

THE REAL ISSUES IN ASIA

John Greenwood

The recent Asian crisis had two main causal components: a cyclical component and a structural component. The *cyclical* component derives from mistakes of macroeconomic policy—mainly monetary policy—which can be solved relatively easily, at least from a technical perspective, although the political impediments to solving the monetary problems should not be underestimated. The cyclical component explains the timing of the crisis, but it does not penetrate deeper questions as to the sustainability of Asia's distinctive growth characteristics. The *structural* component of Asia's crisis is both more difficult to define and more difficult to solve. The problems are often microeconomic in nature, but they are so pervasive and so deep-rooted that they reach far into the politics and culture of Asian societies. This makes it hard to propose an all-encompassing analytical framework that is not subject to numerous exceptions. However, in this paper I attempt to show that an adaptation of the standard Anglo-American political and economic system can offer insights that help to explain numerous aspects of the Asian growth model.

The Cyclical Component of Asia's Economic Crisis

In this paper I shall deal with both Japan and the smaller East Asian economies or non-Japan Asia. The cyclical problem in both cases is similar, in the sense that both Japan and non-Japan Asia are currently experiencing the after-effects of tight monetary policies—except that the Japanese have not sought to correct the problem of overly tight money since 1992.

Japan

Japan's monetary problems began with the currency agreements of 1985 (the Plaza Agreement) and 1987 (the Louvre Accord). Under

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John Greenwood is Chief Economist at Invesco Asia, Ltd. An earlier version of this paper
was presented at the regional meeting of the Mont Pelerin Society in Vancouver, September
1999.

these agreements the Japanese agreed to buy U.S. dollars in the foreign exchange markets, the domestic counterpart being the creation of yen. This derailed Japanese monetary growth as measured by M2+CDs from its long-successful growth path of about 8 percent per year, causing money growth to accelerate to about 12 percent per year. This was the origin of the bubble in equity prices and the bubble in real estate prices in the late 1980s. To prick the bubble, the Japanese authorities started raising interest rates in 1989. For a while, credit growth actually accelerated as firms scrambled to secure credit lines ahead of the squeeze. But then monetary growth collapsed, with M2+CDs recording negative growth on a year-on-year basis in 1992. Not only did asset prices fall as intended, but the economy also went into recession. Further, because money growth remained so low for an extended period, the economy began to experience deflation of goods and service prices as well as asset prices.

The bad debt problems of the banks, the continued weakness of consumption and investment spending, and falling land prices are all symptoms of monetary deflation caused by a growth rate of money that is too slow for Japan's economy. Unfortunately, the Japanese government has addressed these problems mainly by increased government spending, not by raising final domestic demand through monetary easing. After 13 failed stimulus programs, the government is running out of fiscal ammunition as was evident in the downgrading of Japanese government debt.

The only available solution is for the Bank of Japan to engage in large-scale open market purchase operations, just as the Federal Reserve did after 1933. At that time, the U.S. monetary base grew at 35 percent per year for three years, while M2 grew at 16 percent per year for a similar period. However, on the Bank of Japan's policy board there are only two votes—at the best of times—out of nine in favor of such a program of quantitative easing. Consequently, Japan continues to muddle along with sub-par growth rates (interrupted only by the temporary impact of occasional government spending programs) and continuing deflation. Until Japan adopts a more vigorous program of monetary expansion, it is unlikely that we shall see a full-fledged recovery of the Japanese economy.

Non-Japan Asia

Turning to non-Japan Asia, several authors have claimed that the Asian crisis of 1997–98 was not only unexpected but also unprecedented because Asian countries had had such a good macroeconomic track record relative to other developing countries. In particu-

lar, their budget deficits were small, their reported inflation rates were low, and their savings and investment rates were high. However, this leaves out the conduct of monetary policy, which I believe was the crux of the issue.

To see this it is necessary to understand how Asian exchange rate mechanisms were operating in the years 1993 to 1997, and how those in turn contributed to the subsequent crash. Exchange rate systems in the world today can be classified as one of three types: floating exchange rates, operated by central banks; pegged, or managed, exchange rates, operated by central banks (such as crawling pegs or pegging to a basket); and currency board systems operated under constitutional restraints that ensure a permanently fixed exchange rate.

In 1993, all the Asian countries except for Hong Kong and Japan were operating some form of managed, or pegged, exchange rate. At that time, the U.S. federal funds rate was as low as 3 percent and, as a result, money market returns seemed unusually low. U.S. investors were looking for profitable places to invest their money, as were investors in Europe, Canada, and elsewhere. In view of the apparently high rates of return on capital in Asia, large capital flows started to be remitted to the Asian tiger economies. Faced with such large capital inflows, the central banks of those countries had two choices: they could either maintain their exchange rates at roughly fixed nominal levels vis-à-vis the U.S. dollar, or they could permit their currencies to appreciate on the foreign exchange market. In the first case, they would have to buy the excess foreign exchange offered at the fixed price on the local market, and in so doing create Rupiah, or Ringgit, or Baht, which in turn would cause the money supply to increase more rapidly. In the second case, there would have been no excess foreign currency to be absorbed, and domestic monetary conditions could have been left unaltered. Unfortunately, most Asian central banks chose the first option. They decided to keep their exchange rates fixed and to absorb the capital inflow, converting it into domestic currency, which in turn led to a big expansion of money and credit in those countries.

The Problem of Excess Credit and Money Growth

For three years following 1993, all of the smaller Asian countries without exception—Indonesia, Thailand, Malaysia, the Philippines, and so on—experienced excessive monetary growth, with money and credit growth rates at times in excess of 30 percent per year. Despite real growth rates in the past as high as 8 to 10 percent per year and

high income elasticity of demand for money, even Asian tiger economies could not absorb 30 percent per annum money and credit growth. As a result, symptoms of overheating or inflation began to emerge. The first signs appeared in the securities markets, especially in the listed equity markets. Second, there was a surge in the values of real estate in these countries. Next, there was a boom in domestic demand, i.e., spending by consumers, by businesses, and by government on consumption, investment, and inventory. The domestic components of GNP started to grow more rapidly in both real and nominal terms. Again, as a consequence of that, the current account deficits of the balance of payments became larger because domestic spending was too large to be absorbed by the domestic economy, so domestic demand started to spill over in the form of increasing imports. More and more imports were required to maintain the momentum. Current account deficits reached 6 to 8 percent of GDP in Thailand and Malaysia. Such deficits were sustainable only as long as capital continued to flow in from the United States, Europe, Canada, Australia, Japan, and elsewhere.

At this point it is worthwhile to make two digressions. First, several of the non-Japan Asian central banks attempted to offset the effects of capital inflows by sterilization—i.e., by running down domestic assets to offset the build-up of foreign assets, or by issuing central bank debt specifically to absorb the unwelcome increase in domestic liquidity. These operations appeared to be successful initially, but when they were reversed the money supply exploded. The net effect was to change the profile of monetary growth, and perhaps to change the shape of the business expansion slightly, but probably not to change the ultimate impact of monetary policy on asset prices.

Second, an interesting feature of the boom in the smaller East Asian economies during the 1993–96 period was that despite rapid money growth, CPI inflation for the most part remained in single digits. As in Japan in the bubble years (1985–89), excess money growth showed up in the equity and real estate markets, as well as in strong domestic demand, but seemingly not in the form of consumer price inflation. In Japan's case, there are two main explanations for the non-transmission of excess money growth into CPI inflation: (1) the substantial appreciation of the yen between 1985 and 1987; and (2) the extensive liberalization of imports, both of which reduced the reported inflation rates. Unlike Japan, the smaller East Asian countries (with the exception of Singapore) did not experience currency appreciation in the 1993–96 period. However, they did benefit from the great liberalization of world trade that resulted from the end of communism in Eastern Europe and Russia in the late 1980s and early

1990s, and the resultant downward pressure on prices of manufactured goods. Once the Asian currencies devalued during the second half of 1997, the latent inflationary pressures came to the surface in the form of accelerating CPI inflation. Nevertheless, one of the puzzles of the pre-devaluation period is why so little of the excess money growth showed up in the form of goods and service price inflation despite three years or more of excess money growth.

The Asian Financial Crisis of 1997

Why did the Asian overheating climax in July–October 1997? In late 1996 and early 1997, investors started to sense some problems in Asia. They started to realize that the returns from Asian investments would be disappointing. If you had visited Bangkok in late 1996, you would have found the cranes hanging limp over building sites. The buildings were not being completed; the financing was not being made available. There were limits to the growth process. In Malaysia, huge government-orchestrated projects of dubious commercial viability had sprung up: a new airport, new hydroelectric dams, a new capital city, a communications superhighway, the tallest buildings in the world (the Petronas Towers), the longest buildings in the world—the list goes on and on.

As investors started to sense that many of the projects were of dubious commercial viability, they began to pull their funds out, starting in late 1996 or early 1997. Initially, the central banks responded by providing U.S. dollars to the market by running down their foreign exchange reserves to meet the sales of Baht, or Rupiah, or Ringgit. In the Thai case, the Bank of Thailand spent \$7.2 billion in the spot market supporting the Thai Baht. Not only that, it also spent \$23 billion in the forward market. But on July 2, the Bank finally ran out of reserves. The Thai authorities capitulated, and the Thai Baht was floated.

Essentially what happened was that previously substantial capital inflows gradually dried up. Consequently, the central banks had to spend reserves to finance the current account deficits, to make good the lack of capital inflows. Finally, as capital inflows actually started to turn into capital outflows, the pressure on the central banks increased even more.

The leveraged position of local companies that had borrowed foreign currency and the exposure of local banks (which had also borrowed abroad) to customers who could not now repay their loans exacerbated the crisis. Panic selling of Asian equities and currencies, and the abrupt withdrawal of bank credit lines resulted in sharp

equity and currency declines, far below any medium-term assessment of equilibrium or fair value.

Both the aftermath of the Asian crisis and the recovery from recession have been much more conventional. Tight money policies at the macro-level have exerted a severe squeeze on personal and corporate balance sheets (due to the high level of indebtedness in foreign currencies) at the micro-level, which together have resulted in sharp downturns of domestic demand, first in real terms, and later in nominal terms. Current account deficits and capital inflows have been replaced by current account surpluses and capital outflows (either in the form of foreign asset accumulation by the central banks, e.g., in Korea, or in the form of debt repayment, e.g., by Thailand). Gradually, debts are being repaid or restructured, and assets are being sold to repay debt and reduce leverage. As bloated balance sheets are pared back and cash flows start to recover, non-Japan Asia will begin to grow again.

At the macro-level, or at the level of monetary policy, however, it is much less clear that Asia has learned any lessons from the whole experience. If I am right that the cyclical elements of the crisis started with excess growth rates of money and credit from 1993 onwards, then the key lesson for Asian central banks will be to manage monetary policy in the years ahead so as to avoid repeating the mistakes of 1993–97. The general lesson is that to control money and credit growth within reasonable ranges that are compatible with low inflation in the longer run, the external value of the currency must be free to adjust—especially upwards. But already it appears that individual countries are ignoring the lessons of experience, and already there are signs that the foundations for a new crisis are being laid. For example, in Korea foreign exchange reserves have grown from \$10 billion (net) at the height of the crisis to over \$55 billion today. Although the Korean Won has appreciated to about 1,200 from its grossly oversold levels in February 1998 (when it reached 1,640 per U.S. dollar), the currency is still about 35 percent below its pre-crisis levels (890). Yet instead of allowing the currency to appreciate further, the Korean authorities have intervened heavily in the foreign exchange market and sterilized the resulting creation of Korean Won by issuing MSBs (Monetary Stabilization Bonds) almost *pari passu* with the acquisition of foreign assets. Thus, MSBs have grown from Won 23.5 trillion in December 1997 to Won 51 trillion in May 1999.

As was evident in Malaysia in 1994, sterilization is seldom a problem during the build-up phase; the problem comes in the unwinding phase because that is when the liquidity that has been sterilized or withdrawn from the money markets is in effect reinjected. To put it

another way, when the central bank is controlling interest rates, money growth, and the exchange rate, the symptoms of overheating can be suppressed for a while. But when the central bank abandons control of one or more of these instruments—as sooner or later it must—the latent volcano of inflationary pressures emerges much more virulently.

In general it seems clear that most of the smaller East Asian economies are unwilling to give up their prolonged love affair with pegged exchange rate systems. The monetary and political authorities in each country want to eat their cake and have it, too: they want to maintain fixed (and preferably undervalued exchange rates) while sterilizing the capital or current account inflows and avoiding the pain of economic adjustment to a variable exchange rate. Only Hong Kong, which has adopted a currency board system, has had the political will to adopt the disciplined policies implied by a permanently fixed exchange rate. The price of maintaining this macroeconomic rigidity for Hong Kong has been the need to maintain a high degree of flexibility at the microeconomic level. Specifically, prices and wages have had to remain highly flexible and in addition banks have had to maintain a sufficient “cushion” (in the form of high capital adequacy ratios, etc.) in their balance sheets to be able to absorb the impact of economic shocks. But so far other countries have not shown any willingness to adhere to such disciplines.

In addition to the fundamental problem of monetary or macro-mismanagement, three factors aggravated the cyclical crisis: (1) moral hazard, (2) inadequate prudential supervision and an inappropriate regulatory framework, and (3) varying degrees of protectionism. In my view these issues are best considered part of the structural component of the problem discussed below. However, due to their close relation to the cyclical or monetary issues, they can be handled at this stage.

The Problem of Moral Hazard

The fixed exchange rate regimes of non-Japan Asia created a problem of moral hazard for corporations operating in the region which contributed to the crisis. Banks and corporations assumed that, because the exchange rates had been fixed against the U.S. dollar for a prolonged period, or at least managed within fairly narrow ranges, they would stay fixed. Corporations and financial institutions therefore started to borrow U.S. dollars, which were cheaper, in terms of their interest rate, than domestic currencies. In Thailand's case, for example, domestic interest rates were about 9 or 10 percent for corporate borrowers in 1993–94, but a Thai company could borrow in

U.S. dollars at just 5 or 6 percent. So companies began to leverage themselves using foreign currency, primarily U.S. dollars. In effect, the implicit promise of a fixed exchange rate was accepted as a guarantee by corporate treasurers and used as the basis for leveraging corporate balance sheets. An implied government guarantee became a huge corporate risk. Unfortunately, many firms leveraged their balance sheets very substantially, so when the exchange rates collapsed, starting in July 1997, the local currency value of their foreign liabilities escalated enormously.

The Problem of Poorly Supervised Banking Systems

Another factor contributing to the severity of the downturn in the Asian region has been the problem of poorly supervised banking systems. This is a problem in any developing country. It takes time to acquire the skills for credit analysis and asset-liability management. Many Asian countries had banks that were undercapitalized, and had accounting arrangements that were not as transparent as they should have been. Moreover, rules governing loans by the banks to directors or other related parties were by no means as strict as they should have been. So, for all those reasons, abuses flourished, amplified by the excessive growth rates of money and credit growth.

The Problem of Protectionism

A third contributing element was that many Asian countries practiced various types of protectionism. They protected local companies against the winds of international competition. This meant that they excluded companies measuring up to world standards, and were satisfied with buying goods and services from domestic producers who were not up to standard. At one extreme there were protective tariffs that made goods and services in the country more expensive for consumers. At the other extreme there was a whole system of licensing and crony capitalism (handing out favors to friends and supporters of the president or the ruling party). This was particularly evident in countries like Indonesia, Malaysia, and Thailand. Corruption at the top of the system contributed to the monetary excesses, enhanced bank and corporate vulnerability to sudden withdrawals of capital, and undermined any nascent regulatory framework.

To summarize, the cyclical problem in Asia was primarily a problem of excess money and credit growth stemming from the maintenance of pegged exchange rates and ill-managed attempts to maintain them via sterilization of excessive inflows. This fundamental macroeconomic mistake was exacerbated by three other contributing ele-

ments: (1) moral hazard deriving from an implicit government guarantee that the pegged exchange rate would remain fixed; (2) poorly supervised banking systems; and (3) superimposed on all of that, varying degrees of protectionism, or crony capitalism, which helped to shield the financial system as well as the domestic economy from international competition, and from best practices and standards.

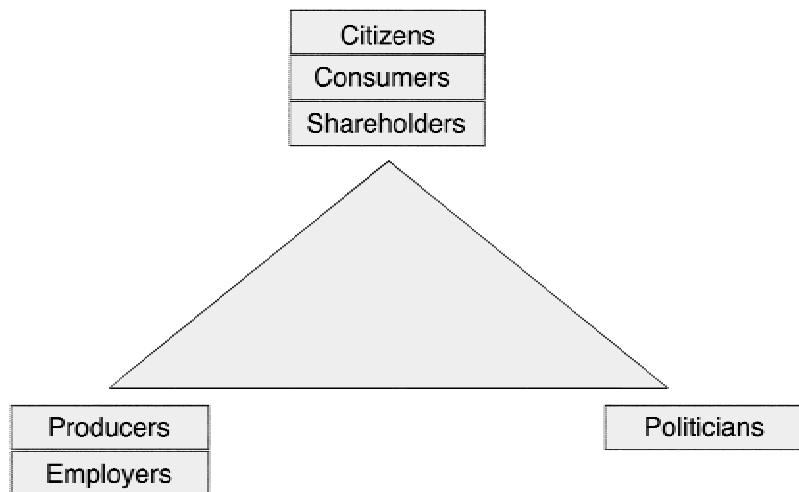
Structural Elements of the Asian Crisis

Cyclical crises affect every country. Asia's crisis was not unusual in that respect. Moreover, there was a surprising degree of contagion, as the Asian crisis swept through equity, currency, and money markets in the region. The extent of the contagion was aided in part by the high degree of synchronization among the Asian tigers' business cycles. It was encouraged by the high degree of similarity in some of their fundamental characteristics—i.e., their relative openness, their dependence on foreign capital inflows, and their high rates of growth of money and credit.

What is different about what has happened in Asia? What caused the Asian crisis to be so pervasive right across Asia? What has caused the Asian crisis to be much deeper and, in some cases (e.g., Japan) much longer than we have seen in other countries? From the analysis of the cyclical elements of Asia's crisis, Asia's recent experience ought not to have been any different in some senses from earlier cyclical crises—e.g., in 1973–74, or in 1980–82, or 1989–91. Yet clearly the downturn has been more severe than in any of these earlier crises. To understand the difference, I believe we must combine the cyclical analysis with the idea that foreign and local investors suddenly woke up to the realization that there was something profoundly different about the Asian growth model.

Subsequently, the Asian crisis of 1997–98 has caused many analysts and commentators to focus on those elements of the Asian growth model that have differentiated these economies from the rest of the world. To highlight the contrast, let us begin by comparing one version of the Japan model of economic growth with what one may call the Anglo-Saxon paradigm. As will become clear, many of the Southeast Asian countries had aspects of the Japan growth model in their systems up to the time of the crisis, and indeed still have them today. But whereas in my judgment the problems in Japan are both structural and cyclical, the problems in non-Japan Asia are primarily cyclical, and somewhat less structural. The extent to which these economies are able to shift from the Japan model to the Anglo-Saxon model

FIGURE 1
THE ANGLO-SAXON GROWTH MODEL



will be a significant factor in deciding whether or not they can correct and reform their systems. Let me briefly explain these two models.

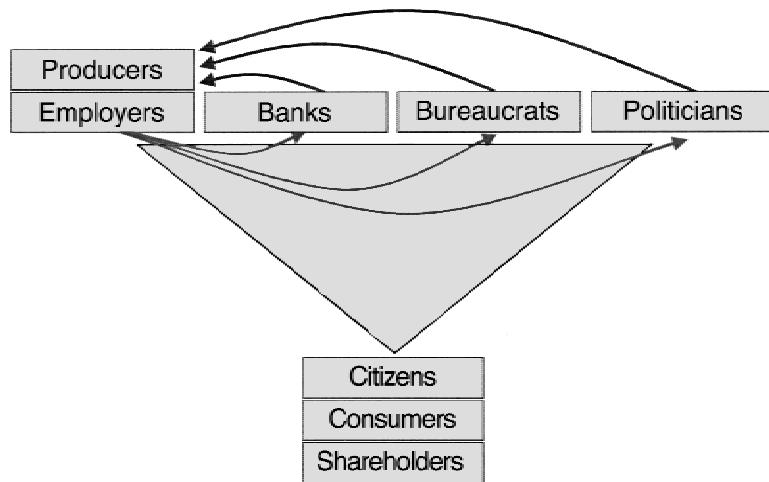
The Anglo-Saxon Model of Economic Growth

We begin with the Anglo-Saxon model of economic growth. Imagine an equilateral triangle (Figure 1), which has at its apex citizens (the voters), consumers, and shareholders. At the two base angles of the triangle are politicians (the government) on the one side, and producers and employers (firms) on the other side. In the Anglo-Saxon paradigm, citizens, consumers, and shareholders have ultimate sovereignty over both the government and firms.

Citizens are able to vote in elections from time to time to decide who will be the local representatives, who will form the ruling party, and who will govern the country, etc. In their role as *consumers*, citizens get to vote every day with their dollars or their pounds or their euros as to what goods and services are to be produced by firms. In their role as *shareholders*, participants in this system get to vote every day on the share price of the company (if it is publicly traded), and hence influence its ability to raise capital. Shareholders may also exercise their vote on mergers and acquisitions, and who will be directors of public companies, etc.

The Anglo-Saxon paradigm is supplemented by the rule of law—a system of courts to enforce fair play—and there is a bureaucracy that

FIGURE 2
THE JAPANESE GROWTH MODEL



carries out, or organizes, the details of government policy. Banks have no special role here; as part of the corporate sector, they act as intermediaries, transferring funds from savers to investors. The Anglo-Saxon paradigm has proved to be very adaptable to changes in demographics and technology, to economic shocks, and to differing tastes and attitudes. Consequently, it has generated great prosperity over many decades and across several continents.

The Japanese Model of Economic Growth

To understand the Japanese model, our imaginary triangle has to be inverted. Again, imagine a triangle, but this time inverted, with the horizontal line at the top, and the apex of the triangle now at the bottom (Figure 2). Citizens, consumers, and shareholders are at the bottom of the triangle. The people in charge are the politicians, bureaucrats, bankers, producers, and employers. These groups can be thought of as occupying the commanding heights of society (the triangle), exerting power and authority in their own interests over the citizens, consumers, and shareholders at the bottom of the triangle.

Fundamentally, the problem of the Japan model is that citizens, consumers, and shareholders are to a greater or lesser extent disenfranchised; they lack the ultimate sovereignty that their counterparts

enjoy in the Anglo-Saxon paradigm. There are clear parallels between this system and socialist or communist societies with their *nomenclatura* and their centrally planned economies.

In Japan the system has developed to the extent where I would call it institutionalized corruption (see Mitchell 1996). In the Japanese inverted triangle there is a network of unwritten and unspoken obligations between firms and bureaucrats, and between firms and banks. These cover questions such as who will have access to bank credit, who will get the operating licences, what investments will be made, what industries will be allowed to develop, which competitors will be allowed to operate in the market, and so on.

In the Japanese model all of these things were regulated by the bureaucrats acting on behalf of the government with wide discretion to carry out administrative guidance under broad but sometimes unspecific legislation. For example, under the Foreign Exchange and Trade Control Law of 1947—a very simple eight-clause law that virtually prohibited all transactions by Japanese residents in foreign currencies and all transactions by non-residents in yen—the bureaucrats at the Ministry of Finance and at the Bank of Japan built up a formidable amount of power over firms and individuals conducting any kind of foreign exchange transaction by developing a whole range of permitted exceptions. In legal terms, this system is sometimes termed feudal law (everything is prohibited except what is explicitly authorized), in contrast to modern law (everything is permitted except what is explicitly prohibited). Such bureaucratic discretion was clearly unhealthy, yet this kind of guidance was widely accepted and praised by numerous Japanese and foreign scholars (see, e.g., Johnson 1982). These arrangements amounted to a kind of corporate state with a partially planned economy, but a planned economy within which the corporate sector was protected, and the citizens, consumers, and shareholders were effectively excluded from substantial parts of the political and economic decisionmaking process.

It is a commonly accepted truth that Japanese firms have typically promised lifetime employment to their employees, and that this became the standard practice for Japanese companies after World War II. (Again it should be noted that such promises were unwritten and unspoken, yet nonetheless part of a widely understood social contract.) In a sense, that was part of the deal. The corollary was that many Japanese considered that, in return for these benefits, they had to accept certain costs. For example, it was taboo to complain about the price of rice. Yet the Japanese consumer has been condemned through agricultural protectionism to pay six or seven times the world price for rice for most of the postwar era.

Another illustration of the disenfranchisement of Japanese consumers is the system called *amakudari*, the descent from heaven. When bureaucrats retire at the age of 55 (the compulsory retirement age), what do they do? Many take their fixed, lump-sum pension and go into obscure retirement. But for others, retirement from the civil service marks the start of a second career. These talented and ambitious individuals go and work as directors for the companies that they have been regulating. So what is the incentive for talented Japanese bureaucrats to deregulate any industry? Wholesale deregulation will only jeopardize their retirement income. This is why the pace of Japanese deregulation across many sectors has been so glacial.

Not surprisingly, the discretion granted to the bureaucrats and the opportunities available to them led to a huge amount of corruption. During the 1970s, 1980s, and 1990s there has been a whole series of such scandals, culminating in the arrest of members of the Ministry of Finance and the Bank of Japan, in 1998, for allegedly tipping off banks about forthcoming inspections. Although these temptations have existed for many years, the revelations of the extent of these scandals have caused the Japanese public to become deeply disillusioned with the integrity of their supposedly elite bureaucracy. Yet it is the incentives in Japan's system of large discretionary power granted to the bureaucrats that need to be addressed and amended; it is not simply a matter of punishing and replacing the individual transgressors.

In the Anglo-Saxon triangle, shareholders have ultimate control over how a corporation is run. They normally appoint (or at least approve) directors to act for them, and from time to time they vote on significant corporate actions (e.g., dividend payments, acquisitions or disposals, new capital raising, etc.). In Japan the *kabushiki-kaisha* (literally a company based on shares) nominally takes this form, but the reality is very different. In practice, the shares of most major corporations are owned to a large degree—sometimes a majority ownership—by banks and affiliated companies in the same *zaibatsu* or business grouping. These so-called cross-shareholdings were usually voted in a block in favor of plans proposed by existing management. The ability of individual Japanese or foreign shareholders to obtain a directorship, or resist plans proposed by existing management, was negligible. Indeed, so paranoid did corporate Japan become that shareholder meetings of companies in the same sector were often held on the same day at the same time, thus ensuring that unfriendly criticism or proposals by disgruntled shareholders were kept to a minimum.

Furthermore, to ensure smooth passage of resolutions presented by incumbent management, *yakuza* (gangsters) known as *sohkai-ya* (literally AGM specialists) were employed to attend AGMs with a view to intimidating any shareholders who dared to raise questions about or objections to management proposals. In short, the genuine ultimate shareholder was disenfranchised while the wishes of the corporate and wider governmental/political/bureaucratic and banking hierarchies were adopted. The same mechanisms, supported by indicative planning, administrative guidance, credit allocation, and top-down control over the economy underpinned the pattern of growth and development in Japan since the end of World War II.

The Problem with the Japanese Growth Model

The curious fact is that the system appeared to work remarkably well until the early 1990s. Through the 1950s, 1960s, and 1970s, Japan averaged a growth rate of something close to 8 percent per annum. But in the 1980s, it slowed to 4 or 5 percent per annum, and in the 1990s, Japan has hardly grown at all. It has basically stagnated. I attribute the slowdown in the 1980s to the phenomenon discussed by Paul Krugman (1994) and others of growth regressing to the norm following a prolonged period of catch-up when Japan was able to inject more inputs and achieve greater output. But the stagnation of the 1990s starts from a slowdown of the underlying growth rate and was precipitated by two additional factors: mistakes in monetary policy combined with the Japanese model reaching its limits.

The Japanese growth model worked well while Japan was catching up with richer economies. As long as the bureaucrats could say: "We need a cement industry, we need a steel industry, we need a machine tool industry, we need an auto industry, we need shipbuilding, electronics, and so on," the country could follow that kind of road map without suffering too greatly. But now Japan has got to a point where it is a highly developed economy. It has reached the frontier, so to speak, of economic growth, and has run out of a road map. The bureaucrats cannot pick winners any more. So the Japanese growth model is failing. The financial crisis of the early 1990s has exposed the lack of adaptability inherent in the Japanese growth model.

Application of the Japanese Model to Non-Japan Asia

I think it is fair to say that, with the exception of Hong Kong, the countries in non-Japan Asia all adopted certain elements of the Japa-

nese growth model in their systems. South Korea, for example, adopted substantial parts of the Japanese growth model: indicative planning, administrative guidance, preferential credit to major industrial groups, national preference in regulatory systems, and a general preference for the producer over the consumer. Malaysia, too, adopted some of the rhetoric of the Japanese model, but did not really implement the system. Protectionism and national preference have been fairly widespread in Asia, though hardly on the scale seen in other parts of the developing world. Since most other Asian economies have not adopted the Japanese model to the same extent, their problems are largely cyclical rather than structural. Of course, there are the issues mentioned earlier—poor supervision of the banking system resulting in maturity and currency mismatches, the moral hazard implicit in the pegged exchange rate system, and corruption—but failure to solve these problems will not prevent a recovery in non-Japan Asia, whereas the recovery process in Japan is going to take much longer than the recovery process in non-Japan East Asia. Because the smaller East Asian economies had fewer of these kinds of structural issues to deal with, their recovery will be more dependent upon cyclical factors than any reform of their basic economic structure.

Conclusion

Several changes must take place for the Southeast Asian crisis to be cured. First, clearly there must be a reform of monetary policy. I mentioned at the beginning that the fixed exchange rate system, and the way that the central banks had reacted to capital inflows, was the trigger for the undoing of these Asian economies. In the future, these economies must either have more flexible exchange rates or go the way of Hong Kong and have a permanently fixed rate. But they cannot expect to maintain some kind of interim position with a quasi-pegged rate, and not suffer significant consequences.

In addition, banking system reform or restructuring must take place. There are various models to follow, but among the best is the approach adopted by the United States in the wake of the savings and loan crisis in the late 1980s. This system saw the creation of the Resolution Trust Corporation (RTC) and the vigorous acquisition of the bad debts of the savings and loan corporations by the RTC. This was followed by the sale of those debts into the market to create a liquid market in bank debt, and the seizure of the underlying collat-

eral for the loans, and the aggressive sale of that collateral—mainly real estate—back into the market. The losses were ultimately absorbed by taxpayers. The crux of this program was the creation of a liquid market in bank assets, and a liquid market in the underlying real estate.

Once again the Japanese model for bank restructuring would not be a good model to follow. Weak attempts have been made to try to reform Japan's banking system over the past decade, but so far with little impact on management practices, lending policies, or investment returns. The reluctance to tackle these problems can only be understood, in my view, in the context of the inverted triangle presented earlier. The resistance is deeply ingrained and will take years, if not decades, to overcome.

By contrast, non-Japan Asia's banking problems, though large in scale with bad debts amounting to 30–35 percent of GDP in the case of several countries, are being tackled more directly and more effectively, albeit under IMF supervision. The lack of proper bankruptcy laws in Thailand and Indonesia has prevented creditors from foreclosing on debtors' assets, and the thinness of markets has meant that it has been difficult to liquidate loans at a discount or sell the underlying collateral. Nevertheless, progress is being made, and no doubt these countries will emerge stronger and wiser at the end of the whole process. Greater transparency, better corporate governance, and more accountability will be achieved. But we should not deceive ourselves. These countries will not overnight achieve best international standards. Indeed, if only 20 percent of the desirable reforms are accomplished in the wake of the 1997–98 crisis, that will be a considerable step forward.

The smaller East Asian countries are going to have to move more toward the Anglo-Saxon system if they are going to have successful, adaptable, flexible economies. In short, there really is no satisfactory middle way, no sure-fire Asian way, to do things. There is a way to do things that is consistent with market disciplines, and consistent with sustainable economic growth. I have argued that "doing things right" has a monetary component (i.e., maintaining monetary stability), and a structural component (i.e., organizing the institutions of society so as to ensure that citizens, consumers, and shareholders maintain their sovereignty). But if Asian countries choose to do things differently, they risk getting penalized by market operators around the world who will be scrutinizing the details of their macroeconomic and microeconomic policies.

For many years, both the monetary and structural problems of East Asia were concealed by the fact that these economies were small,

were remote from the mainstream, and did not intrude upon the rest of the world because capital flows were so much smaller. The recent crisis has gained so much attention only because globalization and the opening of capital markets have facilitated large-scale foreign participation in these economies. Consequently, while Asia was able to conceal these problems in the past, they have now come out into the open. Investors and policymakers will be much more aware of the problems, and Asia will not be able to pull the wool over our eyes quite so easily in the future.

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