THE "ASIAN CONTAGION"

A Reader's Guide

By Peter Frost

The multiple economic crises that have swept over a number of countries in Asia in the 1990s—the "Asian Contagion" in Karl Jackson's apt phrase[1]—require all of us who teach in the area to do some serious rethinking. First to fall was the once mighty Japanese economy; there the stock market kicked off the new decade by falling about 50 percent, following which real estate prices tumbled, and banks were saddled with bad loans. Despite repeated rescue and pump priming packages, annual GDP (gross domestic product) growth rates plummeted to 1 percent or less a year. Even bigger crises occurred in South Korea and Thailand in 1997 when the collapse of several business ventures led to major devaluation of the currencies and the fall of the governments in both countries. In the coming months, complex, though clearly related, financial crises occurred in the once seemingly healthy economies of Indonesia, Korea and Malaysia. As neighboring nations were also affected to varying degrees, it became increasingly difficult to talk of the "Asian Economic Miracle" or the coming "Pacific Century."

Illustration by Stephen F. Hayes

Just how should we undertake this rethinking? While it is hardly easy to talk about events that are both ongoing and unclear, we fortunately have both a number of good print materials to help us get some background, and several Web sites that can keep us up to date. Before listing these, however, I thought it best to set down my own notes on the subject—a primer, if you will. These notes revolve around four key questions:

(1) Why is the once mighty Japan now mired in its longest postwar recession?

(2) What relation does this recession have to the various financial crises that have swept through much of the rest of Asia after 1997?

(3) Why have the rescue efforts been criticized?

(4) What lies ahead?

Since the answers to these questions are still being hotly debated, my main hope in what follows is to identify, rather than solve, the key elements in the (note the plural) Asian Financial Crises.

Illustration by Robin Jareaux

The Japanese Crisis

Since the Japanese recession occurred first, let's start with economic events in that country and then move to what happened after enormous amounts of international capital began to flow into the rest of Asia.

Divested of its colonies by defeat in war, blessed with a young, hard working and highly trained populace, able to take advantage of ideal world conditions, and guided by industrial policies geared toward growth, post-war Japan developed an economic system that involved a high degree of bureaucratic guidance over the economy, close linkages between banks and allied business firms, a relatively greater use of bank loans rather than stock issues, and strategies that placed less emphasis upon short-term profits than long-term market share. This "Plan Rational" system (the term is Chalmers Johnson's) helped make Japan's Gross Domestic Product (GDP) grow by an average 9.3 percent between 1956 and 1973. Even after the oil crisis raised energy prices and other nations began to complain about Japanese exports, the GDP grew by an average 4.1 percent from 1975 to 1991.[2]

While many Asian nations were so impressed by these statistics that they adopted roughly similar economic systems, the huge merchandise trade surpluses that Japan racked up as part of this growth also caused resentments throughout the world. In an attempt to cut down on these surpluses, the so-called G-7 (major industrialized nations) in the 1985 Plaza Agreement insisted that Japan agree to policies designed to raise the value of the yen. A stronger yen, they hoped, would help their trade deficits by making Japanese exports more expensive and G-7 imports into that country cheaper.

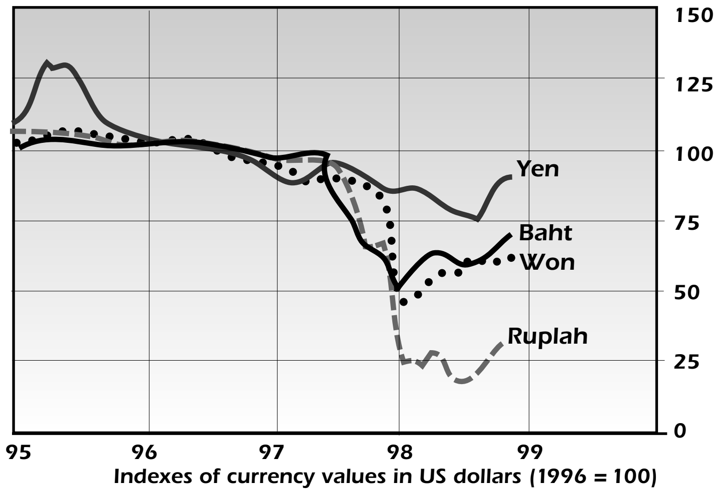
To prevent the value of the yen from rising too high and hence help keep Japan's economy growing, Japan's Ministry of Finance lowered bank interest rates and increased the money supply. Domestically, this led to a speculator's paradise, a rapid rise in the prices of stocks and real estate that is now known as the "bubble economy." Internationally, it led to a "hollowing out" or the investment of Japanese capital and the building of plants in other parts of Asia where labor rates were cheaper.

By 1990, Japan's economy was in trouble. As might have been expected (but wasn't), the wildly inflated "bubble" prices burst in 1990, causing Japan's once fabulous stock market to fall to about half its former value. Real estate (once four times the value of the U.S.) also tumbled, and hence Japan's overly ambitious banks were left holding an unspecified but undoubtedly large number of bad loans. As the slump dragged on, government rescue efforts pumped nowhere near enough money into the economy. Nor, as Richard Katz has pointed out, did Japan's fabled "Plan Rational" system appear able to change the basic economic system so that business could better respond to current needs. In short, for a variety of reasons, economic growth in Japan after 1991 slumped (with the exception of 1996) to 1 percent or less a year.[3]

Other Asian Crises

While all this was going on, both Japanese and Westerners were investing in Asia. Thanks largely to U.S. pressure to liberalize the international financial system, banks, pension fund managers, and a largely unregulated group of firms known as "hedge funds" began to move massive amounts of currency around the world.[4] New computer technologies also helped. Soon flows equivalent to 10 percent of the world's GDP or 50 percent of the U.S. GDP were being traded each day. In the process, capital investment in Asia more than tripled from $110 billion in 1990 to $390 billion in 1997. Roughly two-thirds of that money consisted of short-term loans due in one year or less.[5]

Initially, these investments brought prosperity to Asia. Impressed by Japan's growth, a number of non-Communist countries set similar policies that emphasized bureaucratic guidance over the economy, a relatively greater use of bank loans than stocks to raise



Courtesy of The Bank of Hawaii, Hawaii 1998, Annual Economic Report, volume 47, page 9.

capital and projects designed to encourage educated and eager workers to move into specifically targeted industries. Many of these firms produced export goods that were estimated to be responsible for anywhere from 20 to 40 percent of the area's growth. As these economies grew, the number of Asians said to be earning less than a dollar a day dropped from 60 percent of the population in 1975 to 20 percent in 1995.[6] Commentators were now talking enthusiastically about the superiority of "Confucian Capitalism."

Not all of this capital, however, was invested wisely. While Communist states generally restricted foreign capital investments, and officials in places like Taiwan and Singapore had more experience in international finance, other Asian states were unable to deal effectively with the influx of capital. Too often, banks were badly regulated, and there were only minimal requirements to report their transactions publicly. Loans were made to friends of the government and/or energy, aerospace, infrastructure, real estate and construction projects for which there was as yet no market. As short-term debts piled up on overvalued investments, more and more exports were needed to keep further loans coming.

Meanwhile in China, a new emphasis upon industrial growth and a 1994 decision to devalue the *renminbi* by some 40 percent against the U.S. dollar helped it compete far more effectively with the rest of Asia for export markets. Conversely, even though a strong American economy—and hence a strong dollar—helped Southeast Asian exports to the United States, the dollar price of imports (many of which were essential for Southeast Asian exports) were now more expensive. Thus, just when many Asian countries needed more and more exports to keep financing their many short-term loans, the Japanese were unable to buy as many goods or provide as much capital, China was cutting its prices, and the rise in the dollar brought only mixed blessings. As might be expected in such troubled times, exports stopped growing.

As export growth leveled off, investors began to worry about the ability of various countries to handle their increasing government budget and "current account" (foreign trade and investment) deficits. If these accounts were not doing well, they reasoned, governments might have to devalue their currency. Foreign loans would then become harder to repay, investments would yield little or no return, and speculators would incur massive losses in the value of any of their locally held currencies. Despite vigorous efforts by local government authorities to maintain their currencies, these speculators, as they had earlier in Mexico, began to withdraw their money. Often they did this simply by refusing to renew their many short-term loans.

As works such as those listed below by Karl Jackson and K. S. Jomo attempt to make clear, a series of complex, independent and yet related crises now took place. By January 1998, South Korea's currency collapsed (see chart) after some of its big industrial complexes (*chaebol*) went bankrupt. On July 2, 1997, Thailand, stung by the failure of real estate ventures, gave up trying to protect its currency, and the value of the *baht* dropped by about half. As Indonesia and the Philippines got into trouble, new governments were formed. Malaysia's Prime Minister Mahatir Mohammed blasted international financiers in nasty, even anti-Semitic terms, arrested his chief rival, and imposed currency controls. Taiwan devalued its currency (perhaps to embarrass the mainland), and Beijing's new Hong Kong stock market went down. Even China, after expecting that its socialist government would protect the nation from the slings and arrows of international finance, became concerned lest the relatively large and growing number of unemployed link up with intellectuals; dissidents began to go back to jail, and criticisms were deflected towards issues such as the U.S. bombing of a Chinese embassy in Belgrade, Yugoslavia.[7]

Illustration by Jonathan Evans

Rescue Efforts

Enter the World Bank's International Monetary Fund (IMF). Whereas its largest previous loan had been a $4 billion dollar bailout of Great Britain, both the 1995 Mexico crisis (where the IMF supported a $52 billion multilateral loan package) and this one (where the rescue package topped $95 billion) were enormous.[8] The IMF made this money available on condition that the countries involved improve their banking procedures, a move that almost everyone applauded. More controversial were requirements that governments borrowing IMF funds sharply reduce their national deficits by cutting back on government expenditures. Critics argued that these rather standard anti-inflation measures only prolonged the depression caused by the various crises.

Conversely, others worried that the IMF was creating a "moral hazard" by offering to rescue countries that do not properly manage their own affairs. Some even wanted to make rescue money dependent upon U.S. definitions of human rights and population control. As the various Asian countries slowly began to rebuild their fiscal systems and fiscal crises moved on to other areas of the world, articles on the IMF Web site (listed below) argued that its Asian policies were both prudent and slowly beginning to work.

What's Next

While it is obviously foolish to predict the future of crises that are both ongoing and often made worse by irrational investor panic, the above narrative suggests six factors that will surely affect the future.

The first of these is obviously the extraordinary power of international investors and financiers to move money around the world. The Asian financial crises are hardly just "Asian," but rather represent an unhappy collision between new, largely unregulated, and highly volatile international capital markets on the one hand, and badly prepared local financial systems on the other. Hence one key to controlling these sorts of crises will involve figuring out how to prevent large amounts of highly speculative foreign money from suddenly leaving a country without discouraging badly needed investments. Particularly if Malaysia's regulations show that this is possible, we can expect more controls.

The flip side of this argument, of course, is that the borrowers also need better controls. In Japan, companies found it too easy to borrow too much money using badly overvalued assets as collateral; similarly, stocks during the "bubble economy" soared to unrealistic levels that were way above annual earnings. As in the rest of Asia, better training in risk analysis, more transparent auditing procedures, and a generally far greater amount of public information is needed. While IMF requirements and a desire to avoid new disasters will no doubt encourage various Asian countries to implement some of these badly needed reforms, they will also present serious challenges to the financial power of traditional elites. There may well be changes, but they will not be easily imposed. The best progress will probably be made in countries that have the strongest democratic traditions, and hence the most respect for the rule of law.

The International Monetary Fund will also play a major role. As the United States is one of the biggest contributors to the fund, how the U.S. Congress reacts to the various criticisms of the IMF stated above will obviously have a big impact on that institution's ability to help.

A resumption of growth in Japan is another key part of the puzzle. Over the past few years, a series of Japanese governments have tried to pump more money into public works projects, in the process changing Japan's 1991 budget surplus of 3 percent of the GDP into a 1996 deficit of 4 percent. "Big Bang" proposals announced in 1996 have promised to speed up growth by reducing government interference in the economy, and tax cuts and bank rescue plans are being implemented. Japan thus recognizes the need for action, but has also to worry about saving enough money so that it can have adequate pension and health care for its rapidly aging society. This conflict between deficit spenders and savers is compounded by a relatively weak political system and by bureaucrats who are worried about the future and hence committed to financial austerity. The resulting delays in Japan's and perhaps Korea's structural reforms, some argue, make it all the harder for the rest of Asia to recover from crises that are more financial in nature.[9]

Much will also depend on the actions of what C. Fred Bergsten calls the "strong center" economies of China, Hong Kong, Singapore and Taiwan. As noted, China's 1994 devaluation of its currency helped trigger the current crisis. Taiwan's subsequent decision to devalue its currency may have been deliberately designed, Bergsten suggests, to embarrass China by hurting the Hong Kong economy, but its net effect was to further a sense of panic among Asians and to worsen the effect of the bank failures in Korea.[10] Hence, even countries with relatively well-regulated financial systems and economies strong enough to help the rest of Asia recover may also worsen the situation by succumbing to competitive economic and political pressures.

Given the new global economy, other parts of the world will clearly have an impact. The largely unrelated crisis in Russia occurred after the initial collapse of Thailand's currency, for example, but it clearly made a bad situation worse. Similarly, the crisis in Brazil that started in the fall and winter of 1998–99 both reflected investor panic after the Asian crisis, and lowered chances of a quick recovery in Asia. Europe's relatively strong economies at present can also help it play its part in the recovery. Predictions here are made all the more difficult by the fact that all too often, government actions and investor behavior cannot be subjected to a rational analysis.

Finally, we Americans will play a key role. Recently our relatively high growth rate has increased consumer demand for Asian goods just when our strong dollar has made these goods relatively inexpensive; conversely, slow or negative growth in their countries and the strong dollar have made it hard for Asians to buy what we have to sell. As a result, American exports to Asia have already started to decrease at least relative to imports from Asia. If the merchandise trade deficit gets bigger, there will inevitably be cries to protect American labor, and proposals to shut down imports from Asia. Yet these imports, as noted, are crucial to the revival of many Asian economies.

The various Asian financial crises are thus at least indirectly related. Both the Japanese and the various Asian crises call for the rethinking of long-standing, interlocked fiscal and business systems. Both have been profoundly affected by the enormous amount of largely unregulated capital that now flows around the world, and prolonged by tepid and, some would argue overly deflationary countermeasures. Putting all this together is surely difficult, and yet it is not impossible. Given the sources listed below, we who teach in the field should at least be able to tell our students that just as a healthy Asia is essential to our own economy, so we too are part of the "Asian Contagion." ■

. . . WE TOO ARE PART OF THE "ASIAN CONTAGION."

NOTES

1. Karl D. Jackson, ed., *Asian Contagion: The Causes and Consequences of a Financial Crisis* (Boulder, Colorado: Westview Press, 1999).
2. Richard Katz, *Japan, The System That Soured: The Rise and Fall of the Japanese Economic Miracle*. New York: M. E. Sharpe, 1998. See also the Chalmers Johnson references.
3. The Posen and Katz references spell out these issues in greater detail.
4. "Hedge Funds" are difficult to define. See Leon Levy and Jeff Madrick, "Hedge Fund Mysteries," *New York Review of Books*, XLV no. 20, December 17, 1998.
5. *U.S. News and World Report*, September 20, 1998, 51; Barry Bosworth, "The Asian Financial Crisis," in *The Brookings Review*, Summer 1998, 8.
6. Joseph Stiglitz, Senior Vice President and Chief Economist, The World Bank. "Road to Recovery," *Asiaweek*, July 17, 1998. Web site: www.pathfinder.com/asiaweek.
7. The *Asiaweek* Web site: www.pathfinder.com/asiaweek has a useful chronology. China's role is stressed by C. Fred Bergsten's testimony before the Committee on Banking and Services, U.S. House of Representatives, November 13, 1997. I have taken this from the Institute of International Economics Web site listed below.
8. *The Brookings Review* is one of several sources for IMF figures.
9. The Posen and Katz references spell out these issues in greater detail.
10. See endnote 4.

Illustration by Stephen F. Hayes

REFERENCES

Asher, David. "What Became of the Japanese Miracle?" *Orbis*, Spring 1996. This excellent analysis of Japan's current troubles should be read in conjunction with the harsh rebuttal in Chalmers Johnson, "Japan's 'Miracle' Economy," *Orbis*, Summer 1996.

Asiaweek, June 17, 1997. Used here primarily for its chronology; the articles are interesting but sketchier than other sources. Updated materials available on the Web at www.pathfinder.com/asiaweek.

Brookings Review, Summer 1998. This is the official publication of the Brookings Institute, 1775 Massachusetts Avenue NW., Washington, D.C. 20036. It features clearly written, nontechnical explanations of the crisis by many of the leading U.S. experts.

Goldstein, Morris. *The Asian Financial Crisis: Causes*, *Cures and Systemic Implications*. Washington, D.C.: Institute for International Economics, 1998. A major source, but it sometimes uses jargon and technical terms.

Henderson, Callum. *Asia Falling: Making Sense of the Asian Currency Crisis and Its Aftermath*. New York: McGraw Hill, 1998. Written by a financial analyst.

Institute for International Economics, the Web site, www.iie.com, has lots of updated and nontechnical information.

International Monetary Fund Web site: www.imf.com.

Jackson, Carl D., editor. *Asian Contagion*: *The Causes and Consequences of a Financial Crisis*. Westview: New York, 1999. Intelligent essays by leading experts.

Johnson, Chalmers. *MITI and the Japanese Miracle*: *The Growth of Industrial Policy, 1925–1975*. Stanford: Stanford University Press, 1982. Johnson develops his notion of a "plan rational" or "developmental state" in this classic scholarly work. He has restated his thesis more simply in a number of articles and letters (see Asher, above) and in *Japan*, *Who Governs? The Rise of the Developmental State*. New York, W. W. Norton, 1995.

Jomo, K. S. *Tigers in Trouble*: *Financial Governance*, *Liberalization and Crises in East Asia*. London: Zed Books, 1998. An interesting book critical of liberal market solutions.

Katz, Richard. *Japan*, *The System That Soured*: *The Rise and Fall of the Japanese Economic Miracle*. New York: M. E. Sharpe, 1998. Written for the general reader, this stimulating work argues that the heavily bureaucratic planning that originally helped Japan's economic growth now holds it back.

Krugman, Paul. "What Happened to Asia?" www.mit.edu/krugman/DISENTER.html. The Web site should be checked for other materials; Krugman regularly writes on the world economy.

Levy, Leon and Jeff Madrick. "Hedge Fund Mysteries," *New York Review of Books*, XLV no. 20, December 17, 1998. A nice, short interview with a major investor. See George Soros, below.

Posen, Adam. *Restoring Japan's Economic Growth*. Washington D.C.: Institute for International Economics, 1998. This book blames Japan's problems on poor policy, and hence serves as a counter to Katz. It unfortunately requires a good knowledge of economics to be fully effective.

Roubini, Nouriel. Materials and commentary by the New York University professor can be found at www.stern.nyu.edu/~nroubini/asia/Asia.Homepage.html.

Soros, George and Jeff Madrick. "Behind the Financial Crisis," *New York Review of Books*, LXVI no.1, January 14, 1999. While less useful than the Levy interview cited above, Soros is a major financier whose views should be read. Note that he has written a book, *The Crisis of Global Capitalism*: *Open Society Endangered*. New York: BBS Publications, 1998.

World Bank, the Web site www.worldbank.org clearly states this organization's point of view.

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