

economic downturn to recovery. This is a situation that requires rectifying since, naturally, in all of the countries affected by the financial crisis in East Asia, for both governments and citizens alike, this is not only a true story that we have experienced, but also an invaluable lesson for us to bear in mind for the future.

In the introductory chapter of this volume, first of all, we examine the importance of the issue of the East Asian financial crisis from an historical perspective. From the very first signs of the financial crisis, there have been many arguments regarding the causes; we go on to review the various explanations provided, presenting a model used to explore the root causes of the crisis. We also talk about the role of the government in facing the challenge of the financial crisis and the function of the IMF's rescue program. Since many signs indicate that East Asia is gradually recovering from crisis, we would like to explore its reasons. Finally, we explain the purpose and the structure of this volume.

2. THE IMPORTANCE OF THE ISSUE: THE FINANCIAL CRISIS IN EAST ASIA

During the twentieth century, there have been two major financial crises that have struck on an international scale. The first of these occurred during the period 1929–30, mainly affecting the developed nations on both sides of the North Atlantic, while the second crisis, which struck in 1997 and persisted until 1999, was experienced mainly by the newly emerging economies in East Asia. The important lesson learned from the first financial crisis was the need to construct much more sound financial systems within these developed countries and recognition of the requirement for separation of the business of banks, from dealings in stocks and insurance. The banking system was considered a key financial institution, which, above all, must maintain its independence and soundness so as to protect depositors. It was therefore imperative that the banking system was in a position to be able to avoid the impact of the inherent risks involved in stock market and insurance transactions. The by-product of the 'great depression', which resulted from

the first of these financial crises, was J. M. Keynes' "The General Theory of Employment, Interest and Money" (1936), which dominated mainstream economic thought for around four decades. Even now, many governments still prefer to pursue Keynesian fiscal policy to stimulate their sluggish economies.

The two major financial crises have some similarities. Prior to the 1930s, most western nations lacked any form of sound financial system. In the aftermath of the crisis, these countries embarked upon various programs aimed at setting up much more sound financial systems, which would have the capability of meeting various challenges. Therefore, these countries were in a position to withstand the contagion from the second, recent financial crisis in East Asia. Similarly, this second crisis also occurred in countries where financial institutions were still in an embryonic state. When this crisis struck, sweeping quickly across all the newly emerging economies in East Asia, none of these countries were in any position to avoid the contagion.

In short, the first financial crisis forced the developed countries to strengthen their financial systems to create effective barriers against any future potential crisis. As for the recent crisis in East Asia, whether or not strengthening the financial institutions of the newly emerging economies will prove similarly beneficial, depends largely upon the attitude, and subsequent actions, of the various governments. And whether this will also bring about the emergence of a new economic paradigm will depend mainly upon the wisdom of today's economists.

For us, the importance of the Asian financial crisis lies in the lessons we can learn on how to eliminate internal causes and how to avoid external impacts. The former is usually the rootstock of any financial crisis, whilst the latter tends to be the catalyst in bringing about financial crisis. Sound economic fundamentals can clearly help to reduce the potential of future financial crises, but they cannot completely remove the possibility of contagion from any regional financial crises which, theoretically, are transmitted through trade and capital flows, but which, practically, are transmitted by highly modernized communication instruments, such as television, the Internet, and so on. Nevertheless, the means of entry for any regional financial crisis is a country's foreign exchange and stock markets.

During the 1990s, it seems clear that financial economy has gradually become the predominant consideration in the mainstream of the world economy. As a result of general economic liberalization and internationalization, controls on capital movement and non-tariff barriers to trade have both been greatly reduced. This move towards free capital movement and trade transfers results in all the countries within a region becoming closely related and reliant upon each other, thus, a financial crisis in one country can quickly spread to neighboring countries. Furthermore, capital flow and trade flow, are also closely linked together.

It should be noted that as a result of the liberalization of capital movement, international funds have formed a powerful stream, exerting great influence over a country's exchange and stock markets. In any country where the market was comparatively small, the international funds would have the potential for dominance and control of its stock market. When huge amounts of capital flowed in, stock prices would soar; when capital of such magnitude flowed out, the stock market would collapse, virtually overnight. This phenomenon has led to the question: what kind of financial mechanism for an individual country would be able to face the challenge of a financial crisis? Needless to say, so far, no definite answer has been provided. This is why many governments still prefer to maintain some measure of control over their capital movement, and tend to be somewhat reluctant to open up their capital account completely.

However, since financial conditions have become more dynamic, more uncertain and more complicated than ever before, it has become necessary to consider the possibility of setting up a series of financial indicators that will reflect the signals of impending financial crisis, while providing a coherent approach for effectively preventing contagion from external financial crises.

3. VARIOUS EXPLANATIONS OF THE CAUSES OF THE FINANCIAL CRISIS

Since the 1960s, the four so-called 'Asian Dragons', Taiwan, Hong Kong, Singapore and Korea, have all achieved high economic growth, largely