

# Are Banks in Asia “Rotten”?

by

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## 1. Introduction

For many observers the financial crisis which hit many countries in Asia in the course of 1997 and 1998 is mainly a crisis of the banking system in these countries. Even today, after the turnaround of growth rates and signs of an overall improvement in the economic situation, it is a widely perceived view that the banking system in Asia has to be restructured fundamentally. According to this view Asia as a whole can only return to the growth path experienced in the last decades if this restructuring has been completed. But such a view raises many questions. How has it been possible that countries with a “rotten” banking system had been extremely successful in terms of catching up with the western world. No region of the world, outside the part we call today the “western industrialized countries”, has ever accomplished such a long and stable phase of high growth rates as the Asian “Tigers” in the 80s and the 90s. The most remarkable one is the performance of Japan after the Second World War. But even this country could not avoid a deep “structural” crisis if the mainstream analysis is right.

The Japanese slump leads to the most important question: Why is it that very different countries had been subject of a banking crisis? On the one hand we have seen the failure of countries with current account deficits and competitive weaknesses, like Thailand and Korea. On the other hand, and this is a neglected fact of the events which are called “Asian Crisis”, with Japan a country got into trouble with a still very high current account surplus and without fundamental competitive problems. The gulf which separates Japan from the others can be easily identified. The remedy for the acute crisis in the “weak” countries had been a devaluation of their currency vis a vis the rest of the world which tended to overshoot and had to be fought by buying domestic currency with US- Dollars. In Japan it was just the other way round. The Yen was strong most of the time and this year Japan faces a revaluation which tends to overshoot and has to be fought by the central bank by buying foreign currency with Yen.

Paradoxically, this constellation is sometimes taken as a proof that something fundamentally has gone wrong in Asia as countries with weak as well as with strong currencies are hit by the same virus. But if a country has a weak currency because it has a “rotten” banking system, how can a country like Japan have a very strong currency although it seems to have the same weaknesses of the banking system? Thus, the conjecture of a “fundamental rottenness of the banking system in Asia” is - for a priori reasons - not a convincing hypothesis. There must be

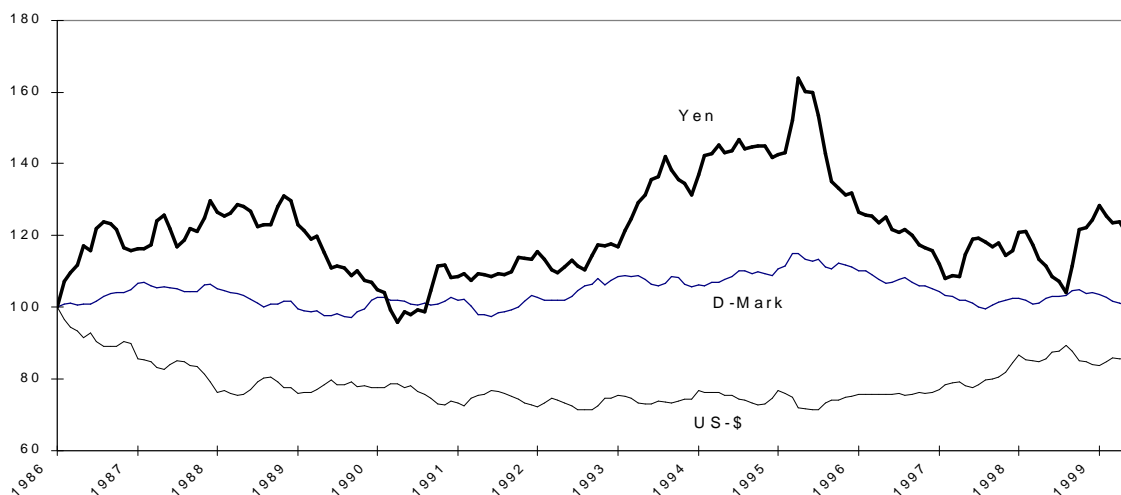
other factors which explain the problems of the banking system beyond “rotteness”? I will look at the two different groups of countries in Asia, namely Japan and Non-Japan, and try to find similarities which do not have common roots in the banking system as such but, nevertheless, may explain the problems in that sector of the economy which have been coming up during the Asian financial crisis.

## 2. The Japanese Slump

Japan’s economy is in a deep crisis for the fourth consecutive year. Although there are first signs now that it has gone through the trough the overall situation and the outlook remain rather bleak. In the last years a lot of ideas have been launched to explain the persistent slump of an economy which, for decades, had been the role model for many „sclerotic“ economies in the Western World. Most explanations of the Japanese crisis focus on factors like a long isolated and inflexible banking system, the low profit margins of Japanese companies or the kind of cooperatism between the government and the private sector which indeed had characterized the Japanese „model“.

The role of one factor, however, seems to be systematically underestimated even in those analyses which do not only stress the importance of „structural“ causes of the crisis: The exchange rate of the Yen. The Yen had wildly fluctuated in the last 20 years. But erratic fluctuations are not adequate to describe what has happened in the beginning of that period. After the bubble in the stock and real estate market in the first years of the 90s had burst in response to a late but effective tightening of monetary policy, the exchange market entered the stage in an unprecedented and unpredicted manner. The nominal exchange rate of the Yen had already been overshooting the inflation and unit labor cost differentials with the rest of the world throughout the whole of the 70s and the 80s. The resulting real appreciation already falsified the traditionally held theory that the real rate cannot have a trend. But after the sharp recession

Real Exchange Rate of D-Mark, US-\$ and Yen



in the first two years of the 90s things got even worse.

Between 1992 and 1995 the **real** rate of the Yen appreciated, according to different calculation methods, in a range of 50 to 100 %!<sup>1</sup> Not one of the larger economies in the world has ever suffered from such an appreciation shock on top of a long phase of overvaluation. Germany, for example had a real revaluation of around 15% at the same time and was hardly hit by the consequent fall in export volumes, the loss of market shares and a rise in unemployment. A shock like in Japan, five to eight times that large would have led to a big crisis. But, and this is the surprising fact for western observers, in Japan, despite the extraordinary dimension of the shock, neither a sharp drop in market shares nor a rise in unemployment can be observed. The growth rates of exports slowed down, but, according to OECD data, not even touched an absolute reduction. The unemployment rate in Japan rose slightly, employment stagnated but didn't fall.

A huge external shock like the one Japan has experienced after the real appreciation of the Yen would have brought about huge repercussions for the government sector under the institutional arrangements given in Western industrialized economies. Companies would have adjusted their labor force downwards, unemployment would have risen sharply, government deficits would have mushroomed. In Japan, in the first round at least, not much of that happened. As unemployment did hardly rise, the deficit in the public budgets increased slightly up to 1995, not even as much as in one of the major recessions in western countries. Clearly visible is the shock, however, in non-residential fixed capital formation.

There is in my opinion only one explanation for such an outcome. Obviously, in the Japanese system, companies, for a remarkably long time, stabilized the system by bearing most of the unavoidable burden of the huge shock. Keeping the labor force, with the growth rates of total compensation per employee only coming down in small steps, means that the shock had to be absorbed to the largest part by a profit squeeze. Such a profit squeeze would have led, again, under the auspices of a western system, to a sharp reduction of bank lending to companies due to much higher risk of default. In Japan, however, bank lending only stagnated at a rather late stage of the process. Close institutional relations of the banking system with the company sector and an insufficient supervision of banking activities have definitively played a role if we want to explain this kind of burden sharing. Only after the danger of major bank defaults the government had to step in and to consolidate the banking system thereby accepting mushrooming public budget deficits.

The conclusion of this analysis is not as simple as the one which is based on „structural“ explanations of the Japanese crisis. Japanese or Asian institutional arrangements, i.e., the relationship between government, companies and banks, are not per se inferior to western ones. Given the size of the shock that the Japanese society had to absorb in one way or the other, any western economy would have tumbled too. In western societies the government would only step in at an earlier stage and the private sector would have to shoulder the burden to a much larger extent from the beginning. In Germany, for example, the small, 15 % real appreciation induced a persistent debate about a fundamental loss of competitiveness and a lack of flexibility in the German society. With an appreciation of the Japanese size most of the existing German institutional arrangements and achievements would have been put in question.

Thus, if adequate room in the analysis of the Japanese crisis is given to the external shock the Japanese economy faced in the first half of the 90s the simple messages lose their persuasive power. Those who explain the visible weaknesses of institutions without taking into account

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<sup>1</sup> The data in the graph are from the OECD and are based on consumer prices.

the strain posed upon these institutions by external and, to a certain extent, exogenous shocks, tend to overemphasize „structural factors“ as well as „structural remedies“. This may lead quickly to an „overshooting effect“ concerning the steps recommended to reform institutions. Given many differences in the traditional values of our societies on the one hand and the Asian economies on the other hand, western advisors should be very careful by recommending to superimpose our institutions over an Asian society.

### 3. The Non – Japanese Slump

The story of the slump in Asia outside Japan is a bit more complicated and needs a bit more theoretical elaboration. The Asian countries had been under pressure from the West during the 80s to liberalize their markets and thus to open their economies for goods as well as for capital. In consequence these countries had to decide about adequate exchange rate regimes under open market conditions. In the light of the experiences of some smaller countries in Europe and a number of newly industrializing countries with a successful stabilization of the price level in the short term, many international observers and advisers recommended in recent years that emerging countries including the Asian “Tigers” should employ a fixed exchange rate vis-à-vis Western countries. In these regimes the nominal exchange rate acts as the nominal anchor, giving incentives to all sectors of the economy to adjust their nominal claims to the conditions prevailing in the Western world. Even for large transition economies like Russia, Ukraine, and Kazakhstan this was considered by the IMF and others to be a reasonable strategy<sup>7</sup>. This strategy, the proponents argued, should render the steering of monetary policy and the stabilization of inflation rates easier in countries where the credibility of the central bank is not sufficient to keep a check on inflation in the short term. In the extreme case of the so-called currency board, monetary policy is deprived of any scope for autonomous action.

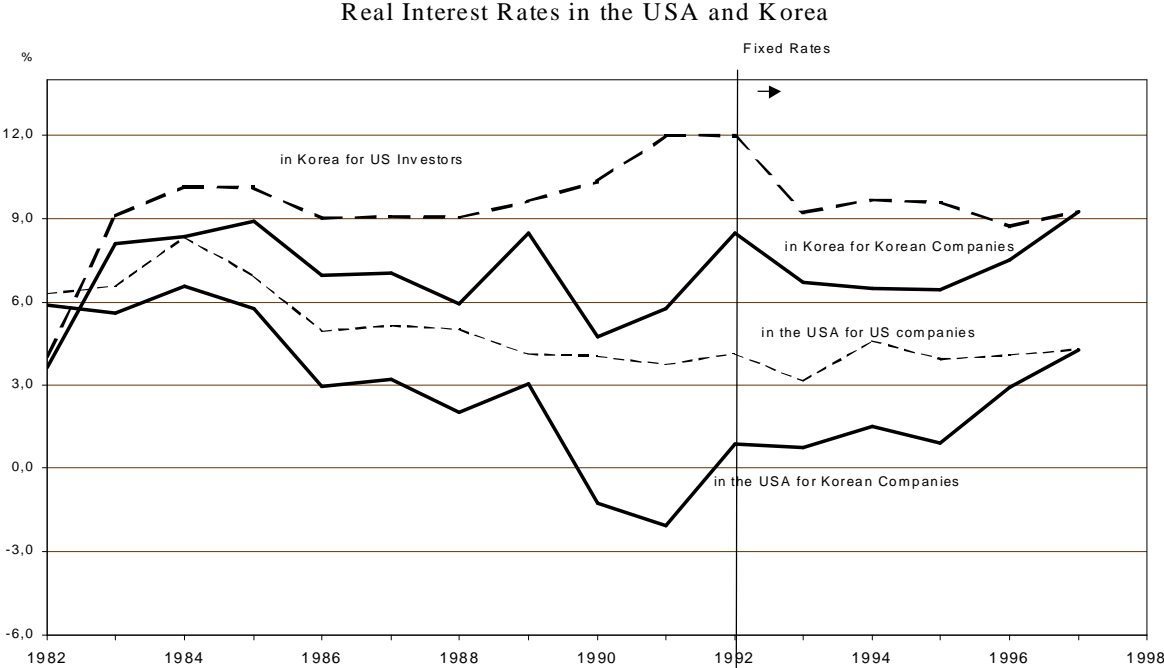
The strategy of anchoring a national currency by fixing its nominal rate vis-à-vis a big and stable country has found many supporters in Asia too because it seemed to offer another major advantage compared to domestic solutions. Investment, according to the basic tenet of the school of thought which dominates the IMF and the mainstream of economics today, depends on the prior accumulation of savings. These, however, due to relatively low levels of income are too small in emerging economies, if they exist at all. In Asia the ratio of investment was high but there seemed to be a scarcity of capital which could be removed by opening the borders. It was, according to this view, just necessary to meet certain institutional and procedural requirements in order to get the “necessary” inflow of foreign capital. Anchoring the exchange rate would create stable monetary conditions for foreign as well as for domestic investors. More and more countries therefore turned to the strategy of pegging their exchange rate to some lead currency, just as Austria, for instance, had successfully linked the Schilling to the German Mark for several years.

If such a strategy of pegging the exchange rate is adopted, the nominal interest rate of the anchoring country is fixed at roughly the nominal interest rate of the anchor country, after adjusting for any differences in the rates of inflation. Thus, real interest rates, being the crucial quantity for fixed investment, are, in the eyes of potential investors, in the anchoring country approximately as high as in the anchor country. Additionally, these arrangements do not bestow any special advantage on the financing of long-term fixed investment in the anchoring

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<sup>7</sup> In accordance with concepts promulgated by the IMF, controlling the national money supply was in the first phase of transition seen as the best way to achieve this objective and to accomplish the necessary consolidation of public budgets. However, it soon became clear that this was not a feasible way to fight inflation. In particular, this was true for small open economies which experienced huge exchange rate fluctuations and an unstable money demand.

emerging country. If there the expected return on investment is higher (due to the enhanced productivity of capital), the process of catching up becomes possible. But, exactly at this stage of affairs, the monetary conditions, the combination of interest rates and exchange rates is in disequilibrium.



Let us look at Korea, one of the countries in which there had been a successful catching-up for decades and which collapsed suddenly in the new environment of open markets and fixed exchange rates. The relevant data are in the graph below: Korea started fixing the nominal rate more or less in 1992. At that time the real interest rate for a Korean company searching for a loan in the United States was very low, namely close to zero. For US investors at the same time the interest rate offered in Korea was close to 10 % and thus much higher than in the States.

Proponents of the “nominal anchor approach” usually overlook the fact that in this situation

**Table 1: Real Interest Rates for Investors / Debtors in the U.S.A. and Asia**  
**When Nominal Exchange Rates Are Fixed**  
 (as %)

|               | 1              | 2                     | 3                          | 4  | 5  | 6                                | 7   |
|---------------|----------------|-----------------------|----------------------------|--|--|----------------------------------|---|
|               | Inflation rate | Nominal interest rate | Real interest rate (2)-(1) | Real interest rate for investors / debtors in the U.S.A. | Real interest rate for investors / debtors in Asia | Changes in nominal exchange rate | Changes in real exchange rate (appreciation: +) |
| In the U.S.A. | 2              | 6                     | 4                          | 4  | 6-14=-8  | 0                                | -12   |
| In Asia       | 14             | 18                    | 4                          | 18-2=16  | 4  |                                  | +12   |

foreign investors can take advantage of de facto short-term arbitrage opportunities. The numerical example in Table 1 demonstrates the point: Even though the differential between nominal interest rates corresponds to the one between inflation rates, given the anchor approach, there is no risk that the anchoring country's currency will depreciate in the short run. The inflation rate in the anchoring country is of no concern to the foreign investor, as he usually calculates with his domestic inflation rate. For him it is important that the real rate of return he can earn with financial assets in the anchoring country exceeds the one he could earn at home.

In the numerical example the real rate difference is equal to the differential between the rates of inflation. Conversely, it is attractive for debtors in the emerging country to borrow in the anchor country, because they can take advantage of lower nominal interest rates without having to accept any exchange-rate risk. Both effects generate a permanent flow of foreign capital to the anchoring (emerging) country. Since wages, unit labor costs and prices rise faster in the newly industrializing country than in the hard-currency country, the currency of the anchoring country appreciates in real terms, the country loses competitiveness. As a result, the inflow of capital will be mirrored by corresponding deficits in the current account. As a rule, capital inflows will mainly consist of short-term funds, because short-term opportunity for quasi-arbitrage will be a more attractive option than the considerable risks involved in making profitable fixed investments in the anchoring country.

Thus, nominal exchange-rate stabilization destabilizes short-term international capital flows and directly undermines sound banking principles. Exchange-rate stabilization can only be implemented if, during the period of disinflation, the anchoring country offers consistently higher interest rates than hard-currency countries if negative real interest rates are to be avoided. The inflation-rate differentials between transforming and hard-currency countries are matched by corresponding interest-rate differentials. But, unlike the conditions normally prevailing in the global market for capital, the inflation differentials are not matched by a corresponding risk of depreciation of the anchoring country's currency.

Using the exchange rate as a nominal anchor will inevitably break the link between inflation differentials and the risk of depreciation. If a country chooses to adopt this strategy, its assets become extremely attractive during the period of disinflation, because international investors base their decisions solely on nominal interest rates and the risk of depreciation but not on inflation differentials per se. As a result, speculative capital starts to flow into the country and domestic banks and companies borrow much more abroad than they would if the risk of a depreciation would not have been eliminated de facto. At the same time, as in any period of disinflation the conditions for domestic investment deteriorate. Real interest rates deflated by the actual inflation rate may not be extraordinary high but if the real rate is calculated by using the medium-term inflation target it is usually very high.

Thus, international investors may earn very high rates of return in countries where real income and domestic profits may be falling. Moreover, the transforming country is unable to cut interest rates because this would endanger the credibility of monetary policy at home. In the short term, at least, the political will to achieve economic stability is reflected in the decision to keep nominal interest rates high. Real-world examples of this constellation were provided by the Baltic republics in 1992 and 1993, Mexico in 1994, and Russia, Ukraine and Kazakhstan in 1995 and by Asia quite recently<sup>3</sup>.

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<sup>3</sup> Given the very often unreliable data a simple but straightforward rule to identify a coming exchange rate crisis or a collapse of the real economy in an "emerging market" is the following: If nominal short-term interest rates

How long an external economic imbalance following the exchange rate peg can be sustained is an open question. With growing visible imbalances the markets willingness to believe in the emerging country's exchange-rate policy will fade. As soon as investors are convinced that the anchoring country will not manage to slow down the growth of its external debt within an adequate period of time, confidence in the exchange-rate's stability deteriorates. Fearing the ultimately inevitable devaluation of the currency, foreign investors withdraw their short-term funds and domestic companies stop borrowing abroad. This will cause liquidity shortages in the anchoring country. At the same time, increasing amounts of this country's currency are offered for sale in foreign-exchange markets which forces policy makers to restrict liquidity even more. Sooner or later, policymakers have to abandon the exchange-rate peg, which is usually followed by a currency crisis. Enormous dislocations in all sectors of the economy are the result. The problem may be aggravated by close ties and cross-holdings between banks and non-financial business, the government's too hesitant withdrawal from the financial sector, insider lending, adverse selection and moral hazard, but the core of the problem has been the anchor strategy.

The economic situation in Non – Japan Asia was not as extraordinary as many observers believed in the first round. Given the heavy exposure of domestic companies in foreign markets the sharp depreciation of the exchange rates would under any “structural “ conditions have led to enormous problems with the bank's balance sheets. That in Europe similar problems could have been avoided in the past has two reasons. Firstly, there was usually a “safety net” for devaluation as most of the devaluations had taken place with members of certain currency systems, like the EMS. Secondly, an expectation about a certain “necessary” amount of depreciation of the weak currencies had always been in the markets as the differences in nominal exchange rates between countries in a similar stage of development could not be interpreted as a good bargain but as an early warning of a coming depreciation. Nevertheless, even in Europe there had been big devaluations accompanied by banking problems. Sweden in the 90s offers an example. But there is virtually no case where, after a rather long period of exchange rate stability, a currency lost half or more of its value within a short period of time.

In the long run, emerging economies can avoid such an outcome only if they succeed in the control of inflation without letting high real interest rates stifle growth. This means that they have to implement wage and income policies comparable to those in the country whose currency they prefer to pick as an anchor. Since it is very hard and time-consuming to pursue such wage policies in emerging countries, it is imperative that any solutions implemented during the period of adjustment shield these countries from cumulative bouts of devaluation. According to textbook economics, this can be accomplished by announcing in advance a crawling peg aimed at keeping the emerging country's exchange rate constant in real terms.

The rationale behind such a crawling peg is illustrated in Table 2. The interest rate differential as well as the inflation differential reflect the announced depreciation of the high-inflation-country. In theoretical terms: The exchange rate doesn't follow the interest rate parity but the purchasing power parity even in the short run. Real world examples are most of the Eastern European countries which are in a stage of transformation still. The best example seems to be

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in a developing or transition economy are higher than in industrialized countries and the nominal exchange rate of the former does not fall at a (annual) rate that equals the difference in (annual) interest rates the constellation of data is not sustainable as either the interest rates or the exchange rate are too high in the “emerging market”.

Hungary. The country has achieved to stabilize the real rate of the Forint over a couple of years now without being subject to speculative attacks from the markets.

Such a policy will, however, not induce immense capital inflows from abroad. At the very least, controls on the flow of capital must be imposed in order to safeguard the policy. Even though this involves problems of its own, it does not preclude the implementation of a successful strategy of development. As I will argue below, dynamic investment activity does not

**Table 2: Real Interest Rates for Investors / Debtors in the U.S.A. and Asia  
When Exchange Rates Change in Accordance with the Theory of  
Purchasing Power Parity  
(as %)**

|               | 1              | 2                     | 3                          | 4  | 5  | 6                                | 7                             |
|---------------|----------------|-----------------------|----------------------------|--|--|----------------------------------|-------------------------------|
|               | Inflation rate | Nominal interest rate | Real interest rate (2)-(1) | Real interest rate for investors / debtors in the U.S.A. | Real interest rate for investors / debtors in Asia | Changes in nominal exchange rate | Changes in real exchange rate |
| In the U.S.A. | 2              | 6                     | 4                          | 4  | 6-14+12=4  | 12                               | 0                             |
| In Asia       | 14             | 18                    | 4                          | 18-2-12=4  | 4  |                                  | 0                             |

depend on the existence of accumulated savings at home and abroad. Investment in all of the successful cases had been financed through bigger profits and higher levels of employment. In this way, investment generates higher incomes and automatically encourages bigger savings. Thus, the process of development depends less on prior financing through existing savings or capital imports than on a favorable monetary environment for investment in the emerging country itself.

These considerations are not at all new. Already in the 1950s and 1960s, the same dilemma was the subject of a debate concerning England.<sup>4</sup> When capital is free to flow between countries, a system of floating or flexible exchange rates will ultimately also be unable effectively to reduce the need for adjustment. It may even be the other way round: With flexible exchange rates in the short term an investment in a developing country may be more attractive as a nominal appreciation adds to the attractive interest rate. This is definitely true for all periods in which the purchasing power theory does not hold and interest rate parity dominates. Developments following this pattern can be observed in many Eastern European countries in the first phase of their transformation.

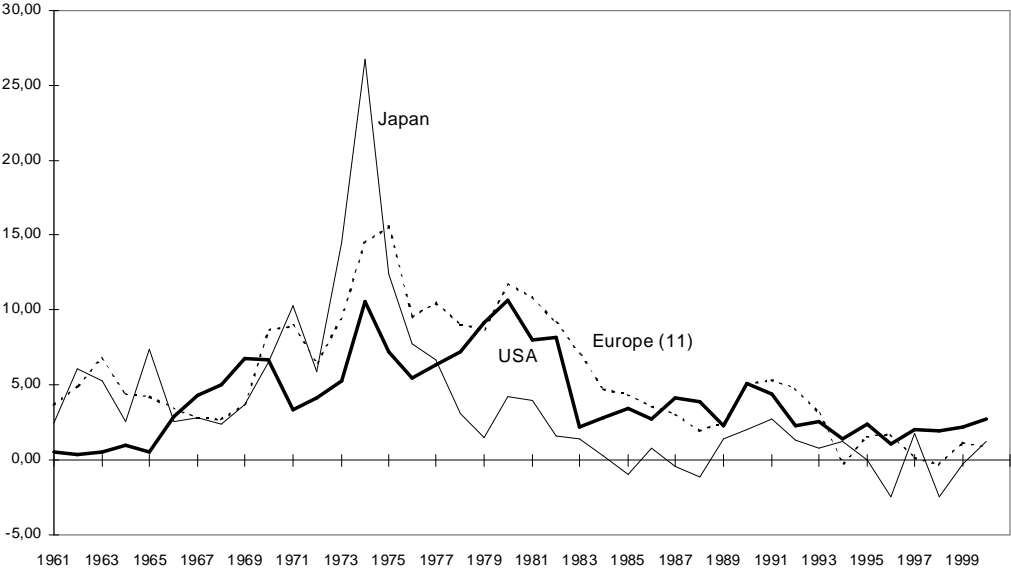
<sup>4</sup> J.R. Hicks wrote in 1968: "To adjust the value of money as a once-for-all measure to meet a single identifiable change (such as that caused by a world war) seems to me to be one thing, a continuing failure of competitive power, to be quite another. If currency depreciation is adopted as a regular policy people must come to foresee it. If they do so, they will decline to hold the depreciating currency; for it is more profitable to hold a stable money than one which is depreciating. Even though the 'soft' currency is fortified by exchange restrictions, the objection is not wholly met; for it is doubtful if any practicable exchange restrictions will suffice to protect a currency, depreciation of which has become a habit. In our own case, in view of the advantages which we gain from the use of sterling as an international medium, this argument is particularly powerful. We may be put to great strains in order to maintain the exchange value of sterling (at least to the outsider), but I doubt if we have any alternative but to bear our cross." Hicks (1968), p. 453.



It is the international division of labor which creates the need to adjust with regard to productivity gains and the rise of money wages not an inadequate exchange rate regime. For a while, flexible or adjustable exchange rates may eclipse the necessity of adjustment, but no monetary system can completely eliminate this predicament. Countries which are candidates for a devaluation of their currency, that is, countries with deficits in their balance of payments, or countries with chronically high inflation rates will have to adjust sooner or later. Otherwise they will get caught in a spiral of devaluation and inflation again and again. They can only avoid this if they finally manage to create the kind of domestic conditions that would also be required by a system of absolutely fixed exchange rates or a currency union. In other words, the free flow of capital can only be guaranteed if unit labor costs and prices do not rise faster at home than abroad. Otherwise, various types of currency crisis, or restraints on the free flow of capital, will prove to be inevitable.

But nominal convergence is only the necessary not the sufficient condition for a stable international monetary environment. The degree of convergence within the group of large industrialized economies, for example, is impressive.

Nominal Unit Labor Costs in National Currency  
(annual increase in %)



Nevertheless, the degree of exchange rate stability is much less impressive. Although Japan has achieved absolute stability of the domestic monetary conditions since a very long time, its currency is time and again the subject of speculative attacks in both directions. To avoid huge fluctuations in the external value of money and to allow at the same time a very high degree of capital mobility a close cooperation of the big player’s central banks and/or a formal exchange rate regime are the only way out. Europe has reached with the introduction of the monetary union the corner solution of absolute fixed exchange rates. This solution requires a high and permanent convergence of the monetary conditions, i.e., mainly unit labor costs and prices. But for countries which are not yet able to guarantee this level of nominal convergence there must be solutions between the “corners” of fully flexible or fully fixed rates.

#### 4. Wages Versus the Exchange Rate as a Nominal Anchor<sup>5</sup>

Most developing countries suffer from rather high and sticky inflation rates. It is this “inertial inflation”, as opposed to virtually “no inflation” in the industrialized countries, which makes it so hard to liberalize capital flows and stabilize prices at the same time. In a vertically fully integrated economy labor is the only non-produced input in the production process. As a consequence the price of labor together with the efficiency by which labor is used in the production process determine the price of all goods. Thus, sticky inflation or inertia are usually closely linked to sticky or rigid wages or better, unit labor costs.

A formula used by Dornbusch and Fischer (1993) with a slight modification (substituting real wages by unit labor costs) reveals the logic of inertial inflation:

$$p = p_{-1} + \alpha(w - \mu) + (1 - \alpha)(e - p_{-1}) + y,$$

where  $p$  is the inflation rate,  $p_{-1}$  is past price inflation,  $\alpha(w - \mu)$  is the change in unit labor costs plus a lag,  $e$  is the rate of depreciation of the nominal exchange rate,  $(1 - \alpha)(e - p_{-1})$  represents the lag in the change of the real exchange rate, and  $y$  is a term for supply shocks. It follows, as Dornbusch and Fischer put it, that

*“Inflation today will be equal to inflation yesterday except for any combination of the following: (i) Wage inflation falls below past price inflation. This requires a break with any implicit or explicit backward-looking indexation. The suspension of indexation, or introduction of an incomes policy, could accomplish this. (ii) Exchange depreciation falls below the rate of past inflation. (iii) Favorable supply shocks lead to disinflation without the need for the exchange rate or wages to take the lead.”<sup>6</sup>*

Thus, the chances of breaking inertial inflation would seem to be equally good, no matter whether the wage regime or the exchange-rate regime is changed. Closer analysis casts doubt on this view, however. The wage regime and the exchange-rate regime cannot be chosen independently of each other. Exchange-rate stabilization, for instance, makes sense only if the aim is to force greater price and cost discipline on the domestic economy via the competitive pressure of imports. If the exchange rate is to be stabilized successfully, unit labor costs in the transforming country must be pegged to those in industrialized countries in a credible way. This must be attainable within a limited period of time. As in the case of a strict monetary regime at home, a fall in the growth rate of unit labor costs can be accomplished only through an adequate incomes policy or by pressure of high unemployment. Deindexation, a break with backward-looking indexation, must be achieved if exchange-rate stabilization is to be successful. Thus, exchange-rate stabilization and a break with backward-looking indexation are not substitutes. Rather, they complement each other.

Seen from another perspective, exchange-rate stabilization looks more ambitious and expensive than direct wage stabilization. The stabilization of the exchange rate can be successful in countries emerging from a period of relatively high inflation only if the domestic currency is devalued substantially at the start of the stabilization phase, in other words, if the currency is undervalued in the first round. As a result, an additional negative supply-side shock, the result of higher import prices, must be overcome at the beginning of the disinflation period. It has to

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<sup>5</sup> This chapter is based on Flassbeck/Hoffmann/Lindlar (1997).

<sup>6</sup> Dornbusch/Fischer (1993), p.11.

be absorbed in the form of a decline in real wages. Subsequently, unit labor costs have to adjust to the prevailing trends in hard-currency countries in a disinflation process. Wage policy faces an especially difficult task, because a disinflation path, once chosen, can only be abandoned at the cost of a substantial loss of credibility in the capital markets. The entire adjustment process, the success of each and every step along the way, and thus each failure with regard to adjustment, are subject to daily evaluation by the capital markets. It will be difficult to explain to investors any reverses in the fight against inflation, even those induced by negative supply-side shocks that might, for example, have been caused by bad harvests or hikes in import prices.

There is, in addition to the economic problems mentioned above, a political problem which tends to pose a major threat to any kind of exchange rate anchor strategy. Economic policy makers choose the anchor approach because they want to fight domestic inflation by the means of cheap imports. If this strategy is successful after a period of painful adjustment by the whole society the final achievement is fundamentally endangered. At the very moment in which the harvest of the political rigor reaches the barn the whole concept is put in question by the unsustainable overvaluation which has been accumulated during the phase of transition from high to low inflation rates. Low inflation is directly endangered as devaluation means higher import prices. In a society which just got rid of the virus of inflation the danger of a new infection is obviously big. Politicians usually hesitate because they fear to lose all their political credit if they quickly agree to a devaluation. But there is no way out. A devaluation is unavoidable. The only alternative to regain competitiveness without nominal devaluation would be wage and price deflation. But a deflation is even more dangerous than inflation and will not help to regain the credibility in the monetary environment.

All in all the strategy of pegging the exchange rate of a high inflation country to an anchor country with low inflation can be a reasonable approach in an environment of open markets for a very limited period of transition. But the strategy will inevitably lead to a currency crisis sooner or later. If there are no precautionary arrangements to limit the degree of speculation against a single currency the currency crisis may easily turn into a major financial crisis. In Asia there had been no precaution and thus the effects on the company and the banking sector had been of an unprecedented dimension. But the huge devaluations, despite their negative effect on the banking system, in the end have been the main factor to explain the turnaround in the real economy and thus may be the seeds of a new and long-lasting recovery of the Asian economies. A restructuring of the banking system will be anyway necessary in the medium run. But as the crisis was not primarily the result of institutional factors in the financial sector the existing weaknesses there will not hinder the recovery of the real economy as they have not hindered the long-lasting catching-up before the outbreak of the crisis.

## 5. Money, Capital and the Central Bank

Another aspect of the banking system is very important to understand the Asian “miracle” before the crisis and the banking problems in and after the crisis. Central banks in Asia in the past have played a different role than in many western economies. Central bank independence, which is seen by many economists as one of the main achievements of economic policy “restructuring” has not been a topic of widespread concern in Asia. Although, by their legal status, some central banks have a certain degree of independence, the consensus approach which dominates the system of policy making in nearly all the Asian countries didn’t give the central banks an outstanding position within this system of policy making. Even more so, price stability was an important ingredient to the success of the catching-up process. But price

stability was primarily seen as the “natural” outcome of the consensual policy approach and not as the result of monetary rigour. By judging Asia today it is very often forgotten that the consensus approach had economic merits which lie beyond its political aspects and the traditional values of Asian societies.

Throughout the modern history of the global economy, failure to achieve monetary stability, in particular stability of the overall price level, has often prevented countries from even remotely living up to the full potential of their real economies. On the other hand, those nations that achieved monetary stabilisation without too much friction, such as Japan and other Asian nations from the 60s to the end of the 80s, often were extremely successful with regard to the real economy performance. In addition, countries engaged in the process of catching up tend to be net importers of capital precisely because they are trying to close the gap in the standard of living, which requires them to import "a high level of productivity". Under these circumstances, "creditworthiness" may prove to be a constraint of paramount importance, as the current crisis in Asia illustrates so amply.

However, the role of money and capital in the process of development is fiercely debated among economists over the last decades. For many members of the profession, capital markets do not fulfil any noteworthy function in the process of development. Instead they are merely a marginal aspect in the overall framework. Monetary policy pursues price stability in order to prevent inflation from distorting the allocation of economic resources. Capital markets have to finance the process of development by allocating existing savings efficiently to the best available investment opportunity. Available savings are the result of the decision of private agents not to consume today but only at a later stage.

This theory has given rise to far-reaching economic policy conclusions which are sometimes named the “Washington Consensus”, i.e., the consensus among major donors and the financial institutions located in Washington. Thus, some economists recommend central-bank independence, as it exists in a number of successful countries, so as to promote price stability to the rank of a “constitutional” condition. Others conclude that countries without tangible savings of their own, such as the transition economies of Eastern Europe, should open their borders for international capital in order to finance economic development. Furthermore, they argue, these countries should offer attractive interest rates as well as a low exchange-rate risk.

The “Washington Consensus”, however, is confronted with a number of puzzles, for which there have not yet been reliable solutions. Why, for example, were many countries unable to initiate successful economic development for several decades, and to acknowledge price stability as a condition of such development, although their inflation rates, as high as they were, never moved in the direction of hyperinflation.<sup>7</sup> The governments of these countries were by no means trying to use steadily accelerating inflation as a way to push up the inflation tax ("seigniorage"). Rather, they tolerated extensive indexation, that is, the economy's adjustment to high inflation rates. Another question that still waits to be answered concerns the reason why countries with very different monetary regimes were similarly successful in stabilising prices **and** in getting the process of economic development and even a catching-up under way. In some Asian countries, such as South Korea, monetary policy has never been even in a semi-independent role. Quite to the contrary, monetary policy has always been directly used to serve the purpose of economic development. Yet, this never led to frequent bouts of accel-

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<sup>7</sup> See, for instance, Dornbusch/Fischer (1993).

erated inflation and, despite the recent troubles, has resulted in a remarkable catching-up process of the Korean economy.<sup>8</sup>

Even more important is the question why no major country has yet succeeded in setting off a process of sustained development by relying to a very large extent on foreign capital. By contrast, many nations very successfully started and completed the process of economic development, largely without foreign assistance, and without previously accumulating any notable savings of their own. Here, the prime examples once more are Japan, the Federal Republic of Germany and South Korea. Germany, for instance, became a net exporter of capital early in the 1950s, just a few years after incomes and savings had collapsed in the wake of World War II.

Apparently, a comprehensive theory of intertemporal structural change including the monetary sphere is necessary to answer these questions. Such a theory of development was propagated, in particular, by J.A. Schumpeter and F.A. Hayek.<sup>9</sup> According to their theory of development, an unbreakable and extremely narrow link exists between intertemporal structural change and a country's monetary system. Rapid economic development as envisioned by Schumpeter, that is development initiated by pioneering firms in product markets, is only possible if monetary policy finances this process of development **in advance**. This means, as Schumpeter says explicitly, that monetary policy has to finance a potentially inflationary process. In the end, however, this process does not turn inflationary, because pioneering companies use the financing advanced by monetary policy for the successful expansion of output. Or, as Hayek puts it, only the creation of fresh money by the banks including the central bank system allows the process of economic development to continue much more rapidly and successfully than would be possible if it had to be financed solely out of existing savings.

In view of this theory, it is easy to see why countries prone to high rates of inflation usually are not very successful in starting and continuing the process of development and catching up. Every attempt to finance development in advance through the creation of money fails, as wage and price inflation rapidly flare up, only to be subdued at once by monetary policy through high interest rates. Conversely, in countries that cultivate a highly disciplined attitude towards price stability, monetary policy is able, with impunity as it were, to let this kind of advance financing take place again and again, without immediately sparking off repeated bouts of inflation. On the contrary, a faster real expansion duly justifies the provision of advance financing, i.e., the trust displayed by monetary policy in advance, while any inclination towards inflation is weakened further.

This theory also disposes of the question whether it is really possible to enjoy the results in a developing country or in a country in transition. It is precisely **because** monetary policy **must** finance economic development in advance that countries without any disposable savings of their own can be successful, too. This is true because the savings that correspond to investment are not a prerequisite of investment but its **result**. Savings are derived from profits and additional income **because** investment is taking place, not the other way round. This also implies that opening the borders for capital is by no means a necessary condition of successful intertemporal structural change. Rather, the decisive factor is the domestic accumulation of capital as the result of economic development based on investment<sup>10</sup>.

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<sup>8</sup> Concerning the question of central-bank independence, growth and the development of inflation see also Barro (1995).

<sup>9</sup> See Schumpeter (1964), Hayek (1933).

<sup>10</sup> See Flassbeck (1999) for the Keynesian or Kaleckian roots of this approach.

According to the theory of Schumpeter and Hayek, countries are successful not because they rely on their central bank's independence, but because they manage, largely irrespective of the central bank's status, to keep inflation under control. The crucial point is to reach a social consensus to avoid distributive struggles which could easily become inflationary. In effect, such a consensus allows a rapid economic development, and the resulting opportunities for profits. Profits in the long run are either tolerated or made tolerable by giving all groups an adequate share in national income.<sup>11</sup> Monetary policy steps in only when this consensus is threatened by inflationary pressures, for example, during periods of full or over-employment.

Given this theory, the wisdom of trying to attract foreign capital with the help of high interest rates and a fixed exchange rate must be questioned as well as the idea that only with a restrictive monetary policy and high real interest rates domestic savings can be mobilised for domestic investment. Instead, the high level of interest rates required by these strategies threatens the domestic potential for development.

## 6. Conclusion

The answer to the question put in the title is a simple one. Not everything may be okay with the Asian banking system but there is no reason to believe that with a different, a western style banking system the financial crisis of 1997 and 1998 could have been avoided. The heavy exposure of banks during the crisis was the result of a misguided and misunderstood exchange rate policy in the case of the countries outside Japan and the result of speculative attacks on the yen in the case of Japan. In Japan the extraordinary overvaluation of the Yen during the first half of the 90s had deteriorated banks balance sheets. The attempt to contain the effects of the unavoidable loss of competitiveness on the Japanese society had put most of the burden of adjustment on the company sector in the first round and on the banking sector in the second. Only now the consolidation of balance sheets with the assistance of the government puts the burden where, in a western style institutional arrangement, it had been in the first round, namely with the government.

Outside Japan banks were heavily exposed because companies had been borrowing in western markets at stable exchange rates and low interest rates during the phase of disinflation. After the large and overshooting devaluation of these country's currencies the debt burden exploded and funds from the rest of the world were withdrawn. Any banking system would have suffered under these circumstances. Bad loans were accumulated to a very large extent and in a very short period of time as the devaluation took everybody by surprise. Given the fact that no rating agency, no government and no international institution had submitted an early warning banks could not act cautiously enough to avoid the impact of the big devaluation of currencies and loans at the same time. In western countries sound banking systems may be able to avoid losses which are due to microeconomic mismanagement. But, as many events have shown, they cannot avoid losses which result directly from macroeconomic mismanagement or from exogenous shocks.

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<sup>11</sup> The adoption of a consensus-based strategy early on also prevents the sort of gridlock in economic policy that can currently be observed in several CIS countries. There, policymakers stick to restrictive macroeconomic policies, as they wait for restructuring to proceed successfully at the microeconomic level before they are ready to switch to an expansionary course. However, this ignores the fact that only a change in macroeconomic policy, especially in the form of lower interest rates, permits successful readjustment to take place at the microeconomic level.

In all the Asian countries a special relationship between banks, companies and government plays a certain role in the explanation of the size of the problem of the banking system. But this is no reason for western arrogance. Responsibility for macroeconomic distress may be assumed to the government alone as it is the case in some of those countries which have not been hit by the world financial crisis. Other countries which could keep out quite well have different assignments of responsibility assuming a role for banks and big companies too. For the “rating“ of a country as a whole this is not a decisive factor. In the least analysis all groups of the society suffer in case of a big external shock like a devaluation or a overvaluation. Each society may decide how to distribute the effects of a shock among the different groups and individuals. In the history of mankind there are many examples to prove the fact that societies where consensus is the dominating rule instead of conflict can be quite successful regarding nearly any aspect of economic life. Asia provides the most outstanding example in the last 30 years – despite the big turmoil it had to go through in the last 30 months.

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