Institute for the Study of Diplomacy
Edmund A. Walsh School of Foreign Service
GEORGETOWN UNIVERSITY

Discourse, Dissent, and Strategic Surprise:
Formulating American Security in an Age of Uncertainty

The Asian Financial Crisis of 1997–1998: Adapting U.S. Intelligence and Policy-Making to the Challenges of Global Economics

WORKING GROUP REPORT, NO. V, FEBRUARY 27, 2006
WITH THE SUPPORT OF THE JOHN D. AND CATHERINE T. MACARTHUR FOUNDATION

Co-Chairs: DOUG MACEACHIN AND JANNE E. NOLAN
Project Coordinator: KRISTINE TOCKMAN

Introduction

On February 27, 2006, the Institute for the Study of Diplomacy's Working Group on Discourse, Dissent, and Strategic Surprise held a meeting to discuss the relative role of intelligence and policy planning in the failure to anticipate and prevent the Asian financial crisis of 1997–98. This is the fifth and final case the Working Group is examining in this study of "strategic surprise" and the resulting setbacks to American interests. The previous cases include the fall of the Shah of Iran in 1979; the bombings of American embassies by al-Qaeda terrorists in 1998; the invasion of Afghanistan in 1979; and the decision by the U.S. to terminate its involvement in Afghanistan in 1991 once Soviet forces had withdrawn.

The central objective of the study is to analyze the degree to which unexpected international developments with adverse consequences for American interests are the result of inadequate intelligence about emerging threats, or, by contrast, stem more from failures of the policy community to assimilate intelligence and information that could better inform the choice of strategy and instruments used. The intent is not to seek and ascribe blame to partic-

ular government agencies or individuals *ex post facto*. To the contrary, the purpose is to examine the complex interactions of intelligence and policy processes, to understand why policy-makers often seem reluctant to accept information or analysis which runs counter to assumptions underlying the prevailing consensus, to identify systemic similarities across cases and, on the basis of the analyses, to develop lessons for the future.

The discussion of the Asian crisis began with the keynote presentation by David Lipton, Managing Director and Head of Global Country Risk Management at Citigroup, who as Undersecretary of the U.S. Department of the Treasury was the key policy player in the management of these events. A second presentation was given by Richard N. Cooper, Professor of Economics at Harvard University, who chaired the U.S. National Intelligence Council (NIC) during the period just before the crisis emerged, from mid-1995 to early 1997. The presentations were followed by commentary provided by Ann Goodbody, former Executive Vice President at Citigroup, and Robert Bailey, also a former Citigroup senior executive, who provided perspective from the viewpoint of the private financial sector. Members of the Working group with varying expertise in security, intelligence, and foreign policy joined specialists in economics and finance in the general discussion.

This case differs from its predecessors in several important respects. First, the national security and intelligence challenges the Working Group examined previously did not involve interaction of the government with the private sector nearly to the extent that took place in the Asian crisis. Intelligence reporting was not an important source of information or analysis compared to information from the international financial institutions and business. Second, the management of the Asian crisis fell to and largely remained under the purview of agencies responsible for managing U.S. financial interests, particularly the Department of the Treasury and the Federal Reserve, while the national security agencies played only a marginal, albeit at times powerful role. Third, the challenges to U.S. and international security stemmed in large measure from activities of the private sector operating outside of government control—in ways which adversely affected international markets and national economies. The extent of private debt in the region, let alone its influence on financial trends, economic performance and ultimately security interests, was not widely known by U.S. officials prior to the crisis. Fourth, the remedies needed to promote regional economic recovery required unprecedented cooperation among governments, international financial institutions and the private sector. Although the United States

played a powerful role in pressing for stringent reforms in return for intervention from the International Monetary Fund and others, it found it could not dictate policies unilaterally. This case presages the growing reality in the 21st century that U.S. intelligence and policy planners can no longer work from the assumption that the U.S. acting alone can control important events and outcomes in the international system.

Highlights and Summary of Events

The Asian financial crisis of 1997–1998, initially sparked by a sudden decline in the currencies of several Asian states, prompted widespread and severe economic recession in states of central interest to the United States, including Indonesia, Thailand and South Korea.[1] The crisis posed not just widespread economic but political and security implications, as well. It also revealed the unprecedented level of global financial interdependence that had been growing steadily over decades, a trend whose implications were not well understood within the U.S. government at the time. And it underscored the ascendance of the private sector relative to sovereign interests in determining national economic conditions and the fate of international financial markets.

This episode served as a wake-up call for the United States and its international partners by highlighting the unprecedented susceptibility of global stability to adverse economic developments emerging from a single region. The crisis also revealed fundamental weaknesses in the underlying conditions of countries that had long been heralded as the development miracles of the late 20th century. An overly broad consensus prevailed that saw the export-led development strategy used by these "Asian tigers," yielding astonishingly high growth rates, as an unqualified success. This mindset at times led to complacency and distracted attention from fundamental structural weaknesses in these states' economic and political conditions. The significant interests of American private investors in the region, moreover, also may have discouraged official scrutiny.

The governments of several rapidly growing economies had implicitly supported widespread mismanagement and chronically weak regulation of financial activities, a by-product of the collusion between public and private interests to promote overseas internal investment and highly competitive trade sectors. Taken together, ineffectual regulatory institutions, government-sanctioned economic corruption ("crony capitalism"), and various

other forms of politicized economic practices revealed that the "Asian model" of development had serious limitations. The Achilles heel proved to be the spiraling level of short term external indebtedness incurred by private entrepreneurs operating with negligible regulation or international transparency.

The rise of around-the-clock global capital flows, enabled by new communication and information technology, hastened the decline of government influence over financial markets throughout the l980s and l990s. There was no common understanding, however, that global private investment could cause sudden and significant shifts in regional and even global economic conditions, wreaking havoc on economic as well as political stability. As the first crisis of its kind to occur largely outside of government control, moreover, the unfolding events in Asia revealed an urgent need for reforms in the management of global capital investments, not least to protect the U.S. against unanticipated risks to its security interests.

The United States was conceptually and organizationally unprepared for the challenge emerging in Asia, which began in early 1997 and persisted through most of 1998. The familiar remedies used in previous financial crises of this kind—intervention by the International Monetary Fund consisting of the infusion of capital in return for drastic economic restructuring, for example—were not well suited to enforce sustained changes on private sector activities. A more complex set of instruments had to be mobilized which could operate across the spectrum of governmental and private interests, which in turn required the collaboration of many international partners.[2] In the end, the crisis was contained by a variety of established and ad hoc measures devised in part by a small number of creative U.S. officials with expertise in international finance. Despite the obvious lack of formal policy coordination just within agencies in the U.S. government, the experience did not result in a consensus then or now about the need for a uniform international system of financial regulation to manage future risks, nor for commensurate reforms in U.S. policy-making or intelligence. The priority accorded to the role of economic trends in national security planning or in intelligence analysis still remains relatively low.

Political Challenges

There is disagreement among experts and practitioners about the timing and relative importance of the events which sparked the rapid economic recession in Asia beginning in 1997 and lasting through 1998. Different countries

experienced different effects at different times, with lesser or greater adversity depending on the character of the regime in power, the kind of intervention offered, and how the country responded to the conditions imposed by the IMF and others in return.

There is general agreement that the financial crisis was brought about by weak or distorted national policies guiding private sector behavior. Outside powers devoted little analysis to the way in which these successfully growing economies were being governed and chose instead to trumpet the growth figurers. The ability of the U.S. and its international partners to contain the crisis involved important political challenges. At least in the short- to midterm, the reforms urgently needed to achieve economic recovery posed the risk of exacerbating the kinds of social dislocations, like growing unemployment, which could lead to widespread political instability. The economic crisis tested the relationship between economic systems, which had been steadily liberalizing, and—with the exception of Indonesia—the gradual development of democratic governance in states only recently emerging from legacies of autocratic rule. Participatory political systems such as those of Korea and Thailand recovered more readily that the more authoritarian system in Indonesia,[3] although public consensus needed to implement reform programs proved difficult to mobilize whether or not state power was centralized.

Thailand

Thailand, the first to be severely affected among the three countries the Working Group considered, experienced pronounced social dislocation after the devaluation of its currency triggered massive, rapid loss of employment in its export production sectors. Exceptionally large financial support was arranged with the IMF, based on the government of Thailand's pledge to undertake an ambitious economic reform program.[4] The combination of regional recession and the austerity measures imposed by the IMF added to the political and social complications of Thailand's recovery program, especially as prices for consumer products continued to rise quickly for over a year, in some cases actually doubling.

Thailand had been warned months before by the IMF and others that its economic stability was becoming precarious and required prompt action. The Thais had consented to publication of the IMF's annual economic review of their economy—the so-called "surveillance" report—and the July 1996 report identified the main problems clearly enough for those familiar

with the understated language in which the reports are written. Money had begun to flow out of Thailand in the fall of 1996, and the stagnation of the highly leveraged real estate sector in Thailand was readily apparent. What was missing was the ability to enforce remedies. The Thais did little to follow up on the reform recommendations, depleting their reserves instead in the futile attempt to defend their currency, while maintaining publicly that their reserve position had not been compromised. This led to disastrous consequences when the Thai baht was finally allowed to float in the exchange markets beginning in July 1997.

Indonesia

Indonesia, which faced intense pressure on its currency in the late summer and fall of 1997, turned to the IMF for financial help after trying in vain to stem an accelerating capital outflow.5 An initial aid and reform program was agreed to by the IMF and Indonesian authorities in the first week of November 1997. David Lipton noted that many of the economic conditions spelled out in the IMF programs for Indonesia, which were orchestrated by the U.S., were "rather intrusive into areas that were not traditionally the preserve of the IMF," including demands for stringent reforms of specific sectors such as the clothing industry, which was operating as a monopoly, and other aspects of the industrial structure.

The gravity of Indonesia's economic crisis was intricately related to its political conditions, the result of the deep and corrupt involvement of members of President Suharto's family and other well-connected cronies in major banking and industrial enterprises. While the Suharto family's penetration into and manipulation of the economy did not start the crisis, it was a factor contributing to Indonesia's susceptibility to crisis and made it almost impossible to manage. The intrusive measures contained in two of the IMF programs initially agreed to by economic officials in the Suharto administration revealed the latter's discomfort with the regime's crony capitalist practices and their desire to undermine the Suharto family's control of key sectors. This situation virtually guaranteed the Indonesian regime's non-compliance to the IMF demands, given the adverse impact they posed for the interests of the Suharto family.

The net effects of the economic downturn triggered by the crisis and recovery efforts ultimately brought about the fall of the Suharto regime in May 1998. To underscore the influence of political distortions in Indonesia's

economy, Suharto's demise was soon followed by the stabilization of the rupiah, fulfillment of the conditions imposed by the third IMF program, and the resulting steady flow of IMF funds to assist Indonesia to full recovery.

South Korea

The most urgent and difficult political challenge came from South Korea. In late 1997, Korean authorities represented to the public, to U.S. authorities and to the IMF that their foreign exchange reserves were still significant—a total of $28 billion. In reality, reserves had been almost entirely depleted to help offset withdrawals of deposits from the offshore branches of Korean banks. Overstating reserves was not unusual among the emerging market economies—Thailand and many others had done so. But the U.S. Treasury was especially surprised to be deceived by Korea, adding to the tensions in subsequent negotiations with the Koreans on financial packages and economic reforms.

Because Korea had demonstrated such a high level of economic success (even becoming a member of the advanced industrial economies' club, the Organization for Economic Cooperation and Development), trouble in Korea raised wider economic and financial risks than had seemed the case when the crisis afflicted mainly Indonesia and Thailand. U.S. policymakers realized that China and even Japan might be unable to avoid the same fate and that the regional financial crisis might become global if it could not be stopped in Korea. David Lipton emphasized that from the onset of the Korean crisis, the U.S. Treasury demanded that Korea agree to IMF conditions forcing significant reforms in economic management.[6]

The Korean case proved tractable because the cooperative behavior of major banks was sufficient to stabilize deposits in the offshore branches of Korean banks, which in turn was the key to halting capital outflow and stabilizing the exchange rate. Reaching a viable agreement even with the limited number of creditor banks needed to stabilize the Korean situation was still very difficult to accomplish at the time, Lipton recalled. He observed that it might not have been possible in a country that had a fully developed domestic capital market and many international bondholders. As the web of capital market interactions in all countries becomes denser, utilizing many different kinds of financial instruments, coordinating responses by government and the private sector during a crisis may become less feasible.

Security Implications

The literature on the Asian financial crisis has focused on its economic and financial dimensions, to a lesser degree on the political consequences within the countries directly affected, but rarely on the security implications for the United States, the region, or the global order. Initially the crisis was perceived as a containable, if urgent, currency challenge. When the effects of the financial crisis reached South Korea, it was recognized as a challenge of a higher order for U.S. security. With U.S. troops deployed there in large numbers and the constant concern about what North Korea might do to exploit a crisis situation, the dangers posed by severe economic downturn and possible political division and uncertainty in the South heightened the urgency of intervention.

American officials from Treasury and the Fed became deeply involved in the Korean crisis, interacting with sectors of the Korean economy and political structure in ways which went well beyond information exchange. David Lipton explained that Treasury and the Fed reached an agreement first with bank supervisors around the world and then with banks in the respective regions to stop pulling their money out of Korea. As one former banker at the Working Group meeting expressed it, Treasury and the Fed "put the arm on" the U.S. banks to roll over their positions in Korea as part of the overall package.

U.S. political and security relations with other states in the region were also far more at risk than was evident at first. Thailand had long been a close ally, as had Suharto's Indonesia. Not only were these important economic relationships, they occupied geographically strategic points as well. Regime change, especially violent change, could jeopardize vital U.S. interests. The longer and deeper the economic troubles, the greater the jeopardy to the survival of political and military stability.

The Asian crisis highlighted the lack of coordination between economic and security planning. It underscored a willingness to avoid careful scrutiny of economic situations that could lead to policy recommendations perceived as contrary to security interests. In the view of two participants, the Asian crisis, up until Korea's appeal for assistance, was discussed too much in the National Economic Council rather than in the National Security Council. At the same time, others noted that even with better coordination, economic managers and the NSC may find they have incompatible views of what to do. Given the sensitivity of relations between the U.S. and Indonesia, for

example, it was difficult in the early phases of the crisis to get agreement within the U.S. government to try to dismantle the kind of "crony capitalism" that was impeding the restoration of confidence in Indonesia. David Lipton cautioned that when major security or foreign policy interests are involved, the agencies responsible for such matters tend to press for prompt and liberal financial support to the crisis country, while Treasury has to consider whether the country is committed to taking corrective policy measures. In the Korean case, Treasury wanted to be certain that the Koreans were committed to a strong reform program. Other agencies favored rapid relief for Korea. Treasury managed to persuade the rest of the U.S. government that time was needed to negotiate with the Koreans on agreements for strengthening their economic program. Fortunately, the newly elected President of Korea, Kim Dae-jung, was convinced that Korea had to address its serious economic problems and took public ownership of the reform program.

Surprise?

The events in Asia proved to be both a policy and an intelligence surprise given a failure of U.S. officials to recognize that what seemed like a currency crisis threatened economic collapse in Asia on a scale that could provoke widespread political and military instability. Some of the underlying weaknesses in the economic conditions of Thailand, Indonesia and South Korea were commonly known among economic and other officials prior to the crisis. Key trends were not well understood, however, including the extent of domestic private sector debts denominated in dollars and the degree of vulnerability of domestic financial sectors to shifts in currency values—both of which had been severely underestimated. The crisis revealed how difficult it had become to determine the extent of foreign exchange exposure of banks and especially of non-bank financial enterprises taking the form of various market instruments, including hedge funds and derivatives. David Lipton noted that Treasury had tried without success to make a quick estimate of such exposure in the first few days of the Korean crisis. Because capital markets continue to grow and become more complex and sophisticated, the lack of transparency will make such calculations even more difficult in the future. The relative lack of real time financial intelligence integrated across the foreign and security policy agencies in the U.S. government, moreover, is still a constraint that would affect U.S. crisis response in the future.

Could the crisis have nonetheless been prevented if officials had used the information that was available? A closer study by U.S. and other officials of existing data might have revealed the problem earlier, according to Richard Cooper. He noted that information on most countries' debt to international banking institutions is contained in data gathered by the Bank of International Settlements (BIS), although with a lag, as well as some questions about the accuracy and comprehensiveness of the data. Not in the habit of reviewing BIS data to manage urgent policy priorities, U.S. policy-makers clearly did not anticipate a scenario in which an entire region could be brought to the brink of economic collapse by unregulated private debt. According to several intelligence officials consulted about this case, moreover, there was no intelligence warning about impending regional economic failures; it simply was not an intelligence priority until after the crisis unfolded.

The most important and deep-seated problems, which went largely unheeded or were ignored prior to the crisis involved management and governance in several Asian countries. It was treated as a revelation to the mainstream of the policy community at the time that the "Asian tigers" suffered from badly managed, practically insolvent companies and banks, weak supervision of the financial sector, and governance issues such as corruption, cronyism, and lack of public accountability affecting the performance of both private and public entities. This intelligence/policy oversight reveals a clash between the prevailing mindset of the time—which perceived the rapidly growing Asian economies as "miracles"—and the facts on the ground, including the consequences of corruption on sustained economic prosperity. The clash of a mindset and actual conditions locally and regionally is a common phenomenon across the five cases that the Working Group has analyzed.

Several developments have probably reduced the risk of financial crises, at least of crises along the lines of those witnessed in the past decade. The increasing multiplicity of actors and financial instruments that would complicate coordinated crisis resolution contributes to crisis prevention by providing more opportunities for diversification and wider distribution of risks. They may also lessen the chances that all market actors will take the same view without independent analysis, leading to sudden shifts in one direction (one participant termed this a "lemming-like quality") seen in some markets in the past. Second, the adoption of more flexible exchange rate arrangements in some emerging market economies reflects the lesson from the Asian

crisis (and the Russian crisis) that fixed exchange rates may be vulnerable in the face of domestic structural economic problems, even if fiscal and monetary policies are relatively sound.

Third, there is greater transparency of economic and financial information and policies in most countries since the Asian crisis (the wider acceptance of publication of IMF surveillance reports was an important step—only Thailand among the crisis countries had agreed to such publication prior to 1997). Fourth, IMF and other reports on economies and financial markets are arguably more thorough and candid than they were before the Asian crisis. Fifth, many emerging market economies have been running budget and current account surpluses and have greatly increased their foreign exchange reserves in recent years, which may enable them to deter or deflect speculative attacks. Sixth, for all the foregoing reasons, contagion appears much less likely. Working Group members considered it significant that the more recent crises in Turkey, Argentina, and Brazil had had little effect on the financial stability of other emerging market economies.

Lessons Learned

The Working Group focused on several main issues which emerged from the Asian crisis, and which need policymakers' attention in preventing future crises: the similarities and differences in the problems of policy planning and coordination in international financial crises and international security crises, the roles of key players in crisis prevention and management, information sharing, and the potential utility of preventive measures such as official gaming exercises.

With respect to policy planning and coordination of economic and security challenges, both areas face the constant challenge of determining the right questions to ask, when to ask them, and how to collect and analyze critical information accurately. Time-tested formulas and procedures may prove inadequate in the face of new developments, as the previous case studies in this project have revealed, particularly so when the events are happening with the rapidity witnessed in the Asian case. Given the universal tendency of bureaucratic institutions to protect their turf by rationing the information they share with counterparts, it was clear that interagency forums were not and still are not sufficiently empowered to demand full information sharing.

There is a need to balance security and economic considerations and for

systematic discussions of ways to achieve policy coordination is particularly pointed here. Integrating international economic trends into the analysis of and preparation for security challenges of the future is vitally needed, including in the intelligence community. It is safe to say that the U.S. government's preparation for analyzing global financial flows did not become a priority until some time after 9/11 and then for very different objectives.

In the late 1990s, the primary forum for information exchange was to have been the National Economic Council (NEC) comprising the economic agencies. A key participant cautioned against excessive reliance on the NEC. When it comes to events with the potential to significantly affect U.S. security interests, the NEC had proven useful but was not an adequate substitute for involvement of the National Security Council, where all the principal intelligence, security, and foreign policy agencies are represented.

Given the nature of American government, moreover, in which competing interests and agencies vie for policy influence often based on institutional biases, devising prompt and coherent responses that send a clear message internationally—critical in the case of financial market—can be very difficult. Congress can act in ways which reflect particular concerns that may not be part of a clear and coherent strategy or consistent with the expectations of an ally. Thailand, for example, expected to receive a bilateral loan from the United States because the U.S. had made a very large bilateral loan to Mexico in 1994 from the Exchange Stabilization Fund administered by Treasury. Treasury declined to provide direct financing to Thailand (which it considered a single country case, not an example of the systemic risk posed by the Mexican crisis.) This view in part reflected and was supported by the relevant Congressional committees on the use of the ESF following the Mexican experience, which Congress believed represented an instance in which the Executive Branch had exceeded its authority. The decision led to strained bilateral relations in which Thailand was not fully aware of the influence of Congressional constraints on Executive Branch actions.

With respect to the role of information in the potential prevention of crises, it was noted that the IMF's surveillance reports often identify economic and financial problems that countries needed to address, including the imbalances in the U.S. and other major countries, but the IMF lacks leverage to persuade countries to take action. Some participants favored strengthening the IMF's surveillance role, but no specific recommendations for doing so were advanced. Treasury and the Federal Reserve are almost exclusively responsible for information gathering and communication with the private

financial sector. Understandably, they tend to hold closely any information that might be market sensitive. Other agencies, including those representing the foreign policy and intelligence communities, find it difficult to develop balanced views of complex situations or to anticipate various contingencies unless Treasury and the Fed share more complete and timely information and analyses with them. Intelligence agencies need to study economic and financial risks in areas of strategic importance but Treasury, among others, has a long legacy of refusing to share its financial information with other parts of the government.[7] Gathering timely and accurate information from the private financial sector is essential for crisis prevention. Some improvements in financial reporting have been made since the Asian crisis, in the area of hedge funds, for example, which report their positions weekly.

Obtaining information useful for analyzing the dynamics of capital market sentiment, such as how and through what triggers major players in international markets might alter their assessments of countries' competitiveness, is even more difficult. The IMF, the BIS's Financial Stability Forum (comprising central bankers and other officials), individual major commercial banks, and other institutions try to identify both country and systemic risks and conduct analytical "stress testing" under various scenarios. Such exercises are mainly theoretical, however, and generally do not draw upon the current thinking of leading market players.

Participants agreed that future financial crises could not be ruled out, but if they occur they will probably take a different form from that of the Asian crisis and other recent ones. After each crisis, including the Asian regional crisis, much work had gone into improving policies and procedures to avoid or resolve more rapidly similar crises in future. The IMF and the rest of the international financial community had gotten good at preventing crises like previous ones, noted David Lipton, but history demonstrates that new crises nearly always take new and unexpected forms.

A few Working Group members suggested that something akin to the gaming exercises conducted in the security realm be considered for assessing possible scenarios for financial crises. Others expected limited benefits from formal gaming in the economic and financial area. They questioned whether the exercises would be taken seriously. Introducing unorthodox thinking into governmental debate is always difficult, and there is the further problem of how to infuse the lessons of the outcomes into policy planning. Better information on the perspectives of leading market players would help in assessing vulnerabilities but cannot be garnered easily. Major banks and

other players who form views internally during risk assessment exercises are reluctant to disclose these to the government. To make better information exchange possible, officials would have to provide measures to ensure careful discretion in soliciting and using information from the private sector. Even a list of questions posed by the authorities could provide enough clues about officials' preoccupations to be "tradable" information.

Conclusion

The Asian crisis revealed that sound macroeconomic policies (budget and monetary policies) and large currency reserves may not be sufficient to enable a country to defend a fixed exchange rate successfully in the presence of large structural and sectoral problems. The most important and deep-seated problems, as such, emerged at the micro level: badly managed, practically insolvent companies and banks, weak supervision of the financial sector; and governance issues, including corruption, cronyism, and lack of public accountability affecting the performance of both private and public entities. Politics and economics, in other words, are deeply intertwined—not a novel insight but also not a reality represented adequately in the alignment of U.S. government agencies or the intelligence community.

The Asia case was also a crash course in globalization. U.S. policy planners can no longer work from the assumption that the U.S. can control events and outcomes in the international system; the financial system is only a harbinger in this respect. Limited governmental resources (the relatively modest financial resources of the IMF, for example, along with the weaknesses in intelligence expertise and interest in this sector (other than for tracking terrorism financing) and very limited leverage on markets (whether bilateral or through the IMF) imply that the U.S. will need to rely more on diplomatic initiatives and collaborative international approaches in this and other arenas. The Asia experience prompted the U.S. and other countries to press for greater transparency of all countries' reserve holdings and related liabilities—an objective largely achieved since the crisis and a welcome one. In the end, however, there was no sentiment expressed by the group that the United States governmen—in policy or intelligence—is equipped to respond swiftly or effectively if faced with another financial challenge of this—let alone greater-complexity and magnitude.

NOTES

1. A chronology of events of the Asian crisis appears on page 16. In summary form, the immediate causes of the crisis stemmed from economic "bubble" conditions beginning in Japan and spreading to several other Asia states. Japanese overinvestment in the productive sectors of states like Korea, Thailand and Indonesia had fueled the overvaluation of Japan's and others' currencies, most of which were pegged to the dollar. When Japan suggested in 1997 it might devalue the yen relative to the dollar, it catalyzed currency devaluation across several states in the region, in turn undercutting the cost competitiveness of their exports, forcing contractions in productivity and severely slowing the pace of growth. A loss of international confidence in these economies led to immediate declines in foreign direct investment, leaving countries to cope high levels of external indebtedness, especially short-term corporate debt incurred without benefit of adequate government oversight. IMF and U.S. intervention—infusions of capital to defend currencies and arrangements to re-schedule short term debt in return for austerity programs, economic restructuring and management reform—ultimately stemmed the crisis in mid- to late-1998. For further discussion, see for example Scott Snyder and Richard H. Solomon, "Beyond The Asian Financial Crisis: Challenges and Opportunities for U.S. Leadership, United States Institute of Peace, Special Report 29, April 1998.

2. Economic intervention by the IMF and others required cooperative measures that spanned across the region and the international system as a whole, underscoring the critical interrelationships among national, regional and global policies in affecting economic recovery. Common indicators identified as essential for restoring economic viability included full implementation of stringent IMF reform programs; completion of debt-restructuring programs; constraints on powers such as China and Taiwan to prevent opportunistic currency devaluations; the opening of the Japanese market to regional exports and a global commitment to a fair and open market system that could allow Asian countries to recapitalize through the resumption of competitive exports.

3. This is not universally true. China's system of authoritarian government managed to maintain sufficient isolation to be buffered from the crisis. With its strict regulations of social and political life, Singapore also weathered the crisis with minimum effects.

4. The Thai currency (the baht) came under strong exchange market pressure in the winter and spring of 1997, forcing the Thais to abandon the fixed exchange rate they had maintained against the U.S. dollar for many years

5. The weakness of the Indonesian rupiah which followed soon after also was not very surprising. The central bank responded sensibly with a widening of the exchange rate band, allowing the rupiah to depreciate somewhat, and it raised interest rates. When the pressure continued, however, and when the rupiah was allowed to float after August 14, its value plunged rapidly. Domestic businesses and banks began moving capital abroad; international banks and investors soon followed. The failure to stem capital flight had not been anticipated but the bigger surprise was the scale of the short-term (dollar-denominated debt) in the Indonesian private sector. Comprised of both financial institutions and non-financial enterprises, the private sector had incurred about $80 billion in external debt. As this became known, the rupiah depreciated further, rendering much of Indonesia's business sector insolvent.

6. The Korean government had maintained sound macroeconomic policies. Its problems arose from its over-dependency on the performance of giant oligopolistic entities that spanned the industrial and financial sectors and relied on government subsidies whenever they encountered setbacks. After the election of President Kim Dae-jung and an orchestrated stabilization of the dollar deposits in offshore branches of Korean banks in January 1998, the new economic program took hold and confidence began to return.

7. One participant cited an instance in which Treasury objected to preparation by the National Intelligence Council at the CIA of a paper discussing economic fragility in a major Asian country.

8. Congressional Research Service.

Chronology of the Asian Financial Crisis[8]

Early May (1997) Japan hints that it might raise interest rates to defend the yen. The threat never materializes, but it shifts the perceptions of global investors who begin to sell Southeast Asian currencies and sets off a tumble both in currencies and local stock markets.

July 2 After using $33 billion in foreign exchange, Thailand announces a managed float of the baht. The Philippines intervenes to defend its peso.

July 18 IMF approves an extension of credit to the Philippines of $1.1 billion.

July 24 Asian currencies fall dramatically. Malaysian Prime Minister Mahathir attacks "rogue speculators" and later points to financier George Soros.

August 13–14 The Indonesian rupiah comes under severe pressure. Indonesia abolishes its system of managing its exchange rate through the use of a band.

August 20 IMF announces $17.2 billion support package for Thailand with $3.9 billion from the IMF.

August 28 Asian stock markets plunge. Manila is down 9.3%, Jakarta 4.5%.

September 4 The peso, Malaysian ringgit, and rupiah continue to fall.

October 8 Rupiah hits a low; Indonesia says it will seek IMF assistance.

October 14 Thailand announces a package to strengthen its financial sector.

October 20–23 The Hong Kong dollar comes under speculative attack; Hong Kong aggressively defends its currency. The Hong Kong stock market drops, while Wall Street and other stock markets also take severe hits.

October 28+ The value of the Korean won drops as investors sell Korean stocks.

November 5 The IMF announces a stabilization package of about $40 billion for Indonesia. The United States pledges a standby credit of $3 billion.

November 3–24 Japanese brokerage firm (Sanyo Securities), largest securities firm (Yamaichi Securities), and 10* largest bank (Hokkaido Takushoku) collapse.

November 21 South Korea announces that it will seek IMF support.

November 25 At the APEC Summit, leaders of the 18 Asia Pacific economies endorse a framework to cope with financial crises.

December 5 Malaysia imposes tough reforms to reduce its balance of payments deficit.

December 3 Korea and IMF agree on $57 billion support package.

December 18 Koreans elect opposition leader Kim, Dae-jung as new President.

December 25 IMF and others provide $10 billion in loans to South Korea.

1998

January 6 Indonesia unveils new budget that does not appear to meet IMF austerity conditions. Value of rupiah drops.

January 8 IMF and S. Korea agree to a 90-day rollover of short-term debt.

January 12 Peregrine Investments Holdings of Hong Kong collapses. Japan discloses that its banks carry about $580 billion in bad or questionable loans.

January 15 IMF and Indonesia sign an agreement strengthening economic reforms.

January 29 South Korea and 13 international banks agree to convert $24 billion in short-term debt, due in March 1998, into government-backed loans.
January 31 South Korea orders 10 of 14 ailing merchant banks to close.
February 2 The sense of crisis in Asia ebbs. Stock markets continue recovery.

Institute for the Study of Diplomacy
1316 36th Street, N.W., Washington, D.C. 20007
Tel 202-965-5735 *Fax* 202-965-5652
Web http://isd.georgetown.edu
Copyright 2006. Institute for the Study of Diplomacy. All Rights Reserved.

The Institute for the Study of Diplomacy (ISD), founded in 1978, is part of Georgetown University's Edmund A. Walsh School of Foreign Service and is the School's primary window on the world of the foreign affairs practitioner.

ISD studies the practitioner's craft : how diplomats and other foreign affairs professionals succeed and the lessons to be learned from their successes and failures. Institute programs focus on the foreign policy process: how decisions are made and implemented.

ISD conducts its programs through a small staff and resident and nonresident "associates." Associates, primarily U.S. and foreign government officials, are detailed to or affiliated with the Institute for a year or more. The Institute seeks to build academic-practitioner collaborations around issues using associates and Georgetown faculty. ISD staff and associates teach courses, organize lectures and discussions, mentor students, and participate on university committees.

In addition, ISD's Pew Case Studies in International Affairs are used in over 1,000 courses across the country and around the world.

Discourse, Dissent, and Strategic Surprise

With generous support from the John D. and Catherine T. MacArthur Foundation, the Institute for the Study of Diplomacy has established a Working Group of senior experts to examine how the U.S. national security establishment at critical junctures has ignored information or analysis that challenged prevailing policy assumptions—to the detriment of American security interests

Given the many urgent security challenges on the horizon, the project seeks to identify ways American officials might learn contemporary lessons from past experience. What lessons can be learned for future policy from historical cases of "intelligence failures" which were actually failures to take that information into account?

Drawing on several key case studies, this new project seeks to provide insights into the dynamics among national security and intelligence agencies, the president and key advisers, the Congress, the media, various interest groups and experts in evaluating intelligence and defining national security priorities and policy choices. This project complements ISD's ongoing Schlesinger Working Group on Strategic Surprise, which seeks to anticipate future challenges to U.S. national security interests.

This work was made possible through a grant by the John D. and Catherine T. MacArthur Foundation. Any opinions, findings, conclusions, or recommendations expressed in this material are those of the author and do not necessarily reflect those of the John D. and Catherine T. MacArthur Foundation.

The views expressed in this monograph do not necessarily reflect the views of any of the organizations, governmental or private, with which the individual participants in the discussion group are affiliated.