



NORTH-HOLLAND

Lessons From the Corporatist Crisis in Some Asian Nations

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1. INTRODUCTION

I have eight points to make on what I see to be the main causes and main effects of the recent financial crisis and the desirable direction of economic reform.

1. First, *rapid change* in investment flows—both flows to individual domestic industries within a market economy and flows to individual countries operating in a global market economy—is a *normal feature* of our traditional *competitive equilibrium* models of intertemporal resource allocation.¹ Investment's moving finger writes, then moves on. In this respect—through the removal of policy barriers to capital movements and the leaps in the information technology—the real world has been moving to catch up to theory.
2. Second, a typical result in these traditional models is that the intertemporal equilibrium path is *efficient*: the equilibrium path does not contain any wasteful behavior whose correction (through taxes and other interventions) would enable everyone to be better off. So when we observe the rapid subsiding of a capital inflow into some country, this may only reflect that the economy receiving the flow is rapidly reaching the largest stock of capital it can justify in view of the global cost of capital.
3. Third, if, in *fact*, there is *excessive* fluctuation in international investment flows, which I do not doubt, this implies that

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¹After the early work of Fisher (1909), Hayek (1926), Ramsey (1928), and Hotelling (1930s), there was a wave of heterogeneous-capital-goods models by Samuelson and Solow (1956), Malinvaud (1950s), McKenzie (1960s), and others.

some (or all) countries in the global economy are either *far from equilibrium at times* or else their economies fall *critically short of perfect competition and perfect information*—or both. I am going to argue that in parts of east Asia *both* of these factors have operated in the 1990s (even earlier in some countries) and interacted to produce particularly bad results. In contrast, some observers emphasize the first failing to the exclusion of the second, and others bring up the second while downplaying the first.

4. To me, it is compelling that a long *disequilibrium* lay at the root of the collapse that some Asian economies have experienced—notably Japan and later South Korea. In this “story,” the heads of the enterprises (including the big conglomerates) developed *unsustainable expectations* (more precisely, *unsustainably optimistic expectations*) about the future returns on the investment they were undertaking and/or about the future interest rates on the loans they were getting from domestic banks.² (By unsustainable here I mean that the expectations were self-disappointing, so they would be abandoned sooner or later.) In the enriched version, nicely sketched by Paul Krugman, the domestic banks had unsustainable expectations about the capacity of the government to make good on its implicit loan guarantees in the event that a large quantity of these loans went sour.³ As a result, there was a domestic asset–price inflation, including, very importantly, a rise in the *real prices of non-tradable capital goods*, which drove the production of nontradable capital goods above its equilibrium path—and thus total employment above its equilibrium path. When these expected returns began to look unrealizable, and furthermore, when the banks saw they had to call in loans or raise interest rates, as the government could not guarantee on the expected scale, the real prices of these assets had to fall back. With the asset–price bubble punctured, it is clear that these real prices would have to fall at least down to the “reference path” that would have prevailed had the disequilibrium “bubble” never got started—and employment would have to fall at least back to *its* reference path.

²This goes back to von Mises (1926). The inessentiality of money to the argument was later emphasized by Hayek (1939).

³The Economist, January 1998.

We need more than that, though. We want a model that shows how the boom creates the seeds of a genuine *slump*—that shows why these asset prices and employment will *overshoot* their reference paths to reach a depressed level below where it was when the bubble started. How can we argue there will be a hangover after the party? *One* way is to recognize that the workers, having enjoyed elevated employment and wage rates during the disequilibrium, have become richer as a result than they otherwise would have been, so they cannot be persuaded to drop back to the wage rates they would have accepted now had the bubble never happened.⁴ (As a matter of fact, I suspect that in Korea the disequilibrium itself had roots in upward pressure on wage rates as workers became ever more comfortable over the years: the government, desperate to keep the prosperity going in the face of rising labor costs, resorted to encouraging the banks to fuel the investment boom.) *Another* way is to recognize that the cumulative “overinvestment” caused by the bubble may be contractionary: it causes a fall in the relative price of the goods, such as memory chips in the semiconductor industry, that the domestic capital produces—and that translates into a fall in the “real (consumption) wages” that employers can pay at any given level of employment, which is very possibly contractionary.⁵ (Note, however, that if all wealth is held in the form of ownership claims to chips or the capital that makes them, and if all payments (like wages) and entitlements are paid in such chip claims, the drop in their relative price does not necessarily matter at all; to ensure that it matters, we had better suppose that the workers hold their wealth in diversified forms, so they will not accept a cut in real consumption wages in proportion to the drop in the real price of chips.) The *third* main way—and maybe the only important remaining way—is to recognize that the domestic banks are not receiving the anticipated flow of interest and repayments on the loans they extended, which makes it hazardous for creditors to lend to them (the banks), so these banks can no longer make the normal volume of new loans. And with fewer firms able to put up

⁴This is in the spirit of the models in Phelps, *Structural Slumps* (1994).

⁵Perhaps Hayek might be cited here. On the factor of asset diversification see Phelps (1994).

collateral, industries find themselves less credit worthy.⁶ *Finally*, there may be “malinvestment” in composition of capital.

5. The *seriousness* of the disequilibrium, as measured by the size of the internal imbalances left in its wake—the amount of added wealth, the amount of the overinvestment, etc.—will tend to be *less* when the lenders and share buyers of the economy have easy access to extensive and timely information than when they have to “shoot in the dark.” Hans Tietmeyer told a conference in New York that he had talked to Western bankers who clearly knew “nothing” about some of the Asian countries in which they were lending. That may be counterintuitive to economists, because we were brought up to think that the business of banks is monitoring (which is less and less needed these days, which is why they are losing out to the commercial paper market). But my reading of the theoretical finance literature is that it may be rational for a large and diversified lender to lend to some borrowers under considerable ignorance about their balance sheets, income statements, and the rest.

My proposition (which I think is obvious) is simply that in the event of excessive or misdirected investment such that a crisis of some size or other is going to follow, it is good that the crisis come soon—the sooner the better. Then internal imbalances will not build up to so large a size. If the true situation of the borrowers is not left obscure or kept hidden from the lenders, then old lenders will tend to recall loans sooner and new lenders will not be gulled into lending out of ignorance about the size of the lending already done by other lenders.

I think it is also possible to argue another proposition—even if it seems contradictory to the above proposition. As Keynes emphasized, in economies where there is extensive ignorance about conditions and current results at firms, the beliefs on which profit forecasts are based on “flimsy”: the smallest tid-bit of new information may set off a small panic or mania. In a highly uninformed economy, then, both booms

⁶The banks’ balance sheets and firms’ creditworthiness have been a focus of Stiglitz since the mid-1980s. A new paper by Aghion and collaborators (1998) rests the slump on the latter factor.

and slumps are quite precarious. So although the mean duration of booms and slumps is long on that account, the variance of the duration may also be great. The economy is volatile.

6. The above account of the collapse in some east Asian economies is entirely a nonmonetary story in the sense that money and nominal variables play no essential role. The contrasting *monetary* story is that when the overindebtedness and consequent loss of confidence came, some amount of nominal exchange-rate depreciation was appropriate to augment the real exchange-rate depreciation that was occurring in order to boost employment from its depressed level; and an adequate depreciation was resisted by national governments and effectively precluded by the tight-money policy required by the IMF in return for its loans.

Possibly nominal depreciation can serve to substitute export production for non-tradeable investment-goods production while the “internal imbalances” I described above are being worked down; but his Keynesian stimulus is apt to wear off as money wage and price levels adjust. And you have to wonder whether in a state of corporate indebtedness and bad loans at the banks, firms will be willing and able to invest in additional overseas customers or new markets.

Would a nominal depreciation hasten the end of the internal imbalances? Yes if, say, it could induce the labor unions to accept a lower real wage at a given level of employment—that is, if it shifted down the real-wage setting curve. That would happen if the resulting inflation materially impoverished the workers, but I am not sure that such a step would be justified. And, yes, it would do so if it could restart lending and investment. It may be that a rise in the price level, in reducing the real indebtedness of the firms, would improve their creditworthiness and their investment demand, but in reducing the real value of the banks’ assets it might further weaken their willingness or ability to lend.

7. I come finally to reform of the international credit system. What started me on that subject was the feeling that the global system needs a *new institution* to disseminate timely information that would help to curb asset–price disequilibriums before they create serious imbalances. The IMF can not be expected to be willing in all circumstances to broadcast to the world the extensive information it might be able to collect from a member country on the corporate income,

corporate balance sheets, conditions of the banks, etc., because the Fund would know that by publishing such information it might precipitate a crisis that the country might contend it would otherwise have escaped (with some luck, at any rate). The private credit-rating agencies, such as Moody and Standard & Poor, can not be expected to do the job, because if they were to agree to publish information or adjust ratings to warn markets of a crisis in some country each agency would have an incentive to depart secretly from that policy by offering more lenient terms to one or more clients of the other agency to win them away; so the policy of being tough on clients would soon unravel.

The innovation I have in mind is an institution that would gather information of interest to lenders and investors on emerging market countries, and that would disseminate that information to the Western banks and investment funds that were the subscribers or owners of the institute. After all, in Britain and the U.S. the central bank began as an entity owned by the private banks. So, to some extent we are just reinventing the wheel here. Smaller banks and funds would not be able to afford this service, so they would be in the market for the services of a second-tier institute that would collect less information and be less costly for the subscribers or owners. Two selling points: a bank would be uncomfortable about not subscribing; it would smack of failure to exercise diligence in a concrete, detectable way. And an emerging market economy would think twice about refusing to provide information, because doing so would risk a pull-out by the Western lenders and investors.

I am not sure, though, that this sort of innovation will fully solve the problem unless pressure is put on the emerging market economies to meet improved standards of information gathering and dissemination. Imaginably, the OECD countries could withhold access to Western capital to a country as long as that country insists on withholding the desired financial and economic information. Students hearing such a proposal look shocked. They think the advanced capitalist economies have no right to demand of another economy that it reform itself in their image. That is muddled thinking. Each of us in our business transactions demands of other parties that they behave in a certain way if they want us to be a customer, and certainly the friendship we extend others is

likewise conditional. (Ford entering an agreement with a supplier—an agreement in which agents acting for it would be making transactions with agents acting for the supplier—would certainly require the supplier to agree to certain rules and standards.) A restriction on what the advanced countries may demand of prospective partners in trade and investment would also stop the socially useful pressure on potential partners to raise their standards to an acceptable level for their own benefit and that of the rest of the global economy.

The real difficulty with this approach is quite different. Western financial interests would also be damaged by the application of the penalty. So announcement of the penalty might not have enough credibility to be effective. And the Western nations have all sorts of particular relationships with the individual emerging-market nations, so those nations could play off Western countries against one another. So, again, there may be a problem of credibility. Nevertheless, the West is within its rights to request and to demand that the emerging market nations raise their financial standards for the benefit of all members of the global economy.

8. Finally, I acknowledge that some *other* commentators on the collapses in east Asia—some of them economists, some noneconomists—also start from the hypothesis of disequilibrium. They also believe that unrealizably rosy expectations created the boom, and when they were finally corrected the boom gave way to bust. Unfortunately, the commentators I refer to draw the conclusion that it is *unregulated global capitalism* that is responsible.⁷ I find their reasoning to that conclusion unconvincing, and I want to dissociate myself from it.

- (a) The premise in *some* of this commentary is that the arrival in east Asia of capitalism, with its famously *uncoordinated entrepreneurs and financiers*, planted the problem: Asian companies and Asian banks came to be over-optimistic, as capitalist entrepreneurs and financiers are prone eventually to do.

But East Asia as a whole is not very capitalist, and the Asian economies suffering the most are the least

⁷This camp includes, among economists, Dani Rodrick and Jeffrey Sachs and among noneconomists, Robert Samuelson and George Soros.

capitalist. Capitalism means that private capital is king; it is free to enter most or all industries and free to exit, with no need for a license from the state or a seal of approval to show a bank to get a loan. Capitalism does *not* mean a “free market”—an economy in which nothing is taxed, nothing is subsidized, and nothing is regulated; on the contrary, to function with efficiency and dynamism capitalism *requires* regulations ensuring transparency, disclosure, bankruptcy, etc., and to function fairly and peaceably it may *require* subsidies for the employment of workers of little education or marketable abilities. Some of the stricken east Asian economies appear to be still somewhat closer to the *corporatist* system of the 17th century Mercantilists and the 20th century Fascists. The governments in these Asian nations exercise considerable guidance over the direction of investment by greenlighting the finance of approved investments and not greenlighting others. In east Asia, moreover, the worst contractions are in the more corporatist economies—Korea, Indonesia, Malaysia, and perhaps Japan—while we find little or no contraction in the more capitalist economies—the Philippines, Taiwan, Australia, and New Zealand. (Hong Kong is an exception—it is capitalist and it has contracted, but it has been hit by unusual external forces.)

- (b) The alternative premise, found in other parts of the anti-capitalist commentary, is that the financial crisis originated in the system’s *financial center*—the West—which directs huge movements of capital *in* and *out* of the “periphery”—Asia, Russia and Latin America—at the drop of a hat. Some of these commentators rest their case or supplement it with the argument that Western lenders and investors have been emboldened by the bailout machinery they instituted with the creation of the International Monetary Fund.

But, if the instability of international flows lies in the erratic push of capital from the center rather than erratic pulls inside the periphery, how do the commentators explain that in the 1990s international flows to east Asia shot up far more than flows to Latin America did? And how do they explain that within east Asia some economies received far more flow than the others; and that,

to repeat, it was the more corporatist economies that were the biggest takers.

So, to me, the troubles in east Asia are a *crisis of corporatism*, not a crisis of capitalism. That also seems to be the lesson drawn by Singapore: its new policy is to open wide its doors to inward foreign investment and to loosen restrictions on doing business there to attract more overseas firms.

It is true that nations and regions in the world have to be seen as competing for the world's savings. The opening of the East to the global marketplace over the 1980s kept world real interest rates very elevated (whatever drove them up sharply to begin with), making it tough for western Europe and the rust belt of the United States to regain its former levels of employment.⁸ When in the 1990s recession struck western Europe and North America, lenders and investors had a larger flow of capital to provide the East, and many economies there boomed; and when that slump ended in the U.S. and lessened in parts of Europe, lenders tightened credit to borrowers in the East. But it is not the fault of the West and its capitalist system that east Asia got the lion's share of the increase in the capital flow, and that when the overlending and overinvestment came to light the inflow from the West came to a sudden stop.

⁸Fitoussi and I stressed this thesis years ago (1986, 1988) and portions of my book *Structural Slumps* (1994) recast the argument in terms of purely nonmonetary models of the equilibrium unemployment rate path.