

LESSONS FROM THE EAST ASIAN EXPERIENCE: OPENING ADDRESS

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Tonight I have chosen to talk about East Asia from a rather broad perspective, something that might create a backdrop to the fascinating conference papers that I have already looked at today. I thought I would go from the miracle to the debacle and touch on the broad lessons one can draw from the East Asian experience.

Financial crises have a very special meaning for me, in a variety of ways. First, Charlie Kindleberger was my teacher at MIT. Every year, aside from *Manias, Panics, and Crashes*, on which I was brought up as a student, he sends me another pamphlet that has taken the crashes back another two centuries. And I think if he keeps going he will bring them back to the Garden of Eden.

My students like Paul Krugman, Maurice Obstfeld, and others also have worked on destabilizing speculation, an age-old problem, showing how it can generate crises under a variety of assumptions. So, in a way, the subject of financial crises is something that is never really away from my or anyone else's thinking. In fact, one of the interesting questions is, "Why?" Why, in fact, did the IMF and the U.S. Treasury, people who were fully aware, who were taught by the same teachers, who were students together, happen to forget these lessons? I am going to come back to that in a little bit.

As a trade economist, I find that these financial crises have had repercussions on the trade debate and on the possibility of pushing forward trade liberalization. It is because of what I call, in a recent *Foreign Affairs* essay, "The Fallacy of Aggregation." People think of globalization

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as a great big blob. They do not distinguish between the different dimensions on which you globalize, but just assume that everything goes together. If you are a free trader you must be for free immigration, you must be for free capital flows, you must be for free foreign investment, you must be for free love, you must be for free everything. And by the same token then, the flip side is that if capital flows somehow went astray, then obviously trade must be bad, too.

We know that the East Asian crisis was, in fact, the “Mother” of all crises, and while it has abated, it has left a number of interesting issues for us to worry about. So I want to start with the miracle and then explore why it led into a debacle that has had an enormous impact in that region—even though we are now pulling out of it, of course—and then determine what lessons we can draw from the event.

WAS IT AN ASIAN MIRACLE?

First, let me say that the whole of Asia has always surprised economists. If I may take a slightly historical view, in the 1950s economists generally interested in world development always thought India and China would be the great winners in the race for economic development. The only question was whether India, despite its democratic regime, would be able to mobilize its resources the way an authoritarian regime could. This was a concern because all the focus then was on creating a surplus, both in the classical models of growth and in Marxist models of growth, so capital accumulation was the name of the game.

Clearly everybody thought China would have an enormous advantage, but everybody was rooting for India because it was a democracy. It never occurred to anyone that the winners in the race would be the four tigers, which I now call the Old Asian Four: South Korea, Taiwan, Singapore, and Hong Kong. That was a big surprise. The New Asian Four are the ones that crashed, as it were, doing the financial thing. One of them overlapped with the Old Four, Korea. But then you have Thailand, where the crash began, Malaysia, and Indonesia, on top of Korea.

Now, to be fair, I would say that no one really predicted this disaster. People claim that Paul Krugman foresaw it in his famous *Foreign Affairs* article on the Asian miracle, or the myth of the Asian miracle. (I want to get into this because it does get us to where, in fact, the East Asian massive performance came from, and that bears on the debacle as well.) Basically, Krugman said in his article that the Asian performance was not a miracle, because it was really all due to investment.

Now, of course, everything turns on what we mean by a miracle. If by a miracle we mean something we can think of no possible explanation for, then of course, there is nothing more to say. But the other view is that a miracle is something off the charts: something so unusual that we cannot explain it, but just remarkable, something we have not see happen

before. I think it is a miracle in that sense, when you say that it is all in investment and no technical change, which was really what Krugman was saying. Based on Alwyn Young's work, Krugman basically was saying that we remove the miracle, in the sense of extraordinary performance, from the outcome when we account for the immediate or proximate cause, namely, investment. The fact is that the investment itself was quite remarkable, in the 30 to 35 percent range over a sustained period of almost two and one-half decades, and it was productive. That has no parallel I know of, in history or in cross-section analysis. It is off the charts and something that remains, therefore, as a miracle.

EXPLANATIONS OF THE CRASH

Krugman went on to say that, with no technical change going on, then diminishing returns will eventually set in. He drew an analogy with the Soviet experience, where if you see the chart of Soviet growth before Gorbachev takes over, for about two decades, income is growing. Then, if you see a later chart, the growth rate is steadily going down. Krugman argues that diminishing returns can help explain the Soviet experience. However, the analogy he drew raises questions. First, the analogy itself is imperfect. Two explanations can be given, using standard production function estimation, for the decline in Soviet economic growth, both of which fit the data and have good r-squares. One is, of course, that capital is accumulating relative to labor and technical change remains constant—causing diminishing returns to eventually set in. The other is that there is a deceleration in technical change. Now if you look at the Soviet Union, clearly the most logical, most appealing explanation is that of a slowing of technical change, due to the lack of political and economic incentives, not because of diminishing returns. I do not think it makes sense even to look at the Soviet Union in terms of diminishing returns.

I also see no evidence at all that before the crash anything like diminishing returns was going on in Asia, especially not in East Asia anyway, if you are simply saying that diminishing returns will take place because capital is accumulating so rapidly. Supposing 30 years ago somebody had declared that East Asia was going to invest so heavily, what would the average economist have said? Diminishing returns are bound to set in somewhere, sometime. Right? The interesting question is: Why did they not set in? Because if you look at the growth rates, they did not decline, but remained pretty good throughout. Something must have been going on; maybe total factor productivity was improving. If you group the data into different time periods, as some people have done in Asia, you see total factor productivity picking up, certainly in countries like Singapore. And that is what you would expect anyway.

Countries like Japan began with an elementary kind of imitation of foreign goods. Then they started improving products, followed by

processes. This is historical maturation of their technological capabilities. That is what was happening and it is not consistent with diminishing returns. The most decisive argument, of course, is the fact that in the end, the situation collapsed in a sharp break. If this break was caused by diminishing returns or if they were playing a role, you would have seen a gradual and continuous decline. Instead, you had a steady positive growth rate and suddenly a sharp, discontinuous fall into the negative quadrant, as far as the growth of income is concerned.

A financial crisis is what really interrupted the Asian miracle, and there is no evidence of any diminishing returns. When we look at what is going to happen in the future, the lessons we draw about the crisis really have nothing to do with the hypothesis of diminishing returns at all, in my view. The return to capital can fall because of misallocation of resources or poor industrial policy. For instance, many people believe that industrial policy was fine for Korea so long as it was simply pushing labor-intensive products that would have been produced anyway, because Korea was labor abundant. But by the time the country got to its second phase of more advanced technology, industrial policy began to have negative consequences. Or take the Japanese example, if you like, of misallocating resources of the banking system, which causes a lower rate of return. Many hypotheses are possible, even if you were to show that the rates of return to capital were falling or were low.

EXPLANATIONS OF THE ASIAN MIRACLE

So, what was going on in terms of the East Asian miracle? Why was it a miracle? Why did it work? What was it? All things are policy-related, in the end. So what was the policy? And once we get out of this crisis, will we get back to a fairly respectable growth rate? Or are we going to go into a tailspin again? That is where theory really begins to bite.

First, let me say that I think the Asian economy is going to do more or less well once we get back to trend level. The trend is going to be reasonably good—maybe not 8 to 10 percent per annum but maybe 6 to 8 percent. Certainly it will not be 2 to 3 percent or a declining rate, simply because I think the trend level was policy-related, in the sense of an outward orientation. Stocks have already come back to trade a little bit. I will get into the financial sector in a moment.

If you do a little cross-country analysis, you will see that the main impact on East Asia came from its policy of outward orientation, compared to a lot of tropical countries. I am not going to talk about neoclassical efficiency, allocated resources, gains, and so on, which also are there to some degree. But I am going to talk about the marginal efficiency of investment, because I want to explain the high rate of productive investment, which is key. Basically, these East Asian areas invested more compared to, say, my own original country, India, which

after the 1960s turned inward very badly. When you turn inward, your investment center depends on the size of the domestic market. When you turn outward, you have the world at your command, if you really mean business and if you have policies that have an outward orientation.

What happens when you turn inward and attempt to industrialize, for example, which is more or less what happens when you try to grow in those conditions? The growth of your market depends essentially on the growth of the agricultural sector, which is the area of the economy where the bulk of demand is going to come from. No country in the world, in no period, has had growth in the agricultural sector of more than 4 percent per annum over a sustained period of more than 10 years. When China turned away from communes, of course, it caught up in three years. But then it goes back to agriculture growing at a maximum of 4 percent per annum; there is just so much you can do by creating inducements to invest in the manufacturing sector. You are constrained in terms of the amount of investment the private sector will carry out: Investors just go into the world economy.

So I start with the inducement-to-invest story. Savings were accommodating to the high rates of investment. Once you also have high rates for earnings as part of the outward orientation, the high investment is directed toward the export market. That means you are also importing a lot of technology. Well, you are taking advantage of, not the latest innovation, but the last but one or two and, as we know, a technological product like a computer goes down in price as soon as a new one comes out. The social marginal product from importing the technology is going to be far in excess of the world price at which it is selling, so you get a big surplus out of it. This surplus increases the productivity of the equipment and creates demand for educated labor.

So you had a virtuous circle set up, because the East Asian countries had a reasonable amount of highly educated labor, and higher education then gets accentuated. And then the more the successful gain, the more they can export. What you have got, therefore, is a virtuous circle built around an outward orientation. And the inward-looking countries have missed out on it. Today, countries like India and some of the Latin American countries are starting where they should have started 25 to 30 years ago, following the same strategy. So I think the miracle was man-made. Now some people say it was really education that did it. But just having high levels of education can lead to unemployed people in Calcutta who burn tram cars. It is like the "Field of Dreams": Just having education is not enough. You have to have the jobs, and to have the jobs you have to have this sort of virtuous circle.

I believe that the main story of outward orientation is a critical one and a true source of success in East Asia. Now if you buy that line (and I find it attractive and plausible because I thought of it myself), then that is the kind of story you get for the countries that finally caught on to it,

like Thailand. India is now beginning to get into it too, largely because of the speed at which the country is moving ahead in the information technology sector, which nobody has been able to control effectively. In another five years we expect IT exports in India to be greater than all the remaining exports put together. IT is becoming a leading sector that governments cannot control effectively, because most of it is on line and does not depend on infrastructure. IT is overtaking India much more rapidly than the government can manage, even through dismantling all its traditional policies of restraints and so on. India is basically moving into the same position as East Asia about 25 years ago. So I think that the miracle—duly explained—actually has reproduced itself.

People say if everybody gets in on outward orientation, there will be no markets. But that is a fallacy because if I export to you, you are going to export to me, unless one of us is building up surpluses. So when I export more, I create more markets, symmetrically. There may be adjustment problems in terms of composition, but none in terms of overall markets: I do not take anything away from you without adding something to the pot, equally. It is a fallacy to think that somehow markets operate at the expense of other people. That is not true except in specific markets, and that is an adjustment problem, not an overall market problem for exports as such.

A major question, of course, is how the U.S. economy is going to do. At the moment things look reasonable, although nobody can tell what is going to happen. Normally I keep away from macroeconomic forecasts, because they are a surefire way of losing your reputation, whatever it may be. So who knows? There could be a possibility of weakness in Asia if the United States begins to go into a tailspin, but my own view is that we can manage a softer landing here, and we have instruments with which we can try and get out of it without difficulty. So that is probably the only cloud on the Asian horizon. Otherwise, the region is poised, in my opinion, to recover well from the financial crisis. If East Asia is able to get out of the financial crisis, I would expect fairly high growth rates to resume in the region. Down the road someday, diminishing returns may set in, but I am not going to lose sleep over it right now. Already some evidence shows that the countries are getting back to reasonably high growth rates. So my optimism, at the moment, is justified.

THE ROLE OF THE IMF AND THE U.S. TREASURY

Now when it comes to the crisis itself, that is a very different story. There is, of course, an enormous amount of controversy, as all of you know, and I do not have to remind you of the various positions officials and economists have taken. But let me put the following three points before you. I believe it is unreasonable to argue that the Asian countries' haste in opening up the financial sector in these areas was less than wise.

I have talked with several finance ministers among the developing countries on my own, and they all reported continuous pressure from the IMF to open up. Now this does not mean that when they opened up, they should not have exercised caution. But, of course, the IMF was not suggesting caution. The U.S. Treasury was not suggesting caution. These countries were being pressured into moving ahead. So where you allocate responsibility, of course, will depend on whose team you want to play for. But there is no question in my mind that there was pressure. That is point number one.

I think privately the IMF today concedes this point, although the U.S. Treasury will not. Obviously, if you are in that position of power you cannot go around saying, "I made a mistake," particularly if whatever you say might have repercussions beyond what you intend. But when the history is written, this point will be admitted. Barry Eichengreen has more or less conceded the point in several of his recent writings. He says, "Only in recent years and in response to pressure from the IMF and the United States have governments, first in Europe and Japan and later in most emerging markets, abandoned capital controls. The Asian crisis suggested, at least in the case of developing economies, this was a serious mistake." Now that is a judgment on the consequences of it, but I am concentrating on the first part, the fact that pressure was applied by external forces. Developing countries are simply not ready for prime time in freeing up capital flows.

Finally, the U.S. Treasury needs to overcome its "Wall Street complex." Now that last phrase comes from me, because in my mischievous way I have suggested something called the Treasury-Wall Street complex. It sounds like a conspiracy theory, but all I meant was the following: that just as professors like tenure and push for it, Wall Street, like any other business, likes expanded markets. So they were pressuring for more and more markets, more and more financial opening. I have no objection to that: It is a fact of life. Every lobby will do that for its own markets. So that was one part of the story.

The other part of the story was what we call the "swing of the pendulum." Interventionism was going on around the world in the 1950s and 1960s: Once I said that in developing countries the real problem was that Adam Smith's invisible hand was nowhere to be seen. If any kind of problem arose, immediately the government would intervene with a knee-jerk reaction. So you had massive interventions everywhere. The whole story of the 1960s and 1970s was that all of this was gumming up the works and creating all kinds of problems and reducing our growth rates, our ability to affect poverty, every good thing in life. We have gotten away from that, but the swing of the pendulum ideologically has gone to the other extreme. This is the continuing story of policymaking, in virtually every sphere. You go to the other extreme because you are so fed up with all this interventionism. It is human nature to get carried

away, to say, "Look, let's move ahead and dismantle as much as we can." So I think that is the ideas part, which was inevitable as a normal swing of the pendulum.

So this was a combination of the Treasury, largely reflecting ideas, and Wall Street, reflecting what we call in political science "interests," or a lobby. And of course I was thinking also of networking in the sense that people go back and forth between the two sectors continuously, with a whole network of these kinds of in-and-out jobs, between State and Treasury and IMF and the World Bank and Wall Street firms and so on. And as I said, it is nothing more than networking. But then anyone who has another point of view is unlikely to be heard, because everybody shares the same assumptions. I think the train was not stoppable until something disastrous happened.

CONCERNS FOR DEVELOPING COUNTRIES

Now I think the real problem is the thinness of the capital markets. These countries do not have adequate political credibility or, in many cases, adequate economic credibility, so the slightest bit of panic can lead to outflows of capital. All of these worries do affect investors, and they want movement to capital account convertibility, where anybody can walk into a bank and take as much money out as they want to. However, when your government's credibility—its policy credibility on economics and its economic performance credibility—are at stake, as they are in many poor countries, then capital account convertibility is too risky. Prudentially, one does not want to recommend that. One wants to be a bit more careful. Maybe we will learn how to manage it, but until we are really sure, it may be difficult.

Without question, any good economist will say that if you segment capital markets, as in any market, there will be deadweight loss. There will also be a loss of freedom. Economic freedom is something you should not sacrifice without good reason to do so. There is also this enormous danger that you may actually go into a tailspin, and then you may compromise all your market reforms, because people do not distinguish one kind of liberalization from another. This is the very battle we are fighting in the developing countries. Many of the economic reforms are still very fragile, and many of the anti-reform people are still waiting in the wings. Very often they are on center stage, just looking for any excuse. And in fact, the lives of most people have become extremely complicated, post-Asian financial crisis. Regardless of who is to blame, this fact should make us pause.

The second point is about how you would manage if you were already in the game. Like Malaysia. Nobody forced capital account liberalization on Malaysia. In fact, Malaysia wanted to be a financial center. Then it ran into the financial crisis coming in from Thailand

through contagion. And then it wanted to return to capital controls. Now that is a slightly different problem. Getting into a game of capital account convertibility for countries like India is one kind of problem. For countries already in the game, to get out is a different problem.

And I think those are two very separate types of problems. You really can segment a market and lower your interest rate. It will break the link between foreign and domestic prices of goods, just the way a tariff does. However, the problem really is that even if you do that, you still may not be able to increase your investment and undertake an expansionary policy, simply because people may think you are doing something crazy. This is particularly true if nobody else is doing it or if the United States and the IMF are saying that it is a crazy policy. That view may spread, in which case you will not get your economy to revive, because macroeconomics depends on expectations and how people react to policy.

So the solution is not just about enacting a tariff and saying my price at home is different from that abroad. You are trying to revive an economy, insulate it, the way we teach in the classroom, and still expectations may just go the wrong way. The IMF now, as we all know, has agreed that temporary controls may be okay. Maybe Malaysia did not do so badly. But my view is that Malaysia did not do badly largely because it did not go to the IMF, and therefore it did not accept the IMF conditionality. It did not have to. The IMF conditionality was, at least in the first year, counterproductive. So, perhaps it was not capital controls that really helped Malaysia, but rather the fact that it did not go in for the drastic reduction in expenditures and so on that the other countries did, which intensified the crisis.

LESSONS FROM THE CRISIS

The IMF now accepts the possibility that countries may revert to imposing capital controls on a short-run basis, and it has stopped putting pressure on countries that are not into the convertibility of capital accounts. Those are two definite changes. Now some people do not like the IMF changes, but I believe they are a positive move and will remain positive until our macroeconomist friends can really assure us that they know how to deal with all these problems. They certainly do not give me that impression now.

And until economists make up their minds as to what exactly the answer is and give some degree of confidence to people, you are not going to have countries enthusiastically moving toward free capital flows. I hope the confidence will come some day, but it is a little premature right now. Until the optimal way of handling these problems is determined and until we have reached some stability after the Asian crisis, it is just foolhardy to keep pushing people and countries into doing

things that they would rather not do. Increasingly, people get around capital controls, of course. But that is something that cannot be stopped, and people live with it. But to say you should simply dismantle controls—accelerate the process—that is a different matter. So I think that is the first set of lessons.

The second set, I think, relates to the fact that the IMF imposed excessively severe deflationary conditionality on its aid in the first year after the crisis. I think it was partly a matter of the luck of the draw. Thailand came to the IMF first, and Thailand was really much like Mexico. Thailand's fundamentals were not good, Thailand's international exposure was extensive, just as in the case of Mexico's *tesobonos*, and at the same time Thailand's current account deficit was unsustainable. The Fund had been telling them that already. So the application of the same medicine as in Mexico was exactly what most people would have prescribed. If the crisis had come first in Korea, the fundamentals were much better there and it would have been a different model. But the crisis came in Thailand and therefore the same formula went on.

And, as I have said, I think geopolitical reasons were also involved. Japan did offer, conditionality-free, one hundred billion dollars to set up an alternative fund to assist, although the offer did not necessarily come from the Cabinet or from any serious source. But we killed the idea outright, because we said the aid was not going to be subject to conditionality, and it was clearly geopolitical. It stemmed from Japan's fear of IMF influence, which would be intensified. We were not going to give in to a Japanese fear of influence here, and the result was that, again, the IMF conditionality became more operative than it needed to be. Whatever the Japanese reason for not wanting to impose conditionality, it would have been nice if its aid had come through. But we wanted all the action to be by the IMF, where we have more influence. And, too, Japan's model was not something that was relevant to us in terms of the kind of economics we do.

If you go back to the Thailand case and to Korea (Indonesia is more complicated), it is clear that the role of the banking system is important. And that is what this conference is largely about. If you could really clean up the financial sector, which certainly interacted with excessive borrowing and foreign-currency-denominated debt, with bank lending the main form of it, that would certainly help reduce the probability of another crisis. My only worry is that it probably will not be enough. It would be foolhardy to think it was, but it is an important part of the story, so it needs to be done.

But I do think there is a certain problem with the rest of the reforms in the system. I am not convinced that the industrial organization part needs to be thrown out as well. The financial sector in that area of Asia is so weak that it is unbelievable, even in Japan. In a way, the IMF is doing them a service by strengthening the financial sector. I go to Japan often,

and frequently they'll just pay you the large sum for your airfare in cash! But when you go to the bank and say, "Send me a draft," they cannot do it for six or eight weeks. You cannot have a financial sector like that. It is brilliant inside, I am told, but externally it is completely incompetent.

We cannot operate in the world economy on such a basis. I think this crisis has actually been good, in a way, for the region as a whole, because the financial sector had lagged totally behind the rest of the economy. They were fantastic in manufacturing because there was more concern for quality and for consumers and so on, and that swept us off our feet until we regained our competitiveness by learning from the Japanese ways of doing business. But in the financial sector they still have to learn from us. And I think this is where you are going to get a major change; this is the main lesson, in my judgment, of that particular episode as well.

I believe the long-run comparative advantage is also seriously out of whack as far as the financial sector is concerned, and that once that is set in place you are going to get an additional reason for optimism in East Asia. I think the system is going to bounce back as we fix up the financial sector. It is already reviving, because the Fund conditionality has become more expansionist. The conditionality has changed, they are bouncing back, and the financial sector is improving, although maybe not rapidly.

I am not worried about chaebol, keiretsu, and the like, because the tendency to throw out everything people consider somehow incompetent is ridiculous. James Tobin, who is on the side of those who worry about the financial system, and I were just looking at a report where somebody in the U.S. administration was saying how keiretsu were bad, and that now, instead of long-run maximization, which was supposed to be good on the part of Japan, short-run maximization is good. Jim questioned this, saying, "If this is a financial crisis, what does it have to do with whether you maximize in the long run or in the short run?" Maybe that is something we need to discuss on its own.

The tendency now is to think that everything that those countries were doing in industrial organization—everything—was somehow bad. I think that is something we have to avoid, because you cannot reach that conclusion just from the fact that the financial crisis happened there. You also cannot deduce that for the banking sector, which we are focusing on here. Someday it will happen that the United States will go down and Japan will come up. Are we then going to throw everything we do out of the window? That is nonsense, really.

A lot of non sequiturs like that are going around, just because Japan has fallen down. During Japan's heyday, many people were saying that we must imitate what the Japanese do: not just take a leaf from their book, but take the whole book. And that was crazy, too, because things must fit into their own economic and cultural framework.