

## CHAPTER V

# Beyond the Asian Financial Crisis

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THE ASIAN FINANCIAL CRISIS of 1997 has affected China, Japan, and the United States not just economically but also in the political and security realms. In terms of three-way China-Japan-U.S. economic relations, in particular, the effects are best discerned by examining two phenomena that predate the crisis. The first is the continuation of economic transition in China. The second is paralysis in Japanese economic policy making.

### REVIEW OF THE ASIAN FINANCIAL CRISIS\*

The crisis economies have all displayed some combination of a dearth of prudent regulation, a lack of competition, and widespread cronyism. Overvalued currencies with fixed exchange rate regimes undermined stability in this environment. High returns from investments in these economies, partly owing to the artificial strength of the currencies,

\* As a prefatory note, I plead guilty to attempting to compartmentalize phenomena that in reality are intertwined. Japan's stagnation was both a contributor to and—to the extent that it will be prolonged—a consequence of the larger financial crisis. China's transition has similarly reflected Japanese macroeconomic realities and the fallout from the crisis. In all cases, the actions of other economies in the region have been critically important to shaping constraints and priorities, for the United States as well as for China and Japan. Nonetheless, my concern here is the trilateral relationship.

led to a focus on short-term capital inflows at the expense of less volatile long-term investments. Fragile financial sectors could neither cope effectively with large inflows of short-term capital nor curb increasing maturity mismatches. In addition, much of the corporate borrowing for investments in these countries was not hedged against foreign exchange risk. Signs of market volatility in the region thus hastened traders' decisions to sell holdings of vulnerable currencies.

Nonproductive investment aggravated financial fragility. Property sector investment, especially, led to inflated asset bases and property speculation. The inclination to ignore such realities intensified at the first sign of trouble. The unwillingness of leaders in several countries to address the consequences of their policies by making macroeconomic adjustments, cleaning up widespread corruption, or allowing currencies to adjust naturally and gradually ahead of speculative betting fueled confidence problems.

Such conditions created the potential for contagion. Because many developing nations export similar products, one devaluation led to another, as markets bet that neighbors would have no choice but to follow suit. Because many countries in the region had similar financial-sector problems, the logic of attacking one country's currency was easily extended to others. Rosy assumptions that had benefited more advanced economies in the region quickly withered.

None of this should have been a surprise. Before Thailand's market collapsed, economic observers ranging from the conservative (the International Monetary Fund [IMF]) to the maverick (Paul Krugman) to the populist (William Greider) had commented on every aspect of Asia's weakness. Rather, what was surprising is that the two countries most capable of responding forcefully to the crisis—Japan and the United States—did not, whereas the one that could have been forgiven for fumbling—China—exceeded expectations.

#### CHINA'S TRANSITION

China's transition to a market economy has been well documented, but the depictions of booming construction and consumption in China's cities have obscured the distance that remains. The biggest challenge for the trilateral relationship is keeping China on track

toward economic liberalization. The worst-case scenarios for China's economic, political, and security well-being derive from a failure to accomplish that. Clearly, the crisis has made this task harder in the short term by diminishing marginal market growth for Chinese exports and indirectly contributing to a decline in foreign direct investment. In the medium term, we may find that the crisis accelerated certain virtuous domestic reforms, but for now the challenges are greater. In fact, the surprisingly bold World Trade Organization (WTO) accession terms proposed by Zhu Rongji in Washington, D.C., in April 1999 were early evidence that the crisis has accelerated reforms in China.

Although the burden is mostly China's, of course, no one can deny any longer that the actions of Japan and the United States have an important impact on China's position, given the degree to which China is already integrated with the external economy. Therefore, it is appropriate to talk about China's transition in the context of the trilateral relationship, even though managing the transition is China's sovereign affair in narrow terms.

The biggest hurdles in China's transition are as follows:

- Closure, recapitalization, privatization, or reorganization of the remaining state-owned enterprises (SOEs). Although precise figures are hard to confirm, tens of thousands of enterprises, employing over 110 million Chinese as of 1996, remain in state hands. Fewer than 1 percent of these account for more than 50 percent of all recorded SOE profits. If this sector does not become more competitive, 100 million Chinese stand to become unemployed. That is plainly unacceptable to China's leaders. Therefore, if these firms are not made more competitive, the sectors in which they operate cannot be liberalized fully, which puts Chinese economic officials in conflict with Japanese and U.S. officials.
- Weakness in the financial sector. China's financial sector is still programmed to sustain bad investments that should not have been made because they squander scarce resources that should be invested elsewhere. On the consumer side, companies are deprived of adequate financial services to compete well, and households have little opportunity to select worthy savings vehicles and develop sound investment habits.

These aspects of reform would have been the key challenge of the 1990s even without the regional financial meltdown. Postcrisis, the

tasks are harder still because volatility has scared away some investors and trade surpluses are trending downward at the same time social costs are rising. However, the Chinese leaders appear to understand the situation.

China can solve its problems by adopting several government policies, with support from Japan and the United States:

- Building the central regulatory capacity needed to allow efficient producers and vendors of goods or services—whether local or foreign—to enter and exit markets and thus compete. This capacity must be designed to protect consumer welfare and be enforceable at the local level.
- Provision of new financial regulations, incentives, and institutions to permit efficient long-term capital intermediation. This will permit better investment in productive economic activity as well as better management of individual wealth, all of which would diversify risk and thus dampen volatility.
- Centrally led investment in professional education, especially at the postsecondary level, to provide for the needs of a complex society, instead of relying on either foreign experts, foreign-educated Chinese, or substandard employees—the three choices employers now face for many critical positions.
- Sustained use of foreign competition to introduce new ideas and technologies, to prod domestic firms to increase productivity and adopt a customer orientation, to lessen parochial Chinese nationalism, and to diversify the risk of local downturns by deepening the globalization of the Chinese economy.

The public and private sectors of Japan and the United States have the ability to support or to hamper these tasks. Expatriates in China too often argue for collusion, exceptional treatment, and devolution of authority away from Beijing. Policymakers and businesspeople alike, on the other hand, ought to ask how they could better support the efforts of Chinese authorities as proposed above.

#### JAPAN'S PARALYSIS

The biggest surprise from the Asian financial crisis was the weakness of Japan's economic and political institutions. The crisis turned

a suspicion into a conclusion: Japan has not yet fully grasped either the nature of its own low domestic growth or its responsibilities in assuming external economic leadership. It should not have been a surprise, however, as Japan's economy has underperformed expectations since 1992.

My colleague Adam Posen of the Institute for International Economics has identified four competing views concerning Japan's stagnation:

- Japan needs deep structural reforms steered by the government before growth can be restored.
- Japan's problems are no longer solvable by vested interests, and a crisis sufficient to destroy old ways is needed to restore growth.
- Japan's current growth slowdown is the inevitable product of demographics, and slogging through is the responsible thing to do for long-term optimality.
- Japan has lost the 1990s as a result of misguided macroeconomic policies.\*

Posen accepts a role for factors other than macroeconomic policy, while placing priority on fiscal stimulus and competition. But regardless of which explanation best explains Japan's poor growth, the Japanese authorities have failed to consider the implications of their malaise for neighboring economies looking to their stronger former model for support. Stagnant domestic consumption has dragged down regional market growth, and Japanese producers have crowded other regional developed markets with goods that could not find demand at home. Direct and indirect effects on exchange rates, lending, and direct investment all result from this poor performance to some degree.

One effect on the United States has been a rising trade deficit with Japan. The deficit was exacerbated by a weakening yen as markets lost faith that Japan could restore economic strength through domestic demand growth. This, in turn, has made it difficult politically for the United States to take a leadership stance on economic issues in Asia, including funding the IMF. China has lost export opportunities to serve Japanese consumers but also, and even more important, has lost exchange rate competitiveness from being the only major country not to devalue to match the yen.

\* Posen, Adam S. 1998. *Restoring Japan's Economic Growth*. Washington, D.C.: Institute for International Economics.

Japan did not cause the Asian financial crisis of 1997. However, its dithering has undermined regional economic confidence severely since the crisis began and thereby caused unnecessary pain for other Asian economies, many of which, ironically, have emulated Japan until recently.

## CONCLUSION

What are the implications of the Asian financial crisis for the trilateral relationship? First, the urgency of the crisis forced all three countries to demonstrate their capacity for leadership and to clarify the thinking of their senior leaders.

- China, by its decision not to devalue the renminbi, encouraged some calm in the region. It was not, in fact, its decision to refrain initially but its subsequent stalwartness that was useful. Although it may be true that China's overall well-being is actually served by not devaluing, given that counter-devaluations would surely follow and the high volume of dollar-denominated re-export content of its exports, there were many domestic interests that preferred a cheaper renminbi. China stood firm because, probably for the first time in its history, its calculus of national welfare took into account the regional and global, not just domestic, economies.
- Japan, meanwhile, unmasked its domestic uncertainty and inflexibility and a preoccupation with domestic vested interests at the expense of regional imperatives. Like the United States, Japan's politics at home ran counter to globalization.
- The United States failed to act decisively at the start of the crisis, choosing not to contribute to the rescue of Thailand and thereby marginally eroding confidence that a broader crisis could be stemmed. In the months that followed, U.S. domestic politics stood in the way of provisioning multilateral financial authorities with the resources they might need to fight further meltdowns, not just in Asia but in Latin America and Europe as well. This is not the strong United States that took decisive steps to head off a financial crisis in Mexico in 1995, but then this is the United States whose president was rebuked severely at home for his willingness to act at that time.

These new parameters for what each of the partners can contribute to international economic leadership suggest new alignments in managing the system. China is willing to contribute more than previously expected and Japan less, at a time when the United States increasingly needs to leverage its own efforts. Thus, the first implication of the crisis is for greater China-U.S. cooperation on economic matters in the future and less emphasis on the Japan-U.S. consensus. This is the net implication of the financial crisis; perhaps facts in other areas will offset these trends at the economic margin. Such a realignment would create anxieties among the three partners and in many other countries as well, but, because it is inevitable, the three countries should make the best effort possible to accomplish it smoothly and without rancor—as difficult as that seems in light of the China-U.S. frictions stemming from the accidental bombing of the Chinese Embassy in Belgrade by the North Atlantic Treaty Organization and allegations of extensive espionage by Chinese agents in the United States.

Second, the crisis has forced us to review our current international economic system. It has raised questions, in particular, concerning the role of macroeconomic monitoring and the availability and use of official funds in the event of emergencies. These are complex questions not easily answered in an overview; designing a new architecture would require Chinese, Japanese, and U.S. participation. Japan and the United States are prone to be distracted from this task by domestic issues and residual bilateral matters, and although China is not likewise distracted to the same extent, it remains outside important forums. For the three-way relationship to be used to maximum benefit, it is imperative that China participate actively in the forums where the system is conceived and managed. Of import here are of course the WTO and the G-8.

Finally, the crisis was, in some ways, a bearer of a type of “creative destruction” that was ripe to occur. The crisis destroyed models of unguarded intervention in commerce by authorities not held to a popular test, inefficient loan portfolios, and projects that foolishly had been allocated scarce resources. It has also laid waste to commonly held beliefs in a commercial alternative to contestable markets and the rule of law. The implication of this is increased long-term potential for healthy economic development along sustainable lines, if

social stability can be maintained in the coming, transitional years. For the China-Japan-U.S. economic relationship, that means a chance for invigorated cooperation based on a single set of assumptions, and it means a set of common social objectives instead of the bickering of recent years.

Taking advantage of this chance means working toward economic stability and dynamic change at the same time, in a manner that will necessarily redistribute power and wealth. This redistribution will take place within each of the three partner economies, and among them, and the outcomes may not be equal. By transferring resources to those better able to produce efficiently and competitively, all three nations will generate not only new wealth but also more stable economic underpinnings. But for now, this driving force is less stable than it is dynamic. It portends major adjustments in political alignments, balance of payments surpluses and deficits, and other elements of national accounts—including long-term Chinese debt.

What is required more than anything else during such a process is mutual trust and respect. The China-U.S. summit in Beijing generated a new wealth of trust largely because both sides abandoned long-held formulas for dealing with one another and embraced practical new ones. Sadly, much of that trust has been squandered now over spies, bombs, and the WTO. Let us hope it is not too late to recoup that trust.