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Asia and the Meltdown of American Finance

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The boardrooms and finance ministries of Seoul, Bangkok, Jakarta and Kuala Lumpur are today filled with a fair degree of schadenfreude at America's troubles. Schadenfreude is not a very nice emotion; Theodor Adorno once defined it as "unanticipated delight in the sufferings of another." But asking Asia's business and governing elites to repress shivers of pleasure at the meltdown of the American financial system is probably demanding more than flesh and blood can bear. The spectacle of the politicians, pundits and academics of Washington and Chicago thrashing about in attempts to justify the vast amounts of money being shoveled at their, um, cronies on Wall Street is just a little too rich. Particularly since much of the money will have to be borrowed from the very people who a decade ago at the time of the so-called Asian Financial Crisis were being pooh-poohed for their "crony capitalism," "opaque" banking systems, "incestuous" government-business relations, not to mention their supposed absence of transparent financial reporting, good corporate governance, or accountable executives and regulators.

Bank run of 1873

But the glee in seeing the United States hoisted by its own petard must surely be mixed with a good deal of apprehension. Not only because Asia cannot escape this crisis unmarked. But because the crisis could conceivably force Asia's elites to engage in the open political discussions they have largely avoided until now– discussions about the kinds of economies they expect to shape in the wake of the American debacle; discussions that carry with them all kinds of risks.

Countries most affected by the 1997 Asian Financial Crisis

The economic and financial dangers to Asia of the crisis need not detain us long for they are obvious. The region's stock markets are caught in the global downdraft. Asia's financial institutions are just as closely linked as those in every other part of the world to Lehman Brothers, AIG, Merrill Lynch and their devil's spawn of credit default swaps and "toxic waste" assets. We have already seen bank runs in Hong Kong and widespread layoffs by some of the regions' leading financial institutions. We are likely to see more of these troubles in Asia before the crisis plays itself out.

The United States appears headed into a recession that may be as bad as anything the country has faced since the 1930s. That in itself will spell trouble for a region that directly or indirectly relies on the United States as the final engine of demand. Japan last month, for example, ran its first trade deficit since 1982, something that is widely attributed to falling demand from the U.S.

But while this is all generally understood and prudent business and financial leaders in the region are already battening down the proverbial hatches, there is more going on here than simply the shrinking of the region's most important external market. For what we are seeing strikes at the heart of the entire process by which the region transformed itself over the past 50 years.

To be sure, Asia had little to do with the "sub-prime" mortgages, the slicing and dicing of rotten credits, the heads-I-win, tails-you-lose ethos on Wall Street that form the immediate causes of this catastrophe. But as Charles Kindleberger pointed out in his classic Manias, Panics, and Crashes, manias of the type that have just ended so spectacularly on Wall Street cannot occur in the absence of rapid credit creation. That credit creation in the present case stems directly from the ability of the United States to pawn off on the rest of the world an endless flood of dollar obligations, obligations that for a good forty years now have never been presented for redemption with anything other than more U.S. government paper. It has been so long now that the United States had to obtain the money to service its debts by the usual means – selling more goods and services abroad than are bought; borrowing in a currency controlled by the lender rather than the borrower – that its politicians no longer have any institutional memory of what it all implies: the hard trade-offs of falling living standards and forced savings.

Like an alcoholic's wife who furtively keeps her husband plied with booze while managing to avoid thinking about exactly what she is doing, Asia has long facilitated the U.S. addiction to drowning its problems in endless dollar cocktails. But the current crisis suggests that the days of cirrhosis of the American liver and delirium tremens are upon us. Without a clear grasp of the ways in which Asia's economic methods have facilitated American political pathologies, without a plan to replace

Asia's reflexive reliance on exports to the United States with another economic driver, Asia too will be drawn into the economic and political maelstrom that now engulfs Washington.

Asia did not set out to become America's pusher; it happened through historical accident and the logic of the situation rather than any thought-through strategy. To see this, we have to go back to the circumstances of the late 1940s. The United States had emerged from the Second World War with something over half the intact production capacity of the entire planet. But Washington was haunted by two fears: that the end of the pumped-up demand of the war years would mean the return of the Great Depression. And that a militant, monolithic Communism would capitalize on the war's devastation to bring much of the world under its control. The so-called Iron Curtain had descended to divide Europe and Korea, Mao Zedong's Communist Party had driven the American-allied Guomindang out of mainland China, while Communist-led anti-colonialist insurgencies were emerging in French Indochina and British Malaya.

The U.S. economic response was two-fold. First, at home, the United States adopted the new-fangled tools of Keynesian demand management to keep the country from sliding back into Depression. Meanwhile, abroad, the United States through such measures as the Marshall Plan and aid to Occupied Japan, essentially offered to finance on very easy terms the transfer of production capacity to war-devastated nations. And then agreed to accept the exports manufactured thereby without reciprocal demands for imports of American products. The notion that places like Japan could ever pose a serious economic threat to American industry did not occur to anyone on either side of the Pacific. What Washington cared about was that Japan and Western Europe not follow China and Poland into what was seen then as Moscow's orbit.

But the Keynesian synthesis that so electrified economists and policy makers of the time in the United States seemed to have little relevance to the challenges faced by an Asia emerging from colonialism and war. Keynes had addressed himself to the problems of a highly developed economy finding itself stuck in a trough of structural unemployment and idle production capacity; in 1946, Japan and Korea did not have production capacity to idle. Instead, there were two alternative models of development on offer. One was the Marxist-Leninist; the other went under the rubric of import substitution or dependency theory – i.e., that the goal of development ought to be the freeing of a country from dependence on foreign financing and imported capital equipment. Both called for state-directed capital accumulation and autarkic development, although the latter did allow for market mechanisms to function at the local level. Both boasted an extensive theoretical literature. In early postwar Asia, China would be the champion of the former, India of the latter.

Japan, however, adopted neither. With the United States providing the initial wherewithal to rebuild its economy (albeit at the price of aligning its foreign policy with Washington's and ensuring that leftists were kept away from the levers of power), Japan chose instead to engineer an economic structure that focused on the rapid accumulation of dollars so that it could buy the capital equipment it needed. This meant the deliberate channeling of scarce domestic savings into externally competitive export industries. It is here that we see the origins of the distinctive Asian model of export-led growth. The distinction between this and the import substitution model then being championed by India's Mahatma Gandhi and, subsequently, Jawaharlal Nehru may appear a semantic one in that both called for the development of domestic industry behind protectionist walls. But they differed crucially in their stance towards the existing global financial order. India sought to eliminate its dependence on that order; Japan to accumulate sufficient dollars in order to exploit it for its own domestic needs. Largely for geo-political reasons, the architect and designated caretaker of that order – the United States – was perfectly willing and even happy to see Japan use it to cement postwar recovery and join the ranks of the non-Communist developed nations.

I wrote above that Japan "chose" its postwar path of development, but this is not quite correct. It happened not, as in Beijing or New Delhi, through any deliberate choice of an overarching theoretical model, but because the pressures and opportunities of the time made it seem inevitable to Japan's decision makers. The priority of recovery from the war's devastation was so obvious that it required no political discussion to give it legitimacy. The war years had left Tokyo with an intact institutional apparatus that could be used to channel scarce financing into targeted industries – it was easy enough to redirect the flows from munitions makers to promising export industries. With the fortuitous (for Japan) outbreak of the Korean War, the United States suddenly began placing large orders for Japanese goods needed to equip its military. Thus through a process more akin to biological evolution than conscious political choice, Japan found itself in a niche that functioned well-nigh perfectly for the country in the economic ecology of the era.

The results exceeded anyone's expectations. Between 1955 when the final elements of the postwar Japanese system were put into place and 1969 when its growth began to alter the global economic ecology which had fostered it, Japan boasted the highest growth rates that had ever been recorded by any economy in human history. But the circumstances of its birth – its coming into being without any real debate on the matter or generally accepted theoretical foundation – help explain what is happening today.

The late 1960s provided the first evidence that things could not keep on going as they had without adjustment. The rigid international financial architecture of the time, labeled the Bretton Woods system for the small New Hampshire resort town where it had been hammered out in 1944, could not accommodate the emergence of Japan's export surpluses – joined to a lesser extent by those of West Germany – and their mirror images, the first substantial trade deficits run by the United States for a century or more. Attempts to rework the formal arrangements of the Bretton Woods system collapsed in the political chaos surrounding the Watergate scandals and the American defeat in Vietnam. The world economy limped through the rest of the 1970s until Paul Volcker was appointed Chairman of the Federal Reserve in 1979 with a mandate to do what it took to halt the inflation that threatened to destroy the dollar as a store of value. Japan's vote of confidence in Volcker's policies – snapping up U.S. dollar securities – permitted the rebuilding of the organizing principle of Bretton Woods: the dollar's central role in the international financial system. But instead of Bretton Wood's formal arrangements that required the United States to back the dollar by gold while other participants maintained fixed exchange rates with the dollar, the new system was predicated purely on the willingness and ability of the likes of Japan to continue to accumulate and hold stores of dollars.

Meanwhile, Japan's 25-year sprint from devastation to the front ranks of the world's industrial powers provided an overwhelming example to the region. South Korea, Taiwan and Malaysia all pro-actively adopted export-led growth strategies with concomitant suppression of domestic demand, undervalued currencies, and savings channeled into the development of internationally competitive industries. With the coming to power in 1977 of Deng Xiaoping and Beijing's tacit adoption of the Japanese economic model, the region turned decisively away from autarkic development models. Vietnam would arrive at the party in the late 1980s, and in 2000 India would formally abandon Nehru's legacy of import substitution to join in the scramble to build industries for export.

But not only did most Asian countries emulate Japan in making the highest national priority the building of internationally competitive export industries, they followed Japan in accumulating reserves in dollars – a trend that accelerated after the crisis of a decade ago. Most countries in the region, whether they had suffered badly (Thailand; South Korea), or largely escaped the worst effects (Malaysia; China) resolved they would never again be in a position where emissaries from Washington – or anywhere else, for that matter – would be in a position to dictate their macroeconomic policies or how they ought to structure their banking systems. They redoubled their efforts to build impregnable fortresses of international reserves against the slings and arrows of future balance of payments crises.

That effectively meant accumulating reserves in U.S. dollars. Aggregate two-way trade and investment flows between Europe and Asia are not large enough to permit the Euro to circulate yet in sufficient quantities in the region to see the Euro substitute for the dollar as the region's reserve currency, even if the region's businesses were willing to switch from dollars to Euros as their primary cross-border settlements currency. As for the yen, neither Japan nor China for separate reasons want to see the yen supplant the dollar in the region. China is not prepared to cede that kind of economic leadership to Japan, while the wrenching changes that the emergence of the yen as a major international currency would pose to the Japanese economic and political order insure that Tokyo will move to bring that about only when there is no alternative. (I discuss the reluctance of Japan to see the yen as an international currency here.)

But when a country accumulates reserves in dollars, it is effectively leaving its export earnings inside the American banking system where they can be used, among other things, to finance the building of houses for people who do not earn enough to afford those houses. The result is 7 figure salaries for gamblers with other people's money and tax cuts enacted while spending soars on entitlements and wars of choice.

The latest surge of dollar holdings in Asia on top of a generation of dollar accumulation in countries such as Japan and Korea coincided with the coming to power of the most fiscally irresponsible administration in American history. Not only did Asia's soaring dollar holdings help the George W. Bush administration avoid the usual financial consequences in ripping open the sutures its predecessor had stitched up between America's taxes and government spending. They also facilitated a horrendous asset bubble in American housing while Alan Greenspan's Federal Reserve watched idly from the sidelines.

The era of American "deficits without tears," in the famous phrase of the French economist Jacques Rueff, has ended with the Panic of 2008. The core institutions of American finance are collapsing. The United States is still – and will remain for some time to come – the world's largest and most productive economy. But it can no longer act as the world's engine of demand, no matter how many dollars Asia throws at it. For while those dollars may be "owned" by Asian central banks and businesses, they reside inside a ruined financial system whose panicked participants will not lend to those who need credit to keep their businesses running. As the Japanese can explain from their own experience of the mid 1990s, you can pour all the money you want into tottering banks and brokers, but when they are paralyzed by fear and will do nothing but lend back to the government, it does little for your economy.

The days of export-led growth for Asia are over (at least exports outside the region – intra-regional trade is another matter provided importers in the region can be found to equal exporters – and that the final demand is in Asia; i.e., exports of parts and supplies from one Asian country to another for finished products headed for the U.S. market don't count). As the Koreans and Thais can easily testify given their own recent traumas, the United States cannot recover from the mess it is in without more savings – another way of saying less consumption. That in turn means the U.S. after 40 years of profligacy will have to export more than it imports. For this to happen, much of the production capacity that has been steadily transferred to Asia over the last fifty years will have to be repatriated back to the United States so that Americans will have enough factories again in which to go to work to pay off the debts that their politicians and bankers so recklessly ran up. Otherwise, all those dollars Asia holds will quickly be worth very little. What, after all, is a dollar other than a claim on the output of an American? The Americans will have to have the means to create that output if the dollar is to have value.

Meanwhile, what of Asia? How is Asia going to wean itself from its dependence on the U.S. market? One lesson the world may finally learn from this crisis is that genuine, long-term prosperity comes not from continuously shoveling money at distant foreigners so they can keep buying your stuff. And certainly not from games playing and speculation by would-be plutocrats. But rather from a large, economically secure middle class – a middle class with the means to purchase the output of a nation's factories, farms, and service providers.

Here is where we see a connection between the meltdown of American finance and the political turmoil that has been wracking practically every country in the region. Each specific example has it own local causes and flavors: the struggle in Thailand over former Prime Minister Thaksin's buy-rural-votes-populism; the political insurrection led by Anwar Ibrahim in Malaysia against the entrenched UMNO elite; the seemingly out-of-proportion demonstrations in South Korea over beef imports; the palpable rage in China at the inability of the government to enforce safety standards in construction and food provision; the challenge posed by Japan's first serious, united opposition in 50 years to the Liberal Democratic Party's control of that country's formal political institutions.

But behind these varied struggles one can hear a common theme: a demand for accountable, responsible government that puts the interests of the middle class first. I wrote at the beginning of this piece that the political discussion necessary to restructure the region's economies carries with it all kinds of risks. We have been seeing those played out in the streets of Bangkok and Seoul or on-line behind the firewalls that Beijing builds in its attempts to contain and control discussion of China's future. These struggles threaten, among other things, the workings of essential economic machinery, as Thailand's tourist-related businesses can readily testify. The struggles provide a profound challenge to elites that are accustomed to effecting minor corrections behind closed cockpit doors to national trajectories that have long been taken for granted.

But the meltdown of American finance has closed the destination of an economy humming with industries for export. Whether Asia's economies have the political will and ability to chart a new course will determine how they ride out the present storm.

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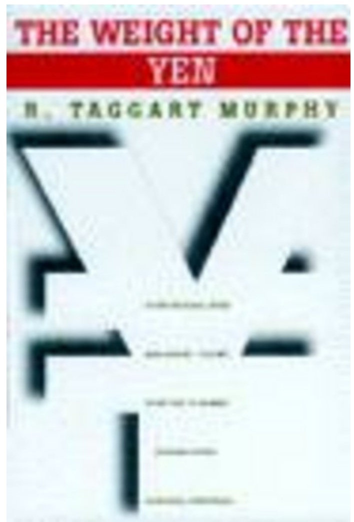

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