When East Asia experienced sharp economic reversals in 1997–1998, the profusion of media reports used words like “meltdown,” “collapse,” and “crash.” East Asia’s recovery in 1999 and 2000 has been no less dramatic, but the rhetoric used to describe it has been both more restrained and less abundant.

This asymmetry has several explanations. One is simply the media’s predilection for bad news over good.

A second relates to uncertainty about the robustness of the recovery, and the desire of commentators to avoid being too far out on a limb if the turnaround turns around.

A third explanation is that the 1997–1998 economic shocks jeopardized the balance sheets of money-center banks in the United States, Europe, and Japan. The jeopardy arose because billions of dollars of short-term loans were made in the frenetic 1995–1997 period without adequate attention to the “due diligence” standards which the banks profess, but did not follow in this instance. By 1999, when the Asian recovery was well underway, the banks’ predicament had been significantly relieved by the largesse of the IMF and its governmental contributors.

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A slightly edited version was published in The Los Angeles Times on July 23, 2000 under the title “Have You Heard About the Incredible Journey?”
There is no question that the economic turmoil, which ensued in East Asia in 1997–1998, was severe. Four Asian economies—Thailand, Korea, Malaysia, and Indonesia—that had realized high positive GDP growth in 1996 experienced negative growth between 5 percent and 12 percent in 1997 and 1998. Asset values in these “crisis” countries plummeted by about 75 percent due to the combined effects of currency depreciation, and deflated equity and property valuations. Averaging over the four economies, an asset worth $100 in June was worth only $25 a year later.

By the second quarter of 2000, the turnaround has been extraordinary. Korea, Thailand, and Malaysia currently have annual growth rates equal to or above those of 1996. Indonesia’s growth—about 3-4 percent—is surprisingly high as well as shaky because of serious problems and uncertainties which beset it largely unrelated to the 1997–1998 economic turmoil. The problems include civil and military unrest in Timor, Atjeh, and the Moluccas, and the continuously ambiguous if not portentous position of its military establishment in the country’s political future.

Other indicators of the recovery’s surprising strength abound. Capital inflows have resumed, mainly in the form of direct investment rather than debt. Korea, which was almost closed to foreign direct investment prior to the turmoil of 1997, received $15.5 billion of FDI in 1999, five times the 1996 inflow. The current accounts of the four economies are positive, and their foreign exchange reserves are above those held in 1996 (except for Indonesia). Their currencies—whose exchange rates are now flexible rather than artificially pegged as they were in 1997—have regained more than 50 percent of their pre-crisis values. Finally, the foreign debt that remains has been substantially restructured in favor of long-term rather than short-term obligations.

The abundant evidence of recovery is all the more impressive because the Japanese economy, which had long been viewed by the conventional unwisdom in the United States and in the International Monetary Fund as the essential engine for East Asia’s recovery, continues to stagnate. Japan’s deep-seated economic troubles predate and transcend the Asian financial crisis, and have been only marginally affected by it.
Asia’s other major economy, China, continues to register significant growth, although still beset by problems which are largely independent of the 1997–1998 crisis: for example, the continuing heavy burden of its subsidized state-owned enterprises, a poorly managed and vulnerable banking sector, and widespread corruption.

Although the East Asian economies are doing remarkably well, this doesn’t mean that all their vulnerabilities have been overcome, nor that business cycles have been repealed. Indonesia’s serious and still unfolding problems have already been mentioned. Korea’s large and amorphous chaebols still require reform, as well as explicit non-preferment in their access to credit or other benefactions. In Thailand, one-third of the banking systems’ loans are “non-performing.” And Malaysia’s Mahathir has perhaps only temporarily backed away from his belief that tightly-regulated capital markets are better than less-regulated ones.

Nevertheless, the upward trajectory of the Asian economies is likely to endure because of five lessons—four tactical and one strategic—which appear to have been learned from the debacles of 1997–1998:

As a form of foreign capital inflow, direct investment is far preferable to debt.

- When emerging market countries or corporations borrow abroad they should not borrow short and invest or re-lend long—a pervasive practice leading up to and precipitating the 1997 Asian crisis.

- Borrowing in foreign (“hard”) currency and re-lending or investing for purposes that do not generate foreign currency earnings should be avoided, or at least limited by availability of ample foreign exchange reserves.

- Domestic currency shouldn’t be pegged to the U.S. dollar, unless fiscal and monetary policies and institutions are strong enough to support the peg.

Finally, in charting development strategy, what used to be referred as the “Japan development model” should be eschewed. The Japan model, much extolled in the 1970s and 1980s, predicated resource allocations on the basis of non-market, industrial-policy preferment
for chosen firms or industries, rather than on market criteria of costs and profitability.

While these lessons provide grounds for optimism, there is also a perverse lesson conveyed by the previous financial turmoil and the quick-fix remedies adopted to redress it. Moral hazard is the perverse lesson that may well counter, if not negate, the positive lessons that have been learned. If events turn sour—whether as a consequence of mistaken public policies in emerging market countries, or of the misguided lending practices of banking institutions in the wealthy countries, a belief has been nurtured that IMF or other government bailouts will come to the rescue. The unintended but perverse result may be to encourage irresponsible behavior that can lead to crises in the future. Notwithstanding the hoped-for reform of the International Monetary Fund, its increased financial resources and heightened aspirations may actually intensify the dangers of moral hazard in the future.

Postaudit

The points about foreign lending, direct investment, and especially moral hazard that seemed to me important lessons from the 1997–1998 Asian financial troubles remain valid and relevant.