestConsult, said the trade surplus was deceptive because the largest export turnover came from re-exporting 2.3 billion dollars worth of gold. “It would be a big mistake if we just looked at this trade surplus and thought Vietnam's economy was doing well amid global turmoil,” Bat said.<sup>11)</sup>

The exports of agricultural products were not good. The only item that fared well was rice, which topped the list of exports at 1.75 million tonnes, worth nearly 800 million dollars. That was up 71 percent by volume and 76 percent by value over the same period last year. Apart from this, Vietnam reportedly raked in 1.1

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10) *Vietnam News*, March 17, 2008.

11) *Vietnam News Briefs*, (Tuesday, April 21, 2009.)



billion dollars from shipments of agricultural, forestry and seafood products in the first month of 2009, down 12 percent from the same period of last year, and 21 percent from a month earlier, according to the Ministry of Agriculture and Rural Development.<sup>12)</sup> Other sources indicate that export of rice showed on year rise of 152.8 percent to 130 million dollars, while, exports of forestry and seafood products dropped by 32 percent and 19 percent against January of 2008.<sup>13)</sup> The Ministry of Agriculture and Rural Development said global economic crisis resulting in low demand made sales of agricultural, forestry and seafood decreased. It said orders for Vietnamese cashew nuts, pepper, woodwork and seafood from the US and EU decreased by 20-30 percent. Several other export items also showed sharp decrease: 45.3 percent for electric cable, 22.9 percent for furniture, 19.9 percent for ceramics, 10.8 percent for footwear, and 10.4 percent for aquacultural products. Rubber products dropped 50.5 percent, crude oil 42.4 percent, woodwork 26.3 percent, paper 39.2 percent, cotton cloth 38.3 percent, fertiliser 22.1 percent and cooking oil 14.5 percent.<sup>14)</sup>

## FDI Decrease

FDI also decreased sharply. In 2008, Vietnam attracted about USD 64 billion new FDI. But the rate of realisation is low, because of (i) the scarcity of credits,

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12) Of the total, export of farm produce brought in \$580 million; forestry products, \$250 million; and seafood, \$270 million. The country earned \$217 million from coffee; \$28 million from fruit and vegetable; \$72 million from rubber; \$17 million from pepper; \$55 million from cashew nuts and \$9 million from tea exports, down 40%; 23%; 43%; 20%; 22% and 28% on year, respectively. Vietnam News Briefs, (Tuesday, April 21, 2009.)

13) *Vnexpress.net* (Tuesday, March 17, 2009.)

14) *Vietnam & World Economy*, February 5 p. 6, (GSO January Edition) Copyright 2009 Vietnam News Briefs, provided by *Financial Times* Information Limited - Asia Africa Intelligence Wire



(ii) stricter conditions for credits in the international financial markets, and (iii) bottlenecks in the infrastructure, institutions and workforce.<sup>15)</sup>

New foreign direct investment commitments were 185 million dollars in January, down about 90 percent from a year earlier, according to the Planning and Industry Ministry. The registered FDI for the first two months of 2009 amounted to more than USD 5.3 billion, equaled to 70 percent of FDI attracted in the first two months of 2008. EIU estimates that FDI will decrease 70 percent for 2009.<sup>16)</sup>

By the end of March, total FDI reached USD 6 billion, a 40 percent decrease as compared to the previous year. To be more specific, licenses to 93 new FDI projects were granted with the total fund amounting to USD 2.2 billion, a 72 percent and 70 percent decrease in terms of capital and number of projects respectively. Yet, 34 new FDI projects by investors who have already been doing business in Vietnam were launched with USD 3.8 billion, a 70 percent decrease in term of number of projects, but a 34 percent increase in term of capital. On March 31, 2009, Phan HUU Thang, General Director of the Department for FDI (MPI) stated that the new volume of registered FDI in January was USD 200 million, a 8.5 percent reduction as compared to the same period in 2008 and 18 percent decrease as compared to December 2008. By February 20, the number of FDI projects decreased 65 percent with the registered funds amounting to USD 1.5 billion, a 69 percent decrease as compared to the same period in 2008.<sup>17)</sup>

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15) According to MPI, Vietnam attracted USD 65 billion, but the realised fund was close to USD 11 billion, showing a widening gap between pledged and spent capital.

16) *Lao dong (Labour) Newspaper*, March 14, 2008.

17) Vietnam News Briefs, (Monday April 6, 2009.)



## Labour Contraction

According to the Ministry of Labour, Invalids and Social Affairs (MOLISA) statistics, 400,000 workers lost their jobs in February 2009. Yet, the situation could have been worse. Nguyen Thi Lan Huong, director of the Institute for Labor Studies introduced a research that said the number of unemployed workers was 490,000 when the economy grew between 5 and 6 percent. The number can rise to 742,000 in 2010 if the economy showed no signs of recovery.<sup>18)</sup> This figure refers to the jobs that the economy is unable to create for those who are just joining the labour force and not about those losing their jobs because of economic downturn.<sup>19)</sup> Another source said that in 2009, 440,000 people will lose their jobs and 510,000 others will see their working hours being cut while the official figure provided by Minister of Labour is 300,000, mainly in the export-related sectors.<sup>20)</sup>

Tran Dinh Thien, Director of the Institute of Vietnamese Economy, saw a link between reduction of growth rate and increase in unemployment. According to him, a 1 percent increase in growth rate means 0.34 percent increase in job creation. Therefore, when the economy is slowing down, the jobless number must rise. EIU forecasts that the unemployment of Vietnam in 2009 will be up to 8.2 percent.<sup>21)</sup>

MOLISA statistics for the first two months of 2009 showed that 10 percent of the craft villages are in trouble because of business contraction and bankruptcy. The Department of Labour Management that deals with exported labour - which

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18) *Youth Newspaper*, Saturday, March 21, 2009.

19) Huong pointed out that in 2008 only 800,000 new jobs were created as compared to 1.3 millions in 2007.

20) *Youth Newspaper*, Saturday, March 21, 2009.

21) *VnExpress* May 15, 2009.



reached 85,000 in 2008 (and expected to reach 90,000 in 2009 - announced that from November 2008 to February 2009, about 5,000 workers had to return to Vietnam before their labour contracts end; by March 15, this figure is 6,195. The Department predicts that this number will rise to 10,000.<sup>22)</sup>

## Tourist Decline

The tourism industry contracted as well with foreign visitors in January down 12 percent year-on-year. It is evident that 2009 will pose a difficult challenge for the tourism operators of Vietnam. The number of foreign tourists to Vietnam in the first two months of 2009 was 688,800, a 10.3 percent decrease as compared to the previous year. The volume of guests travelling to Vietnam by air dropped 8 percent in the same period.<sup>23)</sup>

The target of international tourists in Vietnam for 2008 was five million. Yet, since September, inbound tourism has plummeted, with the Minister for Culture, Sport and Tourism, Hoang Tuan Anh casting doubts that Vietnam will meet its annual target. The year-on-year figures until August showed 6.9 percent growth, but in August, the number of foreign visitors fell by 4.8 percent compared to August 2007. “Due to the economic slowdown, many travellers from key source markets for Vietnam have changed their mind, taking domestic trips rather than travelling overseas,” Anh continued. Tour bookings for 2008-2009 have plunged by 25 to 40 percent, according to Viet Thuy Tien, Director of Asian Trails

22) 22,000 workers went abroad in the first quarter of 2009.

23) The number of guests from China dropped 27.5%, from Thailand 24.7%, Korea 22.3%, Japan 8.7%, and Taiwan 5.9%. In March, number of foreign tourists reached 340,000, a 1% decrease as compared to February. The number of guests from Thailand dropped 32%, Korea 23%, China 21%, Japan 10%, Malaysia 8.6%. *Youth Newspaper*, Saturday, March 12, 2009.





Company.<sup>24)</sup>

The reduction in overseas revenue has not only affected hotel occupancy, but has led to difficulties in other industries such as construction, *Thanh Nien News* reports. “A big part of development here has been resorts and hotels, and with tourism coming down, people don't see as much urgency to invest, which means construction also comes down,” said Ayumi Konishi, Vietnam country director for the Asian Development Bank.<sup>25)</sup>

## Decreased Remittance

In 2007, money remittance via the central bank - Hanoi arm - reached VND383.8 trillion by the end of last year, rising by nearly 19 percent against a year earlier. Of the total, interbank electronic money remittance recorded VND151.6 trillion, up 6.3 percent.<sup>26)</sup> Remittances from overseas Vietnamese reached about US\$3.8 billion in 2007, an increase of 20 percent over 2006. Remittances by exported labors amount to about USD 2 billion annually in the same period.<sup>27)</sup>

According to Pham Thi Nga - director of remittance department of Vietcombank, for the first two months of 2009, remittances through the bank reached USD 200 million, a 12 percent decrease as compared to the same period of 2008. East Asian Bank reported a 16 percent decrease and Sacomrex 14

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24) Ibid.

25) Vietnam fails to meet tourism targets for first time since SARS, *VnExpress* Wednesday, December 10, 2008.

26) “Banking & Finance Hanoi Reports Non-Cash Payment At 90%,” *Vietnam News Briefs*, January 12, 2007 Friday.

27) “Overseas Vietnamese Sending More Money Home,” *Vietnam News Briefs*, Hanoi, October 27, 2007.



percent. Banks report the reduction of remittance from Taiwan, Malaysia, Czechoslovakia, and Middle East (where Vietnamese labourers are working) while money sent from the United States, Canada, Australia, and Europe by Vietnamese became less and irregular.<sup>28)</sup>

## Budget and Depreciation of VND

Fewer revenues and more funds for stimulus packages are increasing the budget deficits. The government plans to boost spending this year by 23 percent (almost 100 trillion dong, or \$8 billion, about 6 percent of GDP). Of this, about \$1 billion will subsidise loans to cash-strapped exporters.<sup>29)</sup>

Commercial banks in February lent a combined VND93 trillion (\$5.3 billion) to businesses at discount rates under a government loan subsidy programme, according to the central bank. The government said it would spend VND300 trillion (US\$17 billion) this year to halt a slowdown in economic growth amid the global financial crisis. The amount, almost a quarter of the country's \$71 billion GDP, would be used to develop infrastructure, spur exports, and fund other social security projects, Prime Minister Nguyen Tan Dung said in a statement on the government's website accessed in March 2009.<sup>30)</sup>

The spending is part of the government's VND491 trillion (\$28 billion) overall budget for this year, which is 23 percent higher than last year's. In the statement issued after a two-day cabinet meeting in late March, the government said it would quickly deploy VND60 trillion (\$3.4 billion) raised by selling government

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28) *Youth Newspaper*, Saturday, March 21, 2009.

29) Funds for stimulus packages can reach USD 8 billion. *Thanh Nien*, April 21, 2009.

30) At <http://www.chinhphu.vn>



bonds to boost production and exports. “The spending will help boost economic growth and investors' confidence,” Cao Sy Kiem, president of the Vietnam Association for Small-and Medium-sized Enterprises, said in a telephone interview from Hanoi Wednesday with *Thanh Nien (Youth) Newspaper*.<sup>31)</sup>

**Scenario for 2009 (billion USD, 2007 value)**

	2007	2008	2009	2009 compared to 2008
<b>Exports</b>	54.7	58.5	52.6	-10%
<b>Imports</b>	64.2	74.7	64.6	-15%
<b>Imports for domestic productions</b>	48.2	51.1	52.8	3%
<b>Imports for domestic consumptions and savings</b>	16.1	23.6	11.8	-50%
<b>Trade balance</b>	-9.6	-16.2	-12.0	-30%
<b>Savings</b>	29.6	34.1	32.4	-5%
<b>Final consumptions</b>	50.5	57.0	57.0	0%
<b>GDP</b>	70.6	74.9	77.4	3,4%
<b>% GDP</b>		6.1%	3.4%	

(Source: Vu Quang Viet, at *Viet-studies.info*)

Government budget income was 52.9 thousand billion, equivalent to 13.6 percent of estimated budget for the whole year, a 28.1 percent decrease while expenditures amounted to 63.3 thousand billion. According to Tran Dinh Thien, Director of the Institute of Vietnamese Economy, budget deficits may rise to between 9 percent and 10 percent and this might rekindle the threat of hyperinflation and depreciation of the Vietnamese Dong.<sup>32)</sup>

31) *Youth Newspaper*, Saturday, March 21, 2009.

32) *VnExpress* May 26, 2009 at <http://vnexpress.net/GL/Kinh-doanh/2009/05/3BA0F685/>



## Impacts of Other Types

Open discussions over matters of public concerns, as witnessed in printed and electronic newspapers and other means, have become a new feature of Vietnam's political changes. This is increasingly the case in times of greater economic difficulties. The most salient examples will testify to this trend.

The government's bauxite mining projects in the Central Highland has drawn most attention from all walks of life. Strong public criticisms have been voiced against plans to exploitation of bauxite in the area especially from economists, environmentalists and social preservationists. The main concern was that the bauxite projects would destroy the environment by discharging hazardous chemical agents to the land and consuming up much of the water resources, already scarce in the area. If environmental protection costs were taken into consideration, these bauxite projects could become too costly in economic terms. In addition, many people seem unhappy with the way these projects were designed as too much secrecy was involved and too little consultation with experts was done, which gives rise to various explanations of conspiracy theory nature. Under pressures, by the end of 2008, the government had to announce that it would begin a series of public seminars in which the press and specialists in the related fields could talk with central and local government officials as well as representatives bauxite businesses to "build greater consensus" over the issue. Such seminars were held in March and April 2009 and by the end of May, the National Assembly held open debates on these bauxite projects where the Prime Minister openly pledged that government agencies would closely monitor the environmental and social impacts of the bauxite mines while many Deputies remain unpersuaded.<sup>33)</sup>

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33) Many Deputies also complained that they had not been provided with sufficient information of the projects. See <http://vietnewsonline.vn/News/Politics/6094/Parliament-to-review-bauxite-mining-report.htm>, accessed on May 26, 2009 and [vnexpress.net](http://vnexpress.net) accessed on May 27, 2009.



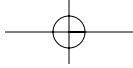
In another example, local newspapers helped to expose a serious case of pollution. As the story unfolds, from the mid-1990s, Taiwanese-owned condiment company Vedan in Dong Nai province had illegally discharged untreated wastewater into the Thi Vai River through concealed pipes. The collected evidences have proved that the pollution made it impossible for local aquaculture farmers to raise fish and shrimp. According to one account, 8,000 farmers in the provinces of Ho Chi Minh City, Dong Nai, and Ba Ria-Vung Tau have petitioned the government demanding compensation from Vedan. They also worked through farmers' associations and sought legal assistance to suit the company. The government then had to organise fact-finding missions to investigate the damage. In October, Vedan was ordered to suspend operation and pay a 7.7 million dollar fine although compensations agreements have not been reached.<sup>34)</sup>

Environmental concerns also give rise to strong criticisms against a major construction project of a four-star hotel in Hanoi. The SAS Royal Hotel, a USD 40 million joint venture between Hanoi Tourism Corporation and SIH Investment Limited from Singapore was put under city planning experts' scrutiny when it became clear that the construction had taken a part of the nearby public park, the biggest one in town. The local authority was asked to give proper explanations of why this happened. Moreover, environmental and city planning experts, supported by local citizens and media, questioned the connections between the joint venture and some local authorities, implying an example of high-level corruption. In the end, the case reached the Prime Minister who acted as a referee and declared the halt of the project. In addition, he asked the Hanoi authorities to run a check on all the public parks in the capital city to make sure that they were in good shape and service.<sup>35)</sup>

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34) Vietnam News Briefs, (Tuesday, April 21, 2009.)

35) *Vietnamnet*, (<http://www.vnn.vn> accessed on April 15, 2009).



These cases, among others, suggested that impacts of the economic crisis can also be found in term of social and political developments in Vietnam. In the first place, the public - with help from media - have been more conscious of the problems affecting their daily life and become more proactive in raising problems and seeking solutions. To be more specific, government policies and “good governance” in general are now put into greater scrutiny. In other words, issues of “low politics” such as economic and environmental concerns can and in fact have become those of “high politics,” thus paving the way for serious discussions on topics related to government policies and greater participation in policy design and implementation. This turns out that the crisis does contribute to the new efforts among Vietnamese to seek more effective policies to overcome the economic difficulty, especially as discussed earlier, when its roots can be found within the country.

