

A NEW PARADIGM FOR A NATION'S COMPETITIVENESS: THE CASE OF ASIAN ECONOMIC CRISIS

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Countries under the IMF reform prescriptions often do not agree with its bailout plans. Scholars have different perspectives on the purported IMF mission and policies. Despite continuing debates, an appropriate paradigm for effective prescriptions has not yet been found. This paper introduces a diamond model that is useful to solve the recent economic crisis in Asia. In this paradigm – first introduced by Porter (1990) and extended by Moon, Rugman, and Verbeke (1995, 1998) – important parameters of a nation's competitiveness are analyzed and policy implications are suggested.

1. INTRODUCTION

There is still no appropriate model that will help restore and enhance the competitiveness of Asian countries despite a number of studies on the recent Asian economic crisis. Some optimistic analysts predict that the Asian economy will soon bottom out its worst recession and start the road back to growth. However, any recovery will only be temporary without major economic reforms that fundamentally correct the causes of the crisis. This paper will address these grass-root issues and introduce a new paradigm for a nation's competitiveness.

There is a fundamental difference between the government and the International Monetary Fund (IMF) in understanding the causes of and solutions for the problem. Moreover, they differ in their negotiation strategies, which may worsen the relationship between the government and the IMF. Misleading information, misguided relationship, and misperception often cause anti-IMF and anti-Western sentiment among the people in the countries that seek IMF bailout plans. It is very important to understand the negotiating partner's goals and strategies in solving the economic problem. This paper will review the different approaches by the Korean government and the IMF to show how these differences have worsened their relationship and thereby slowed the recovery of the Korean economy. Thus, the Korean government and the IMF will find useful implications.

Diverse views and prescriptions among the scholars may also worsen the relationship between the government and the IMF and confuse the issue even further. This paper will compare and contrast opinions of prominent scholars such as Jeffrey Sachs, Henry Kissinger, and Martin Feldstein. Suggestions for a new paradigm will then be provided, by integrating realities of the problem with different perspectives. This paper highlights the Korean case. There are many similarities between the Korean case and those of other countries. Some differences among the Asian countries and those in other regions will also be discussed, when necessary. Implications of this study will be useful for the policy makers of Korea and other countries.

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2. THE KOREAN APPROACH

The most important issue of the economic crisis is related to the capability to forecast economic outlook. Until the eve of the economic crisis, major economic institutions reported an optimistic future of the Korean economy. In early October of 1997, the Bank of Korea reported that Korea's gross domestic product (GDP) was expected to grow by 6.3 percent in the second half of 1997 for an annual expansion of 6.1 percent. The central bank also predicted that the nation's current-account deficit would narrow to \$13.7 billion during 1997, sharply down from a shortfall of \$23.7 billion recorded the previous year. In a separate report, the state-run Korea Development Institute predicted that the economy would grow at an annualized 6.4 percent with current-account shortfalls narrowing to \$13.4 billion.

Surprisingly, the IMF also confirmed an optimistic outlook for the Korean economy. The IMF estimated the Korean economy to grow by a robust 6.5 percent in 1998, with the current-account deficit narrowing to about \$10 billion. "Judging from our in-depth reviews, the long-term outlook for the Korean economy is very bright," Charles Adams, assistant director of the IMF's Asia and Pacific Department, said in a news conference. After a period of rapid growth, the Korean economy is now in the phase of cyclical restructuring. Thus, the economy will shortly bottom out and enter an upward curve, said Adams, who headed the six-member IMF mission to Korea. Adams also said, "In an election year, there is surely an element of uncertainty in economic situation. But the Korean economy is already big enough to overcome any political fallout."

In mid-November of 1997, foreign business and academic sectors predicted that relatively bright prospects were in store for the Korean economy despite the daunting economic downturn. On November 14, the Korea Trade Investment Promotion Agency published its research showing that many overseas experts and economic institutes predicted the Korean economy would recover from the slowdown. The research was conducted on interviews of major entrepreneurs, journalists and academics by the agency's overseas branches.

From mid-October till mid-November, however, some ominous symptoms were apparent. First, foreign exchange outflows from Korea were surging due to the increase in personal remittances and emigration. In the first half of 1997, \$1.75 billion in personal remittances and immigration investment was transferred abroad, up 28.7 percent from \$1.36 billion a year ago. Of the remittances, immigration investment, namely settlement fees, accounted for \$600 million between January and June, compared with \$400 million in all of 1993, \$320 million in 1994, \$400 million in 1995 and \$510 million in 1996. Such a sharp increase was the result of the government's hike in June 1996 of the limit of personal remittance and settlement fee from \$10,000 per annum to \$20,000 and from \$200,000 to \$400,000, respectively.

Second, Korea lagged far behind its Asian rivals, including Japan, Taiwan, and Singapore in foreign exchange reserves. Korea's foreign exchange reserves stood at \$30.4 billion, or about one-seventh of Japan's \$222.2 billion. The reserves were also about one-third of Taiwan's \$95.5 billion, and represented about two-fifths of Singapore's \$80.4 billion. The optimum level of a nation's foreign exchange reserves as recommended by the IMF

is an amount sufficient enough to cover three months' import bills. Based on this guideline, Korea's reserves were not sufficient in view of the size of imports exceeding \$12 billion a month on average.

Finally, the stability of the Korean currency faltered. The exchange rate went up to almost 1,000 won to the American dollar. On October 31, 1997, the won opened at 965 won to the dollar, but the Bank of Korea immediately intervened in the market to hold the won below 965 won. Despite the central bank's heavy intervention, the Korean won came under renewed pressure, with the exchange rate of dollar moving close to the 1,000-won level.

A. THE KOREAN APPROACH 1

The banks' cash-selling rate of dollar tumbled past the 1,000-won level for the first time on November 10, 1997. The Korea Exchange Bank posted the day's dollar basic rate and cash selling rate at 999 won and 1,013 won, respectively. Taken aback by the sharp drop, the central bank strongly intervened in the domestic foreign-exchange market in a desperate move to keep the Korean unit from falling below the 1,000-won barrier. Thanks to the central bank's intervention, the won slightly recovered to 996 won but fell again back to 998.50. The morning session was closed at 999 won. The Korean government said that it would not allow the won to decline below the 1,000-mark.

Another strategy of the Korean government was that it would not let any Korean financial institutions default on foreign debt while it would work out steps to help foreign currency-strapped merchant banks. The Ministry of Finance and Economy announced that it would soon produce measures to improve the nation's shaky financial systems. From the perspective of foreigners, the ongoing slow pace of Korea's financial reforms seemed to be the major reason behind foreign investors' declining confidence in the Korean financial market.

At this time, the Korean government reconfirmed that Korea's foreign holdings were enough to defend the won, and that Korea would not ask help from the IMF. The government was standing ready to exert all possible means to keep the currency below 1,000 won. Government officials believed that the won's rapid depreciation against the dollar was not caused by market forces, but by speculative demand. They were ready to fight against speculation but did not understand the ever-deteriorating reality.

B. THE KOREAN APPROACH 2

The Korean government announced a new financial package that called for, among others, a hike in the won's daily-fluctuation band from the previous 2.25 percent to 10 percent. On November 20, the won reached the daily low of 1,139 won from the previous day's 1,035.50 won. The won's 10-percent fall to 1,139.00 came just after half an hour's trading, and one day after the Korean government unveiled an emergency bailout package. The won depreciated about 25 percent from the end of 1996. A number of market participants predicted that the won would continue to fall further. The Korean

government could not defend the won any longer.

On November 21, Korea decided to apply for a bailout loan from the IMF. However, Korea made another strategic mistake. Instead of directly approaching the IMF, Korea turned for help to the United States and Japan, but got cool responses from both. The United States insisted Korea seek help from the IMF, as did Thailand and Indonesia. Korea had not resorted to the IMF because Korea would have to implement economic programs demanded by the Fund, such as slow economic growth, strong financial reform, and a low inflation rate that would be painful to the Korean people.

However, the government officials did not understand the U.S. policy. On November 23, leaders of the United States and Japan reaffirmed their commitment to participate actively in the IMF's plans to aid Korea, ahead of the opening of the annual meeting of the Asia-Pacific Economic Cooperation forum. The U.S. President Bill Clinton said, "We basically, in response to the Asian financial markets crisis, said that there ought to be a three-step plan. Number one: the IMF ought to take the lead. Number two: it can't take the lead unless countries themselves have responsible policies that inspire investor confidence. Number three: the other developed countries ought to be in a position to have a sort of a backup stabilizing reassurance support. It does not involve an enormous amount of money on the part of any country, nowhere near, for example, the commitment the United States made in Mexico." So, the Mexican case was exceptional. Korea should have directly approached the IMF.

C. THE KOREAN APPROACH 3

The Korean government finally decided to deal directly with the IMF. However, the government chose a wrong strategy that led to a confrontational relationship with the IMF. Government officials said, "We will have to negotiate Korea's various macroeconomic figures with the IMF. Nevertheless, we won't accept IMF's excessive demands." They even warned that Korea's humiliating reliance on the IMF for help might serve as an occasion to help open the domestic markets recklessly.

In order to secure an advantageous position, government officials often resorted to tactics but in vain. On December 1, the Ministry of Finance and Economy announced that the visiting IMF delegation and the Ministry had reached a provisional agreement on the amount and terms for emergency bailout package. In Kuala Lumpur, however, IMF Managing Director, Michel Camdessus, flatly denied the Korean assertion on package settlement, saying it was considered to be part of Korea's negotiating tactics. Camdessus was known to express negative views about parts of the tentative accord, worked out by the working-group officials of the two sides. The Korean government then had to accept the IMF proposal.

At that time, civic groups also criticized the agreement. Several civic and social organizations labeled the agreement as "unfair," held rallies and issued statements to criticize the agreement and to call for renegotiation. An official of the Citizens' Coalition for Economic Justice said, "Holding the nearly-bankrupt Korean economy as hostage, the IMF forced the government to accept its demands – tied to the U.S. and Japanese interests – like opening the capital market to foreigners and ending the import source

diversification system.”

In addition, politicians condemned the IMF agreement. The election camps of the two major presidential candidates also denounced the IMF for infringing on Korea's sovereignty. “We cannot help taking issue with the negotiation attitude of the IMF, which acted as if it were economic occupation forces,” said the campaign spokesman of the Grand National Party. “It is deplorable that we have opened an era of economic trusteeship,” said the campaign spokesman of the National Congress for New Politics. Politicians tried to exploit public anger over the IMF bailout.

Politicians got in trouble because of these reckless responses. Presidential candidate Dae-Jung Kim was advised by the IMF chief to clarify his ambiguous posture on IMF deals. In a letter to Kim, Michel Camdessus asked Kim to have his unequivocal statement of support for the agreement made known to a wider audience to counter any misinterpretation that might have arisen. George Soros also advised Kim to fulfill the agreement with the IMF. Micky Kantor added that politicians must not take advantage of the situation as a part of their election campaign strategies.

Korean politicians and their economic advisors did not fully grasp the functions of the IMF. One of the most important functions of the IMF is to provide short and medium term financial assistance to member nations that run into temporary balance of payments difficulties. The financial assistance involves the provision by the IMF of convertible currencies, but only in return for the government's promise to reform the economic policies that caused the balance of payments problem in the first place. The IMF had to confirm this necessary condition with the Korean politicians.

As discussed, there were three different time periods of Korean approaches to the IMF. Korea made different strategic mistakes in each of the three approaches. However, one common mistake was the misunderstanding of the IMF roles and policies, which will be discussed in the next section.

3. THE IMF APPROACH

On December 4, 1997, the IMF approved Korea's request for a three-year stand-by credit equivalent to SDR 15.5 billion (about \$21 billion) in support of the government's economic and financial program. The stand-by credit was equivalent to 1,939 percent of Korea's quota of SDR 799.6 million (about \$1.09 billion) in the IMF. In its press release, the IMF explained Korea's economic problems as follows:

For the past several decades, the Korean economy has grown rapidly. At the same time, in the process of development, the limitations of Korea's system of detailed government intervention at the micro level have become increasingly apparent. In particular, the legacy of intervention has left an inefficient financial sector, which has led to a highly leveraged corporate sector that lacks effective market discipline.

In order to solve these problems, the IMF demanded a painful process of structural adjustment. In particular, Korea had to lower the growth rate, and tighten monetary and fiscal policies, which would increase unemployment. Thus, the main criticism on the IMF is that its reform conditions are too harsh. Another criticism is that the IMF

recommends the same, standardized solution package to countries that may have different causes of the problem. These two issues are discussed in this section.

A. THE IMF APPROACH 1: HARSH CONDITIONS

a. Macroeconomic Stabilization

The immediate objective of the IMF program was to overcome the currency crisis. To this end, the IMF recommended that Korea maintain a flexible exchange rate with intervention limited to smoothing operations. In addition, to demonstrate the government's resolve to fight the current crisis, monetary policy should be tightened immediately to restore stability in the markets and contain the inflationary impact of the recent won depreciation. The day-to-day conduct of monetary policy would be guided by movements in the exchange rate and short-term interest rates that would be used as indicators of monetary conditions.

Korea then needed to build up international reserves that would cover more than two months of imports, which required improvements in balance of payments and tight fiscal policy. Tight fiscal measures included: further increases in mineral oil taxes; a broadening of the VAT base and selective increases in income and corporate taxes; cuts in current expenditures, and, to a limited extent, in infrastructure and other capital expenditures.

b. Structural Reform

Macroeconomic stability cannot be achieved without restructuring and strengthening the financial system. The IMF strategy comprised three elements: transparency, market-orientation, and supervision. To improve transparency, large financial institutions would be required to have their financial statements audited by internationally recognized firms. To promote market-orientation, mergers and acquisitions would be allowed by domestic or foreign firms. In addition, foreigners could establish bank subsidiaries. Finally, to strengthen financial sector supervision, an agency should be set up to consolidate the supervisory functions that were scattered among various agencies. The Bank of Korea should also be made independent.

Although its foremost objective was to stabilize the financial crisis, the IMF also requested liberalization in commodity, investment, and labor markets in order to enhance competition or market-orientation. Korea needed to further liberalize its domestic commodity market in line with World Trade Organization's commitments to eliminate trade-related subsidies, restrictive import licensing, and the import diversification program. In addition, the country should substantially accelerate its ongoing capital account liberalization program, including an increase in the ceiling on foreign ownership of Korean shares and a simplified procedure of foreign investment. Finally, to facilitate the ability of the Korean labor market to respond to changing economic conditions, easing dismissal restrictions under mergers and acquisitions and corporate restructuring would enhance labor market flexibility.

The IMF is frequently under fire for seemingly draconian structural reforms. The

reform programs may be harsh; nevertheless, those measures are required to achieve macroeconomic stabilization. It is still controversial whether the IMF stretches beyond its original mission of stabilizing macroeconomic parameters. However, we need to consider the root of the problem in which harsh measures are required to cure the chronic problem.

B. STANDARDIZED PACKAGE

Table 1 shows the IMF conditions recently implemented in the Asian countries. As discussed previously and summarized in Table 1, the IMF approved Korea's request on December 4, 1997, equivalent to \$21 billion. The underlying problem was in government intervention and chaebols. Major problems were found in the banking system and inefficient regulation. In its Korean program, the IMF in particular emphasized chaebol restructuring and labor flexibility.

Table 1. The IMF Programs for Asian Countries

	Korea	Indonesia	Thailand
Date	Dec 4, 1997	Nov 5, 1997	Aug 20, 1997
Amounts	US\$ 21 billion	US\$ 10.14 billion	US\$ 3.9 billion
Background	Government Chaebol	Trade regulation Transparency	Current deficits External debt
Major Problems	Banking Regulation	Banking Regulation	Banking Regulation
Special Interests	Chaebol Labor	Privatization	Export Education

The credit for Indonesia, about \$ 10.14 billion (490 percent of Indonesia's quota of about \$ 2.07 billion), was approved on November 5, 1997. The primary economic problems were rigidities in domestic trade regulations and some import monopolies. At the same time, relatively less than transparent decision-making increased uncertainty and adversely affected investor confidence. Recently, large capital inflows intermediated through a weak banking system exposed Indonesia to a shift in financial market sentiment. Indonesia's banking sector coupled with inefficient regulations in many business areas was not prepared to withstand the financial crisis. Important elements of Indonesia's structural reform efforts included privatization as well as deregulation. Responsibility for the management and restructuring of public enterprises were shifted from line ministries to the Ministry of Finance, and a new Privatization Board was established. A clear framework for the management and privatization of government assets was being developed, which would establish explicit criteria for determining whether an enterprise should be shut down, restructured, or privatized.

Thailand was approved for a loan about \$ 3.9 billion (505 percent of Thailand's quota of about \$ 780 million) on August 20, 1997. Thailand's economic situation deteriorated progressively in recent years, as reflected in a persistent and widening current account deficit, which peaked at 8 percent of GDP in 1996, and an associated high external debt burden (50 percent of GDP), of which some 40 percent was short-term. Structural reforms to address the causes of economic difficulties were essential to the strategy, in particular the strengthening of the financial system and elimination of the inefficient regulations. Special emphasis was directed on boosting exports and strengthening secondary education and training to assist in the structural adjustment to higher-technology production and exports.

Asian economic crisis started in July 1997. Backgrounds of the problems might be different among the countries under the IMF programs, but these countries faced the same financial turmoil that swept the region. It would be interesting to compare the Asian countries with other countries that also experienced the IMF programs but with different backgrounds and timeframe. Table 2 lists the cases of Mexico, Argentina, and Russia.

Table 2. The IMF Programs for Other Countries

	Mexico	Argentina	Russia
Date	Feb 1, 1995	April 12, 1996	April 11, 1995
Amounts	US\$ 17.8 billion	US\$ 1.04 billion	US\$ 6.8 billion
Background	Current deficits Savings < Investment	Crisis in Mexico	Inflation Government deficits
Major Problems	Banking? Regulation?	Banking? Regulation?	Banking? Regulation?
Special Interests	Further Privatization	Further Privatization	Open trade Privatization

Mexico was approved for a credit of \$ 17.8 billion (about 688 percent of its IMF quota) on February 1, 1995. By that time, this was the largest-ever financing package approved by the IMF for a member country, both in terms of the amount and the overall percentage of quota. Mexico had achieved a remarkable economic transformation since the late 1980s. The government's development program resulted in a sharp reduction in fiscal imbalances. Mexico had recorded surpluses in overall fiscal balance since 1992. However, there was a substantial increase in the current account deficit from 3.2 percent in 1990 to 8 percent in 1994. This was related to the widening gap between gross national savings and gross domestic investment over this period. This gap was 5.6 percent in 1990 and 8.1 percent in 1995, respectively.

During 1994, investors' concerns about the sustainability of the current account deficit began to increase. To prevent capital outflows, the Mexican authorities raised interest rates, allowed a greater limit to the exchange rate band, and substituted short-term indebtedness denominated in foreign currency for local currency-denominated debt.

Nevertheless, there was a significant loss of external reserves. The availability of external financing to support the conversion of short-term government debt into medium- and long-term debt and to help domestic commercial banks to meet their short-term external obligations was expected to ease investors' immediate concerns about the situation in Mexico and reverse the overshooting of the currency depreciation.

The IMF program's specific objectives for 1995 were to reduce the current account deficit and inflation rate. The program focused on a policy of wage, price, and credit restraint supported by an improvement in the fiscal position to achieve the outlined goals. In addition, further privatization was enforced. Mexico had made substantial progress in privatization, but mainly concentrated on commercial enterprises, although some concessions had been granted for the operation of highways. Beginning in 1995, privatization also would involve basic infrastructure such as rail, ports, airports, electricity, and telecommunications.

A credit of \$ 1.04 billion (about 47 percent of its IMF quota) was approved for Argentina on April 12, 1996. The Argentina's economy was in good shape in the early 1990s. Inflation declined from over 2,000 percent in 1990 to 3.9 percent in 1994, while average real GDP expanded by 7.7 percent a year during 1991-1994. However, the crisis in Mexico in late 1994, together with growing fiscal instability, triggered a slump in confidence. Argentina experienced large outflows of capital, and by April 1995 international reserves had fallen by one-third. However, because the situation was not detrimental to inflict severe setbacks, the economy soon recovered with a package of monetary and fiscal measures. In 1996, the authorities also announced plans to privatize the remaining state-owned electricity companies and to sell share holdings in a number of companies already under private majority ownership.

Russia was approved for a credit of \$ 6.8 billion (100 percent of its IMF quota) on April 11, 1995. During 1992-1994, overall performance of the Russian economy was disappointing. Inflation rates ranged from 300 to 1,300 percent. Federal government deficit was about 6 to 10 percent of GDP. The IMF program targeted on a major tightening of monetary policy and a substantial cut in the fiscal deficit. The program also accelerated the move to a market economy through wide-ranging structural reforms, including, in particular, measures to liberalize the trade regime and the oil sector.

It is interesting to note that all three countries – Mexico, Argentina, and Russia – had different backgrounds to their problems, but that the IMF imposed quite similar programs focusing on tight monetary and fiscal policies as well as market-driven liberalization. The fundamental causes of the economic crises in these countries might be weaknesses in banking and inefficient regulations. In its program of structural reforms, however, the IMF did not explicitly specify plans to restructure banking sectors or eliminate a wide-range of regulations, except in the area of privatization. The IMF has extended its function and imposed these structural measures on the programs for the Asian countries starting 1997.

The IMF programs are quite standardized in terms of pushing tight government policies and market-orientation. The backgrounds of the problems among the countries are different, but the IMF believes that the same medicine with different doses should work because the core of the problems is the same. Although its major prescription is similar, the IMF often pays keen attention to the distinct characteristics of the countries

in particular ever since the Asian crisis. The IMF program included some measures for chaebols and labor in Korea; privatization in Indonesia; and export and education in Thailand.

Should the relatively standardized program of the IMF be criticized? As long as it believes that its standardized medicine can cure the country's economic problem, the IMF will continue to use that medicine with varying doses. It should be the country concerned, or in cooperation with the IMF, but not the IMF alone, which should prove its unique economic circumstances to get a more customized prescription. On the other hand, the debate on the IMF should be on whether its original mission has changed and thereby whether it needs to be restructured.

4. DEBATES OVER THE IMF

Scholars around the world have shown different perspectives on the Asian economic crisis and the related IMF programs. Some of them are very useful, but others are superficial and may mislead to inappropriate policies. Since we have scrutinized this case extensively, we can now correctly assess some views of eminent scholars. Summaries of the viewpoints of three scholars will be followed by an evaluation.

A. JEFFREY SACHS

(Harvard Professor, Summarized from *The Financial Times*, December 11, 1997)

a. Forecasting Reliability

Consider what the Fund has said about Korea just three months ago in its 1997 annual report. "Directors welcomed Korea's continued impressive macroeconomic performance and praised the authorities for their enviable fiscal record." Three months ago there was not a hint of alarm, only a call for further financial sector reform – incidentally without mentioning the chaebol (conglomerates), or the issue of foreign ownership of banks, or banking supervision that now figure so prominently in the IMF's Korea program. In the same report, the IMF had this to say about Thailand. "Directors strongly praised Thailand's remarkable economic performance and the authorities' consistent record of sound macroeconomic policies." With a straight face, Michel Camdessus, the IMF managing director, now blames Asian governments for the deep failures of macroeconomic and financial policies. It would have been more useful instead, for the IMF to ponder why the situation looked so much better three months ago, for therein lies a basic truth about the situation in Asia.

b. Rush Decision and Lack of Transparency

These bailout operations, if handled incorrectly, could end up helping a few dozen international banks to escape losses for risky loans by forcing Asian governments to cover the losses on private transactions that have gone bad. Yet the IMF decisions have

been taken without any public debate, comment, or scrutiny. While it pays lip service to "transparency," the IMF offers virtually no substantive public documentation of its decisions, except for a few pages in press releases. The people most affected by these policies have little knowledge or input. In Korea, the IMF insisted that all presidential candidates immediately "endorse" an agreement they had no part in drafting or negotiation – and no time to understand.

c. Fundamental Reason

There is no "fundamental" reason for Asia's financial calamity except financial panic itself. Asia's need for significant financial sector reform is real, but not a sufficient cause for the panic, and not a justification for harsh macroeconomic policy adjustments. Asia's fundamentals are adequate to forestall an economic contraction: budgets are in balance or surplus, inflation is low, private saving rates are high, economies are poised for export growth. Asia is reeling not from a crisis of fundamentals, but from a self-fulfilling withdrawal of short-term loans, one that is fuelled by each investor's recognition that all other investors are withdrawing their claims.

d. Solution

An appropriate solution would have been for the IMF to stress the strengths rather than the weaknesses of the Korean economy, thereby calming the markets rather than further convincing them of the need to flee the country. Months ago, when the financial crisis began, the Fund could have quietly encouraged Japan, the United States, and Europe to provide some credit support to the Bank of Korea. It might well have worked with the major banks to encourage them to roll over their short-term debts without inflaming the panic.

B. HENRY KISSINGER

(Former US Secretary of State, Summarized from *The Washington Post*, February 2, 1998)

a. Forecasting Reliability

No defender of either model in Southeast Asia or in the world's financial centers foresaw the current crisis. Until its very eve, conventional wisdom had it that Southeast Asia was well managed: Inflation was low, budgets were substantially in balance, savings rates ranged from 20 to 35 percent, privatization was pursued energetically, and growth was 6 to 9 percent. Cronyism, corruption, and weak, nontransparent banking systems were widespread. But until last summer, these were treated by what were the largest and most sophisticated lenders and investors in the world as tolerable risks, not as obstacles to lending. For every eager borrower, there was an eager lender willing to ignore risk and to encourage leverage.

b. One Medicine for Every Illness

The typical IMF rescue program is in urgent need of reevaluation. Its pattern was developed in the Latin American debt crisis of the 1980s. When most of the debt had been governmental, the remedy had been to shrink government services, devalue the currency, and push exports. Even though in Latin America these changes were relevant to the causes of the crisis, they generated severe political problems by imposing additional austerity on already hard-pressed countries. But in Southeast Asia, these programs were not relevant to most of the key problems because most governments had respectable budgets, and the debt was largely in the private sector. As the chief economist of the Deutsche Bank in Tokyo pointed out, the IMF acts like a doctor specializing in measles and tries to cure every illness with one remedy.

c. Fundamental Reason

The Thai currency, the baht, at first was pegged by the Central Bank to G-7 hard currencies, then to the U.S. dollar. Thus assured against devaluation, capital from the outside world rushed in. That flow was magnified because investors were in a position to exploit the gap between Thai and American interest rates by borrowing dollars in America and converting them into bahts in Thai banks at higher interest rates. At this point, in 1995, Thailand and the rest of Asia were overwhelmed by the unexpected rise in the value of the U.S. dollar – a factor outside Asian control. Concurrently, the yen declined, and Chinese currency was devalued. As Asian exports became less and less competitive and Asian current accounts fell into deficit, the capital flow into Thailand dried up. Thai foreign exchange reserves were almost depleted. A drastic devaluation of the currency became inevitable. A panic in Indonesia followed a similar pattern, though it was soon aggravated by political instability. The economic crisis probably would not have occurred except as a speculative reaction to events in Thailand.

d. Solution

The crisis is in essence political. If Indonesia falls into chaos, we will pay for it with decades of Southeast Asian instability. Similarly, democracy in Thailand will be threatened if IMF conditions are not eased. The international financial structure is in urgent need of revision lest one of the crises it now generates turn into a global collapse. I do not pretend to have the technical competence to offer solutions. However, it is clear that world leaders need a better understanding of global capital flows and their potential impact on the economies of both industrialized and developing countries.

C. MARTIN FELDSTEIN

(Harvard Professor, Summarized from *Foreign Affairs*, March/April 1998)

a. Changing Role of the IMF

Today's emphasis on structural and institutional reforms has not always been part of IMF programs. The IMF was founded in 1945 to help operate a system of fixed exchange rates that experts then considered necessary to encourage international trade. When the fixed rate system collapsed completely in 1971, the IMF was forced to find a new role. The fund found a new and important role in the 1980s. During the period of Latin American debt crisis, the IMF monitored policy adjustments and provided moderate amounts of credit to indicate that it was satisfied with the policy progress that the debtors were making. The next major chapter in the IMF's history began with the collapse of the Soviet Union and the Eastern Europe. These countries needed to shift from communism to a market economy. The IMF provided advice on a much wider range of economic issues than it had previously done in Latin America or elsewhere in the world.

b. One Medicine for Every Illness

The IMF is now acting in Southeast Asia and Korea in much the same way that it did in the former Soviet Union and Eastern Europe: insisting on fundamental changes in economic and institutional structures as a condition for receiving IMF funds. It is doing so even though the situations of the Asian countries are very different from those the former Soviet Union and Eastern Europe. In addition, the IMF is applying its traditional tight monetary and fiscal policies that were successful in Latin America. But the IMF's role in Southeast Asia went far beyond the role that it played in Latin America. For example, the government of Indonesia has been told to end the country's widespread corruption and curtail the special business privileges used to enrich President Suharto's family.

c. Fundamental Reason

The primary thing that kept foreign funds coming to Thailand and local funds staying there was the combination of relatively high interest rates on Thai baht deposits and a promise that the baht's value would remain fixed at 25 baht per dollar. But the baht's fixed value relative to the dollar could not be sustained. The Thai government secretly bought the baht to support its value but eventually had to give up. The Thai currency collapse spread to Indonesia, Malaysia, and the Philippines. Each country was forced to abandon its fixed exchange-rate policy and let the market determine the currency's value. The Korean situation is different from that of the Southeast Asian countries. Korea's problem did not stem from an overvalued exchange rate and an excessive current account deficit. The value of the Korean won was not fixed and the Korean economy was performing well. Since Korea's total foreign debt was only about 30 percent of GDP,

this was clearly a case of temporary illiquidity rather than fundamental insolvency. Moreover, since the current account deficit was very small and rapidly shrinking, there was no need for the traditional IMF policy of reduced government spending, higher taxes, and tight credit.

d. Solution

Today, there is nothing like unanimity about the appropriate policies for Korea or Southeast Asia. Even if it were desirable for Korea to shift toward labor, goods, and capital markets more like those of the United States, it may be best to evolve in that direction more gradually and with fewer shocks to existing businesses. Making the transition in the midst of a currency crisis would be very poor timing. When the foreign exchange crisis hit Korea, the primary need was to persuade foreign creditors to continue to lend by rolling over existing loans as they came due. The key to achieving such credit without an IMF guarantee of outstanding loans was to persuade lenders that Korea's lack of adequate foreign exchange reserves was a temporary shortage, not permanent insolvency.

D. CRITICISM ON THE CRITICS

a. Jeffrey Sachs

Sachs, a well-known critic on the IMF, blames the IMF along the four dimensions discussed previously. The first two points are very useful, but the other two points are rather controversial. Sachs argues that there was no "fundamental" factor that brought about the Asian crisis because macroeconomic variables such as budgets, inflation, savings rates, and export growth were good. However, he is inconsistent in his line of reasoning as he already mentioned that these numbers do not accurately reflect reality and result from poor forecasting. In addition, he claims that an appropriate solution would have been for the IMF to stress the strengths rather than the weaknesses of the Korean economy. Would the skeptical international investors believe this? Sachs also maintains that the IMF could have quietly encouraged Japan, the United States, and Europe to provide some credit support to the Bank of Korea. Sachs further criticizes the IMF for its lack of transparency. He is now suggesting the Fund a policy, which is not very transparent, to influence Japan, the United States, and Europe to do something outside the IMF. As we have already discussed, the Korean government in fact approached Japan and the United States for assistance but got cool responses. The Korean government (now Jeffrey Sachs) did not understand the IMF role and President Clinton's three-step plan.

b. Henry Kissinger

Former U.S. Secretary of State, Henry Kissinger, severely criticizes the IMF's forecasting capability, as Jeffrey Sachs does. Then he criticizes the standardized package of the IMF.

Kissinger argues that the debt of Latin America was in the public sector, but that the debt of Asia is largely in the private sector. However, he should have compared the Asian crisis with the Latin American crisis of 1995, not 1980s. As already discussed, Mexico's fiscal balance became surplus in early 1990s. Mexico's financial crisis in 1995 came not from the governmental debt, but from the increased current account deficit and savings gap. The IMF program at that time focused on tight monetary and fiscal policies and market orientation. This kind of program may also be useful in correcting the recent Asian economic crisis. However, Kissinger shows a different perspective on the Asian case. He blames two outside variables – high value of the U.S. dollar and speculation – as fundamental causes of the crisis. What are the policy implications for Asian countries, if the causes of the problem are exogenous and quite uncontrollable? Therefore, Kissinger cannot provide specific solutions but just asks world leaders to have a better understanding of global capital flows and their potential impact on the global economy.

c. Martin Feldstein

Feldstein explains the changing roles of the IMF and criticizes its uniform and standardized program. He argues that the IMF acts in Asia in much the same way that it did in former communist countries. However, the IMF approach to the Asian crisis is different. As Feldstein points out, the IMF's role in Asia went far beyond its original mission to the extent that the government of Indonesia was told to end the country's widespread corruption and special privileges of President Suharto's family. It is controversial whether this kind of role is beyond the IMF's mission. Anyhow, the IMF programs are not without differentiation. Feldstein understands that the primary cause of the Southeast Asian crisis is the fixed exchange-rate policy, and he argues that the Korean situation is different because Korea has a flexible exchange-rate system. According to Feldstein, therefore, Korea's problem is a case of temporary illiquidity rather than fundamental insolvency. He also argues that making the transition in the midst of a currency crisis would be very poor timing. Instead, Feldstein suggests a policy to persuade foreign creditors to continue to lend by rolling over existing loans as they come due. Korea did this in the early 1998, but only after foreign creditors were assured with the IMF bailout package.

d. Overall Evaluation

The critics mainly focus on three points. First, the IMF conditions are too harsh. Second, the package is standardized. Finally, countries should try to solve the problems outside the IMF. However, we have found that if the causes of the crisis are not superficial but fundamental, harsh conditions can be justified. We have also found that the basic tools of the programs are the same, but the IMF pays special attention to some particular aspects of each country. And finally, all three critics suggest solutions, probably outside the IMF. Jeffrey Sachs recommends the IMF to quietly encourage other countries to support the troubled country. Henry Kissinger suggests world leaders to have a better understanding of global capital flows. Martin Feldstein likes a policy to persuade foreign creditors to roll over existing loans. In reality, however, other countries,

world leaders, and foreign creditors would not be assured without an active role of the IMF. As reflected in the Clinton's three-step plan, the IMF should take a lead to call upon other countries and world leader, and to attract foreign capital to the countries in economic trouble.

5. PARAMETERS OF A NEW PARADIGM

In the previous section, the critics on the IMF have been critically evaluated. However, this does not mean that the IMF is correct. There are basically two issues regarding the operations of the IMF. The first issue is whether the crisis is superficial or fundamental. The second issue is whether the IMF is acting beyond its original mission. The second issue, which is quite legal and political, is beyond the scope of this paper. In this section, we will discuss the actual causes of the crisis and find parameters of a new paradigm that can cure the crisis.

To find the real causes of the crisis, we have to find where the crisis started. The Asian crisis started in Thailand, which turned to the IMF in August 1997, but in fact it started a little earlier in Hong Kong in July. China took over territorial control of Hong Kong on July 1, 1997. Despite China's promise to maintain the capitalistic system of Hong Kong, international investors began to reshuffle their portfolios across countries, and Hong Kong's stock market was hit first. But Hong Kong survived. Some countries such as Singapore and Japan also survived, while others not.

The Asian crisis is basically international by nature in the region. The same virus of the flu attacked several Asian countries. The most important question is why some countries could survive while others not. The answer is that immune systems are different among countries. Without improving the immune system, the flu cannot be cured. Some medicines may reduce the symptoms, but only temporarily. So, the Asian crisis is a "fundamental" problem. Also, the crisis is not just financial, but economic. The country in trouble needs to reform the fundamental structure of its economy to restore or enhance its international competitiveness. We now have to find parameters that constitute a nation's competitiveness.

A. THE SINGLE DIAMOND MODEL

The most useful model, concerning a nation's competitiveness, is Michael Porter's (1990) diamond model. According to Porter, national competitiveness comes from neither macroeconomic variables such as the currency value and interest rates nor classical factor endowments such as natural resources and labor pool. Instead, he suggested a new theory, the so-called diamond model that has four parameters as follows:

a. Factor Conditions

According to Porter, classical economics, whose origins date back to Adam Smith and David Ricardo, is at best incomplete and at worst incorrect. In today's sophisticated

economy, a nation does not inherit but instead creates the most important factors of production. Advanced factors such as skilled human resources and a scientific base are more important than basic factors such as a pool of labor and a local raw-material source.

b. Demand Conditions

Nations gain competitive advantage in industries where the home demand gives their companies a clearer picture of emerging buyer needs, and where demanding buyers pressure companies to innovate faster and achieve more sophisticated competitive advantages than their foreign rivals. So, the character of home demand is more important than the size of home demand.

c. Related and Supporting Industries

The third parameter is the home base of related and supporting industries. This view is similar to the linkage effects of related sectors. However, Porter further argues that these industries should be located near each other to take advantage of short lines of communication, quick and constant flow of information, and an ongoing exchange of ideas and innovations.

d. Firm Strategy, Structure, and Rivalry

National competitive advantage results from a good match among firm strategy, structure, and rivalry. However, according to Porter, no single managerial system is universally appropriate because the way in which firms are managed and choose to compete is affected by national circumstances. Instead, he expresses a strong preference in favor of vigorous domestic rivalry creating and sustaining competitive advantage.

B. THE GENERALIZED DOUBLE DIAMOND MODEL

Porter's single diamond model is very systematic and useful in understanding the fundamental parameters of national competitive advantage. However, whereas Porter's framework may be applied usefully to explain the past development of a number of countries, it is not necessarily appropriate for describing other countries in today's global economy. When using Porter's single diamond approach, firms' capabilities to tap into the location advantages of other nations are viewed as very limited. For example, some small economies, like Korea, do not consider their home countries as their only bases for competitive advantage. They often neglect their small domestic markets and directly target the global market.

Rugman (1991, 1992) first pointed out the weakness of the Porter model. He argued that Porter did not adequately consider the nature of multinational activities. Rugman then introduced a "double diamond" model. This double diamond model, formally developed by Rugman and D'Cruz (1993), suggests that managers build upon both domestic and foreign diamonds to become globally competitive in terms of survival, profitability, and

growth. Moon, Rugman, and Verbeke (1995) developed the Rugman and D'Cruz's model to a "generalized double diamond." Further, Moon, Rugman, and Verbeke (1998) introduced a methodology to operationalize the double diamond. Whereas Porter's original diamond considered mainly the impact of traditional home based activities, the generalized double diamond includes the impact of foreign nations and firms on a particular country's competitiveness. The new paradigm also incorporates the government factor, not as an exogenous but an endogenous variable.

This new paradigm is useful in analyzing the Asian economic crisis, in particular the Korean case. The most important competitive advantage in Korea was its inexpensive and well-disciplined human resource. This cheap and controllable labor was very productive under the guidance of Korean entrepreneurs (chaebol) that were strongly supported by the government. At present, however, all these three economic agents – labor, chaebol, and government – are under severe criticism. Labor is not cheap and disciplined, but expensive and unstable. Chaebol is not an effective entrepreneur but a dinosaur that has too many limbs. The government is not a strong supporter but an annoying regulator. With declining productivities of all these three economic agents, Korea's competitiveness was deteriorating, but not its currency value. The result was financial and then economic crisis. Therefore, the Korean crisis is not just financial and superficial, but structural and fundamental.

Lack of globalization is probably the most important reason behind lagging competitiveness. When labor productivity was not in line with increases in wages, Korean entrepreneurs should have become more aggressive in outward foreign direct investment to lower-cost locations in other countries. They should also have eagerly attracted management and technologies of advanced multinational firms into Korea. However, Korean government's regulations on both outward and inward foreign direct investment restricted their multinational activities. Korean workers should also have enhanced their productivity to the international level. They should have borne in mind that their competitors were not Korean managers, but workers in other countries.

The generalized double diamond model is useful in analyzing other important parameters, as well as the importance of multinational activities. In this paradigm, workers comprise the parameter of factor conditions and entrepreneurs partly comprise the parameter of firm strategy, structure, and rivalry. Two other parameters – demand conditions and related and supporting industries – need to be discussed. Korea's domestic market is not large enough for desirable economies of scale. Korean firms should target the international markets, but their exports did not perform well. They could sell products from their foreign subsidiaries, but their outward investments were not significant. Korea could have expanded its demand conditions if Korean firms had pursued well-diversified strategies of entering foreign country. For various types of entry strategies, see Moon (1994, 1997). Finally, related and supporting industries are important elements. Transportation, telecommunication, and particularly financial sectors are important, but were weak compared to an international standard of Korea's competitors.

In sum, Korea has lost its competitiveness because all four corners of its diamond have shrunk. So, Korea's problem is not superficial but fundamental. Since the parameters of the diamond model reinforce each other, Korea needs resolute and wide-range reforms that will strengthen all the parameters to recover its competitiveness.

6. CONCLUSION

There is often a testy relationship between the IMF and the country receiving the IMF bailout. This paper highlighted the Korean case. The Korean government committed strategic mistakes mainly because it did not correctly understand the roles and policies of the IMF. Critics on the IMF showed different perspectives on the IMF and were in turn critically evaluated in this paper. However, the IMF is not without criticism. The most important issue centers on whether the crisis is superficial or fundamental. And if it is fundamental, what are the parameters? It was discussed that the Asian crisis was fundamental rather than superficial. A new paradigm, the generalized double diamond, was then introduced to analyze important parameters to restore and enhance a nation's competitiveness.

Within this new paradigm, Korea suffered weaknesses in all four parameters. Strategic implications were suggested to improve all the corners simultaneously rather than one at a time because the parameters reinforce each other and produce synergy effect within the diamond system. Korea might have suffered from the beatings of the crisis because it opened the area of international portfolio investment without strengthening the banking sector and other parameters of the diamond. The country is now opening up the banking and other sectors to foreign investors but at much cheaper prices. Korea should have opened and strengthened the related sectors first, and then or simultaneously, opened the capital market. The most important implication of the new paradigm is that some parameters work together.

Korea has achieved a significant economic success for the last couple of decades. The country is now in crisis and under the IMF bailout program. The crisis is real and not easy to overcome. However, if reforms are implemented properly, today's crisis will turn into tomorrow's golden opportunity. This is a turning point for Korea to be ready for fundamental change and progress. Korea can overcome the economic hardship sooner and reemerge stronger when the Korean people consider the crisis more fundamentally, rather than superficially.

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