January 12, 1998, Volume 3, Issue 17

the weekly Standard

The Asian Crisis

BY DAVID M. SMICK

IT IS THE MOMENT in the great late-1990s Asian financial meltdown for the inevitable Monday-morning quarter-backing. The stakes could not be higher. Since 1990, the countries of East Asia (excluding Japan) have accounted for half of the growth in world output, despite representing only 20 percent of world GDP An incredible two-thirds of all world capital investment since 1990 has taken place in East Asia. The recent Asian meltdown could rob as much as one percentage point from the growth of the U.S. economy for 1998. Because the Asian economies have seen their currencies weaken dramatically against the dollar in recent months, at least one thing is certain: The new Asian game plan will be to try to export those economies out of the basement—with America the global consumer of last resort. Some analysts are predicting $300 billion U.S. trade deficits in the next year or two.

What is most troubling is that the international community continues to avoid addressing the real issue. The IMF tinkers with stopgap financing schemes for the smaller Asian economies. But the reality is that Korea, Thailand, Malaysia, and the rest are a mere sideshow. There is one issue and one alone that must be addressed first: Japan. The Southeast Asian economies cannot truly recover until the Japanese financial system is restructured and the real-estate market revives. To talk about long-term IMF plans for, say, Korea is shortsighted, simply because Japan, the world's second largest economy, is so dominant in the region.

Consider the financial linkages within the region. Because of Japan's ailing banking structure, the Bank of Japan has been forced for years to set official interest rates at close to zero percent. This was an attempt to avoid a general credit crunch and, more important, to provide banks with a steady, government-issued profit stream (borrow for next to nothing and lend at a profit). The unintentional result: huge outflows of Japanese bank lending to Asian economies, creating a dangerous financial bubble of excess capital. It was not long before Japanese bank balance sheets, already bleeding badly from a growing load of non-performing domestic assets, began hemorrhaging. Some banks now have loan/loss ratios of an incredible 20 to 25 percent on their Thai loans alone.

True, there is blame to go around. The IMF has hardly performed brilliantly in recent years. Its reports gave thumbs-up assessments to both the Thai and Korean financial systems as recently as last year. And what ever happened to that "early warning system" promised after the 1994–95 Mexican bailout?

The Clinton administration shouldn't break out the champagne either. There is the so-called moral-hazard dilemma and the important question: Did the Mexican bailout contribute to the Asian financial bubble? Note that back when the Mexican bailout package was being negotiated, European policymakers privately insisted that the holders of dollar-denominated Mexican public debt—led by many large U.S. investment houses—should suffer at least a minor loss lest a moral-hazard problem arise. The "heartless" Europeans were quickly overruled, but their concern had merit. Every fund manager worldwide was tempted to believe that the IMF and the G-7 would forever provide a safety net for large institutional investors, for fear of a risk to the entire international system posed by any failure. The Mexican bailout served as a green light for massive and sometimes foolhardy capital flows to Asia and other developing economies with little transparency. A dangerous precedent to say the least.

IMF officials respond that they have no choice but to chase markets to prevent systemic panic. While true in one sense, this suggests a serious misunderstanding of the issues at hand.

The Thai meltdown this fall, for example, was not started by George Soros and other hedge-fund operators who, as some allege, sucked liquidity out of the system with reckless abandon. The meltdown started when domestic investors with an intimate knowledge of the corruption, inefficiency, and stupidity within the Thai financial system were the first to sell out of their overvalued market positions. The same thing is happening in Japan, where domestic investors have been net sellers of the Nikkei 225 for more than five years. Indeed, after last month's much ballyhooed Hashimoto fiscal plan was announced, the stock market fell through the floor. The reason was that Japanese industrial investors, looking to get out of their cross shareholdings of Japanese bank stocks, sold on every uptick in the market. The result has been a disappointing downward trend.

These private investors understand what so many in the international policy community miss: that the Asian crisis can never truly be resolved until the Japanese financial system is restructured. Each month the banks domestically lend less and less, creating horribly dangerous credit-crunch conditions for small and medium-sized companies, which today are forced to pay effective interest rates (including fees) of as high as 25 percent to short-term money lenders. As a result, Japanese investment and consumer confidence are plummeting.

David M. Smick is president of Johnson Smick International and editor and publisher of the International Economy Magazine.

The Asian Crisis, CONTINUED

The yen must be propped up with central-bank intervention schemes, hardly leaving Japan in a position to play a role in reviving the Asian economies.

For Japan, which has ample resources, fixing the system is a political rather than a financial challenge. It is an issue of power. To put it crudely, if Japan were to mount a U.S.-style savings-and-loan-type restructuring that involved large amounts of taxpayer money, the Japanese people would demand accountability. In other words, the entire financial elite, including the banking bureau of the Ministry of Finance and perhaps officials at the Bank of Japan as well, would lose out. In such a restructuring, European and American financial institutions, through joint ventures and takeovers, would almost certainly gain considerable influence in the Japanese financial system.

For now, Japan has decided to take an incremental approach, to patch up the existing system with chewing gum and chicken wire. Remember, restructuring almost always involves retribution. The U.S. S&L experience of the early 1990s saw more than 1,100 S&L executives prosecuted by federal and state authorities and hundreds of institutions closed. Indeed, the situation turned around surprisingly quickly mainly because of Wall Street greed. U.S. government bailout authorities threw S&L assets on the market at bargain-basement prices. Global investors did a U-turn, and investments poured in. The entire U.S. banking industry revived much faster than expected.

To Japanese authorities, the risk of such a rough-and-tumble remedy, which would entail quickly finding the bottom of the real-estate market, is too great at this time. Unfortunately, the incremental approach itself carries significant risk. In 1992, exports to Southeast Asia were roughly 10 percent of Japanese trade. Last year, the figure was between 40 percent and 45 percent. As Southeast Asia weakens, Japan cannot avoid even further weakening; the yen, which is still overvalued against the Asian currencies, will weaken, too.

The danger is that all parties might seek further competitive currency devaluations, the ever-tempting export solution. That would force all eyes onto the 800-pound gorilla that has stayed quiet during the recent crisis — China. If in mid to late 1998 China decides it has no choice but to join in the devaluation game (recent Asian devaluations have made these economies more competitive with the Chinese economy), it'll be Katie bar the door. With the global economy awash in excess capacity, a further flood of Chinese goods could exacerbate already serious deflationary conditions, bringing new bank difficulties and a rapidly rising tide of protectionism. The world will then have a problem indeed, and no amount of IMF bailout money will matter much at all. ◆