Part 1
Region
The East Asian Miracle in Retrospect

Similarity in Diversity

East Asia is the most diverse region in the world. It is comprised of nations that are very different in size: from China with its 1.3 billion people to the 4-million-strong city-state of Singapore. Development and wealth gaps are bigger here than anywhere else. Singapore, Hong Kong, and Japan are among the wealthiest nations in the world while Cambodia, Laos, and Myanmar are among the poorest. In 2007, per-capita gross domestic product (GDP) in Singapore was 48 times greater than in Myanmar and the gap between the average per-capita GDP for Japan and the newly industrialized economies (NIEs) on the one hand and the four countries with the lowest per-capita incomes (Cambodia, Laos, Myanmar, and Vietnam) on the other reached 19 times (International Monetary Fund (IMF) 2008; per-capita GDP is calculated on the basis of the purchasing power parity (PPP) of the national currencies).

Political systems also vary. Some East Asian nations are parliamentary democracies while others are ruled by authoritarian regimes or even military dictators. Sometimes, formally democratic countries are governed in an authoritarian way as one party or political organization has a de facto monopoly on power and the activities of the opposition parties and groups are restrained.

Finally, there is a unique diversity of religious cultures—Brunei, Indonesia, and Malaysia are mostly Muslim, the Philippines is Christian, and Thailand is Buddhist. However, the latter two also have Muslim majorities in their southern provinces. Cambodia, Laos, and Myanmar are Buddhist as well. South Korea is both Christian and Buddhist. The Japanese never hesitate to point out that in their country Buddhism, Shintoism, and Christianity coexist in a most peaceful and positive way. Various traditional religions and beliefs also retain their influence. Above all, Confucian values and philosophy are very important throughout the region, especially among the Chinese and Koreans.

The question arises: If East Asian countries are so different from one another, is it relevant to view the region as an entity in any sense other than purely geographical?
The answer is “yes, most of these countries do.” Their major common feature is rapid economic growth and development. East Asia has established itself as the most dynamically growing region in the world (see Table 1.1). In the postwar decades, practically all of the region’s major economies joined the ranks of the fastest runners. Japan started the spurt in the 1950s and was the most dynamic developed economy until the early 1990s. The four newly industrialized economies (NIEs)—Hong Kong, Singapore, South Korea, and Taiwan—and Thailand and, at a lower growth rate, Malaysia began their rapid economic development in the 1960s, followed by Indonesia in the 1970s, China in the 1980s, and Vietnam in the 1990s. In the latest developments, Russia, including its Asian part, has been growing fast since 1999 and Cambodia and Mongolia have reached the level of double-digit growth in this decade. As far as growth dynamics are concerned, until recently, only the Philippines was an exception among the region’s emerging-market countries.

The combined share of Japan, the four NIEs, the ASEAN 4 (Indonesia, Malaysia, the Philippines, and Thailand), and China in the world GDP increased from 13.6 percent in 1970 to 19.4 percent in 1990 (the author’s calculations based on: NationMaster 2008; Council of Economic Development and

Table 1.1  Average real growth rates of major East Asian economies (%)

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<td>Industrially developed countries average (North America, Western Europe, Japan, Australia, New Zealand)</td>
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<td>China</td>
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Planning, Republic of China 2008), and their share in world exports surged from 9.0 percent in 1960 to 21.4 percent in 1990 (Takushoku 2000).

In 1968, Japan rose to the position of the second-largest market economy after the US and in the late 1980s was practically number one in terms of competitiveness and financial might. East Asia’s emerging-market economies—the NIEs, ASEAN 4, and China—developed into one of the world’s four major centers of production and trade, along with North America, Europe, and Japan. Their share of world exports went up from 5.9 percent in 1960 to 12.9 percent in 1990 (Takushoku 2000). In the 1990s, China established itself as the world’s factory, capable of producing an almost full set of industrial products from sneakers to personal computers.

The World Bank labeled the remarkable growth of eight East Asian economies—Japan, the four NIEs, Malaysia, Thailand, and Indonesia—as the “East Asian miracle” and defined them as high-performing Asian economies (HPAE) (World Bank 1993). Presumably, the rapid growth of China, and later Vietnam, which gained momentum after the publication of the Bank’s famous report, can be viewed as the continuation of the miracle—if you accept this metaphor.

East Asia’s developing economies performed much better than their counterparts in other regions. Between 1960 and the early 1990s the eight HPAE were growing roughly three times as fast as the economies of Latin America and South Asia. They managed to visibly enhance living standards and reduce poverty. During 1960–85 real per-capita income increased more than four times in Japan and the NIEs and more than doubled in Indonesia, Malaysia, and Thailand (World Bank 1993). Poverty incidence, defined as the proportion of families living below the poverty line (comparisons between countries are not recommended because the poverty threshold criteria vary from one country to another), between the years 1970 and 1990, fell in South Korea from 23 percent to 5 percent and in Indonesia from 58 percent to 19 percent. In Malaysia it dropped from 37 percent in 1973 to 14 percent in 1987 and in Thailand from 59 percent in 1962 to 22 percent in 1988 (Gerson 1998, 46).

Economic growth was accompanied by a visible reduction of income inequality—opening new opportunities for, and giving hope to, families in the lower income bracket. Many social indicators characterizing people’s well-being improved dramatically—infant mortality fell and school enrollment increased.

East Asia’s postwar growth also played a very important role in world economic history because its major developing economies successfully pursued industrialization, joining the group of leading exporters of manufactured products. In 1980, the share of manufacturing as part of the GDP was 36.2 percent in Taiwan, 28.6 percent in South Korea, 28.0 percent in Singapore, and 22.0 percent in Hong Kong versus 28.2 percent in Japan and 21.5 percent in the US. In 1990, it reached 27.2 percent in Thailand, 26.5 percent in Malaysia, and 25 percent in the Philippines (Takushoku 2000, 27). Thus, not only Japan, but also the majority of East Asian economies, proved that industrialization was not an exclusive characteristic of Europe and North America.
Why Rapid Growth?

Why did major East Asian economies grow so fast? Why was their industrialization successful?

First, East Asia’s saving rates—the highest in the world—provided a sound financial basis for domestic investment. Investment from overseas was also actively promoted.

Second, the demographic situation was favorable. A high share of the population was of working age, in particular the young generation, and this enabled necessary labor inputs, while falling population growth rates made it easier to fight poverty and create jobs.

Third, most of these workers proved to be diligent and quick to learn. In this regard it cannot be denied that values—or to be more specific, attitudes, toward work—also matter a great deal, though their influence is impossible to measure. For many East Asians, working hard for long hours, with few and short holidays was, and is, a normal way of life. Of course, generalizations are risky—within the region itself attitudes toward work differ greatly depending on the country, generation, and social or ethnic group. Not all East Asians are hard workers.

Fourth, in East Asia both the state and private households willingly invested in education. As a result, in the field of basic (primary) education, its emerging-market countries outperformed developing nations in other regions: their ratio of children attending primary and secondary schools was higher and education itself more intensive.

Fifth, in relative terms, East Asian countries were politically stable—at least they experienced fewer cataclysms, such as civil wars, coups, uprisings, or riots, than developing states in other regions—though the guarantor of stability was usually a dictatorship or at least an authoritarian regime.

Finally, the governments were pursuing sound macroeconomic policies—keeping public spending, budget deficits, and inflation relatively low—which were valued by both domestic and foreign investors. Also, the state worked to ensure the security of banks through prudent regulation, restrictions on competition, and administrative guidance.

Next comes a factor of a very special character—East Asia gave birth to a peculiar type, or model, of capitalism (different from Western, especially Anglo-Saxon capitalism in a number of important respects).

The East Asian Model of Capitalism: An Outline

The East Asian Model Exists

In the 1950s and 1960s, in times when a bitter rivalry between capitalist and socialist systems stood behind all the major collisions in the world economy and politics, economically successful East Asian countries opted for capitalism,
recognizing the key role of market competition and private entrepreneurship. China, under Mao Zedong, Mongolia, North Korea, and North Vietnam chose Soviet-style socialism, or a state-dominated planned system, and were economically unsuccessful. China in the 1980s and Vietnam in the 1990s started growing fast after transitioning to a market-style—actually capitalist—economy, though they preserve the Communist Party rule and call their systems “socialist market” for political and ideological reasons.

Capitalism in East Asia, however, turned out to be largely different from the conventional American or European patterns. As far as the economic system is concerned, the major differences emerged in such key areas as the role of the state and its relationship with the private sector, corporate ownership and control, corporate finance patterns, and relations between companies and their employees.

There is no consensus about the contents of the East Asian economic model and, perhaps, even about the relevance of the term itself. The East Asian economic model is sometimes interpreted as almost a synonym of the Japanese model because Japan, the region’s economic leader, was the first to create a complete and cohesive alternative version of highly developed capitalism. In our view, in spite of substantial differences between the economic systems of the various countries around the region, their common features are important enough to say that the East Asian model of capitalism exists and that this notion goes beyond the Japanese model.

The Role of the State

The first major feature of the East Asian model of capitalism is the leading role of the state in the process of economic development. As mentioned, unlike former socialist countries, in the economically successful countries of East Asia the state recognized the primary role of the private sector. Yet, contrary to conventional capitalist wisdom, it did not seek to limit its involvement in the economy to adopting and enforcing laws, providing public services (police, diplomacy, national security, public schools, and so on), and building infrastructure, leaving everything else to private business. Instead, it was actively guiding the private sector, articulating development visions and plans, and, especially important, creating and supporting strategically important industries, as well as particular companies and business groups: national champions. This type of state is called a “developmental state.”

The developmental state led the shift of East Asian economies from import substitution to export-led industrial growth, introducing a wide range of financial and other incentives for exporters. Also, it actively intervened in resource allocation, complementing and correcting the market mechanism. Yet, as time went by, it pursued deregulation, privatization, and import and foreign investment liberalization, creating a more competitive business environment and encouraging private companies to become less dependent on its support.

In spite of the active involvement in their national economies, the governments in East Asia were usually rather compact. The region opted for low taxes and
self-reliance for those who are physically capable of earning their living. Among other things, it stimulated work motivation.

**Asian Companies**

The second major feature of East Asian capitalism is the dominant position of large, widely diversified, financial–industrial groups and companies (conglomerates) with ownership and control structures, business goals, and management practices largely different from those of big corporations in the West. The latter are mostly owned by a large number of dispersed shareholders seeking maximization of profits and company value. Ownership and management are separated and shareholders exercise control over employed managers through boards of directors and other institutions. Large companies with a founder family as a dominant shareholder are not an exception, especially in continental Europe, but in these companies too the interests of minority shareholders are well protected by law. They are run mostly by professional managers personally unrelated to the founder family.

In a large East Asian corporation, on the contrary, the founder family is usually not only a major owner but also a dominant stakeholder, exercising complete control. The voice of other minority, or, to be more precise, outside shareholders (this latter definition is more precise because their share combined may be quite high and even exceed that of a founder) is practically unheard. Legal protection of their rights is weak. Management is not separated from ownership—key managerial posts are occupied by the founder, his family members, and close friends. Corporate governance mechanisms don’t work or can be applied only on a very limited scale. Most (but not all) East Asian conglomerates also have very close ties with politicians and bureaucracy and capitalize on the state support.

Japan is different from other East Asian nations as it has very few strong founder families as dominant owners of big corporations. Most of them were ousted in the wake of postwar economic and political reforms. In this regard, the Japanese economic system is sometimes called “capitalism without capitalists” or “corporate capitalism.” The majority of shares used to be held by corporate shareholders, mutual shareholding being very popular. Between 1970 and 1990, the share of stock of listed corporations owned by other domestic corporations—both nonfinancial companies and financial institutions—went up roughly from 55 percent to 70 percent of the total in terms of value (Cabinet Office 2006, 175). In China, leading domestic corporations were born mostly as a result of the corporatization of state-owned enterprises (SOEs) started in the second half of the 1990s. For the time being the state remains their major stakeholder.

While Japanese and Chinese companies were mostly focused on particular industries, founders of other large East Asian companies and groups definitely preferred a conglomerate-style organization. They would be engaged in a wide variety of businesses which typically included property development, real estate, hotels, catering, banking and finance, telecommunication services,
retailing, and, possibly, some sectors of manufacturing, such as food, textiles, construction materials, or maybe even auto assembly. South Korean conglomerates established a very strong edge in heavy industry too. Conglomerates in other East Asian economies, mostly owned by overseas Chinese, were stronger in the services than in manufacturing, and in light industry rather than in heavy industry.

Western corporations and their shareholders are wary about conglomerate-style business organization because maximization of profits and company value requires focusing the firm’s activities on the areas where it can do its best. However, for East Asian conglomerates and their founders, maximization of dividends and company value was not necessarily the first priority. The stability and expansion of the organization; presence, market share, and influence in a wide range of industries; prestigious jobs for family members; or just personal ambition could well be more important.

**Corporate Finance**

The third feature of the model is the corporate finance pattern. To raise external funds, East Asian corporations relied mostly on debt finance, or borrowing from banks, rather than on equity finance, or the issue of stock. In this regard, the situation in most continental European economies looked similar. However, East Asia’s pattern had two more distinctive features. First, the share of connected lending was high—a significant portion of bank loans went to companies either belonging to the same business group as the lender bank or having close long-term links with it (personal ties, shareholding, the bank’s executives on the company board, and so on). Second, a significant role was played by directed lending—lending orchestrated by the state.

**Labor Relations**

The fourth feature of the East Asian model is the “not quite market” relationship between companies and their employees. It is largely based on the notions of “company as a family,” loyalty, and harmony within the organization. In the East Asian social context, firing a regular worker was difficult because companies were supposed to be responsible for stability of employment and to care about employees’ everyday lives.

**The Reliance on Inward FDI**

Finally, the fifth feature of the model is the leading role of foreign-affiliated companies in the most technologically advanced, export-oriented sectors of the economy. East Asia’s growth was largely driven by inward foreign direct investment (FDI). Foreign firms, mostly leading multinational companies (MNCs), provided not only capital, but also technologies and managerial expertise, as well as the opportunity to use their international distribution networks, sales promotion systems, brands, and so on. Japan and South Korea were the only major countries in the region which did not actively promote inward FDI. However, both were keen to import foreign technology.
The East Asian Model as an Alternative

So, here are the pillars of the East Asian economic model: a developmental state, family-owned and family-controlled conglomerates (in Japan, corporations which own and control one another) as the core players in the private sector, bank lending (especially, connected and directed lending) as the major source of corporate finance, labor relations emphasizing the notions of family and loyalty, and foreign-affiliated companies as leaders in the technologically advanced, export-oriented industries.

The fifth feature aside, this model turned out to be an alternative and even a challenge to conventional Western (especially Anglo-Saxon) capitalism. The most controversial point was the role of the state and its relationship with the private sector. The model questioned such basic principles of Western capitalism as the freedom of private entrepreneurship, resource allocation determined by the invisible hand of the market, a level playing field for all enterprises and industries, and profit maximization as the major goal of company management. Yet, for several postwar decades, all the features of the model contributed to the region’s economic growth.

The East Asian Model of Capitalism: How It Worked for Growth

Developmental States: Promoting Industries

First, the state fixed economic development as the major national goal and worked to concentrate limited financial, material, and human resources in the strategically important industries which were leading growth and structural modernization.

In Japan, South Korea, and Taiwan—in close cooperation with domestic private companies—it managed to create and develop a range of manufacturing industries, including technologically advanced heavy industries, which became highly competitive internationally.

Japanese companies in the 1960s, and South Korean ones a decade later, joined the ranks of the world’s major producers in most sectors of manufacturing—largely due to successful industrial policy. In Singapore and China, actively promoting inward FDI, foreign-affiliated firms played, and are playing, a leading role as exporters of manufacturing products—especially in technologically advanced sectors—but a group of competitive domestic companies has also emerged. Notably, they are mostly state-owned or government-linked.

In ASEAN 4 countries, production and exports in the electronic, auto, and other heavy industries are dominated by foreign subsidiaries. A cohort of internationally competitive domestic firms has emerged, mostly in food and textile industries, as well as in the sectors leveraging natural resources, such as wood processing or production of palm oil. The policy of creating and promoting heavy industries by establishing large, state-owned companies and injecting
public funds, adopted in Malaysia and Indonesia, was not that successful. Newly created industries were internationally uncompetitive in terms of both cost and quality.

Economists’ evaluation of the state’s contribution to growth in these countries is rather mixed. Many of them attach the major growth-stimulating role to inward FDI. The key role of the latter can hardly be denied. Yet, for East Asian countries, the fact that they managed to nourish domestic companies in heavy industry, such as Malaysia’s automaker Proton or Indonesia’s Krakatau Steel, had its own significance. At least they proved to be capable of industrializing on their own and created a significant amount of jobs in the manufacturing sector. It is still not too late to try to make such companies internationally competitive.

**Conglomerates: Bringing Dynamism to the Private Sector**

Second, family-owned conglomerates contributed greatly to economic growth as the leaders of the private sector. Their founders vigorously expanded the range of business activities, giving a boost to many sectors of the economy at one and the same time.

Companies belonging to the same conglomerate, and operating in various business sectors, supported each other’s growth in times when a still immature legal system, weak law enforcement, and underdeveloped financial markets made it difficult to rely on arm’s-length transactions to provide the necessary material and financial inputs.

Japanese corporations’ business philosophy—prioritizing long-term stability and the expansion of the organization, market shares, and production volumes over profit rates—also stimulated economic growth. One more distinctive feature of Japan’s corporate world was the emphasis on long-term transaction ties between major industrial producers, such as Toyota or Hitachi, and their medium- and small-scale suppliers of parts, materials, and equipment. Constant, close interaction between final-product makers and their suppliers enabled growing technological sophistication and scrupulous quality control (Asanuma 1992; Tselichtchev 1992; 1994).

**Massive Bank Lending**

Third, massive bank lending played a pivotal role in the financing of industrial growth as stock markets in the region were mostly underdeveloped. Connected and directed lending minimized risks and helped lenders to monitor their borrowers, overcoming such hurdles as weak corporate governance and lax disclosure standards.

**Labor Relations: Creating Commitment**

Fourth, labor relations—emphasizing the notions of family, loyalty, organizational harmony, and long-term employment—were helpful to enhance work motivation and prevent labor conflicts. Their most sophisticated version, developed in Japan, emerged as a cohesive human resource management system
with such distinctive features as long-term strategies of personnel training, on-the-job rotation, information sharing, and effective delegation of authority within a firm. This system contributed greatly to nurturing highly skilled and strongly committed laborers who were looked upon as the companies’ most precious resource.

The East Asian Model: Working Better Than Western Capitalism?

Initially, the East Asian model of capitalism looked like a transitional system which could be appropriate just for the catch-up economies with still immature market institutions. In the 1970s, and especially the 1980s, the perception changed. In the late 1960s, Japan became one of the world’s economic leaders and subsequently often outperformed the US and Western Europe not only in terms of growth rates but also in terms of quality of products and production efficiency. The four NIEs, and later Malaysia, Thailand, and, with reservations, Indonesia, emerged as successful followers. Therefore, East Asian capitalism, with Japan as its leader, began to be perceived as an alternative model, in many respects superior, to Western capitalism and relevant not only for a catch-up but also for a mature, developed economy. It looked capable of not only providing faster growth and stronger competitiveness but also effectively fighting with such evils of Western (especially, American-style) capitalism such as large income gaps and social inequality, rising unemployment, marginalization and low labor motivation of workers, destructive labor conflicts, and, consequently, social unrest, growing crime rates, moral degradation, and so forth.

The school of thought emphasizing the superiority, or at least substantial advantages, of the East Asian (especially, the Japanese) model found a growing number of supporters, not only in the East but also in the West.

The Asian Crisis: The Final Curtain

Crisis Overview

By the 1990s, the adoration of the East Asian model of capitalism was over and the discussion of its advantages also faded.

The Japanese economy entered a long and painful Heisei depression which lasted from 1991 to 2002. In the 1990s, its average growth rate was only a little more than 1 percent. Then, during 1997–98, the Asian crisis erupted sending the economies of South Korea and the ASEAN 4 into meltdown and posing enormous problems for the region as a whole. In 1998, GDP fell by 6.9 percent in South Korea, 10.5 percent in Thailand, 7.4 percent in Malaysia, and 13.1 percent in Indonesia (ADB 2008).

The crisis played a crucial role in the region’s economic history: it marked the end of its growth within the framework of the model described. The nature of the crisis was both financial—the first financial crisis of the globalization era—and structural—the crisis of the model itself.
The major manifestations of the crisis were abrupt falls in the value of currencies and stocks—mainly in South Korea and the ASEAN 4—as foreign portfolio investors and lenders started to repatriate their capital on an unprecedented scale. The change from an upswing of inward investment to a massive withdrawal of funds was extremely dramatic. While, in 1995, the net inflow of capital in South Korea, Thailand, Malaysia, and Indonesia combined (total financial account surplus of the four countries) reached US$36.973 billion and in 1996—US$63.733 billion; in 1998 the four countries suffered a total net outflow (financial account deficit) of US$25.293 billion (ADB 2008).

Before the crisis, many East Asian currencies, pegged to the US dollar, were effectively overvalued. Central banks maintained the exchange rates through market interventions, buying their national currencies and selling US dollars and other foreign exchange. In early July 1997, having run short of foreign exchange, Thailand eventually floated the baht—which had been pegged at 25 baht for US$1 since 1985. In January 1998, it hit its lowest level of 56 baht for US$1, having lost 53 percent of its value. In 1997, the country’s stock market plunged by 75 percent. In the summer of the same year, the crisis spread to other countries. In 1998, at their lowest levels the Indonesian rupiah lost 83 percent of its value, the South Korean won 47 percent, the Malaysian ringgit (which had not been pegged) 42 percent, and the Philippine peso 40 percent (Cheong 2006, 164). The Hong Kong dollar also faced strong downward pressure from October 1997 but the range of its fall was smaller: just 19 percent.

Stock prices, at their bottom, lost 65 percent of the pre-crisis high in South Korea and Indonesia, 67 percent in the Philippines, and 79 percent in Malaysia.

Singapore and Taiwan floated their currencies to maintain competitiveness of exports in the wake of the currency falls in neighboring states. Both economies, though not hit by the crisis as strongly as South Korea and the ASEAN 4, also experienced a very big drop in stock values: 72 percent and 46 percent respectively (Cheong 2006, 165).

The operations of many banks and other financial institutions in the crisis-impacted countries were paralyzed due to skyrocketing foreign debts (those debts were denominated in foreign currencies but the earnings necessary to pay them back were made mostly in the national currencies—thus, abrupt depreciation of the latter made the debt burden heavier) and nonperforming domestic loans. A number of leading conglomerates collapsed, many others found themselves on the verge of bankruptcy. Currency falls resulted in high inflation, household purchasing power was squeezed, domestic demand curtailed, production fell, and unemployment rose to unprecedented levels.

The Financial Side of the Crisis

Politicians, scholars, and business people in the region often emphasized the purely financial side of the crisis. Sometimes it was argued that it was engineered by international financial capital—mainly hedge funds and other speculators. According to this school of thought, international speculators deliberately crushed the Thai baht causing a chain reaction of subsequent
deprecations. The toughest rhetoric of this kind came from then Malaysian prime minister, Mahathir bin Mohamad. However, it did not find many supporters.

In broader terms, a dramatic rise in the cross-border movement of short-term funds, which can easily come but also easily go, was often viewed as the major reason for the crisis. Yes, financial globalization did intensify the cross-border flow of short-term funds and, in 1997–98, East Asia’s high dependence on those funds did make it vulnerable. Yes, in the age of globalization the exchange rate of every national currency is influenced by the moves of big players on the international money markets much more so than ever before. However, it is hardly relevant to stop here to explain the reasons. After all, the region’s financial problems were rooted in its structural deficiencies.

Before discussing those faults and weaknesses, however, one more factor of the crisis has to be assessed—the policy of pegging national currencies to the US dollar. It was adopted by most East Asian countries to avoid currency risks and prevent import inflation, which was considered vital to boost investors’ confidence. It is very difficult to say, even in retrospect, whether pegging was a good idea or not. It had its rationale, but, presumably, the governments overdid it by failing to show enough flexibility when it was necessary. Keeping exchange rates at high pegging levels significantly reduced the cost of foreign borrowing. As a result, its scale increased and this exacerbated the crisis. Also, it became a deterrent for exports, squeezing foreign exchange revenues.

In the early 1990s the US economy started to recover, boosted by growth in the IT sector. From 1995, the Federal Reserve Board began to raise interest rates to neutralize inflationary pressures. It made the US a more attractive place to invest and raised the value of the US dollar to which many East Asian currencies were pegged. Respectively, the latter appreciated too, hitting the exporters. Consequently, current account deficits soared. In 1996, the deficit of the five crisis-impacted economies combined reached US$55 billion (Economic Report of the President 1999, 241).

Current account deficit can be sustained only as long as the inflow of foreign capital, or the surplus of the financial account, remains sufficient to finance it. As the inflow stops, interest rates go up leading to economic contraction. As foreign capital runs away, downward pressure on the national currencies grows stronger, making it difficult to maintain the peg. A decline in export revenues worsens the problem even further.

Under these conditions the following mechanism starts to work. Expectations of the currency fall arise. Financial market players begin massive selling, which forces the government to terminate the peg. Free currency fall starts. Speculators benefit as now they can buy the same currency cheaper for settlements or acquire the respective countries’ assets for “a discount price.”

They act fully in accordance with the logic of the market, using the mechanism because it exists. However, they don’t create it. It has been created by the financial authorities of the respective Asian countries.
The Structural Side of the Crisis

In a way, in 1997–98, foreign lenders and portfolio investors reckoned that, obsessed with East Asia’s high growth rates, they had lent or invested there a bit too much. Massive repatriation of funds and sales of East Asian currencies began, not least because investors became concerned about the financial condition of local companies and banks. Many of them were on the verge of a default. This was the result of poor management and governance rooted in the following flaws of the East Asian model.

First, a by-product of large-scale state involvement was widespread cronyism. Often, government support was not extended to the most dynamic and, at least potentially, competitive sectors and companies but to well-connected firms and business groups.

Second, as East Asian conglomerates deliberately blocked control by outside shareholders, their managers could often afford to ignore the “discipline of the market” without being penalized. The close relationship with the state and the mutual support within business groups eased natural market pressures even further.

Third, connected and directed lending made East Asian companies addicted to large-scale borrowing. The basic premise of their founders and managers was that money would be “at hand” any time it was needed and the capital cost would be low. Getting a wider access to external borrowing in the wake of globalization and financial liberalization exacerbated the problem even further. Too many East Asian companies did not care that much about the risk of becoming unable to pay back their debts.

East Asian corporations became “famous” for their high and, in most countries, growing leverage, or ratio of total debt to equity. In South Korea it increased from 2.82 in 1988 to 3.47 in 1996 (in other words, in 1996, the total debt of South Korean corporations was 3.47 times as big as their equity capital), in Thailand from 1.60 to 2.36, and in Malaysia from 0.73 to 1.18. In the Philippines, leverage went up from 0.83 in 1991 to 1.29 in 1996, and in Indonesia, over the same period, it slightly decreased from 1.94 to 1.87, still remaining at a high level (Claessens 2000). For a cohort of leading conglomerates the leverage was much higher.

Especially risky was East Asian companies’ high dependence on short-term debt, not least because short-term borrowing was often used for investment projects that basically required long-term financing.

Founders of the conglomerates were too confident that they wouldn’t fail. If grave financial problems emerged, either the government would help or the continuous rise of the market prices of their assets would provide the necessary liquidity, offsetting the losses they made. Many Japanese corporations, especially in the latter half of the 1980s, adopted a similar mode of behavior.

Fourth, Asian-style labor relations also had its faults. Inflexibility of employment made it extremely difficult to fire a poorly performing, incapable, or simply
lazy or irresponsible worker. Rigid remuneration schemes reflected an inability or unwillingness to effectively link individual remuneration and promotion to skills and performance.

The Asian crisis, along with the *Heisei* depression in Japan, was a signal to East Asian economies that they could no longer operate as they used to.

China, though not directly hit by the Asian crisis, had to address structural problems of a similar nature, especially posed by weak banks with huge nonperforming loans (NPLs) and ailing big enterprises—in China’s case state-owned.

**Entering a New Stage**

The Asian crisis was over within a very short period of time—since 1999 practically all major East Asian emerging-market economies have started growing fast again. (However, Japan needed more than a decade to get out of the *Heisei* depression.) Therefore, sometimes it is argued that it was not a crisis of a structural nature. We disagree.

The return to growth was quick because one of the major manifestations of the crisis—a brisk fall of the currencies—also provided the way out. Currency depreciation boosted exports. It led the regional economies back to the familiar path—export-led, industrial growth.

However, it was not a return to the pre-crisis status. East Asia would hardly restore its ability to grow if it did not come out with anti-crisis policies that dramatically accelerated its structural transformation—a transformation which marked the beginning of the end to the East Asian model of capitalism. In the following chapters we will show that post-crisis growth itself is taking place within a new, gradually forming, systemic framework.

The specifics of anti-crisis policies, worked out under the guidance of the International Monetary Fund (IMF), varied from country to country, but their major contents were largely the same. 5

First, the governments had to drastically cut, or eliminate, subsidies supporting particular industries or the consumers of basic products, such as fuels or foodstuffs, as well as curb public expenditure in general.

Second, they were to give up supporting ailing banks and companies with dim prospects of revitalization.

Third, the core of anti-crisis policies was a drastic rationalization of the banking sector. The crisis-hit countries established powerful state institutions, responsible for the disposal of nonperforming loans and the restructuring of the troubled banks, and authorized them to put the banks under direct control. Supervision of banks was strengthened, the criteria of a nonperforming loan tightened, and the requirements regarding the ratio of own capital to assets became strict as never before.

Fourth, East Asian countries took big steps to liberalize imports and inward investment, especially into the service sector.
Fifth, they moved to introduce laws and regulations improving corporate governance, disclosure standards, foreclosure, and bankruptcy procedures.

This set of measures should be viewed in a wider context than just policies to overcome the crisis of 1997–98. It was the start, or at least an accelerator, of a big systemic shift, imposing a much tougher market discipline on the governments, companies, and workers—a shift needed to eliminate East Asia’s structural biases and to make it capable of meeting the challenges of the globalization era. This systemic shift was being undertaken throughout the region, not only in the crisis-hit countries.

In other words, the launch of anti-crisis policies marked the beginning of a new stage in the region’s economic development.

**Endnotes**

1. North Vietnam, or the Democratic Republic of Vietnam, was proclaimed by Ho Chi Minh in 1945. It was ruled by Communists and was an ally of both the Soviet Union and China. In 1976, after the Vietnam War, the single nation, known as the Socialist Republic of Vietnam, was formed. Like China, it pursues market-oriented economic reforms under a Communist regime.

2. One of the recognized theoretical interpretations of the East Asian model, based mostly on the analysis of the Japanese economy, was suggested by Murakami in 1992. He defines three major economic features of the model: market competition based on private property; industrial policy pursued by the government in order to create industries counted upon as future leaders; and the policy of income redistribution aimed at reducing inequality and softening shocks resulting from structural change (Murakami 1992). We are trying to present a wider version.

3. It has to be remembered that not all the features mentioned are applicable to all the major East Asian economies.

4. We interpret a "developmental state" as one which puts economic development on the top of its priority list and actively intervenes in the economy to promote it. Sometimes this notion is associated only with the role of "honest technocrats"—ministerial bureaucracy shielded from political pressures and having the authority to articulate economic policy. We agree that this was part of the "developmental state" story, though, of course, honesty and freedom from political pressures have to be perceived in relative terms. However, the story as a whole has wider issues.

5. Malaysia was an exception. Officially, it rejected the IMF-proposed package and took some steps which ran contrary to its approach. Mainly, it pegged the ringgit to the US dollar, imposed restrictions on the cross-border movement of short-term capital, and refused to pursue speedy liberalization of imports and inward investment. Yet, regarding all the rest, it turned out to be not that different from others.