

Asia's Continuing Crisis

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The geopolitics of Cold War Asia were largely shaped by relative economic development. Initially, Asia experienced a military and ideological standoff: the military standoff symbolised most vividly by the 1954 truce in Korea; the ideological standoff symbolised perhaps most vividly by the predominance of Marxists in the economics faculties of universities like Thailand's Thammasat and Japan's pre-eminent Tokyo University. Instability was endemic in non-communist Asia, and for several decades after the Second World War, US analysts watched anxiously to see whether Marxist movements would gain an edge, not just in places like Thailand but also in Japan.

The US military and alliance system subsequently provided a shield behind which superior economic development gave populations a stake in their societies, provided resources for governments to defend and develop themselves, and funded technological prowess. South Korea illustrates this process. Under Syngman Rhee, president from 1948 to 1960, a predominant share of resources was channelled into the military, but even so, South Korea fell further and further behind what seemed to be superior North Korean military capability, as well as economic performance and social stability. A brief 1960–61 foray into democracy led only to heightened instability and economic mismanagement. Then, in 1961, General Park Chung Hee imposed a new regime that slashed military budgets, relying instead on the US for defence, and bet the national future on superior economic performance. Today, despite North Korea's formidable military forces, South Korea's economy is more than 30 times larger, and provides clear and decisive strategic superiority.

This story was repeated in Japan, Taiwan, Hong Kong, Singapore, Thailand, Malaysia, and even, for a strategically vital interval (1966–97), Indonesia. In the most successful cases, rapid economic development also produced a predominant middle-class with a high level of education, which provided the foundation for stable democracy.

In contrast, North Korea, China, Vietnam, Burma, Laos and Cambodia fell behind. Within a few years of its military triumph over the US, Vietnam, which had towered geopolitically over Thailand in 1975, seemed like a comparative basket case. Sharper than its neighbours, China drew the appropriate conclusion and effectively changed sides: paramount leader Deng Xiaoping

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shifted towards an open, export-oriented economy, befriended virtually all his non-communist neighbours (but not, initially, communist Vietnam), reduced the military budget (as Park Chung Hee had done) from 16.5% of GDP to 3.25% and changed China's foreign-policy objectives from promotion of chaos to promotion of stability.

But times change. The hyper-growth economies of the post-war period were, to varying degrees, based on wartime mobilisation systems in which the government seized control of much of the capital flow and directed it into those industries that seemed to be the foundation of national power – steel, shipbuilding, cars, petrochemicals – and into those firms that seemed most loyal to the cause of national power (and to particular national leaders). In South Korea, President Park's determination to build those industries that would facilitate the defeat of North Korea is relatively recent and clear in our memories. In Japan, most have forgotten that the present and enduring system was designed in 1940 to channel capital into the industries essential for prosecution of the war and to protect them from competition.¹ South-east Asian systems combined emulation of Japan, local protectionist instincts and responses to Western aid missions' requirements for plans. Taiwan's intricate system of economic plans, government-owned banks and Kuomintang (KMT)-controlled conglomerates evolved both from Taiwan's Japanese colonial era and from the KMT's socialist past. The common outcome was excessive government control over the use of capital. This provided initial strategic advantages and later vulnerabilities. Initially, governments were able to channel funds towards vital basic industries that were short of capital. But later, the same policies wasted capital on such a vast scale that whole sectors and whole banking systems risked collapse. The resulting regional crisis is crippling old leaders and opening opportunities for new ones.

Reform and growth after the Asian crisis

In the 1990s, the East and South-east Asian regions suffered from a series of financial bubbles. The medium-term economic prospects of the region depend largely on the seriousness of the structural problems that produced the crises, and on the decisiveness of the reforms that followed. It is already clear that the economic and geopolitical structure of Asia in the future will be quite different. Economic growth rates, domestic politics, geopolitics and investment prospects are all changing drastically. Just as the last generation of generals had to learn about open markets, this generation of politicians and policy-makers must learn about financial bubbles and how to manage them.

The bubble crisis: origins of the change

The bubbles resulted from governments' efforts to accelerate economic development and to shape economies by channelling vast flows of funds in directions other than the market would have done, and in some cases, by inflating the money supply. This resulted in bubbles of two kinds: asset-price

bubbles and overcapacity bubbles. When these bubbles burst, a profound regional crisis resulted.

The best-known case of asset and overcapacity bubbles occurred in Thailand. Early in the 1990s, the government created a facility, the Bangkok International Banking Facility (BIBF), that directed considerable amounts of dollars into the domestic market, at interest rates far below local market rates. Foreign banks were told that their prospects for future branches would depend substantially on how much money they funnelled through the BIBF. These dollars were concentrated in the banks, finance companies and the property market that was their principal business. By mid-decade, cheap credit had induced construction of huge numbers of empty apartments and other buildings, at prices inflated by the exceptional availability of money at below-market rates. Even as the inventory of properties became enormous, building accelerated to levels that were far beyond what the market had ever absorbed. Inevitably, when interest rates rose, the bubble popped, crippling the banks, the property and construction industries, and the rest of the economy.

Inadequate reform of the banks and corporations has hobbled the Thai economy ever since. Despite widely publicised reform efforts, on balance, bank managements have changed little, insolvent companies have been coddled and creditors stiffed. As a result, national resources have remained tied up in dead companies, and banks have been too crippled to lend to any but the most credit-worthy companies.

The economic and market consequences have been dramatic. In the absence of drastic culling of the banks and rapid, extensive corporate restructuring, stimulatory monetary and fiscal policy has proved incapable of reviving economic dynamism. Thailand quickly overcame its lack of foreign exchange reserves, but with the nation's capital and labour tied up in moribund firms a return to rapid, or even satisfactory, economic growth was impossible. Hence Thailand, which had been known as a recession-proof economy and which had averaged more than 7% average GDP growth for more than four decades, has so far been unable to recover momentum.² Its domestic politics have become distressed, and its once-flourishing stock market is now about half the size of a single big company in a more vibrant economy such as Hong Kong.

Thailand's bubble-generated breakdown is exacerbated by an even more intractable problem. Asian 'miracle' economies have to keep moving up the economic ladder (rice, shirts, toys, radios, cars, computer assembly, electronic chips, software) as their wages rise. But Thailand graduates only 14% of its population from high school and thus lacks the skilled labour force necessary to move any further up this ladder, while its higher wages have come to mean the loss of much existing industry to China and India, countries paying lower wages. All this means that Thailand's era as a leader of the Association of South East Asian Nations (ASEAN) is over, at least for many years. Other ASEAN economies, such as Indonesia's, have followed Thailand into a moribund state, with concomitant political instability and social unrest. For now, ASEAN is a

spent force, both economically and politically. The changes in North-east Asia, formerly the regional powerhouse, are even more consequential.

Japan

If Thailand constitutes the most disturbing recent example, Japan provides the ultimate model: world history's largest bubble. After the Second World War, the Japanese government retained the fundamental features of what was called the 1940 system: a set of institutions and economic management practices originally designed to mobilise resources for the war. Most industry was highly protected and controlled by cartels, allowing production on an enormous scale but also creating high prices. Consumers were provided with incentives to save, while high prices and small apartments discouraged consumption. Savings were channelled into government institutions that directed the funds toward favoured industries, such as automobiles and electronics. Banks were associated with large conglomerates (the wartime *zaibatsu*, such as the Mitsubishi group, and later, the bank-led *keiretsu*) and directed funds into their favoured companies, which had very high rates of both savings and investment. The result was that the favoured companies and industries had more funds than they would have had under a 'pure' market, and at lower rates. The risk was that they had fewer market pressures to use the funds efficiently.

For the first quarter-century of post-war reconstruction, this channelling of funds into capable companies and into rebuilding familiar industries resulted in exceptional growth. The use of funds was efficient because the money was going into companies with established track records and was being used to rebuild industries like steel, through companies that had been previously successful in this field. Finally, this was all occurring in a context of great national and corporate urgency.

Before the end of the 1970s, however, those conditions no longer produced rapid, efficient growth. The combination of international protectionism, domestic cartels and easy money was producing conglomerates with rising overcapacity and excessive corporate savings. The excessive savings had two critical consequences. Firstly, they contributed to inflating the asset bubbles in property and stocks, as well as creating overcapacity. Secondly, Japan's excessive savings meant that the economy could grow only through some combination of fiscal stimulus and a rising current account surplus. As the current account surplus unsettled Japan's trading partners, the only means to create growth was, increasingly, a highly stimulatory fiscal policy, a policy that implied a rapidly growing national debt.

The trend toward asset and overcapacity bubbles culminated just as a bloating of money supply in the late 1980s produced the biggest asset bubble in world financial history. At its peak, the bubble included a stock market whose market capitalisation was 49% of all global stock markets combined and a real estate market where the land under the Emperor's palace alone was reputedly worth as much as all of California.

The Japanese bubble, and a parallel Taiwan property and stock market bubble, burst in 1990. In both cases, the policy response was very similar to Thailand's in the face of its own bubble seven years later. The Japanese government continued to tolerate lax bank accounting and reporting practices. After years of writing off non-performing loans (NPLs), the banks' total NPLs have still not decreased. The banking system's total capital of 30 trillion yen is offset several times over by estimated bad loans of 150–240 trillion yen. The government did partial bailouts of the banking system, but did not close significant numbers of banks or demand drastic management changes. To maintain the fiction that the banks had adequate capital, even though much of their capital comprised stocks with declining value, the government propped up the stock market. As with the US Resolution Trust Corporation (RTC), the government bought up real-estate collateral from the banks, but, unlike the RTC, Japan's Resolution Collection Corporation did not sell the properties. This propped up the property market and with it the pretence that the banks had adequate capital. The banks coddled most important insolvent companies, lending them enough to keep them going or forgiving loans rather than foreclosing their collateral. While mostly refusing to address the important issue of bank and corporate restructuring, the government focused attention on fiscal and monetary policy.

Supported by Western economists who focused only on macro-economic issues, the government's stimulatory macro-policies only made the underlying structural problems worse. Massive fiscal stimulus, focused on traditional sectors like construction, ended up substantially expanding the subsidies of inefficient sectors and worsening the overall misallocation of resources. For instance, because of protectionism and cartels, the Japanese construction industry already employed about twice the percentage of the workforce used by other wealthy economies (10% *vs.* 5%), but after a decade of 'reform', the number of construction industry employees had risen from 5,880,000 in 1990 to 6,530,000 in 2000.³ Similarly, zero and near-zero interest rates, which from a macro viewpoint seemed quite sensible, also prolonged and worsened the crisis. Near-zero interest rates meant that banks could carry insolvent companies, and companies could carry uneconomic divisions and loss-making property, at near-zero cost. Meanwhile, the opportunity cost to the overall economy soared. The result was exactly what happened five years later in Thailand. Keynesian stimulation, in the absence of structural reform, exacerbated the inefficient allocation of resources and produced stagnation.

To be fair, the Japanese experience did show the importance of not getting macro policy wrong. For instance, when Prime Minister Ryutaro Hashimoto unwisely raised taxes, the negative stimulus immediately created a recession. But Japan also reduced the exclusive reliance on fiscal and monetary policy to absurdity. By 2001, low interest rates and massive fiscal stimulus had not only failed to revive the economy, but had raised the Japanese government's combined domestic debt, other public-sector debt, contingent liabilities and

unfunded pensions to the highest proportional debt burden – variously estimated at 330–400% of GDP – in economic history, creating the risk of an eventual financial crisis and meltdown.⁴

In limiting the short-term cost of carrying this debt, zero interest rates created a dangerous misperception among the politicians and the public that this burden could be sustained and even increased annually by 10% of GDP, with limited risk. In fact, over the next few years, Japan faces an increasing risk that the sources for funding the debt will dry up or demand higher payment for the risk, that interest rates will then rise, and that the debt will turn into a black hole. Japan runs a budget deficit of around 10% of GDP, against a savings rate of around 10% and a current-account surplus of around 2.5%.⁵ As the economy becomes less efficient, the current account surplus may well dry up. As savers become more aware of the scale of the debt, they will likely come to want a risk premium. If so, that risk premium would probably appear suddenly, as it did when Japanese banks suddenly got into trouble in the late 1990s.

Economically, this is the most dangerous situation in the world today. A Japanese financial implosion could take much of Asia's and the world's economy with it. Politically, it is the most insidious, because, except to credit analysts, it appears innocuous until the day when interest rates start to rise significantly. By that time, the condition is terminal.

By the turn of the decade, scholarly literature increasingly addressed the real situation⁶ but it was only with the Koizumi election campaign of 2001 that the gravity of the problems and the painful potential remedies became Japan's core political controversy. Prior to that, the Japanese public was vaguely aware that something was not right and the popularity of the Mori cabinet sank to 9% in February 2001. The courageous Governor of the Bank of Japan, Masaru Hayami, stretched his mandate, risking his job and the central bank's independence, by backing away from zero interest rates for a while to dramatise the need for structural reform. Then an outspoken, iconoclastic politician, Junichiro Koizumi, took advantage of the situation to seize the prime minister's job on the basis of a demand for structural reform – with public approval levels of 86% in June 2001. Koizumi, however, still faces the entrenched opposition of most of his own Liberal Democratic (LDP) Party, most of the bureaucracy and most of the banking and business establishment. It is unlikely that he will be able to force through fundamental reform in the short term. Real reform may require a potentially shattering clash between Koizumi and the bulk of the political establishment. The good news is that he currently has overwhelming public support, so his ideas may emerge victorious even if he personally does not.

The contrast between Japan's decade-long mismanagement of the post-bubble era and China's superior management of worse problems (discussed below) has drastically altered Asians' perceptions of their big neighbours. In 1989, Japan was king of the economic world, an envied model even for the US, and China was a hapless socialist backwater. Today, many Asians see China as serious and Japan as unable to keep its own house in order.

Taiwan

Taiwan has mimicked Japan's problems, but in miniature. It has also mimicked Japan's policies, but in the context of an economy that is more entrepreneurial and industry that is less dependent on the banks. The result has been squeeze without crisis.

Taiwan's problems derive from its banks. Taiwan's banks traditionally have three businesses: participating in the stock market and providing margin loans for it; participating in the property market and writing mortgages; and lending to traditional industries. By 1990, Taiwan had property-market and stock-market bubbles similar to Japan's, and they burst at the same time. On 10 February 1990, the stock market was at a peak of 12,496; by 1 October, it had fallen to a low of 2,560.⁷ The property market, like Japan's, has essentially been falling ever since. The third sphere of bank business – lending to traditional industries – took longer to cause real trouble. Unlike Japan's economy, Taiwan's was sufficiently resilient to perform well in the years after the initial 1990 crash. A dynamic, entrepreneurial, export-oriented electronics sector was proportionately bigger than its Japanese counterparts (cars and consumer electronics) and much less dependent on bank funding. (Taiwan's electronics companies mostly fund themselves through the stock market.) Thus, there was no overwhelming incentive to reform the financial system.

By the time of the 1997–98 Asian financial crisis, Taiwan's banks had invested large amounts of their own money in the stock market and had provided huge volumes of margin loans for stock purchases. They had not extricated themselves from the problems of the property sector. They were lending heavily to traditional export industries (e.g. shoes, socks, garments, plastics, toys) that were increasingly unprofitable because their wage and other costs were becoming uncompetitive, but unlike their counterparts elsewhere, were prevented for political reasons from moving all their manufacturing to the mainland. And they were heavily committed to a group of politically well-connected conglomerates that were also increasingly uncompetitive.

At the end of 1998, the Asia crisis affected Taiwan. The stock market declined. The property market declined further. Many of the traditional companies found themselves in a squeeze. And about 40 conglomerates, mostly connected to the governing Kuomintang, found themselves in financial trouble. The government feared a domino-type financial debacle if the stock market plunged below 7,000. Unlike Korea, Thailand and Indonesia, Taiwan did not lack foreign exchange and had little foreign or domestic debt. So the government did what its prosperous neighbour Japan did: stimulated the economy; forced the banks to create a multi-billion dollar fund to prop up the stock market; provided subsidies for people to buy houses; required the banks to sustain the politically well-connected conglomerates; gave the banks compensatory tax breaks; and looked the other way while the banks disguised and under-reported their non-performing loans. What it did not do was to reform the financial system – not even to the extent that Thailand had. Although the government

feared a meltdown, favourable regional and global economic trends powered Taiwan out of its trough in the first quarter of 1999.

The present author had warned shortly thereafter that the failure to reform meant failure, in the future, to realise the economy's potential, together with the risk of another financial squeeze.⁸ By early 2000, the squeeze recurred, this time in more severe form, and the government responded with the same kinds of policies as it had before.

Taiwan's new president Chen Shui-bian was an able politician but not an economic visionary. He and his party publicly acknowledged that they had little experience with economic policy. As Chen delayed his response to the squeeze, the financial problem quickly became his political problem rather than being linked to his predecessors, who were in fact responsible for creating it. The KMT, now the opposition party, still controlled the legislature and had little incentive to cooperate with reform, since the banks and conglomerates needing such reform were in many cases owned or controlled by the KMT. Moreover, the KMT believed its chances in the December 2001 legislative election would be enhanced if economic problems worsened in the meantime. Similarly, Chen's newly formed Democratic Progressive Party (DPP) government believed that it would have a better chance in the upcoming election if it deferred painful economic reforms and controversial steps in relations with Beijing until after the elections. In the absence of a public sense of emergency, as there had been in Korea at the time of its December 1997 squeeze, both government and opposition were able to get away with these stalling tactics. Instead of undertaking urgent reforms, the government:

- spent vast sums to prop up the stock market;
- created financial incentives for people to buy property in order to support the property market;
- intervened to prop up the currency;
- continued to demand that the banks carry dozens of large, insolvent conglomerates at a cost of billions of dollars;
- forced the banks to roll over the principal payments for weak companies in traditional industries and to create a pool of funds to bail them out;
- propped up the banks through a 2% tax cut and other means;
- planned a toothless, Japanese-style bank consolidation with no failures and negligible layoffs;
- provided for asset management companies, but not for the rules that would make them effective, such as forced foreclosures and a securitisation law;
- allowed some foreign buying into weak local banks – a positive step;
- suppressed publication of consumer confidence;
- continued to use a loose definition of NPLs and to tolerate or even encourage banks to severely understate their loans.

Because of such policies, Taiwan, which initially was in far better shape than Korea, has subsequently under-performed Korea by a wide margin. Korea's stock

market has performed better since 1999, and domestic confidence and demand are reviving far more slowly. This is the opposite of what should happen: normally, Taiwan's numerous smaller companies are far more nimble than Korea's giants and greatly outperform them in a downturn.

What Taiwan should have done was:

- Stop listed companies from using subsidiaries to inflate their own share prices and then using inflated shares as collateral for bank loans.
- Limit banks' exposure to the stock market.
- Regulate the (unseemly) level of margin debt.
- Put an end to the control of certain banks by property companies.
- End political control of the banking system and political party control of certain banks.
- Force the banks to rapidly clean out their non-performing loans, based on a tough definition, foreclosing on companies and selling collateral as necessary.
- Cease the practice of forcing the banks to support large, politically well-connected conglomerates.
- Stop pressuring the banks to support financially weak companies in traditional sectors.

Had Taiwan followed these measures, today it might well have the most efficient economy in the world. The new government could have carried out these reforms: the financial system was under sufficient strain that Taiwan's well-educated middle class could have been mobilised and persuaded to accept such measures. And for the first time in modern Taiwanese history, the ruling party was not the party that owned or controlled the big conglomerates and key banks.

Because Taiwan initially was in so much better shape, Japanese-style policies have not led to Japanese-style stagnation and risk of fiscal collapse. Like Japan, it has huge foreign exchange reserves and little foreign debt. Unlike Japan, it has very limited domestic debt. Most importantly, it has a proportionately much larger unprotected, uncartelised, internationally competitive manufacturing sector focused on its electronics industry. And unlike Japan, Taiwan has historically been open to foreign direct investment (except, notably, in its financial sector) and therefore has absorbed international best practices into a larger proportion of its economy than Japan. Unlike Japan, Taiwan's most competitive companies get most of their funding from the equity markets rather than the banks.

However, even if Taiwan has enjoyed greater leeway in pursuing misguided policies, it has not been able to avoid substantial consequences from financial mismanagement. Local stock-market investors periodically pull back because they fear the consequences of a domino-like fall of a fragile financial system. The waste of a substantial part of the economy's financial resources has slowed growth and recovery unnecessarily. The failure, for the first time in Taiwan's

history, to shift resources decisively into more modern industries, has led to a situation where the bulk of Taiwan's industries other than electronics are experiencing some degree of financial squeeze, and the bulk of the southern two-thirds of the territory is in a slump. As a natural result of this, consumer confidence is low and domestic demand is not recovering as fast as it has in Korea. This is a striking reversal for an economy whose smaller, more innovative firms have traditionally made it far more resilient than Korea in a downturn.

The risk for Taiwan is not collapse, but rather a combination of relatively mild but cumulatively important disappointments: much slower growth than necessary; loss of key opportunities to Asian competitors; and a troubled banking system that does not revive for many years after it should have. This could also involve much greater social stress than necessary as the floodgates hitherto preventing many companies from moving to the mainland open and the territory finds that its workers, its companies, and its financial system have to make sudden, wrenching adjustments rather than the more gradual adjustments that would have sufficed if reform had begun earlier and moved faster.

All these problems are exacerbated by political controls over investment in the mainland. Had the traditional industries been able to move smoothly to the mainland, as Hong Kong's did, the southern two-thirds of Taiwan would be economically healthy today. Had the high-tech companies been able to allocate production according to market dictates, the shift of production to lower-cost locations would have been gradual and would have led to rapidly increasing living standards as in Hong Kong. Instead, most of the non high-tech sectors are in trouble and the high-tech sector seems on the verge of a sudden, potentially traumatic shift to the mainland.

Taiwan's high-tech firms are at last finding ways around the political barriers to mainland investment. The families owning the firms are selling their shares to raise capital and borrowing from the banks under false pretences, moving the funds offshore to the US, the Cayman Islands, or other tax havens, and then investing in the mainland as US or Cayman Island firms. They are pretending to their government that they are obeying the technology restrictions, while trying to raise their stock prices by boasting to brokers that they are circumventing the rules. The resulting shift is rapid and massive. Over 300,000 Taiwanese now live in Shanghai alone, and leaders of the Taiwan community in Shanghai recently told investors that the number of Taiwan expatriates in China probably now exceeds one million – 5% of the entire population of Taiwan, 10% of the island's total workforce. While Taiwan companies make 90% of the world's scanners, over 85% of those in turn are manufactured on the mainland.⁹

As a result, Taiwan now fears a rapid industrial hollowing out, rising unemployment, and disruptive and spasmodic industrial development. Its economic dependence on the mainland will be greater than is really necessary. In the future, it will negotiate with the mainland from a position of diminishing economic superiority and diminishing political self-confidence.

South Korea

This represents the sharpest possible contrast with developments in Korea. In the earliest aftermath of the Asian financial crisis, South Korea seemed to be in far greater trouble than Taiwan. Unlike Japan, Taiwan and China, Korea's bubbles were inflated with foreign, not local currency. Hence Korea shared with Thailand and Indonesia the problem of simply running out of foreign exchange when its bubbles popped. Domestically, the economic problem also was far worse than Taiwan's; very large proportions of Korea's most prominent corporations and banks were in severe financial difficulty. Moreover, Korea was hobbled politically by a president, Kim Young Sam, who was at the time the most unpopular leader in Asia (opinion polls showed single-digit levels of approval).¹⁰

In retrospect, however, South Korea was lucky. The fact that the government simply ran out of foreign exchange and had to go to the International Monetary Fund (IMF) shocked a proud nation that thought of itself as one of the great miracles of economic history. South Korea had just passed \$10,000 in per capita income – a proud moment for a country that was one of the world's poorest in 1960. It had just joined the OECD. Suddenly it felt bankrupt and had to take excruciating austerity measures. This created a sense of urgency that was lacking in Japan and Taiwan – an urgency symbolised by thousands of Koreans donating their gold jewellery to bail out the nation.

Korea's political ill-fortune to be led into the crisis by the hapless Kim Young Sam became transmuted into good luck. An election held at the same time as the crisis brought to power a new and blameless leader, Kim Dae Jung, who had a vision of a reformed Korea: more market-oriented, more open, and more democratic. This vision long predated the crisis but coincided precisely with post-crisis requirements for restructuring and rejuvenation. The sense of national urgency enabled the new president to implement much of his vision. In face of the opposition's complaints about the painful measures, every major reform bill was passed. Although the reforms were opposed by some of the world's most powerful corporations and by labour unions that were possibly the world's most spoiled and obstinate, a middle-class consensus in favour of the reforms overcame both

Korea's policy response to the Asian crisis was painful in the extreme. A severe dose of IMF-inspired austerity restored foreign exchange reserves. The banking sector became the priority for reform. Initially 21 of 30 merchant banks were closed and nine of 26 commercial banks. On 1 July 2000, the government forced the Investment Trust Companies, most of which were in financial trouble, to value their portfolios at current (low) market prices rather than at the (high) prices initially paid, triggering a crisis. In January 2001, it deprived the banks of full deposit insurance, a policy it announced a year in advance to create a flight to quality and to drive the worst banks to the wall. It forced the banks to draw up self-rescue plans for government scrutiny. Those institutions which failed to clear these successive hurdles were consolidated under a government holding company. In the process, 38% of commercial bank employees lost their jobs.

Corporate reform was the second priority. The cream of South Korean industry before the crisis were 30 giant conglomerates, or *chaebol*. Fourteen of those no longer exist. Of the five biggest, which collectively controlled over half of GDP, Daewoo has been completely dismembered, Hyundai is in an advanced state of gradual dismemberment and the remaining three now operate very differently to before. All are increasingly transparent, increasingly subject to normal credit scrutiny by the banks and severely limited in the degree to which member companies may support each other.

In addition, there have been many smaller bankruptcies and the state enterprise sector is being gradually privatised. Employment in the 11 big enterprises being privatised has declined by roughly one quarter, from 210,000 to 168,000.¹¹ Pressure on companies to become competitive has been increased by substantial liberalisation of Korean trade and foreign-investment restrictions. On top of the pain of austerity, bankruptcies, reorganisations, and layoffs, Korean capital markets have been repressed by the extreme risk aversion that necessarily accompanies large-scale bank and corporate closures. This pain has resulted, however, in a transformation of the Korean economy. The release of capital and of skilled employees from the old, bureaucratic, heavy industrial and banking sectors has transformed the way Korea works. Previously, the *chaebol* had monopolised most of the most talented workers for life; now, such employees are leaving to try their luck with a 'new economy' company, and, if that doesn't make their fortune, moving back to a *chaebol*. Capital that once was largely earmarked for the biggest *chaebol*, regardless of productivity or creditworthiness, now increasingly moves according to the market. This is not to suggest that reform is anywhere near completion. But economic growth and corporate profit come from progress at the margin, and that is exactly where Korea is making considerable progress.

As a result, 'new economy' companies and the service sectors have flourished. As of 13 June 2001, the new Kosdaq market had 584 stocks with a market capitalisation of \$37.7bn. Although this market has been battered by the global technology down-cycle, most of its companies are not profitless dot-coms but profitable manufacturers of tangible products. Beneath this group of listed companies, thousands of unlisted technology and services companies that would mostly never have existed without the crisis are flourishing. (As in China, the entire services sector had previously been suppressed by lack of access to capital.) A surprisingly robust software and Internet sector has suffused Korean society and is becoming a global force. And the surviving *chaebol* are paying attention for the first time to return on equity and are using their now-scarce resources with new efficiency.

Given Korea's state of crisis in 1998 relative to Taiwan's apparent prosperous calm, it is remarkable that only three and a half years later Korea has more rapid revival of domestic demand, a stronger banking system and better stock-market performance. One of Korea's foremost social scientists put it more succinctly, arguing that Korea is finally able to enjoy the full freedom and creativity of modern society.

Economic reform is transforming South Korea's international role. In 1997, its *chaebol*-dominated economy faced stagnation; now it is emerging as a major player. While keeping an eye on North Korean tanks, leaders of the South now act with the confidence of an economy 30 times larger. The target of strategic competition is shifting from North Korea to where South Korean leaders have always thought it should be: Japan. And there is a new questioning of Korea's relationship with the US. As Taiwan becomes more dependent on Washington by the day, South Korea is increasingly willing to ask whether it is really necessary to follow Washington's whims, especially toward unnecessary conflict with China. Above all, South Korea's leaders do not want to be deflected – by the Americans or anyone else – from their pursuit of peaceful reunification. Their determination has profound implications for the geopolitics of North-east Asia.

China

If South Korea is a hero of reform, China is so far the superhero. China's economic problems were comparable to Korea's, but it faced them far more proactively and decisively. As in Korea, China's government had traditionally forced the banks to reserve most capital for a group of favoured companies; they were called state enterprises rather than *chaebol*, but the consequences were similar. In both cases, the companies' special access to capital had led them to spend on lifetime employment for workers and vast overcapacity. Such wasteful use of capital had eventually rendered the companies incapable of repaying the banks. The only solution was reorganisation and recapitalisation of the banks and extensive restructuring of the leading companies, accompanied by many bankruptcies and layoffs. In both the Korean and Chinese cases, the resulting shock to the economy hampered business investment and consumer spending, and the economy had to be revived by fiscal stimulus and export success.

Unlike in Korea, China's leaders did not wait for a crisis to happen. From the early 1990s, China's leaders began speaking publicly about how certain problems would eventually create a crisis if they were not properly addressed: inflation, inefficient state enterprises, troubled banks, corruption. They began a campaign of severe reform that started by forcing inflation down from 22% to negative numbers.¹² The painful reforms depressed growth for seven years.

Whereas Korea decided to focus first on the banks, then use the banks to force reforms on their problem customers (the *chaebol*), China gave priority to reforming the banks' problem customers, namely the state-owned enterprises (SOEs). The result has been a collapse of state enterprise employment from 109.5 million in March 1997 to 80.3m in March 2001.¹³ The government is far advanced into a process of halving the total workforce of the Chinese government from 8m a few years ago to a projected 4m. Forty ministries have become 29. Ten vice-ministerial industrial bureaus running major industries have become one.

Government reform has been accompanied by military reform. Most importantly, in 1998, the military was told to get out of business – a seemingly

impossible task that neither Thailand nor Indonesia would attempt. Nonetheless, within a little over a year, the military's once-pervasive business presence was reduced to limited outposts in telecoms, weaponry and the like.¹⁴ The economic impact was enormous. Despite a weak economy, imports of food and beverages increased 40% by mid-1999 – not because the Chinese people were eating 40% more, but rather, the smuggling operations of the army had been so much reduced that China's actual imports started to show up in statistics for the first time.¹⁵ This in turn contributed to the rise of Chinese government revenues from 10% of GDP to 14% over just a few years.¹⁶ It also made a major contribution to the ongoing effort to contain (still serious) corruption.

So severe were the reforms that observers legitimately questioned whether the economy could recover from the resulting collapse of consumer spending, business investment and bank funding, not to speak of the risk of social instability from all the layoffs. In 2000, this question was answered affirmatively. The government resorted to the same basic tactics as other Asian countries, such as Korea: fiscal stimulus, easy money and rising exports. As in Korea, when these were combined with the vast reallocation of resources from structural reform, they revived the economy decisively. It was precisely the pain accepted by China and Korea, unlike Japan, that validated the efforts of fiscal and monetary policy. In 2000, GDP growth rose to 8%, exports expanded by 28%, retail sales rose by 9.7% and deflation ended (the consumer price index rose 0.4%). Inventories and overcapacity declined, and the *renminbi* was stable. Foreign direct investment approvals rose 50.8%.¹⁷ As the rest of the world slowed down, China benefited from a difficult 1998 decision that Japan has been unwilling to face since at least the late 1970s: to move towards a more domestic-led economy and to foreswear the easy stimulus of competitive devaluation. Most amazingly, consumer confidence rose to near record-levels. Under conventional wisdom, such high levels of consumer confidence were unthinkable in the context of such huge layoffs. But rising retail sales proved this rise of consumer confidence.

The fact that consumer confidence could rise in the context of such painful reforms provides an insight into one source of political stability: the public accepts that the government is taking necessary measures to deal with serious problems. While sporadic worker and farmer protests have occurred, what has been remarkable in this era of reform has been the lack of a Solidarity-type labour movement spreading economic sabotage; the lack of Maoist insurgencies in the countryside; and the absence of extreme anti-government ideologies. Unlike Korea's situation throughout the twentieth century, the current Chinese government has the acceptance (not necessarily active support) of the vast majority of the country's intellectuals. Unlike many developing countries, the Chinese government and military are essentially in agreement over the country's basic direction. The system is stable for now, despite the pain of reform, because the government has successfully made its case that it is doing its best for the country at a difficult moment in history.

This doesn't mean that nothing will change. As China's economy changes, so do its politics. Beneath the continuity of labels and leaders, China has a different polity than 25 years ago. But transformation is occurring without upheaval. Continued growth, and particularly continued domestic growth, are being sustained by a constant shift of resources. People are moving from unproductive SOEs and farms to new industries. Capital is being allocated more efficiently by the banks, although this is a slow process. Above all, the capital markets are becoming significant allocators of capital. Both the quantitative growth and qualitative reform of China's stock markets dwarf all Asian competitors. Most of the increase in Hong Kong's market capitalisation has come from the listing of big Chinese companies like China Mobile (Hong Kong), China Unicom and the oil companies. Hong Kong, Shanghai and Shenzhen are becoming part of an integrated Chinese capital-market strategy. The market capitalisation of the Chinese and Hong Kong markets has risen to about \$1.2 trillion.¹⁸

As happened with the West's non-communist allies in the period 1955–90, China's acceptance of painful reforms has resulted in economic growth, political cohesion and market success. This has also provided the government with the resources to build a more modern military, and it has given China international prestige – the kind of prestige Japan had around 1975.

China's reforms now have considerable momentum. Success has generated a near-consensus on the direction of needed reform. However, implementing that consensus requires strong leadership in order to impose the layoffs and drastic institutional changes that are naturally resisted by entrenched interest groups and (usually) their associated ministries. China cannot afford even a couple of years of weak reforms. While its rate of return overshadows all competitors, its banks are still in terrible shape, its state enterprises still need major reforms and the Chinese physical environment continually suffers from catastrophic droughts, floods and pollution. Above all, while the Chinese people have enjoyed rapid growth, per capita income is still only \$853 (mid-year 2000) as compared to Japan's \$38,000.¹⁹ If leadership were to weaken, crises could suddenly emerge in all these areas simultaneously. This is not, in this writer's view, a likely outcome, but with a leadership transition beginning at the end of 2002, the risk needs to be monitored carefully. If, on the other hand, the new leadership provides the dynamic reforms already being promised, then the geopolitics of Asia will be transformed in China's favour.

Geopolitical implications of the crisis

Asia is being transformed by differential responses to the Asian crisis, broadly construed as a regional misallocation of capital arising from a similar set of capital allocation policies and attendant banking system weaknesses. China and Korea are being strengthened by vigorous reforms. Japan and Taiwan are being weakened by failure to reform.

Japan, formerly the strongest OECD economy, has become the weakest. Not only has it lost its leadership role in Asia and in the world, but if it continues its present policies to 2005, it will become the greatest threat to global economic

stability. Economic weakness has destroyed Japan's international strategy, which was to become the leader of Asia through peaceful economic dominance while continuing to shelter behind the US defence shield. Perhaps appropriately, the strategy of pacifist Asian dominance has failed because it relied on an obsolete economic strategy designed to mobilise resources for the Second World War. There is now broader interest in rebuilding the military, but not necessarily with the same deference to the US. The desires to reform the economy, rebuild the military and distance Japan from the US are powerfully integrated. Prime Minister Junichiro Koizumi is at the mild end of this spectrum and Tokyo Mayor Shintaro Ishihara at the extreme end. If the extremists prevail, there could be radical changes in Japan's domestic politics.

China, where fanatical Maoism once starved millions, has become the bulwark of Asian growth and stability during a global downturn. With a still backward and small economy relative to Japan's, and with a military that does not even approach Japan's technological sophistication, mobility and regional potency, China has become more influential in regional politics merely by reforming its economy faster.

Taiwan, hitherto the developing world's most resilient economy outside the Hong Kong and Singapore city-states, has become fragile and accident-prone, with every bankruptcy threatening domino effects. Korea, formerly on the way to becoming a park for corporate dinosaurs, is becoming a flexible entrepreneurial economy. This is not to say that either will continue in its current path.

As a result of these shifts in economic and thus political power, Asia has become less predictable and Cold War assumptions no longer apply. If one were to take the last two decades of Asian history and project to 2010, one would forecast a Japan crippled by a debt crisis and politically incapable of becoming a modern market economy. The great debt collapse of 2005 would take decades to repair. Its politics might well be dangerously unstable. China in such a scenario would be a much more open, market-oriented economy than Japan. While those addicted to the verities of the past will find this idea ridiculous, the omens are everywhere. China has just committed in its WTO accession agreement with the US to cap any agricultural subsidies at 8.5%; much of Japan's effective protection can only be measured in hundreds of percentage points. China's trade equals 44% of its GDP, Japan's only 14%. Clear Customs in Beijing and you will probably see 500 consecutive people pass without an inspection; in Tokyo, the inspectors seldom waive five. China's leadership educates its élite in the US; most Japanese parents still fear the stigma of sending their children to a foreign school. In every major market sector, Chinese leaders are making a significant effort to enhance competition; Japanese leaders still suppress their own competition laws. China is proportionately more open to foreign investment than any other economy in the world; in the year 2000, the US still received the largest foreign direct investment, but Hong Kong was second and China third, with Japan lagging well behind. On a similar trend line, by 2010, a unified Korea may well be challenging Japan across a much broader range of industries.

These are straight line projections of recent trends; for that reason alone, they should be considered sceptically. The trend line could be broken, with Japan under Koizumi achieving real reform; China after Zhu Rongji faltering; Korea after Kim Dae Jung suffering a conservative reaction; and Taiwan reaching a deal with Beijing and achieving economic regeneration. But if the straight line is unlikely to continue, the Asia-Pacific region's future power configurations are even less likely to be based on the Cold War past. For the foreseeable future, China, a small and backward but decisively managed economy, is increasingly acknowledged within Asia as the region's leader – not loved, to some extent feared, but respected. Japan, with a huge and modern but mismanaged economy, has become the sick man of North-east Asia. The shape of Asia has already changed.

Notes

- ¹ See William Overholt, 'Japan's Economy, at war with itself', *Foreign Affairs*, January–February 2002.
- ² These growth rates are available in the IMF's International Financial Statistics, published monthly. More recent data are available on the Bank of Thailand website, <http://www.bot.or.th/bothomepage/databank/Econdata>.
- ³ These data are available from the home page of the Ministry of Public Management, Home Affairs, Posts and Telecommunications, <http://stat.go.jp>.
- ⁴ The Japanese government's contingent liabilities mainly comprise guarantees of bank loans to troubled medium-sized businesses and similar commitments.
- ⁵ Japanese budgets are available on the Ministry of Finance website: <http://mof.go.jp/english>. The current account balances are available from IMF, *International Financial Statistics*. The FY2000 budget deficit was 9.4%, according to *Japanese Budget in Brief*, available on the IMF site in Section 2: General Government Fiscal Position.
- ⁶ See for instance, Michael E. Porter and Hirotaka Takeuchi, 'Fixing What Really Ails Japan,' *Foreign Affairs*, May/June 1999, p. 63ff., and Richard Katz, *Japan: The System That Soured* (New York: M.E. Sharpe Inc., 1998).
- ⁷ Stock market indices are available from Bloomberg's online service or from the *Financial Times* or *Asian Wall Street Journal*.
- ⁸ William H. Overholt, 'Taiwan Strategy: Escaping the Flames', Nomura International, 16 April 1999.
- ⁹ Figures compiled by Citigroup, Hong Kong, and presented at the International Think Tank Forum, Shenzhen, 15 June 2001.
- ¹⁰ Kim Young Sam's popularity declined to 9% by March 1997 and further after a subsequent series of scandals. See, for instance, Andrew Spaeth, 'Broken Faith', *Time*, 3 March 1997, vol. 149, no. 9.
- ¹¹ See *OECD Economic Survey of Korea*, 2000, p. 115.
- ¹² Chinese growth and inflation statistics are available in the annual *China Statistics Yearbook*, published by the State Statistics Bureau, Beijing.
- ¹³ Sectoral employment statistics compiled from Chinese government publications by CEIC electronic database, <http://www.ntu.edu.sg/library/collections/db/lib2/ceic.htm>.
- ¹⁴ For a review, see James Mulvenon, 'Eating Imperial Grain: The Ongoing Divestiture of the Chinese Military–Business Complex, 1998–2000', in Andrew Scohell (ed.), *The Costs of Conflict: The Impact on China of a Future War* (Carlisle, PA: US Army Studies Institute, 2001), chapter 10.
- ¹⁵ CEIC electronic database.
- ¹⁶ *China Statistics Yearbook*
- ¹⁷ All data from CEIC database.
- ¹⁸ Market capitalisation data available from Bloomberg and Reuters electronic financial news services.
- ¹⁹ Compiled from IMF, *International Financial Statistics*.