20th Anniversary: Countries Affected by the Asian Financial Crisis Are Confronted with Common Issues Accompanied by Growth

— Japan Must Be a Successful Example of Tackling the Income Gap and Aging Population

Ohno Kenichi, Professor, National Graduate Institute for Policy Studies (GRIPS)

<Key Points>
- Criticism of East Asia's unsuccessful development model misses the point.
- Economic growth requires robust initiatives in both the private and public sectors.
- Leapfrogging may be possible for latecomer countries in the field of information technology.

Ohno Kenichi, Professor, National Graduate Institute for Policy Studies (GRIPS)

The Asian financial crisis started in July 1997, wreaking havoc on economies in the region throughout the following year. It had a devastating impact on countries like Thailand, South Korea and Indonesia, which had previously enjoyed strong economic growth, causing significant currency devaluation and a collapse in domestic demand. The debacle could be characterized as a new type of crisis caused by the massive short-term capital flows into countries where international capital transactions had become liberalized. What was the impact of the financial turmoil in the Asian region which has had a long history of economic development?

*** *** ***

Following the crisis, significant social changes occurred in the most seriously affected countries. For example, in Indonesia, President Suharto was forced to step down after 30 years in power. South Korea implemented a shift in its economic policy toward a liberal market economy from the previous one dominated by business conglomerates. In Thailand, initiatives were undertaken to change its industrial structure, followed by political struggles between pro- and anti-Thaksin groups that have become increasingly intense.

The International Monetary Fund (IMF) recommended severe austerity packages and interest rate hikes as part of bailout programs in response to this new type of crisis. However, this was later criticized for making matters even worse. Consequently, Asian countries have established the Chiang Mai Initiative (CMI), a multilateral currency swap arrangement among countries within the region without relying on the IMF funding, and have undertaken research on constructing an early warning system against future financial crises.

How did the crisis affect the growth trend in the region? The attached figure indicates trends of per capita real income for Asian countries, with the United States as the comparator. First, it reveals the shocking fact that Japan has fallen from its top position within the region since the economic bubble burst. In contrast, China has shown rapid growth, moving into the middle income range from the lowest position. This is the primary reason for the geopolitical change in East Asia.

Other countries and areas in Asia seem to have managed to maintain relatively high growth trends since the 1960s. Singapore and Hong Kong have continued to achieve sharp growth, along with Taiwan and South Korea, both surging in contrast to Japan's lackluster performance. However, even these countries have also seen a slowdown in economic growth in recent years.

Malaysia and Thailand followed upward trends that are less steep, suggesting that these countries have fallen into middle income traps. Indonesia and the Philippines are positioned further below with a much slower pace of growth. The per capita income for Vietnam has remained stagnant, failing to grow as quickly as China, although they adopted a similar single-party political system under communist rule.

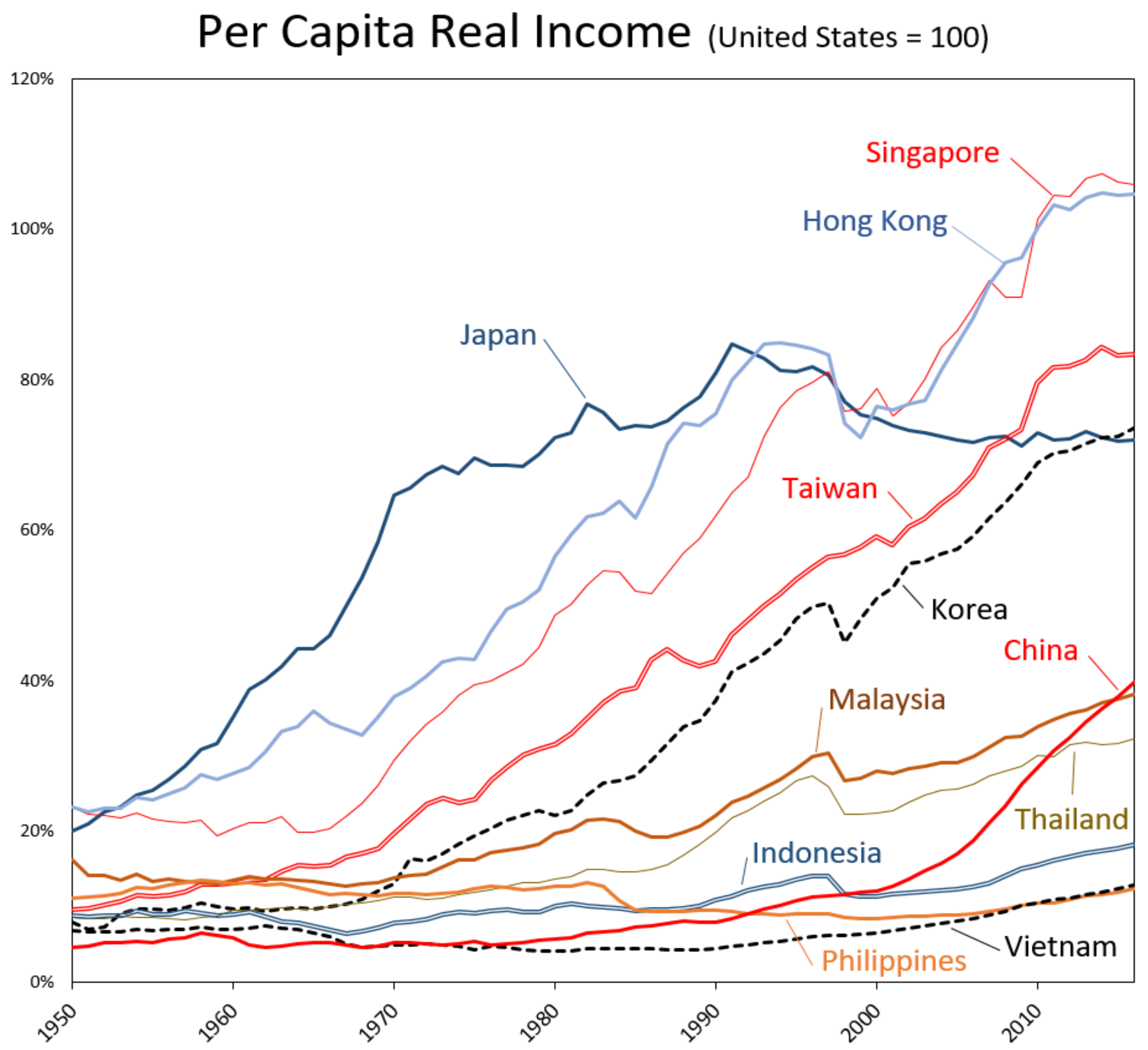
The Asian Financial Crisis did not seem to have a significant impact on long-term trends of per capita real income for individual countries within the region. Some temporary ups and downs in growth rates were seen across the region, from late 1997 to the beginning of 1998, but they did not affect their long-term trajectories. Japan's protracted economic downturn and China's rise also appear not to be directly related to the currency crisis in 1997-98 or financial meltdown triggered by the Lehman Brothers collapse in 2008.

Therefore, other reasons must exist for divergent growth trends experienced by the economies in the region, and the Asian Financial Crisis was merely a temporary shock in the long history of economic development in the region. Some experts argue that the crisis revealed the failure of the East Asian model of economic development, but such arguments miss the point.

*** *** ***

What determines the growth potential of individual countries? There is a range of factors including education and training, investment and savings, trade and investment, science and technology, innovations and the attraction of foreign capital. While each of these factors plays a significant role in determining growth, a dynamic private sector and the government's policy capability are the two fundamental requirements behind these factors that produce successful development.

A country with a strong private sector and a wise government can enjoy high and sustained economic growth. Meanwhile, if a country has neither of these elements, there is little hope for economic development. If only one is available, the country will probably fall into a middle income trap. The presence or absence of these two conditions in each economy can explain a large part of divergent growth trends in the **Figure**.



Source: Angus Maddison, *The World Economy: Historical Statistics*, OECD (2003), updated by author using IMF's purchasing power parity income data.

The long-term fate of a country is determined not so much by what policy is adopted but by the wisdom of the government in executing the policy and the responsiveness of the private sector to such policy. Under the circumstances, what governments can do is to learn seriously from international experiences to improve the quality of its policy and, if the private sector is weak, additionally to learn the way to energize it. This is not impossible but not easy.

In this connection, new types of economic activity have recently been added as possible drivers for climbing the ladder of economic development that was traditionally dominated by the manufacturing sector. This makes the region's industrial competition even more diverse and complex.

For long, Japan has been active in offshoring manufacturing capabilities within the region through direct investments in light manufacturing, electronic assembly, automobiles and machinery. Countries such as Taiwan and South Korea have followed suit. This "flying geese pattern," or ordered dynamism that facilitates industrial transfer from advanced to less advanced economies in the region, is still alive.

In particular, those countries that are ranked as low to middle income must diligently learn sophisticated manufacturing knowhow to further develop their domestic industries. In this respect, Japan is still a good teacher that can help with technical training, kaizen, quality control and how to build strong component producers for domestic mechanical assembly industries, which collectively constitute pivotal elements in *monozukuri* (Japanese style manufacturing). Japan could also earn reciprocal benefits from these countries as suppliers of manpower to Japan as well as receivers and inheritors of monozukuri spirit and skills. For higher tier countries in the region, on the other hand, sustainable growth requires not just learning existing manufacturing from others but invigoration of technological innovation.

More recently, however, new types of industry driven by information technology (IT) have emerged that do not generate orderly and sequential development from advanced to less advanced countries. They include the Internet of Things (IoT), artificial intelligence (AI), big data, financial technology that combines IT with personal finance (Fin Tech) and the sharing economy.

Players in these industries compete on creativity and agility to establish new markets and networks. Their success does not depend on the past achievement of the home country in traditional manufacturing featuring a complex pyramidal structure of suppliers to serve a parent assembly firm. This makes it possible for a latecomer country to overtake an existing leader. South Korea has become a leading country in IT. China is vigorously investing in R&D in advanced fields. In contrast, Japan has been slow in taking ambitious initiatives largely due to remaining government regulations.

Japan's electronics giants once ruled the world, but they are currently besieged by competition from foreign rivals. The Asian market of the 21st century is a place where any country, whether old timer or new comer, can be a winner. To become one of the winners, Japan must have clear strategies to reform existing industries and explore new frontiers. However, Abenomics, which is too broad and without consistent action plans, has not delivered an effective solution.

***   ***   ***

Countries across Asia are confronted with emerging issues caused by their economic growth. Those issues are not directly attributable to the Asian Currency Crisis but have become highly visible since the Crisis.

First, there is a widening gap between the rich and the poor within most countries. In Asia, some countries successfully achieved or maintained equality in people's income during the period of high economic growth. Others worsened or could not ameliorate income inequality while growing fast. The first group includes Japan, Taiwan and South Korea. Meanwhile, Thailand, Malaysia, the Philippines and China, particularly after the 1980s, belong to the second group. Countries such as Vietnam and Indonesia are about to join the latter group. More recently, even countries in the first group have begun to face new types of domestic gap as their economies have matured. If the inequality problem is left unaddressed, it will inevitably impair social stability.

Second, Asian countries confront with an aging population and declining birthrates. This demographic crisis is very acute in Japan. Countries such as Taiwan, South Korea and China are also experiencing the same. Other countries in Southeast Asia will surely face similar demographic challenges in a few to several decades.

If middle-income countries are unable to climb to high income and face the situation of "not yet rich but already old," the cost of providing social security and healthcare to all citizens will become colossal relative to the tax base. Will Japan, with its long struggle with the elderly problem, be able to provide model solutions to aging Asia?

Other problems generated by high growth and social change are environmental destruction, urban traffic and housing congestion, corruption, generational gap, and internal and international migration of labor. These are common challenges across Asia even though specific aspects of these problems depend on the stage of development or social structure of each country.

Asia today is much more complex and diverse than the sequential and well-ordered catch up industrialization formation of member countries observed in the past. Japan is no longer a sole industrial leader in Asia. This is not necessarily bad news, because Japan has long passed the development stage where the government can make people happy simply by pursuing business excellence or competing fiercely with China for the No.1 economic position in Asia.

The unfolding events since the Asian Currency Crisis have suggested the possibility of a new course for Japan in the context of Asia. Japan, with its long and deep experience as a latecomer industrializing nation as well as a solid member of advanced economies, should demonstrate new frontiers of social wellbeing beyond materialistic affluence, and explore them together with the Asian neighbors that are also rich or becoming rich. Japan's global and regional leadership in the 21st century must be built on this principle, not how fast it grows or what gadgets it can produce.

Translated by The Japan Journal, Ltd. The article first appeared in the "*Keizai kyoshitsu*" column of The Nikkei newspaper on 5 July 2017 under the title, "*Tsukakiki 20 nen mukaeta Ajia: Seicho ga umu kadai kakkoku kyotsu* — Kakusa, koreika Nihon wa han shimese (20th Anniversary: Countries Affected by the Asian Financial Crisis Are Confronted with Common Issues Accompanied by Growth — Japan Must Be a Successful Example of Tackling the Income Gap and Aging Population)." *The Nikkei*, 5 July 2017. (Courtesy of the author)

OHNO Kenichi, Ph.D.

Born in 1957. Graduated from Hitotsubashi University, Department of Economics. Ph.D. from Stanford University, specializing in development economics.
