Like the dog that didn’t bark in the classic Sherlock Holmes story, one of the most significant, as well as neglected, facets of the financial turmoil afflicting the international economy since mid-1997 is what did not happen. What did not happen is the global deflation and recession, or anything approaching this dismal prognosis by such occasionally credible sources as The Economist, George Soros, Paul Krugman, and others in the past year. In fact, economies producing more than 80 percent of the global product have adjusted with reasonable speed and effectiveness. Nor has the process of their adjustment significantly affected their prior economic performance, whether it had been relatively bad (e.g., Japan), relatively good (e.g., the United States), or something in between (e.g., the European Union).

To be sure, the collapse of currencies and asset markets in Southeast Asia and Korea in 1997, followed in mid-1998 by the plummeting of the Russian ruble, and in 1999 by the still precariously depreciating real in Brazil, have inflicted severely adverse shocks to these economies. And these shocks have undeniably had repercussions elsewhere. Imports and exports by the Asian countries have sharply declined, painfully depressing Asian living standards and GDPs. Correspondingly, exports to Asia from the United States, Europe, and Japan have also declined, and Japan’s new investments in Asia have been shut down or curtailed. Foreign capital exited from much of

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A slightly edited version was published in The Wall Street Journal on March 2, 1999 under the same title.
Asia, from Russia, and latterly from Brazil. In the Russian case, capital flight followed and reflected the previous flight of indigenous capital engineered by Russia’s so-called “oligarchs.” In Brazil, capital flight has reflected the government’s equivocal policies for controlling and reversing the economy’s huge accumulation of both public and private debt.

Nevertheless, the repercussions from the financial turmoil in Asia, Russia, and Brazil have been modest. They have not had major adverse impacts on the performance of most of the global economy. In fact, the international economy has been more robust and resilient than would be inferred from most prior as well as current commentaries.

The U.S. economy has continued to perform creditably, experiencing both limited harm as well as limited benefits from the financial turmoil elsewhere: limited harm in the form of reduced exports to Asia (by 13 percent between 1997 and 1998), limited benefits through the damping effects of increased imports from Asia (by 4 percent between 1997 and 1998), on latent inflationary pressures in the U.S. economy.¹

The European Union’s GDP growth rate, about 2.7 percent in 1998, has been at or above that of recent prior years, notwithstanding the financial turmoil elsewhere, while leaving virtually unchanged the EU’s staggering unemployment rate of nearly 11 percent.

Japan’s economy has continued to stagnate, experiencing negative growth and rising unemployment. Its lagging performance has been accompanied by a still growing current account surplus, resulting from the economy’s deeply ingrained mercantilist policies favoring exports and inhibiting imports.

In both Europe and Japan, admittedly serious economic problems—high unemployment in Europe, negative GDP growth and rising unemployment in Japan—are fundamentally structural and institutional, rather than cyclical in nature. Both the causes of these problems, and remedies for them, are unrelated to and largely unaffected by the financial turmoil in Asia, Russia, and Brazil.

¹Exports and imports based on data for the first 11 months of 1997 and 1998.
The same point applies to most of the developing world, as well. Thus, the Chinese economy has maintained significant growth (even if the officially reported 7.8 percent rate in 1998 may be overstated), while still beset by serious problems in its costly and subsidized state enterprises and its vulnerable domestic banking institutions. No less than in Japan and Europe, China’s economic problems are quite independent of the financial difficulties elsewhere in Asia, Russia and Brazil, although surely these problems are not eased by the financial turmoil elsewhere.

India, while realizing at best only modest progress in its efforts to liberalize the economy and reduce its bureaucratic shackles, continues to grow at a creditable annual rate between 4 and 5 percent. Once again, quickening the pace of reform in India depends on factors quite unrelated to the financial troubles encountered in Asia, Russia, and Brazil.

Despite the alarmist emanations from Davos and parts of the Washington Beltway (especially in the vicinity of the International Monetary Fund and the World Bank Headquarters), there is and should be a growing recognition that the acute economic setbacks in Asia, Russia, and Brazil, have been largely due to their defective economic policies rather than to the phenomena of “contagion” from one country to another, or “herd behavior” on the part of foreign investors. (Indeed, to the extent that “contagion” has occurred, it can be attributed as much to the hoped-for balm of external bailout funds, as to the activities of speculators and foreign hedge-fund managers.)

In Asia, these defective policies took the form of huge, often concealed short-term debt and unrealistically pegged exchange rates—policies that were, in considerable measure, abetted by the implicit belief of both lenders and borrowers that succor would be forthcoming from foreign governments or and multilateral agencies if things went sour.

In Russia, the defective policies took the form of massive fraud and indigenously manipulated capital exports through under invoicing of product exports and over invoicing of product imports.
And in Brazil, the culpable policies were reflected by unrestrained fiscal deficits, excessive public and private debt, and an unrealistic and unsustainable exchange rate.

It is indeed noteworthy that if and as such defective policies are replaced by manifestly sensible ones—as Korea and Thailand have proceeded to do in the past year—economic prospects improve dramatically. For example, in Korea, negative GDP growth of about 7 percent in 1998 shows promise of being replaced by 1 or 2 percent positive growth in 1999.

In sum, the robustness and resilience of the international economy and its capacity to absorb unwelcome financial shocks have been drastically underestimated, if not misrepresented, in governmental, as well as academic, circles, and certainly in the multilateral agencies. Whether and how much the activities, subventions, and policy advice of the IMF have contributed to or detracted from this capacity is a matter of legitimate debate. At least the resilience that has been evident in the face of the financial shocks of the past 20 months warrants skepticism as to whether the creation of a “new international financial architecture”—which would inevitably encompass expanded resources and authority for the IMF and the World Bank—is warranted. Imposition of such a construct would be as likely to make the global economy more prone to financial volatility and shocks, as to enhance its capacity for absorbing them.

Postaudit

I plainly did not anticipate the U.S. recession in 2001 and its global repercussions, although the emphasis placed in Chapter 5 on national economic policies, rather than the effects of foreign economic events, is still valid.