

## **The East Asian Economies: What Happened?**

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Preface: This paper was written for presentation to an audience that could for the most part be presumed to have only a “layman’s” knowledge of the East Asian economies. It accordingly pays considerable attention to pre-crisis “initial conditions” and correspondingly deals with the immediate causes of the crisis in somewhat summary fashion. [A note regarding references follows the text.]

I am impressed that you are all here, sandwiching a serious lecture between a sociable dinner before and a convivial dance after. And an economics lecture at that! Perhaps you hanker for a quick nap and think an econ lecture the perfect soporific. Or perhaps you misread the lecture title and expect to get up-to-the-minute investment tips on how to profit from the aftermath of East Asia’s economic crisis. While I’ll do my best to keep you awake, I’m bound to disappoint anyone looking for an actionable forecast.

This lecture is about what happened, not about what’s going to happen. That’s okay, though, because no one having any sense can yet say with reasonable confidence what’s going to happen in the near term. But neither do knowledgeable economic observers agree about what did happen. This is not to say that there is disagreement about the facts surrounding the crisis in Asia (for convenience I’ll omit “East”). Quite the contrary, the central facts are by now reasonably well known and agreed upon. Rather, the disagreement is about how to interpret the facts in determining the fundamental cause or causes of the crisis. But, hey, this being economics, disagreement is -- of course -- to be expected. Nonetheless, the disagreement is about issues that are vitally important -- important for the affected countries and for the global economy.

I begin with a quick recap of some basics that you are undoubtedly aware of from media sources. The crisis “hit” in early July of last year, when Thailand gave up trying to maintain a fixed value for its currency, the baht. Shortly thereafter Thailand sought and received IMF assistance. By the end of

the year it had been joined in this respect by Indonesia and Korea. Malaysia and the Philippines have been spared the ignominy of crisis appeals to the IMF but have also experienced severe difficulties. The currencies of all five countries have lost tremendous value relative to the US dollar. Similarly, prices on the stock markets of all five countries have declined greatly. The most recent reports indicate that Indonesia, Korea, and Thailand are experiencing rapidly growing rates of business bankruptcy and labor unemployment along with severe problems in their banking sectors; moreover, that they will suffer pronounced recessions this year, with Malaysia also due to endure a recession. Other countries in East Asia have not escaped unscathed. Most notably, Singapore and Taiwan have experienced declines in the values of their currencies and Hong Kong's has currency endured speculative attack, albeit unsuccessful. Whether, and to what extent, Japan and China will fall victim to the crisis remains to be seen. I trust that I've recalled enough of the story to your minds that the bottom line is clear: the crisis is one of massive proportions in terms of its impact on the three countries -- Indonesia, Korea, and Thailand -- that have been most severely affected as well as in terms of its effects on other countries within Asia.

The Asian crisis is not the first such severe economic crisis to affect the more advanced among the developing countries; preceding it were the Latin American debt crisis of the '80s and the Mexican crisis of '94. But the Asian crisis is unlike the crises that preceded it in significant respects. Most notably, it affected economies that have widely been considered the paragons of development success because of their historically unprecedented records of economic growth. It is not without cause that the World Bank's study of their development performance carries the title, *The Miracle Economies*. In that study the World Bank concluded, as had virtually all knowledgeable observers before it, that the success of the Asian economies was grounded in sound economic policies.

Key among these were policies aimed at the pursuit of overall economic stability: monetary policies that kept inflation from accelerating beyond low or moderate rates; fiscal policies that sought balanced budgets, with government expenditures kept at a comparatively low share of GNP; and exchange rate policies that aimed at maintaining international competitiveness, leading to continued fast-paced export growth. Also central was a policy of general reliance on markets as the means of allocating resources. These policies, taken together, and coupled with large scale investments in education and the provision of appropriate infrastructure, are credited as being the underlying cause of the rapid accumulation of capital and skilled labor that was the proximate source of fast-paced

economic growth. They are also given credit for being the ultimate cause of the remarkable efficiency with which resources were allocated among various undertakings.

But there is more. The Asian economies were not by any means immune to the periodic shocks -- some of them, like the oil crisis of the '70s and '80s, global in their extent -- that affect all economies, developed and less developed alike. Nor were they free from occasional economic difficulties caused by individual policies that proved in some way to be problematic. What very importantly distinguished the miracle economies in this respect -- certainly from other developing economies -- was the "pragmatic flexibility" of their governments' responses to emerging difficulties. Problems were almost always quickly identified and no less quickly resolved, and this without undue further economic disruption. The importance of such flexible and pragmatic policy adjustments to the maintenance of a nearly unbroken record of continual rapid growth can hardly be overstated. Simply put: Effective, rapid development was the end and whatever turned out to work was the chosen means, ideological predictions and political expedience be damned.

So, what happened, what caused the unprecedented disruption of rapid growth: Did the seriously affected economies abandon the core policies that had served them so well for so long? Or did their governments lose the ability to respond with pragmatic flexibility to emerging economic difficulties? The answer to the first question is ostensibly no, core policies were not abandoned, at least not obviously. To the contrary, the only country among the severely affected that was not previously a high flier, namely the Philippines, was in the midst of policy reforms aimed at putting the miracle policies in place when the crisis hit. But why did I qualify my answer to the first question, saying "ostensibly" no? It is because of the continuing controversy over what, precisely, were the core policies.

The sound policies that I enumerated previously are those shared by all of the miracle economies. But these economies have by no means ever been clones of one another; there are pronounced differences among them in critical policy dimensions. In particular, they have differed significantly in the extent and nature of government intervention to direct the allocation of resources. Hong Kong has been at the laissez fair end of the spectrum, with virtually no government intervention in resource allocation. Korea has been at the other end, with strong government intervention most notably occurring through the direction of financing to strategic industrial activities and the promotion of

large conglomerates -- the chaebol. The other miracle economies have been variously positioned between these extremes, with Indonesia closer to Korea and Thailand to Hong Kong.

All informed observers by now recognize that the governments of these economies, Hong Kong's excepted, have long practiced diverse forms of selective intervention, greatly favoring some activities over others. But there has for some time been vigorous disagreement about the consequences. Some argue that stellar performances were achieved in spite of intervention; that more would have been achieved in its absence. Others argue that the interventions were critical to the success of the countries that have practiced them. In the report cited above, the World Bank adopted an intermediate position, arguing that selective interventions generally operated to supplement, rather than supplant, market forces. Specifically, it concluded that interventions designed to promote exports, most importantly the provision of preferential financing, played an important role the achievement of unprecedented performance. My own view is that remarkable success derived from a carefully crafted balance between the practice of selective intervention and reliance on market forces, with the specific combination being different in each country.

Now to return to the question: were core policies abandoned? The answer depends on how selective intervention, where it was practiced, is viewed. Should it be included among the core policies; that is, among those fundamentally responsible for stellar achievement? Has the previously achieved, delicate balance between selective intervention and market reliance somehow been lost? No one can deny the continued use prior to the crisis of selective intervention in the countries seriously affected by it; the media are filled with accounts of its manifestations, the elements of so-called "crony capitalism" chief among them.

Those who do not include selective intervention among the core policies consider that its practice, or the direct results thereof, is ultimately responsible for the crisis. They would argue that the core policy of market reliance was largely supplanted over time by the practice, or consequences, of selective intervention; in effect, success in spite of intervention has turned into failure because of it. Clear recommendations for swift and severe policy reform follow from this view: the tools of selective intervention must be dismantled and its adverse consequences for the organization and structure of economic activity negated. Dismantlement most notably requires extensive restructuring and reform of the financial system, banking in particular, and the abandonment of remaining policies

that protect domestic industries from import competition. Negation significantly requires radical changes in corporate behavior and governance; for example, in Korea, changes the very nature of the chaebol. These reforms are at the heart of the policies contained in the IMF's agreements with Indonesia, Korea, and Thailand.

If it does, in fact, bear ultimate responsibility for the crisis, then selective intervention might be thought to have been shown, once and for all, not to be a significant element of effective development strategy. Thus a singularly important debate in the development literature, one that goes back at least as far as Alexander Hamilton's advocacy of the government's promotion of infant industries through such means as protection from import competition, would be resolved. No one can deny that the intellectual stakes in determining what happened in East Asia are truly large. But there is yet one more question to consider, namely that about the balance between selective intervention and market reliance. It may not be selective intervention per se that is responsible for the crisis, it may rather be that the proper balance between it and market reliance was lost. Recommendations for vital policy change would then have to be far more nuanced, for they would have to address the righting of a delicate and subtle balance of forces.

Indeed, those who include selective intervention among the core policies leading to stellar success do have to be concerned about the possible loss of appropriate balance. Not only are there signs that the balance may have been lost, I think here especially of Korea, but there is also the knowledge that the balance must necessarily change with the progress of an economy's evolution. Whatever may be the factors behind the government's initial advantage in selecting and promoting particular activities for investment, these factors must necessarily erode with the development of the economy. Initially there are few domestic sources of specialized expertise about activities of the sort that characterize a modern economy, and the government enjoys a very important advantage in being able to comprehend the economy in its entirety. But, as modern activities materialize, the economy becomes more complex, and the expertise as well as information needed for fine-grained decision making accumulates within its enterprises. Thus the government's ability to command an overview of the economy becomes something of increasingly less compelling consequence for a growing number of decisions about the economy's future directions. Consider simply this: the decision to build the first large-scale integrated steel mill is one thing; decisions, say, ten years later about the expansion of capacity in various highly specialized varieties of steel are quite another.

In short, an economy's institutional structures, public and private alike, must evolve with the economy's development as the proper balance between selective intervention and market reliance changes. Perhaps most importantly, and certainly widely recognized, the financial system must develop in pace with the growing sophistication of the economy's various agents. Other, more particular, changes are also required. To illustrate from Korean experience: government promotion of the chaebol to capitalize on their leaders' evident talents may well have been appropriate when entrepreneurship appeared to be a severely limiting factor in Korea's industrial development; but continued reliance on the chaebol has led to problems of over-investment in key industries and has retarded the development of the medium and small enterprises that play an important part in the vitality of a modern economy.

Some Asian governments, Singapore and Taiwan for sure, have achieved an appropriately changing balance between selective intervention and market reliance through fostering significant institutional development in various areas of the economy, including but not limited to the financial sector. What about the severely affected economies? In my view, we at this point lack sufficient evidence to judge whether retarded institutional development leading to the maintenance of an outmoded mix between selective intervention and market reliance is -- to some significant degree -- responsible for the severe dislocations that they are experiencing. Why do I say this? It is because the governments of these economies have not neglected the need to promote appropriate institutional changes. In fact, in Korea's case, serious efforts at institutional reform in directions generally thought necessary began at the outset of the 1980s, in reaction to the comparatively mild crisis that Korea experienced as a result of its drive to develop heavy and chemical industries. To me, at least, it is not at all clear that these efforts -- and other such efforts elsewhere -- were insufficient to the needs of continued, effective economic development. But this is not to say the reform efforts were necessarily carried out as expeditiously and effectively as one might have wanted even prior to the crisis.

So, if the crisis was not obviously caused by the abandonment of core policies -- that is, by the excesses of selective intervention -- what did cause it? Was it the governments' loss of their ability to respond pragmatically and flexibly to emerging economic difficulties? The answer must be yes if one thinks that such responses must necessarily succeed in maintaining overall economic stability. But to answer in this way is not only tautological, more importantly it begs the question, for it

assumes that there were clear signals of impending crisis. That there were no clear signals is seemingly unarguable. It follows from the fact that the crisis came as a shocking surprise. In particular, the crisis was wholly unanticipated by the participants in financial markets whose business it is to pay attention to such matters and who, moreover, must be thought to pay serious attention to them owing to the financial stakes involved in erroneous forecasts. Nor was there anything like an even incipient consensus among other knowledgeable observers, economists included. Of course, a few observers did recognize the potential consequences of the conditions that are now understood to have enabled the crisis. But prophets of doom are always among us and knowing which to heed might well be considered more a matter of luck than anything else.

The Asian crisis was a surprise, first, because it occurred in Asia where such things weren't supposed to happen, and, second -- more significantly, because the key indicators that were commonly understood to have signaled the previous crises affecting the Latin economies were safely within the comfort zone. From the debt crisis observers knew very well that fiscal imbalance arising from inability to resolve government deficits was a clear danger sign. But the Asian economies gave no cause for concern on this score. Escalating inflation rates were also understood to be a cautionary signal. Again, there was no cause for concern here either. The Mexican crisis taught observers to pay close attention to savings rates and imports of consumption goods paid for by foreign borrowing. Here too there was no need to worry. Indeed, quite the opposite, savings and investment rates remained at high levels in the Asian economies.

What then were the conditions that enabled the crisis? There were several. First was the maintenance of exchange rates that were leading to increasing over-valuation of the severely affected countries' currencies. The causes of the increasing over-valuation were in large part external, due to changes in the values of other currencies, the US dollar in particular. Second was the fall in the prices of key export commodities, such as memory chips for computers, the stemmed from weak demand. This factor compounded the potential consequences of increasing over-valuation. Taken together these two factors led to growing imbalance between exports and imports, leading these countries to additional borrowing in overseas markets and the consequent buildup of foreign debt. But it is arguable whether the imbalance of trade and the resulting foreign borrowing was at all problematic. For one thing, these countries had experienced similar trade imbalances before, and there were no obvious indications that the imbalances would not be dealt with successfully, as they

had been before. For another, their levels of foreign debt did not seem to be at all excessive. Nonetheless, it was their overseas borrowing that is ultimately responsible for the severity of the crisis.

Not clear at the time, but now abundantly clear, was the immense magnitude of short-term foreign borrowing by these countries. We now know that the short-term debt -- that is, debt that had to be repaid or refinanced within a year -- of Korea, Indonesia, and Thailand greatly exceeded their respective reserves of foreign exchange. This means these countries were financially over-extended; that they could not conceivably repay their short term debt out of resources readily available. In a word, they were vulnerable, dangerously exposed to the possibility of severe crisis. But, lest one think that short-term borrowing in excess of foreign reserves is a clear sign of impending crisis, it is important to note that these three were not the only advanced developing countries so exposed (the others are not East Asian, however). The lesson here, which is the important lesson to which I will return, is that crises of the kind that have affected the Asian economies are perhaps inevitably unforeseeable.

But, to return to the story: There is one more factor to be added, and that is the general and seemingly fast-increasing fragility of these economies' business and financial sectors. The signs of fragility were bankruptcies occurring in the business sector and declared or presumed insolvencies of some leading banks. In Korea, for example, several of the top chaebol became bankrupt before the crisis hit, raising questions about the financial soundness of the banks which had lent to them. In Thailand, the collapse of booms in the property and stock markets led to severe problems for several financial institutions. Knowledge of these difficulties meant that there was growing uncertainty about which businesses and banks would be able to repay borrowed funds at the time when repayment became due. The short-term nature of much foreign debt is obviously important here.

There can be little doubt that the emerging fragility of these economies was due in large measure to a decline in the productivity of investment; in other words, to a fall in the returns to investment. Not only was borrowing financing unsustainable booms in markets for existing assets, it was also leading to substantial region-wide over-investment in the capacities of the automotive, chemical, electronics, and steel sectors, and probably others as well. Previous policy reforms affecting the financial sector - - reforms that removed restrictions on various transactions without imposing offsetting prudential

oversight -- were undoubtedly a significant exacerbating factor in fueling investments premised on overly optimistic forecasts that either neglected or seriously understated the growing risks.

The crisis occurred when doubts about their governments' ability to maintain over-valued exchange rates, coupled with doubts about the ability of individual banks and businesses to make near-term debt repayments, led to defensive actions by private agents -- actions to hedge against currency devaluation and to cease rolling-over short-term debt. In normal times, foreign lenders had willingly permitted borrowers in these countries to repay debt by simply renewing their borrowing. But the times were no longer normal. The severity of the crisis followed from the magnitude of short-term foreign debt. This can be seen in the dramatic size of the reversal of short-term private capital flows in the five most seriously affected countries -- Indonesia, Korea, Malaysia, the Philippines, and Thailand. In 1996, 92.8 billion US dollars flowed into these five countries; in 1997, 12.1 billion dollars flowed out of them. This swing from net borrowing to net repayment amounts to 11 percent of these countries combined GNP.

As previously indicated, the crisis began in Thailand. What caused the ensuing crises in Indonesia and Korea, and what explains the impact on other countries of the region? One factor is surely the effect of the crisis in Thailand on the views of both domestic and foreign agents, who now had good reason to consider far more carefully than previously the economic and political conditions in the other countries of the region. But there were more objective factors at work as well. The economies of the region are highly interdependent: they are closely linked through significant flows of imports and exports as well as through direct and portfolio investments by some in others; additionally, they variously compete for each other's overseas markets. Thus a fall in economic activity in one country leads to depressing effects on economic activity in other countries within the region. No less important, a decline in the values of some countries' currencies means that the values of other countries' currencies must also fall to maintain their competitiveness in shared export markets.

Now that the story of how the crisis began is essentially complete, at least in capsule form, what should we conclude about its fundamental cause? Is it the exposure to vulnerability found in the unarguably dangerous high reliance on short-term foreign borrowing? This is perhaps the easy conclusion, but I think it wrong. In my view the fundamental cause resides in the sources of the fall in the productivity of investment, which in turn led to the fragility of the seriously affected

economies. In the final analysis, it was perceptions of fragility that led to the withdrawal of foreign capital, which had it not occurred -- or had it occurred to a far lesser extent -- would have meant much, much less of a decline in currency values. Once the crisis began, the initial, pronounced fall in currency values could only be taken to signify increased fragility, as debts fixed in foreign currencies became increasingly burdensome in terms of their domestic currency equivalents. Only exporters who earned foreign currencies through their sales abroad stood to gain from devaluation; that is, assuming that their financing of necessarily imported inputs was not endangered (as it in fact appears to have been).

The apparent decline in the productivity of investment could well be the result of selective intervention run amok. But this is far from obvious. Why? Because the Asian crisis, while unique in some respects, is not at all unique in others. Indeed, the economic history of the developed countries features a number of crises that might in their essential details very reasonably be thought not at all unlike the Asian crisis. Think, for example, of the Great Depression that started in 1929. I hasten to add here that I don't mean by this example to suggest that another great depression is now well on its way; the indications are so far rather clearly otherwise, at least as regards a global depression of major proportions -- a major regional depression can not yet be ruled highly unlikely in my view. I mean simply to recall to mind the cumulative forces that can easily lead from boom through fragility to bust and beyond as euphoria is replaced by panic in the views of economic agents.

Economic activity premised on future conditions is by its nature determined by uncertain forecasts; euphoria follows from understating the uncertainty, panic from overstating it. General perceptions of increasing uncertainty affect financial as well as investment behavior. So it is that behavior which is individually rational but collectively irrational can lead to the iterating implosion of financial and real activities, something well established by both empiricists and theoreticians in the economics literature.

I am not alone drawing a connection between the Asian crisis and the sequence from boom to bust and beyond that has periodically and randomly characterized human economic activity. Insofar as the current crisis is but another occurrence of the sequence, the responsibility for the Asian crisis is widely shared indeed. It rests equally with the myriad of economic actors involved directly or indirectly in the Asian region. This is not to argue that governments of the severely affected

countries are blameless; they are to a degree certainly responsible owing to variously flawed economic policies that they have pursued. But to expect or demand that there be no policy failings is to ask for far too much. The real world is simply too complex. Consequently, one can simultaneously argue the necessity of policy reforms in the realm of selective intervention without placing the blame either squarely or solely on its practice.

In closing this lecture it would perhaps be well -- for reasons of concreteness -- for me to identify at least the two key figures in the central disagreement about what happened to the East Asian economies. Before doing so, however, I must, caution that I have rehearsed this disagreement in the terms that I -- not necessarily others -- find most meaningful, which is in fact why I think it useful to name these players. Many of you undoubtedly know them from various media accounts and a number of you may have already matched the names with the two positions in the debate. Larry Summers, Deputy Secretary of the US Treasury, is the proponent of the view that what happened is fundamentally due to obvious and serious policy failures related to selective intervention. Jeffrey Sachs, Director of Harvard's Institute for International Development, is the exponent of the opposing view. Where Summers recommends, indeed is no doubt importantly responsible for, the strong remedies being sought by the IMF, Sachs recommends less strong remedies that he believes would lead to more rapid reversal of the implosion that has occurred. The argument between these two, each of whom is held in exceptionally high regard among academic economists, has for some time captivated the profession. I would add here that they both agree that changes in the management of the global financial system are warranted. But what the nature of the changes should be is beyond the scope of this lecture.

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Note about references: The analysis given here is based on my own evolving views of the crisis as informed by reports in the media as well as by my previous research on East Asian development, some it joint with Howard Pack. [See in particular our article: "Industrial strategy and technological change: theory versus reality," *Journal of Development Economics* 22 (1986), pp. 87-128.] It is also significantly based on materials available from the Asian Crisis Homepage on the Web -- reference: [www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.html](http://www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.html); especially G. Corsetti, P. Pesanti, & N. Roubini, "What caused the Asian currency and financial crisis?" March 1998 and S. Radelet & J. Sachs, "The onset of the East Asian financial crisis," March 30, 1998. Additionally useful was C.P. Kindleberger's *Manias, panics, and crashes* (New York: Basic Books, 1989).