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A New Monetary System For Sovereign Citizens

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East Asian countries were hit hardest by the financial crisis in 1997. However, the discussion on what caused the crisis is not yet settled—despite the fact that clearly, somehow, flows of short-term speculative money triggered the crisis, and so severely damaged living conditions of people in the region. In fact, the major cause of the 1997 crisis was not internal to Asia, but rather, the instability of the global post-1971 floating-rate-system itself, with its 19th-Century-style deregulation, and strong volatility of foreign funds. Under the free-float regime, nobody controls the global movement of capital flows, which intrinsically makes today’s global financial system extremely unstable.

Since 1997, many economists, including myself, revived interest in the Tobin Tax and similar modifications to the floating-rate regime, believing measures to reduce speculation would have helped avoid the 1997 crisis. More recently, however, a number of intellectuals have begun to question the entire viability of today’s globalized regime, and to study proposals for a New Bretton Woods monetary system, based on different principles. Yet considering the damage to East Asia in the crisis, it is surprising their attitude toward Tobin Tax and other fixes—not to mention proposals for a new system—has been silence.

To understand this strange situation, it is necessary to know how desperately East Asian countries depend on foreign money for economic growth. Despite the magnitude of the 1997 crisis, they feel forced to welcome foreign money, to guarantee higher economic performance. They are afraid of even the Tobin Tax, as it may reduce inflows of foreign capital. Meanwhile, they also constantly worry that a similar financial crisis may recur in the future, due to (as they know too well) the fundamental instability of the global regime. This paradox makes them even more fearful to question (in public) the basic premises of the system, not to appear “inhospitable” to today’s powerful, unregulated flows of private funds. Thus, the silence among East Asian countries could be due to a perceived lack of choice.

Let us explore the cause of the crisis, and whether we do have a choice to avoid a new one.

The Post-1997 Shock to Korea

Although the South Korean government never raised any question about the malfunctioning of global finance and its negative consequences, the magnitude of the changes which the 1997 crisis forced, speaks for itself. After the crisis, most countries in the region changed their exchange-rate regime from pegs or other managed exchange-rate systems, to a free float. In Korea the exchange rate had been managed a long time to hold at W700-800/dollar—but just after the 1997 crisis, the won fell to W2000/dollar. Only due to the recent severe global weakness of the dollar itself, has the won come back to around W1000/dollar.

A large volume of foreign funds were introduced, courtesy of the IMF advisors, especially when the dollar rate was above W2000, to buy Korean assets, including Korean stocks and bonds. Many good Korean companies were forced to be sold to foreign investors under the pressure of the government which adopted a policy of “open economy” and capital liberalization under the guidance of the IMF. . . .

Foreign investment in Korea has grown dramatically since the crisis, especially in the banking and stock markets. In 1997, it amounted to 9.1% of total capitalization of Korea’s stock markets, worth 7.4 trillion won. At the end of 2004, however, it shot up to 42% worth or 173.2 trillion won. Foreign investors own more shares than local majority shareholders in every tenth company listed on the Korean Stock Exchange, thus exposing Korean companies to a potential threat of management takeovers.

In the banking sector, foreign investors control three of Korea’s eight major commercial banks. And at four of the remaining five banks, they own more than half of the total shares of each bank. That pushed up the market share of foreign owned banks in Korea, in terms of total assets, from 4.2% in 1997 to 21.8% as of October 2004.

Foreign investment funds are now using loopholes in the Korean tax system to avoid paying taxes on corporate profits.

A good example may be The Carlyle Group and Newbridge Capital—both of which recently made huge profits of W700 billion and W1.15 trillion, after selling Korean banks under their control—while paying no taxes to the Korean government. Texas-based Lone Star Funds avoided tax on capital gains after it sold Seoul’s Star Tower building, earning a whopping W260 billion profits.

Foreign investors are criticized for taking a free ride on the government’s open economy and capital liberalization measures without making a significant contribution to Korea’s economy. The most severe victims are the labor force. Many workers, especially skilled blue collar industrial workers, were laid off during the IMF’s economic restructuring program.

Today more than 50% of workers in Korea are employed on an irregular basis, such that they can be dismissed from their work places any time, at the will of the management, rather than in long-term contracts as was the norm during the “Korean Miracle” of the nation’s industrialization. These employment practices have been promoted under the IMF’s policy of ‘flexible labor’, which breaks down the traditional industrial relations in Korea and increases arbitrariness of management to hire and layoff workers. Few critics realize that the lower workplace morale which resulted from this is a major reason for South Korea’s failure to generate new world-class industries and corporations as we had done before 1997.

The economic system that originally created the Korean Miracle, which also depended on the fixed exchange rate system, has been almost restructured out of existence since 1997.

Politics of Recovery and Resistance to Change

Various attempts have been made to explain the causes of the sudden collapse of East Asian countries. The U.S. and other G7 members argued that Asia’s lack of transparency and unsound financial and macro-economic management were at the heart of the crisis. The opposite argument is that volatility and instability of international capital movement led to the financial turmoil. While the crisis may have been the product of a combination of external and domestic factors, globalization failed to integrate the situation, to say the least.

Political motivations should be understood to have some insights why these countries have shown passive response proposals to change the system.

The crisis hit Korea so hard as to make the won depreciate over 50% between July 1997 and January 1998. Even after a \$57 billion bailout program was announced in December 1997, the decline in won and stock prices continued for several months.

The real problem confronting Korea was the heavy short-term borrowing by the private sector financial institutions from foreign commercial banks. Thus the problems were further deepened with the fall in the won and stock prices.

Faced with a liquidity crunch and default, the then-Korean President, Kim Young Sam, sacked his Finance Minister and replaced him with a former IMF official, Lim Chang-Yuel, on Nov. 19, 1997. Mr. Lim announced liberal policy measures to further open financial markets and remove restrictions on portfolio investments. After removing capital controls, Korean authorities had extensive discussions with IMF officials to work out a bailout plan. The IMF insisted that all shaky financial institutions be shut down as a precondition, and the government must slash public spending and reduce its economic growth target from 6% to 3% for 1998.

The Korean case was rather unusual for the IMF. Normally the IMF is called when a country faces a major budget deficit, current account deficit, and high inflation, and applies standard IMF conditionalities, reducing government spending, and raising taxes and real interest rates. However, this did not apply to Korea, which in fact had a budget surplus, and a high growth rate with low inflation. Korea merely had a short-term capital flow problem, but the IMF turned it into a long-term structural redesign of the whole economy.

The IMF's stiff conditionalities led to more and more bankruptcies and threw millions of people out of work. With domestic industry in deep trouble after the stock crash, owners had little option but to sell their stakes to foreign investors at throwaway prices and very favorable exchange rates. In short, the entire cause of the crisis in Korea was blamed on domestic factors, and the Korean government was forced to follow IMF directions. The Korean government never raised any question about the malfunctioning of global finance and its negative consequences.

Domestic politics partly explains why Korea acted so passively. There was a presidential election at the end of 1997 when Korea turned to the IMF. President-elect Kim Dae-jung used the crisis to push his reform, restructuring Korea's economy to weaken the chaebol—which he saw as the base for his conservative opposition. Dr. Kim utilized the authority of the IMF (as George Soros advised him to do) to weaken internal resistance from the conservative political and economic groups, and followed the prescriptions directed by the IMF—leaving the devastating role of short-term capital during the crisis, unanswered.

Malaysia took an opposite direction. Instead of approaching the IMF, Malaysia adopted exchange and capital controls, naming global finance as a primary cause of the crisis. Prime Minister Mahathir Mohammad made a sharp attack on speculators, saying “there are a lot of things we can now do because we don't have to face actions of speculators to stop us. The free market has failed and failed disastrously because of abuses.”

Mahathir had at first adopted a quasi-IMF style program, but this resulted in substantial capital outflows. On September 1, 1998, the government imposed capital controls: repatriation of ringgit held abroad, an end to all offshore trading in

ringgit and domestic credit facilities for overseas banks and stockbrokers, payment in foreign currency for imports and exports, central bank approval for the conversion of ringgit into foreign currency, and many other regulations.

Some observers, however, believe that Mahathir's criticism against speculators was politically motivated in that he intended to avert people's attention toward the external enemy to escape domestic political plight, and an attempt to starve off a leadership challenge.

But like Korea, Malaysia did not show a big interest in fundamental global changes.

China has been successful in taking advantage of the Asian crisis to assure its neighboring countries that China has been a real assistant, rather than harmful obstacle, in the crisis. At the height of the crisis, China suffered from relative appreciation of its currency because of the large devaluation of other Asian currencies, hurting its exports. But China kept its currency steady, providing neighbors with some stability, at its own expense.

Meanwhile, China managed to protect its economy from the contagious effects of the crisis thanks to capital controls. It still uses policy instruments to deal with capital flows and its impact on the domestic economy. With the help of a fixed exchange rate and an independent monetary policy, Chinese authorities have maintained financial stability. While China accepted IMF Article VIII in 1996 and made the yuan convertible on current account, it has adopted a cautious approach towards liberalization of capital account transactions. China has taken special measures to restrict portfolio investment and short-term speculative inflows.

Thus, China has been able to prevent short-term capital troubles; 80% of its external debt is long term and 90% of investments are in the form of FDI, not loans. Yet, China is still dependent on the biggest inflows of foreign capital in the world.

As for Japan, East Asian countries benefited from the rise of Japan's yen against the dollar following the Plaza Accord of 1985, since their currencies were generally pegged against the dollar. However, 'the Reverse Plaza Accord' which allowed devaluing the yen in 1995 poured cold water upon the optimistic expectation for East Asian economies.

By 1997, the yen had fallen to about 120 to the dollar. And by then, export volumes of Indonesia, Singapore, South Korea, and Thailand had gone into a free fall. That slammed these economies, already beset by high dollar-denominated short-term foreign debt.

In September 1997, the Japanese government proposed the establishment of an Asian Monetary Fund (AMF). The AMF's purpose was to provide liquidity to forestall speculative attacks on the region's currencies. However, it was turned down at the insistence of the U.S. and Europe because it challenged the monopoly of the IMF and the U.S. role in the region.

In October 1998, instead, Japan proposed a framework of “A New Initiative to Overcome the Asian Currency Crisis” (New Miyazawa Initiative) to provide support measures totaling \$30 billion. Notwithstanding several positive elements, one cannot overlook the fact that the Japanese proposals were to serve its interests in the region, just as the U.S. used the IMF. However, also China and Japan both show no special interest in real systemic changes.

New Asian Mechanisms vs. Systemic Change

The 1997 crisis showed that the collective identity of the Asia-Pacific, symbolized by APEC (Asia-Pacific Economic Cooperation) is fictitious; there is a lack of perceived common interests among members. Asian members were not persuaded by the idea that U.S.-pushed trade and investment liberalization is beneficial to all, and began to search for alternatives to truly represent their interests, in the form of regional cooperation.

The 1997 crisis painfully showed that individual countries lack capacity to face financial crises, so regional mechanisms would be useful. The crisis showed that contagious effects were substantially regional, so regional response could be useful in controlling contagion. They also found a serious conflict of interests with the West, which kept stressing the IMF, and which used the crisis as an opportunity to push financial liberalization further.

In 1977, the ASEAN central banks had established an ASEAN swap arrangement, but these were rarely used, due to the limited amount of dollars. However, its importance was recognized after the crisis in 1997. The Finance Ministers of ASEAN+3 countries, whose total foreign reserves then amounted to about \$800 billion, agreed in May 2000 in Chiang Mai, Thailand, to establish a regional financial agreement. This ‘Chiang Mai Initiative’ (CMI) expanded the swap arrangement to all 10 ASEAN countries plus the 3 of Japan, China, and Korea. By May 2005, the total bilateral swap lines among the 13 had been expanded to almost \$12 billion. These 13 nations together now have reserves over \$2 trillion.

The Tobin Tax in East Asia

Yet CMI met with a favorable reception from even the IMF, as so far CMI is not aimed to tackle the ultimate problems of the international monetary system. CMI stresses its supplementary nature to IMF facilities. Any large-scale financial support from the Plus 3 countries to ASEAN is based on bilateral agreements, not (so far) the multilateral arrangement sought with an AMF. The severity of the 1997 crisis also alerted the IMF et al. to the need to co-opt Asian lenders into future financial support operations.

As to fundamental changes to the system, East Asian countries are split even on issues such as the Tobin Tax. Despite the fact that the Tax became a global issue after the 1997 Asian crisis, the reality is that Westerners take lead promoting

it. East Asian countries are only interested in preventing a crisis from recurring in the future, but not in capital control itself, which could reduce their capital inflows. Second, East Asians see the Tobin Tax as being levied on the wealthiest countries and distributed among poor countries.

Third, China and Malaysia employ capital controls, so do not see need of global changes. UNCTAD chief economist Yilmaz Akyuz says “Malaysia’s capital controls are now widely accepted as a success” to re-orient an economy toward a self-reliant direction. Fourth, Korea, Indonesia and Thailand, faithful pupils of the IMF, have promoted structural reform along free-market, Anglo-Saxon lines. They have liberalized capital and exchange markets according to IMF direction. As a result, they are left with very few domestic policy tools. These countries are actually in a dire need of global mechanisms to control speculation, but even the Tobin Tax would be a breach of faith to the IMF ideology.

New Bretton Woods Monetary System And National Sovereignty

As to proposals for a dramatic New Bretton Woods Global Monetary System, Asian nations, like the rest of the world, are actually in need of such a serious change. But again, the question is whether East Asian governments and policy elites can break out of the “victims’ box,” feeling so dependent on the gods of global capital flows. They may require some new vision, to help create a new global alternative to their current dependency status.

For example, under today’s free floating rate regime, a national economy is supposed to have more freedom to adopt independent domestic economic policy. But the reality is totally different. After the 1997 economic crisis, foreign investment became the major controller of the Korean economy, reducing our economic national sovereignty near to zero. As the trading volume of foreign exchange increases too rapidly, now being around 100 times more than trading volume of goods and services, the national economy must instead be constantly on alert to watch out for the movement of foreign funds.

We must also hold larger deposits of foreign reserves in case of financial runs; consider the economic cost of East Asia’s current \$2 trillion-plus in foreign reserves. These funds are essentially frozen and can’t be spent or used for any productive purpose, meanwhile.

The Plaza Accord in 1985 made the Japanese yen stronger and dollar weaker, and Asian economies, including Korea, could promote industrialization as a lot of Japanese money flowed into the region. But after 1995 when U.S. changed policy to a strong dollar, the East Asia economies fell into the crisis in 1997. Meanwhile the Plaza Accord gave a big blow to Japan’s domestic economy, which lost many factories to China. Almost the same pattern is repeating now between the U.S. and China, as the U.S. tries to force China to appreciate

the yuan. China refuses this demand, worried about economic slowdown after appreciation.

All the above show how the East Asian economy is fragile and vulnerable to changes in exchange rates against the U.S. dollar, and show the major leverage power the U.S. has when it changes the dollar's value against Asian currencies. The economic future of East Asia is highly dependent on the dollar value of their currencies. They would like to avoid this and be free from the leverage power of the "Washington Consensus," but don't see how.

Under a New Bretton Woods fixed exchange rate system, however, the trading volume of foreign exchange would stop increasing at the current speed, resulting in a more stable global financial market. And the global capital movement will be attracted more by long-term economic fundamentals than by a short-term speculative incentives.

Thus, under a New Bretton Woods global monetary system, first of all, the Korean government and people would regain their national sovereignty and their autonomy of national economic policies. Under the New Bretton Woods global monetary system, the current way of globalization will be modified in the direction of enhancing the national autonomy and sovereignty.

Secondly, Korean economic production would be organized more on a long-term basis as the volatility of foreign capital is contained under the fixed exchange rate system. Workers would be employed more on a long-term contract. Long-term investment would prevail whether the investment funds are raised domestically or globally.

Thirdly, financial motivation would be less influential and the physical production economy will be the main consideration of economic policies. Then more economic benefits and dividends would go to workers than to management and capital.

Currency Blocs or World Citizens?

One proposed alternative to today's severe dependency upon the dollar, would be to have a single common Asian currency to enhance economic integration in the region, and to be protected against external shocks, including arbitrary change in the value of the dollar. If the East Asian countries had a single currency bloc, in theory, they may achieve a stable fixed exchange rate system among themselves, at least, and a stronger collective bargaining power to have a voice to build up a new global financial architecture.

Many currency bloc specialists say a global fixed rate system might be easier to attain, once a single Asian money is adopted. They say it would then be a more simple matter of linking the dollar, the euro, and the Asian currency unit.

On the other hand, the recent near collapse of the European Union (EU)—and rumors the euro may face an uncertain future—should make us re-consider whether currency blocs are such a good or scientific idea. Under the Maastricht Treaty,

it seems that Europe made the mistake of self-imposed "mini-IMF conditionalities" of tight money and budget cutting, harming the real economy. Finally voters could no longer stand such high unemployment, and voted against the EU in the May 2005 election.

Robert Mundell, who advised Europe to adopt the euro as a "mini-IMF," has also been advising East Asia to adopt an Asian currency of that type—to impose the same policy.

Further, if East Asia merely adopts its own currency and minds its own house, without taking care for the economic and financial needs of the rest of the world, that may be short-sighted. Not only is East Asia highly dependent on trade with the entire globe, but also due to its Confucian tradition, Asians should show moral leadership as world citizens.

Most important, East Asian countries should have a strong voice in building a new global monetary system. Any discussion would be ineffective when East Asian viewpoints are neglected. The principle of global democracy is very important to build up a new global order in the 21st Century. This is another reason why East Asian nations should want to have full participation in designing a new architecture for the entire world, not just for our local neighborhood. The more creative ideas for all nations that Asia can bring to the New Bretton Woods negotiating table, the more Asia's voice will be heard and respected.

DO YOU KNOW

- that the American Revolution was fought *against* British "free trade" economics?
- that Washington and Franklin championed Big Government?
- that the Founding Fathers promoted partnership between private industry and central government?

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