# Asian Development Model and Financial Crisis

# 1. Too Much Government Control

By Charles Wolf Jr. Feb. 4, 1998

Asia’s financial earthquake is the second biggest international surprise of the past decade. The first (and weightier one) was the demise of the Soviet Union. Like the 1991 Soviet shock, Asia’s financial hemorrhaging has had many contributory causes. Most of these have been acknowledged and discussed, with the debate largely focusing on their relative importance.

However, the primary cause of the Asian crisis has been largely obscured: namely, the legacy of the so-called “Japan development model,” and its perverse consequences. Subsequently relabelled the “Asian development model,” because variants of it were applied elsewhere in the region, this strategy of economic growth has been grandly extolled in the past two decades. Its strongest proponents included Eisuke Sakakibara, presently Japan’s vice minister of finance, Malaysia’s prime minister Mahathir Mohamad, such Western commentators as Karel van Wolferen, Chalmers Johnson, James Fallows, Clyde Prestowitz, and numerous Western academics. What is now being witnessed in Asia’s financial turbulence are the model’s accumulated shortcomings.

This is not to deny the role of other proximate causes, but rather to suggest that many of them are traceable to or abetted by the primary one. The proximate causes, on which most discussion has focussed, include:

- Short-term foreign borrowing by Asian banks and companies, and long-term lending or investing; and in some instances relending to other countries or companies in the region. (The same point can, with equal validity, be reformulated to place the onus not on the Asian borrowers, but on the money center banks in Japan, the United States, and Germany that provided the mounting short-term lending to duly-anointed Asian countries and companies.)
- The assumption (by foreign investors) that exchange rates pegged to the U.S. dollar would be maintained—an unrealistic assumption because the dollar pegs depended on forms of capital inflow to the region (namely, short-term lending and portfolio investment) that are readily reversible, rather than direct investment, which is not.

Once these are acknowledged as proximate causes, how does the formerly-celebrated Japan model figure as the principal underlying explanation for Asia’s financial predicament?

## Asian Development Model: An Overlook

The model began with a conceptual framework largely provided by American and Japanese academic economists. Central to it is the phenomenon of “market failure”: the predictable inability of market mechanisms to achieve maximum efficiency and to encourage growth when confronting “economies of scale” and “path dependence.” These conditions may lead to monopolies in the advanced economies and the extinction of competition from late-starters in the development process. If the objectively-based decisions of the marketplace are recognized to have such predictable shortcomings, so the argument has run, then subjectively-based decisions by government agencies or key individuals could be expected to improve upon market outcomes.

In the original version of the model, these subjective judgments were provided by Japan’s Ministry of International Trade and Industry (MITI) and its Ministry of Finance, in collaboration with particular targeted export industries believed to be associated with economies of scale. These priority “winners” were tagged to receive preferred access to capital, as well as protection in domestic markets through the use of non-tariff or tariff barriers to limit foreign competition.

In the Korean variant of the model, the subjective judgments as to who and what would receive preferment (often the same industries targeted by Japan), were exercised by a combination of the presidential Blue House, the benefitting chaebol conglomerates, and their associated and accommodating banks.

And in the Indonesian variant, the subjective oracular sources have been the presidency and its associated family lineage, in conjunction with the soi disant technological community in the Ministry of Research and Technology, led by its minister H. J. Habibie.

The common characteristic in all three versions is substitution of the objective, if sometimes imperfect, decisions of the market by the subjective judgments of government bureaucracies and influential individuals. These judgments then provided the basis for making allocative decisions as to which industries, firms, and individuals should get access to resources, and under what terms.

## Asian Development Model: Negative Effects

To be sure, the Japanese model and its variants produced noteworthy accomplishments. Vast amounts of savings and investment were mobilized for and channeled to the anointed industries and firms. While substantial resources were wasted in the process—for example, MITI’s blunders in the case of steel, shipbuilding, and aircraft—the scale of resource commitments led to world-class performance in other cases—notably, cars, consumer electronics, telecommunications, and semiconductors in Japan, similar heavy industry development in Korea, and light industry development in Indonesia.

But the negative effects of the Asian model were cumulatively enormous, even though often obscured by the apparent successes. The principal negative effects include the following:

- Wasting of resources when mistaken decisions were made by the non-market choice processes. Indonesia's abortive investments in a national car and in a domestic aircraft industry are examples. These "non-market" failures account for the fact, stressed by several academic economists, that Asia's economic growth has been mainly due to large inputs of capital and labor, with relatively limited improvement in factor productivity.
- Structural imbalances within the Asian countries due to overemphasis on export industries and neglect of the domestic economy. As a result, domestic production has been short-changed, and consumption standards held down in favor of aggressive pursuit of export markets.
- Excess capacity has been built up in export industries through the arbitrary processes of picking "winners." Failure to take adequate account of demand saturation while production continued to expand has contributed to currency depreciation, falling prices, and sharply adverse changes in Asia's terms of trade.
- Associated with the Asian model has been, until the mid-1997 shocks, a sense of hubris among the favored industries, firms, and individuals. When these favored entities confronted market tests that they could not meet, they (and their foreign lenders) expected additional resources to be forthcoming to bail them out. Whether the shortfall was in an old-line major banking house (e.g., Yamaichi in Japan), or an established chaebol (e.g., the Halla group in Korea), or the start-up of questionable new ventures (e.g., Indonesia's "Timor" car), it was expected that some "non-market" (i.e., government) preferment would make up the difference.
- Finally, the Asian model has had a corrosive effect on the societies and polities of the affected countries as a result of the favoritism, exclusivity, and corruption associated with the backchannel and non-transparent processes of decisionmaking underlying the Asian model.

That market-mediated allocations of resources have shortcomings associated with them doesn't imply that the subjectively-mediated ones of the Asian model will not have still greater shortcomings. In fact, the legacy of the Japan model and its Asian variants suggests that their associated shortcomings are enormously greater because they tend to be protected and concealed. Lacking the corrective, mediating responses that market mechanisms and incentives usually provide, the shortcomings accumulate until a breakdown occurs.

If this lesson is heeded, Asia's recovery can be rapid and enduring; if it is not, recovery is more likely to be slow and fitful.

# 2. Bad Private-Sector Decisions

By Joseph Stiglitz

Only a year ago, the East Asian countries were held up as models for other developing countries. Today legions of critics are condemning them for their unworkable economic systems, which the critics say have long been bound to collapse into crisis. This dramatic swing in opinions about the Asian development model, matching the dramatic changes in the markets, has gone further than is justified by the fundamentals. No other economic system has delivered so much, to so many, in so short a span of time.

It is useful to remind ourselves that financial and currency crises have occurred elsewhere in the world, most recently in Norway, Sweden and Finland. The fact that these countries had highly transparent economic systems and advanced institutional frameworks demonstrates that transparency is not enough to underpin robust financial systems. Although the lack of transparency in the East Asian economies contributed to the problems, it is probably not responsible for the crisis itself.

At the same time, the crisis in the East Asian countries is very different from crises experienced by many developing countries in the past. East Asian countries have high national saving rates. The East Asian governments have all run budget surpluses or minimal budget deficits in recent years. Also, macroeconomic policy has been relatively stable, as evidenced by their low inflation rates.

The financial crisis in East Asia can be understood as the result of a number of factors that have made these economies especially vulnerable to a sudden withdrawal of confidence. The problems -- including misallocation of investment, unhedged short-term borrowing and, in Korea, very high debt-to-equity ratios -- are rooted in private-sector financial decisions.

This is not to absolve governments of responsibility. Insufficient financial regulation and implicit or explicit government guarantees, as well as misguided exchange-rate and monetary policies, each played an important role in creating the incentives that led to the particular size and character of external financing and internal misallocation of resources.

Many of the problems these countries face today arise not because governments did too much, but because they did too little -- and because they themselves had deviated from the policies that had proved so successful over preceding decades. In several countries, for instance, poorly managed financial liberalization lifted some restrictions, including restrictions on bank lending to real estate, before putting in place a sound regulatory framework.

In their haste to place exclusive blame on the governments in the region, many critics have also forgotten that every loan requires not just a borrower, but also a lender. The borrowers who misallocated their investments share responsibility for the problems with the lenders, many of them international commercial banks, that provided them with the money in the first place. Similarly, one might argue that responsibility lies not just with bank supervisors in the borrowing countries but also with their counterparts in lending countries, particularly if the international community believes that there is sufficient systemic risk to the global economy to warrant interventions.

The buildup of short-term, unhedged debt left East Asia's economies vulnerable to a sudden collapse of confidence. As a result, capital outflow, and with it depreciating currencies and falling asset prices, exacerbated the strains on private-sector balance sheets and thus proved self-fulfilling. The vicious circle has become even more so as financial problems have led to restricted credit, undermining the real economy, and almost inevitably leading to a slowing of the economy. Given the region's financial fragility the economic downturn may well feed on itself, worsening bankruptcies and weakening confidence. Policy responses should be designed to halt this downward spiral by minimizing the depth and duration of the downturn.

Restoring growth in East Asia requires restoring confidence. This is as much a matter of perception as of reality, including the perception of the fundamental strengths of the East Asian economies and their resolve to address their weaknesses. This should be addressed by improving the microeconomic and institutional fundamentals. This includes establishing an effective regulatory system, improving corporate governance and enhancing transparency more broadly.

At the same time, governments and international institutions, including the World Bank, have the responsibility for ensuring that the poor and vulnerable suffer as little as possible in the process of adjustment. Financial crises typically bring large increases in unemployment, which often linger well after the initial crisis has passed. The devastating consequences for the poor can persist long after capital flows and economic growth resume.

In East Asia the poor may be especially vulnerable to an economic downturn. In Thailand, for instance, although the statistics show that almost no one lives on less than $1 a day, millions of people are living on just over $1 a day. Korea has relied on rapid growth and lifetime employment to provide social security for its citizens. It does not have universal unemployment insurance and only a very modest social safety net.

The immediate need is for government in these countries to step in and fill the income-security gap that will be left by companies closing and workers losing their jobs. Over the longer term, we will need to work with the countries in the region to help them design modern, durable social safety nets that complement their other structural reforms. We should be mindful, however, that it will not be possible to create an effective social safety net overnight, especially in rural areas, and the pace and content of reforms should take this into account.

Some of the most important features of East Asia's development were sound macroeconomic fundamentals: high savings, a commitment to education, technologically advanced factories, a relatively egalitarian distribution of income, and an aggressive pursuit of foreign exports. All of these elements are still present, suggesting that East Asia's economic prospects continue to be bright. And these elements of the East Asian success continue to provide a model for successful development throughout the world.

# Questions

1. According to Charles Wolf, what were the proximate causes of 1997 Asian Financial Crisis? What is the principal underlying explanation?
2. How does Charles Wolf characterize East Asian development model? What leads to its success? What are its negative effects? How did its negative effects result in 1997 Asian Financial Crisis?
3. Does Joseph Stiglitz agree with Charles Wolf's interpretation of Asian Financial Crisis? What is his opinion?
4. Is Asian development model the cause of 1997 Asian Financial Crisis? Do you agree with Charles Wolf or Joseph Stiglitz? Why?