Morris Graves, *Pacific Rim Image III*, 1994, acrylic on chinese paper, 26 x 19 inches, Courtesy of Schmidt Bingham Gallery, New York.

WILLIAM H. OVERHOLT

Is the Asian Miracle Over?

How the most dynamic region in the world went astray.

The recent turmoil in Asia has called into question the sustainability of the vaunted Asian miracle. Asian currencies which had been stable for over a decade have declined dramatically. Asian markets that delivered superior returns are delivering spectacular losses, and economies which embodied the concept of export led growth are running huge deficits. Governments whose economic management had seemingly outperformed all others are presiding over banking crises, and after having been consistently out in front in third world liberalization efforts they are now rushing to restrict capital flows. This raises the question of whether the Asian miracle was just a one generation blip.

The immediate crisis has been precipitated by a reversal in the downward trend of the U.S. dollar, rising competition from other regions, the weakness of the Japanese economy, and declining competitiveness in semiconductors. In the mid-1980s, countries like Thailand, Indonesia, and Hong Kong tied their currencies to the U.S. dollar. The nature of the ties varied—Hong Kong had a rigid peg, Indonesia a declining peg, and Thailand a basket of currencies that was more than 80 percent dollars—but their currencies were ultimately dollar-based. The adoption of these exchange rate pegs terminated a cycle of capital flight and frequent devaluations. The declining U.S. dollar then helped to improve the competitiveness of the smaller Asian economies in the Japanese and European markets. In recent times, however, a 60 percent devaluation of the yen and a 40 percent devaluation of the DM have damaged Asian competitiveness.

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During this period the Asian miracle economies were facing new competitive challenges. Latin American and Caribbean countries and Canada were managing their economies more competently and obtaining preferred access to the U.S. market, while China offered investors inexpensive land, cheap and hard working labor, and a more investment friendly government. In the past, when Thailand or others responded to competition by moving up the product ladder, plentiful Japanese technology and money facilitated the move. The strong yen forced Japan to move industry abroad and the country had plenty of money to finance the move, but these conditions have now been reversed. In semiconductors, a focus industry of many Asian countries such as South Korea, Taiwan, Malaysia and Thailand, U.S. competition and a particularly fast and ruthless market cycle repeatedly frustrated the efforts of major Asian companies in the mid-1990s. In this industry the American entrepreneurs of Silicon Valley seemed invincible.

Zhu Rongji

Under his economic leadership China has brought inflation down from 22 to 2 percent while the growth rate has been maintained at 9.5 percent.

These new conditions posed formidable challenges, but they do not explain the Asian debacle. The crisis of 1982, in which Asian economies prospered in an era of high interest rates and energy prices, volatile currencies, and a severe economic downturn, was far worse than the situation in 1997; the latter, however, has been devastating. An explanation for this conundrum is the increasing obsolescence of the national management strategy Asian governments copied from Japan, in which the government manipulated the economy and financial markets to attain specific objectives. South Korea became an avid imitator of Japanese manipulation, and was in turn emulated by Thailand. In the early days when South Korea was essentially a producer of rice and cheap shirts, these techniques were often helpful. The producers lacked the ability to assess overseas markets themselves, but the government could identify the potential markets, encourage local companies to tailor their products to the requirements of those markets, and provide incentives for them to work together to achieve the necessary scale. As the economies became complex, however, quasi-socialist management became ineffective, and by the early 1980s there was evidence that attempts by MITI to manipulate Japanese industry were counterproductive.

In the current crisis the highly manipulated economies of Japan, South Korea, and Thailand have experienced the most severe difficulties. Those of Hong Kong and the Philippines, the least manipulated, have suffered less. An exception is China, which is still at a relatively early stage of its takeoff, is liberalizing much more rapidly than did South Korea or Japan, and is holding its management to exceptionally high standards. This quality of management issue is ultimately more important. For example, while Taiwan heavily subsidized certain industries, the national government once owned all the banks and the Kuomintang Party controlled many of the key companies, most of the favored firms were still forced to meet the test of the market. In contrast, Thailand opened its capital markets faster than Taiwan, but did so precisely in a way that removed the test of the market from a wide variety of companies. The manipulative combination of below market interest rates and managed exchange rates has now unhinged Asian markets. Many Asian currencies were tied in some way to the dollar but offered interest rates higher than U.S. rates. The opportunity to borrow in cheap dollars and invest in higher yielding baht or rupiahs created irresistible arbitrage possibilities for foreign financial institutions. The resulting inflow of billions of dollars provided below market funding for local companies, and for a time this was the world's greatest free lunch. The hurricane of dollars inflated property, heavy industry, and banking bubbles, and in 1997 the free lunch inevitably came to an end as speculators learned to profit by popping the bubbles. As soon as Thailand or Indonesia tried to defend their currencies by raising interest rates, property or industrial bubbles would pop, then banks would deflate. The debacle did not come about because the currencies were wildly overvalued (they were not); this was a bubble crisis, not a currency crisis.

The Political Impact

The bubbles were widely recognized and acknowledged as dangerous, but nothing was done. This seems peculiar because for a generation these economies were among the best managed anywhere. The cause of this deterioration lay in the origins of the Asian economic miracle, which ultimately was

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not economic but political. There was no magical economic formula behind Asian economic growth. Governments kept inflation low, balanced their budgets, encouraged savings rather than subsidizing consumption, mostly accepted market prices, refrained from overvaluing their exchange rates, removed taxes on exports, and encouraged domestic and foreign competition. The miracle lay not in the economic recipe, but in the fact that politicians followed the directions, which rarely happens anywhere. When the Pentagon wanted to close 50 unneeded military bases, the U.S. Congress delayed the move for many years. When the Philippines needed land reform, Cory Aquino supported it only until it began to affect her own family. That is the way politics normally works. But in the 30 years following 1960, the politics of many Asian countries worked quite differently, and the reason for this was fear. South Korea feared North Korea, while Taiwan and Hong Kong feared China. In Southeast Asia, Malaysia feared Indonesia, Thailand feared Vietnam, and Singapore feared everybody.

Faced with mortal threats, the Asian regimes tried different policies. In South Korea, Syngman Rhee gave the military the greatest share of the country's resources, and internal cohesion declined and the South lagged behind the North. His successor tried democracy, but in that impoverished, illiterate peasant society the consequences of democracy were disorder, inflation and ideological polarization. Park Chung Hee gave total priority to economic efficiency. He cut the military budget drastically, and imposed policies that were vital to economic success but would have been politically impossible under a democratic regime. He reestablished economic ties with Japan, something that virtually the whole population opposed, and faced down student riots that continued virtually uninterrupted for a year. The result was an economic takeoff with no counterpart in previous history, one that eventually dwarfed the economy of North Korea. As the Japanese, South Korean, Taiwan and Singapore miracles progressed, other Asian countries concluded that ruthless economic efficiency was the route to survival.

Fear differentiated the countries that took this path from those which that not. Latin America behaved as it had in the past, because the decades long absence of mortal threats allowed politicians to follow the normal political logic of patronage. Within Asia, there was one country, the Philippines, which certainly had the cohesion to behave like a serious country. U.S. military protection provided from Clark Air Base and Subic Naval Base ensured that no foreign country could threaten the Philippines, and when domestic mismanagement threatened to wreck the country, American interventions came to the rescue. The first serious reformist economic policies came from the government that took office after the bases were closed and the Americans had departed.

Thailand, the country whose troubles started the current crisis, represents the extreme example. In an earlier generation, Thailand was disciplined by a peculiar system of checks and balances. Military dictators governed until their repression and corruption became unbearable, whereupon with the backing of the King the middle class threw them out. In 1973, for example, this alliance ousted a dictatorial triumvirate. Democrats then governed until disorder, inflation, socialist ideology and corruption became intolerable, whereupon the middle class and the King invited the military back in, as occurred in 1976. Both sides respected a meritocratic civil service that had few peers in the third world.

By the mid-1980s the economy had become too sophisticated for the military to manage, and the military evolved from a force that imposed economic and political order on irresponsible civilians into an economically irresponsible pressure group, as typified by General Arthit's bold and corrupt televised challenge to Prime Minister Prem Tinsulanonda over the 1984 devaluation. (The King backed Prem, and the challenge faded.) Encouraged by success and stability, the country moved to a civilian democracy in 1988. But Thai democracy had a peculiarly third world shape; parties received no donations in support

The Model Runs Out of Steam

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The Era of China

"Singapore and greater China will fare best in the future. Singapore, in some ways the ultimate dirigiste economy, is managed extremely well—a situation made possible by the fact that it is a small country. It has modest vulnerabilities in its property and industrial sectors, but is at no risk of a crisis. Taiwan has avoided the management that created problems in Japan, Korea, and Thailand, and the economy has no major bubbles. China has many different bubbles, but is dealing with them decisively. The yuan is probably undervalued; the real risk is that failure to deal decisively with the state enterprise problem would lead to a further rapid buildup of bad loans in Chinese banks and create a corporate and banking debacle worse than the Korean. While China has no dangerous external enemies, its leaders know that their future depends on maintaining economic efficiency, since China no longer has an ideological basis for stability. Only if Beijing delivers improved living standards year after year will the regime survive, and so it has supported Zhu Rongji's enormously successful program of fighting inflation and popping bubbles. He is being promoted to prime minister rather than fired for these acts of political hubris. This is the kind of politics that made the original Asian miracle possible."

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of broad policies, but instead funded themselves almost exclusively through bribes. By the time former General Chatichai rose to power at the head of a six party coalition, he was able to retain power only by giving everyone what they wanted. "Everyone" included not just the members of the coalition, but also the military, commanded by General Chavalit Yongchaiyudh, which became almost completely independent of civilian authority. For civilian politics in Bangkok this meant the era of the world class bribe; the amounts of money paid to ministers for contracts were breathtaking even by the standards of Ferdinand Marcos. On the periphery of the country, it produced an army that used its power primarily for pecuniary gain. A major example was the contracting of an agreement between senior Thai officers and their Burmese counterparts to buy teak logs that belonged to the Karen tribe. To overcome Karen resistance, the Thai Army permitted the Burmese Army, Thailand's greatest enemy for most of history, to enter Thailand, where it overran villages and killed Thai citizens.

The relaxation of fear that had made democracy possible also produced complete irresponsibility, and by 1991 the country could no longer tolerate this. The resulting coup was precipitated by Chatichai's attempt to appoint as Minister of Defense former Army Commander in Chief Arthit, who had become famous for his irresponsibility. In February of 1991, with the support of most of the middle class, the civil service, and the King, a group of army officers from Class Five of the military academy overthrew the regime and installed Prime Minister Anand. A civilian of great patriotism, honesty and intelligence, he restored sound management and quickly moved to retire himself from political leadership in favor of a free election. Attempts by officers of Class Five to fix the election by restructuring the competing parties led to a bloody confrontation comparable to Tiananmen Square and discredited military aspirations to political power to a degree that until recently inhibited any military option. This ended the military check on civilian irresponsibility.

The subsequent governments of Chuan Leekpai, a Jimmy Carter-type figure of high principles and weak authority, and more recently of former General Chavalit, have been multiparty coalitions sustained only by giving away the store in patronage. The Chavalit government even sought to politicize the previously sacrosanct Bank of Thailand, a move that contributed directly to the present financial crisis. Recent constitutional changes are hardly enough to clean the Augean stable of Thai politics, for nothing less than a moral and political transformation will save Thailand. In the current climate, fear and political upheaval are the prerequisites of rejuvenation.

The Regional Pattern

Political relaxation has had various consequences for economic policy throughout the region. In South Korea, the transition from an authoritarian regime based on an alliance of military force, big business money, and regulatory dirigisme has become bogged down in a vast series of corruption scandals. When first elected, the civilian democratic regime intended to pursue economic reform vigorously. But when it opened a small door on corruption by requiring real names on financial accounts, the politics of corruption scandals completely overwhelmed banking reform, and wages were allowed to rise higher than those of wealthy Hong Kong and Singapore. The consequence of relaxation, and of political priorities coming to outweigh economic efficiency, was a national economic squeeze.

Yet despite the variations, a common pattern can be ob-

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served in the Asian economies. Industries with subsidized credit, particularly property and heavy industries, become bubbles large enough to affect the whole economy. Speculators then see an opportunity and short the currency, and interest rates rise and the bubbles burst, endangering the banks. The unexpected crisis illuminates the residual third world quality of regulation in many of these countries, frightening investors. In Thailand,

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the inadequacy of bankruptcy laws and enforcement leaves creditors finding themselves substantially unprotected. (Unlike Singapore and Hong Kong, which are better regulated than many other first world countries.) The dirigiste approach to economic management and the cozy relationships between business and political leaders then leads the government to bail out too many firms and delay the adjustment process, which is the key difference between the efficient handling of the U.S. savings and loan crisis of the 1980s and the prolonged banking crisis in Japan.

In the future, Singapore and greater China will fare best. Singapore, in some ways the ultimate dirigiste economy, is managed extremely well—a situation made possible by the fact that it is such a small country. It has modest vulnerabilities in its property and industrial sectors, but is at no risk of a crisis. Taiwan has avoided the management that created problems in Japan, Korea, and Thailand, and the economy has no major bubbles. China has many different bubbles, but is dealing with them decisively. The yuan is probably undervalued; the real risk is that failure to deal decisively with the state enterprise problem would lead to a further rapid buildup of bad loans in Chinese banks and create a corporate and banking debacle worse than the Korean. While China has no dangerous external enemies, its leaders know that their future depends on maintaining economic efficiency, since China no longer has the ideological basis for stability that existed before the Cultural Revolution. Only if Beijing delivers improved living standards year after year will the regime survive, and so it has supported Zhu Rongji's enormously successful program of fighting inflation and popping bubbles. He is being promoted to prime minister rather than fired for these acts of political hubris. This is the kind of politics that made the original Asian miracle possible.

Hong Kong is more complicated. Its management is as competent and tough as that of Singapore and its economy more market driven, but Hong Kong does have a small red chip equity bubble and a large property bubble. The currency is the most defensible in the region; Hong Kong itself has U.S. $88 billion of foreign exchange reserves (compared with Thailand, which with nine times the population had only $38 billion), and China today has more than $131 billion. Hong Kong has no debt, and its banks are Asia's strongest. On the other hand, defense of the Hong Kong currency would require high interest rates, and those interest rates would pop the red chip bubble and precipitate a huge decline in the property market, causing at least a temporary equity market debacle. Some speculators are bound to bet that such pain will be unacceptable to the Hong Kong elite and the new Beijing masters who would bear the brunt of the bubble popping pain. They are wrong; Hong Kong will pay the price. But the Hong Kong authorities who have already declared victory are wrong too, for it has yet to be paid.

The Long Term

Is the Asian miracle over? Parts of it have certainly grown old and gone soft. The days when Japan and South Korea were the world's best managed economies are gone, and it is impossible to imagine a scenario that would return Thailand to the golden age of Prem Tinsulanonda. But the miracle itself has grown and moved northwest, and this is now the age of China. There is nothing in history comparable to what Zhu Rongji has accomplished since January 1994. Inflation has been brought down from 22 to 2 percent while the growth rate has been maintained at 9.5 percent and $45 billion in foreign direct investment was attracted in 1996, raising foreign exchange reserves from $21 to $126 billion. The other pieces of greater China, Hong Kong and Taiwan, are the other most auspicious economies.

Of the old tigers, Thailand has surely moved to the status of Latin America, and the burden is on the Thai government to show that it has the will to move back to Asia. The other countries still have a residual legacy of Asian management; Taiwan has a cabinet loaded with Ph.D.'s where the U.S. cabinet has none. In Asia an aspiring trade minister is expected to have spent a lifetime learning something about trade, and widespread expectations of that kind still differentiate Asian economic management from that of many competitors, including the U.S. Savings rates above 30 percent and habits of rigorous budget control, inflation control, and limitation of interest group influence continue to prevail in the region. Over the long run the old tigers will continue to outperform most of the competition, but not by nearly as much as when they were lean, mean and scared. ◆