Bad Private-Sector Decisions

By JOSEPH STIGLITZ

Only a year ago, the East Asian countries were held up as models for other developing countries. Today legions of critics are condemning them for their unworkable economic systems, which the critics say have long been bound to collapse into crisis. This dramatic swing in opinions about the Asian development model, matching the dramatic changes in the markets, has gone further than is justified by the fundamentals. No other economic system has delivered so much, to so many, in so short a span of time.

It is useful to remind ourselves that financial and currency crises have occurred elsewhere in the world, most recently in Norway, Sweden and Finland. The fact that these countries had highly transparent economic systems and advanced institutional frameworks demonstrates that transparency is not enough to underpin robust financial systems. Although the lack of transparency in the East Asian economies contributed to the problems, it is probably not responsible for the crisis itself.

At the same time, the crisis in the East Asian countries is very different from crises experienced by many developing countries in the past. East Asian countries have high national saving rates. The East Asian governments have all run budget surpluses or minimal budget deficits in recent years. Also, macroeconomic policy has been relatively stable, as evidenced by their low inflation rates.

The financial crisis in East Asia can be understood as the result of a number of factors that have made these economies especially vulnerable to a sudden withdrawal of confidence. The problems—including misallocation of investment, unhedged short-term borrowing and, in Korea, very high debt-to-equity ratios—are rooted in private-sector financial decisions.

This is not to absolve governments of responsibility. Insufficient financial regulation and implicit or explicit government guarantees, as well as misguided exchange-rate and monetary policies, each played an important role in creating the incentives that led to the particular size and character of external financing and internal misallocation of resources.

Many of the problems these countries face today arise not because governments did too much, but because they did too little—and because they themselves had deviated from the policies that had proved so successful over preceding decades. In several countries, for instance, poorly managed financial liberalization lifted some restrictions, including restrictions on bank lending to real estate, before putting in place a sound regulatory framework.

In their haste to place exclusive blame on the governments in the region, many critics have also forgotten that every loan requires not just a borrower, but also a lender. The borrowers who misallocated their investments share responsibility for the problems with the lenders, many of them international commercial banks, that provided them with the money in the first place. Similarly, one might argue that responsibility lies not just with bank supervisors in the borrowing countries but also with their counterparts in lending countries, particularly if the international community believes that there is sufficient systemic risk to the global economy to warrant interventions.

The buildup of short-term, unhedged debt left East Asia's economies vulnerable to a sudden collapse of confidence. As a result, capital outflow, and with it depreciating currencies and falling asset prices, exacerbated the strains on private-sector balance sheets and thus proved self-fulfilling. The vicious circle has become even more so as financial problems have led to restricted credit, undermining the real economy, and almost inevitably leading to a slowing of the economy. Given the region's financial fragility the economic downturn may well feed on itself, worsening bankruptcies and weakening confidence. Policy responses should be designed to halt this downward spiral by minimizing the depth and duration of the downturn.

Restoring growth in East Asia requires restoring confidence. This is as much a matter of perception as of reality, including the perception of the fundamental strengths of the East Asian economies and their resolve to address their weaknesses. This should be addressed by improving the microeconomic and institutional fundamentals. This includes establishing an effective regulatory system, improving corporate governance and enhancing transparency more broadly.

At the same time, governments and international institutions, including the World Bank, have the responsibility for ensuring that the poor and vulnerable suffer as little as possible in the process of adjustment. Financial crises typically bring large increases in unemployment, which often linger well after the initial crisis has passed. The devastating consequences for the poor can persist long after capital flows and economic growth resume.

In East Asia the poor may be especially vulnerable to an economic downturn. In Thailand, for instance, although the statistics show that almost no one lives on less than $1 a day, millions of people are living on just over $1 a day. Korea has relied on rapid growth and lifetime employment to provide social security for its citizens. It does not have universal unemployment insurance and only a very modest social safety net.

The immediate need is for government in these countries to step in and fill the income-security gap that will be left by companies closing and workers losing their jobs. Over the longer term, we will need to work with the countries in the region to help them design modern, durable social safety nets that complement their other structural reforms. We should be mindful, however, that it will not be possible to create an effective social safety net overnight, especially in rural areas, and the pace and content of reforms should take this into account.

Some of the most important features of East Asia's development were sound macroeconomic fundamentals: high savings, a commitment to education, technologically advanced factories, a relatively egalitarian distribution of income, and an aggressive pursuit of foreign exports. All of these elements are still present, suggesting that East Asia's economic prospects continue to be bright. And these elements of the East Asian success continue to provide a model for successful development throughout the world.

Mr. Stiglitz is senior vice president and chief economist of the World Bank.

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