

# East Asia in Transition

## Lesson 3: Economics

World War II devastated the economic infrastructure of many East Asian states. Cities, ports, and factories were demolished. After the war, millions of people were homeless and starving. Over the next three decades, East Asian economies slowly recovered. Beginning in the 1970s, several countries began to experience what is often referred to as the East Asian “economic miracle.” Indeed, since the 1970s, East Asia has had the strongest economic growth of any region in the world. However, in 1997, an economic crisis sparked a severe recession across much of the area. This crisis highlighted many of the economic challenges that remain.

This update examines the 1997 East Asian economic crisis. It then turns to two important case studies of economic change in the region—South Korea and China—and concludes with a look at regional economic integration efforts.

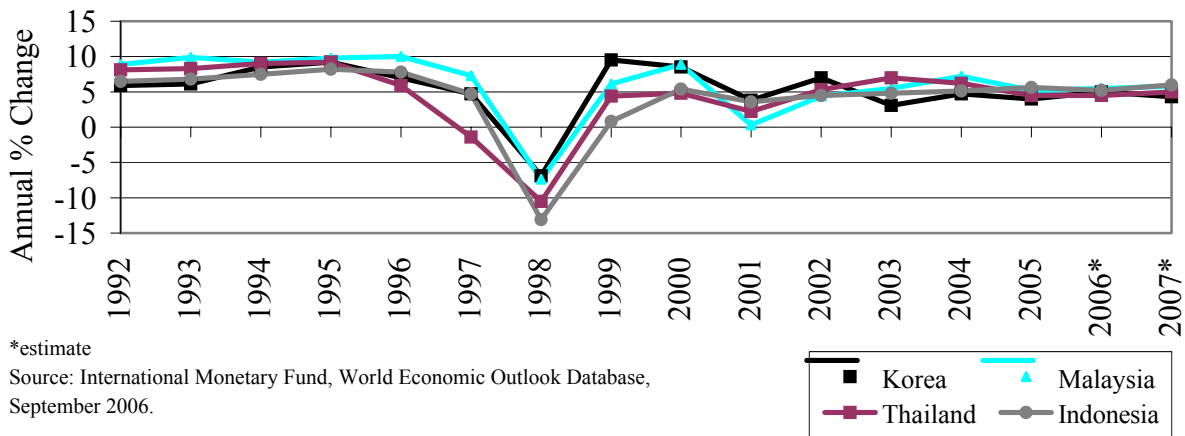
### THE 1997 EAST ASIAN ECONOMIC CRISIS

During the 1970s, 1980s, and into the 1990s, economic growth in East Asia averaged over 7 percent per year.<sup>1</sup> Japan developed the second-largest economy in the world. Hong Kong, Taiwan, Singapore, and South Korea experienced such rapid growth that they were dubbed the “Four Tigers.” Still, other countries lagged far behind. Also, in the countries experiencing strong economic growth, significant problems often arose. These problems included environmental degradation, poor working conditions, and extreme social inequality.

The 1997 East Asian economic crisis abruptly halted economic growth in many parts of East Asia. It started in Thailand and soon spread to Indonesia, South Korea, Malaysia, the Philippines, and elsewhere (see Chart 1). The crisis then spilled over the region’s borders into Russia, Brazil, and other developing economies. Some analysts blame the crisis on problems associated with the “developmental state” model and “Asian values” view (see Lessons 2 and 3 in *East Asia in Transition*). Others blame factors outside the countries, such as the international financial system.

Chart 1

### GDP Growth in the Hard-hit Countries



[Click here for larger view of chart.](#)

**Internal Problems.** Among the major causes of the crisis were the inefficiencies of the “developmental state” model. Japan was the first East Asian state to adopt this model, and questions over its superiority grew after 1990, when the Japanese economic bubble burst.

High economic growth rates prevailed during Japan’s bubble period in the late 1980s. However, this period was also marked by large, often highly questionable investments, especially in the area of real estate. Because of these unwise investments, many argued that Japan’s developmental state model had actually led to “crony capitalism.” In other words, politicians, bankers, and businessmen were supposedly working together to improve the economy. Instead, they made unsound, and sometimes corrupt, economic decisions. The public did not scrutinize these decisions, although they were often backed by public funds. Bad decisions led to bad bank loans, overbuilding, unsustainable growth, and overvalued assets. To keep money-losing companies afloat, Japan’s central bank has kept interest rates at close to zero since 1995, ensuring easy access to new loans.

Because of Japan’s strong exports and immense wealth, it has been able to keep the system going by continuing to pump money into it. However, the social and economic costs have been high. For example, low interest rates have placed a tremendous burden on life insurers and pension fund managers, who have to honor guaranteed returns as high as 6 percent.<sup>2</sup> Low interest rates also hurt Japan’s aging population. Many older people live on fixed incomes, savings, and the interest payments from investments.

An important problem for Japan is that politicians often block economic reform. These politicians have an interest in keeping the existing system going. Cronyism, excessive regulation, and bank loans to unprofitable businesses serve as a social safety net. This safety net preserves millions of unnecessary jobs. In Japan’s “dual economy,” the country’s efficient, export-oriented businesses subsidize less efficient, domestic-oriented businesses. The export-oriented businesses purchase goods at artificially high prices from the domestic-oriented businesses. For example, farmers and small businesses receive loans from government-backed banks. They then sell products to export-oriented businesses at prices higher than these businesses would ordinarily pay if they bought the same products elsewhere. Various special-interest groups that push these policies support the ruling Liberal Democratic Party (LDP). This support makes serious reform politically difficult.

Nevertheless, Japan has overcome the worst of its economic stagnation. It has been able to achieve this recovery mainly through exports. Between 1997 and 2002, the country averaged less than 1 percent annual economic growth. Between 2003 and 2006, it averaged almost 2.5 percent growth.<sup>3</sup> Still, because of traditional values and concerns about their country’s long-term economic recovery, the Japanese people have not increased their consumption of domestic products. This lack of consumption means Japan remains dependent on exports, especially to China.

In order to jump-start economic reform, Prime Minister Junichiro Koizumi called a special election in September 2005. This election challenged the Japanese people to support reform of the Japanese banking system or vote him out of office. The people responded with a mandate to break up and privatize Japan Post. In Japan, Japan Post not only delivers the mail, but also serves

as the largest bank. Most analysts believe this drive for reform must continue in order to ensure the recovery of the Japanese economy.

There are important differences between Japan and other countries in the region. However, many East Asian countries have suffered from problems similar to those of Japan. These problems include poor banking decisions, overbuilding, and bad governance in both the political and corporate sectors. Additionally, these issues played key roles in the severe economic downturns in Thailand, South Korea, Indonesia, Malaysia, and elsewhere in 1997. In several countries, political turmoil followed the economic crunch.

**External Factors.** Most analysts would agree that changes in the international financial system also played an important role in the 1997 economic crisis. During the late 1980s and early 1990s, the United States, Europe, and Japan pressured East Asian governments to remove restrictions on foreign investment. When countries such as South Korea, Taiwan, Malaysia, and Indonesia began to show exceptional growth rates, international banks and investors poured in large amounts of money. This investment led to overbuilding and overvalued assets.

The fact that these countries' currencies were often fixed in their exchange rate with the dollar encouraged this inflow of money. Fixed exchange rates protected investors from a big devaluation of their loans (that is, a loss in the value of a currency means a loss in the value of investor loans). In July 1997, however, the asset bubble created by risky investments burst in Thailand. The Thai government did not have adequate foreign reserves to pay for the loans the country had taken. It could not support the value of its currency, the *baht*. As a result, the Thai government was forced to remove the *baht*'s fixed link to the U.S. dollar. International banks and investors panicked and took large sums of money out of the country. They essentially called in their loans immediately. The *baht* quickly lost more than 50 percent of its value.<sup>4</sup>

Confidence is a very important factor in international finance, especially in an era when trillions of dollars can electronically move around the world in a day. After Thailand's devaluation, the "herd" of international banks and investors lost confidence in much of East Asia. They assumed that neighboring countries must share the same weaknesses. Indonesia, South Korea, and other countries were unable to prevent investors from pulling their money out of their economies. Some countries, such as China, Malaysia, and Singapore, were less affected by the Asian crisis. They were less affected in part because they maintained tight controls on the movement of capital. Some countries also possessed a large amount of foreign reserves to support the value of their currencies.

## **EAST ASIAN ECONOMIC DEVELOPMENT: AN OVERVIEW**

By 1999–2000, most countries affected by the crisis were recovering. This recovery was largely due to demand for their exports in China and elsewhere. Importantly, China was not hit hard by the crisis. China fared better largely because of tight restrictions on the flow of money in and out of its economy. The country was able to sustain its demand for raw materials and other imports from East Asian countries. As a result, East Asia has reclaimed its title as the fastest-growing region in the world. Indeed, the most important long-term effect of the crisis may have actually been political and economic reform. Still, the region's general recovery does not discount the

devastating economic and social costs of the crisis. Some of these costs are still being felt. Here, we look at two important cases of economic development in East Asia: South Korea and China.

**South Korea.** In 1997, after the onset of the crisis, South Korea found itself just days away from defaulting on its loans. It had to accept a \$58 billion bailout arranged by the International Monetary Fund (IMF).<sup>5</sup> As a result of the crisis, 23,000 businesses failed,<sup>6</sup> unemployment soared to its highest level in decades,<sup>7</sup> and the gross domestic product (GDP) shrank by almost 7 percent. To its credit, South Korean society—from the newly elected government to business leaders and labor unions—cooperated in implementing reforms to restore confidence and economic growth. The government forced many corporations (called *chaebols*) to restructure and lower their debt. It moved to strengthen the country's banks. For example, the government bought up many loans that would never have been paid back because the businesses were unprofitable. Importantly, banks also changed their lending practices. They began providing loans to more profitable companies as well as individuals. The strategy paid off. Between 1999 and 2002, the country averaged roughly 7 percent economic growth, despite a global economic slowdown. This led IMF officials to point to South Korea as an example of effective economic reform.

The December 2002 presidential election was a close race between those who favored more reforms and those who favored easing restrictions on the *chaebols*. In the end, the pro-reform movement won, but only by a very narrow margin. Still, growth rates averaged less than 5 percent between 2004 and 2006. Economic reform remains an important part of the South Korean agenda.

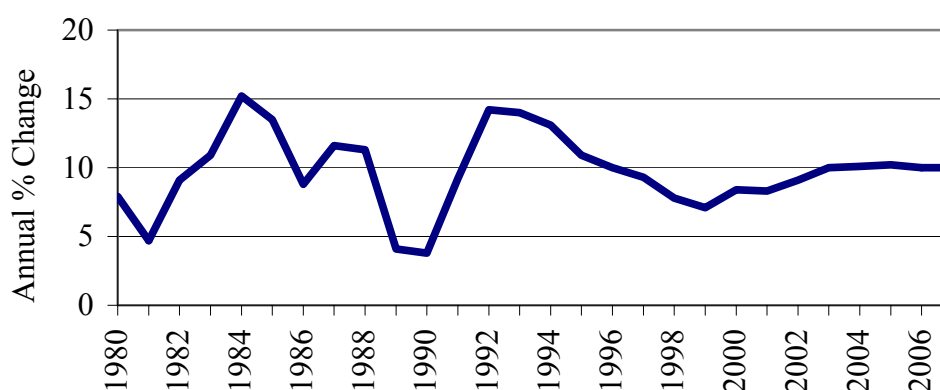
**China.** China has served as an engine of growth in the region and in the world for the last several years. However, it also has the potential to experience its own financial crisis. Indeed, when discussing the Asian economic crisis and its aftermath, communist China has several important similarities and differences with its East Asian neighbors. One key difference is that the economy remains heavily state-dominated. Thousands of state-owned enterprises (SOEs) remain largely immune from market pressures and foreign competition. This state dominance exists despite China's rapid integration with the world economy since the inception of economic reforms in the late 1970s. Another difference is that short-term investment in China is tightly controlled. While this control has its downsides, it helps protect the country from attacks by the "herd" of foreign investors.

However, as with several of its Asian counterparts, the country has severe banking problems, overbuilt assets, and significant problems with corruption. China's weak banking system stems from its loans to unprofitable SOEs. Most of these loans will never be paid back. Modernizing or privatizing SOEs is politically difficult because many of these companies would go bankrupt. Reform would also add to the tens of millions of increasingly restless unemployed people in the country. Instead, the government is counting on high growth rates coupled with gradual reforms to solve its economic problems.

China's economy has averaged roughly 10 percent growth per year since 1980, despite a slowdown following the 1989 Tiananmen Square massacre (see Chart 2). Although this amount of economic growth would be spectacular for many countries, China needs to sustain such a level

to lift its many impoverished citizens out of poverty. If growth falls below this level, domestic, social, and political pressures could threaten stability. Roughly 340 million Chinese, more than a quarter of the country's population, live on less than \$2 a day.<sup>8</sup> Rapid economic growth has also resulted in severe environmental problems. Economic inequality has increased.<sup>9</sup>

**Chart 2**  
**Economic Growth in China**



Source: International Monetary Fund, World Economic Outlook Database, September 2006.

[Click here for larger view of chart.](#)

Nevertheless, there is also a lot of dynamism in the huge and diverse Chinese economy. In many ways, China rivals Japan as the pivotal economic player in the region. Trade is a critical part of the picture. In 2004, China's total trade volume surpassed Japan's. China is now the third-largest trader in the world, after the United States and Germany.<sup>10</sup> Importantly, foreign-funded enterprises produce more than half of Chinese exports. These exports are primarily based on cheap manufacturing and labor.<sup>11</sup> China continues to attract a significant share of the world's foreign direct investment (FDI). In 2005, FDI in China topped \$72 billion.<sup>12</sup>

China is also increasing its level of imports at a record rate due in part to its December 2001 entry into the World Trade Organization (WTO). Under the terms of the WTO entrance treaty, China pledged to significantly reduce its import tariffs and take other steps to allow for foreign participation in its economy. By 2005, the average tariff had dropped to under 10 percent.<sup>13</sup> China is now the largest export market for South Korea and Taiwan.<sup>14</sup> Japan's recent economic recovery is partly due to its exports to China.

In the end, China is a paradoxical picture. It has inefficient SOEs, excessive state control, poverty, corruption, repression, and environmental decline. However, it also has high growth, booming trade, record foreign investment, and an expanding middle class. By 2005, China had the world's fourth-largest economy in terms of GDP.<sup>15</sup> Politically, the government has tried to adapt to dramatic economic and social change while maintaining the authority of the Communist Party.

## REGIONAL ECONOMIC INTEGRATION

Another important part of East Asia's economic picture is the move toward regional economic cooperation and integration. In East Asia, as in other parts of the world, economic integration is viewed as a way to accelerate economic growth and development. The rationale behind this view is that economic integration permits the formation of large market areas without restrictions on trade. Freer trade fosters economic growth and development through larger economies of scale and increased efficiency. Here we focus on two East Asian efforts at economic integration and cooperation: the Association of Southeast Asian Nations (ASEAN) and the Asia-Pacific Economic Cooperation forum (APEC).

**ASEAN.** ASEAN was formed by Indonesia, Malaysia, the Philippines, Singapore, and Thailand in 1967. Since its founding, it has added Brunei, Vietnam, Laos, Myanmar, and Cambodia. Today, the ASEAN region has 550 million people and a combined gross domestic product of more than \$1,030 billion.<sup>16</sup> The United States' annual total trade in goods with ASEAN states tops \$153 billion.<sup>17</sup>

According to its charter, ASEAN's aim is to "accelerate the economic growth, social progress, and cultural development" of its members and to "promote regional peace and stability."<sup>18</sup> Economically, steps have been taken to loosen barriers to trade between member states. In 1992, ASEAN members agreed to form the ASEAN Free Trade Area (AFTA). In the early and mid-1990s, foreign investment in the region grew rapidly. However, the pace of integration slowed because member states were reluctant to take steps that would undermine protected industries and national sovereignty. Also, because of the economic problems faced by several ASEAN countries, they were hit extremely hard by the 1997 economic crisis.

At the turn of the century, the ASEAN states were recovering from the economic crisis. By 2003, significant tariff reductions had been made among the members. In 2005, investment inflows were at record rates.<sup>19</sup> However, some countries, such as Singapore and Malaysia, receive significantly more investment than other countries within the organization. In addition, intra-ASEAN trade remains only a small part of ASEAN's total trade. Other challenges that face the ASEAN states include the extreme poverty found in many of its countries, and the continuation of the harsh military regime in Myanmar.

**APEC.** APEC is a much larger initiative. It was established in 1989 by twelve Pacific Ocean–bordering states (Australia, Brunei, Canada, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, South Korea, Thailand, and the United States). It has since grown to twenty-one members. The new members are Chile, the People's Republic of China, Hong Kong, Mexico, Papua New Guinea, Peru, Russia, Taiwan, and Vietnam. APEC is one of the few international bodies that have both China and Taiwan as members. It links 2.6 billion people, which is over 40 percent of the world's population.<sup>20</sup>

APEC's goal is to enhance growth and prosperity in the Asia-Pacific region. Its members want to eliminate all trade barriers among them by 2020. Member states are also working to increase investment and support economic reform. APEC has contributed to a number of bilateral trade initiatives among its member states since its inception. However, the Asia-Pacific region is

dynamic, huge, and complex. Numerous political and economic obstacles remain in the way of reaching the 2020 goal for economic integration.

Christopher L. Brown

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<sup>1</sup> World Bank, "World Development Indicators Online," GDP growth, <http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20398986~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html> (accessed January 16, 2007).

<sup>2</sup> "Japan Industry: Premium Problems," *EIU ViewsWire*, June 3, 2003.

<sup>3</sup> International Monetary Fund, "World Economic Outlook Database," gross domestic product, <http://www.imf.org/external/pubs/ft/weo/2006/02/data/index.aspx> (; accessed January 16, 2007).

<sup>4</sup> International Monetary Fund, "Exchange Rate Archives by Month," June 1997-February 1998, [http://www.imf.org/external/np/fin/rates/param\\_rms\\_mth.cfm](http://www.imf.org/external/np/fin/rates/param_rms_mth.cfm) (January 16, 2007).

<sup>5</sup> U.S. Embassy Seoul, "FY 2000 Country Commercial Guide: Korea," (U.S. State Department: July 1999), [http://www.state.gov/www/about\\_state/business/com\\_guides/2000/eap/korea\\_CCG2000.pdf](http://www.state.gov/www/about_state/business/com_guides/2000/eap/korea_CCG2000.pdf) (accessed January 16, 2007).

<sup>6</sup> "Address by President Kim Dae-Jung at the Opening of an International Conference on Economic Crisis and Restructuring in Korea," *KUSEC Newsletter* (Seoul: Korea-U.S. Economic Council, Inc., December 1999), p. 2.

<sup>7</sup> Asian Development Bank, "Key Indicators of Developing Asian and Pacific Countries 2000," (Manila: Asian Development Bank, 2000), part II: Country Tables: Korea, Republic of, [http://www.adb.org/Documents/Books/Key\\_Indicators/2000/default.asp?p=statpub](http://www.adb.org/Documents/Books/Key_Indicators/2000/default.asp?p=statpub) (accessed January 12, 2007).

<sup>8</sup> The World Bank: East Asia and Pacific Region, "East Asia Update," November 2006, Appendix Table 8: Poverty in East Asia- Country Estimates, [http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/550192-1163436396659/EAP\\_Update\\_Final\\_Nov06.pdf](http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/550192-1163436396659/EAP_Update_Final_Nov06.pdf) (accessed January 9, 2007).

<sup>9</sup> Ibid.

<sup>10</sup> International Monetary Fund, *Direction of Trade Statistics*, (Washington DC: International Monetary Fund), Yearbook 2006, pp.133, 214, 273, 509.

<sup>11</sup> Wayne M. Morrison, "China's Economic Conditions," Congressional Research Service Report (Library of Congress, July 12, 2006). [http://digital.library.unt.edu/govdocs/crs//data/2006/upl-meta-crs-9475/RL33534\\_2006Jul12.pdf](http://digital.library.unt.edu/govdocs/crs//data/2006/upl-meta-crs-9475/RL33534_2006Jul12.pdf) (accessed January 19, 2007).

<sup>12</sup> United Nations, "World Investment Report 2006- FDI from Developing and Transition Economies: Implications for Development," Appendix Table B.1: FDI Flows, by region and economy, 2003-2005, [http://www.unctad.org/en/docs/wir2006annexes\\_en.pdf](http://www.unctad.org/en/docs/wir2006annexes_en.pdf) (accessed January 19, 2007).

<sup>13</sup> Howard Winn, "Accession Has Brought Change to China and WTO," *The International Herald Tribune*, November 7, 2005.

<sup>14</sup> World Trade Organization, "Statistics Database-Trade Profiles," Korea and Chinese Taipei, September 2006, <http://stat.wto.org/Home/WSDBHome.aspx?Language=E> (accessed January 19, 2007).

<sup>15</sup> World Bank, "Total GDP 2005," July 1, 2006, <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> (accessed January 19, 2007).

<sup>16</sup> World Bank, "World Development Indicators," population, total, op cit; and International Monetary Fund, "World Economic Outlook Database, op cit.

<sup>17</sup> International Monetary Fund, *Direction of Trade Statistics*, p. 510, op cit.

<sup>18</sup> ASEAN, "The ASEAN Declaration," [www.aseansec.org/1629.htm](http://www.aseansec.org/1629.htm) (accessed January 19, 2007).

<sup>19</sup> UNCTAD, "Foreign Direct Investment Database," FDI Inward-flows, [http://stats.unctad.org/fdi/ReportFolders/ReportFolders.aspx?CS\\_referer=&CS\\_ChosenLang=en](http://stats.unctad.org/fdi/ReportFolders/ReportFolders.aspx?CS_referer=&CS_ChosenLang=en) (accessed January 19, 2007).

<sup>20</sup> APEC, "General Economic Indicators," December 6, 2005, [http://www.apec.org/apec/member\\_economies/general\\_economic\\_indicators.html](http://www.apec.org/apec/member_economies/general_economic_indicators.html) (accessed January 19, 2007); and Central Intelligence Agency, "The World Factbook: World," 2006, <https://www.cia.gov/cia/publications/factbook/geos/xx.html> (accessed January 19, 2007).