Asia’s take on austerity

Malaysia needs to maintain capital regulation tools

The austerity debate was the topic du jour at this year’s World Economic Forum in Davos—with good reason. Europe is slipping back into recession just when recovery in the US is finally getting some traction. That has undermined the case for fiscal consolidation, which is so heavily favoured in Europe.

Yet it took away a different conclusion from Davos. I moderated a session on “The New Context in East Asia,” addressed by a panel of senior representatives from Thailand, South Korea, Malaysia, Singapore and Japan. With the exception of the Japanese participant, all had lived and experienced with the devastating Asian financial crisis of the late 1990s.

I couldn’t resist the temptation to draw Asia into the debate between Europe and the US. Rather than ask the Asian panelists to theorise about the impact of austerity in the overly indebted developed West, I asked them to assess their own experiences during and after the crisis of the late 1990s.

Frankly, I was surprised by what I heard. The panelists hit two points first. They initially detected the wrenching adjustment programmes dictated by the terms of the IMF’s so-called conditional bailouts (the South Koreans still refer scornfully to the “IMF crisis” of the late 1990s). Second—and here’s where the surprise came—they all agreed that, with the benefit of hindsight, these excruciating adjustments were worth it, because their crisis-torn economies were forced to embrace structural reforms that paved the way for their spectacular economic performance today.

On the surface, the numbers speak for themselves. In 1998, during the depths of the Asian financial crisis, aggregate output in the so-called ASEAN 4 (Indonesia, Malaysia, the Philippines, Thailand) plunged 8.7%. Real GDP in South Korea—long considered the darling of Asia’s newly industrialised economies—contracted 5.7% that year. But then the tough conditionalities of IMF bailouts and adjustment programmes—Asia’s own dose of austerity—kicked in.

In response, current-account balances—the Achilles’ heel of the so-called East Asian growth miracle—went from deficit to surplus. For the ASEAN-4, current-account deficits averaging 4.4% of GDP in 1995-98 swung dramatically into average surpluses of 6.8% of GDP in 1998-99. A similar transformation occurred in South Korea, where a 2.8% current-account deficit in 1990-96 became an 8.6% surplus in 1998-99.

Since then, the region has never looked back. Within two years, most of Asia’s crisis-ridden economies had regained their pre-crisis peaks. Nor was this a temporary rebound. Beginning in 1999, the ASEAN-4 began a 10-year spell of 5% average annual GDP growth (3.3% in South Korea over the same period). In short, there were no lasting negative effects from the short-term dose of austerity, and, to the extent that austerity was essential to post-crisis healing, the long-term benefits have proven to be both enduring and astounding.

Three lessons for the rest of us come to mind. First, there is no gain without pain. Few of us in the developed world can fathom aggregate—output contractions on the scale that crisis-torn Asia suffered in 1998, let alone muster the political will to impose them on our economies. The economic dislocations and the humiliation of proud nations were, indeed, devastating (as Greeks today can attest). But, once the excesses were purged, Asia’s post-crisis rebounds were both strong and sustainable.

Second, currencies played an important role as an escape valve in the early days of Asia’s post-crisis adjustment process. As the region moved from hard currency pegs to floating rates, Asian currencies plunged—with drops against the dollar ranging from 28% in South Korea and roughly 37% in Thailand, Malaysia, and the Philippines to almost 80% in Indonesia.

Finally, there is no substitute for restructuring. In Asia in the late 1990s, measures aimed at the financial sector dominated IMF-imposed structural adjustment programmes, but there were also programmes that focused on tax and expenditure reforms, corporate governance, privatisation and business-defaultrestructuring. While not all of these programmes were implemented in strict compliance with IMF conditionality, they played a key role in promoting significant improvements in Asian competitiveness.

None of these lessons should be lost on either Europe or the US. While individual countries obviously lack currency flexibility in a monetary union—one of Europe’s most obvious and important differences from Asia in the late 1990s—there is nothing to prevent a depreciation of the euro from boosting pan-regional competitiveness. The same, of course, is true of the US dollar.

But no country—if any group of countries, in Europe’s case—has ever devis ed its way back to prosperity as Asia’s structural lessons are equally important to the developed world. Indeed, Germany’s economy is out-competing a resurgent rest of Europe, largely owing to labour-market reforms and deregulation. The same medicine might prove equally beneficial to the rest of Europe—to say nothing of the US, which faces a major competitiveness challenge of its own.

In the end, Asia’s developing economies had no choice but to accept draconian measures as the price of bailouts in the late 1990s. It remains to be seen if rich developed countries are willing to take the same route. Two decades ago, in their book Changing Fortunes, Paul Volcker and Toyo Gyoenko underscored the glaring double standard of crisis resolution: “When the IMF consults with a poor and weak country, the country gets in line. When it consults with a strong country, the Fund gets in line.”

Perhaps that is the key lesson from the Asian crisis of the late 1990s: austerity can work. But its success or failure ultimately boils down to power politics—namely, a resolution of the tension between short-term bailouts and the commitment to a long-term strategy. That’s where the battle still rages in the West.

— Project Syndicate

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INSIDE

A World Bank for a new world

A pervasive culture of centralisation

The political economy of global rebalancing

An economic nightmare the world should avoid

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By Michael Lim

Mah-Hui and Kevin Gallagher

A 2010 IMF report showed that such measures not only worked but “were associated with avoiding some of the worst growth outcomes” of the current economic crisis. The paper concludes that the “use of capital controls—in addition to both prudential and macroeconomic policy—is justified as part of the policy toolkit.”

Indeed, many of these other countries, such as Chile and Peru, that are also in TPP negotiations, have used capital controls to keep inflows from TPP countries, and to maintain flexibility in trade flows.

Malaysian treaties have been careful to maintain the flexibility to regulate capital flows in many of its other trade treaties. It would be highly prudent to maintain that flexibility in a trade deal with the US—the source of much of the world’s volatile capital flows and the world’s largest financial crisis from the last Depression.

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