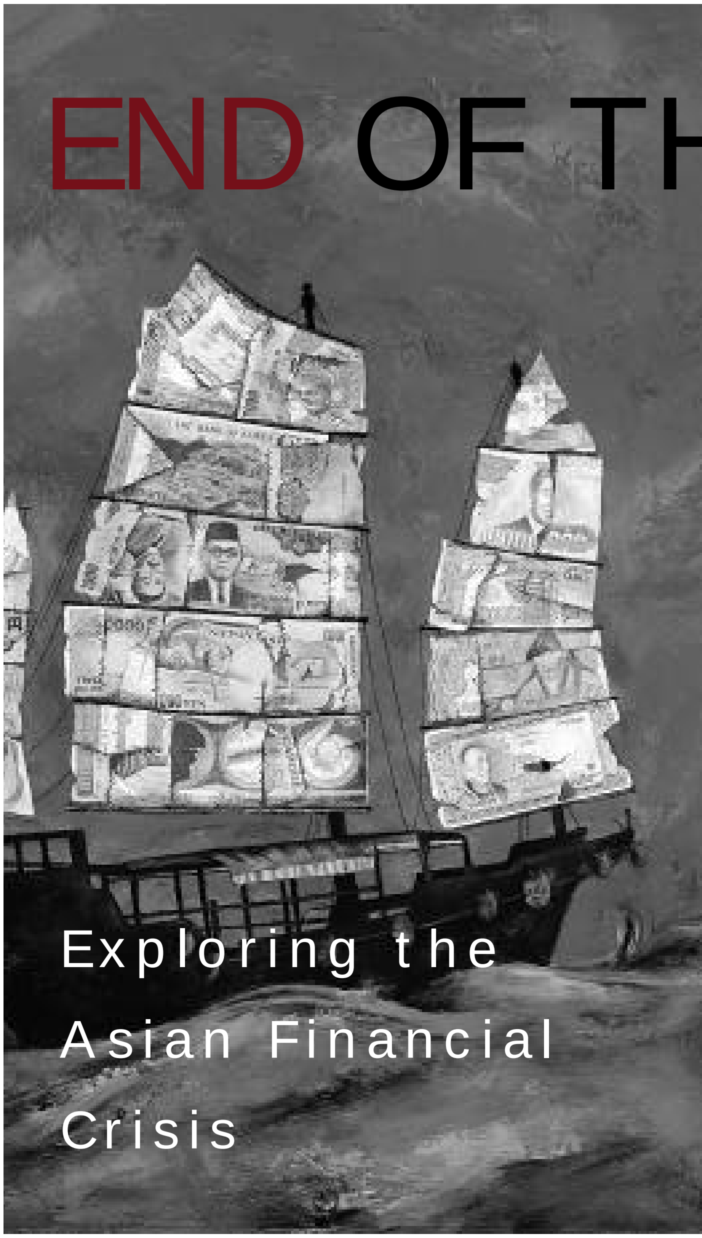
END OF THE MIRACLE

Exploring the Asian Financial Crisis



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Economists and political scientists spent considerable energy in the past decade explaining the Asian economic miracle—the ability of so many Asian countries to sustain high growth and industrial transformation. Until last year few gave much thought to problems or distortions in Asia's development process.

Last summer, the problems began bursting to the fore, starting with Thailand and reverberating across large portions of Asia. Now the need is to explain what went wrong and to analyze the many possible implications of the Asian financial crisis. This issue of the *Brookings Review* brings together a wide range of views on the causes, implications, and possible cures for Asian problems.

Much U.S. press commentary on the crisis in Asia has been tinged with relief; Asia turned out to be less of a challenge to Western neoclassical economic concepts than had been feared. But any analysis of Asia should begin with the recognition that the miracle was real. Over the past three decades, economic growth in many Asian economies has been high on a sustained basis, average standards of living have increased greatly, and the incidence of abject poverty has fallen rapidly. Heavy government intervention in markets through state-directed financial credit and regulation may have had flaws, but it produced an incredible period of sustained economic growth and industrial transformation. Now those societies must grapple with difficult questions of how much reform they must undertake to restore their nations to healthy economic growth and how much reform they can tolerate while remaining true to their broader social ideals. As Ambassador Walter Mondale eloquently points out, Asia matters greatly to us, and the nations of the region deserve our attention and assistance in their struggle to return to economic health.

Press coverage also tends to speak broadly about the Asian crisis, as though it were a single phenomenon. In reality, problems vary widely across the region. If a common thread weaves through most of Asia, it is a combination of weakly developed domestic banking systems exposed to deregulation of international capital flows. Many Asian countries have relied much more heavily on banking than on bond and stock markets to mediate the flow of financial resources. They have also lagged in developing credit risk analysis, either because of strong state guidance over commercial bank lending or because of a reliance on personal relationships rather than analysis. Permitting weak banking systems to borrow internationally in the 1990s—from sources not well informed about local problems—turned out to be a fatal flaw, as Brookings's Barry Bosworth explains.

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These problems were particularly acute in Southeast Asia, as detailed by Stephen Parker, chief economist for the Asia Foundation. Economies that were tending to overheat and lose international export competitiveness began borrowing heavily abroad. Most of the borrowing was private rather than government, and much was in the form of short-term bank borrowings, creating a volatile situation. Southeast Asian countries had only weakly developed control of private-sector banking systems, and governments proved poorly equipped to deal with the result. Thailand and Indonesia have turned to the International Monetary Fund because of the resulting acute international debt problems, but Malaysia, Singapore, and the Philippines have experienced some problems as well.

South Korea also had to turn to the IMF for aid. Problems there stemmed mainly from unrealistic expectations about manufacturing export growth—expectations that were shattered when depreciation of the Japanese yen after early 1995 made Japanese products more price competitive with Korean exports. Korea's international liquidity problem peaked last December, and newly elected President Kim Dae Jung now faces the problem of carrying out extensive economic reform.Yung Chul Park, of Korea University and the Korean Institute of Finance, analyzes the situation in Korea.

Some in Asia hope that Japan can help lead the region to recovery. But Japan has its own problems. Ever since the dramatic collapse of real estate and stock prices after 1990, it has struggled with economic stagnation, large amounts of bad debt, and a political system that seems unable to cope with the economic troubles. Japan, like other nations in the region, suffered from excessive reliance on a poorly developed banking system—though rather than borrowing from abroad, the banking system compounded its problems by lending abroad as unwisely as at home, becoming a major lender to other Asian countries. Japan's continued economic stagnation coupled with its own currency depreciation implies that it will not absorb rising imports from the rest of the region to underwrite their recovery strategies. Robert Feldman, chief economist for Morgan Stanley in Tokyo, discusses Japan's distressing long-term malaise.

What happens in Asia has serious implications for the United States. On the one hand, the decline in Asian currencies has helped curb U.S. inflation at a time when a prolonged economic expansion and low unemployment would normally unleash it. On the other hand, weakness across Asia depresses American exports while the fallen exchange rates are increasing American imports. But so far the interplay of these factors has not seriously affected U.S. economic growth, and even the widening trade deficit has as its flip side an increased inflow of capital that fuels investment and growth (explored further later in the issue by Robert Lawrence). If the United States has a problem, it is one of political leadership, evidenced in the debate in Congress over additional funding for the IMF. David Hale of the Zurich Group explores the effects, economic and political, of the Asian crisis on the United States.

One rather neglected issue is direct investment. Developing countries in Asia attracted foreign direct investment as part of their growth strategies. And though a key element in the Asian crisis was the flight of foreign capital, direct investment remains strong. Certainly foreign investors who entered to produce for the local market have been hurt by the economic downturn. But Asian countries are now even more actively competing to attract foreign investment in manufacturing to boost exports. With weak exchange rates, some Asian countries have become more attractive to multinationals seeking low-cost production bases. Dennis Encarnation of Harvard looks at direct investment across the region.

How does the plunge, in much of Asia, from stunning economic growth to stagnation or contraction affect regional security relations? Internal turmoil, especially in Indonesia, is one concern. Internationally, economic crisis increases the flow of migrant workers—pushing more workers to seek jobs abroad while simultaneously lowering government tolerance for an inflow of workers. Meanwhile, the crisis affects still-tense relations on the Korean peninsula and could affect great-power relations. Brookings's Mike Mochizuki considers this thicket of security issues.

Many Americans also worry about the rising U.S. deficit with Asia. High or rising bilateral or global trade and current account deficits have often been a hot political issue in the United States, and a possible deterioration of the U.S. current account deficit by $100 billion this year could reignite it. But Robert Lawrence, of Harvard and Brookings, argues that so long as the rising current account deficit (and reciprocal increase in net capital inflow from the rest of the world) finances increased investment in a growing U.S. economy, the rising deficit should not be a matter of concern.

Finally, the Asian financial crisis has spawned a vigorous debate in Washington over the role of the IMF. At the extremes, some conservatives oppose the IMF out of a generalized antipathy to all multilateral institutions, and some liberals want to encumber it with a strong social agenda. In the middle ground, debate focuses on appropriate policy responses to international financial crises. Some argue that the unanticipated political and economic costs arising from such crises make the IMF necessary in devising bailout plans to keep the pain in affected countries within tolerable bounds. Others argue that in an Asian-style crisis, in which most of the indebtedness was incurred by the private sector rather than by governments, any bailout raises serious moral hazard problems since risk and the acceptance of risky outcomes must be a central feature of capitalist markets. Representing this debate here are Robert Hormats, of Goldman, Sachs, and Co., Lawrence Lindsey, of the American Enterprise Institute, and Barry Bosworth of Brookings. The larger debate will go on for some time, but the likely outcome will be reform of the IMF, at least redefining its procedures (to make them more transparent) and possibly redefining its overall role.

As is obvious from this lineup of articles, the Asian financial crisis is a broad phenomenon. The most acute phase of currency crisis appears to have passed, but now the nations of the region must deal with the real economic consequences of what happened in 1997. The region will recover, but how rapidly remains unknown—and entails the many issues raised in this *Brookings Review*. ■