This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.

https://www.wsj.com/articles/SB906521085454794500

Missteps of the U.S.'s Best Experts May Have Fostered Economic Crisis

By David Wessel and Bob DavisStaff Reporters of The Wall Street Journal

Sept. 24, 1998 2:42 pm ET

"If there was ever anything that bound the men ... together, it was the belief that sheer intelligence and rationality could answer and solve everything."

-- David Halberstam in "The Best and The Brightest"

WASHINGTON -- With little notice, President Clinton summoned his top advisers to the Oval Office on Labor Day for a late-night huddle on the spreading global financial crisis.

His anxiety about the adequacy of the U.S. response had been building for weeks. From vacation on Martha's Vineyard, Mass., he had phoned Treasury Secretary Robert Rubin, fly-fishing in Alaska, almost daily. On his trip to Moscow, he hectored top aides for new ideas. He and his political soulmate, British Prime Minister Tony Blair, talked about convening an emergency meeting of world leaders. Chief of Staff Erskine Bowles spoke of calling "a new Bretton Woods," referring to the 1944 conference that created the postwar economic order.

To the president, a speech set for Sept. 14 at the Council on Foreign Relations in New York was the place to prove that the U.S. and Bill Clinton could lead the world out of economic turmoil, Kenneth Starr and Monica Lewinsky notwithstanding.

Mr. Clinton wanted bold solutions as big as the problem. But Mr. Rubin wanted to be cautious; he worried that a meeting of world leaders would create unrealistic expectations. To channel the president's desire for action into more-acceptable directions, Deputy Treasury Secretary Lawrence Summers and aides worked through the weekend to come up with alternatives.

In the end, Mr. Clinton backed down. "I don't ever want to do anything that's going to be good for two days and then bad for two months," he said, according to a participant in the Labor Day session. The Sept. 14 speech was well-received, but its specifics were modest.

Mr. Clinton's impatience was understandable. Not long ago, Mr. Rubin and Mr. Summers were being compared to Douglas MacArthur, the general who reshaped Japan after World War II. Under their leadership, Americans were remaking Asia's dysfunctional crony capitalism -- with its close links between government, corporations, banks and in some cases, ruling families -- in America's free-market image.

Today, a less-flattering analogy comes to mind: The year-long financial firestorm may be turning into a Vietnam for Washington's "best and brightest" economic minds.

Through hubris, political clumsiness and the unintended consequences of well-meant policies, the Clinton administration and its allies at the International Monetary Fund have, so far, failed to contain what President Clinton now calls "the worst financial crisis in half a century."

The glimmers of hope in Thailand and South Korea, where interest rates are down and currencies are up, have been overwhelmed by economic collapse in Russia, threats to Latin America and worry about the risk of global recession. The power of the United States, in many ways mightier than ever, seems no match for international flows of money unleashed, in part, at the urging of the U.S. itself.

Robert McNamara, an architect of America's venture in Vietnam, says this reminds him of that war. Even though Mr. Rubin and Mr. Summers are "absolutely terrific," he says, "events are beyond their ability to shape and control. The best of intentions aren't good enough.

"The parallel," he adds, "is that you have to dig deeply and understand your problems and do it early. We didn't understand the political or economic problems in Japan, Indonesia or Russia early enough."

Mr. Rubin and Mr. Summers bristle at the comparison of this crisis to Vietnam. "They are totally not analogous," Mr. Rubin says. "They are different issues, different times, different people, and the role of this country is different." The U.S. now must respond to "enormous forces" as effectively as it can, but accept the limits of its ability to control them, he says.

Mr. Rubin, whose world view was shaped by decades at the investment bank of Goldman, Sachs & Co., counters the Vietnam analogy with one of his own: the 1973-74 stock-market decline that devastated Wall Street.

"The difference between the people who were smart and shrewd, and the people who weren't really smart and shrewd?" he says. "Those people who were really smart and shrewd lost a lot of money. The people who weren't really smart and shrewd got wiped out."

Success, he says, "meant that you managed extremely difficult forces effectively enough to ... come out the other end."

To the Treasury and IMF today, success means restoring economic growth to countries now suffering the worst recessions in a generation and persuading fickle global investors -- who just a few years ago were pouring billions into emerging-market economies -- to stop pulling money out.

"There is zero question in my mind that the world is substantially better off than it would have been without the efforts of the international community," Mr. Rubin says.

It will be years before the world can fully understand what went wrong and whether different policies might have staved off some of the pain. But the need to devise responses today requires an attempt at understanding where America's best and brightest succeeded and where, in retrospect, they failed.

A Bare Cupboard

A pattern was established back in July 1997, when Thailand, with an economy smaller than the state of New York's, ran out of foreign-exchange reserves and was forced to devalue its currency, the baht, and turn to Washington for help.

The Clinton administration wanted to help, but would have to do it on the cheap. The U.S. foreign-aid budget is now the smallest, adjusted for inflation, it has been in 25 years. The U.S. would have to rely instead on the IMF.

And because this is an age in which financial markets often are more powerful than armies, the Treasury Department would call the shots instead of the State Department, which traditionally handles international affairs. Many key decisions would be made by Mr. Rubin in consultation with Federal Reserve Chairman Alan Greenspan, a Rubin-Summers fan who also has lent them his substantial credibility. Decisions often would be shared after the fact with the State Department.

In many ways, Thailand's plight was similar to Mexico's situation in 1994, only less severe. In mid-1997, Mexico's response to the medicine it received seemed to Messrs.

Rubin and Summers a spectacular victory. So they prescribed a similar remedy: Thailand would get $17 billion in an IMF-led loan package in exchange for promising to impose high interest rates, restrain government spending, close insolvent banks and let its currency fall in order to expand exports and curtail imports.

"Mexico worked. How could they not try to repeat the Mexican rescue?" says economist Paul Krugman of the Massachusetts Institute of Technology.

Although Mexico endured a painful recession, its rebound boosted the Rubin Treasury's self-confidence. During that episode, Mr. Summers often quipped, "My human capital is denominated in pesos," his way of saying that his reputation rose or fell with Mexico's fortunes. By July 1997, the Mexican peso had been stable for a year.

The relationship between Mr. Rubin and Mr. Summers, the understated Wall Street veteran and the supercharged Harvard professor, is close and comfortable. "When the history of this is written 10, 15, 20 years from now, if they interview me, I'll tell them all the mistakes Larry made," Mr. Rubin jokes in an interview.

"I don't sign the dollar bills," Mr. Summers shoots back.

"There is that," Mr. Rubin concedes.

Supporting Mr. Rubin and Mr. Summers is a quieter Harvard-trained economist, David Lipton, the Treasury's undersecretary for international affairs, who has nearly two decades of experience at nursing troubled economies.

At the IMF, Mr. Summers installed Stanley Fischer, a Zambian-born M.I.T. economist, in the agency's No. 2 position, a post the U.S. traditionally fills. The two men talk almost daily. IMF Managing Director Michel Camdessus, though he occasionally riles U.S. officials, brings a decade's experience in wrestling with recalcitrant politicians that has been important at pivotal moments.

For all this expertise and brilliance, though, they stumbled. The Mexican formula didn't fit in Thailand. The biggest difference: Mexico shared a border with the largest and healthiest economy on the planet; the U.S. pulled Mexico out of recession. The biggest economy in Thailand's neighborhood, Japan, weakened as the crisis unfolded, and has been impervious to U.S. pressure. But that wasn't obvious in July 1997.

The Treasury pushed the IMF to make a big loan to Thailand, but didn't offer any additional U.S. money, a sharp contrast to its decision to offer Mexico $20 billion in early 1995.

The reasons for Mr. Rubin's tight-fistedness were straightforward. For Mexico, Mr. Rubin had tapped the Treasury's Exchange Stabilization Fund, a kitty that he and the president controlled. Subsequently, an angry Congress slapped restrictions on its future use. Those restrictions were about to expire when Thailand hit. To avoid provoking Congress into extending the restrictions, the Treasury kept its wallet in its pocket. "It was important that we have the freedom to use the ESF when it was needed," Mr. Rubin says. He argues that Thailand suffered more from the dithering of its politicians in the summer of 1997 than from inadequate U.S. aid.

What seemed reasonable in Mr. Rubin's office played poorly in Bangkok and elsewhere in Asia. Thailand felt abandoned, and other Asian governments -- as well as some players in financial markets -- wondered if the U.S. would come to their aid if necessary.

Unhappy at the Treasury's call, the State and Defense departments complained about the decision in interagency meetings. But when the White House asked if they had money in their budgets to send Thailand, they came up empty handed.

Months later, as Mr. Rubin listened uneasily, Defense Secretary William Cohen told the House Banking Committee the administration erred in not lending at least a token amount to Thailand. "The very notion that the United States was unwilling to participate in some form ... sent the signal that perhaps the United States was pulling away," Mr. Cohen said.

Shooting Down Japan's Plan

Japan tried take advantage of the situation. At annual meetings of the IMF and the World Bank last fall in Hong Kong, it proposed an "Asian Monetary Fund." While vague on details, Japan urged Asian countries -- pointedly excluding the U.S. to chip in as much as $100 billion in all to cope with regional crises.

The sum was immense, but Mr. Rubin and Mr. Summers feared the fund would offer big loans with less-stringent conditions than the IMF's and would threaten U.S. economic supremacy. Treasury officials worked the corridors of Hong Kong's convention center and the city's private dining rooms to slow the Japanese plan's momentum. China, South Korea and other nations suspicious of Tokyo's ambitions leaned toward the U.S.

Ultimately, the Treasury prevailed, though some both within and without the administration today wonder if the victory was pyrrhic.

Just before Thanksgiving, finance officials from the U.S., Japan, China and 11 other Asian countries gathered for two days in Manila, where the central bank was decorated with an electronic scoreboard that posted the nation's currency reserves. In drafting sessions and corridor conversations, Mr. Summers deftly put an end to Japan's Asia-centric proposal.

Its denouement was embarrassing for Tokyo. At one meeting, a Malaysian turned to Japan's Eisuke Sakakibara, vice finance minister for international affairs, and asked: "What happened to your proposal for $100 billion?" participants say.

Mr. Sakakibara's response: "If we could do anything, maybe we could do $3 billion."

A victorious Mr. Summers declared afterward, "U.S. economic leadership is crucial to avoid a descent into the kind of regionalism and protectionism that we saw in the periods between the first and second world wars." In a dig at Mr. Sakakibara, who is nicknamed "Mr. Yen," Mr. Summers privately referred to himself as "Dr. Dollar."

Jagdish Bhagwati, a professor at Columbia University, says, "the U.S. faced a dilemma: It wanted Japan to come in and put in real resources, but the U.S. didn't want to give up influence in the area."

The Treasury and the IMF still think the Asian Monetary Fund was a bad idea. But with IMF reserves running low and Congress so far unwilling to refuel the agency, the sharp U.S. reaction is questioned in some quarters. Humiliated by the U.S., Japan never again stepped forward to offer such heavy financial support. And to Asian eyes, the IMF looked, more than ever, like a pawn of U.S. interests. In the parlance of Vietnam, the Treasury had "Americanized" the crisis -- without either sufficient money or congressional support for the strategy.

IMF Medicine

Had Dr. Dollar and his allies produced a quick recovery in Asia, there would be little second-guessing. But they didn't. It's like less-than-successful chemotherapy: The side effects are miserable, the cancer is unconquered and the patient is questioning the doctor's competence.

In the face of such criticism, the Treasury and the IMF counsel patience. Officials observe often that conditions in Thailand and Korea, where new governments embraced IMF-backed reforms, appear to be improving. Conditions in Russia are worse, as are those in Indonesia, which for many months balked at IMF advice.

To bolster the point, administration officials circulate charts showing that trends in exchange rates, interest rates, trade balances and unemployment rates in Thailand and Korea track Mexico's at similar points after its late-1994 crisis. "If you take Thailand and Korea," Mr. Rubin says, "the situations are very substantially better than they would have been without their reform programs and the IMF."

But even early supporters of the Treasury-backed IMF approach are uneasy. Mr. Greenspan told Congress last week he thought the IMF had "misread the depth of some of the really fundamental problems that were involved in the crisis that evolved." He added: "I think their actions were somewhat misguided in the early stages."

Harsher critics say that the IMF made the same mistake President Hoover did when he tried to balance the budget in the face of the Great Depression -- that it forced painfully high interest rates in an unnecessary effort to lift Asian currencies and that it encouraged counterproductive currency devaluations.

Slashing Subsidies

In pushing for budget cuts, the IMF was misled by its own optimistic assumptions. Incorrectly forecasting only mild downturns in Asia, the IMF demanded that governments reduce spending to offset the expense of restructuring banks. That pulled money out of economies that, in retrospect, needed more, not less, government spending; it was like siphoning gasoline out of a truck already low on fuel.

Mr. Rubin now concedes it was an error. "I think they may have been somewhat more stringent than they should have been." But he and Mr. Fischer say the IMF called for easier government budgets as the crisis intensified.

The human cost was greatest in Indonesia, where the IMF insisted on curtailment of fuel and cooking-oil subsidies. It reasoned that the subsidies required to keep prices from rising were growing rapidly as the falling rupiah pushed up import costs, threatening hyperinflation. Indonesia dithered for months, but in May it abruptly cut subsidies and pushed up gasoline prices by 71%, bus fares by 67% and kerosene and cooking oil by 25%. That sparked riots in which hundreds died, and eventually led to Mr. Suharto's resignation.

IMF officials are unrepentant. They note that they didn't demand overnight price increases and that Indonesia didn't take some IMF suggestions -- such as offsetting the effects of fuel prices on bus fares -- that would have protected the poor. "When a government wants to go in a certain way, especially in cutting subsidies, there is a moment when we must accede to what they want to do," Mr. Camdessus says.

But some U.S. officials are haunted by the deaths, and wonder privately if violence might have been avoided had the subsidy cuts been handled differently, perhaps delayed till students were home on vacation.

Few issues are as hotly debated as the currency devaluations that accompanied the problems in Thailand, Indonesia and Korea. To the IMF and Treasury, devaluations are a consequence, not a cause, of failed economic policies. When Mexico or Thailand or Korea ran out of dollars to support their currencies against the assault of the merciless markets, they had no choice but to let the currencies go down. But in each case, the devaluations were far deeper than Washington anticipated.

To a set of conservatives who are influential with congressional Republicans, devaluations are a cause of the problem. They blame the IMF for encouraging such moves, saying that countries, such as Argentina, that firmly and credibly declare they won't devalue are more likely to withstand market attacks.

The Interest-Rate Cure

Neither the Treasury nor the IMF expresses misgivings about advising high interest rates, even to countries that are as bad off as Thailand, Indonesia and Korea. Tight money is the classic prescription for countries that need to support a weak currency, since higher rates generally draw domestic and foreign investors.

But at the World Bank, chief economist Joseph Stiglitz is honing a critique, presented in detail at a recent Brookings Institution seminar, that high interest rates in Asia did more harm to highly leveraged businesses than good in terms of boosting exchange rates.

And Jeffrey Sachs, the Harvard economist who worked closely with the IMF in Eastern Europe and now counsels developing countries to look elsewhere for advice, argues that high rates spooked investors. "The IMF and the U.S. thought the orthodox approach would calm markets and the high-profile approach would instill confidence, and they didn't," he says. "They set off a first-class financial panic."

Mr. Summers and Mr. Fischer, who note that Thai and Korean interest rates have fallen from their peaks, have little patience with these arguments. They say critics don't acknowledge the likely consequence of holding down interest rates: even deeper and more destabilizing devaluations than occurred. "All the caterwauling about a low-interest-rate approach basically keeps avoiding the hard question: 'Why not call it the big-devaluation approach?' " he snaps.

Perhaps the most glaring flaw in the initial U.S.-IMF response was a reluctance to help Asian banks and corporations get out from under debts they would never be able to pay.

In large measure, the issue was ideological: The IMF and Treasury have long helped governments cut deals with their lenders, but have been reluctant to interfere in private debts, such as Indonesian corporate debt or Korean bank borrowing from foreign banks. Indonesian companies, most them near bankruptcy because they had borrowed so heavily in dollars, got sympathy but little else from Washington. Borrowers should negotiate with creditors, the U.S. and IMF said.

All that changed just before Christmas. In early December, the IMF and U.S. assembled a $58 billion rescue package for South Korea that didn't succeed. To their surprise, much of the money they put in immediately flowed out to pay Korean banks' debts to foreign banks. But Korea's foreign-exchange reserves were nearly gone; without them, Korean banks would be forced to renege on their debts. If that happened, the consequences for other indebted countries would be calamitous, Mr. Rubin feared.

Restructuring Debts

As Korea's plight worsened, Mr. Rubin and Mr. Greenspan tossed ideas back and forth with top aides during a long dinner and, later, in a four-hour telephone conference call. Repeatedly, according to other participants, Mr. Rubin said there was no solution to Korea's crisis unless U.S. and other foreign banks agreed to delays on loans that were coming due.

The Japanese, worried about the health of their banks already, were resistant. "Japan would sooner put in aid money and have their banks made whole," says David Folkerts-Landau, a top IMF economist at the time of the Thai crisis who is now at Deutsche Bank AG. The Germans vacillated. The proud Koreans, horrified at being seen as deadbeats, were reluctant, but also determined to cut the best deal possible.

The Treasury, the Fed and the IMF joined forces to put pressure on the international banks, summoning top bankers to a meeting at the Federal Reserve Bank of New York to underscore the urgency. The banks first agreed to extend Korean banks' loans temporarily, then in laborious negotiations agreed to new terms. Default was averted.

Mr. Rubin sees the pact as a model for the future: a kind of orderly and voluntary international bankruptcy reorganization in which private creditors pay a price for having risked money, but the debtor still has to pay most of what it borrowed eventually. With much of corporate Indonesia, Thailand and Korea essentially bankrupt, the Treasury is speeding work on one of the "new ideas" it offered Mr. Clinton on Labor Day: finding a way to get banks to accept equity in exchange for forgiving loans to corporate borrowers.

But why did it take so long to do what, in hindsight, seems obvious? "There was risk in this," Mr. Rubin says. "If the world views this as having been a coerced restructuring, which it was not ..., the banks could have felt, 'They may force us elsewhere. Let's pull out of other places.' "

And then there were tactical considerations. Korea was down to about $5 billion in international reserves and using about $1 billion a day, he recalls. "Unless you were looking down the gun barrel, I think it might have been difficult to get people to focus with sufficient seriousness and speed on the need to work out some kind of voluntary arrangement."

How to Handle Suharto?

If the U.S. team was well stocked with economic talent, it was short on people who could navigate the intricate politics of Indonesia, Japan and Russia. "For the most part, our economic sense of these things has been pretty good -- in fact, very good," Mr. Rubin says. But "it's very hard to figure out how the politics in some other country are going to work."

In Indonesia, the issue was whether to try to cajole Mr. Suharto into embracing economic reforms or to seek a replacement who would be more to U.S. liking. The Treasury and IMF saw Mr. Suharto, the aging dictator whom they had once celebrated for bringing millions of his people out of poverty, as an obstacle to restoring financial-market confidence in the country. Mr. Summers came away from a January meeting with him discouraged.

The State and Defense departments saw no clear Suharto successor -- a contrast to Philippines in 1986, where popular Corazon Aquino replaced Ferdinand Marcos -- and worried about disintegration and bloodshed in the world's fourth-most-populous nation should Mr. Suharto be forced out.

If the U.S. had recognized Mr. Suharto's weaknesses earlier, says Sandra Kristoff, a hard-boiled, chain-smoking, Asia hand on the National Security Council at the time, "there would have been earlier and more-public debate on the kinds of political steps that had to accompany economic reform." Because the Indonesian people had no voice in politics, they refused to accept economic sacrifice, she says. "Everybody missed that in the administration -- except for a few."

The issue came to a head in January and February, when the White House staff was preparing Mr. Clinton for telephone calls to put pressure on Mr. Suharto to get with the IMF program. The rupiah was in free fall. A Suharto son, defying the IMF, had opened a new bank on the site of his old one closed at IMF insistence.

In White House meetings, the question was whether and, if so how, to distance Mr. Clinton from Mr. Suharto. White House aides James Steinberg and Daniel Tarullo feared the president would be embarrassed unless he was strict with Mr. Suharto, both publicly and privately. State and Defense urged caution: Concentrate on the economic reforms, they said; don't push for political change. Pentagon strategists concluded that the best outcome if Mr. Suharto went was military dictatorship, and the worst was a bloody civil war. Neither was appealing.

Influenced by its Embassy in Jakarta, the State Department urged Mr. Clinton to avoid anything that looked like a U.S. plan to depose Mr. Suharto. The Treasury wanted to push for both economic and political reforms, but -- in a rare setback -- found itself overruled by those with more political expertise.

But by March, when Mr. Clinton dispatched former Vice President Walter Mondale in another attempt to turn Mr. Suharto, the U.S. had decided to press for both political and economic change. It was too late. Mr. Mondale's hour-long meeting was a failure, as he had warned the White House it would be.

"I came back with a pessimistic report," Mr. Mondale says. Mr. Suharto "felt he was being victimized. He gave a long speech about how well he had done in the past." What the IMF and the U.S. sought, Mr. Suharto asserted, was "suicide."

The Russia Question

With much of Asia ailing, the administration hoped to prevent Russia from succumbing as well. Overlaid on problems similar to those battering Asia -- too much short-term debt and too little hard currency to pay it -- was the risk of political chaos in a nation still armed with thousands of nuclear weapons.

But how to help? Mr. Rubin and Mr. Summers tried two opposite approaches over the spring and summer. First, they supported pumping more money into Russia; then they agreed to cut Russia off. Neither tactic succeeded.

At the end of May, President Clinton surprised IMF negotiators in Moscow by issuing a statement, at Treasury's urging, endorsing a bigger loan for Russia than the IMF team was negotiating. Mr. Fischer sided with the U.S., arguing that the billions of dollars could prevent Russia's economy from imploding and the global financial crisis from spreading to Latin America.

But some top IMF staffers thought putting more money into Russia was a waste. "I've had deep concerns about how we proceed in the Russian case," says Michael Mussa, the IMF's chief economist, who nonetheless supported the larger loan as "a last-chance effort to avoid catastrophe." During a closed-door meeting months later at the Institute for International Economics, a Washington think tank, Mr. Mussa branded the Russian government a "bunch of criminals" that didn't deserve further aid, according to several witnesses.

The $22.6 billion loan package -- three times as large as the one the IMF first offered -- was a flop. The first installment of $4.8 billion didn't bolster confidence in the ruble, but merely helped those seeking to convert rubles into dollars. The Russian central bank spent nearly all the IMF money bankrolling capital flight.

Russia appealed for more money, but this time the U.S. balked. At a mid-August meeting in the White House situation room, Treasury officials batted down a suggestion from Stuart Eizenstat, undersecretary of state for economic affairs, that the U.S. put together an additional $15 billion lifeline for Russia to give it more time to make economic reforms. That would be throwing good money after bad, Treasury hands argued, and would weaken support on Capitol Hill for added U.S. funding of the IMF.

In a series of conference calls among officials from the U.S., the IMF, Germany and other countries, the IMF warned that failing to bail out Russia could lead to a disruptive devaluation, a default on Russia's foreign debt or both. But the IMF had committed about $26 billion of its own money to Russia since 1992, and Mr. Fischer thought it imprudent for his agency to spend any more. And the industrialized nations -- including Germany, whose support was essential for building consensus in Europe -- were unwilling to put up money.

Mr. Fischer was bitter; he thought more money from them might have bought Russia time to right itself. In an unusual display of public anger against a major stockholder, he told a German newspaper: "I'm not sure whether Chancellor Helmut Kohl wouldn't have acted differently if elections were two years away and not six weeks."

Russia's default on Aug. 17 sent a message to investors world-wide that the rules had changed. The IMF couldn't be counted on any longer for a bailout. Investments as far away as Buenos Aires suddenly seemed riskier, and Latin American stock markets and currencies dived.

"It's a great time," says former Vice President Mondale, "to realize humility about the capacity of even the United States to influence events in a swift and decisive way."