The End of the Asian Miracle

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For its swiftness and confounding of experts, the evaporation of the Asian economic "miracle" probably ranks second only to the unraveling of Soviet socialism as the greatest surprise of the last half-century. All at once convention has been turned on its head, as South Korea, Thailand and Indonesia line up for a multibillion-dollar bailout from the International Monetary Fund, and many of the same institutions and people who recently celebrated the Asian "tigers" as the engine of world growth into the twenty-first century now speak of them as a source of financial contagion, even as the trigger for global deflation.

How did this happen? Why were these economies so fragile after all? And what might a program of radical reform – distinct from the discredited policies of the past and from the free-trade nostrums being pushed by the United States – look like?

The Fall of Fast-Track Capitalism

With events still unfolding, there is a risk in advancing full-brown theories about the collapse. Nevertheless, it is useful to understand the crisis in relation to the different patterns of economic development in Southeast and Northeast Asia.

In Southeast Asia, where most countries' GNP grew between 6 and 10 percent from 1985 to 1995, the crisis stemmed from a development process sustained not principally by domestic savings and investment but by huge infusions of foreign capital. In the late 1980s the region's growth was heavily dependent on Japanese direct investment. When this began to taper off in the early nineties, alternate sources of capital had to be tapped, particularly international banks looking for higher yields on their loans and mutual funds, and other speculative institutions searching for more profitable investments than were available elsewhere.

Thailand's technocrats pioneered a three-pronged strategy for attracting them: liberalization of the financial sector; maintenance of high domestic interest rates to suck in portfolio investment and bank capital; and pegging of the currency to the dollar to reassure foreign investors against currency risk.

Widely regarded as the bedrock of Thailand's rise to tigerhood, this formula was soon copied by finance ministries and central banks in Manila, Kuala Lumpur and Jakarta. All received the blessings of the IMF and the World Bank, which saw any move to eliminate barriers between the domestic and global financial markets as a step in the right direction. Indeed, as recently as late 1996, when it was clear that the Thai economy was headed for trouble, the IMF was still praising the government's "consistent record of sound macroeconomic management policies."

In retrospect, Thailand exemplified the perils of "fast-track capitalism." Net portfolio investment totaled some $24 billion in the past three to four years, while another $50 billion entered as loans to Thai banks and enterprises. This capital never found its way into the domestic manufacturing sector or agriculture –low-yield sectors that would provide a decent rate of return only after a long gestation period. The high-yield sectors with a quick turnaround time to which foreign money gravitated were the stock market, consumer financing and, in particular, real estate.

Not surprisingly, a real estate glut developed rapidly. By 1996 some $20 billion in new property was unsold. Monuments to folly were everywhere -- the Bangkok Land Company's desolate 'residential complex near the airport, the empty thirty-story towers in the city's Bangna-trat area. The rest of the pieces fell quickly. Commercial banks and finance companies were horribly overexposed in real estate. Foreign portfolio investors

and banks that had loaned to Thai entities discovered that their customers were carrying a load of nonperforming loans. With a worsening balance of trade, the country's capacity to repay the debts incurred by the private sector became very cloudy. That the current account (or balance of trade in goods and services) was in deficit to the tone of 8.2 per cent of GDP in 1996 struck fear in the hearts of investors, who recognized this figure as about equal to that of Mexico when it suffered its financial meltdown in 1994.

By early 1997 many investors concluded it was time to get out and get out fast. With over $20 billion in baht parked in Thai stocks or paper or nonresident bank accounts the stampede was potentially disastrous, for it meant unloading trillions of baht for dollars. With too many baht chasing too few dollars, there was huge pressure for devaluation. The scent of panic attracted currency speculators, among them George Soros. The Bank of Thailand initially sought to defend the baht by dumping its dollar reserves on the market, but by July 2, after losing at least $9 billion of its $39 billion in reserves, it had to throw in the towel.

Speculators spotted similar skittish behavior among foreign investors in Manila, Kuala Lumpur and Jakarta, where the same conjunction of commercial bank overexposure in real estate, weak export growth and a widening current account deficit was stoking fears of a currency devaluation that could devastate their investment. As in Thailand, speculators rode on the exit of foreign investors. By late October, the Philippine peso, the Malaysian ringgit and the Indonesian rupiah were still on a downspin as capital continued to exit, resulting in a catastrophic combination of skyrocketing import bills, spiralling costs of servicing the foreign debt of the private sector, heightened interest rates spiking economic activity, and a chain reaction of bankruptcies. The Southeast Asian miracle had come to a screeching stop.

Travails of the Classic Tiger Economy

Meanwhile, things were disintegrating in Korea, where over the past year seven of the country's mighty *chaebol*, or conglomerates, had come crashing.

Unlike Southeast Asia, Korea built its strength principally on domestic savings, generated partly through equity-enhancing policies such as land reform in the 1950s. Foreign capital had played an important part, but local financial resources extracted through a rigorous system of taxation plus profits derived from the sale of goods to a protected domestic market and to foreign markets opened by an aggressive mercantilist strategy constituted the main source of capital accumulation.

The private sector flourished under a regimen in which the state had the commanding role. By picking winners, providing subsidized credit and protecting them from transnational competition in the domestic market, the state nurtured companies that it later pushed out into the international market. In the early 1980s, the state-*chaebol* combine appeared unstoppable, as the deep pockets of commercial banks, extremely responsive to government wishes, provided the wherewithal for Hyundai, Samsung and other conglomerates to carve out international markets. By the early nineties, however, the tide had turned. Failure to invest significantly in research and development translated into continued dependence on Japan for basic machinery, manufacturing inputs and technology, worsening Korea's trade deficit with that country. Also, a bruising US counteroffensive, which included forcing the currency up to raise the price of Korean exports and threatening trade sanctions, reversed its balance of trade with the United States from an $6 billion surplus in 1988 to a $11 billion deficit by 1996.

To maintain shrinking profits, business pushed legislation in late 1996 to expand its rights to slough off "excess labor" and make the surviving work force more productive, on the American model. This was essentially a return to the formula of the early years of the miracle, when the primitive accumulation of capital was derived from harsh exploitation of unskilled labor. When fierce street opposition arose in response to this move, many *chaebol* had no choice but to rely on the government and the banks to keep money-losing operations alive. That lifeline could not be maintained, though, without the banks themselves being run to the

ground. By October nonperforming loans were estimated at more than $50 billion. Foreign banks, which already had about $200 billion worth of investments and loans in Korea, became reluctant to release new funds. By late November, Seoul, saddled with having to repay some $72 billion out of a total foreign debt of $110 billion in one year, joined the IMF queue.

What Happens Next?

Recession is certain, as direct investors follow the example of portfolio investors in reducing their profile in Southeast Asia. Already, nearly all the key Japanese vehicle manufacturers - Toyota, Mitsubishi, Isuzu and Hino - have either shut down or reduced operations in Thailand.

The future is likely to be one of prolonged deflation rather than quick recovery. One reason is that intra-Asian trade, which accounted for 53 percent of all Asian trade in 1995, will cease to be the main motor of regional growth. Japan has been unable to shake off its six-year recession, and unlike the early nineties, when its weakness was offset by the boom in Southeast Asia and steady growth in Korea, today all three sources of regional demand have been doused, while a fourth, China, remains highly protectionist. This leaves Europe and the United States as significant mass markets. But low growth and high unemployment continue to dampen demand in Europe; and in America, East Asian exporters will encounter an uphill battle for market share against China and newly competitive Latin American countries.

How the United States will respond politically to the crisis is, of course, a matter of great concern to the Asian elites, and it is unlikely that Washington will desist from exploiting the situation to achieve what it has been aiming for over the past decade: the free-market transformation of economic systems that are best described as state-assisted capitalist formations.

Since the late 1980s Washington has relentlessly sought to "level the playing field" for US corporations via liberalization, deregulation and privatization of Asian economies. It has used IMF and World Bank "structural adjustment" programs; a harsh trade campaign threatening retaliation so as to open markets and stop unauthorized use of US technologies; a drive to create an Asian-Pacific free-trade area; and a push to implement GATT agreements eliminating trade quotas, reducing tariffs, banning the use of trade policy for industrialization purposes and opening agricultural markets.

Prior to the crisis, these efforts had brought meager results, except perhaps in the case of Korea—though even its trade surplus-turned-deficit has not changed the US Trade Representative's assessment of it as one of the world's most protected economies. The financial crisis is thus a golden opportunity for Washington. Indeed, the rollback of protectionism and activist state intervention is already incorporated into the "stabiliztion" programs being negotiated by the IMF. American officials, who effectively vetoed the creation of an Asian Regional Fund independent of the IMF and therefore of Washington, have also made it known—most recently in the case of Korea—that no US direct aid will be forthcoming until the ailing countries acquiesce to IMF demands. So far, Thai authorities have agreed to remove all limits on foreign ownership of financial firms and are pushing ahead with legislation to allow foreigners to own land, long a taboo. Even before it sought help from the IMF, Jakarta abolished its restrictions on foreign ownership of publicly traded stock, a move replicated by Seoul when it granted foreign investors access to the $64 billion long-term, guaranteed corporate bond market, access they had been seeking for years. In Indonesia the final agreement is expected to include the abandonment of attempts at industrial policy, such as the national car project and an effort to manufacture passenger jets.

Asians Debate the 'Asian Model'

Washington's free-market agenda is not without partisans among the political elite of Asia. In their view, the US corporate sector's embrace of downsizing and other ruthless measures in the early 1990s accounts for

America's marked edge over Japan and Europe. According to this school, state-assisted capitalism may have worked in achieving high growth in the early phases of industrialization but is dysfunctional in an era of globalized markets. Moreover, they argue, state management has spawned corrupt government-business relationships that deprive both local and foreign investors of accurate data on which to make sound decisions, adding to the costs of doing business.

Others, though, are keenly aware of the disturbing side of resurgent US capitalism: the most unequal distribution of income among advanced industrial countries, spreading poverty and deep alienation among the lower classes. Asia's economic chiefs are understandably hesitant about dismantling the institutions of Asian capitalism – for example, lifetime employment of the core industrial labor force, a pillar of Japan, Inc. -- if the price is volatile discontent.

An equally significant objection is that radical free-market reform may lead not to the transformation of Asian capitalism but to its unravelling, since policies that re-create the international economy in the image of the US economy do nothing to build on the strengths of the existing economies but simply establish an arena in which the economic actors that followed one particular historical road to advanced capitalism—the free-market/minimal-state road—will have an unparalleled competitive edge.

In this view, the solution is not to throw out the activist-state baby with the bathwater but to redraw the state-private sector relationship along the lines of more transparency, more accountability to the public and more democratic oversight of both government and corporations. Also along the lines of greater government discipline of the private sector, since one of the key lessons of the crisis is that there was not too much state intervention but too little. In Korea, for instance, the loosening of state regulation in the 1980s encouraged the *chaebol* to pour their profits into speculative investment. Similarly, in Southeast Asia, it was lack of state intervention in financial markets the allowed overinvestment in real estate. From this perspective, the crying need is for more effective regulation of the private sector and, in particular, the breaking up of corrupt patronage networks linking the public and private sectors. In other words, clean up government so it can serve capital as a more effective partner.

Beyond all the foregoing advocates for reform, however, diverse voices in the region from labor leaders to academics to environmentalists are beginning to call for a sharper break with both old-style state-assisted capitalism and free-market zealotry. Although not yet "operationalized" in hardheaded fashion, their agenda is getting an increasingly sympathetic hearing from the public, particularly in Thailand, "ground zero" of the collapse.

It might be characterized as a program of negotiated and selective integration into the global economy. Among its themes:

1. Globalization of financial markets had gone too far, and controls are badly needed on the inflow and outflow of foreign capital. Even the deputy managing director of the IMF has recognized this, telling an IMF-World Bank meeting in September, "Markets are not always right. Sometimes inflows are excessive, and sometimes they may be sustained too long. Markets tend to react late; but then they tend to react fast, sometimes excessively." Capital controls are needed not just for stability, though, but for managing the development process in a healthy direction.

Very popular among reformers in the region today is the idea of a transactions tax on all cross-border flows of capital that are not clearly earmarked as productive investment. That, along with a measure currently being used by the Chileans---requiring portfolio investors to make an interest-free deposit equal to 30 percent of their investment that cannot be withdrawn for one or more years—aims to slow the frenzied movements of finance capital. Such measures would create a strong disincentive for speculative capital to enter and exit arbitrarily, with all the destabilizing consequences, but would not penalize direct investors that are making

more strategic commitments of their money.

2. While foreign investment of the right kind is important, growth must be financed principally from domestic savings and investment. That means good progressive taxation systems. One of the key reasons Southeast Asian elites relied on foreign capital for development was that they did not want to tax themselves. Regressive taxation is the norm in the region, where levies that cut deeply into the incomes of people on the low end of the scale are the chief source of government revenue. Meanwhile, only a tiny minority pays income tax. But progressive taxation would just be a start. Democratic management of national investment policies is also essential if local savings—which in East Asia remain high relative to other countries—are not to be hijacked by financial elites and channeled to speculative gambles.

3. Development must be reoriented around the domestic market as the main stimulus of development. The tremendous dependence on exports has made the region extremely vulnerable to the vagaries of the global market and sparked a race to the bottom that has beggared significant sectors of the labor force while benefiting only foreign investors and domestic manufacturing elites.

A Keynesian strategy of enlarging the domestic market to generate growth must include a more comprehensive program of asset and income reform, including effective land reform. There is in this, of course, the unfinished social justice agenda of the progressive movement in Asia—an agenda marginalized by the regnant ideology of growth during the "miracle". Vast numbers of people remain marginalized because of grinding poverty, particularly in the countryside. Land and assets reform would simultaneously bring them into the market, empower them economically and politically, and create the conditions for social and political stability. Achieving economic sustainability based on a dynamic domestic market can no longer be divorced from issues of equity.

4. While the fundamental mechanism of production, distribution and exchange will have to be something more sensible and rational than the "invisible hand" of the market, neither the interventionist hand of the East Asian state nor the heavy hand of the socialist state is a good substitute. Certainly, the state is essential to curb the market for the common good, but in East Asia the state and the private sector have traditionally worked in nontransparent fashion to advance the interests of the upper classes and foreign capital. While not denying that market and state can play an important and subsidiary role in the allocation of resources, the emerging view is that the fundamental economic mechanism must be democratic decision making by communities, civic organizations and people's movements. The challenge is how to operationalize such institutions of economic democracy.

5. The centrality of ecological sustainability is also one of the hard lessons of the crisis. As any visitor to Bangkok could testify, twelve years of fast-track capitalism has left an industrial infrastructure that will be antiquated in a few years, hundreds of unoccupied high-rises, a horrendous traffic problem only slightly mitigated by the repossession of thousands of late-model cars from bankrupt owners, a rapid rundown of natural resources, and an environment severely, if not mortally, impaired.

Instead of 8 to 10 percent growth rates, many environmentalists speak of rates of 3 to 4 percent. This links the social and environmental agendas, since the elites' addiction to high growth is at least partly explained by their desire to take the lion's share of wealth while still allowing some to trickle down to the lower classes for the sake of social peace. The alternative—redistribution of wealth—is clearly less acceptable to the ruling groups, but is the key to a pattern of development that combines economic growth, political stability and ecological sustainability.

These ideas and other remain to be welded into a coherent strategy, and that strategy in turn awaits a mass movement to carry it. The emergence of such a movement must not be underestimated. One clear lesson of the crisis is that the region's elites are anachronistic. They will fight their displacement, but the drastic loss of

legitimacy stemming from their economic mismanagement provides a window of opportunity for progressive movements, like Thailand's increasingly influential forum of the Poor—a unique alliance of environmentalists, farmers and workers—to translate these ides into effective political strategies for change. Frozen during the years of the long boom, mass politics with a class edge is about to return to centerstage.

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