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I would like to add my own welcome to you all, and my own thanks to Fidelity for its partnership in presenting this conference.

The View from 1989

What a difference a few years make! Ten years ago, Asia appeared unstoppable. We were on the verge of the Pacific century. Now Asia has suffered a severe set-back and the US by most criteria is the best-performing of the world’s major economies. There is always the danger that Pride goes before a Fall, in this case the pride of American triumphalism.¹ But recent events hold important lessons, lessons that have longer-lasting significance than the simple and now-evident truth that financial markets can be fickle. I propose to tour the horizon of the Pacific Rim, first from the viewpoint of ten years ago, and then again from where we stand today.

Let us begin with Japan. In 1989, Japan appeared to be at the peak of its game. Ezra Vogel’s book “Japan as Number 1” [sub-titled: Lessons for America] had just celebrated its tenth anniversary, and had turned out remarkably prescient. Soaring asset prices had pushed Japan’s banks into the top ten slots in the global rankings [and had pushed the real estate value of the grounds of the imperial palace in Tokyo above the market value of all of California]. Japanese management techniques were envied and emulated worldwide, as was the government strategy of industrial policy and administrative guidance. The Japanese financial system, with its reliance on banks, relationships, and long horizons, seemed superior to the American system, with its emphasis on securities markets, quarterly earnings statements and short horizons.

¹ One must acknowledge three pitfalls of punditry: the dangers of analysis by hindsight, the dangers of American triumphalism, and the dangers of excessive swings of the pendulum that is known as “conventional wisdom.” The dangers of 20-20 hindsight are clear. Until recently everyone thought that these countries had good fundamentals.

Across the strait, Korea was far along following in Japan's footsteps [having proven that the model of the developmental state could produce rapid growth, if it had the fundamentals of high investment, education, and export-orientation]. Korea had managed its initial doubling of national income in 11 short years.² To understand how impressive a feat that was: consider that it had taken Japan 35 years to double its income earlier in the century. Before that, it had taken the United States 47 years³, and Britain 58 years in the original Industrial Revolution. While Korea had borrowed as heavily from foreign banks as the Latin American countries after the oil shocks of the 1970s, it had adjusted far better than they, and had not suffered greatly from the international debt crisis of the 1980s.

By 1989 Singapore and Hong Kong had attained levels of income per capita greater than those of many European countries. Hong Kong, in particular, had demonstrated that open free-market policies constituted another model that could produce rapid growth. Most of the rest of South East Asia seemed firmly on the path of emulating the success of Japan and the Four Tigers – the so-called flying-geese pattern. The largest uncertainty was China, especially in the wake of Tiananmen Square. China's economic success – as compared for example to the economic failure of Indian democracy or Soviet perestroika and glasnost – was helping to convince many that the route to economic growth required postponing such encumbrances as democracy and such luxuries as human rights, and that something called Asian values were useful instead.

Even as recently as three or four years ago, in the aftermath of the Mexican peso crisis, the Asian miracle appeared undimmed, its emerging-markets still invulnerable. After all, most Asian countries had the key economic fundamentals right: fiscal and monetary discipline, currencies that were not overvalued, high saving and investment, good primary-level education, greater income equality (overall) than most Western countries, and a high ratio of trade to GDP. Even Japan, which was already well into its recession and stock market crash, could still inspire fear among American pundits as a global competitor. One of the "revisionists" wrote a book arguing that Japan was just playing dead, to lull the West into complacency [Eamonn Fingleton's *Blindsided*]. Thomas Friedman⁴ wrote in the New York Times that the value of the dollar in terms of the yen would approach

² counting from 1966.

³ starting from 1839.

⁴ who had not yet learned his way around his new global beat quite as well as he has now.

zero soon after the turn of the century. The logic seemed ineluctable: the yen/dollar rate had been 360 in the 60s, 270 in the 70s, and 180 in the 80s. When it hit 90 in 1995, the trend seemed clear, and zero in the 00s seemed a natural forecast! The authors fighting the tide of American declinism [I would put Joe Nye's Bound to Lead in this category] were still distinctly in the minority.

The View from 1999

In front of this audience, there is no need for me to review the events of the last few years, and how thoroughly the tables have turned. Now it seems that everything that made Asia special is bad rather than good, and it is instead the US economy that can “do no wrong.” To take the case of the Japanese financial system, precisely the attribute that previously appeared to be a virtue, the willingness of banks to go on lending to firms in distress (because the banks had “longer horizons” than impatient American investors), now turns out to have led to serious problems. Borrowers who should have been cut off were not, with the result that further billions were lost.

What is the outlook for the future? The long-awaited Japanese recovery may at last have arrived, as the growth figures from the first half of the year seem to indicate. While it is possible that this GDP surge will prove to be a repeat of the ill-fated surge of 1996, I think the conditions are better this time around. [Neither an increase in the consumption tax nor an Asian crisis looms on the horizon now.] Perceptions that growth has returned explain the recent appreciation of the yen. There is a danger that the foreign exchange market will overreact to this new trend, and that appreciation of the yen will curtail Japan's exports and abort the recovery. This of course is why the Japanese authorities have intervened to try to put a floor on the yen/dollar rate, and why they are hoping that the US authorities will join them in this effort.

In light of this Saturday's G-7 meeting [on the occasion of the IMF Annual Meetings], perhaps I should say a bit more about whether the US will agree to the Japanese request for joint intervention, or at least about the factors that will determine the US Treasury's thinking. To begin with, Summers, no less than Rubin, has a healthy respect for the power of the financial markets, which implies a presumption against intervention.

Circumstances under which the US has intervened in the past six years, and might again in the future, include a combination of the following:

- First, if there developed an incorrect view that the Administration wanted a weaker dollar. Then it might intervene to prove otherwise, as in 1993-95.
- Second, if the technical conditions for success were favorable. Between May 1993 and May 1994 the US intervened repeatedly to hold the line at 101 yen/\$, and succeeded until June 94.
- Third, if the currency has clearly overshot the level justified by current fundamentals and the market appears to have lost its moorings, as happened to the dollar in 1985 and the yen in 1995.
- Fourth, if necessary to keep a two-way sense of risk in the market. In my view this was a large part of the motivation behind the last intervention, in June 98 (the only one in which the dollar was sold and yen bought).
- Fifth, possibly as a special favor to the Japanese, if Japan were willing to do something important in return; at this point, this means further Japanese monetary expansion (unsterilized intervention). The Bank of Japan again rejected this option this week in a continued determination to demonstrate its new independence from the Ministry of Finance.

Bottom-line prediction: Treasury is not yet ready to sell yen – not enough of the conditions I named are yet met. In particular, on a trade-weighted basis, the dollar has hardly changed at all relative to where it was at the beginning of the year – not enough of a depreciation to pose a threat to US inflation or interest rates. The Treasury might conceivably agree to some communique language hinting at the undesirability of yen appreciation beyond what is justified by fundamentals. But even this is dubious.

But, to return to the subject of economic performance, let's assume Japan's recovery will now be sustained. The era of miracle growth will nonetheless not return. The long-term convergence of per capita incomes to those in the West was completed in the 1980s. The questions that many, not long ago, posed seriously -- whether Japan's economy would pass the US in size or whether the yen would surpass the dollar as the world's premier international currency – have now been answered in the negative. Part of the explanation is demographics. The long-expected aging of the Japanese population is now in full swing: It is now the oldest of the major countries. Japan's population will peak soon after the turn of the century at less than

half the level of the US population, and then start to decline. Thus Japan's GDP will probably at best remain in the vicinity of roughly $\frac{1}{2}$ US GDP. The yen will not take over Asia, much less challenge the dollar for the number one position worldwide. In short, I don't believe that Japan will challenge US economic supremacy in the coming decades.

Elsewhere in Asia, recovery is also underway, for example, in Thailand and Korea, two countries that implemented IMF programs early in the crisis of 1997-98. Korea's V-shaped recovery corresponds to the pattern of Mexico three years earlier, in the aftermath of the peso crisis. I expect many of the developing countries of Asia now to resume the process of catching up with Western incomes. Their growth rates likely will once again exceed those other parts of the world, but will be more gradual than under the growth miracle of the past, which I hope will make development more sustainable. Indeed, I think an eventual slowdown was all along inevitable in Asia for several reasons: declining returns to capital and to rural-urban migration, a narrowing in the gap of know-how between East and West, and perhaps the saturation of international markets in manufactured products such as electronics and steel. In a broad sense, the abruptness of the crisis can be interpreted as a "hard landing," attributable to rapid growth that got out ahead of the ability of the financial structure to evolve to meet the needs of the next stage of development.

Now to China. Why has China done so well, relative to its neighbors, in weathering the East Asia crisis? Is it possible that there is another shoe yet to drop? One can make a case: It is generally agreed that major deep causes of the crises in other Asian countries included corruption, ill-defined property rights, inadequate rule of law, lack of bankruptcy procedures, and banking systems that rely on implicit bail-out guarantees rather than explicit and limited deposit insurance. But China's problems along these lines are worse than anybody's. Will it thus be the next to succumb to financial crisis?

My best guess is no. I have two reasons: (1) China's generally strong balance of payments and high level of reserves, and (2) financial markets that have never been very open to portfolio investment. If you don't run up international debt to begin with, then you are less likely to be hit by an international debt crisis. It would seem to follow that China would be ill-advised to open up its capital markets in the future. But Beijing may, like others, find that it needs a more developed financial sector in order to

continue the development of the rest of the economy, and that it must let in foreign financial institutions in order to develop its domestic financial markets, even at the risk of future volatility.

Lessons from the East Asia Crisis

What are the broader lessons of the crisis? I can think of a number of relevant propositions. Some are genuinely new lessons, some had fallen out of favor but need now to be revived, some we knew before but are in danger of losing, and some purport to be new but we should have known all along.

First: *the old lessons that we are in danger of losing*. There really was an Asian miracle, and the setback of the last few years does not change that. The economic fundamentals of high saving, education, and openness remain important, and indeed the United States still has something to learn from Asia on this score.

Second: *truths that had been rejected that need now to be revived*. For example: Keynesian fiscal policy is not dead. While budget discipline is important in a longer-term perspective, there are times when fiscal stimulus is useful. Japan recently is a case in point. The IMF programs that were adopted by the crisis countries in 1997-98 initially included overly tight budget targets.

Third: *three lessons touted as new but that we should have known all along*.

- (1) While modern open financial markets still do more good than harm overall, they do not function as perfectly as most economic theorists had supposed. They are sometimes characterized by excessive optimism during the boom phase, followed by excessive pessimism when the crisis hits.
- (2) Countries that fix their exchange rate, short of an extreme arrangement like dollarization, need to be alert to signs of overvaluation, and need to consider exiting in favor of greater flexibility well before they run out of reserves.
- (3) The composition of capital inflows is often a better warning indicator than the total inflow. By this I mean that the amount of debt that is short-term, dollar-denominated, and intermediated through the banking system – particularly relative to the level of foreign exchange reserves – is a useful indicator of future trouble.

Finally: *lessons that I regard as genuinely new*. Political liberalization, human rights and democracy are not incompatible with economic liberalization, growth, and free markets. There are financial advantages to the rule of law, transparency, freedom of expression, and clearly-established procedures for government succession -- even leaving aside the non-economic benefits of such rights. Kim Dae Jung, for example, has blamed the economic crisis on authoritarianism. [Elaborated in addendum below.]

I would definitely not go so far as to say that the IMF should make its programs conditional on political reforms. But I do think it is appropriate that the Fund has begun to supplement macroeconomic conditionality with structural conditionality, that is, to require such reforms as a financial system built on arms-length transactions and well-regulated banks. Although it is true that this requires deeper intervention than was the IMF's original mandate, conditionality relating to financial structure was appropriate in the Asian case. This is because the market failure of moral hazard at the level of domestic finance was a more fundamental cause of the crisis than moral hazard at the level of the international financial community. [Corruption-fighting and corporate governance are also important.]

The Asian style has a tendency towards empire-building. Top managers maximize their firm's capacity, sales, or market share, rather than what neoclassical economic theory says firms should maximize, namely profitability or the price of the company's stock. The result is that shareholders, upstart competitors and consumers lose out. For awhile it looked like this was an arcane theoretical point, of interest to economists but not to real-world owners of firms or employees. How could there ever be too much investment or too much growth? Now we see that Asian firms made precisely this mistake. They developed excess capacity in such sectors as steel, shipbuilding, electronics and autos, and are now paying the price. Thus the rules of economics turn out to apply to East Asia as elsewhere.

But I am not one of those who regrets that the Asian recovery began before reforms were far-advanced, thereby reducing the pressure to continue the reforms. I think that many of the lessons have been clear, and that Asia can now resume the business of economic progress, sadder but wiser.

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Addendum: **Political liberalization can support economic liberalization**

Not long ago, it would be said that political freedom (democracy and human rights) was in conflict with economic freedom (the basically free-market approach that is best suited to development). Countries that became democracies before attaining industrialization would face excessive pressure for redistribution from rich to poor. One needed a dictator like Pinochet to enforce property rights, and put in place other unpopular but necessary economic policies. Russia's failure at transition as compared to China's success was attributed to the improper sequencing of political vs. economic reform. Asia's lack of democratic institutions and freedoms was said by some to be a key to its economic success -- and indeed to reflect fundamental "Asian values."

Political liberalization and economic liberalization are such sweeping historical forces that they are unlikely to obey a simple correlation or universal causal relationship with each other. Nonetheless, developments associated with the Asian financial crisis show that the two forces can be in alignment more positively than most had assumed.

We were told in the past that Asian values did not place as high weight as did Westerners on democracy, free speech and other civil freedoms. I would guess that many Asians believe (now, if not before) that there are financial advantages to the rule of law, transparency, freedom of expression, and clearly-established procedures for government succession -- even leaving aside the non-economic benefits of such rights. Kim Dae Jung, for example, has blamed the economic crisis on authoritarianism.ⁱ

Consider the several lessons that one might draw from recent events:

- Lack of rule of law and unclear presidential succession undermine investment (Indonesia).
- Relationship banking turns out to be crony capitalism (Japan and Korea).
- Corruption deters foreign investment and slows growth (Indonesia and many others).ⁱⁱ
- A country aspiring to become a major financial center needs freedom of the press (Singapore).
- Persecution of racial minorities can lead to capital flight (the Chinese in Indonesia & Malaysia)
- The legitimacy of a democratically elected leader allows painful reforms (Korea & Thailand).ⁱⁱⁱ

Linda Tsao Yang (U.S. Executive Director to the Asian Development Bank) has said: "You look at country after country, from Thailand to South Korea, and you find governments that are more accountable to the people, with more rule of law, with less rule by man or connections...If the region can survive the major, major changes and have a peaceful transition period, then the Asia that emerges will be much stronger for the exercise."^{iv}

If this pattern indeed continues to hold up, it will to some degree replicate what happened in Latin America in the 1980s. When the international debt crisis surfaced in

Mexico in 1982, the conventional wisdom was that if Latin America were put through a long and deep reduction in its standard of living, the resulting social unrest would set back progress toward both economic and political liberalization. The reduction in living standards turned out to be as long and deep as anyone's worst fears -- the "lost decade" of growth. Yet there followed a decade of unprecedented progress toward liberalization, both political (as almost every country in Latin America moved toward democracy and human rights) and economic (as they privatized state-owned sectors, opened their economies to domestic and international competition, and adopted fiscal and monetary discipline). Perhaps the same will happen in Asia.

i. "In every country in Asia, including Korea, the major reason for [economic] failure was lack of democracy." Emmerson (1998, p.52).

ii. Corruption, while long neglected by empirical researchers, is now the subject of some interesting statistical studies: Paolo Mauro (IMF, 1995) finds that corruption reduces investment and growth (a country that improves its standing on the 0-10 uncorruption scale from 6 to 8 will enjoy an increase of 4 percentage points in investment as a share of GDP, and in the growth rate by roughly half a percentage point; and government spending on education increases by half a percentage point of GDP). Shang-Jin Wei (NBER, 1997) finds: (1) an increase in corruption from the level of Singapore to that of Mexico is equivalent to raising the tax rate by over 20 percentage points [a corresponding increase in uncertainty is equivalent to raising the tax rate by 32 points]; (2) (May 1998) "if Pakistan were able to reduce its corruption to Singapore's level, its average annual per capital GDP growth rate over 1960-85 would have been higher by 1.8 percentage points....[I]ts per capita income by 1985 could have been more than 50% higher [p/9];" and (3) Asia is no better able to withstand the negative effects of corruption than are other countries.

iii. In Korea the crisis has had the effect, under Kim's leadership, of breaking the political log-jam that blocked needed economic reform, giving firms the freedom to lay off workers, while reining in the excesses of the chaebol in other dimensions (e.g., suppression of union organizing, and unaccountable corporate governance).

iv. Quoted NYT 5/20/98.