The Asian Economic Crisis

Talk by the Deputy Governor, Dr S.A. Grenville, to the Australian Business Economists and the Economic Society of Australia (NSW Branch), Sydney, 12 March 1998.

It is much too early to draw definitive conclusions about the economic crisis currently being played out in Asia, but there is some point in trying to bring together the emerging ideas as to what went wrong, what might be done to fix the immediate problems, and how, in a more fundamental sense, these problems might be avoided in future. One of the things that strikes me is how much thinking has evolved already, in the months since the crisis broke. With that in mind, lessons which now seem to be appropriate will, no doubt, be modified over time. Historians can wait to compose the definitive, fully digested version when the dust settles, but others need to call it continuously, refining and modifying our understanding as we go along, knowing perfectly well that what we write today may seem unperceptive or simply wrong when we come back to it in a year's time.

Ross Garnaut has recently written that: 'The shock of 1997 is a defining event in the economic history of East Asia. Like the great Depression in the West, it has the capacity to change thought about economic development and economic policy in fundamental ways'.[1]

This process is currently underway, and if it sounds more like a damage report rather than the anatomy of a paradigm shift, this may reflect the close range of our current perspective. Among the jumble of likely causes and hypotheses, it is difficult to fit all the pieces together and assign proper weights. That said (and to anticipate one of the later conclusions), the individual elements of the crisis are neither new, nor were they ignored beforehand. But the conjuncture of events produced outcomes that no-one forecast. And once the critical break had come, it was not possible to restore the *status quo ante* by fixing the individual elements that had gone wrong.

General Lessons

The first lesson, which stems directly from the fact that no-one forecast the nature or the extent of the crisis, is the need for humility. While plenty of observers worried about various aspects of these emerging markets, no serious commentator could be said to have forecast these crises, in the sense of defining the nature of the unfolding story with some precision as to timing.[2] Generic weakness in

1. Garnaut (1998, p. 23).
2. For example, Paul Krugman, who was sceptical about aspects of the 'Asian miracle', does not claim to have foreseen the crisis: 'Speculative attacks on currencies are nothing new, and some of us even warned a couple of years ago that South-East Asian countries might be at risk. But the scale and depth of this crisis have surprised everyone; this disaster has demonstrated that there are financial dangers undreamt of in our previous philosophy' (Krugman 1998b).

the financial sector was, like Mark Twain's weather, something that everyone complained about, but no-one did much about. The related point is that there remains much that we do not understand.

This issue of failure to forecast is especially embarrassing because these countries, by and large, did the things which economists had said were important. Their budgets were balanced, they kept inflation low, they reduced (over time) protection and increased their openness, both on trade and capital accounts, and they embraced deregulation (although never completely). Even to the extent that they ran what looked in hindsight to be dangerously large current account deficits at times, there was no doubt that these were 'good' deficits – i.e. they funded high levels of investment, rather than government expenditure or private consumption.

The second general lesson is that it has turned out to be much more complex than it seemed initially. Initially, the crisis was seen in relatively simple terms (President Clinton described it as 'a few little glitches in the road'). The belief was that exchange rates had become overvalued, these economies had run a bit faster than their productive capacities would allow, and that in some cases (most notably Thailand) the current account had blown out in a way that made them vulnerable. The implication was that, with exchange rates floated, they would depreciate modestly, fiscal and monetary policies could be tightened a bit in order to slow growth, and in the process current account deficits would shrink. There was a feeling that 'this isn't a problem; it's an opportunity'. At least, there was a feeling that after some short-term pain, these economies would emerge stronger than before: the crisis would provide the motivation for institutional improvement.

These are the generalisations: let's get more specific about the things that might explain the crisis.

The Exchange Rate

If this was a 'currency crisis', then exchange rates must be the key factor, mustn't they? There are a couple of different aspects of this that need separate discussion. First, did some aspect of the initial exchange rate cause the crisis? Secondly, what can we learn from the behaviour of exchange rates as the crisis emerged?

First, did the exchange rate regimes cause the crisis? The early diagnosis was that the central problem was exchange rates which were overvalued and fixed. Most commentators assess that the exchange rates were overvalued by something in the order of 10 per cent. We know that overvalued exchange rates are vulnerable, so this was clearly an element in the story. But these exchange rates are now at levels around half the starting point, or in the case of Indonesia around a quarter. Whatever overvaluation there was in the exchange rates at the start, markets have taken them much further in the opposite direction. If a 10 per cent exchange rate misalignment in one direction made these countries vulnerable to crisis, where does that leave them now? In short, the initial exchange rate overvaluation seems too small, too routine, and the subsequent behaviour too inexplicable, for this to carry the full weight of being the key cause.

Were *fixed* rates the culprit? Again, fixed rates raise issues of vulnerability, but these countries did not stick to this fixed rate regime out of any perversity – they felt they needed this anchor in their macro policies. At the same time, some of their neighbours which have come through the crisis well also have fixed rates – Hong Kong and China. It might also be noted by those who believe that exchange rate flexibility would have avoided the crisis that these countries' exchange rates had been under substantial *upward* pressure during the first half of the 1990s. While the policies they pursued have clearly turned out to be unsustainable, the counterfactual – earlier introduction of floating exchange rates – might also have been a very bumpy ride.[3]

In short, it may be routine to refer to these as currency crises, but the exchange rate movements are symptomatic of something else. That said, we can learn something, in a pathological sense, about the behaviour of exchange rates from observing their behaviour in times of crisis. The first and most obvious lesson is that when exchange rate regimes shift from fixed to floating, the transition may be quite turbulent, and markets have some trouble establishing a sensible rate. It was naive to believe that a modest overvaluation would be smoothly corrected by floating. Even in deep, well-established markets, such as Japan and the US, exchange rates routinely move by 30 per cent or more.

Perhaps the most extraordinary aspect of this is the degree of *contagion* of exchange rates. Just because the Thai baht moved a fair way, why did the rupiah and won have to move also (not to mention the ringgit and peso)? Two factors seem to be involved here. The first is the 'wake-up call'[4] argument: the fall of the baht made markets look at other currencies, and find the same matters of concern. The second component of the argument is that, once one exchange rate started to move, the others had to move to maintain their competitiveness.[5]

While we are talking about exchange rates and their extreme behaviour, I should say something about the apparent failure of high interest rates to support these exchange rates. Interest rates in these countries have been quite high (both in nominal and real terms) for quite a few years (in fact, this is one of the important causes of the large capital inflows). When the crisis arrived, interest rates were put even higher. This was appropriate, but what is clear is that they were not put high enough to prevent the depreciation overshooting. Why was this so? Some argue that the only thing that went wrong here was that the authorities were not prepared to put them high enough to do the job. There is, however, another side to this story.[6] Briefly:

- extremely high interest rates are not credible: markets expect them to be abandoned quickly;
- the foreign debt was foreign currency denominated, and higher *domestic* interest rates would have made foreign creditors even more nervous about the credit risks they faced, and therefore more likely to withdraw their money; and
- very high interest rates raise problems of adverse selection – the only borrowers are those who do not intend to repay.

Current Account Deficits and Capital Flows

The large current account deficits incurred by these countries are now seen to have been a major source of vulnerability. We noted earlier that these were 'good' deficits, and in defence of Korea and Indonesia, it should also be noted that neither was running a particularly large deficit over recent years (for Korea 2 per cent of GDP in 1990–96, and 3 per cent for Indonesia). But Thailand certainly was – around 8 per cent of GDP. What is very clear, *ex post*, is the vulnerability to extraordinary reversals of capital flows (which we have not, for example, seen in Australia). The inflow into these countries was around US$40 billion in 1995, more than doubled to nearly US$100 billion in 1996, and reversed to an *outflow* of around US$12 billion in 1997. It is hardly surprising that a major adjustment is underway in these countries, to adapt to this reversal.

3. Grenville (1998, p. 33).
4. Goldstein (1998).
5. Those who like this argument would also point to the Chinese effective depreciation of 1994. This is claimed by some to have disturbed international competitiveness and helped to set in train the export shortfalls in other Asian countries, that in turn contributed to the crisis.
6. The following argument is set out in more detail in Grenville (1998, p. 33).

Before we condemn current account deficits as a manifestation of misguided policies, we should note that these deficits were not only 'good' (in the sense that they funded investment, not consumption), but were – to a very large degree – the normal working through of market processes. These countries experienced very high productivity growth as technology was brought to bear, combined with low labour costs. They 'got their act together' and provided a hospitable environment for commerce and investment. It is hardly surprising that there has been, over time, a significant flow of capital from the 'old' high-saving countries to the 'new' investment opportunities in East Asia.[7] If there was an economic miracle taking place, foreign investors wanted a slice of the action. The fast-developing financial infrastructure provided the conduit between domestic borrowers and foreign savers. There is, in fact, an earlier example of this. Singapore went for two decades with a current account deficit averaging more than 10 per cent of GDP, and most people look back on this era as an extraordinary success.

In short, if we can identify a critical problem here, it is the potential for *reversal* of the capital flow, rather than the current account deficit *per se*. This was, of course, exacerbated by two characteristics of the capital flows – their short-term nature and the foreign currency denomination of the debt. These were seen, at the time, as natural-enough characteristics of the institutional structure:[8] to interfere would be to go against the tide of market-oriented policies. But we can now identify them as major sources of vulnerability.[9]

The Financial Sector

A third key weakness, which was identified early on,[10] is that fast-growing financial sectors are very vulnerable, because they inevitably reflect lack of experience, by the commercial bankers, borrowers and prudential supervisors. Just as a rapidly growing balance sheet is a warning sign for an individual financial institution, the same warning signs existed in these countries. But even this was hard to foresee as a devastating problem. As a country moves away from underdeveloped financial 'repression',[11] it is both inevitable and desirable that the depth of the financial sector increases – i.e. the balance sheets of financial institutions expand faster than nominal GDP. That said, of course there is an issue of 'how much faster?'. Less excusable are the inadequate efforts to put in place effective prudential supervision.

Coincidence and Compounding

I have argued, so far, that none of the elements which are usually put forward is, in itself, all that unusual, or enough to explain the extent of the crisis. The fatal flaw was the *combination*.[12] To some extent, the problems

7. Feldstein and Horioka (1980).
8. Grenville (1998, p. 31).
9. The bumpy international environment made the capital flows more volatile, and help to explain both the exchange rate appreciations and the variation in capital flows. The yen/dollar exchange rate moved 20 per cent in the year beginning April 1996, affecting these countries' effective exchange rates, their trade and their capital flows. Low Japanese interest rates initially encouraged excess liquidity to flow to these countries, which reversed when markets began to focus on possible interest rate increases.
10. Grenville (1997) and Macfarlane (1997b).
11. McKinnon (1973).
12. An analogy might illustrate the point about compounding causation: in a car crash, who or what is to blame for the injuries? Is it speed, some act of recklessness such as intoxication, a poor road surface, an under-inflated tyre, an inadequate guardrail, a poorly designed car, or inadequate seat belts? Some of these things are mutually compounding, and others are simply unable to cope with the abnormal strains to which they are subject. So it is with the Asian 'currency' crisis. The search for a single key cause – and, by implication, a single key solution to prevent recurrence – will miss the complexity of the task ahead.

were self-reinforcing – when one weak link broke, this put more pressure on other linkages, which collapsed under the extra burden placed on them. But it is by no means inevitable that these problems should coincide – I would simply note that Australia in the mid 1980s had an exchange rate fall of the magnitude of Thailand's and Korea's without a major crisis, and had an asset price bust of probably the same order of magnitude (in the late 1980s) without this degree of damage.

That said, there are clear linkages between the fault lines, and in the Asian case, there was a conjuncture of problems. Large capital inflows led, more-or-less inevitably, to excessive credit growth and growth of the financial sector, because it was not possible to sterilise them fully. The large flows meant, also, that there was easy funding available for projects (both good and bad), and that asset prices were bid up. Similarly, the large capital flows made it difficult to raise interest rates higher (they were already quite high), for fear of inducing even more capital inflow. High domestic interest rates, at the same time, persuaded many borrowers to take the risk of tapping into attractively lower foreign currency-denominated borrowing. Further, with quasi-fixed exchange rate regimes in these countries, there was little incentive for institutions borrowing in foreign currencies to hedge their debt. These issues should have been recognised as sources of vulnerability, but the focus was on growth, without enough concern about resilience in the face of *variance* in growth.

This failure to recognise the interaction of elements was a key misunderstanding as the crisis broke. With hindsight, it should have been realised that simply freeing the exchange rates would cause them to shift a fair way and this would create enormous problems for a financial sector weighed down by bad debts and large foreign currency-denominated debt. This would, in turn, feed back into the exchange rate. If we were to identify the crucial combination, it would be the large volatile foreign capital flows, plus fragile financial sectors.

These two factors, in combination, made these economies extremely vulnerable to changes of *confidence*. We have in our minds financial markets which are constantly digesting and evaluating information to produce a price – an exchange rate – which reflects the 'fundamentals'. But we see, here, that the more nebulous concept of 'confidence', at times, dominates the fundamentals. 'In a matter of just a few months, the Asian economies went from being the darlings of the investment community to being virtual pariahs. There was a touch of the absurd in the unfolding drama, as international money managers harshly castigated the very same Asian governments they were praising just months before … But, as often happens in financial markets, euphoria turned to panic without missing a beat. Suddenly, Asia's leaders could do no right. The money fled.'[13] This is not, of course, the first time this has happened. Alan Greenspan, describing this reaction in capital flows as 'a visceral, engulfing, fear', went on to say, 'The exchange rate changes appear the consequences, not of the accumulation of new knowledge of a deterioration in fundamentals, but of its opposite: the onset of uncertainties that destroy previous understandings of the way the world works. That has induced massive disengagements of investors and declines in Asian currencies that have no tie to reality. In all aspects of life, when confronted with uncertainty, people tend to withdraw … At one point the economic system appears stable, the next it behaves as though a dam has reached a breaking point, and water (read, confidence) evacuates its reservoir. The United States experienced such a sudden change with the decline in stock prices of more than 20 per cent on 19 October 1987. There is no credible scenario that can readily explain so abrupt a change in the fundamentals of long-term valuation on that one day. Such market panic does not appear to reflect a simple continuum from the immediately previous period'.

Krugman (1998a) has suggested a possible reason for this big shift in confidence. Foreign investors thought they were working in a riskless world, and made their investment

13. Sachs (1997).

decisions accordingly. Then, quite suddenly, they realised the risk, and underwent a fundamental adjustment in expectations. This explanation has some attractions but does not seem to fit the overall reality closely. There were not too many explicit guarantees around, leaving aside bank and sovereign debt (which remained guaranteed), so there was not a rational reason for re-evaluation. The more intuitively appealing explanation (at least to me) is that investors simply changed their minds. They had not known much about the countries (or projects) they invested in to start with, so there was lots of opportunity for them to shift between exuberance and deep pessimism, either based on a modest accretion of news on fundamentals or, more likely, on the basis of what their colleagues in the market were doing. *Correlated shifts in expectations* are the key to understanding what happened. The fundamentals (such as when a thing gets cheaper, people buy more of it) were overwhelmed by something akin to panic – if everyone is running in one direction, we should run too (because it becomes increasingly costly not to). Of course, once the mood had changed, commentators and investors alike found much in these economies that they did not like, particularly issues which come under the broad rubric of 'governance'.

What Can be Done?

There are two relevant time horizons here – what should be done, in the form of 'battle-field dressing', to cope with the crisis and get these economies back on the rails again? Then, in the longer term, what can be done to make them less vulnerable in the face of future problems?

Early on it was recognised that these crises had many of the characteristics of an old-fashioned banking liquidity crisis – a 'bank run'. There had been a massive loss of confidence and withdrawal of money, so what was required – reaching back into the 19th century prescription of Bagehot – was: 'lend freely, but at a penalty rate'. The 'withdrawal' took the form of capital outflow from the country, rather than a domestic shift of funds, but the principle was the same. This was, indeed, the diagnosis and the prescription in Mexico in 1995, and most people, with hindsight, regard this as an overall success. (More on Mexico in a moment.)

While this is clear enough in principle, making it operational presents problems. The most prominent of these has been concern about 'moral hazard'. Moral hazard arises 'when someone can reap the rewards from their actions when things go well but not suffer the full consequences when things go badly'.[14] In the Asian policy debate, there were lots of left-over arguments from the 1995 Mexican episode, with some arguing that the US$50 billion IMF/US bailout had been unduly beneficial to fund management institutions, particularly in the US.

It has to be acknowledged that all types of insurance have significant elements of moral hazard, and the issue is not to avoid doing anything involving moral hazard, but how to keep it in check. The idea that Asian creditors have, in general, been protected is wrong.[15] The problem is a narrower one than is usually posed – applying specifically to government debt and bank debt – the first because of its sovereign nature, and the second because of the systemic implications of widespread bank failure. In these cases, it is difficult to avoid a degree of 'bailing out', and it is just as difficult to expect investors to ignore this.[16]

14. Greenspan (1998, p. 2).
15. Chairman Greenspan has pointed out that: 'Asian equity losses, excluding Japan, since June 1997 worldwide are estimated to have exceeded $700 billion of which more than $30 billion has been lost by US investors. Substantial further losses have been recorded in bonds and real estate' (Greenspan 1998, p. 2).
16. The dramatic fall in interest-rate spreads going into 1997 has to be explained in terms of collective 'exuberance' rather than the moral hazard residual from Mexico, because the narrowing of spreads occurred across all types of debt, including debt which by no stretch of the imagination was going to be subject to any kind of bailout.

We will examine, in a moment, what might be done to address moral hazard issues in the longer term. But meanwhile, with the crisis on us, moral hazard should not be used as the all-encompassing excuse for inaction. Bagehot's prescription worked reasonably well in Mexico, but has not been applied with the same speed and vigour in Asia.

What about the longer-term reforms? Given that the damaging combination seems to have been big foreign capital flows plus fragile financial sectors, this is the place to begin. Longer-term reform must include the building of resilient financial sectors, which can withstand substantial shifts in sentiment, and big changes in the exchange rate. Part-and-parcel of prudential measures would be to discourage the sort of short-term and foreign currency exposures which occurred, and where they occur in the private commercial sector, to insulate the banks from them. A well-functioning banking sector might also act as the stable core of the financial sector which would, to some extent, act as the 'guardian on the gateway to investment'. For this to be possible, banks need not only to be well staffed by people with real business experience, but need to be free from the pressures of 'connected' or 'command' lending pressures, which have been all-too-apparent in these countries in the past.

The difficulties with moral hazard have to be acknowledged, and the crises dealt with in ways that ensure that those who were involved in failed investments are financially penalised. But if, when all other measures are taken to improve transparency and disclosure, these international capital flows remain flighty and volatile, even those who are searching for market purity will have to either accept restrictions on such flows, or the existence of some lender-of-last-resort. The damaging externalities of the reversal of these capital flows cannot simply be left to run their course, with markets 'sorting it out' in the way we are observing currently in Asia.

No-one has yet come up with any clever ideas on how to back up the international lender-of-last-resort by prudential rules to address the moral hazard problem. Just as *disclosure* is an important part of any prudential framework, it will have a role to play – hence the IMF's Special Data Dissemination Standard and the BIS' data on bank lending. No-one could argue with the general principle that 'more information is better than less information', or that when markets are 'blinded by faulty signals, a competitive free-market system cannot reach a firm balance except by chance',[17] but it might be worth focusing on exactly where the information deficiencies lie. Looking back on it, most of the problems which exist were known about in general terms, and it is misleading to argue that if more exact figures had been known, then various market participants would have behaved very differently. Will greater transparency put an end to the problem of correlated expectations in financial markets – the sudden switches from euphoria to gloom? It seems unlikely (there was no shortage of information in stock markets in October 1987). But they might help to limit the extent of the swings. As we have seen in the case of Indonesia, once markets and the press take a set against a country, every new piece of news is given the most pessimistic slant and every negative rumour is treated as established fact.

As we search for what more might be done, it is worth keeping in mind that, for every over-eager borrower in these countries, there was an over-eager lender in the capital-supplying country. Are there measures that could be taken by the prudential authorities in the *capital-supplying* countries so that these authorities look not just at the consequences for their own financial system, but for the financial stability of the capital-receiving country? One obvious lesson is that, in evaluating the 'fundamental health' of countries, we should widen the scope of the assessment of 'fundamentals', to embrace an assessment of the health of the financial system and the effectiveness of prudential supervision.

17. Greenspan (1998, p. 10).

Much more controversial would be any proposal to restrain capital flows. One of the important initiatives to come out of the IMF's meeting in Hong Kong in September 1997 (i.e. shortly after the crisis broke) was to develop an amendment of the IMF Articles of Agreement to make the liberalisation of international capital flows one of the purposes of the Fund. There is the potential for vigorous debate on this. Some argue that the problems of capital flow were caused by 'half-way liberalisation', and things would have worked better if financial markets had been deeper, with a greater range of instruments and greater liquidity. The prescription that follows from this is, of course, to proceed with speed and vigour towards more financial deregulation. The counter argument is that prudential supervision and the general apparatus of administering big capital flows need to develop *pari passu* with the process of financial deregulation, and it is very clear that this did not occur over the past ten years: financial development greatly outpaced the development of the prudential framework. In this view, financial deregulation should only occur as and when the appropriate prudential safeguards can be put in place.

Whatever the outcome of this debate, I suspect that these countries will be much less ready to welcome short-term capital flows, and the enthusiasm for developments such as the Bangkok International Banking Facility (which acted as a frictionless conduit for Thai business people to borrow overseas) has been dampened. There is unlikely to be much enthusiasm for vigorous financial deregulation if this means encouraging the sort of free-wheeling, non-bank institutions which were not only eager to sign up borrowers for foreign currency loans, but then turned around and sold this debt into banks elsewhere in the region, with disastrous consequences for both borrower and lender.

How Quickly will the Recovery Occur?

As the crisis unfolded in the second half of last year, it might have been argued that the best guidance on the likely evolution of these three countries was the Mexican crisis of 1994/95 – styled by the IMF Managing Director as 'the first crisis of the 21st century'.[18] This had the usual characteristics – that the financial aspects unfolded quite quickly, and that after these had stabilised, the real sector effects worked their way through more slowly, over time. The sequence might be characterised like this:

- There was a 50 per cent depreciation.
- A $50 billion IMF/US rescue package was made available: not all of this was needed, and a large part of it was repaid within a year. Private capital flow returned relatively quickly, particularly direct foreign investment (and, in fact, Mexico's foreign debt is larger now than in 1994).
- The annual GDP growth figures were minus 6 per cent in the year following the crisis, and plus 5 per cent in the year after that, so that two years later GDP is back somewhere near the original starting point.
- Inflation of close to 100 per cent in the ensuing three years, so that the improved competitiveness created by the depreciation was more-or-less unwound (at least measured by the CPI) by subsequent inflation.[19]
- There was a very quick closure of the current account deficit, turning into a balance more-or-less as soon as the economy slowed.[20]
- An amount in excess of 10 per cent of GDP was used to rescue the financial sector.

18. It was unlike most earlier IMF crises, in that neither budget deficits nor lax monetary policy were the cause – see Macfarlane (1997a).
19. In terms of wages, a significant real depreciation remains.
20. Contrast this with the mid 1980s in Australia, where, despite the loss of confidence and concerns about the current account deficit, the inflow continued at more than its historic average.

Mexico was, as far as the casual observer can tell, not greatly changed in the process. No doubt the banking system has been strengthened by the cleaning-out of bad debt, but on the basic approach to policy, there has been no paradigm shift. No real-world economic event is just like the pure text-book case, but this *does* look like the international version of an old-fashioned bank run, and the old-fashioned remedy worked well enough. It might be argued that one of the main legacies of the Mexican rescue was the inhibitions to action that it produced, when the problem recurred elsewhere. Despite its success, it triggered a coalition of forces (led by those who are concerned about the moral hazard aspects of the bailout) who have hindered the same prescription being applied in Asia. Why might the Asian countries be different?

- Whereas Mexico received something approaching US$50 billion in available credit from the IMF/US (and the required amounts were quickly disbursed), these countries have received much smaller disbursements: Thailand – US$8½ billion; Korea – US$13 billion; and Indonesia – US$3 billion.
- One reason why Mexico received a quick disbursement of assistance to offset the capital flight was the nature of the foreign debt. It was largely *sovereign* debt (Tesobonos), and there was little debate (at least beforehand) that it should be paid out in full. The IMF/US money made this possible. When it came to Asia, none of the short-term debt was sovereign, so there was, initially, no specific plan to pay it off. The hope was that the announcement of the packages would, itself, instil new confidence so that creditors would roll over their debt.[21]
- These countries may well be headed for the same sorts of negative growth rates that Mexico faced in the first year after the crisis. If so, the *deceleration* in the growth rate is significantly greater, because Mexico had been growing at around 3–4 per cent, whereas these countries grew at 7–8 per cent.
- Mexico had the advantage of being next to the large and growing US market, whereas Asia's crisis comes at a time when the US growth is at the mature phase of the cycle, and Japan is still stagnant.
- As in Mexico, these countries have very quickly (almost immediately) corrected their current account deficits, by reductions in imports stemming largely from the slowing of GDP.
- Mexico began with a much more clearly overvalued exchange rate.
- If Asian exchange rates do not recover, these countries seem headed for very substantial inflation (particularly Indonesia). Mexico was probably more able to handle this, as it had had plenty of recent experience with inflation. The Asian countries have had relative price stability for many decades.
- The unfinished business of rescuing the financial systems of Thailand and Indonesia have already absorbed the sorts of money Mexico used to support its financial sector (i.e. more than 10 per cent of GDP), and they are 'still counting'. This is neither surprising (in Scandinavia, something around 6–8 per cent of GDP was used, and even in the relatively minor case of the American S&Ls, something like 2 per cent of GDP was required), nor is this particularly alarming – all of these countries started with almost no government domestic debt, and they can cope with this degree of future indebtedness. But it is a heavy price to pay, for countries that are still poor.

An important issue is whether these countries will emerge with stronger institutional structures. As the crisis broke, there were many of us who thought that 'this isn't a problem, this is an opportunity'. We had in mind the sort of institutional reform which came in Indonesia in the mid 1970s, following the Pertamina crisis – painful and

21. With Korea close to default in late December 1997, the American authorities stepped in (with the IMF) to broker a rollover for bank-to-bank debt, which included a guarantee by the Korean Government.

expensive, but resulting in significant institutional improvement. These issues were probably a major motivation in the design of the IMF's program, which included a large number of structural or governance issues in the 'conditionality' – the requirements imposed on Indonesia. This fits with the idea that 'out of adversity comes reform'. We probably need more perspective to be able to judge this properly, but in the case of Indonesia, at the moment it looks as if the degree of crisis has far exceeded the 'optimal level' and the process of reform is slipping backwards, rather than moving forward. Most notably, we see the position of the group of economists who have guided Indonesia's economic success over the past thirty years substantially eroded. As they lose their influence, diversions such as the currency board proposal distract attention from facing up to the urgent elements of the crisis – an exchange rate which has wildly overshot; a wounded banking system; and a degree of foreign indebtedness which puts many Indonesian companies not just illiquid, but insolvent.

In the case of Indonesia, the potential crisis is such that it is now time to refocus the reform effort on the core economic issues – the exchange rate, foreign debt; and rebuilding the financial sector. To be sure, reform in the structural issues of governance is eminently desirable, but what is needed now is the kind of triage we see in an emergency room – sorting the life-saving critical priorities from longer-term issues.[22, 23]

Will these countries get back to their old pace of growth relatively soon? They still have many of the attributes that gave them fast growth. There is still plenty of potential to link technology with relatively cheap labour, with all the productivity boost that this implies (to put this point differently, they are still well back from the technological frontier in many areas). That said, it is not going to be easy. As Garnaut has put it: 'Two of the pre-conditions of growth in the old East Asian style have obviously been lost for the time being: a reasonable level of macroeconomic stability; and political coherence around the growth objective'.[24]

What have we learnt about our economic paradigm? The text-book model envisages continuous adjustment of prices and quantities as the system gropes towards equilibrium. Good models acknowledge mis-starts and false cues along the way. But none of this seems to fit the process we see underway in Asia. Exchange rates started modestly overvalued, and are now dramatically undervalued. Current account deficits may have been too large, but these countries are now running surpluses: Thailand has gone from a deficit of 8 per cent of GDP to the prospect of a surplus, this year, of 4 per cent of GDP. This is being achieved (if that is the right word) through a fall in domestic spending (not through exchange-rate-boosted export growth). The main manifestation of the crisis – the falls in currency – have not been the principal equilibrating mechanism, but are producing unfortunate (to say the least) side effects and collateral damage – not just inflation, but enormous damage to bank and commercial balance sheets, to saving, and are distorting relative prices.

What is underway here is not an equilibrating process of adjustment, but one of economic collapse, where markets are no longer operating to provide sensible price signals. It is, in the words of David Hale, an 'unnecessary crisis'. The loss of faith in markets is likely to colour future policy-making (making these governments probably *more* likely to be tempted by very interventionist policies). Foreign markets are likely to be even more uncertain about their relationships with these countries, particularly their investment relationships.

22. Feldstein (1998).
23. Will financial markets accept something short of root-and-branch reform of Indonesian governance? Who can tell? But we know that they worked happily enough with these problems for thirty years.
24. Garnaut (1998, p. 21).

The other side of the coin is that these countries have, until now, been high saving countries and if this saving can be maintained in the face of strong inflation, the wherewithal to fund investment still exists, even without foreign capital flows.

One would have to be more pessimistic if one accepts the commonly held view that the investment done in these countries was predominantly low return. While not claiming any expertise, I am not immediately drawn to this view. If the investment was all that bad, how did they manage to grow at 7–8 per cent for so long? While there has doubtless been excess investment in apartments and office buildings, and when growth prospects change dramatically, over-capacity in other areas is likely, I do not get the impression that there has yet, for instance, been over-investment in city freeways in either Jakarta or Bangkok. To put the point more explicitly, many good, high-return projects have been done, and these will continue to serve their countries well, once the economies can be got back on an even keel.

Conclusion

In 1993, the World Bank produced a book called the *East Asian Miracle* – formally anointing something which had been seen by many other observers quite a few years earlier – the extraordinary economic growth of East Asia. This had begun, some three decades earlier, with the four 'tigers' – Korea, Hong Kong, Taiwan and Singapore. These economies grew, year after year, at pace two or three times as fast as the industrial countries. The performance spread to a number of others – Malaysia, Thailand and Indonesia – and the biggest miracle of all, China.

Two things are worth noting. First, this was not some amazing-but-irrelevantly-trivial miracle, like pulling a white rabbit out of a hat: this made an enormous difference to the living standards of these countries, with per capita income doubling in less than a generation. Hong Kong and Singapore went from being well behind the living standards of Western countries, to being much the same.[25] Secondly, it changed the way economists thought about the so-called 'developing' countries: no longer were they seen as pathological cases to be discussed with a mixture of pity and resignation that nothing much could be done. Instead, they were seen as having some kind of *advantage* – at least in growth terms – over the developed countries which had used up all the easy opportunities for expanding production. Economists started to argue that the best qualification for growing fast was to start from behind.

That was still the broad picture at the start of 1997. But now, in a matter of a few months, real questions are being asked whether this – like so many other miracles – turns out to be some sleight of hand, or not sustainable over time. One of the original sceptics of the miracle – Paul Krugman – might seem vindicated in his likening of these countries to the early years of the Soviet Union, where fast growth was achieved artificially and in a way that could not be sustained in the longer run.[26] Even among the countries themselves, the basis of the miracle – free markets and increasing exposure to the outside world – is now under serious question.

In the face of these doubts and the current crisis, should we abandon this new paradigm and return to some version of the old, low-growth view of these countries? The most powerful reason for not doing this is that the forces which drove growth in the past are still there – the poorer of these countries are still well back from the technological frontier and the application of capital to still-cheap labour,

25. As Stiglitz has said: 'In 1975, six out of 10 Asians lived on less than $1 a day. In Indonesia the absolute poverty rate was even higher. Today, two out of 10 East Asians are living in absolute poverty. Korea, Malaysia, and Thailand have eliminated absolute poverty and Indonesia is within striking distance of that goal … No other economic system has delivered so much, to so many, in so short a span of time' (Stiglitz 1998).

26. Although he was most sceptical about Singapore, which seems to be one of the least affected.

and improvements in organisation and governance mean that fast growth is still achievable. The fact that they are still relatively poor makes this eminently desirable. First priority is to get them back on the rails again. Second priority, when the immediate crisis is over, is to get along with those structural and governance issues that we have heard so much about of late. If they are as economically important as the current debate implies, the growth potential of these countries should be higher still. The countries which can put in place robust, resilient and responsive financial sectors most quickly will be the ones which can return to rapid growth first.

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