TIGERS TAMED

THE END OF THE ASIAN MIRACLE

ROBERT GARRAN

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To Julie and Eleanor

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Robert Garran has produced the first comprehensive history of the intellectual, political and economic trends which set the stage for the East Asia financial crisis.

David Hale

The first attempt to document the story of East Asia in crisis comprehensively—the economics, the politics, the response in each of the troubled economies and their major partners in the region . . . an intelligent guide to the most important questions that have been raised by the crisis.

Peter Drysdale

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Robert Garran
Canberra, July 1998

Note on terms

The geographic scope of this book is East Asia, that is North-East Asia—China, Hong Kong, Taiwan, Korea and Japan—and South-East Asia. The Association of South East Asian Nations (ASEAN) includes all the countries of South East Asia except Cambodia. It comprises Brunei, Indonesia, Laos, Malaysia, Myanmar (Burma), the Philippines, Singapore, Thailand and Vietnam. The four largest ASEAN economies are Indonesia, Thailand, Malaysia and Singapore. The book's main focus is on the more 'miraculous' eight among those fifteen—Japan, the four tigers (Korea, Taiwan, Hong Kong and Singapore) as well as Indonesia, Thailand and Malaysia. References to Korea mean South Korea. North Korea is named explicitly when relevant.

Asian names are given according to local custom, usually family name first, although Japanese family names are given last in accordance with western practice. Many Indonesians have no given name. Currencies are expressed at the exchange rate prevailing at the relevant time. Dollars are US dollars.

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Introduction

In many ways 'miracle' seemed a justly deserved appellation for the dazzling economic performance of East Asia in the half century since World War II. A remarkable number of countries in the region achieved extraordinarily high levels of growth that transformed them from impoverished backwaters to industrial dynamos. Since 1960 the region's top performers—Japan, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia and Thailand—grew more than twice as fast as the rest of East Asia, three times as fast as Latin America and South Asia, and five times faster than sub-Saharan Africa. Average real income per person quadrupled in the five North-East Asian countries and doubled in the three South-East Asians.[1]

But the idea that this was a miracle is a myth. And in 1997 the myth was shattered by a financial crisis that began in Thailand and spread quickly to the Philippines, Malaysia, Singapore and Indonesia. By October Thailand and Indonesia, small players on the world stage, had both agreed to IMF (International Monetary Fund) rescue packages aimed at stabilising their battered financial systems. When in that same month the Hong Kong share market was mauled and in November South Korea's banking system almost seized up, it became clear that the rest of the world would not be immune. The storm reached Japan in mid-November. When a large sharebroker and several smaller banks collapsed, the world's second largest economy and its largest provider of credit narrowly avoided a financial catastrophe that would have had global reverberations. By early 1998 emerging market economies throughout the world had been hit by the combined effects of intense competition from South-East Asia and increasingly nervous investors. The issue then was how far the crisis would affect the large western economies, the United States, Europe, and the rest of the rich world.

The 1997 financial crisis punctured the myth of a distinctive East Asian model of economic development, the idea that the region had discovered a blueprint for faster economic growth. In important ways it was the myth of the Asian miracle that created the East Asian boom in the late 1980s and early 1990s. When investors realised that the miracle was built on sand, the boom was punctured. The myth ended with an abrupt collapse in confidence that sent East Asian currencies, share markets and real estate prices tumbling and delivered to those countries a severe recession.

In what sense was the miracle a myth? Not because East Asian countries did not have substantial and impressive achievements—they did—but because the exaggerated claims for those achievements inspired hubris, a false sense of invincibility. Like most myths, this one contained elements of truth. A surprisingly large number of East Asian economies achieved remarkable rates of economic growth in the years after World War II. Some of them did so with the use of interventionist policies aimed deliberately at 'beating the market'. Clearly some elements of the Asian model were highly successful. What was mythical about the model was the belief that it showed the way to a new kind of policy for economic development, a distinctive and superior road to prosperity. The 1997 crisis should kill off the nostrum that industry policy and Asian values are the keys to high growth.

Economics does not tell the whole story of the Asian crisis, but it is the most important ingredient. The main elements of the economic story are clear: the crisis stemmed from excessive short-term borrowing that led to economic overheating; problems were made worse by fixed exchange rates, inadequate financial systems, cronyism, corruption and inadequate political responses. But within the economics debate there are several key disputes. One question is whether the economies of Asia suffered from a cyclical boom and bust but still remain fundamentally sound and will eventually recover, or whether their problems are more deep-seated. Another question is whether the bust was made worse than necessary by the irrational response of financial markets, and by the actions of the IMF.

The argument here is that while there were cyclical elements to the collapse, there were more deep-seated problems too that will take more to repair than simply awaiting the next upturn in the cycle. The poorly managed financial systems and the cronyism and corruption were fundamental to the crisis; their roots lie deep in the much-vaunted Asian model of economic growth. On the second question, the crisis was made worse by the response of investors in financial markets, in a word, by panic. But panics are a ubiquitous feature of economic life, a factor that points to an important qualification of rational economic behaviour. It was undue faith in the verities of rational economics that led to the overbearing prescriptions of the IMF, imposing remedies that in the long run were correct and would have helped the suffering economies, but in the short run, especially in Indonesia, compounded the problems.

The Asian model encompasses many ideas. Some aspects of the model conform with free-market economic principles; some aim to augment them; other elements, sometimes called Asian values, have more to do with politics and culture than with economics. The argument here is not that every element of the Asian model was mistaken, but that the loose collection of ideas that made up the model took on a life of its own. The whole became greater than the sum of its parts, creating the myth of the miracle. Investors came to believe, in their hearts if not their heads, that East Asia could do no wrong. The rush to invest in Asia became a speculative mania in which mass investor psychology took over from cold, rational assessment. When the mania was deflated, the miracle ended.

The proponents of the Asian model have several goals. One is to describe and explain the unusual success of East Asian economies. Another is to offer a guide to policy in other countries. If the elements that contributed to East Asia's success could be identified and if the model were robust enough, it would provide a powerful tool for policy-makers throughout the developing world. But these aspirations suffer the fate of much social science: the systems they describe and explain are so complex that although some regularities can be identified, they are often not uniform and predictable enough to provide reliable prescriptions or predictions. That does not mean that the effort should not be made, but that the conclusions reached should be treated with humility. It is a postmodern dilemma: the tension between the contingency of knowledge and the desire to find consistent patterns and rigorous explanations.

The East Asia miracle debate has become polarised between those who argue for and against the idea that interventionist industry policy is the key to higher growth. The pro-industry policy school, the revisionists, have merit in pointing to the importance of politics, political institutions, culture and history in explaining any country's development. This is a useful antidote to the more extreme and austere market approaches to economic development. But the revisionist view cannot sustain its claim to offer a useful guide to future policy, in East Asia or elsewhere.

The Asian model was only ever useful for countries behind the frontier of technology and industrialisation. Once Japan, Korea, Singapore, Hong Kong and Taiwan caught up with the rich world's level of technology the model had little to offer. And even if the Asian model once held a useful development formula, the 1997 crash shows that economic conditions have changed in fundamental ways, especially as a result of increasingly rapid global movements of capital.

Asia's leaders, and their boosters in the West, made the mistake of believing their own mythology about the rise of Asia and ignored the dangers this posed. They applauded the strengths of the Asian model—and their success shows its virtues were considerable—without recognising its weaknesses.

The weakness varied from country to country. Many countries in East Asia suffered the dual economy syndrome that afflicted Japan throughout the 1990s: an efficient, competitive export sector, increasingly dragged down by an inefficient, corrupt and costly domestic sector. The crisis of 1997 began in foreign exchange markets, but the trauma of the massive currency sell-offs exposed deeper weaknesses. Countries with sounder financial systems and more efficient domestic economies, such as Singapore and Taiwan, escaped relatively unscathed.

The region's future need not be bleak in the long run. But recovery from the meltdown in the countries worst affected could take half a decade or more. East Asia will have to wait until worldwide demand for the products it excelled at making catches up with its bloated capacity. It will have to repair its seriously flawed financial and economic systems—moves that in some cases will exact a high political and social price. When East Asia does recover there will be no repeat of the rapidity of economic expansion of the miracle years, although once they rebuild there is no reason they can't return to a more measured prosperity.

The 1997 crisis has undermined claims that a distinctive set of Asian values will produce superior economic outcomes. Some so-called Asian values are shared with the West; others, used to defend authoritarian political systems, contributed to the severity of the crisis. The notion of Asian values is recent and self-serving, but its influence has been strong. Yet while the crisis has undermined the potency of Asian values, it has also weakened the authority of another influential prescription for economic success: the more extreme versions of the free-market model espoused by the IMF and others.

The effects of the crisis go beyond economics. The stories Asians and others use to explain East Asia's successes and failures and its place in the world will change radically as a result of the 1997 crisis. The crisis will bring changes in social and cultural attitudes, and in the balance of power within the region. In responding to the crisis Japan was ineffectual and the United States heavy-handed and overbearing. China, by contrast, did everything asked of it by other Asian countries and the United States, and its influence and prestige have grown accordingly. The gradual shift in the region's balance of power towards China accelerated as a result of the crisis, an outcome that will not be welcome to the West and that will add to uncertainty within the region.

Chapter 1

The end of the Asian miracle

The annual meeting of the International Monetary Fund is usually a staid affair. But the gathering in Hong Kong in September 1997 was different. The choice of venue was meant to symbolise the transfer of the quintessentially capitalist state, Hong Kong, to the still nominally Communist China—a sign of the quiet revolution in the global economic order. But instead of the afterglow of the Hong Kong handover, conversation was dominated by the financial storm raging to the south. The crisis had begun with the collapse of the Thai currency on 2 July and quickly spread to the other largest nations in South-East Asia: Malaysia, Indonesia and the Philippines. Within months of the IMF meeting the turmoil had spread to Hong Kong, South Korea and Japan, and was threatening economic prospects throughout the world.

Two men were the focus of attention at the Hong Kong meeting: Malaysian Prime Minister Mahathir Mohamad and American billionaire financier and philanthropist George Soros. Mahathir believed he and other Asian leaders had learned to beat capitalism at its own game. His Look East policy, first enunciated in 1981 and still his exemplar, held Japan's postwar 'developmental state' as a model for Malaysia, a model superior, he said, to that offered by the West.

'After World War II we saw Japan's phenomenal progress and concluded it has the formula for rapid development', Mahathir wrote in 1994. 'East Asia, with Japan leading the way, will continue to drive the world economy and play an increasingly important global role in the coming century.'[1]

Soros is said to have made $1.6 billion in 1992 when he sold sterling ahead of the United Kingdom's decision to pull out of the European Exchange Rate Mechanism and Mahathir blamed him for the Asian meltdown. Soros had made billions from his market speculations and spent more than another $1 billion in aid to former communist states of Eastern Europe. His philanthropic Open Society Institute has been highly critical of the military regime in Burma, another cause of annoyance to Mahathir. Mahathir and Soros had diametrically opposed views of what had gone wrong in Asian financial markets, differences that crystallise the debate on the factors behind Asia's economic miracle, and its downfall.

In September 1997, as the heavies of the financial world descended on Hong Kong, the problems, though serious, seemed to be local. For several months before the IMF meeting, Mahathir had been attacking speculators in general and Soros in particular, branding him the leader among the rapacious speculators he said had set out to ruin his country and the region. 'We have definite information that he [Soros] is involved. Of course, he is not the only one. Others followed suit. But he started it', Dr Mahathir said just before the IMF meeting.[2]

Soros had been attacking ASEAN currencies to punish them for accepting military-ruled Burma into the organisation, Mahathir said. 'All these countries have spent 40 years trying to build up their economy and a moron like Mr Soros comes along with a lot of money.'[3] All through the turmoil Mahathir, the quintessential East Asian chauvinist, had insisted that Malaysia's economy was fundamentally sound and that the financial troubles were the fault of speculators. He hinted at a Jewish conspiracy behind the crisis, pointing out that Soros was a Jew.

Soros was a quirky representative of global finance and an ironic choice of target for Mahathir's venom. Although one of the most successful exploiters of the capitalist system, Soros had an abiding wariness of some of its key features—especially the consequences of unbridled laissez-faire capitalism and the 'excessive individualism' of the West. Soros is one of the most astute critics of the consequences of the growing spread of financial markets and of the kinds of dangers exposed by the East Asian financial turmoil.

By September, South-East Asia's financial turmoil was showing no sign of abating and Mahathir's attacks on Soros were becoming increasingly strident. There was great anticipation over what the two men would say when they appeared, separately, at the IMF meeting. When he addressed hundreds of financiers on 20 September, Mahathir did not disappoint. 'I know I am taking a big risk to suggest it, but I am saying that currency trading is unnecessary, unproductive and immoral. It should be made illegal. We don't need currency trading. We need to buy money only when we want to finance real trade', he railed.[4] 'The traders apparently make billions with each transaction . . . Their profits come from impoverishing others, including very poor countries and poor people', Mahathir said.

Soros replied the next day. 'Dr Mahathir's suggestion to ban currency trading is so inappropriate that it does not deserve serious consideration. Interfering with the convertibility of capital at a moment like this is a recipe for disaster. Dr Mahathir is a menace to his own country', Soros said. 'He is using me as a scapegoat to cover up his own failure. He is playing to a domestic audience and he couldn't get away with it if he and his ideas were subject to the discipline of an independent media in Malaysia.' Soros denied that he had been a big player in the crisis. His huge investment funds had not sold any Malaysian ringgit or other ASEAN currencies for two months before the crisis hit, or during it.

If Soros was not impressed with Mahathir's comments, neither were global and Malaysian investors. On Monday, when the markets next opened, the ringgit fell another 2 per cent and the Kuala Lumpur share index fell 3.4 per cent.

The irony of the spat between Mahathir and Soros is that the forces that undermined Mahathir's Asian model are in some respects equally vehemently opposed by Soros—though for different reasons. Mahathir might even agree with Soros that capitalism has to strike a balance between the needs of the community and the individual. Where they would differ is on where that balance should lie.

Even in a narrow sense, their spat at the Hong Kong IMF meeting was important enough in that it raised two important questions: what were the reasons for the financial meltdown that began with the collapse of the Thai baht in July 1997? Who was to blame? But the Mahathir–Soros dispute goes further, to the heart of a key debate: if Asia really had discovered a better way of running capitalism the lessons could help not just the rich world become richer, but the poor world too. Was Mahathir right, that the otherwise good work of the East Asian miracle had been undone by capricious and wicked speculators? Or was Soros right, that Mahathir was using him as a scapegoat to cover up his own failings—and by extension, the failings of the East Asian miracle model?

This book seeks to answer those questions, in the light of events that have radically altered perceptions of East Asia's prospects and undermined shibboleths in both Asia and the West about the region's dynamism.

Mahathir and the markets

Mahathir has long made a virtue of basing his nation's economic development on the Japanese model. He likes to contrast Asian virtues of frugality, hard work and loyalty with western decadence. Another of Mahathir's themes is that the West, especially America, fears the rise of Asia. The West sees the East as a threat to its own global dominance, Mahathir says. The message resonates well in a region where, aside from Japan and Australia, there is at best only grudging acceptance of America's dominating economic and military presence.

American politicians, academics and journalists provide plenty of fuel for Mahathir's case. Two decades ago the message from the West about Asia was upbeat. In the early 1980s American scholars—notably Chalmers Johnson in *MITI and the Japanese Miracle*—popularised the notion of a distinctive Japanese economic 'miracle'. The miracle moniker was soon applied more broadly throughout the region as other countries imitated Japan's success.

Particularly striking was their view that Japan had demonstrated an alternative model of economic development that improved upon laissez-faire capitalism. This challenged the traditional 'neoclassical' or 'modernisation' view that Asian economies were in a transitional stage of economic development and would in due course come to resemble more fully developed economies, epitomised by the United States. The most influential proponent of the modernisation view was Edwin Reischauer, an American ambassador to Japan and historian. In his book, *Japan: A Reinterpretation*, Patrick Smith argues that Reischauer and his circle, known as the Chrysanthemum Club, were uncritical apologists for Japan who created a highly misleading picture of its inevitable progress towards a western model. Parts of Reischauer's work 'can fairly be called propaganda passed off as history', Smith argues. In the late 1980s the Chrysanthemum Club was challenged by a loose group of journalists and scholars known as the revisionists—a moniker bestowed by journalist Bob Neff in a *Business Week* cover story entitled 'Rethinking Japan' on 7 August 1989. They were bound, as Smith says, by the assumption that the modernisation paradigm is false, and that the West should reassess the way it looks at Japan. The revisionists argued that Japan had assumed only the outward trappings of democracy, that its institutions did not function as westerners expected, that the government was an advocate as well as a regulator, and played an active role in the economy with defined social and economic goals. The revisionists drew another important conclusion: here was a model for economic development that could lift nations from poverty.

But it did not take long for a negative message to emerge in response to the revisionists' insights: Japan was not playing fair, and was exploiting the free-trade system championed since the war by the United States without reciprocating by opening to the West their increasingly wealthy markets. The popular view in America was that Japan was cheating, that Japan was stealing American jobs.

Mahathir knew of the hostility towards Asia spawned in the United States by the revisionist stance, a view that had had a strong influence on the administrations of both Republican George Bush and Democrat Bill Clinton. A consummate politician, Mahathir exploited the ambiguity in western attitudes towards Asia and the unsavoury social consequences of western capitalism. Mahathir wanted to choose selectively from the benefits offered by the West. He wanted its technology and its capital, but not its social problems or the democratic values that could weaken his hold on power. He championed the notion of Asian values, a view that encapsulated his idea that Asia could take a different path.

But the rules of the economic game were changing behind Mahathir's back. There were always some risks in the Asian model, but for half a century they had mostly been avoided. Only Japan, the vanguard of the new model, had suffered in recent years from its shortcomings.

How Japan paved the way

Japan played a bigger role in fomenting the 1997 crisis than any other country. Japan was the inspiration for the idea of a distinctive Asian model of development. And it was the rise in the yen until mid-1995 that created both a flood of capital and an export boom in East Asia. When the yen fell the conditions that created