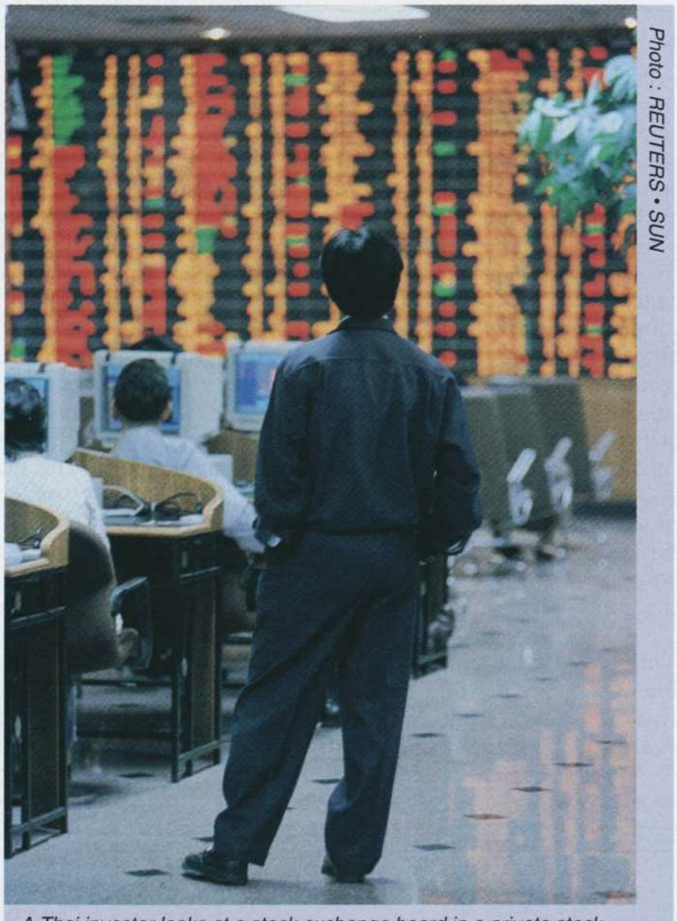
Lessons from the Asian Economic Crisis

By Kojima Akira

Three years have passed since the outbreak of the financial crisis that originated in Thailand and swept all of Asia. Active debates are taking place in Japan now on the real nature of the crisis and whether Asia's biggest economy properly dealt with it.

When the World Bank released a report titled *The East Asian Miracle: Economic growth and public policy* in October 1993, nobody foresaw the outbreak of the 1997 crisis. Companies in Japan and other industrialized countries actively invested in Asian countries and their investments in turn underpinned the Asian miracle right up to the brink of the crisis.



A Thai investor looks at a stock exchange board in a private stock trading room in Bangkok on August 5, 1997

Three years after the meltdown, the World Bank and the Japanese Finance Ministry launched a task force to jointly sum up the crisis and see what Asia would be like in the 21st century. It may be safe to assume that the passage of three years has enabled the two bodies to analyze the crisis in an objective way.

Looking back over the past three years, I am struck more by the drastic changes in experts' understanding of the crisis and the way they debate it than by the development and transition of the crisis itself.

For many years, the Asian economies remained stagnant, and pessimism prevailed over the region's economic future. The rapid economic development in Asia over the 20 to 30 years preceding the 1997 crisis exceeded the expectations of the world. As the phenomenal growth in Asia continued for such a long period of time, pessimistic views began to disappear in favor of an extremely optimistic outlook. This trend was symbolized by the World Bank report *The East Asian Miracle*. Investors throughout the world likewise revised their views.

Asia, previously viewed as a region with hardly any profit opportunities, emerged as a promising investment frontier. "Emerging economy" replaced "stagnant Asian economy" as a symbolic catchphrase. Asia was no longer unprofitable.

Against such a backdrop, money poured into Asia from all over the world, making the Asian miracle more dramatic and leading investors to believe that the region's meteoric growth would continue indefinitely. Asian countries gained self-confidence and held their own values in high esteem.

Suddenly in July 1997, Thailand devalued its currency and plunged into a serious economic crisis. At first, the crisis was considered confined to Thailand, where the economy was showing signs of a bubble on the back of overheating investment. But it spread to Indonesia in no time. The debacle was unforeseen by most commentators and came as a big shock, particularly to the World Bank, which had regarded Indonesia as a model for the developing economies and gave high marks to the country's economic management.

Indonesia was indeed a model as far as economic fundamentals, such as fiscal position and inflation, were concerned. But Indonesia's crisis was far more serious than Thailand's. The crisis then gripped South Korea toward the end of 1997 and spawned the new catchphrase "contagion," as the crisis infected countries as rapidly as a contagious disease.

The speed of the chain reaction across the region outpaced anybody's expectation. The crisis reached South Korea soon after it gained membership in the Organization of Economic Cooperation and Development, a club of advanced economies. It was therefore not limited to developing countries. But the victims of the crisis at this stage were all Asian countries, including South Korea, a nascent advanced country. Analysts and policymakers, particularly those in Western countries, took note of the fact that 1) the crisis was limited to Asian countries and was thus an Asian phenomenon, and 2) the crisis-hit Asian countries all lacked transparency in their disclosure of information on their corporate operations and tended to be self-centered in what amounted to crony capitalism. In their judgment, the crisis that had originated in Thailand was a crisis of Asia or a crisis of crony capitalism.

The case for crony capitalism is based on the understanding that the Asian economic crisis resulted from the basic economic and social structures of Asian countries and the crisis would continue unless the inherent problems of such structures were rectified. In other words, advocates of crony capitalism saw the crisis as a structural problem and expected it to continue over a long period.

But there was a discrepancy between their understanding and reality. The contagion, initially deemed limited to Asia, then struck Russia in August 1998, bringing the country to the verge of default. Amid the Russian crisis, Long-Term Capital Management (LTCM), a major American hedge fund, folded and share prices on Wall Street tumbled. It soon further spread to Latin America, and the International Monetary Fund (IMF) found in November it had to extend an emergency loan of more than 40 billion dollars to Brazil which bore the brunt of the Latin American turmoil.

Economists then began to argue that the contagion was no longer strictly an Asian phenomenon but a crisis of global capitalism.

Under such circumstances, the IMF embarked on studies of its own reform in the autumn of 1998. The IMF-centered international monetary mechanism was created half a century ago against the background of the structure and characteristics of the global economy at that time. The current global economy is radically different from what the IMF originally envisaged. The IMF was therefore unable to predict or prevent the crisis and to offer an adequate remedy.

At the height of the crisis, Malaysian Prime Minister Mahathir Mohamad named American investor George Soros, the symbolic figure of the hedge fund world, as the man who triggered the crisis. As a countermeasure, Mahathir clamped down on capital transactions in his country. Mahathir's action drew stinging criticism from Western policymakers and IMF officials who charged that the Malaysian leader was passing the buck of his economic mismanagement and that restrictions on capital dealings ran counter to the global economic trend of greater liberalization of capital.

Contrary to what the advocates of crony capitalism anticipated, the crisis-hit Asian economies rebounded sharply in 1999.

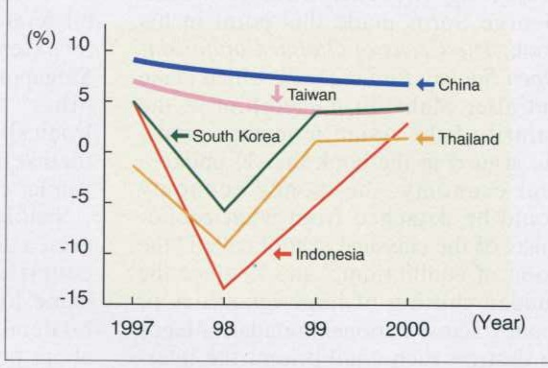
The three years of crisis produced various new economic theories but they were betrayed one after another by the rapidly changing reality.

What should we take to heart from the Asian crisis? What caused such big confusion in arguments on the crisis? At this point, we can point to several lessons we have learned.

Firstly, we confused problems of individual Asian countries, problems common to the region and problems related to the global economic structure.

Secondly, we learned that when a country introduces a new system, it must also build an infrastructure which enables the system to function properly. For example, when a country deregulates its financial system, it must establish a deposit insurance system and a system for monitoring financial institutions, and ensuring proper disclosure of information.

Economic Growth in Asian Countries

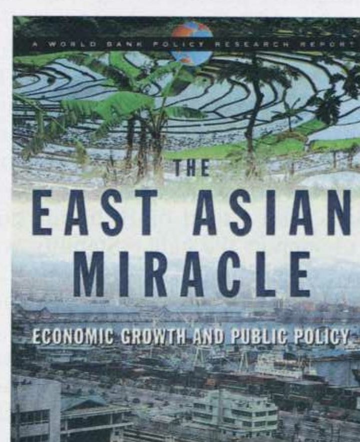


Notes: Figures in 1997 and 1998 represent actual performance. Figures in 1999 and 2000 are predictions by Nomura Research Institute Ltd.
Source: Mainichi Shimbun, 3rd July, 1999

The third point is that every country must properly manage its own macroeconomy, such as the continuity of monetary and financial policies and the maintenance of proper foreign exchange rates.

Fourthly, each country must see to it that it adopts at each stage of development a system adequate to the respective stage. There is no "one size fits all" system that is suitable for any stage of development.

Fifthly, functions of international currencies and the international finan-



The World Bank Report, The East Asian Miracle, Oxford University Press, 1993 cial system must be strengthened, including the IMF reform itself. George Soros made this point in his book, *The Crisis of Global Capitalism: Open Society Endangered,* which came out after Mahathir named him as the culprit of the Asian monetary crisis. He argued in the book that 1) unlike a real economy, the money economy could be detached from what economists of the classical school called "the point of equilibrium," and 2) since the sudden shifting of large quantities of money across national boundaries tends to destroy such equilibrium, the international transfer of capital, particularly short-term capital, must be regulated.

To avoid a repeat of the crisis, policymakers of Japan and some other Asian countries have advocated the establishment of a regional financial cooperation system in Asia. But as the issue is related to the division of power in each country, the argument is assuming a delicate political nature.

During the turmoil the region experienced in and after the summer of 1997, a heated exchange took place between Asian countries on one hand and Western countries, particularly the United States, and the IMF on the other, on the advisability of establishing an Asian Monetary Fund (AMF) as proposed by Japan.

Let us briefly review the process of the conflict.

Speculative attacks on the Thai currency intensified in early May 1997. On May 13 alone, more than 6 billion dollars worth of baht was sold. The next day Thailand and three Asian countries and one region (Singapore, Malaysia and Hong Kong) carried out concerted interventions in currency markets with a total of 10 billion dollars to support the baht. Stability was achieved and the Thai prime minister hosted a party at his official residence on May 16 to celebrate the success of the defense of the baht. But the tranquility was short-lived. Another massive wave of speculation struck the baht in July, forcing the Thai government to seek help from the IMF on July 29.

On August 5, the IMF approved a 17 billion dollar rescue package, including a 4 billion dollar credit line, as well as bilateral aid. Japan immediately agreed to extend 4 billion dollars. China, Singapore, Indonesia, South Korea and other Asian countries followed. Ironically, Indonesia and South Korea themselves would later be struck by similar crises.

Strikingly, the U.S. failed to spare even a dollar on a bilateral basis. Asian countries and regions that promptly came to the rescue of Thailand with bilateral aid then became enthusiastic about boosting mutual cooperation. It was against such a background that Japan proposed to Asian countries the concept of an AMF in mid-August 1997. The gestation of the AMF concept is vividly described by Sakakibara Eisuke, then vice finance minister for international affairs, in his book *Nihon to Sekai ga Furueta Hi: Saiba Shihonsyugi no Seiritsu (The Day Japan and the World Shivered: The Birth of Cyber-Capitalism),* published by Chuo Koron Shinsha in April 2000.

According to Sakakibara, Japan kicked off consultations with China, Hong Kong, South Korea, Australia, Indonesia, Malaysia, Singapore, Thailand and the Philippines on the establishment of a 100 billion dollar fund after learning that countries in the region were eager to build a financial cooperation system among themselves. Initially, Japan intended to realize the concept at a joint general meeting of the IMF and the World Bank scheduled for September 23-24 in Hong Kong.

As the IMF meeting approached, Sakakibara said, the U.S. launched a vigorous campaign to quash the AMF scheme. Late on the night of September 14, then U.S. Deputy Treasury Secretary Lawrence Summers (currently Treasury Secretary) called Sakakibara at his home, though it was Saturday, and criticized the AMF plan in a conversation that lasted as long as two hours. As a follow-up, Treasury Secretary Robert Rubin and Federal Reserve Board Chairman Alan Greenspan jointly sent a letter to the Japanese government, in which they outlined their opposition to Asia creating a financial support system of its own.

The U.S. argued that 1) Asia's establishment of its own financial support

Malaysian Prime Minister Mahathir Mohamad (left) named American investor George Soros (right) as the man who triggered the Asian crisis

Photos : REUTERS • SUN (left) AP/WWP (right) system would impair the function of the IMF, and 2) an Asian system, which would impose looser lending requirements (conditionality) than the IMF's, would cause a moral hazard in aid recipient countries. But such an argument was only for public consumption. The real U.S. intention was apparently to mount a counter-offensive against what it considered a challenge to its global hegemony. While admitting that he should have done more groundwork, Sakakibara says that the AMF concept was only an offshoot of an international meeting for supporting Thailand held in Tokyo on August 11, but Washington seemed to have taken the move as a Japanese challenge to the U.S. hegemony, and that, in a way, they unnecessarily hurt their pride.

Lawrence Summers (extreme right) and Sakakibara Eisuke shake hands after the meeting of deputy finance ministers of Southeast Asia and its partners on 19th November, 1997 in Manila

Sakakibara wrote the book as a memoir only six months after he retired from his Finance Ministry post. It seems to me that he wrote the memoir rather too early. But, given that exchanges held between governments regarding monetary and financial issues tend to be kept secret, Sakakibara can take credit for having offered valuable information. I recommend his book to anyone with an interest in the Asian financial crisis.

Though the AMF concept was shelved, arguments for creating a regional financial cooperation system in Asia persist.

An economist likened the IMF to a large hospital, which is incapable of offering adequate medical services to individuals. He/she argued that just as a home doctor could offer better routine medical services for individual patients, a regional financial system could function better than the IMF, and that Asia needed a regional financial cooperation framework like a home doctor.

Another economist said that since the real economies of many Asian countries are firmly integrated, it is natural, and necessary, for the region to create a system for managing the flow of funds to better cope with cyclical structures of the economy.

Another pointed to the importance of creating a regional financial cooperation system which complements the IMF. He/she said that in view of ongoing globalization, each country must impose thorough exchange controls or find a lender of last resort capable of providing unlimited amounts of money if it wants to be spared a sudden monetary crunch, and that the IMF could not be an ultimate lender, as its response to the Asian financial crisis indicated.

The U.S. can never act as a central bank for Asia. The U.S.-controlled IMF lacks funds. The IMF needs more capital if its function is to be strengthened, but the U.S. Congress tends to oppose such moves. Asian countries are boosting their economic strength and boast huge foreign exchange reserves. They have the will and ability to increase their contributions to the IMF. But a larger Asian stake in the IMF will lower the share of advanced countries. A change in the IMF subscription rate can be boiled down to a redistribution of power among member countries, because, unlike the United Nations, the IMF is something like a joint stock company and member countries with higher shares have stronger voices.

The Asian economic crisis should not be viewed as a mere Asian problem. The global economy is drastically changing amid the development of information technology and financial deregulation. The money economy or "cyber economy" is expanding quickly and its volatility is increasing and the Asian economies continue to grow, with the result that the world economy is now entirely different from what it was half a century ago when the IMF and the World Bank were inaugurated.

The most important challenge facing the world in the 21st century is to maintain an efficient international system capable of responding to these changes and to redistribute global power which is currently fixed and does not reflect reality. JJTI

Kojima Akira is a Managing Director and Editor-in-Chief of the Nihon Keizai Shimbun. He is also a Chairship Professor at the Graduate School of Business & Commerce, Keio University.