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forum

Asia's take on austerity

THE Asia Portfolio

BY STEPHEN ROACH

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 I 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 first-hand experience 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 panellists 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 panellists agreed on two points: first, they initially detested 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-5 — Indonesia, Malaysia, the Philippines, Thailand and Vietnam — plunged 8.3%. Real GDP in South Korea — long considered the darling of Asia's newly industrialised economies — contracted 5.7% that year. But then the tough conditionality 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-5, current-account deficits averaging 4% of GDP in 1996/97 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 1996/97 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-5 began a 10-year spurt of 5% average annual GDP growth (5.5% 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 exchange-rate 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-debt restructuring. 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 — or group of countries, in Europe's case — has ever devalued its way back to prosperity. So Asia's structural lessons are equally important to the developed world. Indeed, Germany's economy is outcompeting and out-growing the 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 Gyohten 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 palliatives and the commitment to a long-term strategy. That's where the battle still rages in the West. — *Project Syndicate* E

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Malaysia needs to maintain capital regulation tools

BY MICHAEL LIM MAH-HUI AND KEVIN GALLAGHER

Proposed measures in the new Trans-Pacific trade pact that the Malaysian government is negotiating could restrict Pacific nations from preventing and mitigating financial crises. Since March 1, the so-called Trans-Pacific Partnership agreement (TPP) — a proposed treaty by the US, Australia, Brunei, Chile, Malaysia, New Zealand, Singapore and Vietnam — has been under negotiation in Australia.

US President Barak Obama has pledged that this will be a "21st century" trade deal that discards many of the harsh conditions of past trade pacts. In the wake of the global financial crisis and with the memory of the Asian crisis still on our minds, any 21st-century trade deal should leave Pacific nations with all the tools necessary to prevent and mitigate financial crises.

Under the proposed deal, however, nations would not be permitted to regulate speculative capital flows to protect their economies from financial crises.

During the Asian financial crisis, Malaysia initially adopted the IMF's policy measures such as raising interest rates and reducing public spending to counteract the economic downturn. This exacerbated the problems. Raising interest rates did not stem massive capital flight and only contracted the economy.

In a change of course, in September 1998, the government introduced several capital control measures that included banning the trading of off-shore ringgit, which was contributing to the outflow of funds due to higher off-shore interest rates. It also pegged the ringgit at 3.80 to US$1 and imposed a one-year moratorium on the repatriation of proceeds from share sales (from the purchase date of shares) to discourage short-term trading of local shares.

Other measures included halting ringgit loans to non-residents, controlling the transfer of ringgit funds and the conversion of ringgit to other currencies except for the purposes of trade and long-term investments.

These measures were gradually loosened and capital now flows freely to and from Malaysia. But we must remember that they allowed the country to have the breathing space to pursue more independent and effective monetary policies. Together with other counter-cyclical fiscal policies and proactive debt restructuring measures, Malaysia recovered more quickly from the Asian financial crisis (indeed, this has been confirmed by US government-sponsored research as well).

Let us hope that the nation, or any other nation for that matter, does not experience such a situation again. But if the time does come, we will need all the possible tools at our disposal.

Malaysia has been careful to be sure that it maintains that breathing room in most of its other trade treaties. A recent study by the Washington-based Institute for Policy Studies shows that most free trade agreements among other TPP nations provide temporary safeguards on capital inflows and outflows to prevent or mitigate financial crises, or defer that matter to the host country's legislation. Indeed, Article 17 of the Malaysia-New Zealand treaty and Article 88 of the Malaysia-Japan treaty have such a safeguard.

However, the TPP would disallow Malaysia these policy options. According to the US proposals, all forms of capital — including derivatives, stocks, bonds and currency speculation — must be permitted to move "freely and without delay" among TPP countries. Moreover, rather than have the enforcement of these provisions be conducted by nation-states, the treaty would allow private firms to directly file claims against governments who have used them.

The experience of Malaysia and that of other countries demonstrate that judicious use of capital regulations is an important tool that countries should have in managing their economy. Indeed, there is a new consensus on capital regulations and crises.

A 2010 IMF report showed that such measures not only work 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 regulation to stem capital inflows to prevent crises from happening in the first place.

Citing this evidence, over 100 economists from TPP nations (including ourselves) sent a letter to their negotiators urging them to safeguard the agreement with the flexibility of using capital account regulations to prevent and mitigate financial crises.

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 since the Great Depression. E

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