



THE CHANGING BASIS OF AMERICAN
HEGEMONY IN THE 1990s: ENTRENCHING THE
WASHINGTON CONSENSUS IN MEXICO AND
SOUTH KOREA

being a Thesis submitted for the Degree of Doctor of
Philosophy in the University of Hull

by

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March 2001

To my parents

ACKNOWLEDGMENTS

The completion of this thesis would not have been possible without the encouragement, support and guidance of Simon Lee and William Lawton who served as my supervisors. Their critical comments and keen insights helped clarify my ideas and greatly improved my research. I offer to them sincere appreciation.

I also wish to thank US Congressman Jim Colbe and John Harrington, from the US-Mexico Chamber of Commerce for their assistance in this research during my visit to Washington DC.

I would also like to thank the following people that provided me with their support and friendship throughout my years as a PhD student: Stella Papadopoulou, Apostolia Pimenidou, Christos Patsalides, George Argyriou, Rita Papapanayotou and George Sisias, for being my closest friends and for the great time we had together during my years as a PhD student; also, Dimitris Demetriou, Fotini Vassilantonaki, Thomas Staikos, Nancy Athanasiou, Iliana Kyriakidou and Dimitra Petropoulou for the wonderful time we had together during my first year as a PhD student; Andromachi Tseloni for her assistance and hospitality during my visit in Washigton DC, Stavroula Tsiplakou for her comments and the good humour and Foivos Apostolopoulos for his comments and the useful discussions we had; Akis Psomas, Antonis Aktselis and George Liamadis, my old friends for their support from Greece. I would also like to acknowledge the support and friendship of Catherine Dasila, Christos Livas, Marianna Bitsakou, Sylvia Franzke, Linda Verbruggen, Valia Fama and everybody else I failed to mention here who helped me and supported me for the last three and a half years.

Finally I would like to thank my parents George and Irene for their unconditional love and support. I will always be grateful to them.

Hull, March 31, 2001

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LIST OF ACRONYMS

APEC	: Asia Pacific Economic Cooperation
AMF	: Asian Monetary Fund
BIBF	: Bangkok International Banking Facility
BIS	: Bank of International Settlements
BNC	: Binational Committee
CEB	: Combined Economic Board
COECES	: Coordinadora de Organismos Empresariales de Comercio Exterior
EVSL	: Early Voluntary Sectoral Liberalisation
EPA	: Environmental Protection Agency
ESF	: Exchange Stabilisation Fund
FSC	: Financial Supervisory Commission
FDI	: Foreign Direct Investment
FOA	: Foreign Operation Administration
FTAA	: Free Trade Area of the Americas
GAO	: General Accounting Office
GATT	: General Agreement on Trade and Tariffs
GDP	: Gross Domestic Product
GNP	: Gross National Product
HST	: Hegemonic Stability Theory
ISI	: Import Substitution Industrialisation
IMF	: International Monetary Fund
IPE	: International Political Economy
KDI	: Korean Development Institute
KIST	: Korean Institute of Science and Technology
MOU	: Memorandum of Understanding
MAI	: Multinational Agreement on Investment
NAB	: New Arrangements to Borrow
NAFTA	: North American Free Trade Agreement
OECD	: Organisation for Economic Cooperation and Development
OPEC	: Organisation of the Petroleum Exporting Countries
PEMEX	: Petroleos Mexicanos

ROK : Republic of Korea
TNC : Transnational Corporation
UNCTAD : United Nations Conference on Trade and
Development
UNESCO : United Nations Educational Scientific and Cultural
Organisation
USAID : United States Agency for International Aid
USFK : United States Forces in Korea
USIA : United States Intelligence Agency
USTR : United States Trade Representative
VAT : Value Added Tax
WTO : World Trade Organisation

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INTRODUCTION

Hegemony derives from the Greek word *hegemonia*, which means the predominant influence of one state over others. Hegemony has both economic and military aspects which reinforce one another. Hegemonic dominance comes not only from a state's economic and military strengths but also from its ability to obtain consent from other states as well. Hegemony is one of the most important concepts in Global Political Economy (GPE) and has generated a continuous debate, especially since the demise of the Bretton Woods system of fixed exchange rates and the oil crisis of 1973 which both appeared to suggest the end of postwar American hegemony. This thesis investigates the changing basis of American hegemony during the 1990s.

For more than twenty years after the end of World War II, the United States dominated the world economy by creating an open international trade system based on the General Agreement on Tariffs and Trade (GATT) and a stable monetary system based on the Bretton Woods agreement. However, concerns about American power arose in the 1970s with the abandonment of the Bretton Woods fixed exchange rate system and the emergence of a more volatile era of floating exchange

rates. Although American policy laid the basis for the growing globalisation of markets, the apparent relative decline of American power prompted a debate over the ability of the United States to influence the direction of the world economy.

This situation began to change in the mid-1980s, following the reassertion of America's international role during the Reagan years (1981-1989). At the same time, the increasing globalisation of economic activity and financial liberalisation resulted in the identification of American institutions with free market ideas. That trend was reinforced by the activities of international institutions such as the International Monetary Fund (IMF) and the World Bank, which acted in concert to support a free market orthodoxy which has come to be known as the "Washington Consensus". As a result, at the beginning of the 1990s and especially after the collapse of the Soviet Union in 1991, an increasing number of countries in different continents, each with a different development experience and with varying economic structures and political systems, embarked on experiments with market reforms, in line with the Washington Consensus.

While during the 1990s a large number of countries experimented with market reforms, there were also periodic financial crises that rocked these countries and spread across national borders in quick and unpredictable ways. The most striking examples of such crises have been the peso crisis in 1994-1995 and the Asian financial crisis (1997-1998).

These crises have demonstrated the vulnerability of national economies to variations in the flow of internationally mobile capital and have posed serious challenges to the Washington Consensus. At the same time these crises have simultaneously offered an opportunity to the United States to further entrench the Washington Consensus via the direct actions of the US Treasury and the conditionality attached to financial assistance through the IMF.

In an era of increasing globalisation and interdependence in the world economy, it is an oversimplification to define the concept of hegemony in terms of the power of one state relative to other states. The basis of American hegemony has been changing with an increased emphasis upon the ideological dimension of hegemony and its transmission and diffusion by the private sector, i.e the Washington Consensus of free market orthodoxy. This thesis explores the hypothesis that the United States has not only retained but also strengthened its hegemonic position. Therefore, this thesis provides a framework for a better understanding of the changing basis of American hegemony by demonstrating how the Washington Consensus was further entrenched in Mexico and in South Korea after the peso crisis and the Asian crisis respectively. Methodologically, this thesis evolves around two case studies of the peso and South Korean crises and relies on primary sources such as official documents from the US House of Representatives and the US Senate, the IMF, the World Bank, Letters of Intent from national

governments to the IMF, official documents from the US State Department and the G7 along with interviews, in order to demonstrate the degree of entrenchment of the Washington consensus in both cases. The two case studies are symmetrically developed, initially providing a background to each crisis before examining the goals of American policy towards Mexico and South Korea.

The first three chapters provide the theoretical background on which this thesis builds. Chapter One provides a review of different approaches to hegemony from neorealist scholars such as Robert Gilpin and Stephen Krasner, neoliberal analysts such as Robert Keohane to neo-Gramscian scholars such as Robert Cox and Stephen Gill. The aim of Chapter One is to highlight the strengths and weaknesses of these perspectives when seen in contemporary context. Chapter Two more specifically introduces the framework of this thesis and the five interdependent variables on which it depends in order to provide an explanation of the changing basis of American hegemony. Chapter Three elaborates on the framework by providing an account of the economic policies of the United States during the 1970s and the 1980s that enabled a shift in American foreign economic policy to more aggressive practices. In this context special emphasis is placed on Reaganomics and the construction of the Washington Consensus.

The next four chapters are the main core of the thesis and analyse the two case studies of Mexico and South Korea. The framework of

Chapter Two is being tested through the case studies of Mexico and South Korea in order to demonstrate the entrenchment of the Washington Consensus in these countries. Chapter Four delivers the first part of the Mexican case study by providing a contextual analysis of Mexico's financial liberalisation after the debt crisis of 1982 until the eve of the crisis in 1994. This chapter gives an account of the role of the United States in the liberalisation of Mexico's economy and the North American Free Trade Agreement that aimed to stabilise the economic reforms in Mexico. Chapter Four argues that the Washington Consensus was already applied in Mexico before it was challenged by the peso crisis. Chapter Five, provides an analysis of the response of the United States to the peso crisis and highlights the role of American interests in the region that drove the Clinton Administration to bail out Mexico despite opposition from the US Congress. Chapter Five argues that the Washington Consensus was further entrenched in Mexico as a result of American policies conducted through the US Treasury. Chapter Six introduces the first part of the South Korean case study, providing a contextual analysis of the Asian developmental state model, South Korea's economic liberalisation and the events that led to the financial crisis of 1997-1998. Chapter Six argues that before the crisis of 1997, the Washington Consensus was not applied in South Korea at the same degree as in Mexico before the crisis of 1994. Chapter Seven analyses the response of the United States and the IMF to the South Korean financial

crisis and the consequent pressures for further financial liberalisation deriving from the conditionalities attached to the assistance packages. Chapter Seven argues that as a result of the American response to the financial crisis of South Korea, mediated through the IMF, the Washington Consensus expanded to areas that were not previously covered in South Korea.

Finally, Chapter Eight concludes the thesis, by providing an analysis that incorporates all the findings of the two case studies and discussing the degree by which the framework of Chapter Two has been confirmed by the case studies of Mexico and South Korea. Chapter Eight argues that state-centric notions of American hegemony developed during the postwar period are now being displaced by a new concept of hegemony in which American foreign economic policy is more concerned with setting a market framework based on the Washington Consensus, through agencies such as the IMF, the World Bank and the World Trade Organisation (WTO). This new concept of hegemony thus challenges notions of American relative decline. Chapter Eight finally concludes that the United States is still a hegemonic power, retaining the ability to establish its preferences about the workings of global economy.

CHAPTER ONE

THE CHANGING BASIS OF HEGEMONY: FROM HEGEMONIC STABILITY THEORY TO NEO- GRAMSCIAN APPROACHES

This chapter provides an overview of the most important concepts of hegemony. It starts with an analysis of the neorealist and neoliberal frameworks, focusing upon hegemonic stability theory before proceeding to a discussion of some alternative concepts of hegemony, notably those of Immanuel Wallerstein, Susan Strange and Joseph Nye.¹ The chapter concludes with a discussion of Gramsci's

¹ For neorealist approaches and hegemonic stability theory see works such as Charles Kindleberger, *The World in Depression: 1929-1939* (University of California Press, Berkeley 1973); Robert Gilpin, *US Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment* (Basic Books, New York 1975); David Calleo, *The Imperious Economy* (Harvard University Press, London 1982); Stephen Krasner, *Defending the National Interest* (Princeton University Press, Princeton 1978). For a neoliberal institutionalist approach, see analyses such as Robert Keohane and Joseph Nye, *Power and Interdependence*, (Scott and Foresman, New York 1989). Alternatives to hegemonic stability theory also include works such as Isabel Grunberg, "Exploring the Myth of Hegemonic Stability", *International Organization*, vol. 44, no. 4, 1990, pp. 431-477; Immanuel Wallerstein, "The Three Instances of Hegemony in the History of the Capitalist World Economy", in G. Crane and A. Amawi, eds. *The Theoretical Evolution of International Political Economy* (Oxford University Press, New York 1991); Mark Rupert, *Producing Hegemony: The Politics of Mass Production and American Global Power* (Cambridge University Press,

conception of hegemony and the application of a Gramscian framework to the contemporary world with a special focus on the work of Robert Cox.² These are the most important approaches to the issue of hegemony and some of them include important elements which are useful for the development of a conceptual theoretical framework in Chapter Two. In this chapter, a critique of each group of approaches is developed to highlight the strengths and weaknesses of these approaches in understanding the changing basis of hegemony during the 1990s and the final part of this chapter points toward the need for a fresh perspective on hegemony.

The term hegemony derives from the ancient Greek and refers to the dominance of one state over others.³ It has been used in diverse and confused ways. The problem is that an unequal distribution of power is a matter of degree and there is no general agreement on how much inequality and what types of power constitute hegemony. Some analysts such as Modelski prefer the term "world leadership" to the

Cambridge 1995); Susan Strange, "The Persistent Myth of Lost Hegemony", *International Organization*, vol. 41, no. 4, 1987, pp. 212-235.

² For neo-Gramscian approaches, see works such as Robert Cox, "Gramsci Hegemony and International Relations: An Essay in Method", in *Millennium*, vol. 12, no. 2, 1983, pp. 162-175; Robert Cox with Timothy Sinclair, *Approaches to World Order* (Cambridge University Press, Cambridge 1996); Giovanni Arrighi, "The Three Hegemonies of Historical Capitalism", in Stephen Gill, ed. *Gramsci Historical Materialism and International Relations* (Cambridge University Press, Cambridge 1993); Stephen Gill, *American Hegemony and the Trilateral Commission* (Cambridge University Press, New York 1990).

³ Greek *hegemonia*, from *hegemon*, leader, from *hegeisthai*, to lead. See *The American Heritage Dictionary of the English Language* (Houghton Mifflin, Boston 1996).

term “hegemony”.⁴ The latter quite often refers to a less desirable system based on domination, coercion, exploitation and inequality. In contrast the term “leadership” has more positive qualities because it is thought of as the provision of the public good of responsibility, rather than exploitation of followers.⁵

The issue of hegemony began to draw extensive scholarly attention after events in the early 1970s, such as the abandonment of the Bretton Woods system of fixed exchange rates and the first OPEC (Organisation of Petroleum Exporting Countries) oil shock in 1973. These events were widely interpreted as signs either of the decline of the leadership held by the United States or of deliberate American retreat from the role. The various approaches to this topic resulted from a lack of agreement on its definition and rules of application. The standards against which to measure American decline were seldom made clear. Part of the difficulty stemmed from a lack of agreement about how much power is necessary to produce hegemony and also from a lack of agreement on the relevant dimensions and indications of power.⁶

⁴ George Modelski, “World Leadership: End Game Scenarios” in David Rapkin, ed., *World Leadership and Hegemony* (Lynne Rienner Publishers, Boulder 1990) p. 241.

⁵ David Rapkin, “The Contested Concept of Hegemonic Leadership”, in D. Rapkin, ed., *World Leadership and Hegemony* (Lynne Rienner Publishers, Boulder 1990) p. 3.

⁶ Bruce Russett, “The Mysterious Case of Vanishing Hegemony; or Is Mark Twain Really Dead?”, *International Organization* vol. 39, no. 2, 1985, p. 209.

Neorealist and Neoliberal Approaches

The school that most influenced International Political Economy (IPE) was that of the neorealists, notably Charles Kindleberger and Robert Gilpin.⁷ The conception of hegemony in the neorealist orthodoxy of IPE focused upon state power and the creation of international regimes for coordination and cooperation among otherwise rival states. Neorealism embodied relatively static theories of politics which emphasised distributional struggles within a given field of social relations. Neorealist IPE was primarily concerned to explain the emergence of a political order in which competing states were understood as pre-constituted individuals, struggling for security in a lawless and amoral world. As a consequence of this position, neorealism suggested that a single, politically and economically preponderant state - a "hegemon" - would be a necessary condition for the construction of order in the international system. In several studies this general framework - which is known as hegemonic stability theory (HST) - overstated the extent to which leading states actually used their extraordinary power to compel others to cooperate in the construction of an encompassing, systemic order. Kindleberger with his explanation

⁷ See Charles Kindleberger, *The World in Depression, 1929-1939*; Robert Gilpin, *US Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment*; Robert Gilpin, "The Theory of Hegemonic War", *Journal of Interdisciplinary History*, vol. 18, no. 4, 1988, pp. 591-613.

of the Great Depression as a consequence of a lack of international leadership and Gilpin's comparison of American hegemony with its nineteenth-century British antecedent sparked a debate over hegemonic leadership and America's alleged decline.

The distinction between neorealism and neoliberalism seems blurred because neoliberalism does not represent a cohesive intellectual movement or school of thought like neorealism. Neoliberalism operates from different assumptions, examining different aspects of the processes through which international change and cooperation might be promoted. In contrast to neorealists, neoliberal analysts assume that the relative decline of a hegemon's economic and military capabilities does not necessarily imply a subsequent period of instability. In neoliberal approaches such as that of Robert Keohane primary attention is given to the influences of international institutions and non-state actors like multinational corporations and the interest in examining the conditions under which the converging and overlapping interests among sovereign political entities result in cooperation.

First, the hegemonic stability theory was initially developed by the economist and historian Charles Kindleberger as a means of explaining why the international monetary disorder of the 1930s had occurred. For Kindleberger the 1929 depression was so severe because the international economic system was rendered unstable by Britain's inability and the United States' unwillingness to assume responsibility

for international economic stability by maintaining a relatively open market for goods and providing counter-cyclical long-term lending. The world economic system would be unstable unless a major economy stabilised it, as Britain had done in the nineteenth century and up until 1913. In 1929, although Britain was willing to supply the public good of international monetary stability, it simply did not have the economic strength to do so. The United States, which had massive economic strength, was able but unwilling to take on the economic leadership from Britain and become the new hegemon.⁸

According to Kindleberger, for the world economy to be stable, it needed a stabiliser, that is a country that would undertake to provide a market for goods, a steady flow of capital and a mechanism for providing liquidity when the monetary system was frozen. Kindleberger later added that world leadership should also manage, in some degree, the structure of foreign exchange rates and provide a degree of coordination of domestic monetary policies.⁹ In this area, and for the maintenance of free trade and a liberal flow of capital and aid, leadership was necessary. When the United States economic leadership in the world economy was faltering in the 1970s, three outcomes were

⁸ Charles Kindleberger: *The World in Depression: 1929-1939*, p. 292.

⁹ Charles Kindleberger, "Dominance and Leadership in the International Economy. Exploitations, Public Goods and Free Rides", *International Studies Quarterly*, vol. 25, no. 2, 1981, p.247. See also, Charles Kindleberger, *The International Economic Order: Essays on Financial Crises and International Public Goods* (Harvester-Wheatsheaf, London 1984).

considered politically stable by Kindleberger. First, continued or revived United States leadership. Second, an assertion of leadership and assumption of responsibility by Europe for the stability of the world system and third, an effective secession of economic sovereignty to international institutions: a world central bank, a world capital market and a General Agreement on Tariffs and Trade. The last was considered by Kindleberger to be the most attractive but the least likely. Politically unstable outcomes would have been: a) competition between the United States and Europe for leadership in the world economy, b) one unable to lead and the other unwilling or c) each retaining a veto over programmes of stability or strengthening of the system without seeking to secure positive programmes of its own.¹⁰ For Kindleberger only an outstanding economic and political power, with the capacity and willingness to lead, could supply and support the infrastructure that permits international exchange. Kindleberger's theory was not concerned with cooperation but rather with unilateral actions taken by the stabilising or hegemonic power.

Like Kindleberger, Gilpin emphasised the similarities between the rise and decline of Britain and the United States. Gilpin argued that the alleged relative economic and industrial decline of the United States during the 1970s was due to a more permanent crisis in the American

¹⁰ Charles Kindleberger, *The World in Depression: 1929-1939*, pp. 308 & 311.

economy and that powerful forces beyond the control of the United States had accounted for this decline. In a combination of neorealist and neoliberal approaches, Gilpin focused upon the role of the American-based multinational corporation, which had performed an important role in the maintenance and expansion of the power of the United States. For Gilpin, American hegemony in the contemporary world rested, in part, on the vast international operations of American corporations. The underlying assumption of American officials had been that the national interest of the United States was well served by the overseas expansion of American corporations. Corporate control by American executives and corporate dependence on the American market had encouraged public officials to believe that the corporations would on the whole behave consistently with the interests of the United States.¹¹ In addition, Gilpin pointed out that through the transformation of American technology and the free enterprise tradition, multinational corporations had helped to create the democratic and pluralistic world of the American liberal vision. This view reached several conclusions, namely that:

'a) The multinational corporation is the most dynamic and vital sector of the American economy; these corporations represent America's greatest strength and should be encouraged; b) the United States would suffer economic and political decline if it failed to exploit to the fullest the potential of the MNC and c) the MNC through the export of capital and technology, raises the standard of living elsewhere, thus

¹¹ Robert Gilpin, *The US Power and the Multinational Corporation*, pp. 142-146 & 197.

creating economic partners for the United States and nation committed to the American values of free enterprise and political democracy.’¹²

However, Gilpin expressed some doubts as to whether or not this assumption of complementarity of corporate and national interests would continue to hold in the future. Gilpin suggested that the decline of American power was leading to an era of grave uncertainty. In a world economy composed of several major centres of economic power, economic bargaining and coalitions would predominate. In fact, the direction of the evolution of the international economy had been from a liberal to a negotiated system.¹³ Although the relative balance of political and market determinants of economic activities would differ from one economic sector to another and from time to time, market shares and the global location of economic activities had become strongly influenced by bargaining among nation-states and multinational corporation.¹⁴

For Gilpin, although American economic and military power had grown immensely in absolute terms throughout the postwar period, the relative position of the United States had dramatically declined. In relationship to other states and to America’s former primacy in all aspects of power (military and economic), the United States had

¹² Robert Gilpin, *The US Power and the Multinational Corporation*, p. 167.

¹³ Robert Gilpin, *The US Power and the Multinational Corporation*, p. 262.

¹⁴ Robert Gilpin, *The Political Economy of International Relations* (Princeton University Press, Princeton 1987) p. 408.

suffered a major decline in power. Gilpin maintained that although the United States continued to be the dominant power and most prestigious state in the system, it no longer had the power to govern the system as it has done in the past. It was increasingly unable to maintain the existing distribution of territory, its spheres of influence and the rules of the world economy. One of Gilpin's main arguments was that decreased US capacity and willingness to provide leadership had caused the postwar liberal international economy to deteriorate seriously. Thus, Gilpin linked American decline with two potentially disastrous results:

'The relative decline of American hegemony has a) seriously undermined the stable political framework that sustained the expansion of a liberal world economy in the postwar era and b) increased protectionism and economic instability.'¹⁵

The United States should accept a greater regionalisation of the world economy, which implied greater representation and voice for other nations and regional blocs in international economic organisations. The attempt to hold on to rather than adjust to the shifting balance of world power could be even more costly for the United States in the long run.¹⁶

¹⁵ Robert Gilpin, *War and Change in World Politics* (Cambridge University Press, Cambridge) p. 232; Robert Gilpin: *The Political Economy of International Relations*, p.351.

¹⁶ Like many observers at the end of the 1980s, Gilpin concentrated on the fact that Japan had become the world's largest creditor. See Robert Gilpin, "Where Does Japan Fit In?", *Millenium*, vol. 18, 1989, pp. 329-342; Robert Gilpin, *The Political Economy of International Relations*, pp. 364-369 & 371.

However, Gilpin, has not explained the ways in which this adjustment could take place. Gilpin has not elaborated on factors such as international financial institutions and has ignored the mechanisms by which the United States could take advantage of a possible instability of the system in the form of a financial crisis. For example there was no connection between financial crises and how these crises offer the opportunity to the United States to promote, through international financial institutions, a specific set of ideas and principles about the workings of the global economy.

One of the most common definitions of hegemony has been provided by Robert Keohane, who described it as a preponderance of material resources. Keohane also defined hegemonic leadership as a situation in which one state is powerful enough to maintain the essential rules governing interstate relations and is willing to do so.¹⁷ Keohane argued that the dominance of a single great power could contribute to order in world politics but it was not a sufficient condition and there was little reason to believe that it was necessary. Regimes produce strong vested interests in cooperation by facilitating recognition of mutual interests and by providing normative incentives to cooperate in the absence of a hegemon.

¹⁷ Robert Keohane, and Joseph Nye, *Power and Interdependence* (Harper Collins Publishers, New York 1989) p. 49.

Departing from hegemonic stability theory, Robert Keohane and Joseph Nye have argued that international leadership could take three forms: hegemony, unilateralism and multilateralism. Hegemonic leadership was one way in which a public good -- responsibility -- could be supplied. But the hegemonic leader would constantly be tempted to use its leadership position for the sake of specific, self-oriented gains. A problem that had occurred was that willing submission to hegemonic leadership was difficult to prolong because the legitimacy of such leadership tended to erode. Thus, the need for compulsion in hegemonic leadership increased. The second type of hegemonic leadership that Keohane and Nye defined was unilateral initiative that set an international example. A large state might not be able or willing to police the behaviour of other states, but because of its size and importance, its actions could determine the regimes that governed situations of interdependence, both because of its direct effects and through imitation. More specifically, because the American economy was dominant and less vulnerable than those of Japan, Germany or France the United States had more leeway in foreign economic policy than its principal competitors. The third type of leadership was based on action to induce other states to help stabilise an international regime. Keohane and Nye asserted that leading states would forego short-run gains in bargaining in order to secure the long-run gains associated with stable international regimes. Large states

were most likely to make such short-run sacrifices, because they were likely to be major beneficiaries of the regime and they could expect their initiatives to have significant effects on world politics. However, for such leadership to be sustainable other states must cooperate. This cooperation depended on the legitimacy of the regime - the widespread perception that it was indeed in the interests of all major parties.¹⁸

Based on the above analysis, Keohane and Nye, writing in 1989, have pointed out that although the United States still had the most powerful economy in the world, the prospects for American hegemony - to the point of being able to determine and maintain the rules - were slim. Unless drastic changes took place in world politics, hegemonic leadership would be out of the question. For Keohane and Nye, the choice was essentially between non-hegemonic leadership and no effective leadership at all. Effective non-hegemonic leadership depended to some extent on unilateral initiatives and setting good examples, but it was also related in complex ways to cooperation and to international institutions.¹⁹ Keohane's basic argument was that:

'Successful hegemonic leadership itself depended on a certain form of asymmetrical cooperation. Material predominance alone does not guarantee either stability or effective leadership. The hegemon may

¹⁸ Keohane and Nye: *Power and Interdependence*, pp. 229-231.

¹⁹ Keohane and Nye: *Power and Interdependence*, p. 231.

have to invest resources in institutions in order to ensure that its preferred rules will guide the behaviour of other countries.'²⁰

This argument suggested the importance of the legitimacy of hegemonic regimes and the coexistence of cooperation. This conception, however, defined cooperation in terms of the presence or absence of conflict. Keohane stressed the significance of the apparently high level of international economic cooperation that had survived the alleged decline of American hegemony but defined cooperation in terms of the existence of formal agreements. International Monetary Fund (IMF) programmes, for example, had elicited an astonishing degree of coordination and compliance, despite their harsh impact. Yet the existence of such agreements strained the meaning of the term cooperation. The IMF might formally agree on a set of policies, but agreement at this level could obscure deeper conflicts and uneven power relations both within and among nations.

According to another advocate of the declinist school, David Calleo, the post-war Western liberal system had been based on American power, imagination and energy, which shaped the great part of the world into a pattern of American design. This system, also known as the *Pax Americana*, not only was faltering but the United

²⁰ See Robert Keohane: *After Hegemony: Cooperation and Discard in the World Political Economy* (Princeton University Press, Princeton 1984) pp. 38, 39 & 46. For more on international regimes see Robert Keohane, "The Demand for International Regimes", *International Organization*, vol. 36, no. 2, 1982, pp. 325-355.

States itself seemed more troubled and uncertain than at any time since the Great Depression of the 1930s. Furthermore, Calleo argued that the postwar system was evolving into a more plural structure in which other powers were becoming more active and powerful. Thus, the test for American statesmanship should be not how long it managed to cling to a deteriorating and overextended hegemony, but how well the liberal international arrangements it had fostered could adapt themselves to the stresses of the more plural order. The question that was raised by Calleo was whether the postwar world system could survive the relative decline of American power.²¹

Stephen Krasner argued that only states whose resources were very large, both absolutely and relatively, could attempt to impose their vision on other countries and the global system. At that point ideology would become a critical determinant of the objectives of foreign policy. According to Krasner, great power removed the usual restraints on central decision-makers. Very powerful states escaped some of the consequences of the inherently anarchic nature of the international system. The association of an ideological foreign policy with a hegemonic state was based implicitly upon an assumption of a hierarchy of goals. States could only move on to higher things if more fundamental aims had been satisfied. Just as man in the biosphere

²¹ David Calleo, *The Imperious Economy*, pp. 1-3.

could engage in many activities not directly related to the survival of the species, so hegemonic states could pursue ideological goals because more basic needs had not been threatened.²² For Krasner, by measure of aggregate capabilities and levels of development, the United States was clearly a hegemon in the first decades after the end of World War II and during these years the United States behaved as a stabilising and liberalising hegemon. At some point between 1960 and the mid-1970s, the United States had lost the margin of power required to successfully perform the hegemonic functions. Other countries, such as Germany and Japan had narrowed the relative lead upon which American hegemony depended. However, Krasner distanced himself from the main framework of hegemonic stability theory by emphasising the fact that there could be stability in the system even if there was no longer a hegemon to act as a stabiliser.²³ However, Krasner has not developed a framework in order to explain how this stability could be achieved. For example there is a lack of explanation about a) the role of capital flows in the appearance of financial crises and b) the role of international financial institutions in stabilising economies in crisis and c) how the policies of these institutions are influenced by the United States.

²² Stephen Krasner, *Defending the National Interest*, p. 341.

²³ Michael Webb and Stephen Krasner, "Hegemonic Stability Theory: An Empirical Assessment", *Review of International Studies*, no. 15, 1989, pp. 185 & 195.

A contribution to the literature that further stimulated the debate around America's relative decline emanated from Paul Kennedy. He argued that if a hegemonic power overextended itself strategically it would run the risk that the potential benefits from external expansion could be outweighed by the great expense of it all - a dilemma that would become acute if the nation concerned entered a period of relative economic decline. Furthermore, Kennedy argued that the history of the rise and the fall of the leading countries in the Great Power system since the advance of Europe in the sixteenth century had shown a very significant correlation over the longer term between productive and revenue-raising capacities on the one hand and military strength on the other.²⁴ In the case of the United States, Kennedy pointed out that America's hegemonic power was in decline and that American statesmen had to recognise this broad trend and to manage affairs so that the relative erosion of the United States' position took place slowly and smoothly and was not accelerated by policies which brought merely short-term advantage but longer-term disadvantage.²⁵ However, this thesis will demonstrate that, in contrast to Kennedy's view, there is rather an adjustment than a decline in the position of the United States. There are certain mechanisms that facilitate the influence of the United States in the global economy which are theoretically analysed in

²⁴ Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (Unwin Hyman, London 1988) p. xvi.

²⁵ Paul Kennedy, *The Rise and Fall of Great Powers*, pp. 534-535.

Chapter Two and applied and tested through the financial crises of the 1990s (the peso crisis 1994-95 and the South Korean crisis 1997-98).

A very common observation in the decline debate was that the contemporary American economy operated in a very different international environment from that of the past. Tom Kemp argued that the United States had to share industrial and technological leadership with other countries. After a century of exceptional growth, which had made it the most powerful nation on earth, America was being overtaken by other countries and had to face the consequences of the loss of industrial and technological leadership. According to this point of view, the relative, if not absolute, decline of the United States as a world power was likely to continue with the irresistible rise of Japan and the growth of Europe. For Kemp, the problem of the 1990s and the prospect for the twenty-first century was much more one of adaptation to world trends which were outside the control of Washington.²⁶ From a similar point of view, Stephen Burman argued that the mechanism of decline was the burden of expenditure, which fell on the hegemon through maintaining collective security:

'Globalisation has entailed the growth of other economic powers capable of challenging American dominance and there is a sense therefore in which the United States, as the sponsor of global

²⁶ Tom Kemp, *The Climax of Capitalism: The US Economy in the Twentieth Century* (Longman, London 1990) pp. 228, 229, 232 & 233.

capitalism, may prove to have been its own gravedigger by setting in motion the very forces that will undermine its position.'²⁷

In a more general critique we could argue that neorealist accounts of hegemony have focused upon state power and the creation of international regimes for the coordination of policy and the facilitation of cooperation among otherwise rival states. Neorealist IPE has been primarily concerned to explain the emergence of political order among competing states by suggesting that a single, politically and economically preponderant state – a systemic leader or hegemon – might be a necessary condition of order in the international system. Thus a hegemonic state would also have a preponderant interest in constructing a global system of order and would be more willing to assume an asymmetrical share of the costs of that order. The general framework of hegemonic stability theory had overstated the extent to which leading states actually used their extraordinary power to compel others to cooperate in the construction of an encompassing, systemic order.²⁸

The theory's oversimplification had shown up in its lack of attention to non-governmental actors' roles in setting or influencing economic policy. In the realist model, the state is the only important

²⁷ Stephen Burman, *America in the Modern World: The Transcendence of United States Hegemony* (Harvester-Wheatsheaf, New York 1991) pp. 28, 29.

²⁸ Mark Rupert, *Producing Hegemony: The Politics of Mass Production and American Global Power*, p. 5

actor. There is no acknowledgement of the complexity of formulating foreign policy in today's world where non-governmental actors, particularly transnational corporations, with their global reach, have tremendous power. As Anthony Tuo-Cofi Gadzey argued, hegemonic stability theory as a typical rational model could not provide a realistic analytical model of contemporary interstate interaction.²⁹ In his critique, Robert Cox argued that neorealism reduced the states to the dimension of material force and similarly reduced the structure of world order to the balance of power as a configuration of material forces. Neorealism, which dismissed social forces as irrelevant, tended to place low value on the normative and institutional aspects of world order.³⁰

There are many reasons to believe that hegemonic stability theory is far from accurate. Both Gilpin's self-exhausting hegemon and Kindleberger's provider of public goods were seen as benevolent actors. For Isabelle Grunberg, in order to believe in the theory's interpretation of postwar history, we would have to agree on two assumptions, namely: a) the United States had definitely declined and b) the decline was due to farsighted, self-sacrificing policies. These two assumptions are closely related to the theory's ethnocentrism and the theory's potentially universal appeal especially to American policy-makers and

²⁹ Anthony Tuo-Cofi Gadzey, *The Political Economy of Power* (Macmillan, London 1994) pp. 4-5.

³⁰ Robert Cox, *Social Forces, States and World Order* (Cambridge University Press, Cambridge 1996) pp. 146-149.

scholars.³¹ Indeed, the theory of hegemonic stability had a built-in, ethnocentric bias simply in the sense that it links the fate of the world with that of the United States, whereas most developments had sprung from a much wider range of variables. In the theory of hegemonic stability, the discussion about America's decline, if it had really taken place, had broadened and taken on a universal dimension. For Americans who perceived their country as the focal point of the whole world, the country's decline should be everyone's concern. As Grunberg explained, the ethnocentrism was certainly less than naïve, at least in its ultimate effects on agenda setting:

'The theory of hegemonic stability offered no escape from chaos, except through a rejuvenation of US power, a rejuvenation to which all allies should contribute for their own good.'³²

Hegemonic stability theory cannot explain regime persistence in the face of relative American decline. In contrast to the neorealist perspective the neoliberal view holds that the relative decline of a hegemonic state does not necessarily imply a subsequent period of instability in the system. Instead there could be a cooperative international environment. The neorealist perspective lacks a recognition that world order involves more than just the relationships of state-based actors. The neoliberal approach recognises the

³¹ Isabel Grunberg, "Exploring the myth of Hegemonic Stability", pp. 443-444.

³² Isabel Grunberg, "Exploring the myth of Hegemonic Stability", pp. 448-449.

importance of non-state actors but fails to address the role of institutions, ideas and domestic elites in shaping state and private actors activities.

Alternatives to Hegemonic Stability Theory

A neo-Marxist or structuralist definition of hegemony was offered by Immanuel Wallerstein who defined hegemony as a temporary characteristic of the world-system as a whole. For Wallerstein's world-systems interpretation, hegemony referred to a situation in which the ongoing rivalry between the so-called great powers was so unbalanced that one power was truly *primus inter pares*, that is, one power could largely impose its rules and its wishes in the economic, political, military, diplomatic and even cultural arenas. Using this definition, Wallerstein identified three instances of hegemony: the Dutch United Provinces in the mid-seventeenth century (1620-72), the United Kingdom in the mid-nineteenth (1815-73) and the United States in the mid-twentieth (1945-67).³³

³³ For more details on these three instances of hegemony see Immanuel Wallerstein, "The Three Instances of Hegemony in the History of the Capitalist World Economy", p. 237.

Wallerstein also considered the politics of hegemony. He argued that global economic pre-eminence clearly shaped the definition of the hegemon's national interest. Hegemons tended to identify their interests with a liberal economic order. They came forward as defenders of the principle of the free flow of the factors of production throughout the world economy. However, hegemonic powers regularly made exceptions to their anti-mercantilism when it was in their interest to do so and they regularly were willing to interfere with political processes in other states in order to ensure their own advantage³⁴. Wallerstein pointed out that the United States was much weaker in the 1980s - economically, politically, culturally - than in the 1960s. Power had shifted for structural reasons and not because of policy errors. A structural factor was the advantage of the latecomer. After 1945, Western Europe and Japan had to "catch up" with US industrial strength, which had emerged from the war unscathed. Entering late into an expanding world-economy permitted productivity leaps because of newer machinery and relatively cheaper skilled labour. Although Wallerstein's theory of the capitalist world-economy had offered one possible alternative to the neorealist and neoliberal assumptions, it too ended up with a highly abstract and one-sided

³⁴ Immanuel Wallerstein, "The Three Instances of Hegemony in the History of the Capitalist World Economy", p. 239.

understanding of states, their historical grounding in state-society relations, and the politics of these relations in the modern world.³⁵

From a structuralist point of view, George Modelski criticised hegemonic stability theory by pointing out that its focus on the interaction of wealth and power was basically materialistic. He also argued that this focus should be recognised as frustratingly narrow. Factors such as the search for identity or knowledge and the process of learning or legitimation were systematically ignored.³⁶ This problem was evident in works such as those of Kindleberger and Gilpin. The importance of legitimate leadership was often ignored in those pure neorealist, materialistic perspectives of hegemonic power. Modelski argued that legitimate leadership “has the capacity of riding out the most threatening storms”. Thus, American global leadership was likely to continue because the United States continued to hold the essential qualifications for it: favourable geographical location, economic potential and military forces capable of global reach. Modelski also stressed the importance of the United States, serving as the capital zone of a global community of democracy. No country had a better claim on all these grounds.³⁷ Structural approaches such as those of Wallerstein and Modelski share the notion that hegemony or leadership is rooted in

³⁵ Mark Rupert, *Producing Hegemony: The Politics of Mass Production and American Global Power*, p. 8.

³⁶ George Modelski, “Global Leadership: End Game Scenarios”, in *World Leadership and Hegemony*, p. 243.

³⁷ George Modelski, “Global Leadership: End Game Scenarios”, pp. 243 & 253.

the distribution of power, which is defined just as in hegemonic stability theory, in terms of material capabilities. These approaches still do not depart from the neorealist conviction that a decline in hegemonic power brings instability in the system.

Joe Nelson offered a different way to interpret the problem. He argued that there was something new under the sun, a new world order, and that this order was a key cause of American economic difficulties and all of this was better explained by recent developments in post-industrial capitalism than by the experiences of the Netherlands in the fifteenth and sixteenth century or Great Britain in the nineteenth century. Hegemonic arguments had ignored the role of managerial strategies in bringing new levels of economic interdependence. Nelson pointed out that recent international developments were qualitatively different than all that had occurred in the past and the alleged decline of American hegemonic power could not by any stretch of the imagination be thought to replicate cycles of the rise and fall of nations.³⁸ Nelson's analysis showed that technological advances had altered the world past from present. These advances had facilitated growth in international trade and growth in a new level of economic interdependence. It was this interdependence - not the hegemony, nor

³⁸ Joe Nelson, *Post-Industrial Capitalism: Exploring Economic Inequality in America*, (SAGE Publications, London 1995) pp. 93, 94.

the rise and fall of nations - that had prompted convergence in world wealth, convergence that had mistakenly been interpreted in terms of America's decline. However, Nelson has ignored factors such as international institutions and the role of financial crises in providing the United States the opportunity to advance free market ideas directly or indirectly through international institutions.

From another perspective, Arthur Stein had argued that without agreements there could be no regime. Hegemons might lead but they needed followers and should make concessions to gain the assent of others. In other words, the liberal trade regimes that had emerged in both centuries in Britain and the United States had been founded on asymmetric bargains that permitted discrimination, especially against the hegemon. Just as the existence of a hegemonic power did not necessarily imply the emergence of a liberal trading order, so its decline did not necessarily mark the end of such a regime.³⁹ Stein's principal argument was that hegemons did not create openness. They could open their economies and they could assure others of non-retaliation as long as others imposed trade barriers only within specified constraints and under specified conditions. Hegemons needed followers in order to liberalise international exchanges:

³⁹ Arthur Stein, "The Hegemon's Dilemma: Great Britain, the United States and the International Economic Order", *International Organization* vol. 38, no. 2, 1984, pp. 35-38.

'The hegemon's decline does not signify that it has become irrelevant. Rather it remains a major, perhaps still *the* major, trading power, and its participation and agreement are necessary if relative openness is to be maintained. Thus, the continued agreement of the United States remains essential for the maintenance of the postwar trading order it made possible by its willingness to bear the costs of openness.'⁴⁰

For her part, Susan Strange was instrumental in identifying the reasons why the myth of America's lost hegemony had taken root so strongly in the United States' academic community about twenty years ago and why it had been so generally accepted since. Strange first criticised the notion that derived from the theory of public goods and the theory of hegemonic stability namely, that the lack of international economic cooperation could be explained by applying the theory to the behaviour of states in conditions of dispersed political power. This critique led to five important propositions, namely: a) the game of states had become much more economic than political, b) the United States' structural power had, on balance, increased, c) "realism" and "unilateralism" were much more evident in the US foreign policy than liberal internationalism, d) the use of hegemonic structural power in ways that were destructive of international order and cooperation had been an important cause of world economic instability, and e) thus, a necessary condition for greater stability and cooperation resided within

⁴⁰ Arthur Stein, "The Hegemon's Dilemma: Great Britain, the United States and the International Economic Order", p. 35

the United States rather than in the institutions and mechanisms of international cooperation.⁴¹

Strange's analysis maintained that in the new competitive game between states it was not relational power - that is the power of A to get B to do something it would not otherwise do - but structural power that mattered. Structural power was the power to choose and to shape the structures of the global political economy within which other states, their political institutions and their economic enterprises, had to operate.⁴² According to Strange, structural power was to be found, not in a single structure, but rather in four separate but interrelated structures: a) a security structure b) a production structure c) a financial structure and d) a knowledge structure. In the international political economy, all four were important, and the state, which was dominant in most aspects of structural power, was the most powerful.⁴³ More importantly, Strange asserted that some American analysts' choice of indicators had misled them into thinking that their country was suffering economic decline:

'It is not the share of industrial manufactured products made in the United States nor the share of US exports of manufactures to world markets that counts. We should look instead at the proportion of total world production of goods and services produced: a) in the United

⁴¹ Susan Strange, "The Persistent Myth of Lost Hegemony", pp. 553, 554.

⁴² Susan Strange, *States and Markets* (Pinter Publishers, London 1987) p. 26.

⁴³ Susan Strange, "The Persistent Myth of Lost Hegemony", pp. 564, 565.

States and b) by enterprises ultimately headquartered in the United States and responsible to the government in Washington.' ⁴⁴

Joseph Nye and William Owens went further by pointing out that knowledge, more than ever before, was power. The one country that could best lead the information revolution would be more powerful than any other. Nye argued that for the foreseeable future, that country would be the United States:

'America has apparent strength in military power and economic production. Yet its more subtle comparative advantage is its ability to collect, process, act upon and disseminate information, an edge that will almost certainly grow over the next decade.' ⁴⁵

This information edge would be equally important as a force multiplier of American diplomacy, including "soft power" - the ability to achieve desired outcomes in international affairs through attraction rather than coercion. It would work by convincing others to follow, or getting them to agree to, norms and institutions that produced the desired behaviour. For Nye and Owens, soft power could rest on the appeal of one's ideas or the ability to set the agenda in ways that shaped the preferences of others. However, Nye and Owens argued that two conceptual problems had prevented the United States from realising its potential. The first was that outmoded thinking had clouded the

⁴⁴ Susan Strange: "The Persistent Myth of Lost Hegemony", pp. 227, 228.

⁴⁵ Joseph Nye and William Owens, "America's Information Edge", *Foreign Affairs*, vol. 75, no. 2, 1996, p. 2.

appreciation of information as power. Traditional measures of military force, gross national product, population, energy, land and minerals had continued to dominate discussions of the balance of power. These power resources still mattered and American leadership continued to depend on them as well as on the information edge. But as Nye pointed out, these measures failed to anticipate the demise of the Soviet Union and they were equally poor means of forecasting for the exercise of American leadership into the next century.⁴⁶ Theorists of hegemonic stability had generally failed to spell out the casual connections between military and economic power and hegemony.

The second conceptual problem according to Nye and Owens had been that information power was hard to categorise because it cut across all other military, economic, social and political power resources, in some cases diminishing their strength, but in others multiplying it. In their concluding remarks, Nye and Owens claimed that the twenty-first century, not the twentieth, would turn out to be the period of America's greatest pre-eminence. Nye suggested that a look at the five-century-old modern state system showed that different power resources had never been static and that they continued to change in the contemporary world. In an age of information-based economies and transnational interdependence, power was becoming less transferable,

⁴⁶ Joseph Nye and William Owens, "America's Information Edge", p. 2.

less tangible and less coercive. For Nye, information was becoming the new coin of the international realm and better than any other country, the United States was now positioned to multiply the potency of its hard and soft power resources through information.⁴⁷

In sum neorealists, neoliberals and world system analysts viewed hegemony very closely linked to state power and state power was conceived in terms of the nation-state. From another perspective the analyses of Susan Strange and Joseph Nye provided the concepts of structural power and soft power which are important in understanding the changing nature of hegemony. However, while these analyses recognised the role of non-state actors and ideas they did not elaborate on the role of transnational mobile capital and domestic elites. The next part of this chapter introduces some basic concepts of the Gramscian framework in order to move to the ideas of Robert Cox, which broaden our understanding of American hegemony especially regarding the role of domestic elites.

⁴⁷ Joseph Nye, "The Changing Nature of World Power", *Political Science Quarterly*, Vol. 105, No.2, 1990, p. 183; Joseph Nye and William Owens, "America's Information Edge", pp. 5 & 9.

The Gramscian Framework

In Antonio Gramsci's approach to hegemony, his concern about legitimacy had led him to define hegemony as more than a simple resource preponderance or success in controlling joint outcomes in the interstate system. However, it must be understood that Gramsci's concepts in general resist ready definition. His concepts, designed to grasp some of the complexities present in social processes are multifaceted. Gramsci's concepts of civil society, historical bloc and hegemony formed the basis upon which the new Global Political Economy has been developed by scholars such as Robert Cox, Stephen Gill, and Giovanni Arrighi⁴⁸. In the *Prison Notebooks*, Gramsci examined the way in which political society or the realm of state power and authority, created and maintained as well as manipulated systems of beliefs and attitudes in civil society and how the predominant class not only created hegemony but could also depend in its quest for power on the consent arising from the masses of people.⁴⁹ This consent was

⁴⁸ See Robert Cox: "Social Forces, States and World Order"; Robert Cox: *Approaches to World Order*; Robert Cox, "Gramsci, Hegemony and International Relations: An Essay in Method."; Stephen Gill, *American Hegemony and the Trilateral Commission*; Stephen Gill: *Gramsci, Historical Materialism and International Relations* (Cambridge Univ. Press, Cambridge 1993); Giovanni Arrighi, "The Three Hegemonies of Historical Capitalism".

⁴⁹ See Antonio Gramsci, *Selections from the Prison Notebooks*, translated by Q. Hoare and G. Nowell Smith (International Publishers, New York 1971).

carried by systems and structures of beliefs, values, norms and practices of everyday life which unconsciously legitimated the order of things.

An emphasis upon the non-material basis of power is the hallmark of Antonio Gramsci's approach to hegemony. According to Gramsci state and society together constituted a solid structure which was called an historic bloc. An historic bloc encompassed political, cultural and economic aspects of a particular social formation and it could not exist without a hegemonic social class.⁵⁰ Gramsci stated that the supremacy of a social group or class manifested itself in two different ways: domination (*dominio*) or coercion, and intellectual and moral leadership (*direzione intellettuale e morale*). This latter type of supremacy constituted hegemony. It followed that hegemony was the predominance obtained by consent rather than force of one class or group over other classes.⁵¹ However, this ideological superiority must have solid economic roots. In other words, if hegemony was ethico-political, it should also be economic. It should also have its foundation in the decisive function that the leading group exercised in the decisive nucleus of economic activity. Thus, hegemonic leadership emerged

⁵⁰ Robert W. Cox, "Gramsci, Hegemony and International Relations: An Essay in Method.", p. 56.

⁵¹ Joseph Femia, *Gramsci's Political Thought. Hegemony Consciousness and the Revolutionary Process*, (Clarendon Press, Oxford 1981) p. 24.

only when the economic material base of a dominant state was set squarely in a uniquely, inspiring philosophical and moral world view.⁵²

The Gramscian idea of hegemony owed its origins to the political thought of Nicolo Machiavelli but helped to broaden even further the potential scope and application of the concept. In the fifteenth century Machiavelli had been concerned with finding the leadership and the supporting social basis for a united Italy. In the twentieth century Gramsci was concerned with the leadership and a supportive basis for an alternative to fascism. Gramsci had taken over from Machiavelli the image of power as a centaur: half man, half beast, a necessary combination of consent and coercion.⁵³

'They are the levels of force and consent, authority and hegemony, violence and civilisation, of the individual moment and of the propaganda, of tactics and of strategy. In actual fact, it often happens that the more the first perspective is immediate and elementary, the more the second has to be distant (not in time but as a dialectical relation) complex and ambitious.'⁵⁴

To the extent that the consensual aspect of power was in the forefront, hegemony would prevail. According to Cox,

'The Machiavellian connection frees the concept of power (and of hegemony as one form of power) from a tie to historically specific social classes and gives it a wider applicability to relations of dominance and subordination, including relations of world order.'⁵⁵

⁵² Anthony Tuo-Kofi Gadzey, *The Political Economy of Power: Hegemony and Economic Liberalism*, p. 29.

⁵³ Nicolo Machiavelli, *The Prince*, Robert Adams, ed. (Norton Critical Edition, New York 1977) pp. 169-170.

⁵⁴ Antonio Gramsci, *Selections from the Prison Notebooks*, pp. 169-170.

⁵⁵ Robert Cox with Timothy Sinclair, *Approaches to World Order*, p. 127.

By identifying hegemony purely and simply with the dominant ideology or a “mechanism of legitimacy”, the Machiavellian distinction between forms of consent was glossed over and a simple identity was postulated between ideology, culture and language.⁵⁶ For Gramsci, however, the effects of hegemony were highly contradictory. The more authentically hegemonic a class was, the more it would leave opposing classes the possibility of organising and forming themselves into an autonomous political force. At this point two crucial and closely related problems had arisen. As Joseph Femia has stated the Gramscian concept of hegemony embodied a hypothesis that within a stable social order, there should be a basis of agreement so powerful that it could counteract the division and disruptive forces arising from conflicting interests. But consent though voluntary agreement could vary in intensity. On the one hand, it could flow from a profound sense of obligation, from wholesale internalisation of dominant values and definitions; on the other hand, from their very partial assimilation, from an uneasy feeling that the status quo was nevertheless the only viable form of society.⁵⁷

For Gramsci, hegemony was not a static concept but a process of continuous creation which, given its massive scale, was bound to be

⁵⁶ Christine Buci-Glucksmann, *Gramsci and the State* (Lawrence and Wishart, London 1975) p. 57.

⁵⁷ Joseph Femia, *Gramsci's Political Thought*, pp. 38-40.

uneven in the degree of legitimacy it commanded and to leave some room for antagonistic cultural expressions to develop.⁵⁸ For example, he characterised hegemony as

‘The spontaneous consent given by the great masses of the population to the general direction imposed on social life by the dominant fundamental group, consent historically caused by the prestige accruing to the dominant group because of its position and function in the production.’⁵⁹

Elsewhere Gramsci suggested that those who were consenting must somehow be truly convinced that the interests of the dominant group were those of society at large, and that the hegemonic group stood for a proper social order in which all men were justly locked.

‘The fact of hegemony undoubtedly presupposes that account be taken of the interests of the groups over which hegemony is to be exercised and that the leading group make sacrifices of an economic-corporate kind.’⁶⁰

As Robert Cox has explained, Gramsci rejected a narrow or superficial view of the state which reduced it, for instance, to the foreign policy bureaucracy or the state’s military capabilities. Indeed, historically, hegemonies were founded by powerful states which had undergone a thorough social and economic revolution which modified not only the internal economic and political structures of the state in

⁵⁸ Walter Adamson, *Hegemony and Revolution: A Study of Antonio Gramsci’s Political and Cultural Theory*, (University of California Press, Berkeley 1980) p. 174

⁵⁹ Joseph V. Femia, *Gramsci’s Political Thought*, p. 42.

⁶⁰ Joseph V. Femia, *Gramsci’s Political Thought*, p. 42.

question but also unleashed energies which expanded beyond the state's boundaries. World hegemony was thus in its beginning an outward expansion of the internal hegemony established by a dominant social class.⁶¹

To illustrate that point it is essential to focus on a part of *The Prison Notebooks* headed "Americanism and Fordism", where Gramsci explored the technocratic and corporatist tendencies at work in advanced capitalism. In particular, he was concerned with the significance of "Taylorism" as a method used by American capitalists to subordinate workers to machine specialisation and the cult of efficiency.⁶² According to Gramsci, Taylor's ideas formed the basis of "Americanism" or "Fordism", which was defined as the ideology of the advanced sectors of American industry. The chief goals of this ideology were to "rationalise production and create a new type of man suited to the new type of work". America, Gramsci believed, enjoyed a preliminary condition, which facilitated the implementation of Fordism. America had no feudal past, and it was "relatively free of these parasitic residues whose presence has hindered the development

⁶¹ Robert Cox, "Gramsci, Hegemony and International Relations", pp. 58, 61.

⁶² Frederick Winslow Taylor (1856-1915) was the preeminent ideologue of "scientific management", which promoted and justified technical rationality and efficiency. Taylor represented this as involving a reconciliation of employers and workers in a new shop-floor consensus, making possible the realisation of a common interest shared by employer and individual workers. Ultimately, the goal of Taylorism was to create a more efficient worker, greater production, and greater profits. Fordism was the application of Taylorism; it was the way in which greater productivity was to be achieved. For more on Taylorism and Fordism, see Mark Rupert, *Producing Hegemony*, Cambridge University Press, Cambridge 1995) pp. 60-62 & 67-73.

of European industry and commerce".⁶³ What is more important however, was that American capitalism appeared inseparably linked to a different form of organisation of hegemony from the dominant class' standpoint. As Christine Bucki-Glucksmann argued, through a combination of force (destruction of unions) and consent (a policy of high wages, social psychology and methods of adaptation) capitalist rationalisation of production aimed at creating a new type of worker compatible with "Fordised" industry. In this type of industry the factory was not separated from society: Hegemony in the factory was accompanied by an intensified system of ideological and moral constraints outside work.⁶⁴

The political apparatus of mass production had been woven into the fabric of socio-political relations in the United States. This neoliberal constellation of public and private powers in the United States was integral to postwar American global power in both an instrumental and a substantive sense. As Rupert has explained:

'Instrumentally, America's mass-production industries produced vast quantities of goods, which helped to defeat fascism, arrest postwar economic crisis in Europe and contribute to a renewal of growth. Substantively, the quality of social organisations reconstructed in the core of the world economy was shaped by the American productivist ethos, its putatively apolitical consensus on economic growth and the limited generalisation of affluence associated with it. The framework of ideological, political and economic stability necessary for the emergence of a vibrant core of liberal capitalist states-societies was

⁶³ Joseph Femia, *Gramsci's Political Thought*, pp. 29-30.

⁶⁴ Christine Buci-Glucksmann, *Gramsci and the State* pp. 82-84.

made possible by the politics of productivity and the reconstruction of state-society relations in the USA.’⁶⁵

This concept of world hegemony referred to the power of a state to exercise governmental functions over a system of sovereign states. In principle, this power might just involve the ordinary management of such a system as instituted at a given time. However, as Giovanni Arrighi has argued, the government of a system of sovereign states in practice always involved some kind of transformative action that changed the mode of operation of the system in a fundamental way.⁶⁶ This power was something more and different than dominance. It was the power associated with dominance expanded by the exercise of intellectual and moral leadership. As Gramsci, with reference to hegemony at the national level, emphasised:

‘The supremacy of a social group manifests itself in two ways, as domination and as intellectual and moral leadership. A social group can and indeed must, already exercise leadership before winning governmental power; it subsequently becomes dominant when it exercises power, but even if it holds it firmly in its grasp, it must continue to lead as well.’⁶⁷

The work of Antonio Gramsci extended the definition of hegemony to include the relationship between social classes. Thus, his conception of hegemony captured the inter-structuring of cultural,

⁶⁵ Mark Rupert, *Producing Hegemony*, p. 103.

⁶⁶ Giovanni Arrighi, “The Three Hegemonies of Historical Capitalism”, pp. 1148-149.

⁶⁷ Antonio Gramsci, *Selections from the Prison Notebooks of Antonio Gramsci*, pp. 57-58.

economic, political and social forces that coalesce to ensure the domination of the ruling elite. Hegemony functioned as a complex of experiences, relationships and activities that maintained the status quo. Although Gramsci's theory had provided a vehicle for criticising the neorealist assumption that power resides primarily in objective structures, it must be understood that he did not conceive of power exclusively in terms of ideological consensus among the ruling class and the subordinate groups. Gramsci's concept of hegemony also included an important policy dimension that was especially applicable to the analysis of American hegemonic power. Not only must the hegemonic group dominate the ideological terrain, controlling morally and doctrinally the terms of debate. It also must be able to implement policies that simultaneously produce consent even as they serve the long-range interests of the ruling group.⁶⁸

The extension of Gramscian ideas to the study of International Relations and Global Political Economy has involved ambitious studies concerned to define the origins, development and dynamics of the emerging global political economy. Nonetheless, Cox, Ikenberry, Gill and Cafruny, have already elaborated on the internationalisation of the state and civil society, the international aspects of social hegemony and supremacy and the transnational class and bloc formations and other issues which help to define the nature of global politics in the twentieth

⁶⁸ Alan Cafruny, "A Gramscian Concept of Declining Hegemony", pp. 103-105.

century. Gramsci's thinking has suggested the need to pay closer attention to the reciprocal relationship between changes in American political economy and changes in the international economy.

The neo-Gramscian Framework of Robert Cox

Robert Cox was the first to explore the implications of Gramsci's concepts of hegemony for international relations. In contrast to both neorealist and Wallerstein's understandings of international hegemony as a preponderance of material resources which one state might deploy in its attempts to secure the compliance of others, Cox pointed to the social organisation of production as it had operated on a global scale and to the qualitative relations of power and hegemony which existed in such a historical structure.⁶⁹

Cox proposed that historical materialism⁷⁰ was a foremost source of critical theory and it corrected neorealism in four important respects.

⁶⁹ See Robert Cox, "Social Forces, States and World Orders: Beyond International Relations Theory" in *Millenium: Journal of International Studies*, vol. 10 no. 2, 1981, pp. 126-155.

⁷⁰ Marxism's historical materialism prescribed that history inevitably followed certain laws and that individuals had little or no influence on its development. Central to historical materialism was the belief that change take place through the meeting of two opposing forces (thesis and antithesis). Their opposition was resolved by combination produced by a higher force (synthesis). See Stanley Aronowitz, *The Crisis in Historical Materialism: Class, Politics and Culture in Marxist Theory* (University of Minnesota Press, Minnesota 1990). Gramsci's historical materialism did not deny the objectivity of material conditions. However, for Gramsci, effective human action was the consequence neither of pure will nor of inexorable forces, but of

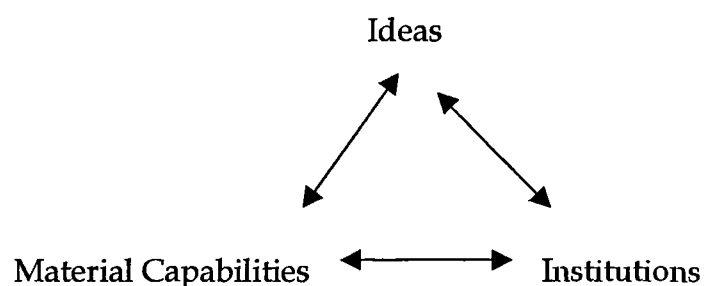
First, both realism and historical materialism had directed attention to conflict. However, neorealism saw conflict as a recurrent consequence of a continuing structure, whereas historical materialism saw conflict as a possible cause of structural change. Second, historical materialism added a new dimension of power to that of rivalry among the most powerful states. This dimension was the dominance and subordination of centre over periphery in a world political economy. Third, historical materialism enlarged the realist perspective through its concern with the relationship between the state and civil society, as defined by Gramsci. Indeed Gramsci had contrasted historical materialism, which recognised the efficacy of ethical and cultural sources of political action (though always relating them to the economic sphere) with what he called historical economism or the reduction of everything to technological and material interests. Fourth, historical materialism focused upon the production process as a critical element in the explanation of the particular historical form taken by a state/society complex. While neorealism implicitly had taken the production process and the power relations inherent in it as a given element of the national interest, historical materialism was sensitive to the dialectical

a particular kind of interaction between objective circumstances and the creative spirit of man. Gramsci's historical materialism also prescribed that the economic base set, in a strict manner, the range of possible outcome, but free political and ideological activity was ultimately decisive in determining which alternative prevailed. See Joseph Femia, *Gramsci's Political Thought*, pp. 120-121.

possibilities of change in the sphere of production which could affect the state and world order.⁷¹

Cox distinguished three categories of forces that interact in a structure, namely material capabilities, ideas and institutions:

FIGURE 1.1 - COX'S THREE CATEGORIES OF FORCES



Material capabilities are productive and destructive potentials. In their dynamic form, these exist as technological and organisational capabilities and in their accumulated forms as natural resources which technology can transform. Ideas are broadly of two kinds. One kind consists of those shared notions of the nature of social relations, which tend to preserve habits and expectations of behaviour. For instance, one of these notions is that people are organised and commanded by states, which have authority over defined territories. Such notions, though durable over long periods of time, are historically confined. The other kind of ideas relevant to a historical structure, are collective images of

⁷¹ For this discussion see Robert Cox, "Social Forces, States and World Orders: Beyond International Relations Theory", pp. 134-137.

social order held by different groups of people. According to Cox, the clash of rival collective images provided evidence of the potential for alternative paths of development and raised questions as to the possible material and institutional basis for the emergence of an alternative structure. Institutionalisation was a means of stabilising and preserving a particular order. Indeed, institutions reflected the power relations prevailing at their point of origin and tended to encourage collective images consistent with these power relations. However, eventually institutions took on their own life. They could become a battleground of opposing tendencies, or rival institutions could reflect different tendencies. As Cox pointed out, institutions were particular amalgams of ideas and material power which in turn influenced the development of ideas and material capabilities.⁷²

Cox particularly emphasised the role of international organisation as a mechanism through which the universal norms of world hegemony were expressed. Cox also explained that international organisation functioned as the process through which the institutions of hegemony and its ideology are developed. International organisation was the product of the hegemonic world order and it ideologically legitimated the norms of the world order. In other words, international institutions and rules were generally initiated by the state which

⁷² Robert Cox, "Social Forces, States and World Orders: Beyond International Relations Theory", pp. 139-143.

established the hegemony. The dominant state secured the acquiescence of other states, according to a hierarchy of powers within the interstate structure of hegemony. There was an informal structure of influence reflecting the different levels of real political and economic power, which underlay the formal procedures for decisions. International institutions reflected orientations favourable to the dominant social and economic forces. The Organisation for Economic Cooperation and Development (OECD), for example, in recommending monetarism, endorsed a dominant consensus of policy thinking in the core countries and strengthened those who were determined to combat inflation this way against others that were less concerned about inflation. International institutions were actually connected with the national hegemonic classes in the core countries and through the intermediary of these classes, had a broader base in these countries.⁷³

G. John Ikenberry and Charles Kupchan subsequently broadened this point to argue that the United States articulated and sought to proliferate throughout Europe a set of normative principles based on the notion of liberal multilateralism. The attempt by the United States to construct a postwar hegemonic system was based as much on international acceptance of a particular set of norms and principles as

⁷³ Robert Cox, "Gramsci, Hegemony and International Relations: An Essay in Method", pp. 162-175.

on the then preponderant US material capabilities. Moreover, in its attempt to legitimate its power:

'The United States was largely successful in inducing other nations to buy into this normative order. In building postwar order, the United States did exercise power through coercion and inducements. But it also articulated norms of international order that, in combination with the provision of material resources, came to be embraced by domestic elites in various countries.'⁷⁴

In applying the concept of hegemony to world order, it became important to determine when a period of hegemony begins and when it ends. To illustrate, Cox considered the past century and a half as falling into four distinguishable periods, namely, 1845-1875, 1875-1945, 1945-1965, and 1965 to the present. The first period (1845-75) was hegemonic because there was a world economy with Britain at its centre. Economic doctrines consistent with British supremacy but universal in form - comparative advantage, free trade and the gold standard - spread gradually outward from Britain. At the same time, Britain held the balance of power in Europe, thereby, preventing any challenge to hegemony from a land-based power. Britain ruled supreme at sea and had the capacity to enforce obedience by peripheral countries to the rules of the market. In the second period (1875-1945) all these features were reversed. Other countries challenged British supremacy. The

⁷⁴ G. John Ikenberry and Charles A. Kupchan, "The Legitimation of Hegemonic Power" in D. Rapkin, ed. *World Leadership and Hegemony* (Lynne Rienner Publishers, London 1991) pp. 59-61.

balance of power in Europe became destabilised, leading to two world wars. Free trade was superseded by protectionism, the Gold standard was abandoned and the world economy fragmented into economic blocs. Cox labelled this period as non-hegemonic. In the third period, following World War II (1945-65), the United States founded a new hegemonic world order with institutions and doctrines adjusted to a more complex world economy and according to Cox, to national societies more sensitive to the political effects of economic crises. Purposive American intervention solidified the basis of centrist, liberal capitalist regimes in the occupied and liberated countries of the West, excluding both communist and fascist alternatives to the neo-liberal state and clearing the way for a moderate consensual politics of growth.⁷⁵ It was in these terms that the American global hegemony of the postwar era was expressed. However, from the later 1960s through to the early 1970s it became evident that this US-based world order was no longer working well. During the uncertain times which followed,

'Three possibilities of structural transformation of world order opened up: a reconstruction of hegemony with a broadening of political management on the lines envisaged by the Trilateral Commission; increased fragmentation of the world economy around big-power-centred economic spheres; and the possible assertion of a Third-World-based counter-hegemony with the concerted demand for a New International Economic Order as a forerunner.'⁷⁶

⁷⁵ Mark Rupert, *Producing Hegemony*, p. 43.

⁷⁶ Robert W. Cox, "Gramsci, Hegemony and International Relations", pp. 168-170.

On the basis of this conditional situation, it would appear that, historically, to become hegemonic, a state would have to found and protect a world order that was universal in conception, which most other states could find compatible with their interests. Historically, hegemonies of this kind had been founded by powerful states which had undergone a thorough social and economic revolution which not only modified the internal economic and political structures of the state in question but unleashed energies which expanded beyond the state's boundaries. Thus, Cox argued that world hegemony was in its beginning an outward expansion of the internal hegemony established by a dominant social class. For Cox, hegemony at the international level was not merely an order among states. It was an order within a world economy with a dominant mode of production, which penetrated into all countries and linked into other subordinate modes of production. It was also a complex of international social relationships, which connected the social classes of the different countries. World hegemony was describable as a social structure, an economic structure and a political structure. Furthermore, hegemony was expressed in universal norms, institutions and mechanisms which laid down general rules of behaviour for states and for those forces of civil society that acted across national boundaries – rules that supported the dominant mode of production.⁷⁷

⁷⁷ Robert Cox, "Gramsci, Hegemony and International Relations", pp. 171-172.

Cox was using the term hegemony as meaning more than the dominance of a single world power. It meant dominance of a particular kind where:

'The dominant state creates an order based ideologically on a broad measure of consent, functioning according to general principles that in fact ensure the continuing supremacy of the leading state or states and leading social classes but at the same time offer some measure of prospect of satisfaction to the less powerful.' ⁷⁸

From a similar point of view, the transnational dimension of American hegemony was underlined by Giovanni Arrighi:

'The contemporaneous development of international organisations and transnational corporations has created an extensive and dense network of pecuniary and non-pecuniary exchanges which no single state can control unilaterally and more importantly, from which no state can de-link except at exorbitant cost.' ⁷⁹

This network included the United Nations, with its General Assembly, the Security Council and specialised agencies, the IMF and the World Bank, the GATT and the US-centred multinational corporations.

This organisational scope and its complexity has been a major factor in enhancing the autonomy of the institutions of US hegemony from each and every member of the inter-state, including the hegemonic state itself. In addition, and more decisively, transnational corporations have developed into an integrated system of production,

⁷⁸ Robert Cox, *Production, Power and World Order*, p. 7.

⁷⁹ Giovanni Arrighi, "The Three Hegemonies of Historical Capitalism" p. 182.

exchange and accumulation which is subject to no state authority and has the power to subject to its "laws" each and every member of the interstate system. For Arrighi, the emergence of this "Free Enterprise System" has been the most distinctive result of US hegemony as well as its ultimate limit. It marks the withering away of the interstate system as the primary locus of world power.⁸⁰ For Strange, the American Empire was spilling out beyond frontiers whose insubstantial nature, where production was concerned, just showed the consolidation of an entirely new kind of non-territorial empire. That non-territorial empire was really the "flourishing economic base" of American power.⁸¹

The approaches of Strange and Arrighi were supplementary to Cox's conclusion that world orders were grounded in social relations and that a significant change in world order was likely to be traceable to some fundamental change in social relations and in the national political order. In Gramsci's thinking this would arise with the emergence of a new historic bloc within national boundaries. The greater richness of such a perspective could be demonstrated by comparing the Coxian or neo-Gramscian account of hegemony with that offered by neo-realist and neo-liberal approaches. The novelty of the neo-Gramscian perspective existed in the attention it gave to the

⁸⁰ Giovanni Arrighi, "The Three Hegemonies of Capitalism", p. 183.

⁸¹ Susan Strange, "The Future of the American Power", *Journal of International Affairs*, vol. 42, no. 2, 1988, pp. 6, & 7.

role of ideology and domestic elites in establishing and maintaining a hegemonic world order.

Other Neo-Gramscian Approaches

From a neo-Gramscian perspective, Stephen Gill and David Law have argued that rise and fall of hegemons has been seen by realists and world systems theorists in terms of a cyclical view of history, in which the dynamism and power resources of a country propel it to hegemony. Hegemony has been seen as a temporary and increasingly short-term condition in the world system.⁸² Stephen Gill and David Law have argued that the interpretation of the implications of changes in the distribution of material power resources is far more complex. In an era of transnational capitalism it was inaccurate to limit the conception of hegemony by defining it simply in terms of the power of one state relative to other states. Furthermore the neorealist approach tended to underestimate the mobilising role of certain aspects of the United States' political culture. According to Gill and Law, this was perhaps linked to the assumptions held by realists that states acted coherently as units, and that states were the only important units in international

⁸² Stephen Gill and David Law, *The Global Political Economy: Perspectives, Problems and Policies* (Harvester Wheatsheaf, New York 1988) p. 336.

relations. Indeed, the state-centric assumptions of realists (like Gilpin and Krasner) and some Marxists (like Wallerstein) could lead to a neglect of the prospect of changes in identification and interest in ways that might effectively augment the power resources of the hegemon, sustain cooperation and mitigate conflicts. Gill has asserted that:

‘Such assumptions lead to an underestimation of the importance not only of American civilisational models and the pro-capitalist and liberal democratic values associated with Americanism, but also to a systematic misunderstanding of the role of liberal economic ideas and associated international institutions in the development of American hegemony.’⁸³

Using a Gramscian approach, Gill and Law argued that a “transnational” hegemony had emerged in which a transnational capital class predominated, leading a hegemonic bloc of mainly transnational capital and incorporated labour. Gill and Law suggested that at the geographical centre of such a potential “transnational” hegemony would be a group of capitalist countries, lead by the United States. The centrality of the United States and the regimes it had created could be seen as facilitating a transnational historic bloc, in which the leadership of the more dynamic transnational corporations was associated with the growing mobility of capital, the revival and spread of market forces and the ideological hegemony of associated liberal frameworks of thought. Thus, it was argued that America’s decline in

⁸³ Stephen Gill, *American Hegemony and the Trilateral Commission*, p. 75.

the global political economy and its effects had been exaggerated. The more crucial issue was the change in the relationship between the American and the world political economy. What had been developing in the 1970s and 1980s was a shift away from an international economic order of economically sovereign states and national political economies, linked together primarily by trade flows, towards a transnational liberal economic order. As American hegemony became more transnational in character it would become less "all-American".⁸⁴

However, according to Atilio Boron, ideological predominance, institutional ingenuity and ceaseless political manoeuvring would not be enough. Hegemony would not be viable without an overwhelming superiority in the military arena because the ability to obtain obedience in the international system largely exceeded the coercive capacities of the superpower. A state whose hegemonic claims were far superior to its real economic and military capacities would suffer a defeat, prompting the reorganisation of the international system. Furthermore, no nation could hope to be the hegemon of the international system without simultaneously being an economic power able to control the critical aspects of the world economy.⁸⁵ In the case of the United States, Boron argued that no country in the foreseeable future could enjoy the

⁸⁴ Stephen Gill, *American Hegemony and the Trilateral Commission*, p. 88; Stephen Gill & David Law, *The Global Political Economy*, pp. 345, 347 & 355-358.

⁸⁵ Atilio Boron, "Towards a Post-Hegemonic Age? The End of Pax Americana", *Security Dialogue* Vol. 25, no. 2, 1994, pp.213-216.

simultaneous overwhelming superiority in the economic, financial, technological, political and military domains that the United States had enjoyed in the past.

The institutional foundations of American leadership were still in place and the widespread worry about the end of American leadership was partly a result of a misunderstanding of what leadership was and the changing conditions in which it must operate.

According to Ikenberry:

'If leadership means the ability to foster cooperation and commonality of social purpose among states, American leadership and its institutional creations will long outlast the decline of its postwar position of economic dominance; and it will outlast the foreign policy stumbling of particular administrations.'⁸⁶

In Ikenberry's argument, leadership was not simply the exercise of power. It had two essential elements - power and purpose. It involved the ability to project a set of common goals or principles that allowed a group of states to define and pursue their interests in concerted or congenial ways. Military power and coercion were overrated forms of leadership assets. It was not in a hegemonic leader's interest to preside over a global order that required constant use of material capabilities to get other states to acquiesce. Legitimacy existed when political order was based on reciprocal consent, and when secondary states bought

⁸⁶ G. John Ikenberry, "The Future of International Leadership", *Political Science Quarterly*, Vol. 111 No. 3, 1996, p. 386.

into rules and norms of the political order as a matter of principle and not simply because they were forced into it. Ikenberry also emphasised another aspect of hegemonic leadership - leadership by example. States were particularly willing to follow a state if that state was successful, that is, if it had developed a particularly appealing and prosperous domestic political order. The appeal of America's booming postwar economy and consumer society was world-wide and this appeal certainly reinforced the hegemonic position of the United States. In recent years major failings within the American society and economy undermined the leadership claims of the United States. However, despite these problems and although much of the material power of American hegemony had eroded, the institutions of reciprocal and legitimate joint governance remained. Ikenberry argued that this system might well remain relatively stable for a very long time⁸⁷

As Bruce Russett argued, there had been a major gain to the United States from the *Pax Americana*, which proved of great significance in the short as well as in the long term: the pervasive cultural influence of the United States. Altogether, the near-global acceptance of so many aspects of American culture - consumption, democracy, language - very quickly laid the basis for what neo-

⁸⁷ G. John Ikenberry, "The Future of International Leadership", pp. 396-399 & 402..

Gramscians called cultural hegemony.⁸⁸ In the longer term it had shaped people's desires and perceptions of alternatives, so that their preferences in international politics and economics were concordant with those of Americans. Pervasive American cultural influence was part of a structural transformation of the international system. Furthermore, the spread of American culture (democratic, capitalist, mass-consumption, anti-Communist) had laid the basis for innumerable American economic and political gains. Thus, cultural hegemony, according to Russett, had provided a long-term influence that persisted. It was among the primary reasons why a decline in dominance over material power had not been reflected in an equivalent loss of control over outcomes.⁸⁹

In his contribution to the debate, Alan Cafruny attempted to apply Gramsci's three levels of hegemony to the case of the United States after the War. These three periodisations could describe trends and forces that overlapped, and could provide a theoretically and empirically useful way of understanding the era of American hegemony. According to Cafruny, a phase of integral hegemony existed from the end of World War II to the London gold crisis of 1960 which revealed the fragility of the dollar and signified the loss of American

⁸⁸ Bruce Russett, "The Mysterious Case of Vanishing Hegemony or, Is Mark Twain Really Dead?", *International Organization*, 39, no. 2, 1985, pp. 228, 229.

⁸⁹ Bruce Russett, "The Mysterious Case of Vanishing Hegemony or, Is Mark Twain Really Dead?", p. 230.

power. Declining hegemony lasted until 1971, when the American decision to abandon the dollar-gold standard indicated that nationalistic and disintegrative tendencies had become irresistible for the United States as well as other countries. From 1971 the international political economy could be characterised as minimally hegemonic. At this point, Cafruny argued that the widespread acceptance of neoliberal ideas throughout the world represented a successful Gramscian strategy on the part of the United States. Rule by consensus rather than coercion might be said to demonstrate the continuity of American hegemony. The concept of minimal hegemony suggested that despite its relative decline, the United States continued to set the agenda for global change.⁹⁰

In conclusion neorealist, neoliberalist and neo-Gramscian conceptions of hegemony differ substantially as to the relative importance of material and non-material basis of power. Neorealists focus on material capabilities, neoliberals on market forces and neo-Gramscians on ideas. Seen from a contemporary context however, there is the need for a fresh perspective on hegemony during the 1990s. There are elements in existing approaches that are useful for our understanding of hegemony but these elements have not been applied and tested through the conditions of the 1990s and especially the two

⁹⁰ Alan Cafruny, "A Gramscian Concept of Declining Hegemony: Stages of US Power and the Evolution of International Economic Relations", pp.114-118.

major financial crises of the last decade, the peso crisis (1994-95) and the South Korean crisis (1997-98). This thesis considers hegemonic stability theory as a starting point for understanding basic concepts of hegemony and power but insufficient for a more complex and deeper explanation of hegemonic power. Gilpin with his recognition of the role of TNCs and Krasner with his explanation of an ideological foreign policy broadened the concept of hegemony. Keohane from a neoliberal perspective placed emphasis upon the role of international institutions and cooperation in the system. This thesis considers the approach of Susan Strange instrumental in explaining the continuity of American hegemony through her concept of structural power and, together with Joseph Nye's emphasis on soft power, has laid the foundations for a different approach to the changing basis of hegemony. However these analyses still ignored the role of domestic elites in establishing and maintaining a hegemonic world order. Robert Cox from a neo-Gramscian perspective filled this gap with his analysis, of the role of domestic elites and the interaction between ideas, material capabilities and institutions. What was missing from Cox's analysis however, was the role of transnational mobile capital. Gill and Law also from a neo-Gramscian point of view addressed this issue by linking the mobility of capital to the ideological hegemony of market forces.

The perspectives mentioned above offer significant insights to the concept of hegemony and more specifically to the issue of American

hegemony. Seen from a contemporary context however, while these approaches analyse important aspects of hegemony none of these is sufficient in order to explain the changing nature of American hegemony in the deregulatory financial environment of the 1990s. What is missing is a new perspective in order to explain American hegemony in the 1990s by analysing the American responses to the two major financial crises of the 1990s: the peso crisis (1994-95) and the South Korean crisis (1997-98). This thesis attempts to fill this gap by introducing in Chapter Two an explanatory framework for the changing basis of American hegemony, which will be tested through the case studies of the peso and South Korean crises.

CHAPTER TWO

THEORISING THE CHANGING BASIS OF AMERICAN HEGEMONY

This chapter introduces a theoretical framework in order to explain the changing basis of American hegemony during the 1990s. This thesis does not totally reject neorealist, neoliberal and neo-Gramscian approaches. To do so it would not be constructive. On the contrary there are elements in previous approaches that provide us with significant notions about the issue of hegemony and world order. However, in the deregulatory financial environment and the globalised economy of the 1990s none of these explanations is adequate to grasp the changes that have occurred in the nature and exercise of American hegemony. The global economy today is more complex and diversified than in the 1960s, the 1970s and the 1980s. No framework that attempts to explain American hegemony in the 1990s can be accurate without

taking into account financial crises which are directly associated with the increased mobility of capital and the globalisation of finance. This thesis attempts to fill this gap in our understanding of the changing basis of American hegemony by constructing an appropriate framework, first, by identifying a set of variables that redefine American hegemony and, second, and most importantly, by applying and testing this framework through an analysis of the response of the United States to the two major financial crises of the 1990s: the peso crisis and the South Korean crisis.

The resulting conceptualisation of American hegemony is based on a set of five variables that are not independent but closely connected to each other. Each variable should be viewed in relation to the others, thus this framework can only be applied as whole. The five variables are:

- a) financial globalisation
- b) the transnational mobility of capital;
- c) the role of international institutions;
- d) ideas that are mediated through domestic elites and
- e) the limited instability of the system.

These five interdependent variables facilitated and continue to facilitate the entrenchment of what is known as the "Washington Consensus"

which was constructed during the 1980s and represents the free market orthodoxy of deregulation, privatisation and financial liberalisation.¹ The Washington Consensus has its origins in neoliberalism, which has achieved a certain degree of hegemony in global society. The Washington Consensus is reflected in governments' economic and trade policies, and the respective roles played by the private sector and international financial institutions such as the IMF and the World Bank in the governance of the global economy.

The five variables of the framework have not appeared suddenly in the 1990s. Their origins are traced back over a period of twenty years from the collapse of Bretton Woods (1971) to the Reagan years (1981-1989). However, while elements of this framework have been analysed in the literature before, such a framework with this specific set of variables has never been applied and tested through both the peso and South Korean crises of the 1990s. While this short chapter only introduces the main elements of this framework, Chapter Three provides an analysis of the Washington Consensus along with events during the 1970s and the 1980s when the five variables were slowly taking shape.

¹ A detailed analysis of the Washington Consensus is provided in Chapter Three, from p. 103.

First Variable: Globalisation of Finance

The first variable is the globalisation of finance which is rooted in a series of decisions taken by the United States over the last 30 years which dismantled the post-war international monetary system, liberalised world markets and granted the financial sector a great degree of autonomy and power. It is the financial sector which sets the pace and imposes normative behaviour. The United States began by abandoning the system of fixed exchange rates established by the Bretton Woods Agreements in 1944 and introducing a system of generalised floating exchange rates. There was a strong economic motive for the decision which American authorities took unilaterally in 1973. They were seeking to compensate for declining competitiveness and a growing national debt by exporting the country's macroeconomic imbalances. The floating exchange rate system provided a flexible and efficient monetary tool that enabled American Administrations to avoid paying for its indebtedness with a relative loss of sovereignty and highly unpopular domestic austerity measures. Furthermore, America's allies could not question American policies without destabilising the cold-war security system from which they derived undoubted benefits.

The deregulation of American financial industry has paved the way for its globalisation via the Wall Street stock exchange and banks. In the United States financial sector deregulation was the most rapid

and far reaching. It was also a world leader in implementing new finance techniques and instruments. During the same period of time international financial markets were thoroughly restructured. This restructuring was closely connected with reforms implemented on national financial markets. Worldwide liberalisation in the 1980s and 1990s gave American financial industry access to the savings of the newly industrialised and emerging countries where rates of return were high. The consequence this globalisation process was that governments, must increasingly measure their performance according to criteria acceptable to the financial markets, such as they must be either sound in order to retain the confidence of the transnational financial community.

This thesis argues that financial globalisation has aided the United States in preserving its influence in the world economy. While during the 1980s analysts such as Chalmers Johnson², were suggesting the superiority of the Asian model of capitalism and raised questions about the validity of the Anglo-American model of capitalism, developments during the 1990s reversed these assumptions. This thesis will demonstrate that the performance of American economy during the 1990s and the major financial crisis in Asia enhanced the hegemony of the market model along the lines of the Washington Consensus and

² See Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy 1925-1975* (Stanford University Press, Stanford 1982).

as a result reduced the policy autonomy of the state. States and state actors, for reasons of domestic economic and political objectives, have sought to convince or pressure other states and transnational actors such as transnational corporations and international institutions to adopt measures, which have shifted the balance of competitive advantage in their favour.³ This thesis however, argues that the role of the state is not irrelevant in the current globalised economy. This is very well demonstrated by the US Treasury's intervention in 1995 after the collapse of the Mexican peso and also by the crucial role that the United States played during the Asian crisis (1997-98) by preventing the collapse of the international banking system and ensuring that liberalisation would continue. American-led IMF assistance has represented an essentially state-driven response to recent financial crises and also the high degree of influence that the United States has over the conditionalities imposed on countries that accept financial assistance from the IMF. Furthermore, as Ewan Anderson, Ivars Gutmanis and Liam Anderson have argued, during the 1990s American Administrations have become significantly more interventionist in support of American business interests both in terms of providing a competitive home base for American firms to operate from and in terms of directly promoting the interests of American firms in global

³ Philip Cerny, "Structuring the Political Arena: Public Goods, States and Governance in a Globalising World", in Ronen Palan, ed *Global Political Economy: Contemporary Theories*, (Routledge, New York 2000) p. 33.

markets.⁴ This will also be demonstrated in Chapters Five and Seven by the response of the United States to the peso and South Korean crises.

Second Variable: Capital Mobility

The second variable is the transnational mobility of capital which has been the key to the process of financial globalisation. Within the globalised economy individual nations are increasingly dependent not only on trade but also on flows of capital from outside. These are seen as necessary to achieve economic growth, gain access to new technologies and maximise employment. The increased demand for foreign investment has also been associated with processes of deregulation of capital transfers and with opportunities created by the privatisation of former public monopolies in sectors such as power supply and telecommunications.⁵ The mobility of capital means that firms which were previously limited to national markets and resources can now raise money anywhere in the world and site production wherever is more profitable. This generates incentives for countries to lighten tax and other regulations faced by transnational firms within

⁴ Ewan Anderson, Ivars Gutmanis and Liam Anderson, *Economic Power in a Changing International System* (Casell, New York 2000) p. 169.

⁵ Robert Holton, *Globalisation and the Nation-State*, Macmillan Press, London 1998, p. 53.

their borders. Investment decisions are becoming increasingly sensitive to such factors as wage rates, and regulatory and tax policies but also the economic potential of the region involved. The globalisation of finance connotes a number of changes in the world's capital markets. These changes include the liberalisation of long-standing regulatory restrictions on financial intermediaries, the introduction of new technologies that speed up capital flows and stimulate the development of innovative financial products. These developments render capital potentially more mobile, both within and across national frontiers. The globalisation of finance places countries and regions in competition with each other for capital. The result of this phenomenon, as Robert Palan and Jason Abbott, pointed out was that a certain discipline has been imposed upon states by the market.⁶ Any significant change in economic policy has to be conducted with consideration of the international money market. States which do not subject their monetary and financial policies to such orthodoxy are likely to experience a sudden shortage of capital. The huge increase in short-term private capital flows leaves developing nations extremely vulnerable to rapid capital flight (i.e. Mexico in 1994-95 and East Asia in 1997-98). In the emerging markets of Asia, for example, capital was flowing at the rate

⁶ Ronen Palan and Jason Abbott, *State Strategies in the Global Political Economy* (Pinter, London 1999) p. 138.

of about \$100 billion a year in 1996. By the second half of 1997 it was flowing out at about the same rate.⁷

It should be noted here that open financial markets are not new in global economy. Conditions similar to today's globalisation of finance existed before 1914 among the most advanced economies and their dependencies. The system, which dated back to the 1870s, rested on a rough consensus among the principal trading nations. At the centre of that consensus was a version of the gold standard, backed by the wealth and power of Great Britain. Following World War I (1914-1918) and the Great Depression of the 1930s a new intergovernmental consensus on monetary issues was built at Bretton Woods in 1944. At the centre of that arrangement was exchange rate stability and limited capital mobility. However, the policies of the United States during the 1970s (especially the abolition in 1974 of remaining domestic controls on capital) and the 1980s under the Reagan Administration reflected a long-term transformation in American strategy toward an informal market-based system of control, which has also been expressed in the financial orthodoxy of the Washington Consensus. Although the liberalisation of financial movements can be traced back to the 1960s with the creation of the Eurodollar market, it was during the 1970s and 1980s that American policy-makers assumed that an open, liberal order

⁷ See Sarah Anderson, "International Financial Flows", *Foreign Policy in Focus*, vol. 3, no. 41, 1998 (Foreign Policy in Focus Website, <http://www.foreignpolicy-infocus.org>).

would preserve America's hegemonic position in global finance. Indeed the United States has a powerful interest in maintaining and expanding the free worldwide movement of capital. Capital liberalisation has replaced trade liberalisation at the top of American foreign policy agenda. As Robert Wade argued, the United States, in order to maintain its high levels of consumption and investment, needed access to the world's savings which is much easier to do if world financial markets are highly integrated.⁸ As demonstrated in Chapter Three, the economic policies of the Reagan Administration had the effect of facilitating the interpenetration of capital, the liberalisation of markets and deepening the interdependence between American and other states' macroeconomic policy conditions. As Stephen Gill argued, the economic policies of the 1980s advocated a more liberal world market where the largest and most mobile forms of capital would tend to become stronger.⁹

Transnational mobility of capital as a key element of globalisation has affected the broader economic and political conditions which prevail in every country and as a consequence, has redefined hegemony. The worldwide free market based on transnational mobility of capital, is strengthening the American model of capitalism, which

⁸ Robert Wade, "The Coming Fight Over Capital Flows", *Foreign Affairs*, vol.78, no. 2, 1999, p. 45.

⁹ Stephen Gill, *American Hegemony and the Trilateral Commission* (Cambridge University Press, New York 1990) p. 107.

relies on its strong comparative advantages in the post-industrial sectors of financial and cultural services, communications and leading-edge technologies. It is the United States which is laying down the dominant economic norms (profitability and shareholder value) and the regulatory criteria (ratings of companies and states). For instance, the behaviour of markets is shaped by the ratings awarded by two major American private rating agencies, Moody's and Standard & Poor.¹⁰ Thus, on the basis of the leadership role played by the United States in the emergence of the present transnational configuration American hegemony has not declined but has been redefined during the 1990s. This thesis will demonstrate through the case studies of peso and South Korean crises that in this deregulatory financial environment the Washington Consensus has both shaped the governance of the global economy, and by fostering conditions of domestic financial instability, created a scenario to enable American hegemony to become further entrenched in the post-crisis international economy.

¹⁰ Noelle Burgi and Philips Golub, "The States We Are Still In", *Le Monde Diplomatique*, April 2000.

Third Variable: International Institutions

While the mobility of capital is a key element for globalisation, international institutions – the third variable of the framework – are instrumental for global governance. This conceptual framework accepts the neoliberal argument that international institutions are mechanisms created by states in order to assure continuity in their relations and reduce uncertainty about the reliability of other states.¹¹ In that sense, international institutions reflect the relations of forces that exist in the global economy. Although institutions such as the International Monetary Fund (IMF), and the World Bank, have been in existence throughout most of the Cold War period, their functions have been revised and their missions broadened in order to institutionalise free market orthodoxy in public policy. From the 1980s, the IMF and the World Bank have actively promoted free market orthodoxy, the Anglo-American model of capitalism as represented by the Washington Consensus. This has been evident in the conditionalities attached to IMF and World Bank loans to troubled economies during the 1980s and the 1990s. More specifically, the IMF was founded in 1945 to help operate a system of fixed exchange rates, in which all currencies were pegged to the dollar, in turn fixed with respect to gold. When the fixed

¹¹ See Robert Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton University Press, Princeton 1984).

rate system collapsed completely in 1970, the IMF found a new and important role. During the 1980s, changes in economic conditions led Mexico and other Latin American countries to announce they could not meet the interest and principal payments on their large borrowings from overseas commercial banks. As analysed in Chapter Four, default on those obligations would have wiped out the capital of many leading banks in the United States. To meet their interest obligations and reduce their outstanding debt, Latin American countries had to earn more foreign exchange. Latin American governments raised taxes, and cut government spending. The IMF monitored these adjustments and provided moderate amounts of credit to indicate that it was satisfied with the policy progress that these economies were making. The next major chapter in the IMF's history, according to Martin Feldstein, began with the collapse of the Soviet Union and other communist regimes in Eastern Europe (1989-1991). These countries were shifting from communism to a market economy. The IMF provided advice on a wider range of economic issues than it had done in Latin America. Much of IMF's advice was controversial, but the IMF was able to promote its structural adjustment programmes because it brought substantial financial rewards to countries that accepted its advice.¹²

¹² Martin Feldstein, "Refocusing the IMF", *Foreign Affairs*, vol.77, no.2, 1998, pp. 21-22.

During the peso crisis of 1994-95, the necessity for quick action prompted the IMF to short-circuit the usual procedures for board review of new stand-by arrangements. This was necessary after the failure of the Clinton Administration to gain approval for a \$40 billion package of loan guarantees to Mexico. The administration withdrew its request and together with the US Treasury and the IMF composed a package that did not need congressional authorisation. In this package \$18 billion came from the IMF. The rescue package, as analysed in Chapter Five, implied significant exceptions from normal IMF practice. The Fund's contribution turned out to be seven times larger than Mexico's normal limit, an amount that represented almost 20 per cent of the Fund's total liquid resources. In the case of South Korea, which is discussed in Chapter Seven, after the crisis of 1997-98, the IMF organised a \$57 billion package of loans with the participation of the World Bank and the American and Japanese governments. In exchange for those funds the IMF demanded structural changes in South Korean economy along with reduced spending and higher interest rates. This thesis argues that the influence of the United States over macroeconomic and social policy in countries that have accepted IMF and World Bank loans has been substantially increased. The entire direction of the American-led IMF assistance packages to Mexico and South Korea has principally aimed at promoting neoliberal reform and

greater openness to foreign direct investment along the lines of the Washington Consensus.

Fourth Variable: Ideas and Domestic Elites

The fourth variable of this framework refers to the ideas that are accepted and mediated through the domestic elites. As Robert Cox has argued there is a transnational process of consensus formation among policy-makers in both developed and developing countries. This process has generated consensual guidelines, underpinned by globalisation and the ideology of free-market orthodoxy, which have been transmitted into the policy-making of national governments and big corporations. Transnational class formation is a key aspect of the globalisation process. Globalisation redefines the relationship between production and territoriality, between nation-states, economic institutions and social structures. Class formation is less tied to territory and the political jurisdiction of nation-states. As national productive and financial structures become transnationally integrated, world classes whose organic development took place through the nation-state are supranational integration with national classes of other countries.

According to William Robinson and Jerry Harris, transnational fractions of local elites swept to power in countries around the world in

the 1980s and 1990s. They have captured key ministries and bureaucracies in the policymaking apparatus, especially Central Banks, finance and foreign ministries, as key government branches which link countries to global economy. They have utilised national state apparatuses to advance globalisation and to pursue economic restructuring and the dismantling of the old nation-state based Keynesian welfare.¹³ These transnational elites have sought worldwide market liberalisation, projects of economic integration such as the NAFTA, the APEC and the European Union and they promoted a supranational infrastructure of the global economy such as the WTO. The increasingly organised global elite articulated a coherent programme of global economic and political restructuring centred around market liberalisation or what is called the Washington Consensus. It pushed for greater uniformity and standardisation in the codes and rules of the global market. At the Cancun Summit in Mexico in 1982, the developed nation-states, led by the United States, launched global neoliberalism and began imposing structural adjustment programmes on the Third World and other developing countries. Developing countries have been offered the Washington Consensus by the IMF and the United States as a fait accompli, the only option in

¹³ See William Robinson and Jerry Harris, "Transnational Capitalist Class" *Journal of Science and Society*, vol. 64, no. 1, Spring 2000, pp. 11-54. See also James Rosenau, *Along the Domestic-Foreign Frontier: Exploring Governance in a Turbulent World* (Cambridge University Press, Cambridge 1997).

economic theory and political practice. These elites that have followed the IMF's direction have been offered some tangible rewards. For example, budget cuts have had less impact on the upper and middle class than the poorest in society. Furthermore, domestic elites by accepting the free market orthodoxy and applying it in their own countries have profited from the resulting cuts in state spending, since these have provided them with business opportunities to expand the role of the domestic private sector. Indeed, as William Robinson has argued, political and economic power has tended to gravitate towards new groups linked to the global economy, either directly or through reorganised local state apparatuses which have functioned as "transmission belts" for transnational interests.¹⁴

This thesis argues that, during their respective financial crises, the role of domestic elites in Mexico and in South Korea (though in different degree) was important in the acceptance and application of IMF conditionalities and the consequent entrenchment of the Washington Consensus in these countries. The role of domestic policy-makers and business was also important not only after the financial crises but also before these crises occurred in opening their economies to foreign investment and trade during the 1980s and early 1990s and thereby fermenting the causes of the crises. However, the two major

¹⁴ William Robinson, *Promoting Polyarchy: Globalisation, US Intervention and Hegemony*, (Cambridge University Press, Cambridge 1996) p. 33.

financial crises of the 1990s, have actually strengthened the consensus around the neoliberal project, which represented a congruence of interests among the dominant groups on the global system. This thesis will demonstrate that despite the debate on the IMF conditionalities and market liberalisation trend that was sparked by the financial crises of the 1990s, the Washington Consensus has achieved ideological hegemony by setting the parameters for and the limits to the debate on options and alternative projects.

Fifth Variable: Instability of the System

The fifth and last variable is the limited instability of the international financial system which has become evident during the 1990s with financial crises such as those of Mexico (1994-95) and East Asia (1997-98) but also Russia (1998). This is a very important factor in this framework since it is directly linked to the globalisation of finance and the mobility of capital. According to Jason Furman and Joseph Stiglitz, financial liberalisation increases the vulnerability of national economies to crises. Financial liberalisation leaves economies with fewer tools to cope with the strains imposed by the surge of capital

inflows in the 1990s.¹⁵ It is very difficult for individual states to remain immune from the effects of global economic forces, in that a shock to any part of the system has the potential to affect the system as a whole. Greater capital mobility causes investment decisions to be dependent on markets rather than public institutions. In contrast to the stable economic order of Bretton Woods, financial liberalism was favoured in early 1970s, on the grounds that it would promote a more efficient global allocation of capital and would prevent the state to interfere with the freedom of individuals to move their money across border. As Eric Helleiner has argued, the neo-liberal bloc involved private financial interests and conservative financial officials and multinational industrial interests whose frustration with capital controls grew as their operations became increasingly global in the 1960s and the 1970s.¹⁶

Greater capital mobility has also increased the vulnerability of national economies to sudden capital movements. Financial crises such as those of Mexico 1994-95 and the Asian crisis of 1997-98 are testaments to the inherent instability of liberalised international capital markets where sudden reversals of market confidence cause periodic panics of different magnitude and duration. Also, it is interesting that

¹⁵ Jason Furman and Joseph Stiglitz, "Economic Crises: Evidence and Insights from East Asia", *Brookings Papers on Economic Activity*, vol. 2, Washington DC 1998, pp. 17-18.

¹⁶ Eric Helleiner, "From Bretton Woods to Global Finance", in R. Stubbs and G Underhill, (eds.) *Political Economy and the Changing Global Order* (Macmillan Press, London 1994) pp. 166-167.

both the Mexican and South Korean crises occurred immediately after these countries joined the OECD and began to conform to the code of capital liberalisation of the organisation. Indeed after the substantial capital liberalisation of five Asian countries – South Korea, Indonesia, Malaysia, Thailand and Philippines – after 1993, approximately \$220 billion dollars in private capital flowed into the region during the three-year period from 1994-1996. The reversal of flows in 1997 due to the sudden shift in confidence amounted to roughly \$100 billion.¹⁷ It is very difficult for a country or a region to tolerate this kind of sudden shift in market confidence from euphoria to panic that causes a huge reversal of private capital flows. This thesis argues that the limited instability of the system that is caused by the increased mobility of capital has offered an opportunity to the United States to promote through the IMF and the World Bank a specific set of policies and ideas about the workings of the world economy. This set of principles is embodied in the Washington Consensus and Chapters Five and Seven will discuss the degree of entrenchment of the Washington Consensus after the peso and South Korean crises, through the conditionalities attached to American-led IMF loans to these countries.

These five variables define the changing basis of American hegemony. This set of variables is applied and tested for the first time

¹⁷ For details on the code of capital liberalisation of OECD see Chapter Six, pp. 224-225.

through the American responses to the peso and South Korean crises. The changing basis of American hegemony is not about shaping the developments in the world economy. It is rather about reacting to developments ensuring that the trend of financial liberalisation would continue in the world economy by strengthening the Washington Consensus. During the two major financial crises of the 1990s, the United States acted to stabilise Mexico and South Korea and to advance economic reforms in order to make these economies more open and market-driven. The specific set of interdependent variables (globalisation of finance, mobility of capital, international institutions, ideas mediated through domestic elites and limited instability of the system) is behind the influential role that the United States has played during the 1990s and especially in the aftermath of the financial crises of Mexico and South Korea. However, as Chapters Five and Seven will demonstrate, the United States has exercised a different degree of influence on Mexico (and the rest of Latin America) and South Korea (and the rest of East Asia), not least because of the different role and significance that each of these five variables has played in the two case studies. This thesis will demonstrate through the application of this framework of five variables that as a result of the peso and South Korean crises the Washington Consensus of free market orthodoxy and financial liberalisation has been entrenched and is more widely applied today than a decade ago. More specifically, based on primary

documents from the US Congress, the US State Department and the IMF, this thesis will demonstrate that during the 1990s, the Washington Consensus has both shaped the governance of the world economy and by fostering conditions of domestic financial instability, created a scenario to enable American hegemony to become further entrenched in the post-crisis international economy.

Before the conceptual framework is tested for the first time Chapter Three elaborates on this framework by identifying the origins of the five variables and discussing the Washington Consensus of free market orthodoxy.

CHAPTER THREE

THE COLLAPSE OF BRETTON WOODS, THE RISE OF REAGANOMICS AND THE CONSTRUCTION OF THE WASHINGTON CONSENSUS

This chapter analyses the origins of the five variables of the conceptual framework that is introduced in Chapter Two in relation to the Washington Consensus. It does so by focusing upon the challenge to the Bretton Woods orthodoxy of controls on capital and the policy response which that challenge helped to facilitate and inspire in the United States, (i.e. Reaganomics) and the construction of the Washington Consensus. The chapter commences with a definition of foreign economic policy before focusing upon the collapse of Bretton Woods and the consequent changes in American economic and trade policies, while the second part analyses the links between the Reagan

Administration's economic policies and the construction of the Washington Consensus during the 1980s.

Foreign policy is the set of policies by which a state attempts to preserve and enhance its position in the international political system. For Howard Letner, foreign policy rests upon three components: economic strength, political cohesion and international structural arrangements affecting both security and economics.¹ Consequently, the economic dimension of foreign policy constitutes a state's foreign economic policy. Foreign policy has always reflected economic objectives, but their relative significance and impact on other issues has dramatically increased. After the end of the Cold War, and with increasing economic globalisation, the relative importance of economic over security issues has increased.² For American foreign policy in particular, it has become a fundamental task to supply the strategic blueprint and maintain the day-to-day organisational framework and operation of the international financial system. However, the growing

¹ Howard Letner, "Implications of the Economic Crisis for East Asian Foreign Policies", *The Journal of East Asian Affairs*, vol. XIII, no. 1, 1999, pp. 9-11.

² See Brian Hocking and Michael Smith, *Beyond Foreign Economic Policy: The United States, the Single European Market and the Changing World Economy* (Pinter Publishers, London 1997) pp. 7-8. Economic globalisation can be defined as growth in economic activities across international borders at a more rapid rate than growth in national economies, resulting in deeper linkages between national economies and international markets. See Ernest Preeg, *From Here to Free Trade*, (The University of Chicago Press, Chicago 1998) p. 2.

complexity of the international financial system has made this task increasingly difficult.³

The main institutional actors in American foreign economic policy are the President, the State Department, the Treasury, and the Congress. For Charles Kegley and Eugene Wittkopf, the foreign policy-making process should be conceptualised as a series of concentric circles as first suggested by Roger Hilsman.⁴ The innermost circle in the foreign policy-making process consists of the President and his immediate personal advisors. The second circle contains departments and agencies of the Executive Branch⁵ (mainly, the State Department and the Treasury) and the outermost circle consists of the Congress, domestic interests groups, public opinion and the mass media (see table 2.1).⁶

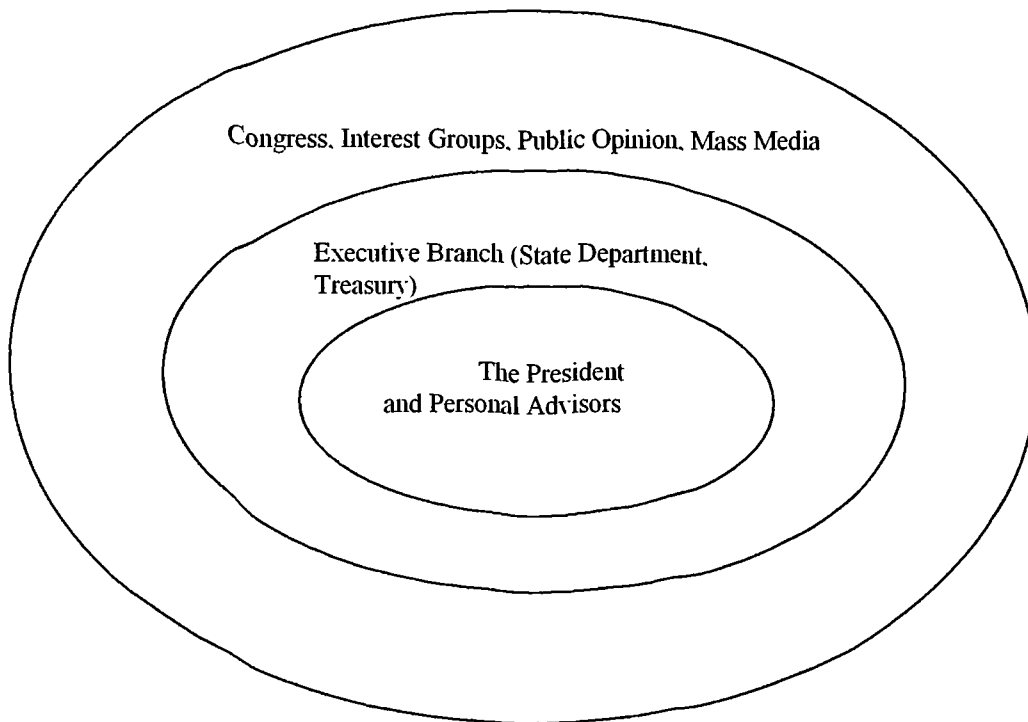
³ Philip Cerny, "American Decline and the Emergence of Embedded Financial Orthodoxy", in Philip Cerny, ed. *Finance and World Politics: Markets, Regimes and States in the Post-Hegemonic Era* (Edward Elgar, Vermont 1993) p. 159.

⁴ See Charles Kegley and Eugene Wittkopf, *American Foreign Policy: Pattern and Process* (St. Martin's Press, London 1987); For the original conception of concentric circles see Roger Hilsman, *To Move a Nation* (Doubleday, New York 1967).

⁵ In Kegley's and Wittkopf's adaptation, the Executive Branch also included the Defence Department, the Central Intelligence Agency, the Department of Commerce, the Department of Agriculture and the Department of Labour. See Hegeley and Wittkopf, *American Foreign Policy: Pattern and Process*, pp. 371-414.

⁶ Charles Kegley and Eugene Wittkopf, *American Foreign Policy*, pp. 334-335.

FIGURE 3.1: THE CONCENTRIC CIRCLES OF AMERICAN FOREIGN ECONOMIC POLICY



Source: C.Kegley and E. Wittkopf, *American Foreign Policy*, p. 335.

American foreign economic policy is produced and exercised through the interaction between these main institutional actors, although the important executive decisions reside with the President. However, it would be simplistic to perceive American foreign economic policy as a consensual product of these actors. Private power can seek to influence foreign policy making by establishing several relationships with the policy making process. For example, a transnational corporation that possesses the capacity to act independently of the United States government might lobby Congress or the Executive Branch concerning a piece of trade legislation or regulation that applies

to international economic transactions.⁷ The globalisation of the world economy has also complicated the links between Washington and American business. As Jeffrey Garten has argued, American business depends on Washington's help to liberalise trade, protect intellectual property, remove regulatory barriers and encourage continuing regulatory reform. On the other hand, Washington needs business to reinforce its goals. The Executive Branch depends on business for technical information regarding trade negotiations and in all emerging markets America's political and economic goals depend largely by the direct investments in factories that only business can deliver.⁸ Furthermore, within the Executive Branch there may appear different views and different patterns of action. However, institutional fragmentation does not necessarily produce incoherent foreign policy, which is demonstrated in Chapters Four and Six on the American policy responses to the peso crisis and the South Korean crisis respectively.

⁷ As with most political processes the form of the relationship between private power and foreign policy making process is seldom static, since the circumstances surrounding the political interplay shift and change. See James Nathan and James Oliver, *Foreign Policy Making and the American Political System* (Little, Brown and Company, Boston 1987) p. 258.

⁸ Jeffrey Garten, "Business and Foreign Policy", *Foreign Affairs*, vol. 76, no. 3, 1997, pp. 70-71.

The Collapse of Bretton Woods and Changes in American Foreign Economic Policy during the 1970s

The 1944 Bretton Woods agreement placed major constraints upon international financial movements. The Bretton Woods system was an attempt to encourage nations to maintain liberal trade policies while allowing some measure of national autonomy. The negotiations were dominated by two figures, John Maynard Keynes from Britain and Harry Dexter White from the United States who had been central figures in the intellectual movement challenging liberalism in the 1930s. There was a consensus among the negotiators at the conference that a liberal financial order was not compatible with the stable system of exchange rates and world trading system they hoped to create. However, it was the American plan that prevailed over Keynes's more ambitious scheme for an international currency (the "bancor"). White's plan proposed that states would contribute according to their means to an international stabilisation fund. Contributions would be made up of gold (25 per cent) and national currencies (75 per cent). In case of need states could draw according to the size of their contribution, the conditions for drawing becoming harder as they reached the limit of their quota. With respect to exchange rates White argued that speculative financial flows had constituted one of the chief causes of foreign exchange disturbances during the inter-war period. Thus, such

movements would need to be controlled to prevent them from disturbing the Bretton Woods financial order. The endorsement of capital controls at Bretton Woods partly reflected a decision to sacrifice financial liberalism in the interests of creating a stable exchange rate system and liberal trading order.⁹ For many years it worked. Global trade increased at an unprecedented rate and the global economy expanded rapidly. From its foundation, however, the Bretton Woods system underwent major changes, especially with respect to finance. Confidence in the dollar eroded as persistent American balance-of-payments' deficits dumped more dollars onto international currency markets than could be redeemed by American gold stocks, eventually forcing the United States to abandon this commitment.¹⁰ With the link

⁹ Eric Helleiner, "From Bretton Woods to Global Finance", in R. Stubbs & G. Underhill, eds. *Political Economy and the Changing Global Order* (Macmillan Press, London 1994) pp. 164-165. See also Susan Starnge, "From Bretton Woods to the Casino Economy", in Stuart Corbridge, Nigel Thrift and Ron Martin, eds. *Money, Power and Space* (Blackwell, London 1988) pp. 53-55.

¹⁰ At this point lies the most obvious design flaw in the Bretton Woods system, the Triffin paradox, named after the Belgian economist Robert Triffin in 1960. The essence of the Triffin paradox is as follows. The main ideas behind Bretton Woods were that: a) the United States guard against inflation by maintaining the value of the dollar constant against gold while b) the United States provided liquidity to the rest of the world economy by means of an increased supply of dollars. Clearly a) and b) could not be pursued simultaneously over the medium term. When the United States began to run a balance of payments deficit - precisely because it helped rebuild the economies of its allies after World War II - non-US citizens and other states became wary about holding dollars. See S. Corbridge, "Bretton Woods Revisited: Hegemony, Stability and Territory", *Environment and Planning A*, vol.26, 1994, p. 1841.

between gold and the dollar broken in the early 1970s most major currencies were allowed to float.¹¹

Eric Helleiner has contended that there were five developments that explain the weakening of the Bretton Woods financial order. The first was the restoration of market confidence in the safety of international financial transactions in the late 1950s. The second was the rapid expansion in market demand for international financial services that accompanied the growth of trade and multinational corporate activity in the 1960s. The third was the depositing of enormous surplus funds in international banking markets by OPEC states after the 1973 oil price increase. The fourth was the move to floating exchange rates in the 1970s, which encouraged market actors to diversify their assets internationally in the new volatile currency markets, although the latter could also be considered as a consequence. Finally, the appearance of financial cartels across the advanced industrial world in the late 1970s and 1980s, which pushed financial operators into the international financial markets as a means of coping with increased competitive pressures.¹²

Although American Administrations supported the Bretton Woods financial order in the early post-war years – even introducing

¹¹ Bruce Moon, *Dilemmas of International Trade*, (Westview Press, Boulder 1996) pp. 85-86.

¹² Eric Helleiner, "From Bretton Woods to Global Finance", p. 165.

their own capital controls programme in the mid-1960s – they turned against it in the early 1970s. Not only did they oppose proposals for co-operative controls, but they also abolished their own capital controls in early 1974 and pushed other countries to do the same. This more liberal American attitude toward financial movements had two sources. The first was the realisation by American policy-makers that an open, liberal order would preserve America's hegemonic position in global finance. Because of the relative attractiveness of American financial markets vis-à-vis their over-regulated counterparts in Europe and Japan, American officials understood that private market actors, if given the freedom to invest internationally, would choose to hold dollars over other currencies and to invest in the United States. These developments were crucial for the United States in this period, given its growing dependence on the dollar's global role and on foreign funds to finance current account and fiscal deficits. This pattern of American policy-making – in which the United States relied on its hegemonic position in the emerging open global financial order to finance external and internal deficits – remained in place throughout the 1970s and was also important in explaining the strong support of the Reagan Administration for financial openness in the 1980s. The second source of American financial liberalism in the early 1970s, according to Helleiner, was a shift away from the Keynesian framework of thought that had influenced American policy-makers in the early post-war years

toward a neo-liberal position advocated by figures such as Milton Friedman and Friedrich Hayek.¹³ Neo-liberals rejected the post-war concern that speculative financial flows would disrupt stable exchange rate arrangements by arguing strongly in favour of a floating exchange rate system. They also did not sympathise with the Bretton Woods commitment to Keynesianism and the autonomy of the welfare state. Instead they desired that international financial markets would discipline government policy and force states to adopt more conservative fiscal and monetary programmes. This neo-liberal ascendancy involved private financial interests as well as multinational industrial interests whose frustration with capital controls increased as their operations became increasingly global in the 1960s and 1970s.¹⁴

The origins of the first two variables of the framework introduced in Chapter Two (financial globalisation and mobility of capital) could be traced back to the creation of the Eurodollar market in London in the 1960s.¹⁵ This market provided a regulation-free

¹³ See, Milton Friedman, *Capitalism and Freedom* (University of Chicago Press, Chicago 1962); Milton Friedman, *From Galbraith to Economic Freedom* (Institute of Economic Affairs, London 1977); Friedrich Hayek, *The Road to Serfdom* (Routledge, New York 1962).

¹⁴ Eric Helleiner, "From Bretton Woods to Global Finance", pp. 166-167. For more analysis on Bretton Woods see also, Armand Van Dormael, *Bretton Woods: Birth of A Monetary System* (Macmillan, London 1978) and A.L. Keith Achenson, *Bretton Woods Revisited* (Macmillan, London 1972).

¹⁵ The British government's support for the Eurodollar market was crucial because it provided a physical base for the market, permitting it to operate in London free from regulation. British financial officials and institutions remained strongly committed to promoting London as an international financial centre long after Britain's financial predominance was over. See Paul Einzig and Brian Scott Quinn, *The Euro-Dollar System: Practice and Theory of International Interest Rates* (Macmillan Press, London 1977) pp. 5-7.

environment in which to trade financial assets denominated in foreign currencies, mainly dollars. The American government did not prevent banks and firms from operating in the Eurodollar market. American banks and transnational corporations demanded the freedom to operate for the limitations on their freedom after the introduction of American capital controls in the mid-1960s. Furthermore, American policy-makers recognised that the unregulated nature of the Eurodollar market would help increase the attractiveness of dollar holdings to investors and banks at a time of growing American balance-of-payments problems. The Eurocurrency market grew from \$3 billion in 1960 to \$75 billion in 1970.

By 1971 official dollar holdings abroad exceeded American gold stocks by over 300 per cent. President Nixon, on August 15, 1971, unilaterally reversed the American commitment to convert every \$35 held by foreign countries into an ounce of American gold. This meant a de facto 10 per cent devaluation of the dollar relative to the German mark, the Japanese yen, the British pound and gold. The move shifted much of the burden of global financial adjustment to those countries which depended heavily on exports to the United States to generate their foreign exchange and to those countries which had huge dollar holdings. In that way, the United States forced its economic partners enjoying large balance-of-payments surpluses to assume the cost of restoring the American economy to equilibrium. The United States was

able to do that because American power in the early 1970s was still sufficiently substantial to force the other Western industrial countries to absorb the cost of adjusting the value of the dollar.¹⁶ Thus, the introduction of the Eurodollar not only developed into a major engine of credit creation for the real world economy but also put tremendous pressures on the exchange rate system that by 1973 the fixed exchange rate system had to be abandoned and give way to the forces of foreign exchange markets.¹⁷

However, the catalyst for the move towards liberalisation was the American decision to remove its capital controls in 1974, to assist the revival of New York as an international financial centre. This was consistent with the American aim of fostering an international monetary system organised on the basis of market principles. The status of the dollar as the world's leading currency gave the United States considerable freedom to borrow from abroad in its own currency, thus permitting the United States to sustain expansionary policies more easily than foreign governments and allowing Washington to coordinate policies with these governments. For example, in 1978, the United States persuaded Japan and Germany to reflate in return for an American commitment to restrain monetary growth and to relax control over oil prices. Therefore, by the mid-1970s, contrary to the

¹⁶ Anthony Tuo-Kofi Gadzey, *The Political Economy of Power. Hegemony and Economic Liberalism*, (Macmillan Press, London 1994) pp.156-157.

¹⁷ Susan Strange, *States and Markets* (Pinter Publishing, London 1994) pp.106-107.

decline of hegemony thesis, the United States had largely succeeded in reshaping the international monetary system in a way that was, according to Andrew Walter, advantageous for American interests.¹⁸

The strategy of the United States had two dimensions, a fact that was clearly demonstrated on the one hand, by the abolition of remaining exchange controls in 1974 and on the other hand, by the passage of the section 301 legislation of 1974 to liberalise markets on terms favourable to American companies so as to institutionalise their competitive advantage. The section 301 legislation of 1974 was broadly directed at foreign restrictions on American trade and used to enforce trade rights as conferred by the GATT and bilateral treaties, if necessary through retaliation against those judged to have violated these rights. Section 301 was characterised by the fact that it enabled the United States to unilaterally make demands for trade concessions by others without offering any matching reciprocal concessions of its own that others might demand in turn. The aggressive unilateralism of Section 301 referred to policies that would allow the United States to impose new trade barriers against countries whose existing barriers to trade were judged to be higher than the corresponding American barriers. For example, in September 1985, the Reagan administration initiated a

¹⁸ Andrew Walter, *World Power and World Money* (Harvester, New York 1993) p. 189.

series of Section 301 actions against Japan and other countries. Later in 1987, a radical proposal came from Democratic Representative Richard Gephardt who advocated automatic retaliation against countries that maintained persistent trade surpluses with the United States. In 1988, this proposal was dropped in favour of the Senate's "Super 301", an amendment of the old Section 301 of 1974.¹⁹ The Super 301 and Special 301 provisions of 1988 added strength to 301 actions against unreasonable practices. Super 301 essentially required the United States Trade Representative (USTR) to establish a priority list of countries and their unreasonable practices and then set deadlines for their removal by the foreign countries and should they fail to comply, for decisions of retaliation by the United States. Special 301 was similar in its approach but it addressed intellectual property rights. For example, in May 1989, the USTR took actions against Japan, India and Brazil according to the Super 301 schedule.²⁰

During the 1970s however, the diversion of capital from trade and production to financial markets failed to revive profitability and to help manage economic problems. It was only at the end of the 1970s

¹⁹ The Trade and Competitiveness Act of 1988 included more than a thousand pages of legislation but its centrepiece was Super 301, which included amendments to Section 301 of the Trade Act of 1974 aimed at curtailing unfair foreign trade practices. See Pierre Martin, "The Politics of International Structural Change: Aggressive Unilateralism in American Trade Policy", in *Political Economy and the Changing Global Order*, p. 440.

²⁰ Jagdish Bhagwati, "Aggressive Unilateralism: An Overview", in J. Bhagwati and H. Patrick, eds. *Aggressive Unilateralism. America's 301 Trade Policy and the World Trading System* (University of Michigan Press, Michigan 1993) pp. 2-5.

and the early 1980s that the situation changed radically. At the roots of this change was a major reversal of American policies following the decision by President Nixon in 1971 to abandon the gold-dollar standard. Since there was no viable alternative to the dollar as the principal international reserve currency and medium of exchange, the abandonment of the gold-dollar standard resulted in the establishment of a pure dollar standard. The result was not the "collapse" of the Bretton Woods system, but as Susan Strange put it, its deliberate destruction. Its rules were consciously rejected by President Nixon, leaving the exchange rate to be determined by market forces.²¹ After 1973 this dollar standard gave American policy-makers an increased degree of freedom in expanding the global supply of money, because it eliminated any need to control American balance-of-payments deficits. The United States was in a position to "tap the resources of the rest of the world virtually without restriction, simply by issuing its own currency".²²

However, American privileges were not as unlimited as they appeared in the mid-1970s. Only a fraction of the liquidity created by the American monetary authorities found its way in new trade and production facilities. Most of it was converted into Eurodollars, which

²¹ Susan Strange, "The "Fall" of the United States: Peace, Stability and Legitimacy", in Geir Lundestad, ed. *The Fall of Great Powers: Peace, Stability and Legitimacy* (Oxford University Press, London 1995) p. 203.

²² Susan Strange, "The Persistent Myth of Lost Hegemony", *International Organisation*, vol. 41, no.4, Autumn 1987, p. 569.

reproduced themselves many times over through the mechanisms of private inter-bank money creation and re-emerged in the global market as competitors to the dollars issued by the American government.²³ On the domestic front, Washington policy-makers found it difficult to tackle successfully a rise in stagflation (high inflation combined with high unemployment) that was largely induced by the two oil shocks of 1973-1974 and 1979. The combination of unemployment and inflation weakened the capacity and the political will of the federal government to deal with the policy problems that were caused by stagflation. The rise in unemployment caused political problems, which led the government regularly to switch its policy objective to stimulating the domestic economy at the expense of inflation.²⁴

As a response to a crisis of confidence in the dollar and the American economy, on October 6, 1979, the Chairman of the US Federal Reserve, Paul Volker, took measures to restrict the supply of dollars in world financial markets. Gilpin has argued that the unwillingness of Germany in particular, to continue to support the dollar in 1979, was a major reason for the shift in American monetary policy and that this policy reversal marked the end of American hegemony.²⁵ However, the

²³ Giovanni Arrighi, "The Global Market", *Journal of World Systems Research*, vol.5, no.2, Spring 1999, p. 215

²⁴ Joseph Hogan, "Reaganomics and Economic Policy, in Dilys Hill, Raymond Moore and Phil Williams, eds. *The Reagan Presidency. An Incomplete Revolution?*" (Macmillan Press, London 1990) p. 136.

²⁵ Robert Gilpin, *The Political Economy of International Relation*, (Princeton UP, Princeton 1987) p. 332.

change in American policy was more a response to the fundamental changes, which had taken place in the international monetary and financial system than a sign of weakness on the part of the United States.²⁶ This switch to restrictive monetary policies undertaken in the last year of the Carter administration marked a shift of the American government from being a competitor to private finance – as it was during the 1970s – to being its most faithful and powerful supporter. Volker’s deflationary move in support of the dollar was only the first step in this direction. This change indicated an important transformation in economic policies by the time of the presidential elections of 1980. During the course of the campaign season and for a period after the elections in November 1980, Ronald Reagan and his advisors developed an economic plan that built upon these changes but moved in more radical directions. Soon came a major deregulation drive aimed at creating in the United States conditions as favourable as anywhere else in the world for financial speculation. With that came a significant expansion of state indebtedness and a consequent escalation in interstate competition for mobile capital.²⁷

²⁶ Andrew Walter, *World Power and World Money*, p. 224.

²⁷ Giovanni Arrighi, “The Global Market”, p. 216.

Reaganomics and the Construction of the “Washington Consensus”

What differentiated Reagan’s economic policy from its predecessors was the domestic mix of monetarism and supply-side economics. The Reagan administration aimed to fight inflation by reducing the money supply and taxes. Just as monetarism implied a substantially reduced economic role for the state, so too did the doctrine of supply-side economics upon which Reagan based his economic policy. Supply-side economics gained wide publicity during 1980. Supply-side economics concentrated on the level of taxes levied by the government and the consequences of those levies for economic activity. There was a new perspective to fiscal policy which focused on the relative price effects. Lower tax rates would encourage saving, investment, productivity and risk-taking. According to supply-siders, as people switched into these activities out of tax shelters and working for non-taxable income, the incentive effects would cause an increase in the market supply of goods and services – hence the term “supply-side economics”. As people responded to their higher after-tax income and wealth or greater profitability, incomes would rise and the tax base

would grow, thus feeding back some of the lost revenues to the Treasury.²⁸

For supply-side economists, such as Milton Friedman and Arthur Laffer, taxes were not the only negative activity of government. Government intervention and regulation were also blamed for the poor economic performance of the 1970s.²⁹ As President Reagan put it in his inaugural address, “government is not the solution to our problem; government is the problem”.³⁰ Thus, the neoliberal ascendancy of the 1980s was grounded in part in the intractability of the domestic economic problems of the 1970s. The apparent inability of the various governments in power in North America and Western Europe and beyond to deal with rising inflation was a central component of the legitimization of neoliberalism. New Right liberal ideas influenced the Reagan administration just as monetarist arguments influenced the

²⁸ Paul Craig Roberts, “Supply-side Economics: An Assessment of the Theory and Results of American Experience in the 1980s”, in James Buchanan et al., eds. *Reaganomics and After* (Institute of Economic Affairs, London 1989) p. 26.

²⁹ The Laffer Curve was named after Professor Arthur Laffer. He was an advisor to President Reagan in the early 1980s. He suggested that, as taxes increased from fairly low levels, tax revenue received by the government would also increase. However, as tax rates rose, there would come a point where people would not regard it as worth working so hard. This lack of incentives would lead to a fall in income and therefore a fall in tax revenue. The logical end-point would be tax rates at 100 per cent where no one would bother to work and so tax revenue would become zero. See Arthur Laffer et al., *Foundations of supply-side economics : Theory and Evidence*, (Academic Press, New York 1983). For the background to the supply-side economic doctrine in the Reagan Administration, see David Stockman, *The Triumph of Politics*, (Harper, New York 1986); and David Green, *The New Right: The Counter Revolution in Political, Economic and Social Thought*, (Wheatsheaf Books, London 1987).

³⁰ President Reagan’s First Inaugural Address, U.S. Capitol, January 20, 1981 (The Ronald Reagan Official Website, <http://www.ronaldreagan.com>).

Thatcher government in the United Kingdom.³¹ For Desmond King, the Reagan administration's economic strategy, based in part upon supply-side economics, had five key elements:

- 'a) a large cut in tax rates to stimulate economic activity by increasing monetary incentives
- b) government control of the rate of growth of the money supply to tackle inflation
- c) a large reduction in non-defence (mainly welfare) public spending by the state
- d) an expansion of state defence expenditure; and
- e) an extensive deregulation of the economy by the government.'

For the Reagan Administration, most government regulation was seen as an excessive burden upon entrepreneurs and producers, which required taxes to be levied for its financing. These constituted a powerful rationale for the deregulation of the economy. The Reagan Administration's deregulation policies revealed the influence of New Right arguments about the free market and minimal government. Economic deregulation along with privatisation was clearly intended to open previously regulated markets to more competition and to give businesses in those markets greater autonomy to set wages and prices according to supply and demand. Like other aspects of Reagan's

³¹ The Thatcher government came into office in May 1979. The instruments of Thatcher's economic policy were a strict monetarist policy, a medium-term financial strategy to lower the budget deficit, restraint on wages, legislation to alter the way trade unions operated and a pound that was appreciating under the influence of high interest rates and strong export earnings from oil. See Alan Walters, *Britain's Economic Renaissance* (Oxford University Press, London 1986).

³² Desmond King, *The New Right: Politics, Market and Citizenship* (Macmillan, London 1987) p. 144.

economic policy, deregulation had begun before 1980. Between 1968 and 1978, for example, steps were taken toward greater deregulation of communications, banking, stock-market transactions and airline transportation. Beginning in 1980, the pace quickened, as trucking and railroads, oil, cable television, were added to the list. A major project was that of the final break-up of the American Telephone and Telegraph Co. into nine regional firms. Deregulation of banking, in particular had radically changed the face of the financial sector. The major changes in banking law, codified in the Depository Institutions Deregulation and Monetary Control Act of 1980, ultimately eliminated all regulation of interest rates and loosened restrictions on the geographic areas served and the services offered by individual banks.³³ The deregulation and privatisation drive of the 1980s aimed to shift traditional responsibilities of the state to the commercial sector. Economic deregulation actually made it extremely difficult for a future Administration to reverse the deregulation policies of the Reagan Administration.

Although during 1979-82, there were record numbers of bankruptcies and an acceleration of the decline of older, less-competitive industries, in 1982 the recession ended due to a combination of fiscal, stimulus and supply-side tax-cutting measures.

³³ Bennet Harrison and Barry Bluestone, *The Great U-Turn: Corporate Restructuring and the Polarising of America*, (Basic Books, New York 1988) pp. 94-96.

The tax cut was indeed massive.³⁴ The 1981 cuts in business and personal taxes were so generous that the value of allowable deductions and actual credits actually exceeded the tax liability on the income that investment in a typical piece of equipment would generate. This meant that investments in equipment had become fully subsidised by the government. In 1983, monetary policy was loosened and budgetary allocations were shifted in favour of military spending which by 1982-83 was growing by 10 per cent a year.³⁵ The hostility towards statist paternalism along with Reagan's stress on the need for a strong America, served to vindicate tax cuts and the deregulation of industry and banking. In this context foreign transnationals became more dependent upon the American market at the same time as American manufacturing capital shifted many of its assets towards high profit sectors, like financial services, real estate, new technology and defence. Reagan's policies facilitated a growth in concentration in these sectors of the American economy, so that its bigger corporations were better able to compete internationally.³⁶

³⁴ President Reagan first proposed a 30 per cent, across the board (i.e., for all taxpayers), tax rate cut during the 1980 primary campaign. President Reagan was able to sign into law the tax cuts in late 1981 after an attempt by congressional Democrats to block the cuts failed but at the reduced rate of 25 per cent, and an effective rate of 23 per cent since the cuts were over three years (5 per cent in 1981, retroactive; 10 per cent for 1982; 10 per cent for 1983. (The Ronald Reagan Official Website, <http://www.ronaldreagan.com>).

³⁵ Bennet Harrison and Barry Bluestone, *The Great U-Turn: Corporate Restructuring and the Polarising of America*, p. 92.

³⁶ Stephen Gill, *American Hegemony and the Trilateral Commission*, (Cambridge University Press, London 1990) pp. 102-104 & 107.

A particular feature of American deregulation was the fact that it took place on an impressive scale. Its influence was also due to two other factors. First, attention focused on its alleged benefits. For example, in the case of airline deregulation attention was drawn to the lower fares in the United States when compared to Europe where tight controls existed until the early 1980s. Second, technological development during the 1980s linked all the main financial centres, to globalise financial markets. As Swann has stressed, once one centre had deregulated and dealing costs had fallen, other centres were forced to follow suit otherwise their trade would be deflected to the lower cost centre. Thus competition from the New York Stock Exchange after 1974-1975 helped to bring deregulation to London in 1979, and this kind of knock-on effect was felt throughout the world.³⁷ Furthermore, the success of the United States in outperforming all other states in global financial markets and forcing its great rival of the Cold War the Soviet Union into bankruptcy, gave credibility to the claim that all states and their citizens would benefit from following the prescriptions of the neoliberal policies followed by the United States.³⁸

The results of the combination of monetarism and supply-side economics pursued by the United States from the late 1970s and

³⁷ Dennis Swann, *The Retreat of the State: Deregulation and Privatisation in the UK and the US*, Harvester, London 1988, pp. 43-44.

³⁸ Giovanni Arrighi, *The Global Market*, p. 221.

especially during the 1980s had the consequence (probably unforeseen at that time) of redefining and cementing American global hegemony. Beyond the economic liberalisation and deregulation on the domestic front there were also external consequences, both financial and commercial. The American trade deficit, which doubled from 1982 to 1983 and again in 1984, induced an export-led recovery within the Western industrialised world. While expanding at a very rapid pace during the 1980s, the United States was willing to tolerate a massive increase in imports, in order to stimulate economic activity in the Western industrialised economies. In that way American economic policy served to reinforce American hegemony in the Western world and to spread American influence and dominance to the rest of the world. The explanation of that resides, according to Augelli and Murphy, with the fact that given the size of the American economy and its links to the rest of the world, American domestic economic policy was actually global economic policy.³⁹ A very good example of that was the Plaza Accord in September 1985 by which American policy-makers sought to reverse the increasing trade deficit with Japan by persuading the G5 central banks to raise the value of the Japanese yen and lower

³⁹ Enrico Augelli and Craig Murphy, *America's Quest for Supremacy and the Third World*, (Pinter Publishers, London 1988) pp. 160-161 & 172-174.

the value of the dollar.⁴⁰ Indeed, the efforts of the central banks were successful in increasing the value of the yen (from 238 yen/dollar in 1985, to 128 yen/dollar by 1988).⁴¹

The New Right's strategy during the 1980s aimed to identify American institutions with the free market. In New Right thinking, the American claim to exemplary modernity and the institutions of the free market had been assimilated into one another. As a result the spread of the free market was represented as the cutting edge of modernity and identified with the extension of American values. For John Gray, if the authority of American institutions was universal and the free market was at the heart of them, then the reach of the American free market could be global. In that sense, freeing up markets was not a conservative project but rather a programme for an economic counter-revolution. But Gray goes further by pointing out that the political economy of Reaganomics was not entirely free market oriented. It was a species of military-led Keynesianism with large budget deficits that were incurred in order to finance the tax cuts and military expenditures.⁴² This spending also boosted investment in new information technologies. The increased government spending on

⁴⁰ However, the appreciation in the value of the yen against the dollar failed to eliminate Japan's bilateral trade surplus with the United States.

⁴¹ Richard Stubbs, "The Political Economy of the Asia-Pacific Region", in Stubbs & Underhill, eds. *Political Economy and the Changing Global Order* (Macmillan, London 1994) p. 371.

⁴² John Gray, *False Dawn: The Delusions of Global Capitalism*, (Granta Books, London 1998) pp. 104-108.

military research, development and production, eventually led to making government spending larger rather than smaller and created unprecedented budget deficits. But Reagan's fear of the "evil empire", the Soviet Union, made military preparedness as important as economic recovery.⁴³

Regarding the third variable of the framework, international institutions, such as the IMF and the World Bank, their re-orientation of their functions and missions has taken place during the 1980s. Indeed, an important dimension of the Reagan Administration's foreign economic policy was the targeting of international organisations as a way of making them an instrument of American policy. An important result of the major review of American involvement in international lending agencies initiated by the Reagan Administration in the early 1980s was a re-affirmation by the IMF, the World Bank and regional development banks that the purpose of development aid was to foster open economies. Although the Administration threatened to withdraw, it did not pull out of the United Nations Conference on Trade and Development (UNCTAD) for instance, or other intergovernmental agencies. But Reagan made his threats credible in 1984 by withdrawing from one prominent agency that was a source of ideological opposition

⁴³ American military expenditures rose from 5.5 per cent of GNP in 1976 to almost 8 per cent in 1986. Military expenditures in the 1980s were greater than in Japan or Germany by a ratio of more than 3/1. (See Stephen Gill, *American Hegemony and the Trilateral Commission*, p. 83). See also Bennet Harrison and Barry Bluestone, *The Great U-Turn: Corporate Restructuring and the Polarising of America*, p. 90.

to his views, namely the United Nations Educational Scientific and Cultural Organisation (UNESCO). As Augelli and Murphy point out, this was not a very costly act. UNESCO's major operations involved cooperation in fields such as science, education and culture, but no large constituency in the United States actually relied upon that agency. In withdrawing from UNESCO, the Administration's threat to undo the international organisation system was given more credibility. After that point, whenever the question of increasing the resources for the multilateral agencies arose, the Reagan Administration responded by demanding that any new finances only be given in exchange for the institutions' more strict adherence to American economic policy objectives.⁴⁴ In the case of the IMF, although the share of American votes had declined, reflecting its falling share of world GDP, it remained sufficiently large to block any significant change in policy.⁴⁵ The United States remained the only country with veto power, thus having a degree of control over outcomes in an institution constructed on the basis of principles favoured by the United States.⁴⁶

⁴⁴ Enrico Augelli and Craig Murphy, *America's Quest for Supremacy and the Third World*, pp. 186-188.

⁴⁵ As of January 2000, the United States had a 17.35 per cent of the total votes of the IMF members. Second was Japan with 6.23 per cent.

(The IMF Website, <http://www.imf.org/external/np/sec/memdir/members.htm#total>).

⁴⁶ Stephen Gill and David Law, *The Global Political Economy. Perspectives, Problems And Policies*, (Cambridge University Press, New York 1990) pp. 345-346.

Indeed, by the mid-1980s most debtor economies had negotiated new stand-by arrangements with the IMF, under which Fund resources and policy advice were made available subject to limits and to performance conditions that were in line with what came to be known as the Washington Consensus. The term "Washington Consensus" was first used by John Williamson in 1990 to describe a list of economic reforms that were being urged on Latin American countries by the United States. According to Williamson, the "Washington" of this term was both the political Washington of Congress and the Administration and the technocratic Washington of the international financial institutions, the economic agencies of the US government, the Federal Reserve and the think tanks.⁴⁷ The Washington Consensus had its roots directly in the economic policies of the Reagan Administration. These could be traced back to July 1981, when William Brock, the United States Trade Representative, had maintained that free trade was essential to the pursuit of a strong US hegemony. At the same time it was also emphasised that the Reagan Administration would strictly enforce US laws and international agreements relating to practices such as government subsidisation.⁴⁸

⁴⁷ John Williamson, *Latin American Adjustment: How Much Has Happened?* (Institute for International Economics, Washington DC 1990) p. 7.

⁴⁸ Robert Baldwin, *Trade Policy in a Changing World Economy*, (Harvester-Wheatsheaf, New York 1986) p. 74.

For Williamson there were ten elements comprising the Washington Consensus:

- a) Fiscal discipline, such that budget deficits should be small enough to be financed without recourse to the inflation tax;
- b) Public expenditure priorities, such that policy reform should re-direct expenditure from politically sensitive areas which typically receive more resources than their economic returns can justify, such as defence and subsidies, toward fields with high economic returns like primary health and education and infrastructure;
- c) Tax reform, with the aim to broaden the tax base and cut marginal taxes;
- d) Financial liberalisation, where the objective was market-determined interest rates;
- e) Exchange rates, where countries needed a unified exchange rate at a level sufficiently competitive to induce a rapid growth in non-traditional exports;
- f) Trade liberalisation, for quantitative trade restrictions should be replaced by tariffs and these should be progressively reduced until a uniform low tariff of at most 20 per cent is achieved;
- g) Foreign direct investment, for barriers impeding the entry of foreign firms should be abolished;
- h) Privatisation, such that state enterprises should be privatised;
- i) Deregulation, in that governments should abolish regulations that impede the entry of new firms or restrict competition; and
- j) Property rights, because the legal system should provide secure property rights without excessive costs.⁴⁹

⁴⁹ For Williamson, the Washington Consensus did not imply a specific model of market to be sought. See John Williamson, "Democracy and the Washington Consensus", *World Development*, vol. 21, no. 8, 1993, pp. 1332-1334.

The general advice for all countries was to adopt outward-oriented trade and investment policies aimed at price stability, fiscal policies aimed at balance in the medium term and most importantly, liberal financial policies designed to build open and solid capital markets. The incentive to move in such a direction was the promise of restructured and reduced bank debt and new financing, mainly in the form of private portfolio and direct investment.⁵⁰

The term Washington Consensus as it was articulated by Williamson was in principle geographically and historically specific - a lowest common denominator of the reforms that he judged Washington could agree were needed in Latin America as of 1989. But in practice there would not have been a lot of difference if Williamson had undertaken a similar exercise for Africa or Asia rather than Latin America. Williamson's Washington Consensus focused principally on policy reforms that reduced the role of government, such as privatisation and the liberalisation of trade, finance and foreign direct investment. It did this because the orthodoxy of the generation whose ideas were embodied in the practices being challenged in 1989 had been much more statist than was by then regarded as advisable, and hence the policy reforms that were needed at that time were all in the

⁵⁰ Louis Pauly, *Who Elected the Bankers? Surveillance and Control in the World Economy* (Cornell University Press, London 1997) pp. 121-122.

direction of liberalisation.⁵¹ These circumstances expanded the meaning of the term to cover a wider set of economic ideas associated with the free market economy.

The fourth variable of the framework, ideas that are accepted by domestic elites, played a significant role during the 1980s in legitimising and applying the Washington Consensus in many regions of the world. Indeed, by the 1990s, most developing countries' governments had become converts to free market policies in varying degrees. Over the course of the 1980s and 1990s, the governments of developing countries substantially reduced trade barriers and many removed longstanding restrictions on capital movements. By the early 1990s the Washington Consensus was changing development policies and practices across the globe. Washington pressed successfully for an acceleration of corporate-friendly globalisation rules, reflected in the North American Free Trade Agreement (NAFTA) in 1993 and the creation of the World Trade Organisation (WTO) in 1994.⁵² The IMF and the World Bank in tandem with the US Treasury also pressed for

⁵¹ John Williamson, "What Should the Bank Think About the Washington Consensus?", paper prepared as a background to the World Bank's *World Development Report 2000*, in July 1999 (The World Bank Website, <http://www.worldbank.org/html/extdr/forjourn.htm>).

⁵² The OECD has also proposed a Multilateral Agreement on Investment (MAI) which would, if it had been implemented, given foreign investors the capacity to seek compensation from domestic governments if they could demonstrate discrimination against them - when compared to the treatment of domestic investors. The OECD began the MAI negotiations in May of 1995 which ended in 1998 with no agreement. (See West Governors' Association Website: <http://www.westgov.org/wga/publicat/maiweb.htm>)

investment liberalisation in South Korea and other East Asian economies.⁵³ As a result the Washington Consensus achieved ideological hegemony and was clustered in governments, the private sector and international financial and political agencies.

Williamson has acknowledged that not all of the assertions he included in his original "ten-best" policy recommendations enjoyed the same degree of consensus. According to his assessment in five of the ten policy prescriptions "consensus has been established". Three of the prescriptions (financial and trade liberalisation and deregulation) were still controversial "in a non-ideological way" meaning that, in his judgement, the emergence of a consensus was just a matter of time and depended only on finding the technical solution that would reconcile the differences that still existed among the experts. The remaining two, changing public budget priorities and according the same treatment to foreign and domestic firms were, in Williamson's view, always bound to be controversial due to their inherent political nature.⁵⁴ This controversy is evident in the cases of the peso crisis (1994-1995) and the Asian crisis (1997-1998), which are examined in Chapters Four and Six.

⁵³ Robin Broad and John Cavanagh, "The Death of the Washington Consensus?", in *World Policy Journal*, vol. XVI, no. 3, 1999, p. 80.

⁵⁴ John Williamson "Democracy and the Washington Consensus" pp. 1332-1333; See also, John Williamson "What should the Bank Think about The Washington Consensus" Paper presented at the World Bank's PREM meetings. July 1999, p. 3.

It should be noted here that foreign economic policy in the United States had been characterised by an occasionally abrasive relationship between the Presidential and Congressional branches of government on who should take the leading role in defining and protecting American interests. During the Bretton Woods era, Congress delegated authority over trade policy to the President and State Department. For example, the 1962 Trade Expansion Act passed by Congress created the Special Representative for Trade Negotiations, which was renamed the United States Trade Representative (USTR) in 1980. The USTR was authorised by President Carter to make and administer American trade policy, lead all trade negotiations and represent the American government in all major international trade organisations.⁵⁵ However, Congress had tried to maintain influence over trade policy by setting out the rules which determined the way in which both it and the executive dealt with foreign economic policy. A major example of this had been the evolution of "fast-track" authority first given to the President in 1974 and intended to speed the conclusion of trade agreements and insulate them from political pressures within Congress. This delegation of authority to the President was limited in the 1988 Omnibus Trade and Competitiveness Act and it became the

⁵⁵ Simon Lee, "Managed or Mismanaged Trade? US-Japan Trade Relations During the Clinton Presidency", in R. Li and I. Cook, eds. *Fragmented Asia*, vol. 2 (Avebury, London 1998) pp. 209-233.

centre of the growing congressional debate over NAFTA during 1992 and 1993. Another example had been the section 301 of the 1974 Trade Act, which required that members of Congress be included in delegations to trade negotiations and that private sector advisory committees be established to inform the trade policy process.⁵⁶

Furthermore, as a result of the economic policies of the 1980s and the subsequent globalisation of finance, the links between Washington and American business had become more complicated. In the era of globalisation of finance and economic activity, it is misleading to limit the conception of hegemony and dominance by defining it simply in terms of the power of one state relative to other states. Today, the US government is extremely concerned about the access of US-based transnational corporations (TNCs) to foreign markets. Government advocacy of free trade is designed to open markets for some industries, particularly the telecommunications and information-related industries. Thus the TNCs have become more direct instruments of macroeconomic policy through research and development (R&D) subsidies, tax concessions and trade agreements.⁵⁷ At the same time, the fact that non-American TNCs appear increasingly strong relative to

⁵⁶ Brian Hocking and Michael Smith, *Beyond Foreign Economic Policy: The United States, the Single European Market and the Changing World Economy* (Pinter Publications, Washington DC 1997) pp. 77-78.

⁵⁷ Edward Comor, "The Global Political Economy of Communication and IPE", in Edward Comor, ed. *The Global Political Economy of Communication: Hegemony, Telecommunication and the Information Economy* (Macmillan Press, London 1996) p. 7.

American companies does not significantly alter the ability of the United States to achieve liberal economic policies. The general trends of globalisation are actually linked to the importance of foreign direct investment in the United States, as foreign TNCs see access to the American market as crucial.⁵⁸ Therefore, even in this context, the United States appears as, if not the dominant, at least the preeminent power in the world economy largely due to the reorientation and the reconstruction of its economic policies during the 1980s. In retrospect, the Reagan Administration's economic policies projected America's structural power⁵⁹ and set the conditions for its economic relations with other states. The effect is best described by Henry Nau:

'The Reagan Administration based its policy on a new appreciation of American economic power in the international marketplace...By renewing incentives to disinflate and enhance market forces at home, the administration used American power not as an end in itself but as a means of encouraging these reforms abroad. Simultaneously it urged new international negotiations to maintain open markets, recognising that American economic policies, could not shape international behaviour if markets closed.'⁶⁰

Reagan's economic policies raised the dependence of other states on the American market. Based initially on domestic remobilisation, Reaganomics promoted the liberalisation of markets and deepened the

⁵⁸ Gill and Law, *The Global Political Economy*, p. 357.

⁵⁹ According to Susan Strange's terminology, structural power is the ability to exercise control over people's security, and the manner or mode of production of goods and services. Structural power also lies with those able to control the supply and distribution of credit and those who possess knowledge. See Susan Strange, *States and Markets* (Pinter Publishers, London 1993) pp. 26-28.

⁶⁰ Henry Nau, "Or the Solution?", *Foreign Policy*, no. 59, 1985, p. 147

interdependence between the macroeconomic policy-making conditions of America and other states.⁶¹

It should not be overlooked that an important factor behind the continuing dominance of the United States in the field of international money and finance has been the extent to which this dominance is linked to the dependence of Europe, Japan and other countries upon American military protection. Although security issues are not the concern of this thesis, the link between financial and security relationships should not be underestimated.

The fifth variable of the framework, the limited instability of the system became evident during the 1990s as a consequence of the globalisation of finance and the increased mobility of capital. The crises of Mexico in 1994-95 and of East Asia in 1997-98 have demonstrated the vulnerability of national economies to sudden movements of capital from one region to the other in the search of greater profitability. As argued in Chapter Two, these financial episodes have provided American policy-makers, directly through the US Treasury or indirectly through the IMF and the World Bank, with the opportunity to advance the Washington Consensus in the troubled economies as the only way out of the crisis. Chapters Five and Seven demonstrate how the Washington Consensus was reinforced during the 1990s through the peso and the South Korean crises.

⁶¹ Stephen Gill, *American Hegemony and the Trilateral Commission*, p. 107.

This chapter has elaborated on the framework of five variables that was introduced in Chapter Two. More specifically this chapter analysed the origins of the five interdependent variables that define the changing basis of American hegemony in relation to the emergence of the open market orthodoxy of the Washington Consensus. The next four chapters analyse the American influence in Mexico and South Korea and the ways in which the United States responded in order to assure the continuity of the liberalisation trend of the 1980s and the 1990s. The framework of five variables will be tested through the case studies of peso and South Korean crises in order to identify the extent to which the Washington Consensus has been entrenched.

CHAPTER FOUR

THE REDEFINITION OF AMERICAN FOREIGN ECONOMIC POLICY TOWARDS MEXICO: FROM THE CRISIS OF 1982 TO NAFTA AND THE PESO CRISIS OF 1994

This chapter analyses the origins of the liberalisation of the Mexican economy that took place during the 1980s and the variables on which the advancement of the Washington Consensus was based before the peso crisis. The first part of this chapter provides an analysis of the Mexican economy and US-Mexican relations before and after the Mexican debt crisis of 1982. The second part of the chapter explains the role of NAFTA in consolidating economic reforms in Mexico and promoting the Washington Consensus in the region and the third part examines the main reasons and the most significant developments that led to the peso crisis (1994-95). This chapter demonstrates the close links between the economies of the United States and Mexico and the

significant influence that the United States has exercised over the path that Mexican economy has followed especially since 1982.

The Mexican Economy and the US-Mexico Relations: The Crisis of 1982

Mexico and the United States are linked together by a two thousand-mile border. The US-Mexico relationship has been characterised by unfriendly or stand-offish relations. American attitudes towards Mexico have ranged from benign neglect to arrogant unilateralism, while the principal goal of Mexican diplomacy for much of the 20th century has been to keep the US at arm's length and to demonstrate its independence by opposing US objectives. For example, Mexican governments spent most of the Cold War period making speeches denouncing American intervention and defending Soviet-sponsored guerrilla movements in the name of national sovereignty. As M. Delal Baer put it, what cooperation took place was hidden as if it was something shameful. Common problems were not tackled in an open, joint spirit of friendly cooperation. Rather, meetings with Mexican officials were laden with a thousand reasons why the two countries could not cooperate, spiced with history lessons reminding the U.S. of its craftiness. Mexico's anti-American dogma defined

virtually all cooperation as a form of capitulation.¹ This relationship was framed by the Mexican Revolution (1910-1940). The main principles of that revolution were land reform, anti-clericalism, nationalism, and anti-foreign capital attitudes. Some of the most characteristic examples in those areas were Mexico's nationalisation of the oil industry in 1938, Mexico's foreign policy stances in the 1960s with regard to Cuba, that were quite at odds with American policy, and its foreign policy stance towards Central America, namely Nicaragua and El Salvador in the 1980s, which was characterised as a very independent policy.²

An important feature of contemporary political history in Mexico was the creation of the National Revolutionary Party in 1929, the precursor of the present day Partido Revolucionario Institucional (PRI) which was founded in 1946 and has held power uninterrupted until December 2000.³ At the conclusion of World War II, under the PRI and the Aleman Administration, Mexico devoted itself to the process of

¹ M. Delal Baer, "Lessons of NAFTA for US Relations with Mexico", Testimony before the US Senate Subcommittee for the Western Hemisphere of the Committee on Foreign Relations, April 27, 2000 (The US Senate Website, <http://www.senate.gov/~foreign/hearings/hrg042700.html>).

² For more on the Mexican Revolution and United States-Mexico relationship, see Charles Harris & Louis Sadler, *The Border And The Revolution* (High-Lonesome Books, Silver City 1988). For an analysis of Mexican policies towards the United States see Clark Reynolds, *The Mexican Economy: Twentieth Century Structure and Growth* (Yale university Press, New London 1970); B. Griffiths, *Mexican Monetary Policy and Economic Development*, Praeger Publishers, New York 1972).

³ In the elections of July 2, 2000, the PRI lost power to Partido Accion Nacional (PAN) and its candidate Vicente Fox signalling the first transition of power in 71 years. PAN was founded in 1939 and is a pro-business, pro-Catholic, centre-right party.

import-substitution industrialisation (ISI). There are at least two common interpretations as to what is meant by import-substitution. Narrowly defined, import substitution is the development by the state of policies designed to close a chronic deficit between the export of primary products and the import of manufactured goods. Broadly defined, import-substitution is a strategy for development, which favours the expansion of the internal market, in contrast to orthodox neoclassical doctrines which emphasise development through the market economy. Within this context, the state is expected to play a crucial role through indicative planning, the construction of state-owned industries in key sectors and the application of temporary protectionist policies in the foreign trade sector.⁴ The goal of ISI was to develop a strong industrial base by encouraging the domestic production of previously imported goods. In Mexico, between 1940 and 1982, the foreign investment laws reflected the government's distrust of foreign investment. For example, Article 27 of the Mexican constitution prohibited foreigners from owning property or any type of real estate within 50 kilometres of the coast and 100 kilometres of the border.⁵ It

⁴ James Cypher, *State and Capital Development in Mexico: Development Policy Since 1940* (Westview Press, Boulder 1990) pp. 5-6.

⁵ Only Mexicans by birth or naturalisation and Mexican companies have the right to acquire ownership of lands, waters, and their appurtenances, or to obtain concessions for the exploitation of mines or of waters. The State may grant the same right to foreigners, provided they agree before the Ministry of Foreign Relations to consider themselves as nationals in respect to such property, and bind themselves not to invoke the protection of their governments in matters relating thereto; under penalty, in case of non-compliance with this agreement, of forfeiture of the property acquired to the Nation. Under no circumstances may foreigners acquire direct ownership of lands or

was for reasons of history and internal political structures that not only Mexico but also most Latin American countries resisted any liberalisation of their economies until the 1980s. Import-substituting industrialisation succeeded in its initial goals of reducing imports and promoting domestic manufacturing. From 1939 to 1969 Mexican imports fell rapidly as a proportion of total Mexican demand and the economy grew at the very impressive annual rate of 6 per cent from 1940 to 1975. At the time Mexico was a model for other countries that employed an ISI strategy.⁶

Until the 1970s, Mexico relied on international institutions to provide capital in the form of loans to spur its economic development. Often these loans carried requirements that made Mexico attentive to scheduled repayments while ensuring economic development under international supervision. However, Mexico's long reluctance to participate in any form of free trade was demonstrated by its refusal to join the General Agreement on Tariffs and Trade (GATT) in 1980. As long as Mexican oil exports could generate increased national wealth, the pressure to join the GATT was never substantial. Mexico followed

waters within a zone of one hundred kilometres along the frontiers and of fifty kilometres along the shores of the country. See *Constitution of Mexico, Chapter 1, Individual Guarantees, Article 27*, (The Mississippi State University Website, http://www.msstate.edu/Archives/History/Latin_America/Mexico).

⁶ Harry Browne, Beth Sims and Tom Barry, *For Richer, For Poorer. Shaping US-Mexican Integration*, (Resource Centre Press and Latin America Bureau, London 1994) p. 12.

the model of a planned economy, with centralised state-guided principles to direct its growth. By avoiding the GATT, Mexico was able to impose import quotas that limited the access of foreign goods to its markets. Tariffs, quotas and import restrictions were supplemented by national ownership of many sectors of the economy. In 1973, for instance, under President Echeverria, a law was passed regulating foreign investment and the transfer of technology from one country to another. The law required that all new companies have at least 51 per cent Mexican ownership. It also called for a National Commission on Foreign Investment to approve or reject all new foreign investment. The Commission was encouraged to direct new investment into areas of the economy not developed by existing firms. In areas where national firms were already in business new foreign investment was discouraged.⁷

As a result, economic development not only for Mexico but also for Latin America took a lower priority during the Nixon, Ford, Carter and Reagan administrations. The US government decided that when Latin American countries needed American capital and technology, these would be channelled through private enterprises and not made available by loans and transfers between governmental organisations. In essence, private loans by American banks, with little or no United

⁷ The Law to Promote Mexican Investment and Regulate Foreign Investment was enacted on February 9, 1973. See Josefina Zoraldá Vasquez and Lorenzo Meyer, *The United States and Mexico* (The University of Chicago Press, Chicago 1985) pp. 185-186 and Frank Macchiarola, "Mexico as a Trading Partner", *Proceedings of the Academy of Political Science*, vol. 37, no. 4, 1990, pp. 101-104.

States government participation, began to replace the loans that had been provided by international organisations.⁸ Loans from private banks were negotiated on a bilateral basis, offered greater freedom to the borrowing nation and were no longer directed toward an agreed-upon policy of economic development for the borrower. Indeed, the entry of private American bankers into the international lending market worked to the short-term advantage of both Mexico and the United States. For Mexico, it meant continued freedom to develop its industries under domestic ownership, with foreign capital being used to finance economic expansion. The United States was able to reduce its economic burden in a time of domestic economic distress, resulting in reduced interest among United States policymakers in the problems of Latin America's political economy.

It was easier for Mexico to borrow from private lenders who were supposedly less politically oriented than official governmental institutions. At the same time the price of oil, which had been \$2.50 a barrel in 1973 began to climb, peaking at \$33.00 a barrel in 1983. For an oil-exporting country, substantial loans stimulated by increasing oil prices created an astonishing – but temporary – boost for the country's economy. Furthermore, the fact that Mexico had the sixth most important world reserves of hydrocarbons enabled the Mexican government to take a stronger and more independent stand vis-à-vis

⁸ Josefina Zoralda, Vazquez and Lorenzo Meyer, *The United States and Mexico*, p. 7.

the United States.⁹ Mexico found it easier to avoid domestic reforms and take advantage of prosperity, but the failure to link the loans to other developmental objectives meant that Mexican industries, many of them state owned could conceal inefficiency, lack of productivity and even corruption.¹⁰

Through the 1970s and early 1980s, Mexico continued to balance its fiscal deficits from loans rather than by increasing taxes on its wealthiest economic sectors. While oil prices remained high, successive Mexican Administrations did not see the need to come to terms with the implications of its substantial borrowings. At the beginning of the 1980s, oil and gas appeared to offer Mexico the opportunity to make the leap from an undeveloped to a developed economy. However, a surplus world supply of fuel transformed a seller's market into a buyer's market and in 1981 the price of oil began to drop. In 1982, Mexico's total (external and domestic) debt reached 51.7 per cent of GDP.¹¹ Instead of devaluing the peso drastically and cutting governmental spending, the Mexican government added \$22 billion to an already large foreign debt. Toward the end of the short-lived oil boom a flight of capital occurred - mostly to the United States

⁹ In 1978, for example, Mexico explored the possibility of shipping crude oil to Cuba. The plan was never carried out but in 1979, Lopez Portillo felt confident enough to receive Fidel Castro on the small Mexican island of Cozumel. See Josefina Zoraida, *The United States and Mexico*, p. 191.

¹⁰ Frank Macchiarola, "Mexico as a Trading Partner", p. 96.

¹¹ Banco de Mexico, Economic and Financial Indicators, (Banco de Mexico Website, <http://www.banxico.org.mx/siteBanxicoINGLES/eInfoFinanciera>).

in the form of \$16 billion between 1981 and 1982. In August 1982, Mexico announced to the world that it was bankrupt and could not make the current payments on its foreign debt of \$83 billion. A month later, the Portillo Administration announced the nationalisation of domestic banks and the imposition of exchange controls.¹² Mexico owed money to 1,400 banks - mostly in the United States. For instance, it owed the Bank of America and Citibank roughly \$43 billion each. Citibank's Mexican exposure equalled two-thirds of its net corporate assets.¹³ The US government acted rapidly to support the Mexican government and thereby avoid a total collapse of Mexico's economy, which could have triggered a series of defaults in Latin America. The Federal Reserve and other American agencies provided an emergency loan of \$1.9 billion and worked closely with Mexican officials and the IMF to renegotiate the Mexican debt. In return, Mexico's new administration under Miguel De La Madrid had to accept an austerity programme negotiated with the IMF and indirectly supported by the

¹² President Lopez Portillo had developed the nationalisation plan in secret, announcing it to his cabinet only twelve hours before his address to the nation. See Sylvia Maxfield, "Capital Mobility and Mexican Financial Liberalisation", in *Capital Ungoverned: Liberalising Finance in M. Loriaux, Meredith Woo-Cumings et. al., eds. Interventionist States* (Cornell University Press, Ithaca 1995) pp. 102-103.

¹³ Kavaljit Singh, *The Globalisation of Finance: A Citizen's Guide* (Zed Books, London 1999) p. 47.

Reagan administration in the United States. The arrangements included devaluation, a cut in government expenditures and salary controls.¹⁴

The response of the American administration to the Mexican debt crisis of 1982 took place in a context of an increasing strategic importance of Mexico to the United States due to Mexico's oil resources, the dimensions of the country's foreign debt that endangered the stability of the US banking system, an impressive increase in bilateral trade, the inflow of Mexican migration to the United States and drug trafficking. These issues created a network of relations that were shared and consolidated during the Mexican economic crisis of 1982. It was then, when many of their common interests reached a critical point, that Mexico and the United States were forced to sit at the negotiating table and establish direct contact.¹⁵ A very good example of this close relationship has been the US-Mexico Binational Commission (BNC) which is a unique forum established by the two countries to allow for regular exchanges at the Cabinet level on a wide range of issues critical to US-Mexico relations. The BNC was established in 1981 by Presidents Reagan and Lopez Portillo and it was envisaged as a simple flexible mechanism that would meet once or twice annually during which US

¹⁴ Josefina Zoraida Vasquez and Lorenzo Meyer, *The United States and Mexico*, pp. 195-196.

¹⁵ Soledad Loaeza, "The Changing Face of Mexican Nationalism", in M. Dela Baer and Sidney Weintraub, eds. *The NAFTA Debate: Grappling with Unconventional Trade Issues* (Lynne Rienner, Boulder 1994) p. 155.

and Mexican counterparts would address issues requiring high-level attention.¹⁶

When Miguel de la Madrid Hurtado became president (1982-1988) following the IMF's and US Treasury's recommendations, the Mexican government made a U-turn in economic policy, dropping ISI and adopting a neoliberal strategy, characterised by the privatisation of public enterprises, the liberalisation of the economy toward foreign markets, salary controls and the reduction of social expenses. Neoliberalism, characterised by a minimalist state, control of inflation and privatisation, holds that reducing all barriers to free market activities will produce economic growth that eventually will benefit everyone. Intent on attracting foreign investment and promoting exports, de la Madrid slashed government spending and rapidly devalued the peso. Slowly some changes began to occur. From 1982 to 1986, Mexican manufacturing imports increased from \$3.4 billion to \$7.8 billion while manufacturing production for domestic markets fell by greater amounts than the increase in imports.

¹⁶ The BNC currently has 14 working groups and two subgroups which reflect the political, economic, law enforcement, social and environmental issues at the centre of US-Mexico relations. BNC working groups range from agriculture, border cooperation, education and cultural affairs to health, labour, trade, investment and migration. See US-Mexico Binational Commission, Fact Sheet Released by the Office of Mexican Affairs, June 10, 1998, (The State Department Website, <http://www.state.gov/www/regions/ara/>).

The Four Variables at Work

From 1986, globalisation of finance, capital flows, international institutions and domestic elites as expressed by the Mexican Administration (four out of five variables of our conceptual framework) played an important role in strengthening the Washington Consensus in Mexico. More specifically, in 1986, President de la Madrid brought Mexico into full participation in the GATT while state-run industries, ranging from sugar plantations to Aeromexico were sold off. These policy shifts responded to the wishes of the IMF and the United States, but they also reflected the economic orientation of the Mexican administration. Once Carlos Salinas de Gortari became president in 1988, there was a further rush to liberalisation. Within three years, import permits - the key instrument for keeping out competitive imports - had been eliminated for practically all goods apart from agriculture and the automotive sector. In May 1989, the government announced the liberalisation of its foreign investment rules to permit 100 per cent ownership of many enterprises with assets as much as \$100 million. As a result, revenues from privatisation and deregulation exceeded 7 per cent of GNP in the 1991-1994 period while the previously nationalised banks reverted to private ownership.¹⁷

¹⁷ A limited return of bank stock into private ownership beginning in 1987 and regulatory changes in 1989 paved the way for full bank re-privatisation in 1991 and 1992. Banking legislation passed in July 1990 permitted 100 per cent private

The government also removed many of the restrictions on foreign investment in the tourism industry and on the system of maquiladoras - the largely American-owned branch-plants located near the United States border that produce goods for export under special legal treatment from both Mexico and the United States. These industries used Mexican labour to assemble American-made parts for shipment back to the United States as finished products. Normal import duties on the finished product had been replaced by much lower duties based on the value added in Mexico by the production of the finished product. Maquiladoras had been in place since 1965, when the Mexican government opened its northern border to foreign - mainly American-owned export processing plants through its Border Industrialisation Program. It represented the first step toward the integration of Mexico into the US manufacturing base. This initiative in effect created an insulated sub-economy governed by different rules and subject to different economic forces. On the one hand the Mexican government encouraged US companies to move to the borderlands and set up maquiladoras, while on the other (until the early 1980s) it discouraged foreign investment in the country's interior. By 1985, these maquiladoras had become the second largest foreign exchange source

ownership of all Mexico's commercial banks. See Sylvia Maxfield, "Capital Mobility and Mexican Financial Liberalisation", pp. 106-108.

in Mexico. Until the mid-1980s the country's economic planners viewed it largely as an employment program (table 3.1).

TABLE 4.1 - MAQUILADORAS, BY PLANTS, EMPLOYEES AND LABOUR COST
1982-1992

YEAR	NUMBER OF PLANTS	EMPLOYEES	AVG HOURLY LABOUR COST (\$)
1982	585	127048	1.78
1983	600	150867	1.28
1984	672	199684	1.43
1985	760	211968	1.39
1986	890	249833	1.02
1987	1125	305523	1.04
1988	1396	369489	1.17
1989	1655	429725	1.30
1990	1930	460293	1.34
1991	1954	489000	1.60
1992	2129	511000	1.64

Source: Harry Browne, *For Richer, For Poorer*, p.14.

However, by the early 1990s export-oriented industrialisation and the production-sharing model of the maquilas were central to the Salinas administration's development strategy for Mexico as a whole.¹⁸

It took seven years of economic reforms (1983-1989) for the new approach to achieve its objective of regaining creditworthiness. In July 1989, after more than seven years, an interim agreement, the Brady Plan, developed by (and named after) the United States Treasury Secretary Nicholas Brady was unveiled by the Bush Administration.¹⁹

¹⁸ Harry Browne, *For Richer, For Poorer*, p. 29.

¹⁹ The Brady Plan was unveiled in a speech by Secretary Brady to the Conference on Third World Debt of the Brookings Institution and the Bretton Woods Committee, March 10, 1989 in Washington DC.

After President Salinas of Mexico signed the agreement (February 1990), Venezuela (March 1990), Costa Rica (March 1990), Uruguay (January 1991), and most of the other major debtors followed over the following two years. The bonus for American interests was that in the process the overall political economy of Mexico and other Latin American countries had been substantially reorganised in a way that made it even more vulnerable to external American penetration than in the past.²⁰ The accord offered bank creditors who held Mexico's \$54 billion of medium and long-term foreign debt three basic choices. First, they could exchange their credit for new bonds carrying a fixed annual interest rate of 6.25 per cent with floating interest rates of more than 10 per cent; second, they could accept a 35 per cent reduction in the face value of these loans and retain the floating interest rate and third they could provide additional loans equal to 25 per cent of their medium and long-term loans. The new bonds issued under the first two options were backed by as much as \$7 billion of United States Treasury securities and accounts financed by the International Monetary Fund (IMF), the World Bank and Japan.²¹ Although Mexico, the United States and the American banks reached an agreement in the matter of the debt crisis, the deliberations were difficult. The United States had been pushing for

²⁰ Anthony Payne, "The United States and its Enterprise for the Americas", in A. Gamble, A. Payne, ed. *Regionalism and World Order* (Macmillan Press, London 1996) p. 101.

²¹ Frank Macchiarola, "Mexico as a Trading Partner", p. 98

a harsh repayment strategy that would have required devaluation of the peso and further reductions in worker salaries. Mexico, on the other hand, was able to point to some substantial measures it had already enacted, notably, a budget with a surplus of 6 per cent, taxes and reduced subsidies. Inflation, which had been 300 per cent annually was brought down to 20 per cent. More than 400 state enterprises were also shut down in the move toward privatisation. The discussions were further complicated by the fact that a bilateral agreement between the United States and Mexico would have been insufficient, since American banks held only 30 per cent of Latin America's debt. International organisations and Japan had to be made part of the solution. The result of delay in reaching and implementing an agreement was to leave Mexico with unmet needs for capital investment. However, Mexico struck the first deal in February 1990 and was followed by other Latin American countries - Venezuela, Costa Rica (1990) and Uruguay (1991) - and most of the other major debtors over the following two years.

The Brady Plan was the first step in focusing upon debt reduction as a way out of the debt crisis. Since the early 1980s the debt crisis had presented US policymakers with two crises: a crisis of US banks which had lent too much to the developing countries and a crisis of the developing countries which had borrowed too much. Thus, US Treasury policies were aimed at keeping the pressure on the debtor countries to continue servicing the debt. The developing countries had

to squeeze their economies to meet the interest payments. The Brady Plan called for the debt problem to be handled on a case-by-case basis, in which each debtor country would negotiate separately with its creditors. Most importantly, it envisaged that any easing of the terms of the debt had to be linked to domestic economic reforms under the supervision of the IMF and the World Bank.²² The bonus for the United States was that in the process, the overall political economy of Latin America had been substantially reshaped in a way that made it even more vulnerable to external penetration than in the past.

The debt crisis produced an unparalleled opportunity to achieve in the debtor countries, the structural reforms favoured by the Reagan administration.²³ In accordance with the Reagan's administration goals of more privatisation and less government regulation, debts were rescheduled in return for lower tariffs and reductions in controls of foreign investment. In addition the Mexican government was forced to privatise state industries. Many of these changes were made under the Brady Plan, which utilised the World Bank, the IMF and world financial markets to pay off their loans. Loans from both the IMF and the World Bank forced Mexico to meet specific conditions for economic readjustment while increasingly guaranteeing foreign access to

²² Jeffrey Sachs, "Making the Brady Plan Work", *Foreign Affairs*, vol. 69, no. , 1989, pp. 90-92.

²³ Jacquelin Roddick, *The Dance of the Millions: Latin America and the Debt Crisis*, (Latin America Bureau, London 1995) p. 43.

Mexico's economy. Included in the reforms were measures to increase the liberalisation of trade, production and finance.²⁴

Mexico's commitment to financial liberalisation was due to the PRI's leaders' aim to reshape the economic and political environment facing potential investors and creditors. As Sylvia Maxfield argued that Mexican policy-makers moved forward with financial liberalisation with the hope that it would lead to a strategic exchange: policy commitments would be made to those who could mobilise finance and investment and they in turn would provide new resources for the national economy.²⁵ Restoring a working relationship with domestic business was more difficult given the climate of distrust and confrontation generated by nationalisations of banks in 1982. In order to win back the economic support and political allegiance of domestic business the De La Madrid Administration also granted economic elites ad hoc concessions through a government-sponsored financial scheme that assisted large firms in restructuring their foreign obligations.

During the De La Madrid Administration two segments of business acquired increasing centrality and weight: exporters and new private financial groups. The growing importance of the former was related to the shift toward outwardness. The growth of a new private

²⁴ Duncan Green, *Silent Revolution*, (Latin America Bureau, London 1995) pp. 32-88.

²⁵ Sylvia Maxfield, "Capital Mobility and Mexican Financial Liberalisation" in Michael Loriaux et al, eds. *Capital Ungoverned: Liberalising Finance in Interventionist States* (Cornell University Press, London 1997) p. 93.

financial elite was the result of the expansion of the non-banking financial sector after 1983. As Blanca Heredia argued the intra-business power shifts triggered by stabilisation and structural adjustment were accompanied by major shifts in the correlation of forces within the state apparatus. The push in favour of markets eroded developmentalist policy elites and boosted the leverage of a new generation of pro-market technocratic elites. These shifts allowed a rising group of technocrats to use market-reform as a vehicle for building a new type of alliance with economic elites.²⁶ The new coalition was based upon a broad heterodox bargain among economic elites, the presidency and remnants of both corporatist and populist groups from the original coalition of the PRI. Power had shifted toward those elites who shared a commitment to a market economy which is embedded in the Washington Consensus. Vital to this move were three pacts (pactos de concertacion) which were used to extract concessions from major groups in exchange for political access and the promise of future benefits. The Programme for Immediate Economic Restructuring (1983), the Pact of Economic Stability (1987) and the Pact of Economic Stability and Growth (1988) sought to curb inflation, and began to put a

²⁶ Blanca Heredia, "State-Business Relations in Contemporary Mexico", in Monica Serrano and Victor Bulmer-Thomas eds. *Rebuilding the State: Mexico After Salinas* (New York 1996) pp. 135-138. See also Sidney Weintraub and M. Delar Baer, "The Interplay Between Economic and Political Opening: The Sequence in Mexico" in *The Washington Quarterly*, vol. 15, no. 2, 1992, p. 192.

neoliberal economic agenda into place. The Pacts were instrumental in persuading the private sector, which constituted the main beneficiary, that the Mexican government was serious about its commitment toward economic liberalisation, private investment and free trade.²⁷

The immediate impact of De La Madrid's policies was the near defeat of his successor, Carlos Salinas de Gortari. In the 1988 presidential elections, many former PRI supporters voted for the left-of-centre candidate Cuauhtemoc Cardenas Solorzano, who promised to end the unpopular austerity measures. Among Cardenas' supporters were government bureaucrats and PRI-affiliated labour unions.²⁸ Although the structural reforms were initiated during the De La Madrid administration the most important changes were undertaken by the Salinas government (1988-1994). The *salinista* reforms included the privatisation of banks, telecommunications monopoly and the two main airline companies. In total, the privatisation process brought revenues of about 10 per cent of the GDP. After a major trade liberalisation Mexico became one of the most open countries in the region. By 1994 each of the ten policy instruments listed by Williamson as forming the basis of the Washington Consensus has been applied in a way that promoted the structural adjustment of the Mexican economy.

²⁷ Guy Poitras and Raymond Robinson, "The Politics of NAFTA in Mexico", *Journal of Interamerican Studies and World Affairs*, vol. 36, no. 1, 1994, pp. 7-10.

²⁸ Susan Kaufman Purcell, "Mexico's New Economic Vitality", *Current History*, February 1992, p. 55.

However, the privatisation of several key enterprises turned out to be a failure. As Carlos Urzua has argued, due in larger part to the biased selection of buyers and a lack of proper supervision after privatisation, the sale of some public enterprises ended up doing more harm than good from a social welfare point of view. Furthermore, the privatised banking sector performed poorly not only according to international standards, but also compared with the performance of publicly owned banks. In addition if one considers several typical general indicators of how the Mexican economy has evolved over the years, the worst performances between 1946 and 1994 occurred during the De La Madrid and Salinas administrations ²⁹ (table 3.2).

TABLE 4.2 - THE MEXICAN ECONOMY 1946-1994

Administration	GDP Growth %	Inflation Rate %	Current Account	% of Poor People
Aleman (1946-52)	5.8	9.6	-1.6	N/a
Ruiz Cortines (1952-58)	6.4	6.7	-2.9	N/a
Lopez Mateos (1958-64)	6.4	2.2	-2.3	77.5
Diaz Ordaz (1964-70)	6.2	3.6	-2.6	72.6
Echeverria (1970-76)	6.0	15.2	-3.7	58.0
Lopez Portillo (1976-82)	6.6	35.7	-5.1	48.5
De La Madrid (1982-88)	0.2	86.7	1.7	58.5
Salinas (1988-94)	3.0	15.9	-5.6	66.0

Source: Carlos Urzua, "How to Provoke an Economic Crisis: The Mexican Way, p. 98.

²⁹ Carlos Urzua, "How to Provoke an Economic Crisis: The Mexican Way", in Monica Serrano, ed. *Mexico: Assessing Neo-Liberal Reform* (Institute for Latin American Studies, London 1997) pp. 97-99.

Mexico also adopted an exchange rate system intended to help stabilise its domestic economy. In 1988, the nominal exchange rate of the peso was fixed temporarily in relation to the US dollar. In 1989 this fixed exchange rate system was replaced by a “crawling peg” system, under which the peso/dollar exchange rate was adjusted daily to allow a slow rate of nominal depreciation of the peso to occur over time. In 1991 the crawling peg was replaced with a band within which the peso was allowed to fluctuate. The ceiling of the band was adjusted daily to permit some appreciation of the dollar to occur (table 3.3).

TABLE 4.3 -EXCHANGE RATE OF PESO AGAINST THE DOLLAR, 1984-1996

YEAR	EXCHANGE RATE
1984	185.19
1985	310.28
1986	637.87
1987	1405.8
1988	2289.58
1989	2483.37
1990	2838.35
1991	3016.15
1992	3004.08
1993	3.162 *
1994	5.325
1995	5.695
1996	7.877

Source: Bank of Mexico. Economic Indicators, 1997

* In 1993 the Mexican government divided the face value of the peso by 1000.

Prior to NAFTA, Mexico’s economic strategy of adopting sound monetary and fiscal policies appeared to be having its intended effects.

Inflation had been steadily reduced, government spending was down and foreign capital investment was significant and growing.³⁰

For Mexico, NAFTA was the climax of an extraordinary decade-long economic reform which shifted Mexico away from an inward-oriented development policy that emphasised import substitution and close regulation of commercial ties with other nations. The Mexican rationale for NAFTA is best understood in terms of the country's need for external finance. Heavy debt-servicing obligations and a depressed world market for oil were among the main factors responsible for investment levels that were too low to create robust recovery. Thus, the resumption of satisfactory rates of economic growth in Mexico depended upon increased external capital inflow. NAFTA could bolster investor confidence, not only by offering a positive signal for future intentions, but also by improving market access for export-oriented activities and by making concessions to American capital.³¹ If economic liberalisation was to work within Mexico, the economy needed external support. A free trade agreement could provide strong incentives for

³⁰ See United States General Accounting Office, "Mexico's Financial Crisis. Origins, Awareness, Assistance and Initial Efforts to Recover", Report to the Chairman, Committee on Banking and Financial Services, House of Representatives Washington DC, February 1996, p. 5.

³¹ Gerald Helleiner, "Considering US-Mexico Free Trade", in Ricardo Grinspun and Maxwell Cameron, eds. *The Political Economy of North American Free Trade* (Macmillan Press, London 1993) p. 48.

both domestic and foreign investors to develop Mexico's markets and bring in new technology and management skills.³²

Regarding the role of ideas mediated through domestic elites as the fourth variable of the framework of this thesis, it is important to stress that NAFTA was not imposed on Mexico by the United States but it reflects the role adopted by the Mexican state representing the interests of its bureaucracy and domestic elites as these were already influenced by foreign capital and the Washington Consensus. Furthermore, membership in the NAFTA was critical to stimulate economic recovery and thus, the regime's own political survival. NAFTA had the effect of reinforcing the reorganised ruling coalition that was formed during the 1980s. The core of private sector support for NAFTA was composed of large Mexican manufacturing firms (especially those with the potential to find a large American market for their exports) medium-sized manufacturers who could find niches in the export market, capital-intensive foreign businesses, the international financial community and domestic suppliers of foreign businesses in Mexico. Pro-NAFTA sentiment also gained momentum within the business community via creation of an association specifically organised for that purpose. In 1990, the *Coordinadora de*

³² Jeffrey Schott, "The Free Trade Area of the Americas: US Interests and Objectives", Statement before the Subcommittee on Trade, House Committee on Ways and Means, Washington DC July 22, 1997 (The Institute for International Economic Website, <http://www.iie.com/ftaa.htm>).

Organismos Empresariales de Comercio Exterior (COECE) emerged to serve as a critical coordinating body linking the government with the private sector. COECE became the most important group of its kind in the private sector and a close ally of the government on the free trade agreement. Indeed as Poitras and Robinson argued COECE shared ideology, personnel and positions of key issues with the Salinas Administration.³³ However, in an open political system, the liberalisation programme and the decision for NAFTA would not have gone so far and so quickly as it had in Mexico. Voters would have attenuated or even rejected it; the media would have discussed and conditioned it; Congress would have screened, slowed and regulated it; and unions would have cut slices off it. Because none of these checks and balances existed in Mexico, Salinas had appeared as a reformer and a free trade hero to many people in the United States.³⁴

The most open challenge to the impact of globalisation on social and political structures has come from a revolutionary movement, the *Zapatista* rebellion of the Mayan Indians in the southern Mexican state of Chiapas that broke out on New Year's day 1994. This was the day on which the NAFTA came into effect. The Zapatistas have attempted to cultivate international support and to change the Mexican political

³³ Guy Poitras and Raymond Robinson, "The Politics of NAFTA in Mexico", pp. 16-17.

³⁴ Adolfo Aguilar Zinser, "Authoritarianism and North American Free Trade: The Debate in Mexico", in Ricardo Grinspun and Maxwell Cameron, eds. *The Political Economy of North American Free Trade*, p. 215

system. They have aimed to become a rallying force for democratic change and to create the beginnings of a counterhegemonic bloc.³⁵

For the United States, free trade with Mexico was consistent with its international trade agenda. During the 1980s, a national debate over “national competitiveness” had made the American public sensitive to the fact that, through formal or informal integration schemes, Asian and European nations (particularly Japan and Germany) were overtaking the United States in terms of productivity and market share.³⁶ From this perspective, the prospect of a trade agreement with Mexico was perceived as an efficient strategy to follow. Indeed this initiative helped to catalyse the Uruguay Round negotiations of the GATT and improve the competitiveness of the American economy by augmenting the size and scope of its regional economy and thus the ability to compete successfully with Japan. Finally, the agreement with Mexico significantly improved the access and protection of US investment in Mexico and provided a useful blueprint for other countries in the hemisphere.³⁷

³⁵ However their attempts to offer an alternative have failed and by the end of 2000, the Zapatistas agreed to stop the rebellion and open dialogue with the new President Vicente Fox. See Robert Cox, “Civil Society at the Turn of the Millenium: Prospects for an Alternative World Order”, *Review of International Studies*, vol. 25, 1999, pp. 23-24.

³⁶ J. Enrique Espinoza and Pedro Noyola, “Emerging Patterns in Mexico-US Trade”, in Barry Bosworth et. al., eds. *Coming Together?* (Brookings Institution Press, Washington DC 1997) p.29.

³⁷ For further analysis on NAFTA and hemispheric free trade see Panayotis Karayannis, *Regional Integration in North America: NAFTA and the American Agenda*, MA Thesis submitted to the University of Hull, UK, September 1996.

There were two central strategic objectives for the United States in NAFTA. First, a key American goal was to promote pluralism in Mexico because it was thought that this would enhance both political and economic stability over the long run. The economic opening that the agreement has reinforced was expected to push developments in that direction. Second, a key objective was to secure the de la Madrid-Salinas reforms against the risk that future Mexican governments might cancel them. NAFTA obligations raised the cost of such a policy alteration and thus protected American interests.³⁸

NAFTA has lowered barriers to an important and growing market of 90 million people, creating new trade opportunities for American exporting firms. As a result, NAFTA has encouraged American companies that have moved their operations to Asia to relocate in Mexico, which has helped the United States. According to a US Senate analysis, first, by moving to Mexico, a company would increase employment in Mexico. This higher employment level would increase United States' exports to Mexico because 70 cents out of every dollar Mexicans spend on imports they spend on American products. Asians on the other hand, only spend about 10 cents to 15 cents out of

³⁸ Statement by Fred Bergsten of the Institute for International Economics before the Ways and Means Committee, US House of Representatives, September 11, 1997 (The Institute for International Economics Website , <http://www.iie.com/sept11.htm>).

every dollar on US goods.³⁹ Second, as trade barriers are coming down, US transnational corporations have a substantial interest in co-production arrangements in the Western Hemisphere. The very basis for the export-processing zones that have proliferated, especially in Mexico is to exploit factor advantages – low labour costs for labour-intensive operations whose proximity minimises transportation costs. By eliminating tariffs on Mexican imports, for example, US automobile firms have been expected to gain a competitive advantage over Japanese automakers through access to low cost Mexican labour and the burgeoning Mexican consumer market.

The more powerful position of the United States, along with Mexico's more pressing need to maintain good relations with its northern neighbour, has placed Mexico in a weak and vulnerable position in trade negotiations. Washington has taken advantage of the asymmetric relationship to gain Mexican cooperation with American priorities. For example, prior to NAFTA, in 1990 the US Trade Representative Carla Hills placed Mexico on the "Priority Watch List" of trading partners whose policies the US Trade Representative considered unfairly biased against American companies. Washington's threat of withdrawal of preferential tariff treatment affecting \$220 million of Mexican chemical industry exports persuaded Mexico to

³⁹ Senate Record Vote Analysis, "North American Free Trade Agreement/Passage" (Bill Passed, 61-38), 103d Congress, 1st Session, November 20, 1993, Vote No. 395, (The US Senate Website, <http://www.senate.gov/~rpc/rva/1031/1031395.htm>).

drastically rewrite its laws on intellectual property rights, even before NAFTA was negotiated.⁴⁰ Indeed, the regional dominance of the United States - not only economically, but also culturally, militarily and politically - has been a key aspect of NAFTA. Asymmetries of power, wealth, technology and cultural influence between Mexico and the United States have guaranteed that the benefits and adjustment costs have been distributed unequally within and between the two countries. When a small country is bargaining for an agreement in which it gains more market access than its more powerful partner, that stronger partner will inevitably extract some compensating concessions.

Enhanced American and Canadian access to the Mexican energy sector is one concession that Mexico had to make to get an agreement. Petroleum has enormous political and symbolic value in Mexico for it is a major power resource that has been used to strengthen Mexico's bargaining position in relation to the United States in the past. It has been argued that a major US objective in trade negotiations with Mexico and Canada has been to gain secure access to the petroleum sources of its neighbours.⁴¹ The Bush Administration's energy strategy called for greater reliance on oil imports from countries outside the Persian Gulf, such as Canada and Mexico. American geopolitical interests demanded

⁴⁰ Harry Browne, *For Richer, For Poorer*, p. 20.

⁴¹ John Dillon, "The Petroleum Sector under Continental Integration", in Ricardo Grinspun and Maxwell Cameron, eds. *The Political Economy of North American Free Trade* (Macmillan, London 1993), p. 315.

that Mexico and Canada concede substantial control over energy as the price for a broad trade agreement. Indeed, to make Petroleos Mexicanos (PEMEX) the state's petroleum company, more attractive to foreign lenders, the Salinas government laid off more than 70,000 workers and in June 1992 split the company into four divisions, isolating ownership and production from refining, marketing and distribution. NAFTA's energy provisions complemented these changes by opening up procurement and offering service contracts to American firms. The reorganisation facilitated increased foreign investment in downstream operations while allowing Mexico to retain ownership over reserves. The changes allowed such transnational corporations as Du Pont, Union Carbide and Allied Chemical to increase their stakes in the production of petroleum-based chemicals.⁴²

NAFTA did not require major changes in American economic policies toward trade and investment. The United States made clear that Mexico would have to improve its trade, investment and related policies before an agreement could be concluded. Hence, NAFTA deserves credit for some part of the Mexican economic reforms implemented since 1990, as well as the substantial further reduction of Mexican tariffs and other trade and investment barriers since NAFTA formally took effect. However, only a few changes that Mexico had not

⁴² Harry Browne, *For Richer For Poorer*, p. 27.

already made or was not planning to make have been implemented. NAFTA represented just another step down the road toward the Washington Consensus. For the most part, economic liberalisation had been occurring within the context of GATT. For Washington the free trade proposal offered the opportunity to achieve multiple objectives. It presented the chance to open the door to Mexico's long-protected market even wider than it had been opened by the country's drive to liberalise trade (table 3.3).

TABLE 4.4- PERCENTAGE OF US-MEXICAN TRADE THAT IS TARIFF-FREE*

	MEXICAN EXPORTS TO THE UNITED STATES	MEXICAN IMPORTS FROM THE UNITED STATES
Free Before NAFTA	13.9	17.9
Free from January 1994	67.7	48.9
Free within 10 years	99.3	98.1
Free within 15 years	100.0	100.0

Source: *The Economist*, October 28, 1995.

*Based on trade in 1990

A boom in industrial investment and production would result in greater demand for US products. In addition, opening new sectors of Mexico's economy – such as financial services and automobiles – to US exports and investment could boost specific troubled industries in the United States. Beyond its own economic reasons, the United States had long sought to ensure that its southern neighbour remained politically stable, even when Mexican leaders attacked the United States rhetorically. A free trade accord could accomplish this by aiding a friendly administration and supporting Mexico's neoliberal economic

strategy. Economic growth could also reduce the flow of Mexican migrants seeking a better life north of the border. As Mexico became more prosperous, so fewer illegal immigrants would enter the United States and as a result local governments would not have to spend as much on providing social services for illegal immigrants.⁴³

For the United States, NAFTA could also serve as a model for multilateral trade agreements with other countries of the Americas. NAFTA represented an attempt to shape economic integration along neoliberal lines, using trade as a tool to limit government's ability to interfere with business priorities. Indeed the case of NAFTA the core of rules and norms around which state actors have made a compromise was to the benefit of market actors, mainly firms and transnational companies. The implementation of NAFTA consolidated and institutionalised the *salinista* reforms, one of the key objectives of American administration. The existence of NAFTA sharply narrowed the available range of policy options for Salina's successors. From the 1940s to the 1980s, Mexico derived some of its stability from the ability of its various regimes to swing from Left to Centre to the Right in their social and economic policies. That option does not exist anymore - whatever the nature of Mexican public opinion. In a sense, it was the autonomy of the state that enabled it to carry out such far-reaching

⁴³ Senate Record Vote Analysis, "North American Free Trade Agreement/Passage" (Bill Passed, 61-38), 103d Congress, 1st Session, November 20, 1993, Vote No. 395, (The US Senate Website, <http://www.senate.gov/~rpc/rva/1031/1031395.htm>).

reforms. One consequence of the salinista strategy was the surrender of this autonomy *vis-à-vis* the business class. Moreover, it seems unlikely that, under NAFTA, Mexico will be able to express serious disagreement with the United States on major issues of international diplomacy. As the then US ambassador in Mexico, John D. Negroponte pointed out in 1991, from a foreign policy perspective, "an FTA would institutionalise acceptance of a North American orientation to Mexico's foreign relations."⁴⁴

After NAFTA, the following elements of the Washington Consensus were in place in Mexico: fiscal discipline, financial liberalisation, trade liberalisation, foreign direct investment, privatisation, deregulation and property rights. NAFTA was designed in the aftermath of a decade or more of forced structural adjustment in Mexico and other Latin American economies and it sought in effect to set out and enforce new economic and political rules of the game in the hemisphere along the lines of the Washington Consensus. These rules reflected the triumph of the Washington Consensus based on economic liberalism, of faith in export-led growth and of belief in the centrality of the private sector to the development process. The core of the consensus under NAFTA was to build a more transparent and predictable environment for market actors, in order to increase the efficiency of

⁴⁴ Peter Smith, "The Political Impact of Free Trade on Mexico", *Journal of Interamerican Studies and World Affairs*, Vol. 34, 1992,, pp. 17-18.

cross-country trade, services and investment transactions.⁴⁵ In a period of intensified global competition, the United States saw Latin America as a part of the world where the United States had a greater natural advantage than either of its main trading rivals. NAFTA was conceived as a device by which to create an increasingly integrated hemispheric economy which the United States could then use as the base from which to export ever more competitively to other markets.⁴⁶

Congressional passage of NAFTA on November 20, 1993 enabled President Clinton, only two days later, on November 22, 1993 to launch a new era in Asia-Pacific economic cooperation via the APEC summit in Seattle. The two events together played a critical role in completing the “trade triple play” of 1993 by bringing the Uruguay Round to a successful conclusion in the following month. NAFTA also represented an initial test of the US strategy of asymmetrical trade liberalisation with important developing countries. NAFTA provided a model for the proposed Western Hemisphere and APEC free trade arrangements where free trade was so clearly in the interest of the United States.⁴⁷ The United States had an important stake in the economic health of Latin America which was already an important market for American

⁴⁵ Isidro Morales, “NAFTA: The Governance of Economic Openness”, *The Annals of the American Academy of Political and Social Science*, no. 565, September 1995, pp. 40-41.

⁴⁶ Anthony Payne, “The United States and its Enterprise for the Americas”, p. 107.

⁴⁷ Fred Bergsten and Jeffrey Schott, “A Preliminary Evaluation of NAFTA”, Statement before the Subcommittee on Trade, US House of Representatives, (The Institute for International Economics Website, <http://www.iie.com/sept11.htm>).

companies and had become increasingly attractive for direct investment as economic reforms had taken root.

This fact was illustrated at the Summit for the Americas in Miami in December 1994, where the United States and 33 other countries in the Western Hemisphere committed themselves to completing negotiations on a Free Trade Area of the Americas (FTAA) by the year 2005. The trade talks were officially launched at the second Summit of the Americas in Santiago, Chile in April 1998. The negotiation of a FTAA with Latin America would not require substantial changes in the existing US law or trade practices. As with NAFTA, an FTAA would require much more from America's trading partners in terms of trade liberalisation and regulatory reform. An FTAA bargain will likely entail substantial new liberalisation by Latin American countries in return for guarantees of continued access to American market.⁴⁸ It was during the age of colonialism in the late nineteenth century that the United States, utilising the implied threat of the Monroe Doctrine of 1823 impeded foreign political competitors and targeted Mexico (and also the Caribbean and Latin America) as its "backyard". Presently, NAFTA can be understood as the economic

⁴⁸ Jeffrey Schott, "The Free Trade Area of the Americas: US Interests and Objectives", Statement before the Subcommittee on Trade, House of Representatives, Washington DC, July 22, 1997 (The Institute for International Economics Website, <http://www.iie.com/ftaa.htm>).

equivalent of the Monroe Doctrine.⁴⁹ A state-sponsored economic pact by a hegemonic state in relative decline with a state that is historically perceived as a region of influence is described by Wallerstein as a situation in which “the declining hegemon corners potential markets and labour via rather traditional zone-of-interest diplomacy”.⁵⁰

The Fifth Variable in the form of The Peso Crisis of 1994-1995

In an increasingly globalised economy, domestic economic policies, whether good or bad, do not alone determine the country's current account. From 1991 to 1993, when large-scale capital inflows to Mexico resumed after years of debt crisis, interest rates in the United States were lower than they had been in years. In 1992 and 1993, three-month US Treasury bills yielded less than 4 per cent for the first time since 1965. With US interest rates so low, investors were willing to consider moving funds to Mexico in the hope of earning higher returns. A significant part of the capital inflow went into short-term financial investments, such as bank deposits and government bonds that could flow out of Mexico with tremendous speed if a financial crisis arose.

⁴⁹ Miguel De Oliver, “The Hegemonic Cycle and Free Trade: The United States and Mexico”, *Political Geography*, vol. 12, no. 5, September 1993, p. 468.

⁵⁰ Immanuel Wallerstein, *Geopolitics and Geoculture*, (Cambridge University Press, New York 1991) p. 43.

Mexico's private capital inflow from 1990 through 1994 totalled \$95 billion and appeared in three main forms. The first was direct investment by foreigners, usually companies, buying or building factories, and retail stores in Mexico. This type of investment, however, was frequently long-term because it involved commitments that could not be reversed quickly and at a low cost. From 1990 through 1994, this type of investment totalled \$24 billion, only a quarter of the total capital inflow. Second, capital inflow took the form of purchases in the Mexican stock market, which totalled \$28 billion over the five years. The third and largest form of capital inflow was the purchase of bonds. From 1990-1994, \$43 billion came into Mexico for this purpose. A large portion of these securities was short-term of one to three months duration. Of the three forms of capital inflow the third posed the greatest danger to the exchange rate of the peso. If anything caused foreign investors to decide to pull out of Mexico, they could simply take their money out of the country, putting tremendous pressure on the government within a matter of weeks.⁵¹

During October and November 1994, the US Treasury cautioned Mexican officials that the peso seemed overvalued and indicated that it was risky to continue the existing exchange rate policy. Federal Reserve and Treasury officials, however, were undecided about the extent to

⁵¹ Joseph Whitt Jr., "The Mexican Peso Crisis", *Economic Review*, Federal Reserve Bank of Atlanta, January 1996, p. 5.

which the peso was overvalued and if and when financial markets might force Mexico to take action. The IMF was less aware of the seriousness of the situation that was developing in Mexico during 1994 than was the American government and for most of 1994 it did not see a compelling case for a change in Mexico's exchange rate policy.⁵² Due in part to a forthcoming presidential election, Mexican authorities were reluctant to take action in the spring and summer of 1994, such as devaluing the peso, that could have reduced this inconsistency. In response to investor concerns, the government issued large amounts of short-term dollar-indexed notes called "tesobonos". Furthermore, the Mexican government treated the production and release of official statistics more like a secret than part of its accountability to society. In fact, for months before the crisis erupted, no official information was available about the level of international reserves, capital flows or outstanding short-term debt.⁵³

The first significant drop in investor confidence in Mexico in 1994, and the related drop in Mexican foreign currency reserves, occurred following the assassination of Mexican presidential candidate Luis Donaldo Colosio on March 23, 1994. On March 24, 1994 the American authorities agreed to make available a temporary short-term

⁵² United States General Accounting Office, "Mexico's Financial Crisis. Origins, Awareness, Assistance and Initial Efforts to Recover", February 1996, pp. 5-6.

⁵³ Moises Naim, "Mexico's Larger Story", p. 120.

credit facility of \$6 billion. Mexico's foreign currency reserves fell from \$24.4 billion at the end of March to \$17.3 billion at the end of April 1994. The peso was allowed to depreciate less than 1 per cent against the dollar, following a 7 per cent depreciation that had taken place in the month preceding the assassination. Also the Bank of Mexico increased domestic interest rates from 9 per cent to 18 per cent on short-term peso-denominated notes called "cetes" in an attempt to stem the outflow of capital. However, despite the higher interest rates, investor demand for cetes continued to lag. Options available to the Mexican government at this time included offering even higher interest rates on cetes or reducing government expenditure to reduce domestic demand, decreasing imports and relieving pressure on the peso, or alternatively devaluing the peso. From the perspective of the Mexican authorities, the first two choices were unattractive in a presidential election year because they could have led to a significant downturn in economic activity. The third choice was also unattractive, since Mexico's success in attracting foreign investment depended on its commitment to maintain a stable exchange rate.⁵⁴

Rather than adopt any of these options, the government chose to increase its issuance of tesobonos. Because tesobonos were dollar-indexed, holders could avoid losses that would otherwise result if Mexico subsequently chose to devalue its currency. Tesobonos proved

⁵⁴ GAO, *Mexico's Financial Crisis*, p. 10.

attractive to domestic and foreign investors. However, as sales of tesobonos rose, Mexico became vulnerable to a financial market crisis because many tesobono holders were portfolio investors who were very sensitive to changes in interest rates and risks. Mexican authorities viewed tesobono financing as the best way to stabilise foreign exchange reserves over the short term and to avoid the immediate costs implicit in the other alternatives. Indeed Mexico's foreign exchange reserves did stabilise at a level of about \$17 billion from the end of April through August, when the presidential elections came to a conclusion. But Mexico had become heavily exposed to a run on its foreign exchange reserves as a result of substantial tesobono financing. Outstanding tesobono obligations increased from \$3.1 billion at the end of March 1994 to \$29.2 billion in December 1994. By that time cetes had shrunk to only 25 per cent of foreign holdings of Mexican government securities; 70 per cent was in tesobonos.⁵⁵ An important external shock added to the problems. Between January 1994 and November 1994, US three-month Treasury bill yields had risen from 3.04 per cent to 5.45 per cent, substantially increasing the attractiveness of American government securities. Concerned that inflationary pressures were building as the American economy approached its potential, the Federal Reserve raised its federal funds rate target for the first time since the recession of 1990-91. In the weeks following the Federal Reserve's interest rate hike, in

⁵⁵ Joseph Witt, "The Mexican Peso Crisis", p. 12.

early February 1994, virtually all major emerging stock markets fall by 20-30 per cent. As US rates continued to rise, net additions to foreign portfolio exposure in emerging markets and elsewhere declined. This decline in foreign flows affected all major Latin American markets, as well as most other emerging markets. Due to its large external financial needs, Mexico was significantly more vulnerable than most other emerging economies.⁵⁶ Mexican economic policymakers responded to this succession of internal and external shocks mostly by treating them as temporary problems and trying to avoid major policy changes. Mexico's presidential election provided strong motivation to delay major initiatives, even after the election policy continued as before.⁵⁷ Salina's reasons for not devaluing the peso before leaving office (December 1, 1994) were both political and personal. Salinas' intention was first to guarantee a PRI victory in the August 1994 presidential election, assuring his place in history as Mexico's great moderniser and becoming the head of the World trade Organisation. No other institution within the Mexican government had the power or autonomy to question the soundness of the president's judgement.⁵⁸

⁵⁶ Testimony by Robert Hormats, Vice Chairman, Goldman Sachs Int., before the Committee on Banking and Financial Services, US House of Representatives, on the Mexican Financial Crisis, February 10, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

⁵⁷ Joseph Witt Jr., "The Mexican Peso Crisis", p. 11.

⁵⁸ Denise Dresser, "Post-NAFTA Politics in Mexico: Uneasy, Uncertain, Unpredictable", in Carol Wise ed. *The Post-NAFTA Political Economy: Mexico and the Western Hemisphere*, (Pennsylvania State University Press, Pennsylvania 1998) p. 225.

In October 1994 and in an effort to attract new foreign capital, Mexico agreed to grant opening licenses to 52 foreign banks and brokerage houses. It was expected that this policy would result in the short to medium run in a flow of at least \$5 billion.⁵⁹ It did not happen. On December 9, 1994 the Mexican administration revealed that it expected an even higher current account deficit in 1995 but planned no change in its exchange rate policy. This decision led to a further loss in confidence by investors and a significant drop in foreign exchange reserves to \$10 billion. On December 20, 1994 Mexican authorities sought to relieve pressure on the exchange rate by announcing a widening of the peso/dollar exchange rate band. The widening of the band effectively devalued the peso by about 15 per cent. However, the government did not announce any new fiscal or monetary measures to accompany the devaluation - such as raising interest rates. The devaluation was accompanied by more than \$4 billion in losses in foreign reserves on December 21 and on December 22, 1994 with reserves reduced to less than \$6 billion, Mexico was forced to float its currency. As a result, the peso plunged and the government's access to credit markets dropped sharply. Almost overnight, Mexico lost its reputation for maintaining a stable exchange rate and sound financial policies - and the major benefits of that reputation. By the end of

⁵⁹ See Sebastian Edwards, "The Mexican Peso Crisis: How Much Did We Know? When Did We Know It?", *National Bureau of Economic Research Working Paper*, no. 6334, December 1997, p 23.

December 1994, the peso had depreciated to 5.3 pesos per dollar, 35 per cent below its value a month earlier. In real terms the peso reached levels previously seen only during the crises of 1982 and 1986-87, even though Mexican economic fundamentals seemed much better than in those earlier years. In short, the Mexican crisis stemmed from a combination of an over-valued exchange rate; a large and growing account deficit; a relatively high level of short-term external debt; political instability; and inappropriate economic policies. An economy reliant on foreign capital had subjected itself to external vulnerabilities. The financial crisis of 1994-95 showed the fragile stability of such a model and its sensitivity to political disturbances.

By the time of the peso crisis, Mexico had applied all ten elements of the Washington Consensus regarding fiscal discipline, public expenditure, tax reform, financial liberalisation, exchange rates, trade liberalisation, foreign direct investment, privatisation, deregulation and property rights. As was demonstrated in this chapter, the advance of the Washington Consensus in Mexico before 1995 was based on the four of the five variables of this thesis' framework: globalisation of finance, mobility of capital, international institutions and ideas accepted by the domestic elites. The fifth variable, the limited instability of the system as expressed through financial crises and episodes was introduced with the peso crisis, which challenged the financial liberalisation that took place in Mexico after 1982. The next

chapter (Chapter Five) analyses the policy response of the United States in order to restore confidence in market-oriented reforms not only in Mexico but also in the rest of Latin America. Chapter Five demonstrates that with the fifth variable in function the result was further entrenchment of the Washington Consensus in Mexico and the rest of Latin America.

CHAPTER FIVE

ENTRENCHING THE WASHINGTON CONSENSUS IN LATIN AMERICA: THE RESPONSE OF THE UNITED STATES TO THE PESO CRISIS OF 1994-95

This chapter examines the policy response of the United States to the peso crisis (1994-95) and the effect that it had on the Mexican economy. The first part of this chapter focuses on the debate over the policy of the United States toward Mexico, which led to the decision by the US President to approve a bailout of Mexico through the US Treasury. The second part of this chapter analyses the conditionality that accompanied the bailout of Mexico to demonstrate the applicability of the afore mentioned conceptual framework's five key variables on which the entrenchment of the Washington Consensus was based in Mexico.

The Peso Crisis, the Interests of the United States and the Debate over Financial Assistance to Mexico

The Clinton administration judged that it was in the interest of the United States to intervene in the Mexican economic crisis of 1994-1995 on the basis of four considerations. First, the possible loss of jobs in the United States if the crisis forced Mexico to slash its American imports. Second, the possible political turmoil if Mexico's financial meltdown continued. Third, the possibility of the new wave of illegal immigrants entering the United States. A near-collapse of the Mexican economy would have led to regional slowdowns in California and Texas and a substantial increase in illegal immigration to the United States. Fourth, was a possibility that the crisis would spread to other developing countries. It was feared that a sudden end to the \$150 billion annual flow of private investment from the industrial core of the world economy to the developing periphery would have caused serious economic crises in Argentina, elsewhere in Latin America and beyond.¹

Some observers, including members of the US Congress (mainly Republicans but also a few Democrats) believed that Mexico and its creditors should have handled the crisis alone, without any special US

¹ See Bradford De Long, Christopher De Long and Sherman Robinson, "The Case for Mexico's Rescue. The Peso Package Looks Even Better Now", *Foreign Affairs*, vol. 75, no. 3, 1996, p. 12.

government loans or guarantees to stave off Mexican government default. In that case, both Mexico and its creditors would suffer but in the future both borrowers and lenders would be more careful.² In this case, American guarantees were portrayed as increasing the likelihood of future crises by encouraging the Mexican government and other developing countries to behave less cautiously. Liberals opposed the bailout because they argued it sent the wrong signal to private markets and developing countries. Any intervention would undermine the credibility of the market-oriented approach to development by substituting official for private capital, by offering implicit insurance to private capital flow and, most importantly, by indicating a lack of confidence in the self correcting capacity of financial markets.³

On January 2, 1995 an \$18 billion line of credit for Mexico was committed, composed of \$9 billion from the United States and \$9 billion from other major governments and a few large private banks, with the hope that investor confidence would be restored sufficiently to end the financial crisis.⁴ On January 11, 1995 a letter opposing the proposed assistance package to Mexico was sent by four members of the House of Representatives to the Treasury Secretary arguing that the total sum of

² This situation is related to what is called moral hazard -- the tendency for insurance to encourage irresponsible behaviour in the future.

³ Cited in Maxwell Cameron and Vinod Aggarwal, "Mexican Meltdown: States, Markets and post-NAFTA Financial Turmoil", *Third World Quarterly*, vol.17, 1996, p. 982.

⁴ Joseph Witt, "The Mexican Peso Crisis", *Economic Review*, The Federal Reserve Bank of Atlanta, January 1996, p. 16.

the bailout represented a huge commitment by the United States, its taxpayers and its banking system. In that letter crucial questions were posed:

- 'a) Under what conditions is Mexico permitted to draw on the \$9 billion line of credit?
- b) If Mexico defaults is it the intention of the US Treasury to enlarge the assistance?
- c) In the NAFTA agreement, American banks won access to the Mexican financial system up to 8%. In view of the peso devaluation what risks are posed to the United States of complete foreign ownership of the Mexican banking system by other nations?'⁵

When the crisis deepened on January 18, 1995, the Clinton administration proposed a large package of \$40 billion in loan guarantees to protect private creditors. Under this plan Mexico would have borrowed dollars to roll over maturing obligations in the financial markets, with the United States guaranteeing repayment if Mexico defaulted. However, it soon became clear that the US Congress would be reluctant to approve it. The arguments against helping Wall Street and billionaires were persuasive for many members in both houses (the House and the Senate).⁶ By January 31 Mexico needed cash quickly to avoid default, but congressional approval of the loan-guarantee

⁵ Letter sent to the Treasury Secretary by Representatives Peter Defazio, Duncan Hunter, Terry Everett and Marcy Kaptur, January 11, 1995 (The Library of Congress Website, <http://thomas.loc.gov/>).

⁶ Rogelio Ramirez de la O, "The Mexican Peso Crisis and Recession of 1994-1995: Preventable Then, Avoidable in the Future?", in Riordan Roett, ed. *The Mexican Peso Crisis: International Perspectives* (Lynne Rienner, New York 1996) p. 41.

package was nowhere in sight.⁷ President Clinton suggested that a refusal to extend this financial support, “would throw Mexico into a major political and economic upheaval, which was bound to hurt the United States. Other emerging markets would suffer too, and with them, the prospects for US exporters and investors”.⁸ Furthermore, what was at stake there was nothing less than the post-Cold War model of opening formerly closed markets the core of the changing basis of American hegemony. The issue was whether the peso collapse was merely the result of some discrete mistakes or whether it was the inevitable outcome of opening an economy.⁹

Supporters of American involvement, such as Federal Reserve Chairman Alan Greenspan, believed that the immediate problems that would arise if Mexico defaulted outweighed these issues and the moral hazard problem. In Greenspan’s opinion, default by the Mexican government would set off a wave of defaults by private entities in Mexico and elsewhere, with unacceptably severe consequences:

‘The objective of the proposed package is to halt the erosion in Mexico’s financing capabilities before it has dramatic impacts far

⁷ The reaction by the Republican leadership to the President's announcement on January 18, 1995 of a loan guarantee package was initially positive. However, within twenty-four hours the opposition began to assemble. Members of Congress, those especially who have voted against NAFTA, said that pending legislation would provide an opportunity for Congress to reassess American participation in NAFTA. See Riordan Roett, "The Mexican Devaluation and the US Response: Potomac Politics, 1995-Style", in Riordan Roett, ed. *The Mexican Peso Crisis: International Perspectives* (Lynne Rienner Publishers, Boulder 1996) pp. 36-37.

⁸ *Gannett News Service*, January 31, 1995, (Gannet News Service Website, www.gannet.com).

⁹ *Wall Street Journal*, "Guaranteeing Mexico", January 23, 1995.

beyond those already evident around the world. This program is the least worst of the various initiatives, which present themselves as possible solutions to a very unsettling international financial problem. Our concerns are with what economists call moral hazard problem where the active involvement of an external guarantor distorts the incentives perceived by investors. Thus appropriate conditionality must be associated with the guarantee to underline the fact that it is being provided at high cost and on rigorous terms in exceptional circumstances.¹⁰

After the end of the Cold War the economic structure of the United States and the rest of the industrial world based on free markets and private ownership appeared as a clearly superior model for the developing nations to emulate. Mexico was perceived to be the model of economic transition from a state-directed system toward a free-market economy. A Mexican failure could have brought a reversal in the global trend towards adopting market-oriented development strategies.¹¹ One of the Washington Consensus' leading commentators on trade policy, Fred Bergsten of the Institute of International Economics, described a potential situation in which:

¹⁰ Testimony by Alan Greenspan, Chairman of the Federal Reserve, before the Foreign Relations Committee, House of Representatives, January 26, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

¹¹ According to Bradford De Long, Assistant Deputy Secretary of the Treasury (1993-1995) a historical analogy to the Mexican financial crisis was the Austrian crisis of 1930-1931, when French Premier Pierre Laval blocked the proposed international support package for Austria that followed the collapse of Austria's largest bank, the Credit-Anstalt, in 1931. Premier Laval refused to provide the French contribution to the Bank for International Settlements-led attempt to provide Austria with the resources to deal with the run on its currency in 1931. Laval insisted on substantial political concessions and a sharp distancing of the relations with Germany as the price of French support. The Austrian government refused to make the required political concessions and the support package collapsed. The crisis spread by contagion first to Germany and then to Britain. A moderate recession in Europe turned into the Great Depression. See Bradford De Long et al., "The Mexican Peso Crisis. In Defence of US Policy Toward Mexico", March 1996 (The University of California at Berkeley Brad DeLong's Website, <http://econ161.berkeley.edu>).

'Many countries would have concluded that it was a serious mistake to rely on market forces and private capital flows, and could easily have reverted to the discredited *dirigiste* policies of the past. Such a reversion would be extremely adverse to the interests of the United States. Indeed a widespread reversal of the liberalisation trend could be even more unfavourable from our standpoint than an immediate financial crisis.'¹²

During the last week of January 1995, congressional hearings were held, in which officials from both the administration and Federal Reserve summarised the case in favour of the package. Secretary of State Warren Christopher testified before the House Banking and Financial Services Committee that the United States had an immense economic and political stake in Mexico's stability. The Secretary also warned that non-approval of the package would have far-reaching implications for the prosperity and stability of Latin America and other emerging markets:

'A reversal of Mexico's economic reforms and a spread of Mexico's financial difficulties to other emerging markets could halt or even reverse the global trend toward market-oriented reform and democratisation. This would be a tragic setback not only for these countries, but for the United States and the rest of the world as well. This is a test of American leadership. By extending this package to Mexico, the United States will demonstrate its unwavering commitment to lead this hemisphere toward stability and prosperity... Only the United States has the capacity to provide the kind of leadership that is necessary in this situation.'¹³

¹² Testimony by Fred Bergsten, Director of the Institute for International Economics, before the Committee on Banking and Financial Services, US House of Representatives, February 10, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

¹³ Testimony by Warren Christopher, Secretary of State, before the House Banking and Financial Services Committee, House of Representatives, January 25, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

Failure to address that crisis would have undermined faith in US leadership. The United States could not afford to let this happen. Christopher stressed that the proposed package for Mexico was about far more than Mexico's economic future:

'It is about America's leadership in this hemisphere and beyond. It is about American jobs, the security of our borders and the future of trade and economic cooperation in our hemisphere. Most fundamentally, this package is about stability in a nation in which the United States has a vital strategic interest and a vast economic interest.'¹⁴

Both the United States and the International Monetary Fund (IMF) were concerned that the loss of confidence in Mexico's economy would disrupt capital flows to developing countries in Latin America. For example, early in the crisis, Argentina was affected by Mexico's problems as investors began to limit capital flows to these countries.¹⁵ According to a US General Accounting Office (GAO) analysis, Mexico had been a paradigm for countries striving to put inward-looking, state-controlled models of economic development behind them and move to

¹⁴ Testimony by Secretary of State, Warren Christopher before the House Committee on Banking and Financial Services, January 25, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

¹⁵ Argentina was the most affected country by the peso devaluation of December 20, 1994, besides Mexico itself. On December 28, 1994, the Central Bank of Argentina sold \$353 millions of reserves. In the three months following the devaluation of the Mexican peso, the central banks sold more than one third of its foreign exchange reserves. Argentina's stock market index dropped by 50 per cent between December 19, 1994 and March 8, 1995 and the Argentine peso interest rate jumped from 11 per cent to 19 per cent during the same period. For an analysis of the financial crisis in Argentina see Eduardo Ganapolsky and Sergio Schmukler, *Crisis Management in Capital Markets: The Impact of Argentine Policy During the Tequila Effect* (World Bank, Washington DC 1998).

free market models. A spread of Mexico's financial difficulties to other emerging markets could have halted or even reversed the global trend toward market-oriented reform and democratisation.¹⁶ The United States had a fundamental national interest in making sure that financial confidence in Mexico was restored. Mexico at the time was the third-largest market for American exports, and the third-largest source for US imports. If the United States had failed to act, American exports to Mexico would have been severely affected and exports to Mexico are critically important to the economies of many American states. For example, exports to Mexico have accounted for about one-fifth of total exports from Michigan, Arizona and New Mexico and for about one-third of those of Texas.¹⁷ Many of the 700,000 jobs these exports supported could have been jeopardised in that event. Based on their belief that immigration from Mexico is inversely related to Mexican economic growth, American officials from the US Treasury were also concerned that turmoil in the Mexican economy could be a catalyst for a surge in illegal immigration to the United States. According to one Treasury Department estimate, Mexican illegal immigration to the United States could have increased by as much as 30 per cent per

¹⁶ United States General Accounting Office, *Mexico's Financial Crisis: Origins, Awareness, Assistance and Initial Efforts to Recover*, Report to the Chairman, Committee on Banking and Financial Services, House of Representatives, February 1996, p. 111.

¹⁷ Testimony by Robert Reich, Secretary, Department of Labour, before the Committee on Banking and Financial Services, House of Representatives, January 25, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

annually as a result of economic difficulties stemming from a financial collapse in Mexico.¹⁸

Even as Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan were lobbying Congress on behalf of the loan guarantee package, support for it appeared to be weak. More and more members of Congress demanded that special conditions be attached to the package. For instance, some of the conditions proposed were for Mexico to sever relations with Cuba, privatise Petroleos Mexicanos (PEMEX) and seal the US-Mexican border against Mexicans emigrating to the United States without authorisation.¹⁹ Many Republicans were opposed to the assistance package because as they claimed, they were elected to Congress to “focus on passing the “Contract with America”, not to approve a handout to the international financial community.”²⁰ In 1994 the Republican Contract with America, with its domestic focus prevented Republican members of Congress from foreign economic policy considerations. The main focus of the House Speaker Newt Gingrich and the Republican members of the House was to bring within the first hundred days of the 104th Congress bills aiming to a balanced budget, withdrawal of all American troops

¹⁸ United States General Accounting Office, “Mexico’s Financial Crisis”, p. 114

¹⁹ Sidney Weintraub, “The Depth of Economic Integration Between Mexico and the United States”, *Washington Quarterly*, vol. 18, no. 4, p. 183.

²⁰ Riordan Roett, “The Mexican Devaluation and the US Response: Potomac Politics, 1995 style”, in R. Roett, ed. *The Mexican Peso Crisis. International Perspectives* (Lynne Rienner Publishers, Boulder 1996) p. 37.

under United Nations (UN) command, and increased national security funding.²¹

Once it became apparent that the US Congress would not approve the assistance package, President Clinton moved on January 31 to use his executive authority.²² The Clinton administration announced a direct-loan package that included \$20 billion from the United States and \$18 billion from the IMF plus about \$13 billion from the Bank of International Settlements.²³ In order to avoid a special congressional vote authorising the assistance, the American contribution was taken from the Exchange Stabilisation Fund (ESF) controlled by the Secretary of the Treasury and normally used for short-term foreign exchange

²¹ Under the Contract with America, Republicans, with a pure domestic focus aimed to bring in the House of Representatives the following bills: the Fiscal Responsibility Act, for a balanced budget; the Taking Back Our Streets Act for cuts in social spending for prison construction and additional law enforcement; the Personal Responsibility Act, to discourage teen pregnancy by prohibiting welfare to minor mothers; the Family Reinforcement Act, for child support enforcement and tax incentives for adoption; the American Dream Restoration Act, with \$500 per child tax credit; the National Security Restoration Act, for withdrawal of American troops under UN command; the Senior Citizens Fairness Act, to raise the social security earnings limit; the Job Creation and Wage Enhancement Act, with small business incentives and capital gains cuts; the Common Sense Legal Reform Act, for reasonable limits on punitive damages; and the Citizens' Legislature Act, to replace career politicians with citizens legislators. For more details see the Newt Gingrich Official Website, <http://www.newt.org/contract.htm>.

²² Alexander Watson, Assistant Secretary of State for Inter-American Affairs, "United States-Mexico Relations", Address to The World Affairs Council of Northern California, San Francisco, February 23, 1995, (<http://www.state.gov>).

²³ Since its creation at the Hague Conference in January 1930, the Bank for International Settlements (BIS) has been a central banking institution, which is unique at the international level. It is owned and controlled by central banks and provides a number of highly specialised services to central banks and, through them, to the international financial system more generally. At 31 March 1999 forty-five central banks had rights of voting and representation at General Meetings. These included all the G10 central banks - those of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. (The Bank for International Settlements Website, <http://www.bis.org/about/index.htm>).

intervention, not for medium-term loans such as those to Mexico.²⁴ However, the United States through ESF had a history of assistance to Mexico dating back to the late 1940s. Mexico had been the only emerging market country that was part of the Federal Reserve “swap network”.²⁵ Mexico’s inclusion reflected both the close economic ties that the United States possessed with Mexico and the importance of Mexico’s economy for the United States.²⁶ The Treasury Secretary, with the approval of the president, had complete discretion to decide when the use of ESF was consistent with the obligations of the United States to the IMF. In deciding to implement the assistance package, the Secretary and the President exercised their executive powers. President Clinton was able to achieve this by linking the crisis to US security and leadership in the global economy.

²⁴ Congress established ESF in 1934 “for the purpose of stabilising the exchange value of the dollar.” Since its passage the statute has been amended to broaden its purpose from the stabilisation of the dollar to include the promotion of orderly exchange arrangements and a stable system of exchange rates. ESF has been used to buy and sell foreign currencies, extend short-term swaps to foreign countries and guarantee obligations of foreign governments. See GAO, “Mexico’s Financial Crisis”, pp. 115-116).

²⁵ An important feature of the foreign currency operations of the Federal Reserve over the past thirty years has been the reciprocal currency (swap) network, which consists of reciprocal short-term arrangements among the Federal Reserve, other central banks and the Bank of International Settlements. These arrangements give the Federal Reserve temporary access to the foreign currencies it needs for intervention operations to support the dollar and give the partner foreign central banks temporary access to the dollars they need to support their own currencies. See *The Federal Reserve System: Purposes and Functions*, (The Board of Governors of the Federal Reserve Bank Website, <http://www.bog.frb.fed.us/pf/pdf/frspf4.pdf>).

²⁶ Mexico’s original standing swap line with Treasury was established in 1941. Mexico drew on this line in the late 1940s and in 1965. Between 1980 and 1994, Mexico drew on ESF six times, for amounts ranging from \$273 million to \$1 billion See, United States General Accounting Office, “Mexico’s Financial Crisis”, p. 150.

The executive decision of the President to use the ESF in order to provide Mexico with financial assistance was the result of different point of views between the President and the US Treasury on the one hand and the Congress on the other, while the State Department was not involved in the final decision. In fact the executive decision of the President came as a surprise for the State Department.²⁷ It was a situation where the executive branch took the initiative from the legislative branch over an important foreign economic policy decision. Treasury Secretary Robert Rubin justified the actions taken by pointing out that there were enormous American interests at stake and "it was clear that the risks of failing to act far outweighed the risks of acting."²⁸ For Alan Greenspan, the actions taken by the Administration and the Treasury were justified because "Mexico is of such special importance to the United States and only the US Administration seemed able to respond with the necessary speed and magnitude".²⁹ It was this decision that led the IMF to extend an assistance package seven times bigger than the normal limit and to expend a fifth of its liquid resources. However, the bail-out revealed cracks in the international

²⁷ Disclosed by John Harrington, Senior Economist at the US-Mexico Chamber at Commerce during an interview conducted by the author of this thesis in Washington DC on September 11, 1998. John Harrington during the peso crisis was serving as a policy advisor on Mexican affairs at the State Department.

²⁸ Testimony by Treasury Secretary Robert Rubin, before the House Committee on Banking and Financial Services, February 9, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

²⁹ Testimony by Alan Greenspan, Chairman of the Federal Reserve, before the House Committee on Banking and Financial Services, January 25, 1995, US Government Printing Office, Serial No. 104-1, Washington DC 1995.

financial system. Six European members of the IMF – Britain, Germany, Denmark, the Netherlands, Belgium and Switzerland – abstained on the vote to provide \$17 billion in loans to Mexico. They said the plan was pushed through too hastily and without regard for the IMF's other obligations or problems of moral hazard. On the other hand American officials noted that the speed of the markets had outstripped the ability of agencies like the IMF to respond. Overall the IMF provided 688 per cent of the quota³⁰ for which Mexico was eligible, the largest financial package ever approved by the Fund at that juncture.³¹

The ESF-IMF Assistance Package to Mexico.

The main aim of the \$51 billion assistance package was to help Mexico avoid financial collapse and to limit any spread of the crisis to other emerging market economies. The United States provided three forms of support to Mexico: short-term swaps through which Mexico

³⁰ Each member of the IMF is assigned a quota, which is expressed in Special Drawing Rights (SDRs) and is equal to its subscription of capital to the IMF. Members' quotas, apart from providing the IMF with its financial resources, serve several other functions with respect to their financial and organizational relations with the IMF. A member's quota determines its voting power in the IMF; each member has 250 basic votes plus one additional vote for each SDR 100,000 of quota. The quota also determines the maximum amount of balance of payments assistance that a member can normally obtain from the IMF. Finally, the quota determines a member's share in allocations of SDRs (The IMF Website, <http://www.imf.org/external/pubs/ft/pam/pam45/II/IIA.htm>).

³¹ Maxwell Cameron and Vinod Aggarwal, "Mexican Meltdown: States, Markets and post-NAFTA Financial Turmoil", p. 980

borrowed dollars for 90 days that could be rolled over for up to one year; medium term swaps for up to five years and securities guarantees for up to ten years.³² The interest rates applied to the short-term swaps were intended to cover the cost of funds to Treasury. Mexico was charged a higher interest rate for medium-term assistance that was at least sufficient to meet the current US government credit risk rating for Mexico.³³ Mexico was required to maintain the dollar value of peso credits to the United States, adjusting the amount of pesos on a quarterly basis, to reflect changes in the peso-dollar exchange rate. In exchange for the assistance, Mexico also agreed to abide by terms and conditions specified in the ESF-IMF packages, including paying interest and fees, implementing a comprehensive and stringent economic plan and providing economic information on a timely basis. Treasury, Federal Reserve and the IMF officials believed that providing immediate assistance would prevent the effects of Mexico's crisis from spreading to the economies of other emerging market nations and beyond. For the United States, an additional concern was to limit the negative effects of the crisis in the areas of trade, employment and immigration. American officials judged that Mexico's imminent

³² "The United States Support for Mexico" - Message from the President of the United States, March 9, 1995, House Document No. 44 (The Library of Congress - Thomas Website, <http://thomas.loc.gov/cgi-bin/query/>).

³³ As of August 1, 1995 the annual rate for short-term swaps was 5.45% and the rates for medium-term swaps were 7.8% for funds disbursed in March, 10.16% for funds disbursed in April and May and 9.2% for funds disbursed in July. See GAO Report, *Mexico's Financial Crisis*, pp. 17-18.

financial collapse could be prevented and investor confidence in Mexico restored by making available large amounts of money to allow for the refinancing of a large portion of Mexico's maturing short-term liabilities.

After the first key decision by President Clinton on January 31, 1995 the second key decision was that on February 21, 1995, when the United States and Mexico entered into four financial agreements that provided Mexico with up to \$20 billion. These were the Framework Agreement, the oil agreement, the Medium-Term Exchange Stabilisation Agreement and the Guarantee Agreement and collectively referred to as "the agreements". Under these agreements, in return for American and IMF assistance, Mexico agreed to an austerity programme, which included the following measures:

- a) The deposit of all Mexican oil earnings in the United States
- b) Adherence to IMF monetary targets through:
 - gas and electricity price increases
 - an increase in the Value Added Tax (VAT)
 - the privatisation of ports, airports and railways
 - fiscal budget cuts
- c) The payment of high interest rates on the loan

- d) The allowance of foreign participation in extraction and exploration in oil.³⁴

The oil agreement provided a source of repayment and set forth the rights and responsibilities of various parties as to the use of proceeds from the export of crude oil and oil derivatives by PEMEX. It remained in place until all of Mexico's payment obligations under the assistance agreements were fully satisfied. Banco de Mexico established a special funds account at the Federal Reserve Bank of New York as required under the oil agreement. The Bank of Mexico authorised the Federal Reserve of New York to use the funds in the special funds account to repay all amounts due and payable under the assistance agreements. The Mexican government was to authorise the Federal Reserve Bank of New York to debit any account, to liquidate investments and to transfer all proceeds to a Treasury account in the event that the Federal Reserve Bank of New York received a notice from the Treasury that Mexico had failed to make any payment under the assistance agreements. The oil agreement also required that PEMEX must cause any of its subsidiaries that export crude oil or oil derivatives in the future to become a party to the oil agreement. Moreover, Mexico had to assure the US Treasury through a consultation arrangement, that

³⁴ Gary Springer and Jorge Molina, "The Mexican Financial Crisis: Genesis, Impact and Implications", *Journal of Interamerican Studies and World Affairs*, vol. 37, no. 2, 1995, pp. 66-67.

it continued to have the means to repay its loan obligations from PEMEX oil and oil derivative export revenues. If the US Treasury was not assured, it and the Mexican government had to agree on new terms that provided such assurance. If Mexico and the Treasury could not reach agreement after consultation the Treasury could enforce mandatory prepayment provisions. These arrangements required close monitoring, frequent consultation and “timely information-sharing” between the Treasury and Mexico. The oil agreement provided an important incentive for the Mexican government to take actions to avoid a default since it would be a politically sensitive issue in Mexico if a point was reached where the United States could start claiming revenues from oil sales.³⁵

The second largest component of the assistance package came from the IMF. The IMF assistance was designed to restructure Mexican debt and was contingent upon several things, including Mexico’s reduction of its current account deficit and inflation rate. On February 1, 1995, the IMF announced an 18-month standby credit of \$17.8 billion for Mexico. This was the largest standby arrangement that the IMF had ever extended as a percentage of a country’s IMF quota, the subscription that member countries pay to the IMF. The package’s specific objectives for 1995 were: a) the reduction in the external current

³⁵ GAO, “Mexico’s Financial Crisis”, pp. 120-122 & 132.

account deficit from 8 per cent of GDP in 1994 to 4 per cent of GDP in 1995, and to 3-3 1/2 per cent of GDP in 1996; and b) a lowering of the annualised rate of inflation to around 9 per cent in the fourth quarter of 1995, from more than 30 per cent in the first quarter of the year.³⁶ However, during the first week of March, the peso had fallen to a record low against the dollar, as financial markets reacted to the Mexican government's delay in announcing policies to deal with the rapid deterioration of the economy. This was largely due to the difficulties encountered in the negotiations for external support and to the perception that Mexico's economy had weakened. Hence, interest rates and the exchange rate continued to show substantial volatility and reached unexpected levels.

In Washington, Deputy Treasury Secretary, Lawrence Summers, indicated that it was clear that economic forecasts made at the time the agreements were first negotiated would have to be revised, but he expected Mexico to live up to its policy commitments to control the growth of credit, maintain budget discipline and continue with the process of privatisation.³⁷ Indeed, the revised plan contained stringent economic policy adjustments consistent with the agreements reached with the IMF and the United States. Its goals were to restore financial stability, strengthen public finances and the banking sector and regain

³⁶ "IMF Approves \$17.8 billion Stand-By Credit to Mexico", *IMF Press Release*, no. 95/10, February 1, 1995.

³⁷ Riordan Roett, "Devaluation and the US Response", *The Mexican Peso Crisis*, p. 42.

confidence. The initial programme was reinforced in four major policy areas that reflected basic elements of the Washington Consensus: a) additional correction in public balances, b) restrictive monetary policy, c) reinforcement of the banking sector and d) minimum wages and rural employment programme. It was recognised that the revised plan would result in an economic shock for the country more severe than had been anticipated in early January 1995.³⁸

All of the announced reforms that accompanied the joint ESF-IMF assistance package, signalled Mexico's firm commitment to pursue market-oriented policies and to provide investors with an adequate and safe environment for the development projects. At this point the role Mexican domestic elites was important in accepting the Washington Consensus and applying the IMF's and ESF's conditionalities. As analysed in Chapter Four, during the 1980s and early 1990s a new coalition of interests was built on the basis of promoting financial liberalisation and a free market economy. Based on these new relationships between the administration and business and social groups that favoured reforms along the lines of the Washington Consensus, the Zedillo Administration implemented the economic adjustment despite social pressures and criticisms. The top policymakers of the Zedillo Administration viewed economic decisions

³⁸ GAO, "Mexico's Financial Crisis", pp. 128-131.

as largely technical in nature and believed that these decisions should not be subject to bargaining and politicising. This was very well demonstrated when the Zedillo Administration modified the Mexican constitution in 1995 to allow for private participation and equity in Mexican telecommunication satellites. The state-owned satellite firm was privatised through sale of stock in late 1997. The TelMex monopoly on long distance and international telephone service ended in August 1996 for corporate accounts and for residential service in the 60 largest cities in 1997. Eight firms were authorised at that time to provide long distance service, five of which had American partners. New rules adopted in 1995 allowed foreign banks to acquire up to 100 per cent ownership in existing banks which have less than 6 per cent of the total capital in the banking system. With the new rules, both Mexican and foreign individuals and companies could own up to 20 per cent of a Mexican financial institution.³⁹ Legislation passed in December 1998 removed the 6 per cent cap, allowing foreigners to own up to 25 per cent of the total net capital of the banking system.⁴⁰

Furthermore, Banco de Mexico, the central bank of Mexico, after the IMF-ESF bailout was agreed announced its commitment to

³⁹ See, The 1997 Mexico Report, submitted by the Department of State to the House Committees on International Relations and Ways and Means and the Senate Committees on Foreign Relations and Finance, (The Board of Governors of the Federal Reserve Bank Website, <http://www.bog.frb.fed.us>).

⁴⁰ See the 1999 Mexico Report on Economic Policy and Trade Practices, released by the Bureau of Economic and Business Affairs, US Department of State, March 2000. (US Department of State Website, <http://www.state.gov>).

conducting a tight monetary policy in order to stabilise the foreign exchange market. In line with this objective, Banco de Mexico established a ceiling on the growth of its net domestic credit of 12 billion new pesos for 1995. This ceiling which represented a 21 percent increase in the monetary base for 1995 was consistent with a projected rate of inflation of 19 per cent and a rate of economic growth of 1.5 percent for the year. The 12 billion new pesos' ceiling was subsequently revised to 10 billion new pesos for 1995.⁴¹

A 1997 Department of State report on Mexico's economic policy and trade practices noted that Mexico had largely achieved the objectives laid out in the emergency economic program developed to cope with the 1995 peso crisis and that Mexico had successfully returned to the international financial markets. According to this report, among the most telling indicators of the success of Mexico's debt strategy were early repayment to the US Treasury of all of the economic support funds extended to Mexico during the 1995 crisis (table 4.1) and the placement by Mexico of over \$24 billion in international capital markets.⁴²

⁴¹ Augustin Carstens and Moises Schwartz, "Mexico's Economic Programme: Achievements and Challenges", in Monica Serrano and Victor Bulmer-Thomas, eds. *Rebuilding the State: Mexico After Salinas* (Lynne Rienner, New York 1996) p. 124.

⁴² Department of State, "Country Reports on Economic Policy and Trade Practices-Mexico", Submitted to the Senate Committee on Foreign Relations and on Finance and to the House Committees on Foreign Affairs and on Ways and Means, January 1998 (The State Department Website, http://www.state.gov/www/issues/economic/trade_reports/latin_america97/).

TABLE 5.1 - DISBURSEMENTS AND AMORTISATIONS OF THE UNITED STATES FINANCIAL ASSISTANCE PACKAGE (\$ millions)

DATE	DISBURSEMENTS	AMORTISATIONS	NET ACC. DEBT
January 11, 1995	500	0	500
January 13, 1995	500	0	1000
February 2, 1995	2000	0	3000
March 14, 1995	0	1000	2000
March 14, 1995	3000	0	5000
April 19, 1995	3000	0	8000
May 19, 1995	2000	0	10000
July 5, 1995	2500	0	12500
October 11, 1995	0	700	11800
January 29, 1996	0	1300	10500
August 5, 1996	0	7000	3500
January 17, 1997	0	3500	0
Total	13500	13500	

Source: *The Mexican Economy 1997*, Banco de Mexico, Mexico City 1997.

The ESF-IMF assistance package illustrated the crucial importance of Mexico to the United States in the context of NAFTA and the extent to which American business interests were affected by the devaluation. If the December 1994 devaluation demonstrated the vulnerability of small nation-states that rely heavily on foreign capital, then the January 1995 bailout demonstrated the power of the United

States in the global economy to act in response to perceived threats to the national interest.⁴³ According to Jeffrey Shafer, then Assistant Secretary for International Affairs at the Treasury, the Mexico support package was designed first and foremost to safeguard American interests and was also critical for averting a crisis that could substantially harm these interests.⁴⁴ Indeed the bailout brought Mexico closer to the Washington Consensus, which meant keeping faith with the market and integrating more closely with the United States through NAFTA (table 4.3).

TABLE 5.2 - MEXICO'S FOREIGN TRADE AND US SHARE BEFORE AND AFTER THE PESO CRISIS
(\$billion)

	1994	1995	1996	1997
Mexico's Total Exports	60.8	79.5	96.0	110.4
Exports to US	51.6	61.7	74.2	94.2
US Share (%)	84.9	77.6	77.3	85.3
Mexico's Total Imports	79.4	72.5	89.5	109.8
Imports from US	54.8	46.3	56.8	78.8
US Share (%)	69.0	63.9	63.5	71.8

Source: US International Trade Commission, *International Economic Review*, March-April 1998, p.5

For example, in September 1998, leading private sector institutions in Mexico were favouring a monetary union with the United States. The debate is expected to grow because of the fragility of the peso, which in

⁴³ Maxwell Cameron and Vinod Aggarwal, "Mexican Meltdown: States, Markets and Post-NAFTA Financial Turmoil", p. 982.

⁴⁴ Testimony of Jeffrey Shafer, Assistant Secretary of International Affairs, US Department of the Treasury, before the Committee on Banking and Financial Services, House of Representatives, April 6, 1995, US Government Printing Office, Serial No. 104-13, Washington DC 1995.

1998 dropped 25% against the dollar.⁴⁵ Furthermore, in 1999, Mexico has requested further assistance from the IMF in the form of a Stand-By Arrangement, to support an economic programme aiming at “consolidating the substantial reform efforts initiated during the 1980s and the gains made during 1996-98 following the 1995 financial crisis to set the economy on a higher, sustainable growth path”. The economic programme of 1999 also aimed at maintaining tight financial policies, promoting structural reforms and reducing external vulnerability.⁴⁶

On the one hand, the peso crisis had resulted in a further implementation of neoliberal reforms along the lines of the Washington Consensus and increased dependence on foreign finance. On the other hand, even before the peso crisis, as successive PRI governments opened up the economy and ceded space to dissent, the PRI’s monopoly of power slowly eroded. For example, in 1988 the Partido de la Revolucion Democratica (PRD) split away from the PRI and has become a legitimate political force. Former PRI member, Cuauhtemoc Cardenas, founded the PRD on a centre-left platform, including increased government control of the economy, expanded social welfare and opposition to foreign trade and investment. In 1997 Cardenas was elected mayor of Mexico City. However, it was the Partido Accion

⁴⁵ *The Financial Times*, “Mexico Ponders Adopting US Dollar: Monetary Union Slide in Peso Sparks Debate on Future of Currency and Links with Washington”, September 24, 1998.

⁴⁶ “Letter of Intent of the Government of Mexico to the IMF”, June 15, 1999 (IMF Web Site, <http://www.imf.org>).

Nacional (PAN) founded in 1939, that won the presidential election of July 2, 2000 with Vicente Fox, a former Coca Cola executive in Mexico. PAN is a pro-business, pro-Catholic, centre-right party. The party won its first senate seat in 1991 and its first governorship in the northern state of Chihuahua in 1992. In the elections of 1996 the PAN captured 121 seats and the PRD 125. Despite the first transition of power in 71 years, neoliberal policies will not be disrupted and the Washington Consensus will not be cancelled in Mexico. Just two weeks after Vicente Fox took office (December 2, 2000) his administration has received three World Bank loans totalling \$1.13 billion to enhance disaster insurance and reconstruction projects in Mexico.⁴⁷ President Fox has also talked of turning the NAFTA into a common market. Tax reform is on his agenda as well as a restructuring of Pemex.⁴⁸

During 1995 there was a debate as to whether NAFTA had played a role in causing the peso crisis. During hearings before the US Subcommittee on Trade, Bergsten argued that NAFTA was not responsible for the peso crisis, but it did facilitate the recovery of the Mexican economy in three ways:

⁴⁷ The World Bank Website, www.wbln0018.worldbank.org

⁴⁸ Vicente Fox's proposal for turning NAFTA into a common market has been received with scepticism by Washington. See, "After the Revolution", A Survey of Mexico, *The Economist*, October 28, 2000.

- a) The financial rescue package helped Mexico restructure its short-term dollar-denominated debt and ease its liquidity crisis;
- b) Because of NAFTA obligations Mexico followed a recovery programme based on Washington Consensus directions rather than trade and capital controls; and
- c) Open access to the American market, backed by NAFTA obligations helped prevented a more drastic recession in Mexico in 1995.⁴⁹

The argument that NAFTA caused the peso crisis is problematic since economic liberalisation in Mexico began in the mid-1980s under the presidency of Miguel de la Madrid and accelerated under Carlos Salinas. But NAFTA may have inspired overconfidence in the Mexican economy. At least in the area of foreign capital inflows, the hype surrounding NAFTA may have helped generate unrealistic expectations and an overvaluation of financial assets. However, within NAFTA import controls were no longer an option for the Mexican government. The speed and magnitude of the response was rather a direct outgrowth of the expanded relationship between the two countries and it would not have occurred without NAFTA.⁵⁰ As

⁴⁹ Statement by Fred Bergsten, before the Subcommittee on Trade, Ways and Means Committee, US House of Representatives, September 11, 1997 (The Institute for International Economics Website, <http://www.iie.com/sept11.htm>).

⁵⁰ See Barry Bosworth, Susan Collins and Nora Claudia Lustig, eds. *Coming Together? Mexico-United States Relations*, pp. 7-8 & 22.

Congressman Jim Kolbe argued, far from worsening the crisis, NAFTA helped stabilise Mexico's political and economic response to the crisis. It prevented Mexico from resorting to the solution of imposing barriers, restricting capital movements and limiting economic activity. Furthermore, the recovery of Mexico was more rapid and consistent compared to the crisis of 1982.⁵¹ In 1996 the Mexican economy grew by 5.1 per cent and in 1997 by 7.1 per cent in real terms (table 4.2)

TABLE 5.3 – ANNUAL MEXICAN GDP GROWTH IN 1981-1997

YEAR	GDP-ANNUAL GROWTH (%)	YEAR	GDP-ANNUAL GROWTH (%)
		1990	4.44
1981	8.77	1991	3.63
1982	-0.063	1992	2.81
1983	-4.20	1993	0.76
1984	3.61	1994	3.52
1985	2.59	1995	-4.65
1986	-3.75	1996	5.1
1987	1.86	1997	7.1
1988	1.25		
1989	3.35		

Source: Bank of Mexico. Economic Indicators, 1997 (<http://banxico.org.mx>).

As a result of the peso crisis, the bilateral relationship between the United States and Mexico has become increasingly multifaceted. Issues such as immigration and drugs that had been ignored in the early 1990s have become prominent policy issues after the peso devaluation and the ESF-IMF assistance package. Furthermore, while

⁵¹ Interview with Congressman Jim Kolbe, member of the Subcommittee on Trade of the House Committee on Ways and Means, conducted by the author of this thesis in Washington DC, on September 9, 1998.

the peso crisis had a major impact on the Mexican economy it has not slowed regional integration as many have expected.⁵² As a broader result of the assistance package, at the end of the 1990s, in Latin America there was a consensus on the fundamental benefits of open markets and free trade. Latin American economies accepted the outward-oriented model of economic development.⁵³ For example, in March 1995, Argentina launched a programme to restructure its financial system and privatise provincial banks, in order to receive a \$2.8 billion loan from the IMF. In November 1998, Brazil jointly with the IMF initialised a fiscal adjustment and privatisation programme in order to receive an \$18 billion loan from the IMF and \$5 billion from the United States through the ESF.⁵⁴ Furthermore, on December 14 2000, Mercosur the South American customs union (composed of four members: Argentina, Brazil, Paraguay and Uruguay) outlined its first common fiscal and inflation targets as part of a wide effort to

⁵² Interview conducted by the author of this thesis with Prof. Riordan Roett, Johns Hopkins University, Washington DC, September 10, 1998.

⁵³ The projections are that by the year 2010 the Western Hemisphere will be a larger market than Western Europe and the Pacific Rim combined. See Stuart Eizenstat, Under Secretary of State for Economic, Business and Agricultural Affairs, "Latin America and US Policy", Remarks at the *Wall Street Journal Conference on the Americas*, New York, October 1, 1998,

(http://www.state.gov/www/policy_remarks/1998/). See also Peter Romero, Acting Assistant Secretary for Inter-American Affairs, Remarks at the *Miami Herald Conference on the Americas*, Coral Gables, Florida, September 18, 1998, (The State Department Website, http://www.state.gov/www/policy_remarks/1998/).

⁵⁴ For details see "IMF Management and Argentina Agree on Programme for 1995", March 23, 1995

(IMF Website, <http://www.imf.org/external/np/sec/nb/1995/NB9510.HTM>);

"Letter of Intent of the Government of Brazil", November 13, 1998

(IMF Website, (<http://www.imf.org/external/np/loi/111398.HTM>); "Brazil: Last Tango In Rio", *Financial Times*, November 18, 1998.

coordinate macroeconomic policy. Reflecting basic elements of the Washington Consensus, the finance ministers and central bank chiefs of Merocsur's four member countries as well as Bolivia and Chile, its two associate members, agreed on an annual inflation ceiling of 5 per cent between 2002-2005 and to limit their net consolidated public sector deficit to a maximum of 3 per cent of GDP as of 2002. Furthermore, Chile has announced in November 2000, that it would negotiate a free trade agreement with the United States.⁵⁵

The IMF-ESF assistance package to Mexico was driven by a concern to protect the returns of foreign and domestic investors and restore confidence in Mexico; to safeguard the stability of the international economic order; to guarantee the continuation of the process of hemispheric integration based on competition for foreign capital and to assure the stability of the Mexican political system and the restructuring of the economy in line with the interests of Washington.⁵⁶ The elements of the Washington Consensus that were in place before the crisis of 1995 regarding fiscal discipline, financial liberalisation, trade liberalisation, exchange rates, foreign direct investment, privatisation, deregulation and property rights were further entrenched. But the entrenchment of the Washington Consensus was a result of a clear split between the President and the US Treasury

⁵⁵ "Mercosur Sets Inflation Targets", *Financial Times*, December 14, 2000.

⁵⁶ Maxwell Cameron and Vinod Aggarwal, "Mexican Meltdown: States, Markets and post-NAFTA Financial Turmoil", p. 983.

on the one side and the Republican-dominated Congress on the other. Beyond that, after the peso crisis the market-oriented development of the region was consolidated and the ability of the United States to influence outcomes in the region was confirmed and further strengthened.

As demonstrated in Chapters Four and Five, the entrenchment of the Washington Consensus in Mexico since 1982 was based on the following variables of this thesis' framework: globalisation of finance, mobility of capital, international institutions and ideas accepted by the domestic elites. With the peso crisis the limited instability of the system (the fifth variable of the framework) was added to confirm the original hypothesis of this thesis that during the 1990s the strengthening of the Washington Consensus was based on all five variables of the framework. Without the fifth variable, American policymakers would not have had the opportunity to "lock" and further advance adjustments and reforms along neoliberal lines in Mexico. However, the Washington Consensus was further questioned with the Asian financial crisis in 1997-98. Chapters Six and Seven therefore analyse the process of financial liberalisation, the financial crisis in South Korea and how the policy response of the United States through the IMF, effectively entrenched the Washington Consensus in South Korea.

CHAPTER SIX

THE REDEFINITION OF AMERICAN FOREIGN ECONOMIC POLICY TOWARDS SOUTH KOREA: FROM THE DEVELOPMENTAL STATE TO ECONOMIC LIBERALISATION AND THE FINANCIAL CRISIS OF 1997

This chapter provides a general background to the basic elements of what is described as the Asian model of development. The main focus is on South Korean economic development and the events that led to the economic crisis of 1997-1998. The aim is not to explain the causes of the Asian crisis but to highlight the links between East Asian and especially South Korean economic development and American foreign economic policy, and also to identify the conceptual framework's variables on which the advance of the Washington Consensus was based before 1997. The first part of the chapter describes the general characteristics of Asian development in relation to developments in the world economy. The second part of the chapter

focuses upon South Korean development and the third part provides an analysis of the shift in American policies from the late 1980s that resulted in increasing pressures from the United States for financial liberalisation in South Korea.

As a basis for the following analysis a definition of South Korean and Japanese development models is provided here. Although a specific single model cannot be applied for the region as a whole, we can distinguish a common denominator, based on an export-led industrial strategy and a close relationship between government and big industries. The relationship between the state, finance and industry in Japan and South Korea has been very different from that of the United States. The former countries have followed a model which involves long-term relationships between the corporations and the main banks. South Korea provides an excellent case because an export-led strategy was the cornerstone of its development policy and because the close relationship between state and industry has been more evident and influential than anywhere else apart from Japan.¹

¹ For an extensive analysis of the Asian developmental state see Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy* (Stanford UP, Stanford 1982). Additionally, in order to describe Asian development, Wade proposed the term "governed market" which says that East Asian growth was due to a combination of a) very high levels of productive investment, making for faster implementation of new techniques into actual production; b) more investment in certain key industries than would have occurred in the absence of government intervention and c) exposure of many industries to international competition in foreign markets if not at home. See Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialisation* (Princeton UP, Princeton 1990); See also Ajit Singh, "Asian Capitalism and the Financial Crisis", in

Japan had been a colonial power in the Korean peninsula, establishing its influence there in the late nineteenth century and formally annexing the country in 1910. Its occupation of Korea was undoubtedly brutal - particularly during the Second World War - but it came at a time when Japan turned itself into a major world industrial power. When South Korea became an independent state in 1948, and again after the Korean War, the Japanese example loomed large in the mind of South Korean leaders. In particular, South Korea borrowed two major concepts from the Japanese. First, it oriented the domestic economy towards aggressive exporting rather than trying, as many poorer countries did, to cope with the superiority of Western economies by 'import substitution', or creating domestic industries that replaced foreign imports.² The second major borrowing was the system of joining companies together in large interlocking corporations or conglomerates. In Japan, they were called *keiretsu*, (known as *zeibetsu* before 1945) in South Korea, *chaebol*. Chaebol started while the Japanese were still in Korea as colonial overlords before the 1940s. There are some big differences between the two. South Korean chaebol have tended to be spread over more than one industry, for example, in

Jonathan Michie and John G. Smith, ed. *Global Instability: The Political Economy of World Economic Governance* (Routledge, London 1999) p. 11.

² Byung-Nak Song, *The Rise of the Korean Economy* (Oxford University Press, Oxford 1997) p. 121.

the manner of old-fashioned conglomerates in the West, whereas Japanese keiretsu have been focused more on one central industry.³

Both Japan and South Korea have very limited natural resources compared to those of most of the advanced Western economies. Since exporting goods was considered the best survival strategy for Japan, the Japanese government has emphasised exports of manufactured goods and services to other countries. From the 1970s, that strategy made Japan the second largest economy in the world.⁴ South Korea also followed the Japanese model in one other important way: although geared towards exports, it closed its own markets to foreign goods. In a sense, both these countries exploited a lag in world competitiveness caused by communism - because half the world was not even trying to be economically competitive, it created exporter slots for countries like Japan and South Korea to walk into.

Furthermore, the Japanese and South Korean development models were followed to varying degrees in Taiwan and Singapore but, more significantly, in Malaysia, Indonesia and Thailand. There have been important differences in aspects of industrial strategy followed by these countries. Nevertheless, all these countries have followed what is generally called the Asian developmental state model - a centralised

³ T. W. Kang, *Is Korea the Next Japan? Understanding the Structure, Strategy, and Tactics of America's Next Competitor* (The Free Press, New York 1989) pp. 30-35.

⁴ According to OECD figures, as of 1998, the Gross Domestic Product (GDP) of the United States and Japan were respectively \$8178.8 billion and \$3049.1 billion (OECD Website, <http://www.oecd.org/publications/figures>).

state interacting with the private sector from a position of preeminence so as to secure development objectives - rather than relying on free competitive markets.

The Asian Developmental State

What were described by advocates of the Washington Consensus, as “corrupt crony capitalism” regimes, were created in the Cold War climate during which the United States supported regimes committed to maintaining a close relationship with Washington.⁵ In an effort to gain legitimacy through economic growth these regimes were accorded privileges by the United States as part of its Cold War strategy. As a result, the United States was often unable to use its dominance in the security realm to achieve economic and other policy changes in East Asian economies. However, while East Asia could often resist external pressure for change the countries of the region proved unwilling to challenge Washington in many issue areas. For example, as Rosemary Foot and Andrew Walter have argued, predictions that Japan/East Asia would wield financial power to demand changes in

⁵ See Paul Krugman, *The Return of Depression Economics* (Penguin Press, New York 1999); See also Morris Goldstein, *The Asian Financial Crisis: Cause, Cures and Systemic Implications* (Institute for International Economics, Washington DC, June 1998) pp. 12-14. See also Michael Pomerleano, "The East Asian Crisis and Corporate Finances: The Untold, Micro Story", *World Bank Policy Research Working Papers*, no. 1990, October 1998.

American policy never materialised, even at the height of America's deficit and general allied dissatisfaction with various American policies in the later 1980s. Most of the states in the region remain highly dependent upon the continued openness of American markets as well as the American security umbrella.⁶

The 1985 Plaza Accord was a major external catalyst for the subsequent Asian export boom because it caused a large fall in the dollar-yen ratio relative to the dollar rates against other Asian currencies. Meanwhile the Asian economies had pegged their currencies to the dollar. This boosted Asian competitiveness at the expense of Japan. The belief that exchange rate pegs would last convinced many investors to borrow in foreign currencies. In addition, the weakness of the dollar and the strength and stability of the Asian currencies facilitated capital inflows to these economies. However, the Plaza Accord and the devaluation of the dollar actually were a domestic policy change for the United States rather than a change forced by international events. As Callum Henderson has stressed, it was in fact a deliberate attempt to get Japan to the negotiating table on trade - and it achieved some results, such as the US-Japan auto trade accord. When the dollar's fall achieved its objectives the policy was reversed. This was

⁶ The dependent relationship with the United States has conditioned many of Japan's aid decisions, which tend to be either supportive of or at least not opposite to American security interests in the region. See Rosemary Foot and Andrew Walter, "Whatever Happened to the Pacific Century?", in *Review of International Studies*, vol. 25, Special Issue, December 1999, pp. 254-255.

clearly demonstrated ten years later, at the G7 Accord of April 1995 to support the dollar. This was the first warning signal for Asia. Support for the dollar led to a rise of more than 50% against the yen. Under these conditions, Asian countries should have allowed their currencies to weaken to reflect the new international market dynamics. However, strong currencies were seen as status symbols and the Asian governments and central banks tried to maintain the stability and strength of the early 1990s.⁷

The East Asian economies' disciplined fiscal positions had given lenders confidence that, should local financial institutions encounter difficulties, the state would have the resources to provide assistance.⁸ While in the more advanced industrialised economies, financial transactions had been heavily supervised and regulated to a much greater degree than trade and investment, the Asian economies simply had not developed sufficient experience in managing a market-based financial sector.⁹ As Jason Furman and Joseph Stiglitz point out, the financial and capital account liberalisation of the 1980s left the East Asian countries with fewer tools to cope with the strains imposed by

⁷ Callum Henderson, *Asia Falling: Making Sense of the Asian Crisis and its Aftermath* (McGraw-Hill, New York 1998) pp. 12, 13 & 28.

⁸ Morris Goldstein, *The Asian Financial Crisis: Causes, Cures and Systemic Implications*, (Institute for International Economics, Washington DC 1998) p. 14.

⁹ Steven Radelet and Jeffrey Sachs, "What Have we Learned So Far From the Asian Financial Crisis?", paper sponsored by the US Agency for International Development (USIA) January 4, 1999, p. 12 (The Harvard Institute for International Development Website, <http://www.hiid.harvard.edu>).

the surge of capital inflows in the 1990s.¹⁰ Since the early 1990s Asian countries had gone under pressure from both the IMF and the World Trade Organisation (WTO) to modernise, liberalise and deregulate their banking and financial systems. In 1993 for example, Thailand created the Offshore International Banking Facility, which was an important reason for the increase in cross-border inter-bank credit flow to Thailand. The Bangkok International Banking Facility (BIBF) allowed for a very rapid growth in the number of financial institutions that could borrow and lend in foreign currencies. Also in 1994, South Korea initiated the conversion of short-term finance companies into investment banks as part of an attempt to introduce features of developed countries' financial systems, such as the creation of offshore investment funds, that were the major vehicles for the sale of derivative products of Korean banks and corporations. This eventually, provided an extra source of foreign borrowing.¹¹

Meanwhile, the World Bank undertook a major study in 1991, published as *The East Asian Miracle* report (1993) which took a critical view of Asian developmental state. The report interpreted East Asian success as a challenge to Bank orthodoxy and to the Washington Consensus and acknowledged a significant role for the state. It also

¹⁰ See Jason Furman and Joseph Stiglitz, "Economic Crises: Evidence and Insights from East Asia", *Brookings Papers on Economic Activity*, vol. 2, 1998

¹¹ J.A. Kregel, "East Asia is not Mexico: The Difference Between Balance of Payment Crises and Debt Inflation", in Jomo K.S., ed. *Tigers in Trouble* (Zed Books, London 1998) p. 48.

placed emphasis on the market-consistency of the successful aspects of East Asian industrial policy interventionism and maintained that most important was the promotion by East Asian governments of export orientation. The report did not satisfy fully either those who felt that East Asian growth demonstrated the superiority of the market, or those who claimed it underrated the guiding role of the state. The report also rejected the notion of a single East Asian model, noting the great diversity of policy practice throughout the region.¹²

For decades the results of the Asian model and its variations were indeed impressive. But the events of 1997 exposed some weaknesses in that model. According to Robert Garan, the Asian model suppressed the true cost of money, fuelling unproductive and unprofitable investments.¹³ Problems began to emerge in the 1990s in both the macroeconomic field (capital inflows, real exchange rate appreciation) and microeconomic fundamentals (credit expansion, financial regulation). At least partly, the Asian financial crisis had its roots in attempts at financial reform in the early 1990s that were aimed at upgrading financial institutions but left individual economies exposed to the instabilities of international financial markets. This rapid expansion in financial services was not matched by careful regulation

¹² See, World Bank, *The East Asian Miracle*, Washington DC 1993.

¹³ Robert Garan, *Tigers Tamed: The End of the Asian Miracle*, (Univ. of Hawaii Press, 1998) p. 4.

and supervision. The huge expansion in banking activity made supervision very difficult. In numerous countries in the region, many banks were owned by politically well-connected individuals who used them to finance the operations of affiliated companies. In Indonesia for example, almost every major corporation had its own bank.¹⁴

As in the case of Mexico in 1994-1995, the East Asian economies had started, but had not completed the process of financial market liberalisation and reform. These reforms led to a dramatic growth of linkages to the international economy, which increased the exposure of these economies to international financial shocks, mainly through a rapid build-up of short-term debts. Countries with stronger financial systems, such as Singapore and Hong Kong, had taken steps to introduce adequate regulations and better supervision and thus were less vulnerable to a crisis. On the other hand, countries that had not undertaken significant financial sector reforms, such as China and Vietnam, were shielded by the fact that they had received much less short-term capital inflow in the early 1990s. Seen in this light, Steven Radelet and Jeffrey Sachs suggest that the crisis was actually an accident of partial financial reforms that exposed these economies more directly to the instability of international financial markets.¹⁵ As with

¹⁴ Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects" *Brookings Papers on Economic Activity*, vol. 1, 1998, p. 22.

¹⁵ Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects", p. 23.

Mexico before the crisis, the East Asian economies were widely viewed by lenders to be among the most attractive sovereign borrowers among emerging markets. After all, during the 1980s and 1990s these economies had been integrated into the world economy and recorded unusually rapid rates of economic growth. (table 5.1)

TABLE 6.1 - GDP GROWTH IN SELECTED EAST ASIAN ECONOMIES 1981-1996 (%)

	1981-90	1990	1991	1992	1993	1994	1995	1996
Korea	12.7	9.5	9.1	5.1	5.8	8.4	9.2	7.1
Singapore	6.5	8.8	6.7	6.3	10.1	10.1	8.9	7.0
Indonesia	6.0	9.0	8.9	7.2	7.3	7.5	7.6	8.0
Malaysia	5.2	9.7	8.6	7.8	8.3	9.2	9.3	8.2
Thailand	7.9	11.2	8.5	8.1	8.3	8.7	8.6	6.4

Source: Callum Henderson, *Asia Falling*, p. 7

In July 1997, Thailand eventually acted as a wake-up call for international investors to reassess the creditworthiness of their Asian borrowers and when they did this reassessment, they found that other Asian economies had weaknesses similar to those in Thailand: weak financial sectors, large external deficits, appreciating real exchange rates, declining quality of investment and overexpansion in certain key industries. As one country after another in the region depreciated its currency, the countries that did not devalue experienced a deterioration in their global competitiveness, which made their currencies more vulnerable to speculative attacks. These competitive dynamics of successive devaluations meant that some Asian currencies came under

increasing pressure after the initial depreciation of the Thai baht on July 2, 1997¹⁶ (table 6.2).

TABLE 6.2 - THE DEPRECIATION OF MAJOR SOUTHEAST ASIAN CURRENCIES 1997-1998

COUNTRY	CURRENCY	RATE/DOLLAR JAN. 31, 1997	RATE/DOLLAR JAN. 20, 1998	DEPRECIATION (%)
Indonesia	Rupiah	2375.0	10200.0	329.5
Thailand	Baht	25.9	53.0	104.8
S. Korea	Won	863.0	1638.0	89.9
Malaysia	Ringgit	2.4	4.1	68.2
Singapore	S. Dollar	1.4	1.7	24.6

Source: Kavaljit Singh, *The Globalisation of Finance*, p. 82

Thus, the devaluation of the baht triggered a process of contagion in the other Asian countries. Shortly after the Thai devaluation, Malaysia and Indonesia floated their currencies. Taiwan devalued in autumn 1997 later, putting the Korean won and the Hong Kong dollar under pressure. Taiwan's small devaluation (12 per cent) in October 1997, despite its high foreign exchange reserves, acted as a bridge from Southeast to East Asia.¹⁷

¹⁶ Morris Goldstein, *The Asian Financial Crisis: Causes, Cures and Systemic Implications*, pp. 19-20.

¹⁷ Robert Wade, "From Miracle to Cronyism: Explaining the Great Asian Slump", *Cambridge Journal of Economics*, no. 22, 1998, p. 699.

South Korean Development

Since the 1950s South Korea had depended heavily on American aid. After the Korean War (1950-1953) the United States recognised a responsibility for economic and military assistance to South Korea. From 1953 through 1962 economic assistance amounted to roughly \$2 billion and military assistance to roughly \$1 billion as Washington also maintained a Mutual Defence Treaty and stationed 37,000 soldiers on the Korean peninsula.¹⁸ American military assistance relieved the South Korean budget of a major part of military expenditure. During the 1960s and the 1970s, defence expenditures varied between 22 and 32 per cent of the South Korean national budget and amounted to 4.5 per cent of GNP.¹⁹ South Korea had spent years investing in its economy the funds saved by relying on the United States. South Korea concentrated on its economic and social development. South Korean economic policy

¹⁸ The Republic of Korea (ROK) - United States Mutual Defence Treaty was signed on October 1, 1953, in Washington, DC, right after the end of the Korean War. It took effect on November 18, 1954. As a framework for jointly countering invasion into South Korea including any North Korean provocations, it has significantly contributed to ROK security and to the stability of Northeast Asia as a whole. Even if the current Armistice Agreement is replaced by a peace treaty and the United Nations Command is disbanded, the Mutual Defence Treaty will serve as the basis for continued presence of the US Forces in Korea (USFK). The ROK-US Mutual Defence Treaty consists of a preamble and six articles. The preamble states the resolve between the two countries for combined defence against armed aggression, and Article 3 defines courses of action according to each country's constitutional procedures. The United States is allowed under Article 4 to deploy its armed forces in the territory of the ROK and its vicinity.

(<http://russia.shaps.hawaii.edu/security/korea/milit2e.html>).

¹⁹ Edward Mason, Mahn Je Kim, Dwight Perkins and others, "The Economic and Social Modernisation of the Republic of Korea" *Harvard East Asian Monographs*, no. 92 (Harvard University Press, Cambridge 1990) pp. 183-184.

was never *laissez faire*, but it generally relied on private entrepreneurship and export-driven growth.²⁰

Especially during the 1950s and the 1960s, American aid funds, managed by the United States Agency for International Development (USAID) established in 1963, were the prime source of American influence on South Korean economic policy. In 1962, the Korean military government introduced the first Five-Year Plan on the basis of a strategy for industrialisation with priority given to light industry.²¹ One of the reasons for choosing industrialisation as the main road to economic development was a preference on the part of the military government for rapid profits from investments and the practical need to solve the problem of employment by enlarging the number of labour intensive factories. At the time the South Korean government could not oppose the constant influx of surplus American agricultural products and manufactured goods. Its main preoccupation at the time was to receive aid in increasing quantity.²²

There were differences of opinion between the United States and the military government. South Koreans, despite the risk of inflation, had given priority to rapid growth to solve the problem of poverty and

²⁰ Doug Bandow, "Free Rider. South Korea's Dual Dependence on America", *Cato Policy Analysis*, no. 308, May 19, 1998.

²¹ It involved labour intensive industries such as textiles, clothing, shoes and metal-plating.

²² Hyung-Dong Kim, *Korea and the United States: The Evolving Transpacific Alliance in the 1960s*, (Research Centre for Peace and Unification of Korea, Seoul 1990) pp. 176-178.

unemployment while the American authorities considered that inflation was the main cause of the economic difficulties and insisted on a programme of economic stabilisation and a restrictive policy on the flow of money and credit. Although American aid was reduced, the American right to intervene was maintained as a result of negotiations for American aid between the United States and South Korea.²³ From the American point of view, the continuing commitment not only to aid but also to keep American forces in South Korea aimed at deterring aggression by North Korea and showing the American determination to remain an Asian power and to maintain a balance of power in the region.²⁴

During the South Korean government's First Plan (1962-1966) the principal objective was to establish the foundations of a self-reliant economy by expanding key industries. Industrialisation in the 1960s, encouraged by General Park's government (1961-1979) with tax incentives and low-investment loans from the government, involved high rates of investment - 25 per cent of GDP in 1965-70. During the

²³ It was the Foreign Operation Administration (FOA) established in 1953 and the US Agency for International Development (USAID) established in 1961, together with the Combined Economic Board (CEB) established in 1953, that negotiated the policy with South Korea. See Hyung-Dong Kim, *Korea and the United States. The Evolving Transpacific Alliance in the 1960s*, pp. 100-107.

²⁴ Especially for the Reagan Administration (1981-1989) South Korea constituted an outpost in its confrontation with the Soviet Union. The American interest was mainly geopolitical. The Reagan Administration recognised that uncertainty would have occurred from a change in its security and financial commitments not only to South Korea but also to East Asia in general. See Brian Bridges, *Korea and the West*, (The Royal Institute of International Affairs, Rutledge, London 1986) pp. 60-61.

Second Plan (1967-1971) the emphasis was placed more on the modernisation of the industrial structure and export industries were encouraged at the expense of other sectors. The success of the first two Plans resulted in a decrease in the dependence of South Korea on American economic aid. Between 1955-1958, the proportion of American aid was between 10 and 16 per cent of South Korea's GNP. At the start of the first Five-Year Plan it was about 8 per cent and by the end of the First Plan the proportion of American aid decreased to 2 per cent of South Korea's GNP.

After 1967 foreign capital inflows began to be dominated by foreign loans and investments coming not only from the United States but also from Japan and other countries. In these circumstances USAID in Seoul placed more emphasis on public loans at the inter-governmental level. There was also a considerable increase in trade with the United States in the form of commercial loans and direct investments. As the main importer of South Korean goods, the United States began to contribute to the economic development of South Korea but no longer from the taxes of the American public. The entrance of American commercial capital from mid 1960s enabled to continue the economic cooperation between the United States and South Korea. For South Korea business, direct contacts in search for foreign capital helped them not only to broaden their horizons with regard to the outside world but also helped them to acquire advanced technologies

for industrial production and management. However, American capital still had considerable influence on South Korean business and political circles.²⁵ For example, American foreign assistance activity involved support for the creation of the Korea Institute of Science and Technology (KIST) in 1966 and the Korea Development Institute (KDI) in 1971. The former institution was intended to help South Korean industry with the adoption and adaptation of modern technology and the latter was to assist the South Korean government with research and analysis of critical economic policy and planning problems.²⁶

American influence at the initial stages of South Korean development is also evident in the fact that South Korea began its export thrust in the mid-1960s by providing shoes, clothing and construction workers to American forces in Vietnam. In 1965, under strong American pressure, General Park signed a normalisation treaty with Japan, Korea's former coloniser. As part of the deal, Japan provided nearly \$1 billion in loans and investments that helped South Korean manufacturing industries including textile and manufacturing. Furthermore, in 1972, President Nixon recognised Japan's role in South

²⁵ For example, such industrial companies as the Ssang Yong Cement, Lucky and Sinjiin were the big recipients of foreign commercial loans, while Hyundai and Hankuk benefited from loans through USAID during the 1960s. See, Hyung-Dong Kim, *Korea and the United States: The Evolving Transpacific Alliance in the 1960s*, pp. 207-230.

²⁶ Edward Mason, Mahn Je Kim, Dwight Perkins and others, *The Economic and Social Modernisation of the Republic of Korea*, (Harvard University Press, Massachusetts 1980) p. 203.

Korea when he revised the US-Japan Security Treaty with a clause stating that South Korea was essential to Japanese security.²⁷

By the 1970s, foreign assistance was a relatively minor factor in South Korea's external relations. Export earnings and foreign private capital were the major elements while, the World Bank and the Asian Development Bank became more active in financing infrastructure projects. Once South Korea had established a credible and firm base it was in a position to enter a phase of more rapid economic expansion. American economic cooperation with South Korea at a governmental level, moved to the corporate sector.²⁸ The Third Plan (1972-1976) emphasised more balanced growth and concentrated on the heavy and chemical industries. The major transformation occurred during that period of time when government planners decided to move out of labour-intensive industries like textiles and into heavy industry: construction, shipbuilding, steel and petrochemicals. In 1976, 74 per cent of all manufacturing investment went to heavy industries; by 1979 this figure was over 80 per cent. World Bank figures suggest that between 1960 and 1979 only three other countries (Japan, Singapore and Romania) grew faster than South Korea. The first three Plans achieved average annual growth rates above those actually planned

²⁷ Tim Shorrocks, "In Focus: Korea", *Foreign Policy in Focus*, vol. 3, no. 2, February 1998, (The Foreign Policy in Focus Journal Website, <http://www.foreignpolicyinfocus.org/briefs/vol3/v3n2kor.html>).

²⁸ Hyung-Dong Kim, *Korea and the United States: The Evolving Transpacific Alliance in the 1960s*, pp. 287-288.

(respectively achieving 7.9, 9.7 and 10.2 per cent).²⁹ In 1980, manufacturing in Korea accounted for about one-third of total output compared with 12 per cent in 1967.³⁰ As table 5.3 shows, the structure of the South Korean economy changed as rapidly as it had grown.

TABLE 6.3 - THE STRUCTURE OF INDUSTRY AND MANUFACTURING
IN SOUTH KOREA 1960-1996

	(%)						
	1960	1970	1973	1977	1980	1990	1996
Industry							
Primary	36.8	27.9	24.9	22.3	14.7	8.7	6.3
Secondary	15.9	21.7	26.2	28.4	29.7	29.7	26.1
Tertiary	47.3	50.4	48.8	49.2	55.6	61.6	67.6
Manufactur.							
Light	76.6	62.2	59.1	48.5	46.4	34.1	23.8
Heavy	23.4	37.8	40.9	51.5	53.6	65.9	76.2

Source: Kim Dae Hwan, "Rush to Growth, Economic Crisis, Limping Modernisation and Dual Risk Society", *Korea Journal*, Spring 1998, p. 32.

In this context, the role of the big financial conglomerates known as chaebol in South Korea is essential. The Park government encouraged the growth of chaebol under direct family control with cross-directorships and cross-shareholdings. Most of the chaebol spread their interests across a large number of industries. As Francis Fukuyama has observed, between 1970 and 1980 the entire sectoral makeup of the Korean economy had shifted. For example, the government urged Hyundai, one of the biggest chaebol, to move into

²⁹ Brian Bridges, *Korea and the West*, pp. 23-24.

³⁰ Korean construction companies also took advantage of the economic boom in Middle East oil-exporting countries after 1973; in 1980 more than 130,000 Korean construction workers were in the Middle East, contributing to Korea's earnings of foreign exchange. See Robert Solomon, *The Transformation of the World Economy*, (Macmillan Press, London 1999) p. 141.

shipbuilding in the early 1970s. The South Korean shipbuilding industry, which had never previously constructed a vessel of more than 10,000 tons jumped into the production of huge 260,000-ton crude carriers.³¹ Chaebol were also selected to conduct big projects beneficial for the South Korean economy, while the chaebol in return rewarded politicians with funds needed to achieve their political goals and economic targets. As a result an excessive influence of the chaebol over government policy-making was created. Banks were also lax in examining large-scale investment project loans for which bank credits were requested by chaebol.

Both the government and the chaebol invested heavily in rapid economic growth, the government attempting to establish its political legitimacy and the chaebol to enjoy economic gains. The government used a number of mechanisms to encourage the growth of the chaebol. First and foremost was its control over credit. The government channelled large amounts of money to the chaebol in an effort to strengthen their global competitive positions. This credit often came at negative real interest rates, a fact, which according to Fukuyama explained the rapid expansion of these conglomerates into businesses even though they had "scant management expertise". Through a high degree of indicative planning, the South Korean government created a

³¹ Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (Penguin, London 1995) pp. 139.

reasonably stable domestic economic environment in which large companies could operate knowing that they would be protected from foreign companies in their domestic markets and supported in their export drives abroad.³²

Given the state's concentrated policy support, the chaebol were able to extend even into fields where small and medium-sized firms were involved. As a result, the number of firms owned by the thirty largest chaebol increased to 819 in 1997, while the average number of business fields per chaebol rose to twenty. Largely this was a result of the government's perception that "size equals modernity". Economic policies, which promoted colossal projects proudly heralded as "the biggest in the Orient" or "one of the biggest in the world".³³ Chaebol were motivated by the desire to increase the size of the group, the number of employees and to produce more sophisticated products, rather than, as in Anglo-American capitalism, to enhance stockholder wealth. As long as the necessary funds could be obtained from the banks, there was little incentive to use resources efficiently. As Nicola Bullard, Walden Bello and Kamal Mallhotra point out, even by the early 1980s, the inefficiencies of what at the time was an extremely successful state-led strategy were becoming evident, as the economy grew and the

³² Francis Fukuyama, *Trust. The Social Virtues and the Creation of Prosperity*, pp. 138-139.

³³ Kim Dae Hwan, , "Rush-To Growth, Economic Crisis, Limping Modernization and a Dual-Risk Society", *Korea Journal*, vol. 38, no. 1, pp. 33-35.

corruption in the state-bank-chaebol nexus multiplied and became apparent. Furthermore, many of the chaebol were protected from competition by a number of barriers to entry into industries, including restrictions on mergers and acquisitions. Many big firms protected their interest by providing financial support to influential politicians. In addition, government-directed banking prevented and delayed any serious efforts at reforming and adapting the South Korean financial system. For many observers, cronyism caused the economy to lose dynamism and flexibility, by making it unresponsive to a changing global economy. Despite this no action was taken to reform the system by either politicians, economists or government bureaucrats or by any of their international backers.³⁴

Three Variables at Work and the Fifth Variable in the form of the Financial Crisis of 1997

From the end of the 1980s, three variables (globalisation of finance, increased capital mobility and international institutions) formed the basis on which the Washington Consensus was strengthened. More specifically, at the end of the 1980s, under the

³⁴ Nicola Bullard, Walden Bello and Kamal Mallhotra, "Taming the Tigers: The IMF and the Asian Crisis", pp. 518-519.

Reagan Administration, American policy changed to one of repeatedly pressurising the East Asian states in order to force them to liberalise their economies. Fearing the emergence of another Japan with which it would constantly be in deficit, Washington subjected Seoul to a trade offensive. In 1988, the change of American policy was reflected in the amendments to Section 301 of the Trade Act of 1974 (also known as "Super 301"), the main American trade law designed to open foreign markets to American investment and exports of goods and services and to achieve adequate and effective protection abroad for intellectual property rights.³⁵ In April 1989, the United States Treasury accused South Korea of continued manipulation of the South Korean currency to retain an artificial trade advantage. South Korean officials and businesspeople, however, complained that the already rapid appreciation of the won was slowing economic growth and threatening exports. In May 1989, South Korea avoided being called an unfair trader by the United States and forestalled possible United States trade sanctions, by promising to open up its agricultural market, ease investment by foreigners, and remove many import restrictions.³⁶

³⁵ For a detailed analysis on Super 301, see Jagdish Bhagwati and Hugh Patrick, ed. *Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System*, (The University of Michigan Press, 1990).

³⁶ See Andrea Matles Savada and William Shaw, *South Korea: A Country Study* (Federal Research Division, Library of Congress, Washington DC 1990, The Library of Congress Website, <http://lcweb.loc.gov/frd>).

As a consequence of “Super 301”, following negotiations with American policy-makers South Korea agreed to remove border closure provisions for reasons of promoting local production. South Korea also agreed to simplify import procedures and abide by the GATT standards code with respect to technical regulations, quality controls and testing and certification. In the foreign direct investment area, South Korea committed itself to terminating the performance requirements on foreign investment.³⁷ The end of the Cold War reduced the willingness of the United States to ignore the negative aspects of authoritarian government in Asia. Pressures for change were exercised directly and indirectly through international institutions in the areas of democratic enlargement, transparency, and economic reforms. Furthermore, from 1993 the “Clinton Doctrine” became one of aggressive foreign economic policy designed to promote exports, to open targeted economies like South Korea’s to American goods and investment to further entrench the Washington Consensus.

In the early 1990s pursuing membership of the OECD, South Korea adopted a more liberal attitude towards foreign capital and finance. In its 1993 Blueprint for Financial Reform, the government outlined a five-year programme of gradual financial sector

³⁷ South Korea also agreed to move from a case-by-case investment approval system to an automatic approval system on a gradual basis. See Chulsu Kim, “Super 301 and the World Trading System: A Korean View”, *Aggressive Unilateralism: America’s 301 Trade Policy and the World Trading System*, p. 255.

deregulation. Under the plan all interest rate controls were to be removed by 1997. Other principal measures of the blueprint included reducing controls on short and long-term capital flows and giving banks greater autonomy on managing their business. Furthermore, in 1994 in return for OECD membership, South Korea abolished the Economic Planning Board, the main body for making economic policy since the early 1960s and loosened virtually all controls over financial institutions.³⁸ South Korea's 1996 accession to the OECD was contingent upon its acceptance of the obligations of the OECD Codes of Liberalisation of Capital Movements.³⁹ The codes are binding on OECD member countries and required them to remove specific restrictions on the movement of capital that are consistent with basic elements of the Washington Consensus. The average acceptance rate among the OECD member countries of the codes on financial liberalisation was 89 per

³⁸ Chalmers Johnson, "Economic Crisis in East Asia: The Clash of Capitalisms", *Cambridge Journal of Economics*, no. 22, 1998 p. 655.

³⁹ The Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations constitute legally binding rules, stipulating progressive, non-discriminatory liberalisation of capital movements, the right of establishment and current invisible transactions (mostly services). Implementation of the Codes, in particular by removal of restrictions on cross-border capital flows and trade in services and the concomitant lifting of country reservations against the Codes, involves "peer pressure" exercised through policy reviews and country examinations to encourage unilateral rather than negotiated liberalisation. The Codes have been improved on various occasions since their initial adoption in 1961; important recent additions were the right of establishment (1986) and cross-border financial services (1992) (OECD Website, <http://www.oecd.org//daf/investment/legal-instruments/codes.htm>).

cent. South Korea accepted 65 per cent of the codes with many of its reservations and exceptions to be phased out by 2000.⁴⁰

The relaxation of controls which had accompanied South Korea's compliance with the requirements of OECD membership and the pressures of globalisation led to massive short-term borrowing abroad by the banks and the chaebol to maintain their profitability by rolling over loans that could not be repaid. In December 1996, the government attempted to deal with the situation by introducing legislation intended to facilitate the shedding of labour. This resulted in a general strike in January 1997 and created much industrial dislocation. After the failed attempt to regain profitability by expanding their rights to shed labour and reduce the workforce, the chaebols had no choice but to rely even more on their close relationship with the state and the banks, to draw even greater amounts of funds to keep their money-losing operations alive. Furthermore, the domestic banking system was not able to neutralise the impact of foreign capital flows by directing the funds into productive and safe lending and eventually the excess liquidity spilled over into risky and speculative investments.⁴¹ A series of bankruptcies of business firms including chaebol such as Hanbo, Sammi and Kia,

⁴⁰ Wendy Dobson & Pierre Jacquet, *Financial Services Liberalisation in the WTO* (Institute for International Economics, 1998) pp. 237-238.

⁴¹ Nicola Bullard, Walden Bello & Kamal Mallhotra, "Taming the Tigers: The IMF and the Asian Crisis", pp. 520-521.

further depressed the economy and exposed the weakness of the banking system.⁴²

Until the financial crisis of 1997 it was thought to be more profitable for chaebol to engage in interest arbitrage than ordinary manufacturing. The crisis demonstrated the South Korean government was not well prepared for the sudden changes in international financial markets. The domestic financial market, which was controlled by the government, did not respond quickly to the change in international financial markets and the inflow of dollars to domestic firms due to getting loans from abroad.⁴³ The domestic banking system was not able to optimise the impact of foreign capital flows by directing the funds into productive and safe lending and eventually the excess liquidity spilled over into risky and speculative investments.⁴⁴

As foreign bank lending continued to rise in the first half of 1997 to a level of \$67.3 billion, the average debt-equity ratio of the thirty largest chaebol grew to almost 4.0 by April 1997 (table 5.4).⁴⁵

⁴² Young Back Choi, "On Financial Crisis in Korea", *Korea Observer*, vol. XXXIX, no. 3, 1998, pp.493-495.

⁴³ Joo-Kwang Yun, "Economic Crisis in South Korea: Causes and Prescription for Private Industries", *Korea Observer*, vol. XXIX, no.3, 1998, pp. 442-443

⁴⁴ A characteristic example is that of Hanbo Group, which went bankrupt in January 1997. Hanbo's steel company amassed \$4.7 billion in debt building a new mill, 22 times its equity. However, the actual investment into the new mill was only \$3.8 billion, which reflected a difference of almost \$1 billion from the outstanding loan.

⁴⁵ Debt equity (D/E) ratio is calculated as long-term debt divided by total shareholders' equity. The ratio only includes long-term debt. High D/E ratio in general implies more financial risk for the firm which may in turn lead to restrictions in business activities because of the restrictive debt covenants. Therefore, South Korean chaebol should have experienced more restrictions on their decisions than companies in the United States, for instance, with lower D/E ratio. On the contrary, the chaebol had kept expanding under the umbrella of the government protection. See Joo

TABLE 6.4 - DEBT/EQUITY RATIOS OF THE LARGEST NINE CHAEBOL
(JUNE 1997)

CHAEBOL	LONG-TERM DEBT (\$ BILLIONS)	DEBT/EQUITY RATIO
HYUNDAI	47.89	4.4
SAMSUNG	40.95	2.7
LG	31.80	3.5
DAEWOO	29.16	3.4
SUNKYUNG	19.94	3.9
SSANGYONG	14.04	4.1
HANJIN	13.03	5.6
KIA	13.14	5.2
HAWHA	10.74	7.8

Source: Joo-Kwang Yun, "Economic Crisis in South Korea", p. 447

By October 1997 it was estimated that non-performing loans by South Korean enterprises totalled more than \$50 billion. At the same time foreign banks, which already had about \$200 billion worth of investments and loans in South Korea became reluctant to release new funds.⁴⁶ South Korea's merchant banks had outstanding loans of \$5.35 billion to chaebol that had either gone bankrupt or sought protection from creditors.⁴⁷ Moreover, a massive and panic withdrawal of funds from the Seoul stock market by foreign investors, combined with a rapid depreciation of the won, created additional demand for the dollar. The South Korean government was not in a position to stabilise its currency, without increasing interest rates. When the won began to depreciate in early November 1997, the government initially claimed

Kwang Yun, "Economic Crisis in South Korea: Causes and Prescription for Private Industries", pp. 447-449.

⁴⁶ Nicola Bullard, Walden Bello and Kamal Mallhotra, "Taming the Tigers: The IMF and the Asian Crisis", p. 521.

⁴⁷ Youn-Suk Kim, "The Korea's Financial and Industrial Crisis: Cause and Implications", p. 515.

that it would not let the won fall below the rate of 1,000 to the US dollar (table 5.5).

TABLE 6.5 – THE WON DEPRECIATION 1996-1998

	DEC. 96	OCT. 97	NOV. 97	DEC. 97	JAN. 98	FEB. 98
Won/US dollar	841	929	1035	1494	1707	1628
Usable Reserves (\$ billions)	29.4	22.3	7.3	8.9	12.4	18.5

Source: Young Back Choi, "On Financial Crisis in Korea", p. 486

As the exit from the won intensified, the government expanded the won's daily band of flexibility to 10 per cent and spent almost \$10 billion of its foreign exchange reserves in efforts to protect the currency.⁴⁸ Official reserves stood at \$30 billion at the end of 1996; by mid-November 1997 they were depleted to \$7.3 billion.⁴⁹ In November 1997, it became clear that the Bank of Korea had been using its foreign exchange reserves for lender of last resort lending to domestic banks unable to roll over their exchange borrowing. And with around \$100 billion of lending to be repaid to foreign lenders, the Bank of Korea was unable to defend the won. When even the wider band of 10 per cent proved ineffective, the government let the won float on November 17, 1997. Those events forced South Korea to seek an IMF rescue. On

⁴⁸ Ilene Grabel, "Rejecting Exceptionalism. Reinterpreting the Asian Financial Crises", in Mitchie and Smith, eds. *Global Instability* (Routledge, London 1999) p. 52.

⁴⁹ Young Back Choi, "On Financial Crisis in Korea", pp. 491-492.

December 3, 1997 the government and the IMF reached an agreement on a record \$57 billion bailout.

By the time of the financial crisis the South Korean economy had moved closer to the Washington Consensus in varying degrees in the following areas: fiscal discipline, public expenditure, financial liberalisation, exchange rates, trade liberalisation, foreign direct investment and property rights. However, the South Korean economy was not as close to the Washington Consensus as the Mexican economy before the peso crisis. In the areas of privatisation and deregulation South Korea's economy was far from the Washington Consensus. The strengthening of the Washington Consensus in South Korea, before the financial crisis of 1997, was based on the following framework's variables: globalisation of finance, mobility of capital, international institutions. The role of domestic elites in accepting ideas related to the Washington Consensus was not as important as in Mexico. The financial crisis challenged the Washington Consensus in South Korea and the rest of East Asia. The next chapter analyses the American policy in relation to the IMF assistance package to South Korea.

CHAPTER SEVEN

ENTRENCHING THE WASHINGTON CONSENSUS IN EAST ASIA: THE RESPONSE OF THE UNITED STATES AND THE IMF TO THE SOUTH KOREAN CRISIS OF 1997- 1998 ¹

This chapter discusses the American response to the South Korean crisis (1997-98) and tests the framework of five variables that were introduced in Chapter Two. The first part of the chapter examines the policy of the United States at the initial stages of the crisis and the role of the IMF in promoting American policy goals. The second part of the chapter analyses the details of the US Treasury-led assistance package of the International Monetary Fund (IMF) to South Korea and

¹ A shorter version of this chapter appears as: Panayotis Karayannis, "The Response of the United States to the Asian Crisis", in Simon Lee, ed. *The Asian Financial Crisis: Causes and Consequences* (Lynne Rienner Publishers, Boulder 2001).

its role along with the change in South Korea's domestic policies in realigning South Korean capitalism toward the Washington Consensus

The Policy of the United States at the Initial Stages of the Asian Crisis

The Asian crisis represented a unique historical opportunity for the United States to promote a particular sort of market-oriented regulatory framework in the region. American observers were prone to believe that just as the fall of the Berlin Wall in 1989 had vindicated the American political model, so the fall of Asia's markets in 1997 proved the wisdom of the American economic model – free market capitalism.² It was a shared belief among analysts and policy-makers in Washington that financial liberalisation exposed the policies of crony capitalism that were being held responsible for causing the recent financial crisis.³ It was also believed that liberalising trade and investment in East Asia would assist the economies of the region to become more market-

² See W. Rober Warne, "Washington's Perceptions on Korea's Financial Crisis", *Korea Observer*, vol. XXIX, no. 3, 1998, pp. 535-545; See also Donald Emmerson, "Americanising Asia?", *Foreign Affairs*, vol. 77, no. 3, May/June 1998, p. 48.

³ See Paul Krugman, *The Return of Depression Economics* (Penguin Press, New York 1999).

oriented helping the United States to sustain its continued economic expansion.⁴

In his statement before the House Committee on Banking and Financial Services in January 1998, Lawrence Lindsey, from the American Enterprise Institute, suggested that the United States should use its negotiating leverage effectively to advance its principles about the workings of the global economy:

‘The taxpayers of Europe and Japan and the working people of Asia would be much better off today if their governments had imitated the actions taken by the United States with regard to reforming its financial system and deregulating its economy. We should be using the present crisis to insist that other nations take those actions now and make those actions a precondition for our assistance.’⁵

The Washington Consensus view, most clearly associated with Alan Greenspan at the US Federal Reserve, the US Treasury and the IMF was that the Achilles heel of the Asian model had been excessive government interventionism. In addition, by the time of the crisis the United States was at its seventh consecutive year of economic expansion with growth at 4 per cent and the unemployment rate averaging only 4.9 per cent. According to the *Economic Report of the*

⁴ Robert O’Quinn, “Solving the Asian Crisis Through Trade and Investment Liberalisation”, *The Heritage Foundation Executive Memorandum*, No. 523, April 10, 1998.

⁵ Statement by Lawrence Lindsey, Resident Scholar of the American Enterprise Institute, before the Committee on Banking and Financial Services, US House of Representatives, January 30, 1998 (The House of Representatives Website, <http://www.house.gov/banking>).

President 1998, more jobs were created in 1997 than in either of the two previous years. Inflation remained subdued, with the consumer price index (CPI) rising just 1.7 percent during the year.⁶ Thus, market capitalism, as practised in the United States was seen as providing greater promise of producing rising standards of living and continuous growth. As Alan Greenspan, Chairman of Federal Reserve Bank argued in 1998:

‘Many of the leaders of these [East Asian] countries and their economic advisors are endeavouring to move their economies much more rapidly toward the type of economic system that we have in the United States. The IMF’s approach in Asia is fully supportive of the views of those in the West who understand the importance of greater reliance on market forces, reduced government controls and scaling back of government-directed investments. My sense is that there is a growing understanding and appreciation of the benefits of market-capitalism as we [the United States] practice it.’⁷

In Asia, such arguments were widely seen as driven by American interests which perceived an opportunity to open East Asian markets to foreign investment and which thereby threatened, as Foot and Walter have argued, to unravel what was a large number of developing success stories.⁸ However, the United States had a very strong stake in the restoration of confidence, sustainable flows of capital

⁶ See *Economic Report of the President 1998*, pp. 105-106 (Government Printing Office Gate, University of California Website, <http://www.gpo.ucop.edu/catalog/erp98.html>).

⁷ *Testimony by Alan Greenspan, Chairman of the Federal Reserve Bank*, before the Subcommittee on Foreign Operations of the Committee on Appropriations, US Senate, March 3, 1998 (The United States Information Agency Website, <http://www.usia.gov/regional/ea/asiafin/grnsn33.htm>).

⁸ Rosemary Foot and Andrew Walter, “Whatever Happened to the Pacific Century?”, *Review of International Studies*, Special Issue, December 1999, p. 263.

and a return to growth in countries where the consequences of the Asian crisis were serious. Equally there was a strong stake in avoiding further contagion to other emerging economies. This stake was based on the growing importance of these markets for American exports and it was also based on the recognition that a prosperous, integrated Asia and a prosperous, integrated global economy were in the strategic interest of the United States.⁹ The Asian markets provided significant trade and investment opportunities for American businesses and through them create substantial employment in the United States. It was estimated that in 1998 almost 3,000,000 American jobs were directly related to trade with Asian economies.¹⁰ According to one calculation, the East Asian economies were expected to absorb a total of \$910 billion worth of global imports in 2010 and if the 1993 US market share was maintained, this would amount to \$120 billion worth of US exports to these economies.¹¹

After the onset of the Asian financial crisis in July 1997, there were high expectations that the Asian Pacific Economic Cooperation group (APEC) would play a leading role in coping with the crisis

⁹ Testimony by Lawrence Summers, Deputy Secretary, US Treasury, before the House Subcommittee on Asia and the Pacific, of the Committee on International Relations, US House of Representatives, November 6, 1997 (The House of Representatives Website, http://www.house.gov/international_relations).

¹⁰ Robert O'Quinn, "Solving Asian Crisis Through Trade and Investment Liberalisation", *Executive Memorandum* no. 523, The Heritage Foundation, April 10, 1998.

¹¹ This figure is possibly on the low side since the US market share in these countries, particularly in China is likely to expand. See Helen Nesadurai, "APEC: A Tool for US Regional Domination?", *The Pacific Review*, vol. 9, no. 1, 1996, p. 39.

because of the belief that APEC was one of the leading forces in the world for trade liberalisation. Fred Bergsten argued that, given the fact that APEC's members accounted for half of the world economy, its commitment to achieve free trade by 2010/2020 remained potentially the most far-reaching trade agreement in history.¹² It was also thought that APEC could provide a solution to the crisis by creating a standby funding agreement to support future IMF programmes in the region. Even when the IMF had given generous multiples of quotas – 700 per cent to Mexico, 500 per cent to Thailand – it was still only a small part of the total package that would be needed to reassure markets and force the troubled economies to take the prescribed corrective action.¹³ However, for American policymakers, it was very important that the IMF remained central to the process of working out the adjustment programmes for the economies in crisis. The centrality of the IMF was critical to the United States. Even if APEC was involved it had to be in coordination with the IMF. A combination of the two institutions (APEC and the IMF), where there was the appearance of consensus in

¹² Statement by Fred Bergsten, Director of the Institute for International Economics, before the Subcommittee on Trade, Committee on Ways and Means, US House of Representatives, February 24, 1998 (The Institute for International Economics Website, <http://www.iie.testimony/fredw&m.html>).

¹³ Testimony by Fred Bergsten, Director, Institute for International Economics, before the Subcommittee on Asia and the Pacific, Committee on International Relations, US House of Representatives, November 6, 1997, (The US House of Representatives Website, http://www.house.gov/international_relations).

APEC but the delivery mechanism was through the IMF was the favourable way to deal with the crisis at the time.

A case that demonstrated the preferences of the United States was its attitude toward a Japanese proposal in September 1997 to establish an Asian Monetary Fund (AMF) of \$500 billion (Japan's share being about \$100 billion) to alleviate the financial distress of Asian economies. The initiative arose from the need to bail out Thailand and the refusal of the United States to participate in the initial \$17 billion IMF assistance. Asian leaders criticised the United States for its reluctance to support Thailand therefore making the spread of the crisis to the other economies of the region easier.¹⁴ For that reason, Japan took the initiative in trying to persuade the United States that an Asian Fund was additional to, not incompatible with the IMF. Japanese support for an AMF offered a good opportunity to demonstrate a leadership role closely connected with its economic importance in the region. Japan had also some good reasons for putting such a proposal on the table. Japanese banks were heavily exposed in Thailand, South Korea and the rest of the region and it was in Japan's interest also to stabilise these economies. The Japanese economy had become deeply integrated with

¹⁴ Southeast Asians were concerned by what many of them saw as congressional indifference, if not hostility, toward helping the region recover. They pointed to the inability of the Clinton Administration to quickly persuade Congress to authorise additional financing for the IMF. See Donald Emmerson, "Americanising Asia?", p. 49.

its neighbours and any regional recession would have had a direct domestic impact.¹⁵

The AMF proposal could have broken the IMF monopoly on economic thought and opened up the market to new ideas and different solutions. The United States insisted that the IMF controlled the adjustment funding and in November 1997 APEC backed an IMF-led response to Asia's problems. For the United States there was the question of whether such an institution as the AMF could act as the basis for the creation of a common currency in East Asia based on the strength of yen. Establishing a yen zone in the region would have weakened American influence on the policy process in Asia. There were also fears expressed from the United States and the IMF that any adjustment funds not under the direct control of the IMF might not be properly used. One of the main concerns was that an AMF-style organisation would slow down the liberalisation of Asian financial markets.¹⁶ Possessing more voting power than any other nation in the IMF, the United States was not convinced of the superiority of a regional rescue effort. Finally, the American desire for the IMF to control adjustment funding prevailed and its dominant role in the adjustment process was endorsed at the Vancouver APEC Forum on

¹⁵ Nicola Bullard, Walden Bello and Kamal Mallhotra, "Taming the Tigers: the IMF and the Asian Crisis", *Third World Quarterly*, vol. 19, no. 3, 1998, p. 541.

¹⁶ Richard Higgott, "The Asian Economic Crisis: A Study in the Politics of Resentment", *New Political Economy*, vol. 3, no. 3, 1998, pp. 340-341 & 345.

November 25, 1997. Ambassador John Wolf, who was the US coordinator for the APEC Forum, justified the importance of the IMF's role in the Asian crisis on the need to ensure that even when countries received funds from outside financial sources, these funds would be used in supported of an adjustment programme that supported the necessary measures to restore financial stability. Thus the IMF was "best positioned to assure a credible adjustment programme".¹⁷

The IMF had served American interests by promoting desired economic reform and it could possibly further improve that role, with greater attention to issues of equity, corruption and more transparent operations.¹⁸ The American policy towards an AMF or in general the creation of new institutions for the world economy reflected, as Higgott has pointed out, a private-sector desire for continued financial liberalisation and a political/bureaucratic institutional desire not to cede the power of the existing international financial institutions over which they would have less ideological and practical control.¹⁹ The main concern of American foreign economic policy was that an AMF-

¹⁷ Testimony by Ambassador John Wolf, US Coordinator for the APEC Forum, Subcommittee on Asia and the Pacific, of the Committee on International Relations, US House of Representatives, November 6, 1997, (The US House of Representatives Website, http://www.house.gov/international_relations).

¹⁸ Testimony by Stephan Haggard, Director, Institute on Global Conflict and Cooperation, before the Subcommittees on Asia and the Pacific and International Economic Policy and Trade of the Committee on International Relations, US House of Representatives, February 4, 1998 (The US House of Representatives Web Site, http://www.house.gov/international_relations).

¹⁹ Richard Higgott, "The Asian Economic Crisis: A Study in the Politics of Resentment", p. 344.

style organisation would slow down the liberalisation of Asian financial markets. Furthermore, the IMF and the broader network of financial institutions such as the World Bank and the WTO had been very important in legitimising the interests of American foreign policy. The United States remained still the dominant actor in the international institutions and a creation of viable alternative organisations would diminish its influence. Indeed the American administration was now having to rely even more on bodies such as the IMF, the WTO and the APEC to push its trade objectives.²⁰

The agenda of the United States and the IMF has been very well summarised by Congressman John LaFalce who has indicated some important elements of conditionality that the United States and the IMF should promote in the context of the Asian crisis:

- a) 'It is critical that the IMF's primary goal should be to stabilise currencies. Agreement should be reached to avoid competitive devaluations that will further destabilise the international financial and trading systems;
- b) The IMF must also seek vast improvements in the financial services sectors of countries using IMF stand-by instruments. The IMF must should seek agreement from the affected countries to reform the laws and regulations governing their domestic financial institutions so that they meet generally accepted international standards;

²⁰ After Michel Camdessus announced his retirement from the IMF, in November 1999, Japan nominated Eisuke Sakakibara, ex-deputy minister of finance, for the position of the managing director of the IMF. During the Asian crisis, Sakakibara led Tokyo's effort to offer unconditional aid as an alternative to the IMF's prescriptions. While the Fund remains Atlanticist, espousing an Anglo-American ideology, Japan lobbied among neighbouring nations to advance Skakibara's candidacy. See Patrick Smith, "Tokyo's Coup de Theatre at the IMF", *International Herald Tribune*, January 22, 2000.

- c) The economies of these countries must be open. The IMF must insist on economic reforms that open economies to both internal and external competition. Assisted countries must be open to competition, trade, investment and capital flows – domestically and internationally. The use of overt trade and investment barriers or indirect regulatory schemes to exclude outside competition must not be tolerated.’²¹

The American pursuit of Washington Consensus-style IMF reform packages at the Vancouver summit, made the gap across the Pacific greater rather than smaller and the inherent tensions more transparent. In that sense the crisis demonstrated the limits of APEC. It was no coincidence as Richard Higgott has suggested, that APEC always found its strongest intellectual and political support among its American, Australian and Canadian members. In East Asia APEC was considered as an additional tool by which the United States could promote the case for further market liberalisation.²² Evidence of that was provided by the fact that in the midst of economic turmoil, in November 1997, the APEC leaders agreed to liberalise trade in fifteen key sectors.²³

²¹ Address by John LaFalce, US House of Representatives, before the Institute for International Economics, Washington DC, January 27, 1998, (The USIA Website, <http://www.usia.gov/regional/ea/asiafin/lafalce.htm>).

²² Richard Higgott, “The Asian Economic Crisis. A Study in the Politics of Resentment”, pp. 341-342 & 651.

²³ Referred to as the Early Voluntary Sectoral Liberalisation (EVSL) initiative, these sectors included chemicals, energy goods and services, environmental goods and services, fish, forest products, gems and jewelry, medical equipment and instruments, toys, civil aircraft, automotive, natural and synthetic rubber, food and oilseed and a mutual recognition agreement in telecommunications products and systems. See Arlene Mayeda, “APEC: Making the Vision a Reality”, *Business America*, vol.119, January 7, 1998, p. 26.

However, by November 1997, it became obvious that an international loan agreement was required, encompassing not just the IMF but other countries with the United States playing an active and important role²⁴ (see table 6.1). It soon became apparent that a major crisis in South Korea would have significant implications for the Japanese yen, the Tokyo Stock Exchange and a contagion effect on markets in Europe and North America. It could also have military implications that might cause North Korea itself to become more assertive if it felt that South Korea was consumed in a great crisis of its form of capitalism. Furthermore, Japan and China, were not able to provide effective leadership, without a major role being played by the United States.²⁵ Influential economists, such as Bergsten, argued that: "we [the United States] should not have to take the lead in Asia like we did with Mexico in this hemisphere but there is nobody else out there that can or will do it".²⁶ The United States responded to the Asian crisis through the IMF, and as in the case of the peso crisis, through separate

²⁴ The Thai authorities were expecting the United States to participate in the bailout programme as Thailand had been one of the region's closest US partners. Thailand was the first country in Asia to establish diplomatic relations with the United States in 1833. Thailand also has maintained a special treaty with the United States since World War II, which gives American citizens and investments a national treatment allowing them special privileges to operate in many areas of business See Kvaljit Singh, *The Globalisation of Finance*, Zed Books, London 1999, p. 105.

²⁵ Testimony by David Hale, Chief Global Economist, Zurich Kemper Investments, before the Committee on Banking and Financial Services, US House of Representatives, November 13, 1997 (The US House of Representatives Website, <http://www.house.gov/banking>).

²⁶ Testimony by Dr Fred Bergsten, before the Committee on Banking and Financial Services, US House of Representatives, November 13, 1997 (The US House of Representatives Website, <http://www.house.gov/banking>).

decisions involving the Exchange Stabilisation Fund. It was the Treasury Department rather than the State Department that had the crucial relationships with finance ministers and central bank directors and understood both the technical details and policy issues. In the case of the Asian crisis there was not a split or any major disagreement between the executive branch and the Congress but there was some degree of fragmentation within the executive branch. The Asian crisis revealed the fact that the State Department was sidelined when it came to crucial global financial issues.²⁷ In this regard the IMF programmes in South Korea and other countries of the region were put in place with the support of the US Treasury and the IMF. However, in contrast to the situation in Mexico in 1995, the IMF was responsible for a major part of the assistance provided, meaning a limited direct financial exposure for the United States.

For American policy-makers the IMF was the appropriate institution to be at the centre of the effort because it could press for Washington Consensus-style reforms in the affected countries and would internationalise the burden of managing international crises. In

²⁷ On many important questions the State Department's advice was decisively overruled. For example, when Thailand asked for immediate assistance from individual governments in the early stages of its crisis, the State Department argued that the United States had to come to Thailand's aid. This advice was not followed and the United States did not contribute to the aid package. In the case of Indonesia, the State Department called for a less intrusive approach to restructuring out of fear of massive social unrest - and yet again it lost the argument. See Jeffrey Garten, "Lessons for the Next Financial Crisis", *Foreign Affairs*, March-April 1999, pp. 84-85.

this context, the IMF served as “a multilateral insurance policy against the prospect of financial meltdown”.²⁸ During a discussion in Congress about the 1999 budget request for funding for the IMF and the World Bank, Treasury Secretary Robert Rubin insisted that:

‘To make the most of the opportunities and manage the risks, we must participate in – and lead in – the international institutions that help shape the global economy. These programmes provide an enormous return for American taxpayers. They help build free markets and free trade, promote growth and reform, promote sustainable development and assist in responding to financial crises such as the current one in Asia. All of which importantly protects and promotes US economic and national security interests.’²⁹

The support of the United States for the IMF as the central institution in the effort to resolve the crisis in Asia is also evident in the words of the Secretary of State Madeleine Albright:

‘The United States is participating in these [IMF] programmes for a very clear reason: the stability of the Asia-Pacific region is in our economic and national security interest. These countries are our friends and allies and their prosperity makes them better customers for US exports. The resources we pledge to the IMF for helping other nations also protect and benefit the United States and the American people. A stable and growing American economy depends on a stable and growing world economy. The IMF supported by the United States, is best suited to monitor the reform process and ensure that momentum is sustained.’³⁰

²⁸ Opening Statement of James Leach, The House Committee on Banking and Financial Services, January 30, 1998 (The USIA Website, <http://www.usia.gov/regional/ea/asianfin/leach130.htm>).

²⁹ Testimony by Treasury Secretary Robert Rubin before the House Appropriations Foreign Operations, Export Financing and Related Programmes Subcommittee, February 11, 1998 (The US Treasury Website, <http://www.ustreas.gov/press/releases/pr2207.htm>).

³⁰ Madeleine Albright, Secretary of State, “The Economic Crisis in Asia”, *Diario Las Americas*, Miami, February 1, 1998 (The Secretary of State Website, <http://secretary.state.gov/www/statements/1998/>).

Indeed, it has been difficult to distinguish between what the IMF is promoting and what the United States is promoting. As Bergsten suggested: "We (the United States) get most of what we want. They (the IMF) pursue most of what we believe in."³¹ The United States has had critical economic and national security interests at stake, when promoting restoration of financial stability. For Robert Rubin, Treasury Secretary, "when we (the United States) support IMF-led programmes, our purpose is clear: to protect and benefit the American people, American workers and American businesses".³²

The Fourth Variable at Work and The US Treasury-led IMF Agreement with South Korea

Regarding the fourth variable, domestic elites started to accept and promote basic principles of the Washington Consensus only after the eruption of the financial crisis as expressed in the Letters of Intent to the IMF. The original IMF Stand-By Arrangement with South Korea

³¹ Testimony by Fred Bergsten, before the House Committee on Banking and Financial Services, January 30, 1998, (The US House of representatives Website, <http://www.house.gov/banking>).

³² Testimony by Robert Rubin, Treasury Secretary, before the House Committee on Banking and Financial Services, January 30, 1998 (The US House of representatives Website <http://www.house.gov/banking>).

was set on December 5, 1997.³³ For the first time an advanced industrial country (Korea became a member of the OECD in 1996) was to be subjected to the tough IMF conditions usually reserved for developing countries. The \$57 billion package comprised \$21 billion from the IMF, \$10 billion from the World Bank, \$4 billion from the Asian Development Bank and \$20 billion from leading industrial countries, including \$10 billion from Japan and \$5 billion from the United States.³⁴

(table 7.1)

TABLE 7.1 - APPROXIMATE CONTRIBUTIONS TO IMF LOANS
(\$ BILLIONS)

SOURCE	THAILAN D	INDONESI A	SOUTH KOREA
INT. MONETARY FUND	4	10	21
ASIA DEVELOPMENT BANK	1.2	3.5	4
WORLD BANK	1.5	4.5	10
JAPAN	4	5	10
UNITED STATES	0	6	5
OTHER MULTILATERAL	6.5	13	7
TOTAL	17.2	41	57

Source: Bullard, Bello, Mallhotra, "Taming the Tigers", p. 522

The \$21 billion contribution of the IMF to South Korea exceeded the previous record loan of \$17.8 billion to Mexico in 1995 and it was

³³ During August - December 1997, the IMF signed three emergency lending arrangements with Thailand (August), Indonesia (November), and Korea (December). These programmes established packages of international financial support at an unprecedented cumulative sum of approximately \$115 billion (\$17.2 billion for Thailand, \$41 billion for Indonesia and \$57 billion for Korea).

³⁴ Furthermore, the American money should it be disbursed, would come from a special fund administered by the Treasury that did not require congressional approval. On top of the American share of the IMF bailout was \$1 billion in credit guarantees for the purchase of American agricultural products. See Doug Bandow, "Free Rider. South Korea's Dual Dependence on America", *Cato Policy Analysis* No. 308, May 19, 1998.

equivalent to almost twenty times South Korea's quota of \$1.09 billion in the IMF.³⁵ The agreement reflected a mix of the traditional IMF formula of fiscal and monetary tightening, combined with measures serving the special interests of foreign bankers and business, such as labour market reform, further opening the South Korean financial sector to American banks. In return the South Korean government agreed to a long list of economic, institutional, labour and industrial reforms aimed at reviving the economy. Despite the fact that American contribution in the assistance package was smaller than that of Japan, IMF conditionalities reflected the Washington Consensus. Nicola Bullard, Walden Bello and other economists argued that the bailout conditions were agreed by the US Treasury, the US Chamber of Commerce and Wall Street bankers even before Korean officials had signed the agreement.³⁶

The key elements of the initial arrangement between the South Korean government and the IMF were in line with the Washington Consensus: a) tightening monetary policy to "restore and sustain calm

³⁵ Of the total \$21 billion of the IMF contribution, \$5.56 billion was available immediately, \$3.58 billion was available December 18 following the first review under the programme and a further \$2 billion on January 8, 1998 following the second review. Subsequent disbursements were to be made available subject to the attainment of performance targets and in some cases programme reviews. See "IMF Approves SDR 15.5 Billion Stand-By Credit for Korea", *IMF Press Release* No. 97/55, December 4, 1997, (The IMF Website, <http://www.imf.org/external/np/sec/pr/1997/pr9/55.htm>).

³⁶ Bullard, Bello, Mallhotra and Chossudovsky, "Taming the Tigers. The IMF and the Asian Crisis, p. 521 and Robert Wade, "From Miracle to Cronyism: Explaining the Great Asian Slump", *Cambridge Journal of Economics*, no.22, 1998, p. 702.

in the markets”, b) raising interest rates from 12.5 per cent to 21 per cent to control liquidity, c) controlling money supply to contain inflation below 5 per cent, d) floating the exchange rate with minimal interventions and e) maintaining a balanced or slightly surplus budget. In addition to these policies the agreement included a series of institutional reforms, notably, establishing an independent central bank, closing troubled financial institutions and accelerating the approval of foreign entry into the domestic financial sector thus allowing foreign banks to establish subsidiaries. The initial programme of economic reform assumed growth of 2.5 per cent in 1998 and featured:

- a) a comprehensive financial sector restructuring that introduced a strong market and supervisory discipline and independence for the central bank and the operations of nine insolvent merchant banks were suspended.
- b) Fiscal measures equivalent to about 2 per cent of GDP to make room for the costs of financial sector restructuring in the budget; fiscal measures also included widening the bases for corporate, income and VAT taxes.
- c) Efforts to dismantle the “inefficient ties” among the government, banks and businesses. The initial agreement committed the big chaebol (such as Hyundai, Samsung, Daewoo, LG) to cutting the number of their affiliates in half and dramatically reducing their debt by the year 2000.
- d) Trade liberalisation measures, including setting a timetable in line with the WTO commitments to eliminate trade-related subsidies.

- e) Capital account liberalisation measures to open up the Korean money, bond and equity markets and to liberalise foreign direct investment.³⁷

The US Treasury-led IMF programme aimed to increase confidence, attract private capital in the short run and to address the longer term problem of allocating capital on a more market-oriented basis. A more market-oriented Asia would be a better trading partner for the United States (ie, more open to American exports) better able to grow and finance American imports and less likely to distort markets with excess capacity, excess concentration of industry and selective production.³⁸ Indeed, the South Korea stabilisation package aimed to open and expand competition in Korea by creating a more market-driven economy. South Korea faced many challenges but for American policymakers such as US Trade Representative Charlene Barshefsky, "if South Korea continued on the path to reform there would be important benefits not only for Korea but also for the United States".³⁹

³⁷ See Initial IMF programme as approved by the IMF's Executive Board on December 4, 1997 (The IMF Website,

<http://www.imf.org/external/pubs/ft/survey/pdf/121597.pdf>).

³⁸ Lawrence Summers, Deputy Treasury Secretary, "Emerging From Crisis: the Beginnings of a New Asia", Remarks at the Economic Strategy Institute, February 11, 1998 (The US Treasury Website,

<http://www.ustreas.gov/press/releases/pr2217.html>).

³⁹ Testimony by Ambassador Charlene Barshefsky, US Trade Representative, before the Subcommittee on Trade of the Ways & Means, US House of Representatives, February 24, 1998 (The US House of Representatives Website, <http://waysandmeans.house.gov>).

However, the initial IMF programme failed to meet the objective of restoring market confidence. The initial response to the crisis led by the US Treasury and the IMF, exacerbated rather than eased the crisis in its early stages. The IMF initially viewed the situation as a series of traditional balance of payments crises, rather than a financial panic and as a result demanded tight and fiscal monetary policies. The IMF's initial approach was to close a series of banks and financial institutions as a means to introduce tough reform measures in East Asian economies. The failed banking approach was clearly demonstrated in Indonesia where 16 banks were closed on November 1, 1997. The problem was that these banks were closed without a comprehensive financial restructuring plan in place. The closures in Indonesia, South Korea and elsewhere, set off a bank run that undermined the rest of the banking system, including healthy banks.⁴⁰ Foreign investors remained unconvinced about the debt servicing capacity of the private debtors despite the announced availability of IMF loans and continued to demand the repayment of short-term loans. Official reserves fell more rapidly than the IMF had predicted. In the case of Korea, the withdrawal of short-term debts was so much more intense than predicted that Korea face imminent default by December 24. By January

⁴⁰ Steven Radelet and Jeffrey Sachs, "What Have We Learned So Far from the Asian Financial Crisis?", Paper sponsored by the US Agency for International Development (USAID) pp. 14-16 (The Harvard Institute for International Development Website, <http://www.hiid.harvard.edu/research>).

1998, the inflation target had been revised upward from 5 per cent to 9 per cent as was the monetary growth target (from 9 per cent to 14 per cent).

Less than a month after the initial agreement, following three weeks of market and currency turmoil South Korea received emergency assistance of \$10 billion to avoid default. The IMF was too slow in disbursing funds but this was partly because the United States was keen to extract additional concessions from South Korea in return for the first tranche of funding. The additional concessions to the United States included: a) closing ailing merchant banks and reducing risky assets to make them more attractive for foreign take-over, b) opening the bond market by the end of 1997, c) liberalising interest rates and d) opening domestic markets to cars and other key industrial goods by mid-1999.⁴¹ Furthermore, on December 30, 1997, the South Korean National Assembly passed legislation, which was needed to implement some of the IMF-imposed reform programmes. The legislation consisted of a) establishing an independent central bank with the primary goal of controlling inflation; b) creating a consolidated supervisory body with jurisdiction over all financial operations and firm independence and; c) mandating companies to report audited and consolidated financial statements.⁴²

⁴¹ Nicola Bullard et al, "Taming the Tigers", pp. 523-525.

⁴² Youn-Suk Kim, "The Korea's Financial and Industrial Crisis: Cause and Implications", *Korea Observer*, Vol. XXIX, No.3 Autumn 1998, p. 517.

Structural reforms in South Korea's IMF/US Treasury package aimed also to complement the trade agenda of the United States by reinforcing and expanding Korea's commitments in the WTO and in the OECD. The South Korean government, by signing the agreement with the IMF on December 4, 1997, also agreed to: a) accelerate implementation of its commitments to WTO members on the elimination of trade-related subsidies and its import diversification programme; and b) liberalise its rules on import licensing and certification, which could help lower entry and distribution barriers for agricultural commodities, food and industrial products, including autos and pharmaceuticals.⁴³ The bailout programme clearly stated that:

'Timetables will be set, in compliance with WTO commitments, at the time of the first review, to eliminate trade-related subsidies; eliminate restrictive import licensing; eliminate the import diversification programme and streamline and improve transparency of the import certification procedures.'⁴⁴

What the United States was unable to attain for many years, through bilateral negotiations or under the WTO, it very quickly achieved through the IMF programme within a few months not only in Korea but also in other troubled East Asian economies. For example, during the negotiation of the World Trade Organisation's financial-services

⁴³ Testimony by USTR Charlene Barshefsky, before the House Ways & Means Trade Subcommittee, February 24, 1998 (The US House of Representatives Website, <http://waysandmeans.house.gov>).

⁴⁴ See IMF Stand-By Arrangement with Republic of Korea, December 4, 1997 (The IMF Website, <http://www.imf.org/external/pubs/ft/survey/pdf/121597.pdf>).

agreement, many developing countries, especially in Asia had opposed this agreement in 1996-97. By December 1997, Asian leaders had dropped their objections and signed an agreement that committed them to open their banking, insurance and securities markets to foreign firms.⁴⁵ In Thailand, where laws were changed in October 1997 to allow foreign majority ownership in Thai financial institutions, foreign banks had arranged to take control of many Thai banks and finance firms. For instance, the American Chamber of Commerce in Bangkok had pressed the government to open up the economy further by issuing a statement calling for additional financial liberalisation, lifting of all restrictions on foreign ownership of assets and greater foreign participation in the service sector.⁴⁶

With the implementation of these conditionalities, American financial companies would be the biggest beneficiaries as the United States had been putting pressure on Korea to open up its financial sector since the late 1980s. As part of its IMF package in early December, South Korea raised its limit on foreign ownership in local listed companies from 26 per cent to 50 per cent in mid-December 1997 and to 55 per cent in December 1998. The IMF also pushed South Korea to let foreign banks establish subsidiaries and brokerage houses and

⁴⁵ Robert Wade, "The Coming Fight Over Capital Flows", *Foreign Policy*, pp. 45-47.

⁴⁶ See Martin Khor, "Are Asians Partners to Be Helped or Rivals to Be Hurt?", *International Herald Tribune*, January 15, 1998.

enable foreign companies to have access to domestic money-market instruments and bond markets. On January 15, 1998, the chaebol had agreed to accept substantial changes such as adopting Western accounting standards, to bring outsiders into their boards of directors and to reduce their debt-equity ratios so that they would be closer to Western standards.⁴⁷ In May 1998, for example, Motorola acquired a stake in Pantech Seoul, a Korean electronics firm, becoming its second largest shareholder with 20 per cent equity. Motorola was planning to invest \$300 million in South Korea to expand its operations and set up new partnerships.⁴⁸ After the IMF bailout, South Korea also launched privatisation of Steelmaker POSCO, Korea Telecom, Korea Gas and others. General Motors and Daewoo, once competitors, signed an exclusive agreement for a new joint venture. The Hanwha Group of South Korea sold its oil refineries to Royal Dutch/Shell after having sold half its chemical joint venture to BASF of Germany. Procter and Gamble Co. obtained a controlling share of Ssangyong Paper Co., in what was the first large take-over of a Korean company by a foreign firm.⁴⁹

Further trade liberalisation on the basis of the Washington Consensus was highly desirable from the standpoint of the United

⁴⁷ Nicholas Kristof, "Crisis Pushing Asian Capitalism Closer to US-Style Free Market", *The New York Times*, January 17, 1998.

⁴⁸ United Nations, *World Investment Report 1998*, New York 1998, p. 225.

⁴⁹ Kavaljit Singh, *The Globalisation of Finance, A Citizen's Guide*, pp. 111-112.

States because it could then fully exploit its strong competitive position. The prevailing view among business people and politicians in Washington was that the United States should continue to play a leadership role in liberalising trade. As Phil Condit from the Boeing Company stated:

'Without continued strong leadership by the United States, the enormous progress we [the United States] have made to date to advance open trade will begin to slip backwards. And such a development would significantly hurt the economy of the world's largest exporting and trading nation - the United States - to say nothing of what it would do to the economies of all other countries in the world. Stabilising Asia is essential to keeping the global economy - our own economy included - growing and prospering.'⁵⁰

TABLE 7.2 - INTERNATIONAL BANK LENDING TO EAST ASIA - (\$ billions, outstanding at the end of 1996)

SELECTED COUNTRIES	US BANKS	JAPANESE BANKS	TOTAL INTERNATIONAL LENDING
INDONESIA	5.3	22.0	55.5
KOREA	9.4	24.3	100.0
MALAYSIA	2.3	8.2	22.2
THAILAND	5.0	37.5	70.2
EAST ASIA TOTAL	46.4	260.6	736.6

Source: Kavaljit Singh, *The Globalisation of Finance*, p. 84

In January 1998, the United States took a more active role despite the limited exposure of the American banks to the region (table 7.2). Concerns about a possible global financial crisis, the dollar's role as the

⁵⁰ Testimony by Phil Condit, Chairman and CEO, The Boeing Company, before the House Ways and Means Trade Subcommittee, February 24, 1998 (The US House of representatives Website, <http://waysandmeans.house.gov>).

leading international reserve currency and the opportunities for American banks and other investors to take advantage of the situation influenced this change of policy.⁵¹ The United States (led by the Federal Reserve and the Treasury) decided to press foreign commercial banks to roll over their short-term credits rather than waiting for market confidence to be restored. On January 28, 1998, \$24 billion of South Korea's short-term debt was restructured into medium-term debt over one to three years, after an agreement was reached with a group of commercial bank creditors in New York. Nevertheless, the South Korean government guaranteed to cover that amount, in case of default by the private sector debtors. In one sense, this arrangement represented the failure of the initial loan package of December, in combination with economic reforms to restore market confidence. The second programme eased off on the monetary and fiscal targets and had as its centrepiece a restructuring of South Korean bank loans owed to international banks. The new arrangements managed to stop the fall of the won and the decline in the stock market.⁵² According to the *Economic Report of the President (1999)* the fact that the crisis in South Korea eased after the new arrangement justified the view that the private sector needed to be involved in preventing the financial crises

⁵¹ Jomo K.S., "Introduction: Financial Governance, Liberalisation and Crises in East Asia", *Tigers in Trouble*, Jomo KS ed., (Zed Books, London 1998), pp. 20-21.

⁵² Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects", pp. 55-56.

and when the crises occurred, needed to contribute constructively to their containment and orderly resolution.⁵³

In a Letter of Intent of May 2, 1998, the South Korean authorities updated the programme of economic reform in view of the weak outlook for economic activity, with the growth forecast for 1998 revised down to -2.0 per cent. The new measures included:

- a) The accommodation of a larger fiscal deficit of about 2 per cent of GDP in 1998, and through the operation of measures to strengthen the social safety net.
- b) Measures to strengthen and expand the social safety net through a widening of the coverage of unemployment insurance.
- c) Formation of an appraisal committee, including international experts to evaluate the recapitalisation plans of undercapitalised commercial banks.
- d) The publication by August 15, 1998 of regulations to bring South Korea's prudential regulations closer to international best practices.
- e) Further liberalisation of the capital account, including loosening restrictions on foreign exchange transactions and foreign ownership of certain assets.⁵⁴

The IMF and the government of South Korea announced a further easing of macroeconomic policies, while giving further priority to financial sector restructuring. The measures in a new Letter of Intent on July 24, 1998, included:

⁵³ *Economic Report of the President 1999* (Government Printing Office Gate, University of California Website, <http://www.gpo.ucop.edu/catalog/erp99.html>).

⁵⁴ Letter of Intent of the South Korean Government to the IMF, May 2, 1998 (The IMF Website, <http://www.imf.org/external/np/loi/050298.HTM>).

- a) The accommodation of a larger fiscal deficit of about 5 per cent of GDP in 1998, reflecting among others an emergency relief spending related to the floods of the summer of 1998.
- b) Measures to bolster the social expenditure programme through another extension of the coverage of unemployment benefits.
- c) The putting in place of a framework for corporate restructuring negotiated with the World Bank to facilitate debt workouts and minimise the use of "rescue" loans.
- d) Further progress in financial sector restructuring including progress on the implementation plans of the remaining seven of the twelve undercapitalised banks.
- e) Further improving capital market development through legislation that allows for the creation of mutual funds and the issuance of asset-backed securities.⁵⁵

In the case of South Korea, it was important that economic and security issues were interlinked. Economic instability in South Korea could affect adversely a fragile peace that the United States had helped to keep in place since 1953 with 37,000 troops stationed in South Korea.⁵⁶ However, since the end of the Cold War, American foreign economic policy had been less concerned with traditional security issues and more concerned with setting a market framework through the IMF, World Bank and WTO to provide opportunities for American

⁵⁵ Letter of Intent of the South Korean Government to the IMF, July 24, 1998 (The IMF Website, <http://www.imf.org/external/np/loi/072498.HTM>).

⁵⁶ In addition, the United States has 40,000 troops in Japan and another 30,000 at sea, which makes a total of more than 100,000 troops in Asia-Pacific.

corporations. In that sense, the effect of delivering a package of \$57 billion was regarded by American policymakers as being similar to the military strategy of overwhelming force – the doctrine that the greater the power committed, the less the likelihood of significant casualties or policy failures.⁵⁷ Furthermore, in the contemporary context, the actions of American companies could be considered more crucial than those of the US Treasury-led IMF package. The investment decisions of Citicorp or Merrill Lynch, for instance, could be more important than assistance decisions of the US Government. American firms would be unlikely to support Washington's bargaining position with other states unless it was in their commercial interests or these interests were not compromised.⁵⁸

The financial crisis also had an impact on the domestic politics and relationships between dominant groups and political parties. After the IMF agreement in December 1997, the presidential elections were held in South Korea. Kim Dae Jung, a long-time dissident and opposition leader, was elected President. A coalition government was formed between Kim Dae Jung's National Congress, heavily supported in the relatively less developed southwest and Kim Jong Pil's Liberal

⁵⁷ Opening Statement of James Leach, Chairman, House Committee on Banking and Financial Services, January 30, 1998 (The USIA Website, <http://www.usia.gov/regional/ea/asianfin/leach130.htm>).

⁵⁸ Helen Nesadurai, "APEC: A Tool for US Regional Domination?", *The Pacific Review*, vol. 9, no. 1, 1996, p. 40.

Democrats, based heavily in the centre of the country. The opposition Grand National Party was based heavily in the more industrialised southeast. IMF conditionalities were not easily accepted and applied by the domestic elites. This was reflected by the fact that Kim Dae Jung campaigned on platform of renegotiating the IMF programme. However, after he came to office in February 1998, Kim Dae Jung complied with the IMF prescriptions.⁵⁹ Furthermore, the new President ascribed the financial crisis to the non-transparent decision making process which was the legacy of military dictatorship in the past. As President Kim Dae Jung stated:

‘Today’s economic crisis began with our failure to correctly push democracy and a free market economic in parallel. That was why collusion between politicians and businessmen, government-controlled banking and corruption and irregularities began to bud. First and foremost we must quickly and effectively carry out reform in four major areas – banking, corporate management, labour and the public sector. I believe that to improve the standard of living and reduce unemployment we must reform the basics of our economy. Therefore, we will concentrate all our efforts on the four biggest reforms to readjust the economic structure’⁶⁰

President Kim’s stance reflected a change of attitude in a country where the economic structure was the product of four decades of state-sponsored development. Government planners interested in controlling economic activity for many years had favoured the domination of large

⁵⁹ Uk Heo, “The Political Economy of Financial Crisis in South Korea: From Economic Miracle to Financial Crisis”, *The Journal of East Asian Affairs*, Vol. XIV, 2000, pp. 51-52.

⁶⁰ South Korean President Kim Dae Jung in an Opening Statement at a Press Conference on the Economy, Seoul, September 28, 1998.

conglomerates. The new South Korean government began restructuring and recapitalising the banking system to address the problem of bad loans and weak capital base. The South Korean government in accordance with the IMF conditionalities strengthened the independence of the Bank of Korea and consolidated all financial sector supervision in a single Financial Supervisory Commission (FSC) separate from the government. Foreign investors also contributed to the recapitalisation of South Korea's banking system. In June 1998, Germany's Commerzbank invested \$249 million in Korea Exchange Bank, acquiring a stake of 30 per cent. In December 1998 an American consortium purchased a 51 per cent stake in the previously nationalised Korea First Bank. In February 1999, HSBC Holdings agreed to purchase a 70 per cent stake in Seoul Bank.⁶¹

Furthermore, under President Kim Dae Jung, the new Foreign Investment Promotion Act, which became effective in 1998 eased barriers to foreign direct investment across a range of sectors. In addition, the United States and South Korea signed a Memorandum of Understanding (MOU) in October 1998, in which South Korea agreed to take measures to further open its automobile market and improve market access for American automobiles.⁶² However, the reforms along

⁶¹ Tomas Jose Balino, *The Korean Financial Crisis of 1997: A Strategy of Financial Sector Reform*, Working Paper 99/28, IMF Publications, March 1, 1999, pp. 32-35.

⁶² Republic of Korea Report on Economic Policy and Trade Practices, US Department of State, March 2000, pp. 4-5.

the lines of the Washington Consensus were not easily accepted in a country whose model for economic development relied on the government choosing the winners. That was the reason behind the willingness of Kim Dae Jung's Administration, after American pressures, to use the media to increase public understanding and acceptance of open markets and free trade, through opinion pieces in newspapers and advertisements. According to Ambassador Richard Fischer, Deputy US Trade Representative this action stemmed at least in part from the provisions in the 1998 MOU on motor vehicle trade on improving consumer perception of imports.⁶³

With regard to the chaebol reform, however, although the South Korean government pressed the chaebol to reduce their unsustainable debt/equity ratios, to improve corporate governance and to restructure their operations, the chaebol only partially implemented government-mandated changes in these areas. This was demonstrated by the World Bank Quarterly Report, on Korea (September 2000) which was critical of the progress of chaebol reform. According to this report many chaebols remained over-leveraged and their profitability and cash flow remained low. For instance, the World Bank report was especially critical of the Daewoo case where it stated that "the restructuring of Daewoo electronics and Daewoo Heavy Industries have been delayed by

⁶³ "The United States and Korea. Charting a Course for a Renewed Pacific Age", Ambassador Richard Fischer, Deputy US Trade Representative addressing the US-Korea 21st Century Council, October 19, 1999.

opposition of minority shareholders to planned debt for equity swaps which would dilute their ownership interests". The report, more generally, however concluded that "good progress has been made in enhancing corporate governance and in improving corporate accounting standards".⁶⁴ Before the end of the Stand-By Agreement (December 2000) with a new Letter of Intent to the IMF, in July 2000, the South Korean government, reflecting the change of attitude in domestic elites and policymakers, reaffirmed its commitment to maintaining the current economic expansion with macroeconomic stability and deepening structural reforms in both the financial and corporate sector.⁶⁵ On December 16, 2000, the Fair Trade Commission (FTC) announced its decision to fine the top four chaebol (Hyundai, Samsung, LG and SK) 44.2 billion won for having conducted unfair intra-group deals worth 2.46 trillion won. The FTC had found eight hidden affiliates held by the top four chaebol attesting that their resolution to reduce their scope of operations had been an illusory facade. This has demonstrated, on the one hand, the change of government policy toward the chaebol and, on the other hand, the difficulties in applying the new approach due to the use by the chaebol of increasingly sophisticated means to continue their practices of purchasing worthless

⁶⁴ See World Bank Quarterly Report on Korea, September 18, 2000, p. 9.

⁶⁵ Letter of Intent of South Korean Government to the IMF, July 12, 2000 (IMF Website, <http://www.imf.org>).

bonds at face value and illicit transfer of personnel to engage in intra-group deals.⁶⁶

The Asian crisis also showed that the dramatic increase in global capital flows had weakened the IMF's ability to respond with the same effect to future crises. That was the reason that President Clinton asked Congress to approve: a) an increase in the quota subscription of the United States and b) a contribution to an augmented emergency facility, the New Arrangements to Borrow (NAB), to supplement the IMF resources to deal with these kinds of crises. Deputy Treasury Secretary Lawrence Summers urged the Congress to support the IMF because:

'It is [the IMF], quite simply, the cheapest, most effective way for us to promote those core American interests...It promotes changes that are in our long-term interest such as making these economies more open to foreign trade and reducing domestic subsidies. And it provides us maximum leverage: each dollar we contribute levers more than five from the rest of the world. Even with these new funds the IMF's resources would still represent well under 1 per cent of global GDP - little more than half what they were 20 years ago.'⁶⁷

For American policymakers, as an agent of market-oriented reform, the IMF is a far more effective instrument than any one government. Because it has an international mandate and financial leverage, it can

⁶⁶ In total, South Korea's conglomerates- including the dismantled Daewoo Group - have been subject to 215 billion won in fines since 1998 for engaging in unlawful intra-group deals. See "Seoul Slaps W44.2 bn in fines on Top 4 Chaebol". *The Korea Herald*, December 16, 2000.

⁶⁷ Statement by Deputy Secretary Lawrence Summers, before the Senate Committee on Finance, February 4, 1998 (<http://www.ustreas.gov/press/releases/pr2195.htm>).

require a country to accept reform conditions that no single government has the capacity to require on its own.⁶⁸

On November 17, 1998, the US Congress had approved a bill by which the United States provided \$18 billion in new funding to the IMF. Of this amount \$14.5 billion represented the American share of a quota increase applying to all IMF members. The remaining \$3.5 billion was the contribution of the United States to a new backup source of financing, the New Arrangements to Borrow.⁶⁹ The bill that had been approved by the House Committee on Banking and Financial Services aimed to increase the effectiveness of the IMF in promoting market-oriented reform and trade liberalisation along the lines of the Washington Consensus. Equally important was the fact that the IMF funding bill required the US Treasury to coordinate with other executive branch departments including Commerce, Labour, State, USTR, USAID and EPA (Environmental Protection Agency) in pursuit of American goals. Also included in the bill was a proposal requiring an annual report and testimony before Congress by the Secretary of the Treasury with regard to financial stabilisation programmes.⁷⁰ However,

⁶⁸ See Memorandum sent by Rep. James A. Leach, Chairman of the House Banking and Financial Services Committee to the Majority Leader Dick Armey, April 20, 1998.

⁶⁹ The NAB was activated shortly after it entered into effect on November 17, 1998, to help finance the IMF arrangement for Brazil, which was agreed on November 13, 1998.

⁷⁰ "Banking Committee Approves IMF Reform, Funding Bill", The Committee on Banking and Financial Services, US House of Representatives, 105th Congress, Press Release, March 5, 1998 (The US House of Representatives Website, <http://www.house.gov/banking/3598pr.htm>).

even with the quota increase, the share of the IMF's resources had declined, when measured against total international capital flows. For example the daily turnover on the world's foreign exchange markets amounts to some \$1.5 trillion, a figure that dwarfs the entire GNP of Indonesia which in 1997 was about \$136 billion.⁷¹ In a testimony at the House of Representatives Greenspan suggested that although "the IMF can play an essential stabilising role, the availability of such support must be limited because its size cannot be expected to expand at the pace of the international financial system."⁷²

As a result of the American and IMF response to the South Korean crisis, the already existing elements of the Washington Consensus regarding fiscal discipline, public expenditure, financial liberalisation, exchange rates, trade liberalisation, foreign direct investment and property rights were further entrenched. In addition, the two elements that were not in place before the crisis - privatisation and deregulation, were introduced as a result of the conditionalities attached to the US Treasury-led IMF package. The case study of South Korea confirms the theoretical framework of this thesis and the

⁷¹ Mark Beeson, "Indonesia, the East Asian Crisis and the Commodification of the Nation-state", *New Political Economy*, vol. 3, no.3, 1998, p. 359.

⁷² Testimony by Alan Greenspan, Chairman of the Federal Reserve before the Committee on Banking and Financial Services, US House of Representatives, January 30, 1998 (The Board of Governors of the Federal Reserve Website, <http://www.bog.frb.fed.us/boarddocs/testimony/19980130.html>).

hypothesis that the entrenchment of the Washington Consensus during the 1990s was based on the following variables: globalisation of finance, mobility of capital, the role of international institutions, ideas mediated through domestic elites and the limited instability of the system as demonstrated by the financial crisis of 1997-98.

However, as will be suggested in the conclusion, the five variables of the conceptual framework did not have the same leverage in Mexico and South Korea. For instance the domestic elites in Mexico were more open and bought more easily into the Washington Consensus and the reforms attached to the American-led IMF assistance packages. The Washington Consensus was not entrenched to the same degree in Mexico and South Korea, while the role of the IMF was more direct in South Korea than in Mexico where the American Administration took a more active stance. The policy of the United States toward South Korea was not a result of a split between the Congress and the executive branch as was the case in the peso crisis. Within the executive branch, the State Department was rather sidelined regarding American decisions toward South Korea. Furthermore, the US Treasury was again - as in the peso crisis, very influential in shaping the overall policy not only of the United States but also of the IMF. The result of these policies was the realignment of South Korean capitalism towards Washington Consensus and the further entrenchment of

American influence not only in South Korea but also in the rest of East Asia.

CHAPTER EIGHT

THE CHANGING BASIS OF AMERICAN HEGEMONY: ANALYSIS AND CONCLUSIONS

This chapter provides a comparative analysis of the peso and South Korean crises in the context of the framework that was introduced in Chapter Two. The framework which consists of five variables (mobility of capital, globalisation of finance, international institutions, ideas and limited instability of the system) offers a fresh perspective on the issue of American hegemony during the 1990s by focusing on the American response to the two major financial crises of that decade. This thesis argues that the five variables of the conceptual framework define and explain American hegemony through the entrenchment of the Washington Consensus. This is the first time that such a framework has been tested through the peso and South Korean

crises in order to explain the changing nature of American hegemony and the entrenchment of the Washington Consensus.

This thesis has attempted to fill a gap in the literature regarding the changing basis of American hegemony during the 1990s by highlighting the weaknesses but also the useful points from existing theories and moving one step forward by taking into account the special circumstances and conditions of the 1990s and especially the financial crises of Mexico and South Korea. According to hegemonic stability theory, the decline of the hegemon tends to be associated with economic closure and instability. From this neorealist perspective, the power of the United States was an essential element in the postwar reconstruction of international capitalism but, since the United States can no longer exercise its hegemony so effectively, the world economy is likely to become unstable. The assumption of American decline became very popular in the 1980s and was given a further boost during the 1990s, especially after the end of the Cold War. The global economy today is more complex, plural and diversified than in the 1950s and the 1960s and under these conditions the global power structure has become much more fragmented and the probabilities of establishing an international hegemonic order have been diminished. However, by taking advantage of financial crises and episodes such as those in Mexico and South Korea, the United States directly or indirectly (through international institutions) promoted a specific model of

economic restructuring in those economies hit by the crisis, making them compatible with and open to its wider financial interests. This is where the role of international institutions has been important. As the earlier analysis of the peso and Asian crises has shown, international institutions such as the IMF and the World Bank largely reflected the interests of the United States.

Indeed, during the two major financial crises of the 1990s, the United States had the opportunity to advance its principles about the workings of the global economy. Both crises were used in order to persuade the countries involved to take actions towards reforming their financial system and deregulating their economies. The United States acted to stabilise Mexico and South Korea and to advance the economic reforms that in the long run will make the Latin American and Asian economies more market-driven, decentralised and open. The American response to the crises was largely an attempt to transform the political economy of Latin America and East Asia by calling for further market liberalisation. In the aftermath of both the peso and South Korean crises, the United States has emerged with much greater power and influence in East Asia than it had before. The Asian crisis along with the peso crisis has strengthened free-market capitalism and confirmed the continuing influence of the United States in the world economy.

Hegemonic stability theory with its emphasis on the material basis of power is inadequate to explain the present nature of American

influence, although it is always a useful starting point in understanding some basic concepts of power. Hegemonic stability theory in all its variations has defined hegemony as a preponderance of material resources. However it has failed to grasp some vital ideological aspects of power. Indeed, today it is difficult to sustain any argument about the decline of American hegemony simply on the basis of trends in the possession or control of basic resources. Outside the realist school, scholars have assigned greater importance to the ideological element of hegemonic power. Scholars such as Calleo, Russett and Strange have emphasised the extraordinary degree of American power and the contributions of the United States to global economic instability. The key concept in that perspective is structural power, which has been manifested in four separate but interrelated structures, namely the security structure, the production structure, the financial structure and the knowledge structure. As Susan Strange has explained, the United States maintains a combined structural power, which gives it predominance in the world economy.

A radical school of political economy, the structuralist or neo-Marxist, also has attempted to deal with the issue of hegemony. For example, Wallerstein has defined hegemony as a rare situation in which there is simultaneously advantage in industrial production, commerce and finance. This view of hegemony has been problematic in explaining the contemporary world order and, in the light of the case studies of the

peso crisis and the Asian crisis, the neo-Marxist explanation of the link between military and economic hegemony appears vague and inaccurate. Within the Gramscian framework, scholars such as Cox, Arrighi, Gill, Augelli and Murphy have assigned greater importance to the role of ideology in exercising hegemony. For the neo-Gramscian school, hegemony has been sustained by universal norms, institutions and mechanisms, which lay down general rules of behaviour for states. This conception of power has stressed the interrelationship between ideological and material sources of power. Neo-Gramscian approaches have differed from the hegemonic stability theory and other neorealist approaches in making possible a broader definition of international power relations. A state might be extremely powerful, in the sense that it can impose its will and preferences on other nations, but not necessarily hegemonic. While the neorealist approach has tended to maintain a sharp distinction between domestic and international levels of analysis, the neo-Gramscian analysis has developed a more systematic account of the linkage between domestic and international politics. Thus, the neo-Gramscian perspective has appeared to be more comprehensive because it has suggested the need to pay closer attention to the relationship between the American political economy and the global political economy.

However, the response of the United States to the peso crisis and the Asian crisis demonstrated that all previous theoretical approaches

to hegemony (from Hegemonic Stability Theory, neoliberal institutionalist and structuralist frameworks to neo-Gramscian explanations) have their limitations in fully assessing and explaining the degree of influence and power that United States has exercised in the world economy during the 1990s. The framework that was introduced in Chapter Two argued that the new basis of American hegemony is to be found in the entrenchment of the Washington Consensus which depends on a specific set of five interdependent variables: a) mobility of capital, b) globalisation of finance, c) international institutions, d) ideas accepted by the domestic elites and e) limited instability of the system as demonstrated by financial crises during the 1990s, not only in Mexico and South Korea but also in other countries such as Russia and Brazil. This framework has been tested through the two major financial crises of the 1990s in order to demonstrate the entrenchment of the Washington Consensus in Mexico and South Korea.

Each of these five variables had a different role and varying degrees of influence in the cases of Mexico and South Korea. The mobility of capital and the globalisation of finance have played a significant role in opening and liberalising the economies of Mexico and South Korea. This process started in Mexico after the debt crisis of 1982 and continued with rapid reforms through the 1980s and the 1990s, leading to NAFTA in 1994. In South Korea there was a more gradual

progress toward financial liberalisation during the 1980s, which has accelerated during the 1990s following pressure from the United States. As a result the Washington Consensus was more deeply rooted in Mexico than in South Korea before their respective financial crises. International institutions such as the IMF and the World Bank began to play a significant role after the debt crisis of 1982 in Mexico. That was the turning point at which the IMF and the World Bank began to take a more active stance, with the support of the United States' Administration and especially the US Treasury, in order to persuade other countries to undertake structural reforms in accordance with what became known as the Washington Consensus.

The rise of Reaganomics and neoliberalism in the United States was matched by the changing intellectual attitudes of the international financial institutions and also domestic elites in periphery countries. The ideological triumph of neoliberalism in the United States was mirrored by policy changes in developing countries either through embracing the Washington Consensus with some enthusiasm (as in Mexico and other Latin American countries) or through a contested, gradual acceptance (as in South Korea and other East Asian countries). In Mexico the IMF was more involved in structural adjustment programmes largely due to the debt crisis of 1982. On the other hand, in South Korea prior to the financial crisis of 1997-98 there was not as much involvement from the IMF or the World Bank. In Mexico during

the 1980s and early 1990s, domestic elites accepted the Washington Consensus and the free market ideas. The structural adjustment that took place in Mexico was promoted with consistency by successive Mexican Administrations reflecting a wider acceptance of the free market model. In South Korea domestic elites were not as open as in Mexico to the Washington Consensus since the South Korean developmental state model produced high rates of growth and there was a very close relationship between the government and the chaebol. In sum, before the financial crises of the 1990s, the Washington Consensus was more widely applied in Mexico than in South Korea on the basis of the four (out of five) variables of the framework.

The fifth variable of the framework, the limited instability of the system as a result of the increased mobility of capital and the globalisation of finance, was introduced in 1994 in Mexico with the peso crisis and in 1997 in South Korea with the Asian financial crisis. This thesis has demonstrated through the case studies that the result of these financial crises was not the weakening of the Washington Consensus but, on the contrary, was the strengthening of the free market orthodoxy through the American-led IMF assistance packages and the conditionalities attached to them. The IMF was more involved in South Korea than in Mexico, after their respective crises. In the case of Mexico there was more direct American involvement while in the case of South Korea the IMF took the initiative. However in both cases the aim was

the same: the entrenchment of the Washington Consensus of free market orthodoxy. Furthermore, both financial crises had an impact on domestic politics, favouring a more open democratic system, and political change as demonstrated by the results of elections that installed opposition parties in power in both countries (South Korea in 1998, Mexico in 2000).

Since the late 1980s and with the formation of NAFTA in 1994 and the eruption of the peso crisis in 1995, the United States has managed to create a broad consensus across Latin America on the fundamental benefits of open markets and free trade. Mexico's and Latin America's commitment to the market model was tested in the financial crisis which followed the Mexican devaluation of the peso in December 1994. The Mexican economy recovered quickly and has been growing ever since. That crisis has reinforced the commitment of the region to market-based reforms.¹ Indeed the Latin American countries, particularly after the peso crisis of 1994-95, consolidated the outward-oriented model of economic development by replacing the import-substitution model of the past.

As the peso crisis strengthened the Washington Consensus in the Western Hemisphere, the crisis in Asia raised important questions

¹ Peter Romero, Acting Assistant Secretary for Inter-American Affairs, "Western Hemisphere Relations in the 21st Century: The US Perspective", Remarks at the *Miami Herald* Conference on the Americas, Florida, September 18, 1998 (<http://www.state.gov>).

about the viability of the East Asian model of capitalism. The Asian crisis seriously undermined the region's credentials as the site of an economic miracle and has had a significant impact on the post-cold war global political economy. Between the 1970s and the mid-1990s, the debate about the causes of and the lessons which could be extracted from the successful industrialisation of a number of economies in East Asia occupied a key position in the wider international development debate.² The Asian financial crisis damaged the credibility of a supposedly distinctive model of economic growth based on cooperation between conglomerates (keiretsu in Japan, chaebol in South Korea, konglomerat in Indonesia) and government. For American policy-makers and analysts, collapsing Asian markets in the end of 1997 revealed the crony capitalism beneath the surface of East Asia's developmental state.³ As argued in chapters Five and Six, for the United States, the recent economic turmoil in Asia had home-grown causes, particularly corrupt national banking systems that promoted misallocation of resources away from their most efficient uses. The IMF concurred with the American diagnosis and made further financial liberalisation a condition of its loans to Indonesia, South Korea and Thailand.

² Mark Berger and Mark Beeson, "Lineages of Liberalism and Miracles of Modernisation", *Third World Quarterly*, vol.19, no.3, 1998, p. 501.

³ See Paul Krugman *The Return of Depression Economic* (Penguin Press, London 1999).

Unlike the Latin American debt crisis of 1982 and the Mexican crisis of 1995, the crisis in Asia involved corporate instead of national debt - a situation that required a more complex policy process to resolve it.⁴ Another difference was that the East Asian economies possessed a lot more domestic debt than Mexico, which made their banking sector problems more serious. Furthermore, Mexico was fortunate with the timing of its peso crisis because in 1994-95, the newly established NAFTA gave it freer access to the American market. After the peso devaluation, Mexico's exports increased by 40 per cent in dollar terms and more than 90 per cent of the increase went to the United States. On the other hand, two-thirds of the East Asian Tigers' exports have gone to other Asian economies, so any post-crisis growth was likely to be more muted than post-crisis Mexico.⁵ In addition, Japan's role in the Asian crisis has contrasted sharply with the American role in the Mexican crisis of 1994-95. Whereas a strongly expanding American economy helped Mexico avoid a worse outcome, the weakness of Japan's economy and financial institutions added to Asia's problems. The contrasting experience in Mexico and East Asia at least at the initial phase of their respective crises, can be explained in terms of different strategic importance. As Chandrasekhar and Ghosh have pointed out, "there was even a sense of a glee in Washington at

⁴ Callum Henderson, *Asia Falling: Making Sense of the Asian Crisis and its Aftermath* (McGraw Hill, New York 1998), p. 283

⁵ "Back from the Brink", East Asian Economies Survey, *The Economist*, March 7, 1998.

the humiliation of the former Tigers and the undoing of their claims to an alternative Asian model of capitalist development⁶ as long as analysts in the United States, were confident that the contagion would not spread to their own stock markets.”⁷ This is of extra significance since the Asian-style capitalism was the most serious rival to classic free-market capitalism as a model for other countries to follow. From this perspective, at the core of the recent economic crisis in East Asia was an incompatibility between the developmental statist and the American model of capitalist economic development.⁸

It is in American interests to have the rest of the world play by American rules for both international finance and transnational corporations, rules that are encapsulated by the Washington Consensus. This goal is especially important in Asia because the Asian system of long-term market relationships and patient capital has put American firms at a significant disadvantage. The peso crisis and the Asian crisis confirmed that financial liberalisation and capital opening have made it more difficult to sustain the long-term relationships and national industrial policy arrangements that have prevailed in the past

⁶ As was mentioned in chapter five, to say that there is an Asian model of capitalism applicable to every single economy of the region is a dangerous oversimplification. Nevertheless, the Japanese and South Korean models of economic development have acted as a pattern for the way in which the other economies of East Asia have developed after World War II.

⁷ C.P. Chandrasekhar and Jayati Ghosh, “Hubris, Hysteria, Hope: The Political Economy of the Crisis and Response in Southeast Asia”, in Jomo K.S., ed. *Tigers in Trouble* (Zed Books, London 1998) p. 74.

⁸ Richard Higgott, “The Asian Economic Crisis and the Politics of Resentment”, *New Political Economy*, vol.3, no.3, 1998, p. 336.

in the Latin American and especially in the Asian political economy.⁹ During the Cold War, the American willingness to supply capital and open its markets for an initial one-way flow of exports was due to security considerations and especially the containment of communism. However, in the environment of the post-cold war years there was an increasing American concern that its partners in East Asia were continuing to “free ride”. Thus, trade liberalisation and financial deregulation in the region are now considered as the pay-off for a continued American security presence. Those political and economic practices of the Asian model that were acceptable for security reasons during the Cold War are now clashing with the interests of private capital in its search for greater market share and profitability in an era of deregulation.¹⁰ The best opportunity for that to be demonstrated was offered by the Asian crisis. Although for a short period of time after the crisis erupted in East Asia there was a hardening nationalist resistance to neoliberalism (in Indonesia, for instance), by early 1999 the American model of market liberalisation seemed to be gaining ground at the expense of the Asian model of development.

⁹ Interview conducted by the author of this thesis with Catherine Mann, Senior Economist at the Institute for International Economics, Washington DC, September 14, 1998. For example, the US Treasury has been leading a campaign to get the main international economic and financial institutions to promote capital liberalisation. One such effort is the revision of the IMF's constitution to require countries to commit themselves to capital account liberalisation as a condition of fund membership. See also Robert Wade, “The Coming Fight Over Capital Flows”, p. 47.

¹⁰ Richard Higgott, “The Asian Economic Crisis and the Politics of Resentment”, pp. 338-339

After the peso crisis, but especially following the Asian financial crisis and the initial IMF response, some observers such as Robin Broad, John Cavanagh and Michael Mastanduno announced the end of the Washington Consensus and economists such as Joseph Stiglitz, who at the time was Senior Vice President at the World Bank, criticised the IMF for its approach to the Asian crisis and called for some degree of regulation in capital flows.¹¹ However the case studies of this thesis have demonstrated that the result of both financial crises was the entrenchment rather than the “death” of the Washington Consensus. There was only an extension or a slight adjustment of the Washington Consensus in order to include the political dimension of democracy and transparency, which made it more acceptable. This change is evident from the World Bank Development Reports of the 1980s which were about structural adjustment in developing countries to the World Development Reports at the end of the 1990s which were accompanied by the phrase “attacking poverty”.

However, the IMF and the Word Bank have never actually questioned the need for market-oriented reforms; they simply

¹¹ For the “death” of the Washington Consensus see Robin Broad and John Cavanagh, “The Death of the Washington Consensus?”, *World Policy Journal*, vol. XVI, no.3, 1999, pp. 79-88; Michael Mastanduno, “Models, Markets and Power: Political Economy and the Asia Pacific, 1989-1999”, *Review of International Studies*, vol. 26, no. 4, 2000, pp. 493-507. For a critique of the IMF conditionalities see Joseph Stiglitz, Senior Vice President at the World Bank, “The Role of International Financial Institutions in the Current Global Economy”, Address to the Chicago Council on Foreign Relations.

recognised that “reforms to build markets can be designed and implemented in a way that is measured and tailored to the economic social and political circumstances of a country”.¹² When the key issue has been more transparency or how to fight corruption, the IMF has insisted that this can only be done through new market-oriented structures.¹³ Furthermore, the G7 has confirmed that the IMF should continue to play a central role in advancing macroeconomic and financial stability as an important precondition for sustainable global growth.¹⁴ Thus the essence of the Washington Consensus remains intact and is not being altered by the addition of elements such as democracy or greater transparency. Even after the end of the Stand-By Agreements of the IMF with Mexico and South Korea, both governments renewed their commitment to financial and other structural reforms along the lines of the Washington Consensus with new Letters of Intent to the IMF (Mexico, June 15, 1999 and South Korea, July 12, 2000)¹⁵. These Letters of Intent also reflected a wider acceptance by the domestic elites and ruling classes of ideas and policies related to the Washington Consensus by the end of the 1990s than ten years before.

¹² World Bank, “World Development Report 2000/2001: Attacking Poverty”, p. 62.

¹³ See Horst Kohler, IMF Managing Director, Remarks at the Conference “Completing Transition: The Main Challenges”, Vienna, Austria, November 6, 2000, *IMF Survey*, vol. 29, no. 22, 2000, pp. 370-371.

¹⁴ G7 Statement on the World Economy, Okinawa Japan, July 21, 2000 (US State Department Web Site, <http://www.state.gov>).

¹⁵ See Appendix, pp. 277 & 290.

Another important issue has been the conduct of American foreign economic policy. In both case studies, the Washington Consensus created tensions within the institutions that shape American foreign economic policy. In the case of the peso crisis, there was a clear split between the President and the Executive Branch on the one hand and the Congress on the other. In the end, the Executive Branch took the initiative with the US Treasury playing a leading role and the State Department sidelined. In the case of the South Korean crisis, there was not a split between the Congress and the Executive Branch. However, within the Executive Branch, the US Treasury again played an important role in shaping the IMF assistance package, while the State Department was once more in a secondary role. Thus, the Washington Consensus was entrenched in both cases despite different perspectives and relationships between the institutions shaping foreign policy but with a leading role played by the US Treasury in both cases.

The five variables of the framework (mobility of capital, globalisation of finance, international institutions, ideas accepted by domestic elites and the limited instability of the system) were inherent in both cases of the peso and Asian crises and have formed the basis of the influential role that the United States along with the IMF have played in aligning troubled economies toward the Washington Consensus.

This thesis has also recognised that there are different levels of American influence in different regions of the world. As Chapters Five and Seven have demonstrated, the United States has maintained a greater degree of influence in Mexico and the rest of Latin America than in East Asia. However there is a common denominator in both cases, which is directly related to the five variables of the framework. In both cases, the pursuit of foreign economic policy goals for the United States was facilitated, and as a result, the Washington Consensus of market economy and financial liberalisation is more widely applied today than a decade ago. The framework for understanding the changing basis of American hegemony developed in this thesis, leads one to conclude that the United States is still a hegemonic power which has redefined its capacity to project a specific set of political and economic principles about effective governance and order in the world economy.

APPENDIX

Selected Documents

Press Release No. 95/10

February 1, 1995

International Monetary Fund

700 19th Street, NW

Washington, D.C. 20431 USA

IMF Approves US\$17.8 Billion Stand-By Credit for Mexico

The International Monetary Fund has approved an 18-month stand-by credit for Mexico of up to the equivalent of SDR 12,070.2 million (about US\$17.8 billion) in support of the Government's 1995-96 economic and financial program. Of the total, SDR 5.259 million (about US\$7.8 billion) or 300 percent of Mexico's IMF quota --is available immediately. As previously announced, the remaining SDR 6,810.3 million (about US\$10 billion) will be provided by the IMF to the extent that contributions of governments and central banks fall short of the targeted amount of US\$10 billion. This is 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, 688.4 percent. The exceptional action was taken with a view to providing an adequate international response to Mexico's financial crisis and giving confidence to the international financial system. The IMF credit is intended to complement other external financing for Mexico announced in recent days..

Background

Mexico has achieved a remarkable economic transformation since the late 1980s on the basis of prudent macroeconomic policies and far-reaching structural reforms. The Government's program resulted in a sharp reduction in fiscal imbalances, a reduction in the role of the state in the economy, a lowering of inflation to close to international levels, and Mexico's greater integration into the global economy. The exchange rate strategy, which limited the movement of the currency within a band that was depreciated by a predetermined amount, played a key role in reducing inflation and ensuring labor's support for the Government's economic program. At the same time, there was a substantial real appreciation of the new peso and a sharp increase in the external current account deficit. Domestic investment increased over this period, while private savings declined substantially.

During 1994, investors' concerns about the sustainability of the current account deficit began to increase, against the background of dramatic adverse political events in Mexico, intense competition for foreign saving in other emerging markets, and generally higher interest rates abroad. To stem capital outflows, the Mexican authorities raised interest rates, allowed the currency to move to the more depreciated limits of 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 between February and April, after which the level of reserves stabilized until October.

A resurgence of investors' fears put further pressures on foreign exchange and financial markets and precipitated the present financial crisis and led to the floating of the peso in late December 1994. Events in Mexico contributed to serious pressures

in financial and exchange markets in a number of other Latin American countries, as well as increased volatility in markets in other parts of the world.

The 1995-96 Program

The program formulated by the Mexican authorities, and supported by the stand-by credit, must be seen against the background of Mexico's favorable economic fundamentals and its past record of macroeconomic and structural reforms. The program involves a two-pronged approach aimed at consolidating the progress made in the past several years and addressing the current liquidity problem of dealing with substantial short-term obligations falling due. 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 is expected to ease investors' immediate concerns about the situation in Mexico, and reverse the overshooting of the depreciation of the currency that has occurred.

The program's specific objectives for 1995 are: (i) the reduction in the external current account deficit from 8 percent of GDP in 1994 to 4 percent of GDP in 1995, and to 3-3 1/2 percent of GDP in 1996; and (ii) a lowering of the annualized rate of inflation to around 9 percent in the fourth quarter of 1995, from more than 30 percent in the first quarter of the year. Economic activity is expected to decline in the first half of the year, as the effects of the change in relative prices and the financial adjustment work through the economy. However, it is expected to recover in the second half of the year as financial conditions stabilize. Real GDP should grow by around 1.5 percent for 1995 as a whole.

To achieve these goals, the program is centered on a policy of wage, price, and credit restraint supported by an improvement in the fiscal position. The revised 1995 budget for the nonfinancial public sector provides for a fiscal surplus of 0.5 percent of GDP (compared with a balanced position in 1994), and a primary surplus (the overall balance excluding interest obligations) of 3.4 percent for the year as a whole, compared with a primary surplus of 2.6 percent of GDP in 1994. The contribution of the public sector to the adjustment process is to be particularly large in the first half of 1995. Moreover, the authorities stand ready to strengthen the public finances through additional measures if necessary.

The fiscal tightening should help to achieve an early stabilization of financial and exchange markets, and the measures can be expected to boost savings and result in a substantial reduction in imports. In addition, an acceleration in export growth should result from the real depreciation of the currency.

The policy on wages and prices that has been formulated within the context of the Agreement of Unity to Overcome the Economic Emergency signed between the Government, the Bank of Mexico, and the labor and business sectors, will set the path for the evolution of wages and public sector price rises during 1995. This agreement implies a significant reduction in real wages on average and represents a major contribution on the part of labor to set the basis for a resumption of growth. Wage policy under the agreement provides for an increase of 7 percent in minimum and

public sector wages, and an additional 3 percent through an income tax credit for workers with incomes of up to twice the minimum wage. Contractual wage negotiations will adhere to these guidelines and, in addition, will include productivity bonuses freely negotiated between labor and business. The pact also limits the increase in public sector tariffs during 1995 to about 10 percent, or about two thirds of the expected average rate of inflation. The price strategy will result in a revenue loss for the public sector (of about 0.6 percent of GDP) that will be compensated by other fiscal measures. The authorities recognize the need to address price distortions that may result from these measures in due course.

Credit policy will play a critical role in achieving the objectives of the program. The monetary program establishes a limit on the growth of net domestic assets of the Bank of Mexico of MexN \$10 billion in 1995, compared with MexN \$60 billion in 1994. Under this limit, credit expansion by the Bank of Mexico would be 17 percent of the monetary base at the end of 1994, a rate which is less than that of projected nominal GDP and is consistent with the inflation target of 19 percent for 1995 as a whole. The Bank of Mexico stands ready to tighten credit conditions further to counter unforeseen pressures in the exchange market.

The program provides for a reduction in the rate of credit expansion by the development banks of more than one half (to 2.1 percent of GDP) in 1995. However, the development banks and trust funds will continue to provide net financing to priority sectors, including exports and agriculture.

The substantial depreciation of the exchange rate that has taken place is expected to contribute to a significant improvement in the current account of the balance of payments. Merchandise exports are projected to grow by close to 25 percent in 1995 helped by the devaluation, the increase in investment in export industries in recent years, and the contraction in internal demand. In addition, the effect of the peso depreciation, the policy of credit restraint, and the expected fall in real incomes should lead to a decline in imports of 7 percent in U.S. dollar terms.

The Bank of Mexico will support the floating exchange rate regime through limited intervention in the foreign exchange market. The authorities envisage that the strength of their economic program, together with external financial support will help to stabilize financial markets and result in a significant correction of the recent overshooting of the exchange rate.

For 1996, the authorities have indicated they will follow policies to lower inflation to single digits and further reduce the external current account deficit to 3-3 1/2 percent of GDP. With the return of financial and exchange market stability, investment could be expected to recover which, together with continued export expansion, would contribute to a rebound in real GDP growth to around 4 percent.

While specific proposals for 1996 will not be developed until the 1996 budget is prepared in the second half of 1995, the authorities are committed to review tax policies to at least maintain the surplus position of the public sector and improve the equity of the tax system.

Structural Reform Policies

Over the past several years, Mexico has made substantial progress in the area of structural reform. The program consolidates and extends this progress in important ways. It provides a reinforcement of the Government's strategy for privatization and the granting of concessions to the private sector in areas previously reserved for the public sector. In the past, the privatization efforts had focused mainly on commercial enterprises (although some concessions have been granted for the operation of highways). Beginning in 1995 privatization also will involve basic infrastructure (rail, ports, airports, electricity generation, and radio and telecommunications). The implementation of the new strategy will require some constitutional changes as well as reforms in the regulatory environment which are already under way.

The authorities expect revenues from privatization and concession operations to be about US\$6 billion in 1995 and an additional US\$6-8 billion in 1996-97. The privatization proceeds will be used largely for the cancellation of the public external debt.

International Financial Support

In addition to the IMF's US\$17.8 billion stand-by credit, the United States is expected to provide US\$20 billion, the G10 central banks through the Bank for International Settlements (BIS) US\$10 billion, and the commercial banks US\$3 billion.

Addressing Social Costs

During the late 1980s and early 1990s there was a significant reduction in the number of families living in extreme poverty, reflecting the strong economic growth and increases in real wages in this period, complemented by a program of targeted social expenditures. The authorities recognize, however, that the peso crisis and the adjustment measures that it entails could complicate efforts to sustain the steady improvement in the well-being of the poorest sectors in the short term. A number of policy measures are being implemented to protect the poor from the adverse effects of the adjustment process. While overall lending by the development banks is being scaled back sharply, it will be focused more heavily on financing of agriculture through specialized agencies that lend to small farmers. To limit the real wage adjustment for the lowest wage earners, employers will be allowed to supplement wages of those earning up to twice the minimum wage and to claim a corresponding tax credit.

The Challenge Ahead

The Mexican authorities have embarked on a strong adjustment program to help deal with the current crisis in financial and foreign exchange markets. The domestic adjustment package, combining prudent fiscal and strong monetary and credit policies, a disciplined incomes policy, and further structural reforms, provides an appropriate policy response to current circumstances. Furthermore, the authorities stand ready to strengthen the program as needed to achieve the program's objectives. The support of the international financial community is crucial to the success of the program.

LETTER OF INTENT OF MEXICAN GOVERNMENT TO THE IMF

Mexico, D.F., Mexico

June 15, 1999

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The attached policy memorandum describes the economic policies and objectives of the Government of Mexico and the Bank of Mexico for the period 1999-2000, in support of which Mexico requests from the Fund an amount equivalent to SDR 3,103 million (120 percent of quota) in the form of a Stand-By Arrangement for the period through end-November 2000. The economic program aims at consolidating the substantial reform efforts initiated during the 1980s and the gains made during 1996-98 following the 1995 financial crisis to set the economy on a higher, sustainable growth path in conditions of low inflation that will expand employment opportunities and foster higher living standards. The economic program will maintain tight financial policies, while promoting structural reforms that are key to increasing national savings, enhancing macroeconomic stability, and reducing external vulnerability.
2. The economic program of the Government of Mexico has been a subject of continuous and close dialogue with the Fund. Mexico considers it important to have a program with the Fund in light of possible uncertainty concerning external developments and to bolster confidence during the period of change in Administration.
3. The Government and the Bank of Mexico believe that the policies set forth in this letter are adequate to achieve the objectives of the program. Nevertheless, we stand ready to take further policy measures if needed. During the period of the arrangement, Mexico will consult with the Fund on the adoption of policy measures that may be appropriate in accordance with existing practices. Over the arrangement period, reviews of the program will be carried out with the Fund before end-December 1999, end-March 2000, and end-June 2000.

Sincerely yours,

Jose Angel Gurria Trevillo	Guillermo Ortiz
Secretary of Finance and	Martinez
Public Credit of Mexico	Governor
	Bank of Mexico

LETTER OF INTENT OF SOUTH KOREAN GOVERNMENT TO THE IMF

Seoul, Korea
December 3, 1997

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The attached Memorandum on the Economic Program outlines the policies that Korea intends to implement over the next three years to address the fundamental causes of its current financial difficulties, thereby restoring and sustaining market confidence and returning the economy to a path of strong sustainable growth. In support of this program, Korea hereby requests a three-year stand-by arrangement from the International Monetary Fund in an amount equivalent to SDR 15.5 billion.
2. As the circumstances did not permit a full specification of the program, the government has implemented strong prior actions to demonstrate its seriousness to strictly implement its policy commitments. A full specification of the program will be put together with the assistance of an IMF team. The program will be reviewed by the Executive Board in December 1997 and January 1998. The latter review will expand the scope of performance criteria, set performance criteria for March and June 1998, and set structural benchmarks. The main focus of the four additional quarterly reviews (in February, April, July, and November) during the first year of the program will also be determined at that time. The review under the emergency procedures will be combined with the review under the arrangement in January 1998. There will be semi-annual reviews in 1999 and 2000.
3. We believe that the policies outlined in the attached Memorandum will serve to quickly restore market confidence. We are putting in place a comprehensive policy package to deal with insolvent and weakened financial institutions, to further liberalize the Korean economy, and to improve corporate governance. These reforms will be supported by prudent monetary and fiscal policies.
4. Accordingly, in the event the situation stabilizes, as we expect it will, Korea intends to forego some of the subsequent purchases and make advance repurchases as soon as conditions permit. Furthermore, the Korean authorities are aware that a new facility, called for at the Manila summit of Asian Finance and Central Bank Deputies, on November 19, for the provision of short-term financing to augment a stand-by arrangement, is being prepared for consideration by the Executive Board of the International Monetary Fund. As soon as such a facility becomes available to members, Korea intends to request that its stand-by arrangement be amended so as to permit the associated resources remaining to be purchased to come both from the

credit tranches and from the facility, in a manner consistent with the purposes and modalities of the facility.

5. The Korean government is firmly committed to implement the policies outlined in the attached memorandum and will ensure that the policies are adequate to achieve the objectives of the program. The Korean government remains firmly committed to take any additional measures that may be necessary for this purpose. During the period of the proposed stand-by arrangement and thereafter, Korea will consult with the Managing Director of the Fund on the adoption of any measures that may be appropriate, at the initiative of either the Korean authorities or the Managing Director, in accordance with the Fund's policies on such consultations. We will also provide the Fund with such information that it requests on the progress made in policy implementation and achievement of program objectives.

Yours sincerely,

Kyung-shik Lee
Governor
Bank of Korea

Chang-Yuel Lim
Deputy Prime Minister and
Minister of Finance and Economy

LETTER OF INTENT OF SOUTH KOREAN GOVERNMENT TO THE IMF

Seoul,
Korea
December
24, 1997

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

In the immediate period ahead, Korea faces the urgent task of restoring market confidence. To this end, the government is pursuing the following strategy: (1) strengthening the economic program through advancing measures already agreed under the stand-by arrangement and implementing additional measures designed to enhance stabilization and structural goals; (2) discussing with foreign banks possibilities of improving the rollover of short-term borrowing and gaining access to medium-term market borrowing; and (3) discussing possibilities of additional and advanced disbursements of official resources.

In support of the measures to strengthen stabilization and reform, we request that the phasing of purchases under the arrangement be modified to allow for a purchase to be made on December 30, 1997.

The measures to strengthen the program are concentrated in the following areas:

1. **Monetary policy** - to restore order in the foreign exchange market and provide appropriate incentives for holding won-denominated assets, interest rates have been raised substantially, reaching about 30 percent on December 24. Further increases will be implemented, if necessary. At the same time, care is being taken to ensure that unequal distribution of liquidity in the system that has developed in recent weeks does not lead to a liquidity crunch in important sectors of the economy that could cause bankruptcies of viable firms.
2. **Capital market opening** - the government will lift all capital account restrictions on foreign investors' access to the government, corporate, and special bond markets as of January 1, 1998, and will accelerate the announced schedule for liberalizing equity inflows. We will, according to a timetable to be set in consultation with the IMF mission in mid-January 1998, eliminate all barriers to capital inflows in the money market
3. **Financial sector restructuring** - the government is developing and implementing a comprehensive restructuring plan for the financial sector that will include the merger and closure of insolvent institutions. In this context, measures will be accelerated wherever feasible, and will be guided by the procedures set out in our earlier letter,

most notably that existing shareholders will bear the first burden. Details of the restructuring strategy are being worked out with financial and technical support from the World Bank and the AsDB under their structural lending operations.

4. Reserve management and exchange rate policy - we have taken further measures to reduce recourse of banks to the BOK to cover their debt-service obligations, including a further substantial increase in the penalty rate of BOK loans to commercial banks. We intend to increase this rate progressively as needed in order to provide strong incentives for banks to seek alternative sources for servicing their short-term debts. As soon as the viability of the foreign exchange cashflow is restored, the separate window will be abolished and banks will have to obtain their total foreign exchange requirements in the market. We intend to take this action at the earliest opportunity in consultation with the Fund.

5. Trade policy - we will accelerate measures to open the economy to imports and eliminate trade-related subsidies in order to increase competition and efficiency in the domestic economy. We will make binding under WTO the liberalization of financial services as agreed with the OECD.

6. Labor market policies - while the program aims to minimize the inevitable slowdown in economic growth, we will aim to facilitate the necessary movement of workers from declining firms to other employment possibilities. The government expects to shortly announce its views on labor market and wage issues, as well as on a fair sharing of the burden between employers and workers in the case of labor redundancies.

7. Fiscal policy - the initial fiscal adjustment of the program will be maintained despite higher costs to the government associated with the larger depreciation of the won and with financial sector restructuring.

8. Data publication - we intend to publish periodically, after completion of preparatory work, data on total external debt and its relevant components.

The measures to strengthen the program have the full support of the economic team of the incoming government. We will monitor the implementation of these measures in close cooperation with the IMF, the IBRD, and the AsDB.

Yours sincerely,

Kyung-shik Lee
Governor
Bank of Korea

Chang-Yuel Lim
Deputy Prime Minister and
Minister of Finance and Economy

LETTER OF INTENT OF SOUTH KOREAN GOVERNMENT TO THE IMF

Seoul, Korea
May 2, 1998

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D. C. 20431

Dear Mr. Camdessus:

1. The inauguration of President Kim Dae-jung on February 25 launched a new administration committed to the principles of a market economy and determined to accelerate structural reform. The government's policies to restore financial stability, backed up by the strong leadership of the President and social stability ensured by the Tripartite Accord, have begun to regain the confidence of international investors. The current account has turned to a substantial surplus and usable reserves have increased to over US\$30 billion. The conclusion of the restructuring of US\$21.8 billion of banks' short-term debt facilitated Korea's return to the international capital market through a sovereign global bond issue of US\$4 billion. The successful offering, four months after the onset of the crisis, was well received by the market, demonstrating investors' confidence in Korea's commitment to reforms.

2. While a corner has been turned in the current crisis, the impact on the real economy is still severe and difficult challenges remain ahead. Many viable firms continue to face a credit crunch; bankruptcies and unemployment are rising. The government is resolved to take all necessary measures to support a sustainable recovery and to this end, the focus of policies will now shift from the external side to structural reforms in the real sector. The government will continue to implement fully its commitments under the IMF-supported economic program. The main thrust of policies will be to accelerate reforms to address the roots of structural inefficiencies.

3. The attached Memorandum on the Economic Program for the Second Quarterly Review updates the Memorandum on the Economic Program of February 7, 1998. Corporate restructuring and financial sector reforms are priorities on our reform agenda as rapid progress in these areas are necessary prerequisites for a sound economy. Major steps are being taken to strengthen the legal and institutional framework to facilitate corporate restructuring through market discipline: improving transparency; enhancing corporate governance; liberalizing mergers and acquisitions; opening to foreign investment; and improving bankruptcy procedures. Corporate restructuring should be voluntary and based on market principles, and public funds will not be used to bail out corporations. It is envisaged that banks will need to play a central role in restructuring corporate debt and in strengthening corporate balance sheets. The government is pushing ahead to restructure and recapitalize the banking sector and to strengthen prudential regulations and supervision. We will continue to work in close collaboration with the IMF and World Bank in our reform program in these areas.

4. Given the large financial resources needed to facilitate corporate restructuring and the current weak state of the banking system, it is important to expedite capital market development, particularly the development of equity and security markets and mutual funds. We seek active support from the international financial community and investors for this initiative. To maintain investor confidence, transparency has been increased in a number of ways, especially through the publication of our letters of intent, as well as by the regular release of statistical information (including Bank of Korea's (BOK) usable reserves, net forward positions, and external debt).

5. While accelerating structural reforms is essential to ensure a rapid recovery, the government also recognizes the need to have flexibility in policy implementation and make modifications to macroeconomic policies to take account of the evolving situation. In particular, a somewhat larger fiscal deficit will be permitted to take account of weaker growth and the ongoing structural adjustments. Interest rate policy will be conducted in a flexible manner reflecting market conditions, subject to the objective of maintaining stability in the foreign exchange market. To offset the credit crunch and the serious financing difficulties experienced by viable small- and medium-sized enterprises, the government will provide temporary assistance to these enterprises to facilitate trade financing.

6. The process of structural reforms will entail social costs of enterprise bankruptcies and unemployment. The government has strengthened the social safety net as part of its contribution to the Tripartite Accord. The maintenance of social stability agreed under the Tripartite Accord remains critical to keep the confidence of international investors. We intend to keep under review the adequacy of the social safety net in light of the evolving economic situation.

7. The government intends to seize the opportunity of a social consensus under the new administration to fully overcome our present difficulties and return the economy to a path of sustained growth.

Chol-Hwan Chon
Governor
Bank of Korea

Kyu-sung Lee
Minister of Finance and
Economy

LETTER OF INTENT OF SOUTH KOREAN GOVERNMENT TO THE IMF

Seoul, Korea
July 24, 1998

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D. C. 20431

Dear Mr. Camdessus:

1. We are pleased that, during our discussions with the IMF over the past two weeks, we have again reached a common understanding on the state of the Korean economy and on the priorities for reform in the period ahead. These policies are described in the attached Memorandum on the Economic Program. Since the last review in May, macroeconomic policies have been eased to contain the extent of economic downturn. At the same time, Korea has been intensifying its reform efforts in all major sectors of the economy. Priority has been given to reform of the banking system, which is key to the success of other restructuring efforts. Corporate reform is also gaining momentum. The government has been working closely with the World Bank and has put in place a framework for corporate debt restructuring, including procedures for debt workouts. The government's corporate restructuring plan, which has been agreed with the World Bank in the context of a Structural Adjustment Loan, is attached to the Memorandum on the Economic Program.

2. Additionally, the voluntary restructuring of the large conglomerates is advancing through the disposal of assets, attraction of foreign capital, and rationalization of business operations. In recent weeks, ambitious plans have been announced for the immediate privatization of five public enterprises, to be followed by the gradual privatization of six others.

3. The domestic economy, however, appears to be falling further into recession and consumer and investor confidence is at a low ebb. Unemployment has increased faster than previously expected and more layoffs are expected to result from the acceleration of restructuring. Externally, the weaker regional economic environment has begun to have a negative impact on export growth.

4. With the strengthening of the external position, we have decided to shift the focus of macroeconomic policies toward supporting an early recovery of domestic demand. The government's priority is to take strong actions at this time to contain the economic recession to a manageable level. On the fiscal side, the budget deficit will be expanded from 1 3/4 percent to 4 percent of GDP. This is consistent with the international consensus on fiscal flexibility as expressed in the recent Joint Manila Framework/G7 Deputies Meeting in Tokyo. Higher government expenditures will be used to bolster the social expenditure program, increase social overhead capital investment, as well as to moderate the credit crunch in small- and medium-sized enterprises, trade financing and the housing sector.

5. The recent strengthening of the won has signaled a return of market confidence and provides an opportunity for continued easing of monetary policy. The government intends to take advantage of exchange rate stability to further reduce interest rates in the period ahead.

6. Korea, under the strong leadership of President Kim Dae-jung, remains fully committed to the ongoing reform process. Our policies for the remainder of 1998 are set out in the attached Memorandum on the Economic Program for the third Quarterly Review which updates the Memorandum on the Economic Program of May 4, 1998. We will continue to work in close collaboration with the Fund and World Bank on developing and implementing policies to strengthen our financial system and industrial base so as to place Korea back on a path of strong and sustainable growth.

Chol-Hwan Chon
Governor
Bank of Korea

Kyu-sung Lee
Minister of Finance and
Economy

LETTER OF INTENT OF SOUTH KOREAN GOVERNMENT TO THE IMF

Seoul, Korea
November 13, 1998

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

1. Almost a year has passed since Korea entered into a standby arrangement with the IMF to cope with the foreign exchange crisis. Faced with depleted foreign reserves, a rapidly depreciating currency and the risk of sovereign bankruptcy, it was inevitable to tighten monetary policy and raise interest rates last December to help stabilize the currency, along with the introduction of a rigorous reform program. Since that time, Korea has made significant progress in strengthening the external position and in advancing economic reform. Interest rates have fallen continuously in 1998, but remained above pre-crisis levels until mid-year due to instability in international financial markets. The exchange rate has stabilized in the range of W1300-1400 to the U.S. dollar, and usable foreign reserves have surpassed US\$45 billion. The first round of financial sector restructuring was completed at the end of September, and important corporate sector restructuring steps will be taken by the end of this year.

2. In the financial sector, 94 financial institutions, including five banks, have thus far either been closed or had their operations suspended. In an effort to stop the vicious cycle of deteriorating asset portfolios and the ensuing credit crunch, the government plans to mobilize fiscal resources totaling W 64 trillion won to support viable financial institutions, out of which W 38 trillion has already been provided for recapitalization and the disposal of nonperforming loans. This support has helped major banks to improve their capital adequacy ratios, setting the stage for a resumption of lending to the real sector that will help expedite economic recovery. Meanwhile, the banks have intensified their own rehabilitation efforts, including steps to reduce staff levels by 32 percent by the end of this year.

3. Progress has also been made in corporate sector restructuring. A number of nonviable firms have been forced to exit, while the process of corporate workouts with creditor banks has begun for viable firms. Large business conglomerates are taking steps to reduce their debt leverage and improve their efficiency. Institutional standards for corporate governance, transparency, and accountability have been greatly improved. By the end of this year, the first phase of corporate restructuring will have been completed.

4. This progress notwithstanding, the economic downturn has been more severe than expected. The government is attempting to stem further economic contraction through a combination of stimulative fiscal policy and accommodating monetary policy. The National Assembly approved the Supplementary Budget in September to allow the fiscal deficit to expand to around 5 percent of GDP in 1998. The draft budget for 1999 also incorporates a fiscal deficit of 5 percent of GDP with public investment spending to be concentrated in the first half of the year. The actual

application of planned spending is being monitored on a weekly basis to make sure that fiscal stimulus takes effect in a timely manner. Monetary policy has also been eased. Call rates have declined well below pre-crisis levels, although lending rates have declined less rapidly.

5. Although Korea has made significant gains in financial stabilization and structural reform, the current instability in international financial markets is limiting access to international capital. We are therefore undertaking various measures, including a further buildup of foreign reserves, to protect Korea from any potential external risks.

6. The attached Memorandum on the Economic Program for the Fourth Quarterly Review outlines the major policies for the coming months and updates the Memorandum on the Economic Program of July 24, 1998. Korea, under the strong leadership of President Kim Dae-Jung, remains committed to reform, and will continue to implement financial and corporate restructuring while pursuing flexible macroeconomic policies conducive to growth. The economy is expected to bottom out in 1999, with positive growth resuming during the year.

Chol-Hwan Chon
Governor
Bank of Korea

Kyu-sung Lee
Minister of Finance and
Economy

LETTER OF INTENT OF SOUTH KOREAN GOVERNMENT TO THE IMF

Seoul, Korea, November 24, 1999

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. Under the strong and democratic leadership of President Kim Dae-jung, the Korean economy has staged a remarkable rebound since entering into a stand-by arrangement with the IMF in December 1997. This dramatic turnaround is evident on a number of fronts: growth has recovered sharply in 1999, the unemployment rate has fallen, investment is picking up, export growth is strong, and there has been a significant increase in usable foreign exchange reserves to more than \$68 billion. At the same time, inflation remains subdued. Bolstered by the strengthening of the external situation, Korea has repurchased funds drawn under the SRF ahead of schedule, and its sovereign credit rating has been raised to investment grade.

2. The economic recovery has been aided by the progressive lowering of interest rates and fiscal stimulus. In addition, the efforts made by the government to expand the social safety net have helped reinforce social stability. Two supplementary budgets have been introduced in 1999, and the consolidated central government budget deficit is now targeted to be about 4 percent of GDP in 1999. With the economic recovery now underway, the process of rebalancing macroeconomic policies is to begin with the 2000 budget that was recently submitted to Parliament. Next year's budget therefore envisages a reduction in the primary balance of the consolidated central government by about 1-1½ percent of GDP.

3. Good progress has been made in consolidating and recapitalizing the banking system, and reforms in the financial sector will increasingly focus on operational improvements. The government has signed terms of investment with Newbridge Capital for the sale of a majority stake in Korea First Bank. Efforts are also being made to find an international team, including a chief executive officer, to take management control of Seoul Bank with a view to preparing it for privatization. The independence and autonomy of the Financial Supervisory Commission have been enhanced through revisions to the Government Organization Act. New loan classification and provisioning guidelines based on forward looking criteria will be implemented by the end of 1999.

4. Greater emphasis is now being put on reforming nonbank financial institutions. In this connection, the government recognizes that reform of the investment trust industry is critical. A comprehensive package of measures is thus being implemented with the aim of putting this sector on a sound financial footing, strengthening its regulation and supervision, and addressing its immediate liquidity problems.

5. The government reiterates its strong commitment to the process of corporate restructuring. The dismantling of the Daewoo group is a major breakthrough in this regard. Restructuring of the other top-5 *chaebol* will be accelerated; these corporations will be required to complete their restructuring in a way that allows them to focus their resources on core businesses. For the *chaebol* ranked 6-64, the debt workout framework is being strengthened with the assistance of the World Bank and a large number of workouts are underway. The relationship between business and labor is now much more stable. In the public sector, a number of public enterprises have been privatized or restructured, and many government bodies have been downsized.

6. Korea's economic policy priorities in the period ahead are to broaden the ongoing economic recovery and to complete structural reforms so as to lay the foundation for sustainable economic growth and an enduring reduction in unemployment. To this end, the Bank of Korea has announced its intention to maintain the current stance of monetary policy for the time being while remaining vigilant to the possible emergence of inflationary pressures. As noted above, the process of medium-term fiscal consolidation is set to begin with the budget for 2000.

7. The attached Memorandum on Economic Policies for the Sixth Review outlines the major policies for the coming months and updates the Memorandum on Economic Policies of March 11, 1999. The government's corporate restructuring program, which has been agreed with the World Bank in the context of a proposed Corporate and Financial Sector Restructuring Loan, is attached to the Memorandum on Economic Policies. During this review, the IMF and Korea agreed to revise Korea's macroeconomic outlook to reflect the swifter-than-expected recovery. In addition, both quantitative and structural performance criteria have been set for the period through May 2000. The Korean government will continue to work in close collaboration with the Fund.

8. Future reviews under the stand-by arrangement will continue to take place semi-annually.

Chol-Hwan Chon
Governor
Bank of Korea

Kang Bong-Kyun
Minister of Finance and
Economy

LETTER OF INTENT OF SOUTH KOREAN GOVERNMENT TO THE IMF

Seoul, Korea
July 12, 2000

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

1. Korea has experienced a strong economic recovery since entering into a stand-by arrangement with the IMF in December 1997, thanks to the resolve of the Korean people and the effective leadership of President Kim Dae-jung. There are ample signs of a remarkable turnaround: economic growth has rebounded sharply; inflation has remained under control; the unemployment rate has fallen; investment has picked up; exports have expanded. The improved external situation has allowed Korea to repurchase the funds drawn under the SRF ahead of schedule, and Korea's sovereign credit rating has been raised to investment grade.
2. Korea's fast recovery has been facilitated by the government's enactment of policies to provide fiscal stimulus and the lowering of interest rates. Moreover, the government's efforts to expand the social safety net have helped to preserve social cohesion, which is necessary for carrying out drastic reforms. With economic recovery under way, the process of rebalancing macroeconomic policies began with the budget for 1999 when the consolidated central government deficit was reduced to 2.7 percent of GDP. Fiscal policy for 2000 envisages an adjustment in the primary balance of the consolidated central government by about 1½-2 percent of GDP, returning Korea to a position of primary surplus.
3. Good progress has been made in consolidating and recapitalizing the banking system, and reforms in the financial sector will increasingly focus on operational improvements. The government has concluded the sale of a majority stake in Korea First Bank to Newbridge Capital. A new chief executive officer of Seoul Bank has been appointed, and privatization of this bank will be prepared, through consultations with Deutsche Bank. The independence and autonomy of the Financial Supervisory Commission have been enhanced through revisions to the Government Organization Act. New loan classification and provisioning guidelines based on forward-looking criteria were implemented at the end of 1999.
4. As for reforming nonbank financial institutions, the government recognizes that the reform of the investment trust industry is critical. A series of measures has been implemented to improve the industry's financial soundness, to strengthen its regulation and supervision, and to address its liquidity problems. New investments in funds will be market-to-market from July 2000, setting the stage for more sound and transparent investment management.

5. The government remains fully committed to the restructuring of the corporate sector. The dismantling of the Daewoo group was a milestone in this regard. The debt-to-equity ratio of chaebols has been lowered significantly, and its progress will be continuously monitored. The relationship between business and labor is now much more stable. In the public sector, a number of public enterprises has been privatized or restructured, and many government regulations have been abolished.

6. In implementing its economic policies in the period ahead, Korea places high priority in maintaining the current economic expansion with macroeconomic stability and deepening structural reforms in both the financial and corporate sector so as to lay the foundation for sustainable economic growth. In setting monetary policy, the Bank of Korea will pay close attention to the possible emergence of inflationary pressures as well as the situation in financial markets. As noted above, the process of medium-term fiscal consolidation has already begun with the budget for 1999. A balanced budget is planned to be achieved by 2003.

7. The attached Memorandum on Economic Policies for the Seventh and Eighth Review outlines the major policies for the coming months and updates the Memorandum on Economic Policies of November 24, 1999. During this review, the IMF and Korea agreed to revise Korea's macroeconomic outlook to reflect the faster than expected recovery. In addition, both quantitative and structural performance criteria have been set for the period through September 2000. The Korean government will continue to work in close collaboration with the Fund in the period ahead.

8. All quantitative performance criteria for end-December 1999 and end-March 2000 have been met, and the two structural performance criteria for end-December 1999 have also been met. With regard to the structural performance criteria for January 31, 2000 and March 31, 2000, although the necessary actions were not completed by the due dates, they have now been completed, or will be completed soon, as outlined in greater detail in Annex A of the attached Memorandum on Economic Policies. On this basis, we request waivers of the structural performance criteria for January 31, 2000 and March 31, 2000.

9. This is the final review under the stand-by arrangement, and the arrangement will expire on December 3, 2000.

Chol-Hwan Chon
Governor
Bank of Korea

Hun-Jai Lee
Minister of Finance
and Economy

Monday, April 20, 1998

Rep. James A. Leach, Chairman of the House Banking and Financial Services Committee, has sent the attached memo on the International Monetary Fund to Majority Leader Dick Armey:

MEMORANDUM

TO: THE MAJORITY LEADER

FROM: REP. JAMES A. LEACH, CHAIRMAN, COMMITTEE ON BANKING AND FINANCIAL SERVICES

RE: THE IMF AND THE ARMEY CRITIQUE

I have read your thoughtful critique of the International Monetary Fund (IMF) in which you conclude by noting that you look forward to hearing the thoughts of your colleagues. Here goes.

American National Interests and the IMF

I believe it is in America's national interest for Congress to promptly approve both the \$3.5 billion New Arrangements to Borrow (NAB) and the \$14.5 billion quota increase for the IMF. At issue is not only the stability of the international financial system and the ability of the IMF to respond to future crises, but the broader question of whether the U.S. intends to be an engaged leader in global economic policy and multilateral diplomacy in general.

While most critiques of the IMF have elements of merit, the problem is that alternative policy options may be more expensive and less effective. The challenge is to establish a policy that neither ignores economic problems such as those which have arisen in Asia nor exclusively Americanizes their solution. In this context, the IMF advances a prudential and relatively inexpensive approach to international problem solving.

The IMF, after all, involves burdensharing - with over 80% of its total resources coming from other countries - and the capacity to influence the shape of the economic infrastructure in countries to which credit is extended.

Many people have used the term "bail out" in discussing IMF-led programs. But bail out indicates that someone is getting something for nothing. This is wrong on two fronts. First, the IMF is a lending, not an aid-granting institution. Second, no government or international institution has the individual capacity to resolve the crisis in Asia. Likewise, there is no single solution. It will take the cooperation of governments, banks, commercial businesses, and, most of all, ordinary citizens to solve this problem.

Since 1968 Congress and the Executive Branch have agreed that transactions with the IMF related to U.S. credit-line arrangements or the U.S. quota subscription are treated as exchanges of monetary assets that do not affect the budget. When the U.S. provides resources to the IMF, it receives a liquid, interest-bearing claim on the IMF backed by the Fund's substantial reserves, which include almost \$40 billion in gold. While there is an element of risk in any lending arrangement, to date no country has ever defaulted on an IMF loan. The U.S. claim is thus like a deposit in a AAA-rated bank, on which the U.S. is paid interest and which it can withdraw on short notice.

According to Federal Reserve Chairman Alan Greenspan – the most widely respected independent central banker in the world today – there is "a small but not negligible probability that the upset in East Asia could have unexpectedly negative effects on Japan, Latin America, and eastern and central Europe that, in turn, could have repercussions elsewhere, including the United States." By bolstering the financial resources of the IMF, Congress will put in place an insurance policy ensuring that a quick response to the crisis is possible if it deepens or widens further. Conversely, failure to support the IMF would leave the U.S. and world economy vulnerable to additional financial shocks in Asia or elsewhere. It would be seen abroad as a repudiation of current American leadership and of the long-standing American commitment to expanding global trade. Indeed, failure to support the IMF would send destabilizing shock waves through the international financial system, with dangerous knock-on effects for broader U.S. security and political interests.

For all of the world's problems, and perhaps because of some of them, this is a time of opportunity for the United States in Asia. If America offers leadership, our ties and influence in the region could be strengthened for decades to come. On the other hand, if we turn a cold shoulder in this time of crisis, the consequences for American political leadership and commercial activities in the region will be profoundly negative for a long time to come.

Congressional Oversight and IMF Reform

You suggested in your memo that the IMF funding request was being considered "without an informed public debate, conditions on its use, or even the possibility of effective congressional oversight in the future..." With due respect, this is not the case.

Beginning last November, the Banking Committee held the first of three extensive hearings on the Asian financial crisis and the role of the IMF. The Committee heard from over 30 witnesses, including proponents and opponents of U.S. participation in the IMF. It was the considered judgment of the Committee that the IMF continues to deserve U.S. support. By a vote of 40-9, the Committee agreed to support new funding for the IMF, with every Minority Member and two-thirds of the Majority Members present in support. Only eight Republicans and Congress' only socialist objected.

In addition to the Banking Committee, IMF funding was strongly supported on a bipartisan basis by the House and Senate Appropriations Committees, as well as the full Senate, which by an overwhelming 84-16 vote included IMF funding in the FY 1998 emergency supplemental appropriations bill.

With respect to the need for reform, virtually all Members agree that the IMF has made mistakes, that improvements are needed in the way it operates, that its deliberations should become more transparent, and that the private sector should bear its share of the losses in countries being assisted by IMF loans. But there is also a solid bipartisan consensus in Congress to use this funding opportunity to advance real, lasting reforms at the IMF and within the international financial system. And I can assure you that the Banking Committee will maintain its vigorous oversight of the IMF as well as the World Bank.

IMF reform is precisely what the Banking Committee required in its authorization for the NAB and IMF quota increase. The Administration is mandated to pursue aggressively a broad spectrum of reforms: increasing the effectiveness of the IMF in promoting market-oriented reforms, strengthening financial systems in developing countries, developing internationally acceptable bankruptcy standards, fostering burden-sharing by the private sector in resolving financial crises, and promoting greater IMF transparency and accountability.

The bill approved by the Banking Committee (H.R. 3114) requires Treasury and the Federal Reserve to initiate international negotiations to establish global standards of accounting and corporate disclosure, as well as bankruptcy mechanisms and open investment practices. The bill also institutionalizes consultation with the Secretary of the Treasury on issues related to IMF reform and the health of the international financial system - similar to the regular consultations required from the Chairman of the Federal Reserve by the Humphrey-Hawkins Act - to ensure effective oversight and enable Congress to evaluate progress in achieving IMF reform. These are realistic reform objectives that deserve strong bipartisan support.

In this regard, I would point out that the FY 1998 supplemental appropriations bill approved by House Appropriations Committee includes roughly 85% of the conditions contained in H.R. 3114 and adds several other provisions related to trade and transparency. While in my view they are imperfectly worded at this stage, these provisions represent credible efforts to promote IMF reform. The supplemental appropriations bill passed by the Senate also contains substantive IMF reform language.

Unworkable "Reforms" Would Effectively Prevent IMF Funding

Though you express grave doubts about supporting the IMF under any conditions, you indicate support for an alternative measure, H.R. 3331, the "IMF Transparency and Efficiency Act of 1998." While the objectives of the bill, which are to promote improved IMF transparency and openness, are generally reasonable, HR 3331 is structured in a way that could indefinitely block U.S. participation in the NAB and

quota increase. The requirement, for instance, that U.S. funding for the IMF include an annual certification vote by Congress is an umbrage to other member states. It also misconstrues the constitutional role of Congress in relation to the executive branch and the role of legislative bodies in the international system.

H.R. 3331 also seeks to require that the IMF charge "market rates" of interest on its loans. While quite reasonable, this suggestion is hardly novel. The IMF's lending rates have been set as the weighted average of short-term interest rates in France, Germany, Japan, the U.K., and the United States. As you may know, falling inflation and stable G-7 monetary policies have tended to lower benchmark global bond yields. Three-month money market rates in the five countries referenced above are 3.57%, 3.62%, 0.61%, 7.47%, and 5.45%, respectively. These rates reflect the cost of potential financing to the Fund. In addition, the existing pricing policy is designed to reflect the risk carried by the IMF on these loans. The IMF is exposed to less credit risk than the private sector because the IMF is in a class by itself as a preferred creditor, with enhanced leverage conferred by its official multilateral status. This is why no country has defaulted on obligations to the Fund.

More generally, the IMF is in many ways analogous to a credit union. It was established on the principle that member countries share a fundamental interest in providing mutual support in preventing or containing disruptive financial crises and preserving the stability of the international financial system. In this cooperative spirit, all IMF members are obligated to contribute to the Fund's financial resources. Likewise, with the one exception discussed below, the IMF's financial access policies are designed to ensure that all members are treated uniformly. A general presumption in favor of discriminatory pricing policies could lead to reduced support for the institution, thus undercutting the basic tenets and mission of the IMF.

Nevertheless, one byproduct of increased global capital flows is that the amount of financial assistance needed to be mobilized by the IMF for individual countries, in order to stem liquidity crises and halt fast-moving financial contagion, has grown ever larger. For example, the amount of resources provided to Mexico by the IMF, \$17.8 billion or roughly 700 percent of that country's quota, was enormous by IMF standards but represented only about 20% of Mexico's financing requirements in 1995 for new money and to roll over maturing obligations. On the other hand, too much potential financing exacerbates moral hazard concerns.

In recognition of this development and spurred by U.S. efforts, the IMF recently adopted a new innovation that raises interest rates on extraordinary IMF financing and includes an explicit risk premium, which increases as the length of the IMF's exposure increases. The new Supplemental Reserve Facility (SRF) provides not only for market rates of interest, but also premium rates some 300 basis points above the Fund's normal cost of financing, with shorter maturities in circumstances where exceptional IMF financing is required. Modeled on an investment banking approach developed by the House Banking Committee during the Mexican peso crisis, and by Treasury's eventual use of the Exchange Stabilization Fund during that crisis, the new facility maximizes the incentive for a quick return by governments to reliance on private market financing. It is available only in the most extreme liquidity crises and

only in association with strong reform policy responses by borrowing governments. In other words, H.R. 3331's call for the establishment of market rates ironically represents a less rigorous prescription than the premium rates already negotiated by the United States government.

The IMF Advances U.S. Principles and Interests

For over 50 years, there has been solid bipartisan support for the IMF and the other international financial institutions. The reason is simple: generally speaking, the IMF has well served U.S. national interests.

By historical background, representatives of some 44 countries met in Bretton Woods, New Hampshire, in 1944 as World War II was drawing to a close with the goal of rebuilding the international economic system, the collapse of which had helped lead both to the Great Depression and the Second World War. The institutions they proposed to create were the IMF, the World Bank, and the General Agreement on Tariffs and Trade (GATT), which has now become the World Trade Organization (WTO).

The Bretton Woods institutions were created to address the causes of depression, to facilitate the rebuilding of Europe after World War II, and, most significantly, to mitigate economic causes of war itself. Here, perspective should not be lost. Any reading of history would indicate that while by no means perfect, the IMF and its sister institutions have advanced U.S. interests in maintaining a stable international political and financial system that promotes global economic growth and open markets. In fact, in the last two decades alone, world GDP has quadrupled and international trade has quintupled.

While the world economy and international financial system have evolved significantly since the creation of the IMF, and while a fixed exchange rate system has largely given way to more flexible exchange relationships, the mission of the IMF has remained much the same: to provide advice and a forum for cooperation on macroeconomic and exchange rate policies, to facilitate the expansion and balanced growth of international trade, and to provide highly conditional financial assistance to countries facing temporary balance of payments problems.

Why is it sometimes appropriate for the IMF to provide temporary loans to countries in distress? Because without access to conditional official financing, countries are likely to respond to balance of trade or liquidity crises with competitive currency devaluations, trade protectionism, and exchange controls. In addition, acute economic distress in one country can create financial contagion that could threaten the integrity of the international financial system and harm global growth. Certainly the economic history of this century should teach Congress that the combination of "beggar thy neighbor" currency devaluations, hostility to balanced trade, and a collapse of the international financial system, jeopardizes our national security as well as economic interests.

As the greatest beneficiary of a vibrant and open world economy, the U.S. has a compelling interest in the viability of the institutions that help assure international financial stability. The leading one, the IMF, not only provides credit, but also uses its authority to advance structural reforms, such as market-based economic policies, trade liberalization, privatization, and prudential macroeconomic and banking policies.

In good times, international organizations may appear to be irrelevant or expensive. When there is a challenge, however, they can be indispensable. If the IMF didn't exist, ad hoc multilateral arrangements would need to be created each time a crisis occurred, possibly at much greater cost to the U.S. and without any guarantee of success. Whatever mistakes in judgment are ascribed to it, the IMF stands as a coherent alternative to international financial chaos.

Partly because of its efforts to restore financial stability in Asia, but mainly because trade has expanded so extraordinarily in recent years, the IMF's financial capacities are at an historically low level in relation to the challenges it faces. At present, the IMF has about \$45 billion in uncommitted liquid resources, but only \$10-15 billion of this amount is available for crisis management because the remainder must be held in reserve to accommodate potential withdrawals by IMF members. In addition, the IMF has access to roughly \$23 billion in existing credit line arrangements, for a total lending capacity of \$33-38 billion. By contrast, the IMF has committed some \$35 billion in the last six months alone to financial stabilization efforts in Asia.

The Asian financial contagion is not the kind of problem from which an economy even as large as ours is immune. According to John Makin, a resident scholar at the American Enterprise Institute, the negative effects of the Asian financial crisis should hit the U.S. economy by early summer, reducing the rate of growth in our economy and increasing our trade deficit. Private sector economists with Chase Securities and Salomon Smith Barney are also forecasting a notable slowdown in U.S. GDP growth as a result of events in Asia. The negative effects on our economy could rise if Asian economies and currencies are not stabilized.

Ignoring the problems in Asia and their potential spillover into other emerging markets, such as

Latin America, east and central Europe and the Indian subcontinent, could produce an economic calamity that would devastate our exports and place U.S. manufacturers and farmers at a competitive disadvantage. It could also call into question U.S. global leadership and undermine security and stability in East Asia, a region in which we have fought three wars in the past 60 years.

Maintaining global financial stability and economic growth is self-evidently a vital U.S. national interest. While the U.S. has the option simply to ignore the issue entirely, the principal activist alternative to reliance on the IMF would be to attempt to protect U.S. interests by going it alone, which would place the taxpayer at substantially greater risk than the IMF does. But few in America or abroad want the U.S. government to bear the burden of being the lender of last resort for the world.

Reliance on the IMF implies not only shared global responsibility, but greater likelihood of repayment and reform.

As an agent of market-oriented reform, the IMF is a far more effective instrument than any one government. Because it has an international mandate and financial leverage, it can require a country to accept reform conditions that no single government has the capacity to require on its own. As for burdensharing, you express dismay in your memorandum that while the U.S. is expected to provide some \$18 billion to the IMF, others will contribute roughly \$94 billion (\$19 billion to the NAB and \$75 billion for the quota increase). Actually, this is reason to be pleased, not displeased, with the IMF. Contributions from the U.S. are matched on a better than five to one ratio on a gross basis, or providing roughly four to one leverage as measured by useable resources. By any measure, other countries are providing the majority of resources to the IMF in support of macroeconomic goals and geo-strategic interests of the United States.

Criticism of the IMF

As a lending institution which establishes conditions for loans it extends, the IMF is continually the subject of criticism. Some is well-founded; most less so. IMF bashing needs to be put into perspective. A decade ago, the IMF was pilloried from the left and the right for advancing anti-inflation policies in Latin America that led to fiscal and monetary restraint. The result of these policy changes, however, has been a radical reduction in inflation rates throughout Latin America and a greater reliance on the market, benefiting people at all levels of society.

As for the current IMF programs in East Asia, the focus of IMF-supported reforms is on making economies more market-oriented through financial sector restructuring and other structural reforms. According to the American Iron and Steel Institute, the IMF's structural reform programs "contain important elements that, if fully complied with, would achieve what 20 years of trade negotiations have failed to do: reduce the role of government and open up key Asian economies to competition and market forces." I know of very few economists and even fewer business leaders who don't strongly support the IMF's efforts to advance greater market competition and reduce the corruption that excessive governmental intervention invariably engenders.

It is true that eminent former public servants like George Shultz and the distinguished Nobel Laureate Milton Friedman dissent from the precept that the IMF advances U.S. principles and interests. But it is also true that an extraordinarily impressive array of former public officials, business leaders, and economists – including Carla Hills, Pete Peterson, Henry Kissinger, Brent Scowcroft, Paul Volcker, Maurice Greenberg, Robert Hormats, David Hale and many others – have come to the opposite conclusion and urge Congress to provide the U.S. share of the IMF's financing as quickly as possible.

The IMF and "Moral Hazard"

The one criticism of the IMF-led stabilization effort in Asia that you raise which I believe has some, but not necessarily compelling, legitimacy is the "moral hazard" argument. In this context, "moral hazard" is generally meant the risk that the provision of financial assistance by the IMF encourages poor resource allocation by loan recipients and imprudent lending policies by banks.

With respect to individual countries, the policy conditionality associated with IMF lending – which requires macroeconomic and financial discipline as well as structural change – helps to mitigate against these moral hazard concerns. Moreover, the economic and social pain experienced by Mexico in 1994-95 and some East Asian countries today is simply too wrenching for any country to wish upon itself. Recent history also strongly suggests that countries in crisis resist turning to the Fund for assistance until they are literally on the brink of default and the IMF is their last option.

Interestingly, Chairman Greenspan has concluded that most bankers made mistakes in Asia not because they thought the IMF would ride to the rescue, but because they foolishly believed foreign governments would stand behind companies in "strategic industries," in some cases because of crony capitalism. This assumption, together with the quest for higher yields by investors, not a belief that an IMF rescue was in the making, appears to be behind most of the imprudent bank lending to the region.

There is an overwhelming consensus in Congress that while the IMF may responsibly act to stabilize economies, it is not the IMF's role to bail out banks. Capitalists should not be shielded from mistakes of capital allocations.

In this context, it should be pointed out that international banks lost a great deal as a result of this crisis. In recent weeks, a number of them, here and abroad, have been forced to write off losses of half a billion dollars and more. In addition, commercial banks are having to roll over their loans at lower than desired rates and at a time when they would normally choose to allocate resources elsewhere. Foreign equity investors have lost even more: nearly three-quarters of the value of their holdings in some Asian markets. Many Asian companies and more than a few Asian banks are likely to go bankrupt, and their lenders quite properly will also share in the losses.

Congressional Process Considerations

Finally, a note about process. It has been the position of Republican Leadership that no bill should come to the floor that a majority of Republicans can't support. This may be a reasonable policy for a majority party, but care should be taken to recognize that wisdom often dictates exceptions to generalized approaches. There is a credible possibility an IMF bill could obtain majority support on the floor with 90% or so of the Democratic vote and perhaps a third of the Republican one. A bipartisan majority of this nature shouldn't be considered improper. Indeed, it would give Republican

skeptics the chance to vote "no" in the context of a debate where all sides can respectfully be heard.

If, on the other hand, Republican leadership doesn't allow the issue to be fairly addressed or weighs IMF legislation down with controversial non-germane matters, the likelihood is strong that thoughtful elements in the public will not be impressed and that the Republican party will be held accountable for an anti-internationalist sentiment that risks a weakening of economies around the globe, including that in the United States.

cc: Members of the House of Representatives

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