

Lessons for Asia from Asia

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Until the late 1960s, conventional wisdom was that, for purposes of economic analysis, there were three groups of countries: the industrial countries (or developed countries, as they were then called), the underdeveloped countries (in the terminology of the day), and the centrally planned economies. Almost the only debate about classification of countries until then concerned Japan: was that country a rich developing country or a poor developed country? And earlier economic growth in the developed, or as they are now called, industrial or OECD countries, had taken place over a century or more. Many observers asserted that the underdeveloped countries could not possibly catch up, or even grow as rapidly as the developed countries, an assertion apparently supported by the more rapid growth of the industrial countries than by most of the developed countries in the 1950s and 1960s. In most of the economics literature and models, there was even posited an "absorption constraint", which was generally regarded as an upper bound on growth rates and was thought to be in the range of 5-6 percent over any significant period of time.

By the late 1960s, however, experience was contradicting the models. As is well known to this audience, Japan had experienced an average growth rate of around 9 percent during the entire decade (since the announcement of the income-doubling plan in the late 1950s), and Taiwan and Korea were both growing at reported double digit rates.

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Subsequently, it became recognized that not only the four "East Asian tigers" were setting new records in terms of sustained growth performance, but that southeast Asian countries' growth was accelerating rapidly. During the 1980s, the East Asian tigers became known as NICs or NIEs, newly industrializing countries or economies, and continued their growth despite the worldwide recession and debt crisis of the early part of the decade. By then, most observers regarded Southeast, and especially East, Asian economies and their growth as invincible.

Because their growth rates were so much higher than earlier experience, the NICs were, in effect, in new territory. But, in the late 1990s, the "Asian financial crisis" erupted. After recovering from disbelief that such a crisis could occur, observers first blamed "contagion" and international capital markets. While these factors surely contributed to the crises, there was more to them than that. And, from that experience and examination of economic history, lessons have been learned about development and economic policy making more generally.

Tonight, I want to provide a stylized version of what took place, and, based on that, suggest lessons from Asia both for the rest of the world and for Asian economic policy makers going forward. I shall focus on South Korea, both because I think the story is perhaps somewhat clearer there, and, time constraints prevent examination of all the Asian crisis countries. While the circumstances of each of the crisis-afflicted countries – Indonesia, Malaysia, South Korea, Thailand – and of those avoiding the worst effects of the crisis but nonetheless affected, all differed in significant regards, there were also commonalities. In drawing lessons, in particular, I shall focus on these. I will conclude with a brief survey of where some of the Asian economies' financial sectors are today.

Pre-Crisis Growth

It is now frequently forgotten how poor the Tigers were in the late 1950s, what obstacles they confronted, and how dramatic their success was. In the Korean case, the after effects of the Second World War and hyper inflation, followed by the Korean war, had left the country devastated. After the end of the Korean war, there was some recovery, but growth rates never exceeded 4-5 percent, inflation was the highest in the world (at around 25 percent), and the country was heavily dependent on foreign aid. Indeed, even in 1960, Korean exports were about 3 percent of GDP, imports about 13 percent, with net domestic savings approximately zero. The gap in the trade account was financed primarily by foreign aid. The currency was revalued only at intervals, and generally, at rates that did not reflect domestic inflation. Given the low level of exports, imports were subject to licensing, and policy was to encourage growth through "import substitution". Most observers regarded economic prospects as dismal. South Korean per capita income was estimated to be the third lowest in Asia, and substantially below most African countries.² Arable land per person was the lowest in the world, and so on.

By the late 1950s, economic reforms had begun, spurred by the poor performance of the economy and by the announcement that aid volumes would henceforth diminish. A first step was an IMF stabilization program in 1958, which brought the nominal exchange rate to a substantially more realistic level (although inflation was not tamed and the exchange rate was fixed). By 1960, ad hoc measures were taken to provide assurances to exporters that the real exchange rate they received would be maintained. At about the same time, the degree of protection against imports was greatly reduced, so that

² For example, it is estimated that Ghana's per capita income was about ten times that of South Korea in the early 1960s; in 2000 it was estimated that South Korea's was 22 times that of Ghana.

incentives for production of exportable and import-competing goods were much more balanced than had earlier been the case. Simultaneously, the inflation rate was brought down, and budgetary procedure were restored so that, by the late 1960s, Korea had a fairly freely floating exchange rate, fiscal balance, and a rate of inflation less than 10 percent.

The results were immediately dramatic. Exports began growing dramatically, and the dollar value of exports grew at an average annual rate of 40 percent for the decade starting in 1963 (a period during which world dollar prices did not increase significantly). After reforms that enabled positive real rates of interest, the Korean savings (and investment) rate began rising dramatically. Despite the rapid increases in the savings rate, profitable investment opportunities opened even more rapidly in response to the changed economic incentives and rapid growth itself. The authorities therefore permitted borrowing from foreign banks by domestic exporting firms. While they rationed the amount that could be borrowed, lending to Korea by commercial banks rose to about 10 percent of GDP in the latter part of the 1960s.

With an annual growth rate of real GDP of around 13 percent, however, the debt/GDP ratio did not rise during the decade. By 1970, Korean exports accounted for 14 percent of GDP and by 1980, stood at 33 percent; investment had risen to 29 percent of GDP, and foreign loans were 13 percent of GDP.³

Korea was as hard hit by the oil price increase and commodity boom of the early 1970s as a developing country with virtually no domestic supplies of oil and other commodities. The Korean response was to raise the price of oil to international levels,

³ Data are from Charles R. Frank, Kwang Suk Kim, and Larry Westphal, South Korea, NBER New York 1975

and to allow the currency to depreciate. In response, exports of construction services – building ports, roads, schools, hospitals, and other infrastructure in the middle east – increased rapidly; Korean growth hardly slackened. By the 1990s, Korean per capita income is estimated to have been at least 9 times what it was in the early 1960s, Korea's savings rate financed Korean investment and, in fact, Korea had begun experiencing a current account surplus by the late 1980s.

Indeed, Korea's performance throughout the 1980s was a major factor in convincing policy makers and development economists of the failures of closed economy (import substituting) development strategies. And it remains true that no developing country has achieved a high sustainable rate of growth over any significant period of time without opening up its economy at least to trade in goods and services. And, parenthetically, it is not practical to impose and enforce very restrictive capital controls if the exchange rate regime is truly open for current account transactions.

I could continue to dwell on Korea's spectacular growth performance over the three and a half decades prior to 1997. But, for present purposes, it is also important to note that a number of mistakes in economic policy were made along the way. There were a large number of mid-course corrections. Most notable among these for present purposes were the heavy and chemical industry drive of the mid-1970s, a near-debt crisis in the late 1970s, and continued credit rationing. The first two of these were quickly recognized as mistakes and policies were altered shortly thereafter. Indeed, a hallmark of Korean economic policy was its pragmatism: when things appeared to be moving off-track – inflationary pressure, incipient unfinanceable current account imbalances, lagging export growth, etc., the policy response was to make changes quickly.

The major exception to this pragmatic rapid response was credit rationing and associated policies with regard to the chaebol. Recall that in the early 1960s, exports constituted only 3 percent of GDP while imports were 13 percent. Korea was truly a closed economy and, given her dependence on imports of raw materials, it was clear that without considerably more rapid growth of exports, growth of the domestic economy would necessarily be unacceptably slow.

In those early days, credit was tightly controlled. Credit rationing according to pre-set criteria, mostly export performance, was used as one of the major incentives for exporters. Credit at controlled (and, initially, negative real) interest rates was uniformly available for successful exporters. The real interest rate subsequently became positive, but deregulation of interest rates did not begin until the late 1980s.

The chaebol were central to the growth story in the early years. They were conglomerates that grew rapidly through exporting (although most of them had been producing goods for the domestic market earlier). Those chaebol that were most successful in exporting grew most rapidly. For many years, the chaebol were national heroes, seen as spearheading economic growth.

At the beginning of reforms, credit financed a very large part of investment, and clearly enabled more rapid expansion of the successful exporters than would have been possible if they had had to rely on reinvested profits only for financing additional capacity. Rationed credit also insured very high rates of return: in the first decade, it is estimated that chaebol enjoyed rates of return of about 35 percent – so high that there would have been even more borrowing had it been allowed.

It can be argued that in the early years of rapid Korean growth, credit rationing did little harm. The chaebol borrowed on the curb market to supplement the rationed credit they received. Since the criterion for allocating credit was export performance, and since it was evident that allocation of resources to expanding exports was economically efficient, it is likely that almost all credit allocated resulted in projects with high rates of return.

But, over time, two things happened. On one hand, as growth and investment continued, rates of return on investment fell, as they should have. The real interest rate charged on loans rose and the gap between the controlled rate and the market clearing rate narrowed. But, by the 1980s, rates of return were slightly lower for chaebol than for Korean manufacturing firms as a whole. By the latter part of that decade, rates of return in Korea were on average slightly above 4 percent, and they fell to under 2 percent in the early 1990s and were negative by 1997. This contrasts with considerably higher and sustained rates of return in the United States and even with the 2.3 percent average rate of return in Japan during its slow-growth decade.

What had happened was that the chaebol had increased in importance as credit continued to be allocated to them. And, given their size, major difficulties arose. From the mid-1980s, the largest 30, and the largest 5, chaebol were increasing output at around 20 to 30 percent annually. By law, they were not permitted to lay off workers so, as productivity rose in existing production lines, they added new ones. By the time of the 1997 crisis, their assets were 14 times higher (for the largest 30) and 19 times higher (for the big 5) than they had been 12 years earlier, and the Big 5 accounted for 40 percent of ALL manufacturing assets. But the close links between firms within a chaebol meant that

they were investing in each other, guaranteeing bank debt for each other, and borrowing from banks owned within the group.

There were relatively few sources of non-bank finance (aside from reinvested profits). In consequence, Korean firms were highly leveraged. By the mid-1990s, Korean manufacturing firms had debt equivalent to about three and a half times their equity. This was two to three times higher than in the United States at the onset of the crisis. And chaebol firms were even more highly leveraged than all Korean manufacturing.

This set of policies and outcomes had worked reasonably well in the early years of reforms, as already noted. But as the Korean economy became more complex, credit rationing had negative consequences: new firms had little access to credit, and existing firms were so large that failure to enable them to continue borrowing was perceived to present real threats to the economy.

This was reflected in bank incomes and balance sheets. Bank assets rose sharply between 1992 and 1997, but net income peaked in 1994 and the rate of return on bank assets thereafter fell continuously, as did the rate of return on equity. Although non-performing loans (NPLs) did not show any significant increase prior to the crisis, in hindsight that appears to have been in large part the result of "evergreening", whereby banks extended new loans to enable borrowers to avoid default and service old debts.

Conventional wisdom at the time of the crisis attributed the source of the trouble to the foreign currency exposure of the banking system. But that had helped to sustain rapid credit expansion at home. The major source of Korea's problems was home-grown, as the quality of bank loan portfolios deteriorated.

In a paper by Jungho Yoo and myself, we described early 1997 Korea as a disaster waiting to happen. Because of the need to sustain lending to the chaebol, the banking system, and ultimately the economy had become so vulnerable that any relatively small shock would have been enough to bring the system to the breaking point unless the authorities acted first. The trigger was the foreign exchange crisis resulting from the sharp increases in interest rates needed to stem the outflow of capital as foreigners and domestic residents tried to get out of won. But that rise in interest rates made debt servicing difficult or impossible for many. And the situation was complicated by the need to restructure the chaebol as well as the banks.

Among other things, these events showed the vulnerability of the real economy to weaknesses in the banking system. In Korea's case, they were intensified by the fact that non-bank markets – bond, insurance, equity – were not developed. Because most (non-retained earnings) investment was financed by the banks, their failure to allocate capital to the highest risk-adjusted rate of return projects fed through to the real sector and the overall rate of growth.

Lessons from the Crisis

Other countries – Mexico, Turkey, and Brazil among them – experienced crises which were unique in some regards but which also went through the banking system into the economy as a whole. There are a number of lessons, some about the financial system, and some about the process of economic development.

Turning first to the lessons for development in general, the most obvious is that policies that may be acceptable and sustain economic growth in the early stages of development may not be appropriate at later stages of development. In the Korean case,

credit rationing in the 1960s probably led to little, if any, resource misallocation, judging by the high rate of return on capital generally. A major part of the reason was undoubtedly the fact that the structure of the economy was fairly simple, and earlier policies had sufficiently distorted the structure of production so that any observer could judge that supporting projects that would lead to increased exports was probably worthwhile.

But as exports grew as a percentage of GDP, so that the optimal allocation of new resources was almost certainly one that was more balanced between exportables, import-competing goods, and non-traded goods, the banks were not equipped to provide appropriate project analysis and, even if they had been, credit was directed toward the chaebol because they were becoming, and later had become, such a large segment of the economy.

Clearly, by the mid-1980s (at the latest), there was a strong need for greater liberalization of the banking sector from credit controls. The financial sector needed to become wider and deeper at that stage of economic growth. But earlier, the very fact that interest rates were suppressed undoubtedly served to deter the development of new financing instruments. And, as the chaebols' gearing ratios rose, their attractiveness to non-bank financiers would in any event have diminished. Of course, had that happened earlier, growth may have been somewhat slower in the decade following 1985, but the crisis could probably have been avoided. But with growth, firms need diversified sources of finance: well-developed bond and equity markets can sustain growth, while their absence (and failure of banks to provide appropriate assessment of alternative borrowers) serves as a deterrent. The ability to raise longer-term finance through equities or

securities reduces firms' reliance on short-term bank finance and thus reduces vulnerabilities. As growth proceeds, citizens and institutions also need to be able to hold foreign securities, which itself is a natural part of the globalization/integration process and reduces the concentration of risk.

While it may be possible, as the Korean (and other) experience indicates, to grow fairly rapidly with credit rationing (assuming positive real interest rates) at early stages of development, a well-functioning banking system becomes more vital as growth proceeds. The same may be true of other less-than-optimal economic policies: licensing of imports may not be too harmful in very early stages of development, but can rapidly become a quagmire. In the case of credit rationing, as with import licensing, the establishment of some state enterprises, and other controls, initial successful economic growth brings with it additional complexity, and that in itself makes nonmarket mechanisms and bureaucratic controls increasingly cumbersome and costly.

Thus, the first lesson is that, even if the current policies deliver rapid growth, there is no guarantee they will continue to do so. Policy makers need to be especially alert to policies that worked well in earlier stages of development, and become cumbersome or inefficient as economies grow in size and complexity.

A second, and related, lesson is that many policies build political support that makes their reversal very difficult. While import licensing may seem appropriate at early stages of development and, indeed, may not be very detrimental, businesses that thrive in response to it, and especially new businesses that start protected from imports, resist the dismantlement of controls for obvious reasons. And, even if they do not resist, initially successful development of state owned enterprises or of large private firms (protected

from imports) generally means that the labor force and the owners of the enterprises will resist any effort to reduce protection. In the case of Korea, it was probably the fact that the chaebol employed such a large fraction of the labor force that made the authorities reluctant to reduce their access to credit. Hence, in the selection of policies, it is not sufficient to examine the cost-benefit of those policies in the short run, but to examine the ease with which those policies can be politically reversed should they later prove inappropriate.

A third lesson is more speculative. Korea experienced an extended period of very rapid growth – more than thirty years. As already mentioned, mistakes were made but reversed. It is very tempting, if not irresistible, to conclude that Korean policy makers were successful not only because of the initial choices they made, but because, in the course of the three decades of rapid development, they altered policies before the point came at which those policies may have resulted in a crisis. It can be argued that crisis is what happens when a policy becomes increasingly costly to a growing economy and is not altered while policy makers strive to maintain growth rates.. Policy makers then have the choices of continuing the policy with ever-diminishing growth or even declining output, attempting to continue growth until crisis occurs, or amending the policy stance in order to enable the resumption of more rapid growth. In the Korean case, other crises that might have taken place (foreign exchange crisis in response to the heavy and chemical industry initiative, debt crisis in the early 1980s, etc.) were avoided by timely policy changes. It was not until credit rationing and the surrounding policies became the key bottleneck that policy makers could or did not change course in sufficient time to avoid crisis.

Other lessons were learned from the Asian crisis as well. One that has been well-learned is the importance of appropriate assessment of balance-sheet risk. Until the 1990s, country-risk assessments, such as they were, usually focused on flow, and not stock, variables. Another has to do with the riskiness of connected lending. Yet another has to do with the advisability of flexible exchange rates for most countries. Issues concerning banking supervision, development of the financial system and financial regulation also are much better understood than they were. But those will be discussed in more detail in other sessions.

Asian Financial Sectors Today

Let me therefore turn to my last topic: the extent to which the financial systems have improved in the Asian countries. A first point to be noted is that there is wide variation in the extent to which Asian economies have recovered from the crises. Part of this reflects initial conditions: Korea's economic development, for example, was far more advanced than that of the Philippines or Indonesia. Part of the variation was the alacrity with which policy makers responded to the challenges with which the crises confronted them.

Secondly, all financial systems have been strengthened. In most instances, corporate restructuring was necessary for reasons indicated earlier, and it has been undertaken in all countries. The fact that large surpluses and reserves have been built up provides more of a cushion in which to take any necessary policy actions, and one consequence is the greater liquidity of most banking systems. Some countries have reformed state banks or completely restructured ownership within the banking system, while others have moved more slowly in moving NPLs from the banks. And supervisory

oversight has strengthened in many countries, while foreign banks' entry has been facilitated or even encouraged in many. But, as concluded by Turner⁴, foreign banks have not become as important as they are in some emerging markets, the state-owned banking sector has been reduced in size but is larger than seems optimal. Banking consolidation has occurred when there were too many small banks, but still has a way to go. Turner also notes that "the quality of balance sheet data has improved beyond recognition", itself a major improvement, and profitability has risen substantially.

Overall, Korea reformed most, and most rapidly, and has since attained a higher overall growth of real GDP than the other crisis countries. At the other end of the distribution, Indonesia's growth has been the slowest to pick up.

Likewise, the financial sectors were significantly different prior to the crises, and their current statuses reflect both the reforms undertaken since the crises and initial conditions. I do not wish here to go into detail: others are much better informed than I. But data from the World Bank provide a general indication of where things stand, and may be an appropriate note on which to end.

In the handout, there are two tables, based on the latest World Bank Doing Business. These estimates are far from perfect, but at least provide something of an indication of the situation. The data are not fully comparable, for a number of reasons, so should be taken with a grain of salt. There are 175 countries covered, and rankings are from best (number one) to worst (number 175). It should of course be noted that, when many countries are reforming and trying to improve their systems, a constant ranking does not prove there is no improvement: indeed, countries that do not make some

⁴ Philip Turner, "Are Banking Systems in East Asia Stronger?" Asian Economic Policy Review, 2007, 2, pp. 75-95

improvements probably fall in the rankings. The first table provides the estimates of several components that help determine access to credit in individual countries.

Asian countries' data are given in the top 9 rows, and comparative data for four industrialized countries are given below. As can be seen, there is a wide variation among the Asian countries. Some, including Hong Kong, Japan, Malaysia and Singapore receive very high ranks in terms of the ease with which producers can obtain credit. There are four measurable components that determine the World Bank's rankings. Strength of legal rights is ranked from zero (the worst) to ten (the best). As can be seen, Hong Kong and the United Kingdom are ranked among the best, while Australia and Singapore are close. Among the Asian crisis countries, the Philippines is judged to have very weak legal rights, and many of the others receive no more than a ranking of five or six. Depth of credit information is deemed important, as lenders are more reluctant to extend credit the less they are informed about the credit status of potential borrowers. The availability of credit bureau information is critical for the same reason, as it enables potential lenders to learn about prior behavior of would-be borrowers.

A second, and related, set of indicators important for financial development is contract enforcement. Ironically, the weaker is the enforcement of contract rights, the less likely borrowers are to receive credit, as creditors are unable to count on collateral in the event of non-performing loans or default. As can be seen from the second table, there is again considerable variability among Asian countries. Indonesia ranks very poorly, while Japan, Hong Kong, Korea and Singapore rank fairly highly. In Indonesia, not only are there many procedures and long delays in contract enforcement, but the World Bank estimates suggest that it may not be worth trying: the cost of attempting legal action to

gain contractual rights may exceed the value of the legal rights! Even Malaysia's average 20 per cent seems somewhat high. By contrast, Korea's costs of collection are reported to be only 5.5 percent of the claim, lower than any of the industrial countries listed.

While most of the Asian crisis countries (and others) have improved their financial systems, including regulatory regimes, gearing ratios, openness to foreign institutions, and other aspects in addition to those covered in the tables, it is clear that there still remains considerable scope for improvement, with sizeable variation among countries in the apparent current rankings and different components of financial regimes that would appear – at least from a relative standpoint – to be most in need of improvement.

Conclusions

Most of the crisis-stricken Asian economies have experienced growth far beyond what was thought feasible at the outset of the financial crises. All in the policy and development community gained a greater appreciation for the important role of the financial system in economic growth – in developed and developing countries.

Since the crisis, reforms have been made which have greatly strengthened financial systems. But much remains to be done, simply to enable catch-up with other countries. In addition, and perhaps even more important, remaining weaknesses in financial systems are likely to put significant brakes on growth, or even generate future crises, unless they are addressed. A major lesson of the financial crises of the 1990s is that addressing weaknesses and distortions before crises is far easier, and less costly, than remedying the situation once crises have occurred. The Federal Reserve Bank of San Francisco is to be

congratulated on its sponsorship of this conference as one means of enabling further improvements in financial systems, and hence of enhancing growth prospects for Asia.

TABLE 1

EASE OF GETTING CREDIT

Country	Overall Rank	Strength of Legal Rights	Depth of Credit Infor-	Credit Bureau Coverage	
				Public	Private
China	101	2	4	10.2	0.0
Hong Kong	2	10	5	0.0	64.5
Indonesia	83	5	2	8.4	0.2
Japan	13	6	6	0.0	---
Korea	21	6	6	0.0	76.6
Malaysia	3	8	6	42.2	----
Philippines	101	3	3	0.0	4.8
Singapore	7	9	4	0.0	38.6
Taiwan	48	4	5	0.0	59.6
Thailand	33	5	5	0.0	21.7
Australia	3	9	5	0.0	100.0
Sweden	33	6	4	0.0	100.0
U.K.	1	10	6	0.0	100.0
U.S.	7	7	6	0.0	100.0

Source; World Bank, Doing Business 2007, IBRD Washington, 2006

Notes:

Rank: first is best. There are 175 countries covered.

Indexes (Legal Rights and Depth of Credit Information) are from 9 (worst) to 10 (best)

Table 2.

CONTRACT ENFORCEMENT

Country	Overall Rank	Procedures (number)	Time (days)	Cost (% of claim)
China	63	31	292	26.8
Hong Kong	10	16	211	14.2
Indonesia	145	34	570	126.5
Japan	5	20	242	9.5
Korea	17	29	230	5.5
Malaysia	81	31	450	21.3
Philippines	59	25	600	16.0
Singapore	23	29	120	14.6
Taiwan	62	28	510	16.6
Thailand	44	26	425	17.5
Australia	7	19	181	12.8
Sweden	2	19	208	5.9
U.K.	22	19	229	16.8
U.S.	6	17	300	7.7

Source: Same as Table 1.

