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The End of the Asian Miracle

Consequences and Repercussions

By Georg Erber*

Summary

The article reconsiders the vision of the Asian miracle of the past with the dramatically changed perspective emerging from the Asian Crisis since 1997. It challenges the view of many commentators that the Asian Crisis has not been envisioned by economists. It might be true that the form and speed of the collapse has not been predicted correctly, but there were early warnings that significant slow-downs of growth in most parts of East and South-East Asia were under way. The works of Young, Lau and Krugman had received much attention but rejection of the public and the political establishment in Asia. From this perspective the financial and banking crisis is just a consequence of a failed adjustment that high returns of financial investments could not be supported by high returns of investments in production facilities and real estate. Since all countries followed the same vision of an unsustainable long-term growth path the contagion effects spreading across the region are not surprising. The Asian crisis has its financial origin in Japan. Japanese banks and companies together with other Western countries made significantly higher financial investments in the region after the financial bubble in Japan had burst in the early 1990s. Japan exported her financial bubble to other parts of Asia. Furthermore the financial crisis in Asia was significantly related to the sequence of competitive devaluations of Asian currencies against the US Dollar. To avoid future risks of competitive devaluation shocks the countries of the region should therefore start to set up an Asian Monetary System similar to the European Monetary System. The AMS should finally converge to an Asian Monetary Union. By adjusting their long-term growth perspectives to sustainable growth patterns and by establishing an AMS the region would significantly regain a better economic perspective even if the age of miracles has ended.

1. Introduction

In August 1993 when Western Europe experienced the worst recession since the end of the second world war (see e.g. Dornbusch, 1993) the World Bank (1993) published a report under the title, *The East Asian Miracle, Economic Growth and Public Policy*, which claimed to explain the origins of the past highly successful developments in most of the East Asian economies as a result of a particular successful institutional setting different from the rest of most developing countries of the world. The enduring success and future perspectives of this particular East Asian model were explained by the authors to a significant extent to noneconomic factors, including culture, politics, and history, which could teach the rest of the world a lot how to run a dynamic modern market economy.

After the Thailand shock of July 1997 which, like an epidemic triggered a sequence of major devaluations of Asian currencies and stock market crashes and finally lead to panics and political turmoil at least in countries like Indonesia, South Korea and Thailand afterwards, it is obvious to ask what happened to this Asian Miracle which was considered by even many Western observers to lead to a

Pacific 21st century and a fading importance of the sclerotic Western civilisation of established European and North American traditional capitalist economies.

The most recent development in Asia raises at least questions like those, why could many Western and Asian observers be so terribly wrong in their assessments of the economic potentials of the Asian economies, and, what will be the immediate and more long-term consequences of current developments for Asia and the rest of the world?

Furthermore it sets an agenda for an urgently needed debate on what should be done to contain the negative effects to spill-over to the rest of the world and what should be done to stabilise the faltering economies of the East and South-East Asian region. Do we need new Megapolicies (see e.g. Montgomery; Rondelli, 1995) to deal with the current crisis in Asia or could things get under control by trusting the efficiency of global financial and money markets to deal with this crisis on its own?

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Every economic event like other events offers at least two different perspectives so that it might be judged as beneficial or harmful to the observer depending on his preferences. So even the emerging major economic crisis in East and South-East Asia which might even lead to a long-lasting depression for a number of years and its potential spill-over effects for the rest of world economy may be judged differently from the perspective of outsiders of the Asian drama.

Peter Stihl, president of the German Chamber of Industry and Trade (DIHT), points to the improved comparative advantage of Germany as an investment location as a result of the default of many East and South-East economies (see Spiegel, 1998). This, however, is a major misconception what is currently at risk for all of us. The global economy is not a zero-sum game where losses of one or a number of players automatically leads to profits for all others. If growth in one major region of the world economy falters — and it seems that this will be the case for some time at least for all countries of the region — including the Peoples Republic of China — all other economies closely linked to them by a network of direct or indirect trade, financial and other vital economic relations will to some degree suffer along with them.¹

Before we start to discuss the issues in detail we should define the region we consider as part of our whole analytical framework. Between many authors like Krugman (1998)², McKinnon (1998)³ or Bergsten (1997)⁴, just to name a few leading U.S. experts, there is a substantial disagreement which countries are part of the problem.

This is in principle due to the fact that the crisis of the whole region — which includes in my opinion all countries in East and South-East Asia and is therefore close to the view of Bergsten — started with an exchange rate and stock market crisis in Thailand beginning in the second half of 1997. Therefore as Krugman (1998) or McKinnon (1998) point out, the crisis was judged in the beginning only to be a typical case of an isolated crisis of one country which had overspent, overinvested and overborrowed in foreign exchange denominated money and financial markets. After this behaviour became obvious in the badly regulated financial markets of Thailand to a broader international audience of private as well as institutional investors and speculators in the emerging market economies, the shift from the overoptimistic expectations, which endured since then, led to a dramatic shift destroying first the reputation and credibility⁵ of the Thai central bank, the Thai banking system and finally that of the Thai government of premier Chavalit to be able to cope with the crisis. The recipes to deal with such a crisis are quite well known from standard economic theory (see Obstfeld, 1994) and the hope was that the IMF which finally had to step in to save the Thai economy from bankruptcy — due to its near insolvency to international creditors — could only be saved by injection of fresh hard currencies of billions of U.S. dollar credits to keep the Thai economy financially afloat. However this attempt to stabilise the Thai economy failed, on the one hand, due to a reluctant behaviour of Thai institutions to take timely ac-

tions to avert a major international as well as national long lasting credibility shock and, on the other hand, due to more fundamental problems which are present in the domestic real economy, i.e. misallocations and overinvestment in the construction and real estate sectors as well as in many other industrial and service industries.

Hoping for an even further accelerating growth of the Thai economy since 1994, the government raised its long-term growth rate prediction for the Thai economy from 7 % to 8 % annually. This view neglected the already fragile state of the Thai economy at this time. Many Asians were misled by the extraordinary high reported growth of the PR China during the late 1980s and early 1990s. By asking themselves, "if they can do it why we can't do it?", they were tempted to raise their already ambitious growth targets. They misjudged by this the capabilities of the Thai economy to project its past growth performance into the future on a sustainable growth path. The capacities built up in Thailand during the first half of the 1990s in the real estate sectors but as well in many other industries like tourism, telecommunication services, etc. could not match with the growth of its effective demand. The substantial influx of foreign money or foreign direct investments in the 1990s depended on unrealistic assumptions on the potential rate of return of investments in Thailand like in other East and South-East Asian economies.

However, this story is in my opinion not the beginning of the process which led to the current Asian crisis but rather a result which came up from a mismanagement of the collapse of the Japanese bubble economy at the end of the 1980s or early 1990s respectively. Therefore the failure of the Thai economy in 1997 is just the result of an Asian disease originating from Japan which infected nearly all East and South-East Asian countries during the 1990s like an epidemic. The Japan virus infecting the other Asian economies were credits given to them from Japanese financial and banking institutions which tried to recover there tremendous hidden losses from the Japanese asset and real estate bubble of the late 1980s. This was possible

¹ Cf. for e.g. German Morgan Grenfell calculations of respective sales and profit ratios of major German based multinational corporations in Asia even excluding Japan and the PR China. Kronos with 24 % and 3 %, Schering with 18 % and 20 %, Bayer with 16 % and 7 %, Metallgesellschaft with 15 % and 15 %, Hoechst with 14 % and 8 %, MAN with 14 % and 17 %, BASF with 10 % and 2 %, Siemens with 9 % and 3 %, Hochtief with 8 % and 8 %, Krupp with 7 % and 3 %, Mannesmann with 7 % and 5 %, and SAP with 7 % and 6 % (see Spiegel, 1998).

² Krugman chooses the MIT countries (Malaysia, Thailand, Indonesia) as his agenda for his analysis and includes later on South Korea as a distinct part of his analysis of the Asian crisis.

³ McKinnon chooses the East Asian five big dollar debtors (Thailand, Indonesia, Malaysia, Philippines and South Korea) as his agenda.

⁴ Bergsten considers an even broader region including Japan and the PR of China as well as Taiwan, Hong Kong, Singapore to it.

⁵ On concepts of how credibility and reputation formation and its impacts in an economy cf. e.g. Erber, Hagemann (1997).

because the Japanese central bank, by lowering step by step its discount rate to 0.5 %, offered a refinancing opportunity for Japanese banking institutions at zero or even negative real interest rates. By giving credits to those countries with significant higher expected rates of return or making substantial foreign direct investments (FDIs) in the region it offered seemingly unlimited opportunities of high returns from these emerging markets in a situation where the Japanese domestic demand stayed more or less stagnant since the early 1990s. The enormous debts of the private sector in Japan which had to be paid back kept most households and small and medium sized enterprises (SMEs) in Japan from using this cheap money to expand their demand by taking additional credits. Even a couple of major deficit spending programs and tax cuts to stimulate domestic demand in Japan ended in a failure to revitalise the Japanese economy and bring back the high growth rates of the 1980s.⁶

Extremely low interest rates by historical standards in Japan supported a financing spree of the Japanese banking system in this region which was already heavily burdened by bad debts caused from the deflated Japanese bubble economy especially because the Japanese economy did not recover briskly from the slump of the early 1990s. The dramatic rising stock market prices in the East Asian emerging market economies helped to trigger an asset price inflation there, leading finally to a new bubble economy in Asia this time outside of Japan but financed to a significant degree by Japanese financial institutions. Japans financial institutions were exporting a financial bubble to East and South East Asia. It already caused a dramatic rise in the inflation rate in the PR China in 1993 which led to the devaluation of the Chinese currency and attempts of the Chinese government to limit the capital import at this time. This event already signalled that the Chinese economy had reached capacity limits and the previous high growth might be unsustainable in the future.

Economic development rests as many people in Asia now become increasingly aware not only on sound fundamentals and past trends of economic growth but sometimes even more on expectations, credibility and reputation as immaterial but important factors determining economic decisions. When the illusion of a long-term sustainable high growth era in Asia started to be questioned by Western economist like Young (1992, 1994, 1995) or Krugman (1994, 1995) their arguments were turned down by a broad majority of Asian economists and politicians as premature. Instead one insisted that the current growth rates in Asia would be sustainable at least for the next twenty years. One still felt in line with the mainstream economists like Lucas (1993) and for e.g. Felipe (1997) and other authors of the region tried to present arguments against a significant medium term slow down in growth rates in Asia.

The major argument raised by authors like Young and Krugman was that in the past the growth process rested nearly exclusively on an accumulation process of resources

like capital and additional labour inputs but much less on a high rate of technological progress. By already reaching extremely high saving ratios and high employment shares in their population the same sources of growth could not be the cause of future high growth. A further increase in the savings rates or the labour participation would simply be not feasible for them. Without any empirical indication that the qualitative factors of economic growth have the capacity to become substitutes for the resource driven growth the conclusion could only be that growth rates in Asia would have to come down in the medium-term.

By ignoring the timely warnings and insisting on a similar high future growth pattern most high growth economies in Asia had to rely more and more on capital imports (Cohen, 1994). This made these economies more and more vulnerable to exchange rate shocks especially because their financial institutions relied on debt financing in foreign hard currency denominated credits. The short-term advantage of lower financing costs at quasi-fixed exchange rates was counter balanced by an implicit exchange rate risk which was ignored because everybody trusted the peg of their currencies to the U.S. Dollar. The devaluation of U.S. Dollar in relation to the Japanese Yen already caused some pain when credits were denominated in Yen for these countries. But this could at least be compensated by an increase in price competitiveness to the Japanese economy. The situation became more fragile when because of strong growth of the U.S. economy, expectations were rising due to remarks made at the end of 1996 and early 1997 by Allan Greenspan, the chairman of the Fed, that the U.S. central bank would soon raise interest rates to avoid an overheating of the American economy. These changes in expectations concerning the interest rates already led to some bank failures in Thailand before the Thai central bank had to float the Thai Bhat in August 1997. The agenda was set to a dramatic shift in the perception of the future growth path in many Asian economies.

2. Are International Money and Financial Markets Efficient?

One cornerstone of modern economic theory is the belief that markets and in particular money and financial markets are the most efficient resource allocation mechanism. The question one might raise, however, is whether this belief is valid under all circumstances. By accepting in principle that unregulated stock markets are endogenously generating speculative bubbles as already has previously been demonstrated by the major global stock market crash in 1987 and for Japan in 1989 and accepted by the economic mainstream, the question is to what extent markets are only

⁶ One should keep in mind that Japans rapid growth era compared to those of South Korea, Taiwan or currently the PR China already ended after the first oil price shock. However, economic growth stayed at a comparative higher level than in most other already industrialized countries.

efficient if they are operating in a close proximity of a stable equilibrium path which have to be determined by other factors. The consistency of a macroeconomic policy design and more generally the social and political environment of a society are external factors which might be perceived by economic agents but cannot be controlled through market activities. Speculations that certain current and future social and political environments are inconsistent with the present market valuation then easily lead to revaluation shocks. Speculative attacks on stock or real estate markets as institutions which deal in particular with the valuation of long-term wealth and therefore on the sustainability of current trends, just are means to express by market signals that major inconsistencies in the economic development of an economy have occurred. They are sometimes an early warning mechanism if social and political institutions fail to address those inconsistencies in a timely manner and by this create a major accelerating disequilibrium process of a previously sustainable growth trajectory.

3. Competitive Devaluations in Asia and how to stop them

The heavy foreign debt financing of the rapid expansion of the East and South-East Asian economies led to the contagious currency crisis of Thailand which immediately infected Malaysia and Indonesia and spread out to South Korea afterwards. Only countries belonging to the greater China area (cf. Wong, 1995, i.e. PR China, Hong Kong, Taiwan and Singapore) could maintain a more moderate stand. This is as Bergsten (1997) has pointed out due to the fact that the PR China devalued its currency in 1994 by about 40 %. As well the East and South-East Asian countries lost a significant competitive advantage in 1995 and 1996 when the Japanese Yen devalued against the U.S. by over 25 %. This sharp decline of the two key currencies in the region put tremendous competitive pressures on the rest of Asia, which had a close peg of their currencies to the U.S. dollar. While losing their transitional comparative locational advantage they experienced during the appreciation of the yen to the U.S. dollar and facing stiff competition of the PR Chinas exports of goods and redirecting the FDIs to China from the rest of Asia, the growth perspectives for the previously hold export led growth strategies rapidly became obsolete. The capacities built up in much of the East and South-East Asian economies for exports to the region and the rest of the world became excessive at the emerging exchange rate regime in Asia. Here again the expectations of economic agents in these countries might have played a major role. If the exchange rate volatility is only fluctuating in the short-run around the purchasing power parities it might not be harmful for the long-term export performance. However, if they endure much longer than expected they will lead to significant decreases in exports especially to hard currency countries in America and Europe, because all Asian economies address these marktes heavily. By decreasing hard currency inflows from

exports in most countries East and South-East Asian economies the ability to service the outstanding foreign debt payments decreased dramatically. By attempting to bridge the widening gap by short-run credit financing the need for additional credits and rollover credits accumulated the longer this unbalanced exchange rates between the Asian economies endured. The countries who might have thought in the beginning that they would cover this gap for some time finally were caught in a debt trap. If they would start to float their currencies, the U.S. dollar or yen denominated credits would squeeze the rate of returns of the investments made. They might even become negative. Since the export industries are highly concentrated in a few sectors like electronics and information technology equipment or automotive parts, a conflict between investors in the export oriented industries and those who invested in real estate emerged. If both had financed their investment in foreign currency denominated debt, the former would be compensated by a devaluation by rising exports while the latter would not.

The conflict of interest of different groups of investors in each country had no easy political solution and has postponed a timely action which just became unavoidable when speculative attacks from the international financial markets and the depletion of the hard currency reserves of the central banks made floating their currencies unavoidable.

When countries, which still had a solid foreign exchange position and trade surpluses like Taiwan, started to follow the spiral of devaluation to maintain their current international trade position (see the remarks of Bergsten, 1997), the situation became worse. It will even deteriorate further when the rest of the greater China countries follow suit. The situation will then have strong similarities with the competitive devaluations during the world economic crisis in 1929 at least for Asia. The only way out of this downward spiral seems to be to come to an international settlement between the countries of the region to search for a joint exchange rate equilibrium, stopping a beggar-my-neighbor policy.

However, at the moment there seems to be no political leader in the world to orchestrate such a bargaining-equilibrium of these countries. The major actor for this role would be the U.S. government, as McKinnon (1998) has pointed out. But it is very doubtful if the U.S. president has enough room to manoeuvre a major bailout deal like the Brady-plan which ended the last debt crisis at the end of the 1980s, because he has insufficient support from the Republican congress. During the Peso crisis of Mexico in 1994-95 the Clinton government had already, together with the IMF, to stress its influence to the limit. The European countries on the other hand are at the moment too much involved to solve their transition process to the European Monetary Union (EMU) and consider the fallout from the Asian crisis to be minor for them. Even the attempt of the IMF to raise its financial resources to deal with the Asian crisis was refuted by the German minister of Finance at a

meeting in December 1997 with Camdessus, the IMF managing director. Therefore there seems to be little direct help available from the U.S. and Europe by giving additional financial resources to the hard currency strapped Asian economies. Additionally, the question of moral hazard associated with such bailouts is unsolved.

In the end many Asian countries will finally have to declare bankruptcy and stop servicing their debt to start at least a bargaining process with the creditor countries for a new debt servicing schedule. The short-term rollover credits given until now to many of them by private banks from Japan, the U.S. or Europe are not a long-term solution. It might not be of help if in the future one might show — as Friedman, Schwartz have done for the world economic crisis after 1929 — that it was caused by a number of major policy failures. At the moment, the world monetary and financial system is at the fringe of a similar chaotic state due to political inactivity to develop a long-term strategy to overcome the crisis.

4. Asia Needs an AMS⁷ — Eight Theses

1. The crisis which started as a currency crisis in Thailand, followed by a stock market crash and a banking crisis, has to be considered as a major regional crisis involving currently nearly all East and Southeast Asian economies. Without accepting this as a basic hypothesis and by this accepting the interdependency between the economic events in the country group, policy actions taken by the IMF, the U.S. and regional governments might be insufficient to solve the crisis at lower costs in foregone growth, unemployment, etc. Without a major crisis in Japan and the PR China resulting from these events, the financial turmoil will be manageable in the traditional framework of debt crisis management in developing countries. If the crisis spreads to those major economies of the region it will become unmanageable by the current form of IMF crisis management.

2. The sequence of stock market crashes and rapid currency depreciation not only in Thailand, South Korea and Indonesia but also in Malaysia, Singapore, Taiwan, Hong Kong, Japan, Philippines, poses the risk of a downward spiral of uncontrolled devaluations of Asian currencies against the US dollar and all other currencies with a strong currency peg to the US and the European currencies. The major question is, *"How long will this inter Asian and extra Asian disparities in the parity grid of the world currency system prevail?"* If the current disparities would *only be transitory*, i.e. several months, major reallocations of investments and export-import-patterns will not occur. If the current disparities are at least *permanent for some time*, e.g. at least last one to two years, the new exchange rate grid will heavily influence investment decisions and international trade relations. At the moment there is little indication for a rapid realignment to a sustainable exchange rate regime in Asia and with the rest of the world. However, the

current high volatility leads to attentism with respect to trade and investment redirections because of the uncertainty about the international medium-term exchange rate relations. Furthermore the political and social instability which might prevail for some time in the region to absorb the shocks from past events if they work through the economies of the different countries will contain the willingness of local and foreign investors to make their decisions according only to the economic factors, i.e. exchange rates, local wages, etc. Before the systemic risks⁸ in countries like Indonesia, South Korea, Thailand, have been diminished to neglectable magnitudes, the financial markets and investors of the world economy will be fairly reluctant to exploit comparative advantages which emerged from the Asian crisis. This will delay the impacts from potential rapidly increasing exports from these countries to the rest of the world.

3. The current policy leader in the Asian financial market turmoil is the IMF together with representatives from the US government like Lawrence Summers, Daniel Cohen, Robert Rubin. Their strategy is to contain the crisis by making agreements with the different officials in the PR China together with Hong Kong and Japan as the two major regional powers to stabilise their currencies and maintain or stimulate their internal economic growth. Without such containment of the regional crisis to the smaller economies in East and Southeast Asia, the risk of further contagion to other parts of the world economy seems very likely. Now Latin America and Eastern Europe especially Russia as other regions which are heavily indebted to the international financial markets feel the strain of diminishing credibility (see e.g. Erber, Hagemann, 1998) into the economic stability of emerging market economies. Until now no grand strategy seems to be on the agenda to stabilise world financial markets by credibility enhancing institutional arrangements except the financial bailouts of the IMF and restrictive consolidation programs in the Asian economies seeking the support of the IMF. The short-coming of the current strategy is that it rests only on a number of bilateral political declarations, not well founded on economic facts and an integrated strategy for the whole region. For example, the attempt of the PR China to maintain high economic growth of more than 8 per cent in 1998 and the following years might be a political target but there is accumulating evidence that economic growth in China will slow down further, due to internal structural imbalances and the decreasing willingness of international investors to support this growth strategy by further foreign direct investments or credit financing of projects with uncertain

⁷ AMS — Asian Monetary System.

⁸ Due to the crisis the pre-crisis governments and respective ruling parties in Thailand of Chavalit and in South Korea of Kim Young-sam and his Grand National Party (GNP) have been ousted. In Indonesia political unrest seems quite likely after corruption endemic in the Suharto government after 32 years in power is seen as a major source blocking economic reforms urgently needed to solve the economic troubles.

rates of return and credit risks, as has happened in Mexico in 1993. The currently favourable Chinese position in high trade surpluses and high hard currency reserves might in the medium term be eroded by the loss in price competitiveness to other regional economies like South Korea, etc. This will — similarly as in Thailand before their crisis — make devaluations of the Chinese Yuan in the medium term irresistible. Even if the political leaders in the PR China try to avoid it, developments will make the Yuan an easy target for international financial speculators if the trade surplus and the currency reserves rapidly diminish during the next twelve months. The attempt of Robert Rubin to encourage the Japanese government to give further economic demand stimuli to the ailing Japanese economy by additional substantial deficit spending or tax cuts might be limited by the already high public debt of the public sector in Japan. The short-term effects of this kind of policy will in the medium and long run cripple the Japanese government future policy because the enormous debt burden has to be serviced in the future. A long-term solution of the Japanese banking crisis through a major general bailout of the banks and financial institutions therefore seems to be very limited from the perspective of current budget constraints of the public sector (the current public deficit to GDP ratio in Japan is already at about 7 per cent compared to 3 per cent in the EU countries and zero in the US). If actions taken by the Japanese government just compensate for the negative impacts already resulting from the regional slowdown in economic growth, a positive net effect for the domestic and the rest of the region is quite unlikely to occur.

4. To stabilise the situation over the next months and the medium term, it will be necessary to set up an exchange rate parity grid which is close to the PPPs of the countries of the region. Without such a fairly balanced exchange rate system, a sequence of major exchange rate shocks in the currency system in Asia seems quite likely, especially if exchange rate pegs to the US dollar like the HK \$ prevail.⁹ A mixed pegged and floating exchange rate system in Asia seems to be the most inefficient way to search the new equilibrium. The past experiences in Europe with the setting up of the EMS exchange rate mechanism might be a very useful historical example to help markets to find a new stable exchange rate equilibrium in Asia more rapidly if a similar strategy is chosen for Asia. For this to make it happen, one has, however, to give up the simple model of dollar pegged exchange rates in Asia. Instead a managed floating exchange rate system is urgently needed for Asia to give appropriate market signals to reach more rapidly a new sustainable exchange rate equilibrium.¹⁰ By determining upper and lower boundaries to exchange rate volatility at the perceived surrounding vicinity of the perceived new equilibrium the convergence process might take place more rapidly. Monetary policy intervention of Asian central banks members of such an Asian Monetary System will jointly defend these boundaries. However, if there is substantial disagreement about the sustainability of the

parity grid, this should lead to a regional bargaining process of realignments and respective policy measures of the countries to diminish the imbalances in their economic policies (e.g. fiscal policies, etc.). This makes it necessary to have political coordination across the region.

5. Repercussions of the Asian crisis on the European and German economy in particular are not only due to direct but probably more to indirect effects through the global economy. Since the direct exports or trade relations to the core countries of the Asian crisis have been small many observers in Europe have argued that the fallout from the crisis in Europe would be minor. They neglect, however, that the impacts might emerge through an indirect chain of events and are delayed to some extent because of the current highly volatile and unstable situation in the countries of the region. But even now, countries who have not directly been significantly affected by an exchange rate crisis like Japan compared to Thailand, South Korea or Indonesia, now face a significant decline in their export demand from this region which was about 30 per cent of total Japanese exports. Together with sluggish domestic demand, Japanese companies will be forced to redirect their exports to other parts of the world especially the US and Europe. Therefore the German Association of Machinery and Equipment Manufacturing Industries already foresees a growing price competition of Japanese companies in international markets especially in North America. As well to fend off low price competition from East and Southeast countries which now will try to gain market shares in other parts of the world, companies in major export oriented industries like machinery, chemicals, motor vehicles, electric equipment, computers and office equipment, telecommunication equipment will have to lower their prices to maintain their market shares and in so doing erode profitability. The Association of the German chemical industry

⁹ Convergence in a single exchange rate market to a new equilibrium after a major external shock is much more rapid than in a multiple exchange rate system. A major currency shock not only destabilizes e.g. the US \$ to Thai Baht exchange rate, but also at the same time the exchange rates to other major trading partners or competitors. Therefore a two country model will not represent adequately the convergence mechanism especially the convergence speed to a new general exchange rate equilibrium. The maintained hypothesis here is that in a multiple exchange rate system with many countries, convergence by unregulated markets will be much slower than in a simple bilateral exchange rate two country framework. If markets are far off from the equilibrium, convergence could lead to substantial increases in volatility and very slow adjustment processes in all exchange rates.

¹⁰ In the beginning these boundaries could be chosen to be fairly wide, e.g. 15-20 % in both directions. If the situation has significantly become more stable the boundaries could be narrowed. Since national economic policies and the public in the member countries will perceive the boundaries as limiting policy choices of feasible policies consistent with a stable exchange rate regime, it will quite likely restrict politicians to choose overly ambitious growth strategies which lead to unsustainable growth in those countries.

therefore expects that because of sluggish demand in Asia, international competition especially in the basic chemical goods branches will intensify. The fairly high level of orders in most of those industries in Germany during the last year might be at the moment not a reliable indicator of short-run stability of export demand when negative effects on the German economy occur because orders are canceled or postponed. The two big civil aircraft manufacturers in the US and Europe, Boeing and Airbus Industries already face a significant number of order cancellations from Asia. This will increase the level of cancellation of contracts already in the near future. Furthermore the financial sector in the US and Europe with Germany in particular has been heavily involved in the financing of loans to the Asian region (about 220 billion DM). This will as well have negative effects on the profitability of German financial institutions leading to increasing interest rates. Private individuals and institutional investors in Europe and the US have as well spent substantial amounts in assets and emerging market funds in the hope of high returns of these financial investments. With the collapse of the Asian stock markets and a series of bankruptcies of a significant number of Asian companies, the profitability of those financial investments has been converted to significant losses if assets holders sell at the depressed market prices or have to write off their investments. How this negative wealth effect will influence the already sluggish domestic consumption in Germany and Europe is hard to assess but one should not be optimistic that the effect will be negligible.

6. The financial crisis in Asia began when the fairly long period of internationally falling or low interest rates was expected to come to an end during the last year. The high growth in the US economy raised expectations in international financial markets that the FED would raise the discount rate to contain inflation in the US at an early state. This expectation of a turning point in the international interest rates worked as a trigger for the Asian crisis. When financial institutions which were heavily indebted especially in short-term hard currency lendings faced higher future credit costs, a number of them started to fail. With the emergence of the Asian financial and banking crisis, the situation now has changed. Because the US economy will feel significant negative impacts from Asia — more directly than Europe — the growth in the US economy will slowdown this year and in so doing dampen the potential of domestic inflationary pressures. Alan Greenspan even has raised the topic that there might currently even be a risk of a deflationary process if monetary policy in the US would be too restrictive. Therefore instead of a rise in long-term interest rates internationally, a decline is now taking place. This helps to stabilise stock markets in the world which face a "bear market" situation and opens the possibility to refinance bad loans in Asia at lower costs. For 1998 a further lowering of interest rates therefore took place in the U.S. and Europe to compensate for the negative effects spreading out from Asia. However, this would make it useful for the two major central banks, i.e. the ECB and the FED,

to coordinate their interest rate policies and especially the timing of such changes to make these positive effects for the world economy most effective.

7. Only if the international community, especially the U.S. and Europe together with the two major regional powers, Japan and the PR China, coordinates their policies to stabilise international financial markets especially in Asia and maintains a high level of domestic demand there, major secondary shocks in the region and contagious effects to other parts of the world could be avoided. Up to now, a design of such an international coordinated policy is not in sight if one looks at the ongoing negotiations in the region. Therefore the risk — that by uncoordinated actions and unforeseen events the situation might deteriorate even further — persists and urgently needs a timely active policy of the major economic powers of the world economy to prevent such trends.

8. If a temporary stabilisation of the still highly fragile situation in Asian financial markets can be accomplished, this will allow sufficient time to go ahead with the necessary institutional reform of the financial sector in the Asian economies. Without such an international macro stabilisation of the exchange rate regime, the regions institutional reforms will be very difficult to accomplish. Therefore an international macro-economic stabilisation has to be the first step to permanently contain the Asian crisis and help to rebuilt the financial systems of the respective countries. If an agreement to set up an AMS (Asian Monetary System) similar to the EMS (European Monetary System) could be accomplished during the next couple of months, this might be a major stabilisation activity to give the Asian countries the urgently needed more stable exchange rate grid.

5. Moral Hazard and the Bailout Question

After things happened in the manner they did in Asia and billions of asset values have "gone down the drain", one major question is open to the public debate: Who is going to pay for it? Since whole financial systems in most East and South-East Asians countries are at risk including Japan,¹¹ leading to a cumulative process of financial collapses spreading like an epidemic through the Asian economies. The attempt by the Japanese government to stabilise expectations by establishing a rescue fund financed by the government of more than \$ 130 billion in December 1997 have not been enough to regain credibility that this will stop the process of cumulative failures in the Japanese financial system. Since the discount rate in Japan already is at a historical low of 0.5 % a further reduction is nearly impossible. This raises the real danger of a deflationary process.

¹¹ As the Ministry of Finance in Japan announced on January 12, 1998 the Japanese banks carry \$ 4.5 trillion bad loans (76.7 trillion yen) in bad and questionable loans. This amount is almost three times of the previously reported figure of bad debt. (see Nikkei Net on January 13, 1998, URL: <http://www.nikkei.jp/enews/homehtml>).

If prices for goods and services in Japan start to fall, the real interest rate will rise giving little opportunity to the Japanese central bank to sterilise this trend by lowering the nominal interest rate. Since the tax increase, in the spring of 1997, of the Japanese government the domestic demand in Japan faltered, bringing the Japanese economy in recession, Japan faces huge excess capacities on the supply side. Since at the same time the Asian economies which are a major export market for Japanese goods and services face as well a dramatic growth slowdown, and the price competitiveness of Japanese products has dramatically decreased due to the excessive devaluation of the currencies of the Asian trading partners in relation to the Japanese yen, the export perspectives look gloomy as well. Furthermore, if the Asian economies, which have nearly devalued their currencies in the last six months of 1997 by 50 %, this could lead to an import surge of their products to the Japanese markets, squeezing the effective demand for Japanese products even more.

The difficulties with the banking systems in East and South-East Asia are nothing new to the international community of monetary and financial experts (see e.g. Worldbank, 1993, pp. 249-251) as well as the national governments (see e.g. the analysis of South Korea by Marcus Noland, 1996).¹²

6. Conclusions

What lessons can be learned from the current Asian crisis?

First, it seems that the ambitions raised by the success stories of Japan and the four Asian tigers (Singapore, Hong Kong, Taiwan, South Korea) until the end of the 1980s for Japan and the four tigers until 1994 that a rapid catch-up process for all other East and South-East Asian countries could be feasible for countries like Thailand, Indonesia, Malaysia, Philippines, and last but not least the PR China by switching their economic policy to export-led growth strategies, have come to a dramatic halt.

Second, there have already been early warnings by Western economists like Young (1992, 1994, 1995) or Krugman (1994, 1995) that the high expectations, that rapid growth in Asia will go on as before, are not supported by empirical evidence. The capability to use the available human and natural resources in addition to a much more moderate capability to supplement this by physical capital accumulation based on domestic savings, showed already in 1994 signs of exhaustion. A slow-down in the medium- and long-term growth rates of those countries seemed inevitable. However, the political and economic elites in Asia blinded by their past success and unwilling to give up the hope of rapid convergence to the leading industrial countries tried even harder to go on. This was only possible by massive imports of foreign capital through FDIs especially from Japan and by borrowing on international capital markets. This strategy to extend the high-growth period in Asia,

however, rested on feeble grounds. One was that the trend of decreasing long-term real interest rates in the world would last for quite some time. When international expectations emerged in 1997 that a turning point in the low-interest development especially in the U.S. due to first signs of overheating rapid growth sprang up, it became obvious to many investors in Asia that they would be unable to service their US dollar denominated debts in the future. Furthermore the surpluses in trade and services to the hard currency countries had already reversed to deficits in the years before with the exception of the PR China in particular. Therefore most high-growth East and South-East Asian countries the untypical inverse relation of export surpluses and current account surpluses had changed to the traditional pattern of developing countries with trade balance deficits and current account deficits with the Western developed countries (see also Krugman, 1997)¹³. However, this development is only beneficial for a country if its economic growth path is consistent with a long-term sustainable growth trajectory (see e.g. Cohen, 1994).

Therefore the conclusion is that East and South-East Asia has in addition to its dealing with the actual exchange rate and crisis of its financial system to adjust its long-term expectations for economic growth to a sustainable level. That means that the Asian miracle of excessive high-growth has come to an end. That life goes on even after a miracle ended is an experience the developed Western countries have already learned to live with (see Dornbusch, 1993; Krugman, 1992).

Furthermore Asia will need to rework its institutional setting so that corruption which has become a major obstacle in the government and private sector relations, will not dampen the growth perspectives of Asia even further (see e.g. Mauro, 1995). What the World Bank considered in their

¹² Noland summarizes his analyses of the South Korean banking system by the following statement:

"Historically, Korean financial markets have been repressed. This has inhibited the proper functioning of the financial system with deleterious effects on the competitiveness of the nonfinancial sector. Financial repression has facilitated state interference in the decision-making of private firms and has contributed to corruption in the political system." (Noland, 1996, p. 21).

¹³ "The proposition that newly industrializing economies will in general increase their spending as much as their income is also a statement about their balance of payments: it is equivalent to the statement that they will in general import as much as they export.

As much or more: on reflection, our Panglossian economist might well predict that emerging economies will in general run trade deficits. After all, one might expect these economies to attract inflows of investment from abroad. And a country that attracts a net inflow of capital must, by definition, be a country where domestic investments exceeds domestic savings, and therefore where spending exceeds income — that is, a country that runs a trade deficit (or more precisely a deficit on the current account, which includes services and the income from past investments)." (Krugman, 1997, p. 13).

1993 report on the Asian miracle to be a very successful institutional setting has become more and more a nightmare for countries who try to catch-up to the standard of Western industrialised countries. The belief of many Asian political leaders like Lee Kuan Yew, Mahatir or Suharto that Asian values have proven superior to Western values, now face

again a major challenge. This time not like in the PR China on the political agenda of the Tien An Men events, but on the economic agenda. If Asia fails to solve these problems in an appropriate time frame, the Asian miracle might easily shift back to the Asian drama envisioned by Myrdal about two decades ago.

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Zusammenfassung

Das Ende des asiatischen Wirtschaftswunders Konsequenzen und Auswirkungen

Der Aufsatz betrachtet die Vision eines Asiatischen Wirtschaftswunders vor dem Hintergrund der dramatisch veränderten Perspektiven nach dem Beginn der Asienkrise im Jahr 1997. Der Verfasser bezweifelt die Ansicht von Kommentatoren, daß die Asienkrise von Ökonomen nicht vorhergesehen worden sei. Es mag zutreffen, daß die Form und der Zeitpunkt des Zusammenbruchs nicht vorhersehbar waren, aber es gab frühzeitige Warnungen, daß eine deutliche Verlangsamung des Wachstums in Ost- und Südostasien unvermeidlich sein würde. Aus dieser Perspektive ist die Finanz- und Bankenkrise eine Folge einer unterlassenen Anpassung. Hohe Erträge aus Finanzinvestitionen wurden dort nicht mehr durch hohe Erträge von Investitionen in Ausrüstungen und Bauten gestützt. Die Asienkrise hat ihren finanziellen Ursprung in Japan. Japanische Banken und Unternehmen haben gemeinsam mit anderen westlichen Industrieländern deutlich höhere Finanzinvestitionen in der Region getätigt nachdem die Finanzblase in Japan geplatzt war. Japan exportierte seine Finanzblase in andere Teile Asiens. Weiterhin war die asiatische Finanzkrise von einer Folge von Abwertungen der asiatischen Währungen gegenüber dem US Dollar begleitet. Um daher zukünftige Risiken derartiger Abwertungsschocks zu vermeiden, sollte die Region damit beginnen ein Asiatisches Währungssystem (AMS) ähnlich dem europäischen entwickeln. Das AMS sollte am Ende zu einer Asiatischen Währungsunion führen. In dem die Länder ihre langfristigen Wachstumsperspektiven an nachhaltige Wachstumspfade anpassen, und, in dem sie ein AMS gründen, würde die Region deutlich günstigere Zukunftsperspektiven erreichen, selbst wenn das Zeitalter der Wunder vorbei wäre.