Is the Asian Flu Fatal?

Why Asia's economies got sick—and what can be done to cure them.

For most of the 1990s, East Asian economies were king, sucking up foreign capital and rewarding investors with handsome returns. Times change. The first signs of trouble came in spring 1997, when currency traders attacked the Thai baht. After belatedly attempting to reform its financial policies, Thailand abandoned its fixed exchange rate in June 1997, prompting the baht to plunge 20 percent. Other countries quickly followed. By November 1997, the International Monetary Fund had announced bailout packages for Thailand, Indonesia, and South Korea. Even the soundest and largest Asian economies were hit hard. Hong Kong, while repelling an attack on its currency, saw its stock market decline 40 percent in October. Japan, which had been deep in deflationary doldrums for the entire decade, saw its fourth-largest trading firm collapse under a pile of bad debt.

The sudden turn of fortune in Asia raises a host of questions: Why didn't anyone see this coming? What does this say about the Asian Way, and the Asian Miracle it supposedly produced? How should the IMF and the United States respond to the crisis?

While the first two questions make for interesting cocktail party chat, the last has been dominating discussion in Washington, where the Clinton administration is asking Congress to pony up $18 billion for the IMF's bailout fund. The debate over the IMF hinges on the relative harms posed to the international economy by "systemic risk" or "contagion" vs. the damage of "moral hazard." Proponents of the IMF argue that its virtue lies in the necessity of having an institution that can inoculate a region against "contagion" if a nation's economic system threatens collapse. As with the bank runs that took place in the United States during the Great Depression, if a country defaults on its commercial loans, investors may panic and pull their money from other countries in the region. Even though these national economies are fundamentally sound, this withdrawal causes a liquidity crisis as banks become unable to pay depositors; unless a third party such as the IMF steps up to provide needed cash ("liquidity"), the system can collapse.

Yet this risk must be weighed against the "moral hazard" the IMF creates. People who have insurance against broken legs, for instance, may be slightly more reckless skiers than those who have no health insurance and, in case of an accident, have to pay doctors' fees from their own pockets. In finance, investors will undertake more dicey investments if a portion of the real risk is insured by a third party which guarantees that it will repay investors, no matter how poorly they manage their money. By bailing out countries, the IMF
encourages unwise risk taking.

REASON assembled a diverse group of experts to address these questions in mid-February at the American Enterprise Institute in Washington, D.C. James K. Glassman, a Reason Foundation trustee, American Enterprise Institute fellow, and Washington Post columnist, led the discussion. The other participants were Contributing Editor Brink Lindsey, who runs the Cato Institute's Center for Trade Policy Studies and spent seven years as an international trade attorney, representing clients throughout East Asia; Robert Litan, who directs the Economic Studies Program at the Brookings Institution, where he has most recently focused on financial regulation; Sebastian Mallaby, who covered Asian financial markets for The Economist from Japan and is now the magazine's Washington bureau chief; and Allan H. Meltzer, professor of political economy at Carnegie Mellon University, a visiting scholar at the American Enterprise Institute, and a leading critic of the IMF.

James K. Glassman: What is the problem in Asia and how did it come about?

Sebastian Mallaby: The problem in Asia is the collapse of a financial bubble rather similar to the one that we saw collapse in the early 1990s in Japan, where the financial community had got into its head that asset prices would go up only and not down. Property became massively overvalued, Bank lending, collateralized on their property prices, increased massively, to the point that when one of these asset markets went down, the whole packet collapsed.

Brink Lindsey: I see the Asian crisis here as the harmonic convergence of three sets of bad policies that have all come together and come to a head.

First, you have the bubble that Sebastian alluded to. That bubble is the effect of bad policies that led to a coddled, backward, and protected banking sector that was used as often as not as a slush fund for politically influential borrowers.

The second set is the mismatch between monetary policies and exchange rate policies. You had countries that were attempting to peg their exchange rates to the dollar, while at the same time attempting to run monetary policies that were in conflict with that peg. So you ended up with this big spread between domestic currency interest rates and foreign currency interest rates. Thailand, for instance, was paying rates of 14 percent or 15 percent, which were significantly higher than the U.S. prime. It created this suction effect, sucking in foreign capital. Banks could borrow in U.S. dollars and basically print money by turning around and lending that borrowed money at a markup.

The third set of policies is that for all of these Asian banks borrowing, you had U.S., European, Japanese banks lending recklessly because of the moral hazard created by the expectation that if things went sour, the IMF or some international body would bail them out of their troubles.

Glassman: Did the Asian model of command-and-control capitalism help precipitate this crisis?

Lindsey: The Asian miracle really happened. We had irrational exuberance about Asian values and the Asian system and that they could do no wrong, and that everyone over there was 10 feet tall and bulletproof. Now we have a sort of irrational panic that the whole thing was a fraud and it was all just crony capital-

ism and a completely corrupt system from top to bottom.

The bottom line is, South Korea went from $100 per person income in the early 1960s to European standards of living today. Even in this recent mess, they have gone from 24 times North Korea's GDP per head down to 23 times. So the progress they have made is stunning and enormous.

And I would argue that the progress is due to the extent to which the economies in East Asia followed a few simple pro-market rules. They had decent respect for property rights, they were oriented toward the global economy, and so forth.

But nonetheless, these countries all had serious structural problems. Most notably, while they developed wonderful manufacturing sectors, they had lousy, backward, primitive, uncompetitive financial sectors. Maybe short-term capital controls can mask those problems, but they can't make them go away. In the long term, if East Asia is going to continue on this miraculous growth path, they are going to have to clean house in the financial sector.

Glassman: But specifically how did that structure contribute to the current crisis?

Lindsey: The banks lent to a bunch of unworthy borrowers. They lent to build factories that weren't needed. They lent to build high-rises that were never going to be occupied. There was an enormous misallocation of capital.

Glassman: Directed by the government?

Lindsey: Sometimes, yes. In the case of South Korea, in the case of Indonesia, credit allocation was often a matter of national industrial policy. But even in other situations, in Thailand, also in Indonesia, you have enormous amounts of capital allocation going through banks as opposed to equity markets. You have these small clubby banks that are all run by ex-government ministers lending to cousins or pals of the people in power. You have an entire system of taking those wonderful Asian savings rates and pumping them out into the economy in a way that just ignores market criteria.

Mallaby: I could perhaps add a bit to that with the specific case of South Korea, which is what I know best. It's to say that it's not just the Asian model which is a problem here. It's actually the attempt to get away from that model which in some sense causes the crisis.

In the 1970s, Korea industrialized through a process of government-directed lending. At that time, the banks were told to lend to heavy industry. This industry grew massively fast, rather inefficiently because money was being pumped in without really paying attention to whether these projects were viable.

Then in 1979, when President Park Chung Hee was assassinated, a new team of top economists took over, which represented a shift from Japanese-trained economists who believed in the Asian model to MIT- and Harvard-trained economists who did not. This new team of Western-trained economists decided in 1980 to get away from state-directed lending. They said to these chaebol [large corporate conglomerates] and banks, "We're not going to direct your lending any more." These guys had spent 10 years being told, "We are directing your lending," and therefore by extension, "If it goes wrong, we will bail you out." So when the state direction was eased off a little bit, the chaebol and the banks invested crazily, all over the
place. They went totally nuts.

The government put on the controls again in the 1980s. Then there was a period of relaxation and massive expansion of investment because the controls had been taken off. Then the government put on the controls again.

This is why South Korea has followed a boom-bust cycle since 1980. What I think is interesting here is the attempt to unravel the Asian model because it was perceived as long ago as 17 years ago, 18 years ago, to be a mistake. It proved extremely difficult because every time you tried to loosen state controls, investment would balloon again. This is actually what is going on in this current crisis.

The chaebol were enjoying a period of relative liberalization in economic policy in the middle 1990s. Because of that, they were allowed to do massive investment and finance these investments by this big borrowing, much of it in dollars.

When I was there, for example, in 1995, there were already too many car factories, but Samsung [one of the big chaebol] had just been given a permit to get into the car industry. And Samsung decided, "OK, we will build a lot of cars. We'll build a huge factory. We'll do all these other investments." Samsung's expansion plans proposed to add to South Korea's economy over the next few years the size of Sweden's whole GDP. That is what happens when you have got countries which are used to being directed by the government [that are] suddenly told, "OK, now you are free."

**Allan H. Meltzer:** I would simplify it down to three factors. The first was South Korea's size; it's the 11th largest economy in the world. In income it's the size of Los Angeles County. Now we would not think to have a banking system in Los Angeles County that was completely concentrated on Los Angeles County, because we would know that as soon as the entertainment industry went down, the banking system would go down.

**Lindsey:** The track record of IMF's conditionality is pretty miserable. The IMF is sort of like a substitute teacher. As soon as it leaves the room, the spit wads are flying and everything goes back to chaotic normal.

The second problem was that they compounded the problem by having, permitting, encouraging debt-to-equity ratios which were astronomical. There are companies there which have four times the amount of debt outstanding as they have equity, as compared to the heavily debt-burdened European companies, which have 80 percent, 80-20 split, or the United States, where it's about 15 percent.

The third thing is one aspect of the Asian model. While I agree with much of what Sebastian just said, I disagree on two points. One is that in the 1980s Korea picked the chemical industry, and it put a lot of money into the chemical industry. It turned out to be a bad investment. Most of the banks were left holding a lot of worthless paper.

In the late 1980s and the early 1990s, it was the semiconductor industry. Now part of that was a response to the U.S.-Japanese semiconductor agreement, which set a minimum price on semiconductors in the U.S. market for Japan. The Koreans decided to come in underneath that. The semiconductor market collapsed. They ended up owning a lot of paper from the semiconductor industry.

That is why Korea was in trouble a year before the stock market there was going down, down, down. Korean companies had really made a lot of investments which proved to be bad. Those investment decisions were made by the government.

**Glassman:** So do you think governments have learned that they shouldn't pick the chemical industry or the semiconductor industry or tell the chaebol how much they should invest or the banks how much they should lend?

**Meltzer:** I will light a candle and hope for the best. But I don't believe it.

**Mallaby:** I will look at Japan and observe that it has taken them an awful long time to get anywhere toward liberalization. They have been trying for a long time.

**Glassman:** Why did everyone miss what was going on? It seems to me a stunning misjudgment by almost everyone in the world.

**Robert Litan:** That's a $64 billion question. There were a few people who were producing a collapse or a major financial panic, although no one stuck their neck out saying when it would occur. The IMF at least is claiming that it was warning these countries privately but not publicly at least several months before the crisis. But this is a case where we have lots of irrational exuberance to go around. Alan Greenspan [who complained about "irrational exuberance"] among investors in the U.S. stock market, analogizing to the Japanese bubble] probably had the term right but the region wrong. I think Brink and Sebastian are right, that there was irrational exuberance by banks, by investors, by governments—they thought 7 percent or 8 percent growth would continue and trees would grow to the sky uninterrupted.

**Lindsey:** I don't think that there was a wholesale failure to see these problems. Anybody who is familiar with these economies knew they had rotten financial sectors, knew that there was endemic corruption, knew that there was a lot of crony capitalism, knew that the exchange rate pegs and macroeconomic fundamentals were in conflict. Yet you get lulled into 8 percent growth year after year after year. You start thinking, "Well, these problems exist but the virtues of these places seem to outweigh the problems." I think the moral hazard element tends to increase that lulling effect.

**Litan:** I was going to add one more thing that I think everyone missed: the suddenness and the severity of the problem once it became manifested. We had a classic case of contagion here, where even countries with strong fundamentals like Singapore and Taiwan, both countries with lots of reserves in the bank, got hit by the flu.

**Meltzer:** But that didn't last more than a few hours or days, Right?
James K. Glassman: I don’t know what the bankruptcy laws are in Mexico, but I think they are probably better than they were in Asia. I thought the whole point of what the IMF was doing was to use the money as kind of a carrot, a lure to get them to accept these kinds of changes. You can tell [Indonesian President] Suharto, “We’ll give you $20 billion, but you need new bankruptcy laws.”

Meltzer: Ten percent, something of that order?

Litan: Ten percent is not chicken feed.

Meltzer: No, no. But the market quickly did discriminate between those who were in trouble and those who were not. One of the things that has been left out here is the revaluation of the dollar. These countries peg [their currencies] to the dollar. They got the benefit of lower prices in Japan as a result of being pegged to the dollar. Then when the dollar revalued, they were in a less competitive position.

So I don’t think that their problems were unforeseen. As a matter of fact, lenders began to demand guarantees from the state long before the crisis actually broke out in the form in which we know it in the fall.

Glassman: You say that lenders demanded guarantees from the state. These were not explicit. What makes this different from what happened in Latin America in the 1980s is most of these loans were to private corporations or banks.

Meltzer: That’s right. But they said, “We won’t renew our loan unless you give us a guarantee on some of the private debt.” In the case of Korea, the government offered the guarantee on the private debt in order to keep the money from turning over.

Glassman: Capital was flowing into these countries before there were any kinds of guarantees by the governments themselves.

Meltzer: Yes. The reason for that is moral hazard. The banks didn’t believe, as far as I can see, that they were going to ever lose. So they didn’t ask for balance sheets, they didn’t ask how much was outstanding in loans. They didn’t worry about the fact that there was exchange risk that they would take. And the reason they didn’t do that is because they were expected not to pay for any defaults.

Glassman: So it was clear to investors that if things went bad with their loans to Korean banks, the Korean government would step up. Then behind the Korean government is somebody else [the IMF]. Do you agree with that, Sebastian?

Mallaby: First of all, it wasn’t entirely clear that the IMF would step up. When the crisis did hit, there was a lot of controversy, there was a lot of uncertainty about what would happen. I lived in Tokyo and I went to Korea a lot between 1992 and the end of 1995. I covered finance and I talked to bankers all the time. None of them ever told me, “This lending is fine because the IMF is going to pay this out.” They told me, “This is fine because these economies are very strong and they are growing very fast, and they can generate enough profits to service these debts.”

Lindsay: I am sure that you would be hard pressed to find investors that were saying, “OK, I have got nothing but upside here, and if these loans all go south, then the IMF is going to bail me out.” However, it’s hard to argue that you wouldn’t have seen dramatically different behavior if all of the European and U.S. banks that are currently exposed had gotten burned in Mexico and hadn’t gotten bailed out. If they had to pay up a few years ago, it’s hard to imagine they wouldn’t have been more cautious and more discriminating in how they diversified their portfolios in Asia.

Meltzer: I’m with Brink. How can you explain why people didn’t look at a spread between 15 percent and 20 percent interest rates and 4 or 5 or 6 percent interest rates and ask themselves why that spread is there? And how can you explain sophisticated lenders letting people borrow without showing the total amount of their debt and assets outstanding? These banks were lending without even asking for balance sheets.

Glassman: Mexico is cited by both sides in this debate. How do you characterize what happened in Mexico?

Meltzer: It was a success for the bankers. The bankers claim
Brink Lindsey: The Asian miracle really happened. South Korea went from $100 per person income in the early 1960s to European standards of living today. So the progress they have made is stunning and enormous. And I would argue that the progress is due to the extent to which the economies in East Asia followed a few simple pro-market rules.

Glassman: So let me give you an analogy. A family owns a house, bought it for $100,000 and has an 8 percent mortgage, and then suddenly they can't make the mortgage payments. Another friendly banker comes in and says, "I'll take care of the mortgage payments for you," but at 12 percent.

Meinzer: And at four times the mortgage. So we're not only going to give them more debt, more of their income is going to go to service that debt.

Litan: Well, there were contagion effects in Mexico. I agree with everything that Allan said. Mexico is certainly not in great shape. The question to ask is how much worse shape would it have been in if there had been no rescue at all. And that's the relevant question to ask for all the Asian economies.

In all these countries, the common element is they suffer loss of confidence, and their foreign exchange reserves are disappearing rapidly. The IMF comes along and says, "We're willing to lend you some foreign exchange reserves in return for a price." Then they impose all these conditions.

The conditions impose lots of pain. But the question is, when you are running out of foreign exchange and nobody has any confidence, are you better off to essentially let the market do its work and let the economy grind to a halt, with no trade, no foreign exchange? Or do you give it lender-of-last-resort assistance? My view of why the IMF exists is to be the international lender of last resort.

Glassman: So for you, Mexico was a success?

Litan: It was a qualified success. I say it was a success in the sense that Allan talks about. The loan was paid back. I think we avoided a larger contagion.

Mallaby: I agree with Allan, which is one of the reasons why I think that the moral hazard argument has to be stated very carefully. If you are saying correctly that Mexico has gone through a tremendous amount of pain since then, it's hard to argue that countries in Asia would have looked to the Mexican experience and said, "That's fine, the IMF bailed them out. We'll do this too."

The fact is that from the country point of view and from the household point of view, there is massive pain. The moral hazard argument applies specifically and only to the lenders.

Glassman: You didn't give me a final judgment on the Mexican bailout.

Mallaby: I think it's good.

Glassman: Brink?

Lindsey: Bob said that the Mexican bailout helped to quell or at least minimize a contagion effect. But in so doing I believe it provoked another one. Not only are the Mexicans worse off because of the Mexican bailout, but so are the Thais, the Indonesians, and the Koreans, because the message sent by the IMF after the Mexican crisis is a large contributor to the mess we have right now.

If there had been no bailout, you would have had loan workouts. The bankers who had lent to Mexico would have had to write off part of their debts. Mexico would have been relieved of part of its debt burden. Instead, it's now facing a greater debt burden than ever. Furthermore, you sent the signal that it's privatization of upside and socialization of downside the next
Sebastian Mallaby: We would love for there to be a great bankruptcy law in Korea and Indonesia, but there pretty much isn't any law in Indonesia. Since we're dealing with countries with a lack of the kind of transparency and rule of law and orderly mechanisms that we would all wish for, what do we do in the interim? Do we risk systemic collapse?

The system we need is one where the IMF is a lender of last resort. What we now have is a lender of first resort. We have someone who says, "I am going to lend to them at low interest rates in order to prevent the crisis," instead of saying what a true lender of last resort says: "I will lend on good collateral at a penalty rate."

Glassman: I don't know what the bankruptcy laws are in Mexico, but I think they are probably better than they were in Asia. Certainly the debt-converted-to-equity possibilities are probably better in Mexico than they are right now in Asia, where it's pretty hard for any American company to own anything in Korea. Would the nonbailout have been a solution in Mexico?

The problem in Asia is they have little or no bankruptcy laws. A clear policy goal is to get bankruptcy legislation in these countries and credible mechanisms that work. And we have to find a way to make banks automatically either take a haircut or have their debt converted into equity when some kind of certifiable crisis arises.

Mallaby: We have to be a bit real-worldish. We would love for there to be a great bankruptcy law in Korea and Indonesia, but there pretty much isn't any law in Indonesia, let alone bankruptcy law. Since we're dealing with countries with a lack of the kind of transparency and rule of law and orderly mechanisms that we would all wish for, what do we do in the interim? Do we risk systemic collapse?
to accept these kinds of changes. You can tell [Indonesian President] Suharto, "We'll give you $20 billion, but you need new bankruptcy laws." He says no. Then what is the next move?

**Lindsey:** The track record of IMF’s conditionality is pretty miserable. The IMF is sort of like a substitute teacher. As soon as it leaves the room, the spit wads are flying and everything goes back to chaotic normal.

Clearly these countries would all be better off if they had decent bankruptcy codes. My understanding is that in Taiwan bankruptcy is much more common. Perhaps that’s why they have avoided some of the structural problems that some of the other economies in Asia are now suffering from.

But the issue here is between the foreign lending banks and the Asian borrowing banks. I don’t see why in the absence of domestic bankruptcy codes, those banks couldn’t work out negotiations where the foreign banks agree to come up with some realistic payback amount and payout period, and lump it for the rest.

**Meltzer:** I think we are going to see that.

**Glassman:** Let’s say the IMF just disappeared. There was no IMF solution in Asia. What would happen?

**Meltzer:** There would be defaults. They would have to renegotiate the debt. Indonesia is already in default. There would be more of them.

**Glassman:** Would lives of the people who live in Indonesia be worse, or better? Would the Indonesian economy in the short term be worse or better?

**Meltzer:** The short-term effect would be small in either direction. Once the loans are renegotiated, then the people would be better off because they would be able to grow again without the problems of increased debt.

**Glassman:** Do you think there is systemic risk?

**Meltzer:** There is a systemic risk. It comes from the fact that we have a large amount of borrowing in foreign currencies, so that if we have a sudden withdrawal of those foreign currencies, there can be disruption in the system. The question is, Can we find a way to reduce that risk without at the same time imposing moral hazard? The proposals I made earlier are steps in that direction.

**Glassman:** Just to be clear, systemic risk comes from what, rolling default?

**Meltzer:** There are a lot of renewable 90-day loans. When you learn that his bank or your bank has decided not to renew its loan, and another bank has decided not to renew its loan, then you say there may be a crisis. I won’t renew my loan because things are not likely to get much safer and they might get a lot worse. So we get a whole lot of these loans withdrawn at the same time. That pushes the country into a liquidity crisis.

Korea had a whole lot of loans coming due in the first quarter. If it had gotten through the first quarter, it had no other government loans to banks and [foreign] governments coming due for the rest of the year—it had private loans coming due—and it would have gotten through the crisis. But they all got called at the same time, and that produces a crisis. There is a systemic risk there that we may be able to reduce and perhaps eliminate.

**Glassman:** Let me ask Brink if he would accept an IMF under those conditions.

**Lindsey:** I think we would be living in a much better world if we had that kind of international lender of last resort. I think it is certainly possible that global banks could band together and in their common interest set up institutions that would mimic precisely this kind of governmental body. But certainly this kind of governmental body would be a lot better than what we have now.

**Litzen:** If we were to abolish the IMF tomorrow, the U.S. Treasury would become the IMF or would be tempted to become it. There would be tremendous pressure on the United States to do it, at least for the large countries, the ones that are our friends.

Is the United States going to sit by with all these troops in Korea, and let Korea go down the tubes without an IMF? It is not going to do that. We are better off having the IMF do this than having the U.S. Treasury do it.

**Meltzer:** I think everything Bob said is exactly right. The Treasury would do it, and that would be much worse.

For most economic sectors there isn’t an IMF. There is no IMF to bail out car companies around the world. There is no IMF to come in and fix a retailing sector if your [Main] Street closes down. There is an IMF for the financial sector because the financial sector is special.

You can believe in free markets, as we do at The Economist, but you have to concede that there is something special about financial markets. If you allow one country in Southeast Asia to go down, and that country owes money to a neighbor, the neighbor will suddenly find it won’t be repaid that cash and it will go down too. You will have a crisis. [It] is not fundamentally a solvency crisis, as I think as Brink was saying earlier; we would still be fundamentally bullish about East Asia. I mean, these are economies which will probably recover from this and do pretty well. You don’t have a solvency crisis, but you do have a liquidity one. That is where the IMF has a short-term role in just stabilizing things.

Let’s take a different kind of risk contagion argument. Not from one country to another country, but [from] one area of the country to another. I am thinking of the contagion from the financial trouble to social unrest to political instability, then possibly to war.

In South Korea, nationalism is so acute that when a Korean woman dates an American diplomat for a year, a serious relationship where they are thinking about getting married, this girl gets locked up in her room by her family and told that if she
Robert Litan: There is going to be a lot more unemployment in these countries. There already is a growing backlash against the West. These countries don't have unemployment insurance mechanisms. You could have political instability in these countries which could move you away from markets toward more state control, toward more closed societies.

carries on with this American she's disgracing herself and she is disgracing all her siblings, who will never be able to marry anybody. We are talking about serious nationalism.

So let us suppose because of this nationalism that South Korea refuses to allow foreign banks to come and buy Korean banks. Under your rules, we would cut off all IMF assistance to this country. Since the Korean economy is interlaid with the chaebol, which dominate large chunks of GDP, you could get a massive bankruptcy because of a liquidity crisis, which would cause big social unrest. And you have got U.S. troops [in your territory] and a [neighboring] communist country with lots of soldiers on the border. Do you really want to risk that?

Meltzer: Yes. That's the only way you are going to get reform. You have to set up some rules. You tell people what the rules are. You enforce those rules.

Lindsey: I think it's pretty obvious that the Koreans do a fine job of overcoming their xenophobia when the alternative is meltdown.

Glassman: So Allan has given us his remedy for Asia. What is yours, Bob?

Litan: It's very similar. I think the IMF already has been press these countries to open up their banking systems. Allan wants to make a hard and fast rule from now on: You have got to be open to get the assistance.

The penalty rate I agree with. And inside the countries themselves, we shouldn't be waiting for the next crisis, I still think we ought to be pushing hard to have workable bankruptcy mechanisms in these countries and some kind of automatic haircut rules of the kind I mentioned.

And I think there is a role for judicious limitation by the countries themselves of excessive foreign borrowing, short-term borrowing. I think these countries clearly went overboard borrowing short term.

Glassman: Could this have a happy ending?

Litan: Certainly it could. Is there a chance for a bad outcome? Certainly there is.

We have not seen the end here. There is going to be a lot more unemployment in these countries. There already is a growing backlash against the West. These countries don't have unemployment insurance mechanisms. Korea is now working on one, but the other countries aren't. They didn't have these safety nets precisely because growth was bailing them out for 25 years. Now all of a sudden they don't have [it]. You could have political instability in these countries which could move you away from markets toward more state control, toward more closed societies.

Lindsey: Allow me to be cautiously optimistic. I don't think Japanese foot-dragging is necessarily a model for the rest of the countries in this region. Japan suffers from the advantage of having enormous domestic resources which allow it to avoid facing up to its own internal problems. These other countries don't, and perhaps they will do the right thing of having intense short-term pain in exchange for a longer-term gain.

I think it is quite likely that over the medium-to-long term, you are going to have significantly greater foreign presence of banks in these economies, and you are going to have significant financial liberalization so that equity markets in these economies are not so suppressed. You are going to see a lot more foreign players involved.

It's quite hopeful and even a little bit astonishing that all of these countries signed on to the World Trade Organization Financial Services Agreement last December. Ten or 15 years ago, the idea that any developing countries would allow foreign banks to come in even to a limited extent was unthinkable.

Litan: I agree with that 100 percent.

Glassman: And you think that that was the result in part of the problems that they are having now?

Lindsey: I think that certainly goosed things along.

Meltzer: Whether they'll let them operate there in a competitive way remains to be seen.

Glassman: Japan has been in the doldrums now for eight
Allan H. Meltzer: The role of people inside government is also to say, "It isn't my money. [Chaos is] not going to happen on my watch. Therefore, I am not going to let it happen on my watch. Why should I take the risk that my watch will be seen to have failed when in fact by using public money I can make sure that that doesn't happen?" That is really where the moral hazard arises.

years. If Japan could wake up its economy, then maybe these Asian problems would be solved very quickly. Is that an accurate characterization?

Mallaby: It's true that if Japan was booming right now, it could suck in Asian imports. That would help the Asians and [provide] the foreign currency they need to service their debts.

It is also true that if Japan was booming right now, it would be perhaps exporting a lot of capital through its banking system and other mechanisms into Asia. A nice flood of yen into the region would be wonderful because that would also buoy East Asian currencies and ease their debt service burden.

The problem is that Japan has moved during the 1990s from a position where it ran budget surpluses to a position where by some measures Japan's budget deficit is at 5.4 percent of GDP, which is the biggest of any of the G7 countries.

There isn't really much room in Japan for a big fiscal boost. The Japanese are just talking about a ¥1 trillion supplementary spending package. If you compare that to 1995, when they did two packages which collectively were worth more than ¥20 trillion, you see the scale of the problem. They have just spent so much money recently that they can't do much more about it.

And they have a demographic crunch coming which makes America's entitlement problem look like a picnic.

Glassman: What about a monetary boost, Allan?

Meltzer: There are three reasons why a monetary boost would be very good. One is you want to get asset prices rising. If you have asset prices rising, then the banking problem would look considerably smaller. The third thing would be [that] you would create some domestic demand.

Litman: I'm not sure I agree. Look, I don't disagree with the need for stimulus. But if I had to choose between the two, I would step on the fiscal pedal before I stepped on the monetary pedal, because a more expansionary monetary policy will lead to a lower value of the yen, which would provoke cries in the United States that Japan was trying to export their way out of their mess.

I would put more into the fiscal gas. They made a severe mistake by having that tax increase. At a minimum, they ought to get rid of that. They ought to, in my opinion, have more short-term fiscal stimulus.

Glassman: But these are not alternatives. They could do both.

Litman: Agreed. Doing both would keep interest rates from falling and thus depreciating the yen. Then the third thing of course is their banking mess, which we haven't talked about.

Glassman: What is the solution there?

Litman: Well, there are two basic models. One is the Resolution Trust Corporation model. At least for banks, an RTC mechanism would throw all the bad assets into essentially one liquidation outfit and sell off the healthy parts of banks, which are the deposits and the few good assets that they have.

Our banks and other foreign banks would be interested in buying "clean" institutions. But these dirty institutions full of bad debt and God knows what else... it's not clear if anybody would want them.

The alternative is the Reconstruction Finance Corporation model, which we used in the Depression. Under this approach, the Japanese government would invest a bunch of money in banks in order to prop up their capital.

The reason the Japanese have so far chosen the RFC model is that if they decided to take the good bank/bad bank approach, as a practical matter there are very few people or institutions in Japan that are healthy enough to buy the unhealthy stuff.

So as a practical matter, you would directly lead into Allan's favored solution, which I agree with in an ideal world. The only buyers would be foreign. You would have German and American and Swiss banks buying up all the Japanese banks. It would be great. As an economist's dream, that's exactly what should happen. They should follow this model. Politically, getting that to happen in Japan is exceedingly difficult, to put it mildly.

Meltzer: To put it mildly.

Litman: So that is why they chose the RFC model of injecting government money.

Now as a second-best alternative, I would still take the RFC model, which is what they are doing, compared to doing nothing at all.

Glassman: And meanwhile the problem with the banks, just
so everyone understands, is that they have all these bad loans, gigantic amounts of bad loans which they can't recognize. Correct? Otherwise the banks would be technically insolvent?

**Meltzer:** And the order of magnitude of that problem is probably in current dollars more than twice the size of the savings and loan problem here at its worst. It affects the whole banking system.

But that problem would be smaller if we had asset prices rising instead of falling. We shouldn't overlook the fact that as long as asset prices are falling or not rising, people say there is no rush to buy any real property because tomorrow it will be cheaper, and nothing much is going to happen to change that.

**Litzen:** I'm just going to make two quick points. One is that in the fourth quarter of 1997, the official total of problem loans in Japan was about $170 billion. Privately, the analysts will tell you the number is anywhere from three to four times that. So let's say in round numbers Japan's banks have $700 billion of problem debt.

In the United States, if you add up all the bank loans to American business—commercial and industrial loans—it's roughly $700 billion. So basically they have the equivalent of our entire commercial and industrial sector [in] bad debt.

The other beauty about an RTC solution, if you could ever do it, is that an RTC in Japan would end up inheriting at least a trillion dollars of real estate assets, which it would then sell. There have been virtually no sales of real estate in Japan for decades. You could open up the real estate market in a tremendous way, not only to foreigners, but to Japanese. Real estate doesn't move in Japan now because there are heavy taxes on the transfer. The government could sell all this real estate without the tax penalty, and could basically reshuffle the deck. It would be a dream come true, but I don't think we'll see it.

**Meltzer:** When we started to estimate what our savings and loan problem was, we got numbers like $300 billion. When we actually realized it, because we got asset prices to rise, it turned out only to be $150 billion.

**Glassman:** What kind of political problems here in the United States are going to be caused by Asia exporting its way out of this mess? We have already seen a group in Congress that's defeated fast track [approval for trade agreements], and that protectionist wing seems to be growing.

**Lindsey:** I think there is going to be a lot of hand wringing and name calling as the trade deficit rises. But I really don't expect to see any serious policy reversals here in the United States, any serious reversions to protectionism on account of this.

**Mallaby:** If Japan was booming right now, it would be perhaps exporting a lot of capital into Asia. A nice flood of yen into the region would be wonderful because that would also buoy East Asian currencies and ease their debt service burden.

Compared to the 1980s, where you had rising trade deficits and rising protectionist pressures, there are two big differences. One, U.S. industries have already been through 10 or 15 years of grueling restructuring. They are just much better poised to face the competitive challenge that's raised by this shift in ex-