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The Asian Financial Crisis 10 Years Later: Time to Reaffirm Economic Freedom

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This summer marks the 10th anniversary of the 1997 Asian financial crisis. The 1997 crisis triggered extensive economic and political unrest in emerging Asian markets, sending many countries from Thailand to South Korea into recession. At the time, one common interpretation was that the crisis debunked the "Asian Miracle." Capitalism and globalization were repudiated and blamed for the bursting of currency and property bubbles and the resultant difficulties.

The 10 years since the crisis have shown that this interpretation was exaggerated. The countries that were most affected by the crisis have been recovering by embracing the free market and globalization. Asia is once again the most dynamic region in the global economy. In hindsight, the 1997 crisis was nothing more than a regional recession, a transitory setback that spurred more openness and transparency.

Continuing economic recovery will depend critically on further strengthening of the institutional framework of the regional economy. Advancing economic freedom is the way forward, not only to reduce vulnerability to future crises, but also to establish the institutional infrastructure essential for dynamic and sustainable economic growth. It is in America's interest to pursue policies that encourage such progress in these countries. Indeed, it should be a strategic, integral part of U.S. foreign policy in Asia.

Asia's economic environment has changed dramatically in the past 10 years. Most noticeably, China has catapulted itself onto the global stage by flexing its economic and political muscles. In this new environ-

Talking Points

- In retrospect, the 1997 Asian financial crisis was just a transitory regional recession that spurred much-needed reforms that increased openness and transparency.
- The Asian countries should use this 10-year anniversary to solidify their ongoing recovery by bolstering their commitment to greater economic freedom.
- In this new environment in which some fear that America's economic leadership in Asia is fading, the U.S. should seize the opportunity to reinforce its vision of economic freedom and prosperity in the region.
- Growing protectionist sentiment in Congress will only undermine U.S. economic diplomacy in Asia, which is home to many vital U.S. allies.
- To strengthen American leadership in Asia, expand economic freedom, and counter China's growing economic influence in the region, Washington should support countries' efforts to increase their economic freedom, and Congress should renew the President's expired trade promotion authority.

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ment in which some fear that American economic and trade leadership in Asia is fading, Washington should seize the opportunity to reinforce its vision of economic freedom and prosperity in the region.

The 1997 Crisis and Subsequent Recovery

The Asian financial crisis began in Thailand in July 1997 and then spread to neighboring countries, including Malaysia, Indonesia, and South Korea. In general, a period of financial turmoil in foreign exchange markets eroded investor confidence, triggering sharp drops in currency values. Rapid and sharp capital outflows resulted in further currency devaluations, stock market crashes, soaring inflation, and a severe economic recession.

A number of complex factors appear to have contributed to the financial crisis. Most diagnoses center around a combination of factors, including overreliance on short-term foreign capital, excessive investment in real estate, inadequate financial supervision, and politically motivated credit allocations that resulted in a massive non-performing loan problem.[1]

Whether measured in terms of output, investment, or jobs, the crisis caused considerable economic distress in the affected countries. Nervous investors moved over $100 billion out of the region in 1997–1998—about 5 percent of the region's annual gross domestic product (GDP). In a matter of months, the number of unemployed workers increased by over 800,000 in Indonesia, 1.5 million in Thailand, and about 1.35 million in South Korea. As currency values plummeted, people's effective wages also dropped. By the end of 1998, real wages had dropped by 12.5 percent in South Korea and by 6 percent in Thailand.[2]

The impact of the financial crisis went beyond the economic landscape. While Thailand and South Korea went through peaceful changes in their governments, other countries experienced political upheavals after the economic dislocation.

However, as painful as it was, the crisis has also given affected countries the incentives and political momentum needed to make their economic systems more open and transparent. Over the past decade, these countries have attempted to repair the structural defects that led to the crisis. Unlike previous economic crises in Mexico and Latin America, the Asian crisis was not caused by excessive government spending or unmanageable public debt, but instead was mainly rooted in the private sector.[3]

To their credit, most Asian governments have taken steps to address their problems by reforming financial sectors, improving transparency of regulations, strengthening corporate governance, and opening their markets to more competition. In addition, they have continued to promote their economic advantages by embracing foreign trade and seizing opportunities to integrate themselves into the global trading system. (See Chart 1.) Their overall total trade with the world has increased despite some slowdowns.

Although it took time for post-crisis reforms to restore investor confidence, the subsequent recovery was stronger and swifter than has been typical in other emerging-market financial crises.[4] Ten years after the financial crisis, the Asian countries are rebounding. Real GDP per capita in the affected countries has passed its pre-crisis level. (See Chart 2.) Production fell sharply in 1997 and 1998, but positive growth resumed almost immediately. Most countries had bounced back to the same point by 2003 and are now even more "miraculous" than before.

During 1998, the validity of Asia's economic success in previous decades was questioned. One interpretation of the economic disturbance was that the

1. Richard P. Cronin, "Asian Financial Crisis: An Analysis of U.S. Foreign Policy Interests and Options," Congressional Research Service *Report for Congress*, April 23, 1998, at *www.stimson.org/southeastasia/pdf/98-74f_1998Apr23.pdf* (July 12, 2007).
2. World Bank, *East Asia & Pacific Update: 10 Years After the Financial Crisis*, April 5, 2007, at *www.worldbank.org/eapupdate* (July 12, 2007).
3. Cronin, "Asian Financial Crisis."
4. Timothy Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, "Asia, the World Economy and the International Financial System," speech at the 2007 Annual Dinner of the Economic Society of Singapore, Singapore, June 13, 2007, at *www.newyorkfed.org/newsevents/speeches/2007/gei070613.html* (July 12, 2007).

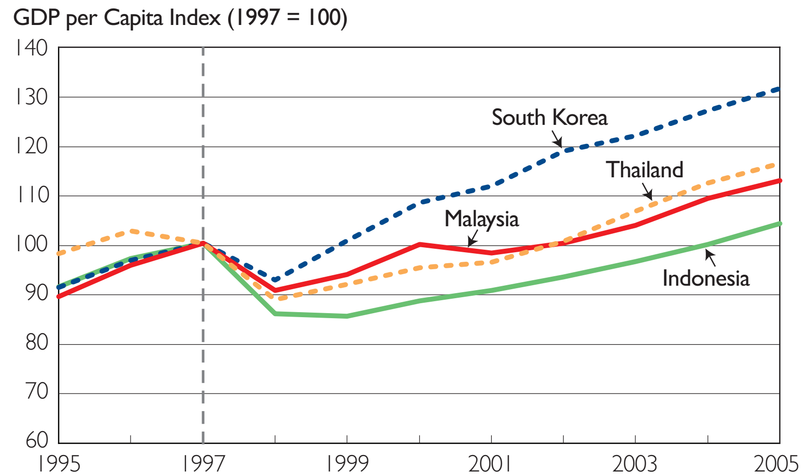
Asian Miracle was a mirage. According to *The Economist*, some observers argued that "the Asian miracle was always a sham" and predicted "a decade of lost growth in East Asia, like the one that Latin America went through after its debt crisis in the early 1980s."[5]

Yet the economic recovery after the crisis has proven that reports of the Asian Miracle's demise were premature. In hindsight, the crisis was just a temporary setback.[6] The late Milton Friedman stated that the "Asian Miracle is real" and observed that the thought that "one crisis discredits three decades of growth is allowing the headlines to overwhelm history."[7] As the recovery has shown, Friedman was correct in predicting that the Asian economies would fix their problems and get back on track.[8] Indeed, the temporary setback provided needed momentum to adjust their economic systems to the constantly changing global economy.

The aftermath of the 1997 crisis also generated accusations against market capitalism and globalization. Much of this criticism centered on the notion that free-market fundamentalism not only caused the economic crisis, but also exacerbated and spread it. Yet the backlash against globalization in the region was neither strong nor widespread. Instead, the affected countries continued to embrace globalization and the free-market system rather than withdraw from them, and this has made their relatively swift recoveries possible.

Chart 1 B 2054

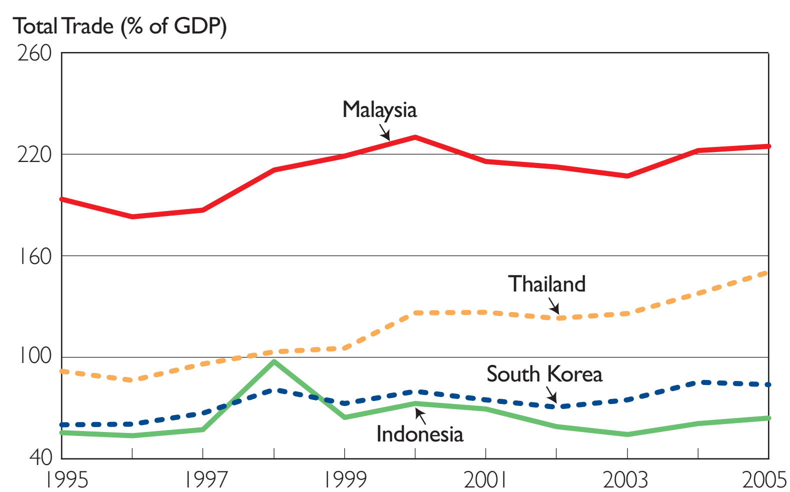
Economic Recovery After the Setback



Source: World Bank, *World Development Indicators Online*, at *go.worldbank.org/B53SONGPA0* (July 12, 2007; subscription required).

Chart 2 B 2054

Continued Integration into the Global Economy



Source: World Bank, *World Development Indicators Online*, at *go.worldbank.org/B53SONGPA0* (July 12, 2007; subscription required).

5. "Tigers Adrift," *The Economist*, March 5, 1998.
6. David Burton and Alessandro Zanello, "Asia Ten Years After," International Monetary Fund, *Finance & Development*, Vol. 44, No. 2 (June 2007), at *www.imf.org/external/pubs/ft/fandd/2007/06/burton.htm* (July 12, 2007).
7. *Ibid.*
8. Editorial, "Friedman: Asian Miracle Was Real," *Far Eastern Economic Review*, March 26, 1998.

The renewal of the Asian Miracle is especially relevant to China, which avoided the regional recession. The view that free markets were the core problem is especially popular among China's elites, who still believe that strong economic central planning is superior to free markets. China's leaders would do well to note that most of the post-crisis economies are now more prosperous than they were before the crisis in terms of per capita income and that the supposed debunking of capitalism was itself a mirage.

Challenges and Tasks Beyond the Crisis

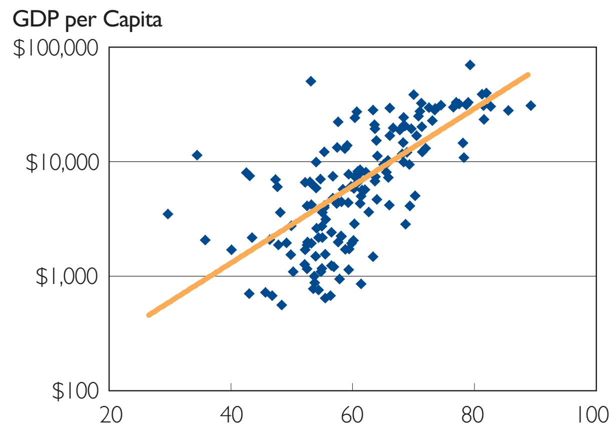
Beyond celebrating the economic recovery from the crisis, the governments of the affected countries should use its 10-year anniversary as a time to strengthen the ongoing recovery by bolstering their commitment to greater economic freedom. They should guard against complacency and be steadfast in providing unambiguous policy direction to deal effectively with reform fatigue. Lingering uncertainty is one of the biggest constraints on entrepreneurial activities in their countries.[9]

Today's economic growth and prosperity depend on maintaining and improving an environment in which entrepreneurial activities and innovation can flourish. Investment capital and entrepreneurial talent will flow toward economies with low taxes, secure property rights, sound money, and sensible regulatory policies. Countries with higher degrees of openness and flexibility benefit from the free exchange of commerce and thereby enjoy sustainable economic growth and prosperity.

This relationship is documented in the *Index of Economic Freedom*, published by The Heritage Foundation and *The Wall Street Journal*, which measures economic freedom around the globe.[10] The *Index* identifies the strong synergies among the 10 key ingredients of economic freedom, which include (among others) low tax rates, low tariffs, low levels of regulation, limited government intervention, strong property rights, open capital markets, and low levels of corruption. For the past 13 years, the *Index* has demonstrated that economic freedom is

Chart 3 B 2054

Economic Freedom vs. GDP per Capita



Source: Tim Kane, Kim Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index.*

crucial to economic development and sustained prosperity in an increasingly integrated global market.

Why would economic freedom contribute to economic growth and prosperity? In a framework of economic freedom, people are free to use their abilities and have a better chance of success when trying their innovative ideas and starting new entrepreneurial activities. With more opportunities and the prospect of greater returns, people are more willing to invest. As a result, the level of investment and innovation increases.

This is how virtuous cycles of expanding prosperity are created. The experiences of Hong Kong, Ireland, and Chile have shown that forces of economic freedom encourage entrepreneurship and boost productivity. Simply put, around the world, countries with a higher degree of and strong commitment to economic freedom enjoy higher standards of living and enduring prosperity.

The empirical findings of the *Index* confirm this. Countries with greater economic freedom are more

9. World Bank, Enterprise Surveys, June 2007.

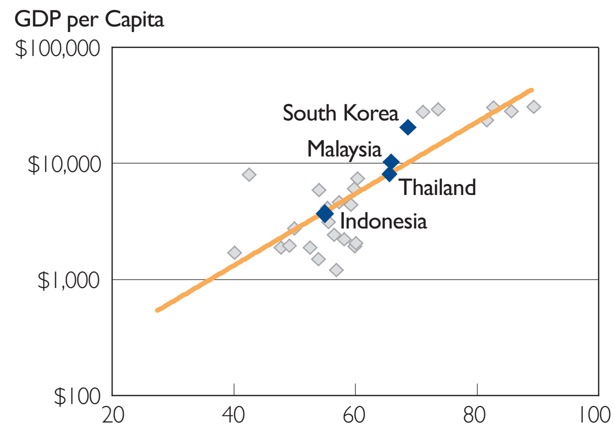
10. Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/research/features/index*.

prosperous than are those with less economic freedom. Chart 3 clearly shows the statistically positive relationship between economic freedom and GDP per capita. Economies built on greater economic freedom are inherently and fundamentally stronger.

Asia's economies follow the same pattern. Chart 4 shows the positive relationship between economic freedom and prosperity in the region. This relationship holds for the countries that were most affected by the Asian crisis.

Chart 4 B 2054

Economic Freedom in Asia and the Pacific



Source: Tim Kane, Kim Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index.*

Economic Freedom in the Four Most Affected Countries

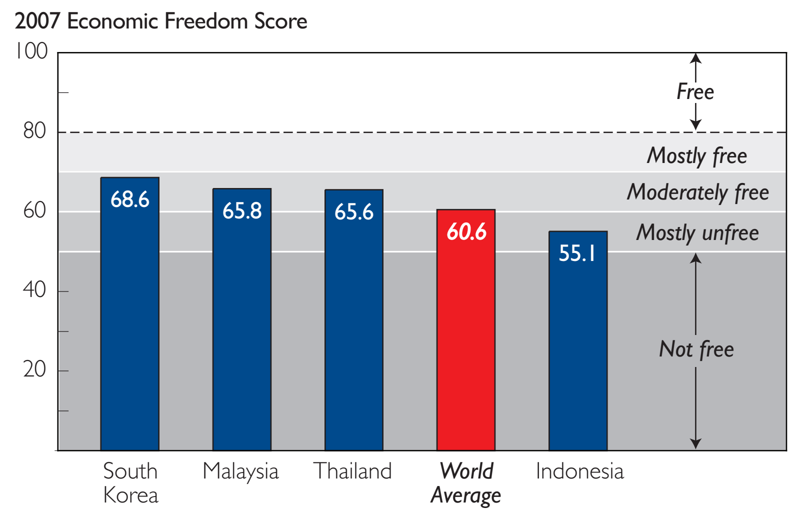
Progress toward greater economic freedom in the countries most affected by the Asian crisis still faces lingering obstacles. While economic freedom in South Korea, Thailand, and Malaysia is above the global average, none of them has a truly "free" economy. (See Chart 5.) Indonesia's economy is classified as "mostly unfree," and its level of economic freedom is lower than the world average.[11] Slow and sometimes inconsistent reform continues to hold these countries back from reaching their true economic potential.

This may explain why their investment rates have stagnated despite their relatively swift economic recovery after the crisis. According to the Asian Development Bank, the countries' economic growth in recent years "has settled on a lower trajectory." From 1990–1996 to 2000–2006, the bank reports that their economic growth rates have slowed by an average of 2.5 percentage points per year. Their investment rates, which plunged after the financial crisis, have not returned to pre-crisis levels.[12]

Table 1 shows the status of overall economic freedom and each of the 10 freedoms in the four countries. Each country has reasonably good scores in some of the 10 key factors of economic freedom, such as fiscal

Chart 5 B 2054

Economic Freedom Needs to Be Enhanced



Source: Tim Kane, Kim Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index.*

11. *Ibid.*

Table 1 B 2054

Economic Freedom Scores and Rankings

World Rank	Country	Economic Freedom	Business Freedom	Trade Freedom	Fiscal Freedom	Freedom from Govern-ment	Monetary Freedom	Invest-ment Freedom	Financial Freedom	Property Rights	Freedom from Corrup-tion	Labor Freedom
36	South Korea	68.6	83.1	64.2	81.0	81.5	79.0	70	50	70	50.0	57.7
48	Malaysia	65.8	68.6	71.8	87.8	79.8	80.0	40	40	50	51.0	89.5
50	Thailand	65.6	76.1	69.2	83.2	91.2	77.6	30	50	50	38.0	90.4
110	Indonesia	55.1	45.7	69.0	85.0	90.7	70.9	30	40	30	22.0	67.5

Source: Tim Kane, Kim Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index.*

freedom, monetary freedom, and freedom from government, which measures government spending, but needs to improve significantly in other key areas.

South Korea. After the financial meltdown, South Korea implemented many reforms to correct the weaknesses that led to the crisis. Nonperforming loans have been dealt with effectively through extensive financial reforms. The banking sector has been strengthened. Today, South Korea's economy is 68.6 percent free and ranks as the world's 36th freest.

Yet South Korea still has room for improvement in economic freedom. For example, although its regulatory process has been improved, bureaucracy and lack of transparency still hinder entrepreneurial activities. South Korea's labor freedom (57.7 percent free) is constrained by inflexible employment regulations that hamper growth in employment and productivity despite the reforms that have been made.

Malaysia. In response to the financial crisis, Malaysia imposed capital controls and restrictions, but the government has since removed them.[13] Malaysia's economy is rated 65.8 percent free in the 2007 *Index* and enjoys high levels of monetary freedom and labor freedom, but the dominance of state enterprises in several sectors restrains investment and limits business opportunities. Although it has gradually withdrawn from direct participation in enterprises, the government still retains large industrial and commercial holdings.[14]

Investment freedom and financial freedom are the two weakest areas. Malaysia encourages foreign direct investment in export-oriented manufacturing and high-technology industries, but the state maintains considerable discretionary authority over individual investments and restricts foreign investment in other sectors.[15]

Thailand. After the 1997 financial crisis, Thailand implemented significant reforms to achieve fiscal and monetary stability, strengthen economic governance, and boost incentives for increased competition.

12. Asian Development Bank, *Asian Development Outlook 2007: Growth and Change* (Hong Kong: Asian Development Bank, March 2007), at *www.adb.org/Documents/Books/ADO/2007/default.asp* (July 12, 2007).

13. Capital controls imposed by the Malaysian government in September 1998 have not yielded major benefits. For a comprehensive analysis, see Simon Johnson, Kalpana Kochhar, Todd Mitton, and Natalia Tamirisa, "Malaysian Capital Controls: Macroeconomics and Institutions," International Monetary Fund *Working Paper* No. WP/06/51, February 2006, at *www.imf.org/external/pubs/ft/wp/2006/wp0651.pdf* (July 12, 2007).

14. Economist Intelligence Unit, "Country Commerce," June 27, 2007.

15. Office of the U.S. Trade Representative, *2007 National Trade Estimate Report on Foreign Trade Barriers*, April 2, 2007, at *www.ustr.gov/Document_Library/Reports_Publications/2007/2007_NTE_Report/Section_Index.html* (July 12, 2007).

According to the 2007 *Index*, Thailand's economic freedom is 65.6 percent, with relatively high degrees of labor freedom and business freedom.

Despite economic reforms made over the past few years, Thailand still needs to enhance market transparency and implement several structural reforms in the financial sector.[16] Weak investment freedom, financial freedom, property rights, and freedom from corruption still limit Thailand's overall economic freedom.

Greater policy uncertainty also looms. Thailand had been negotiating a free trade agreement (FTA) with the U.S. that could have locked in ongoing reform efforts to enhance its economic freedom. However, negotiations were suspended after the coup in September 2006. Private investment growth has been declining in recent years, and the Thai Cabinet's recent amendments to the Foreign Business Act are viewed as more restrictive.[17]

Indonesia. Indonesia's economy is 55.1 percent free, which is lower than the world average. Overall progress on reform has been slow. Commitment to economic freedom has not been strong enough to bring tangible improvements to the lives of ordinary Indonesians, and this sense of drift is undermining confidence in economic reforms. The government still plays a significant role in economic activities, and 158 state-owned enterprises dominate many sectors of the economy. The state also controls prices on several basic goods, including fuel, rice, and electricity.[18]

Unemployment and lack of economic opportunity remain serious problems, and labor market reforms have been abandoned in the face of strong trade union opposition.[19] As indicated by its low score on property rights, Indonesia also continues to suffer from a weak and non-transparent judicial system. The commercial courts, although equipped with a new bankruptcy law, have proven ineffective.[20]

In each of these four countries, a stronger commitment to economic freedom is needed to reinforce the ongoing economic recovery and respond positively to constant changes in the global economy. As the *Index* findings show, countries that implement partial measures to avoid short-term pain run a high risk of sacrificing long-term prosperity, falling behind innovation elsewhere, and making themselves more vulnerable to economic downturns.

Changing Asia's Economic Environment

For their countries to evolve into more competitive and dynamic economies, Asian governments should bolster their commitment to and perseverance in advancing economic freedom. Similarly, the U.S. should pursue policies that encourage this progress, especially in post-crisis countries.

This is becoming more of a strategic necessity for U.S. foreign policy in Asia, where the economic environment is very different from the environment that existed 10 years ago. Most noticeably, China has catapulted onto the global stage with an average annual economic growth rate of more than 10 percent over the past decade.[21] China's economic diplomacy in the region has intensified dramatically since 1997, when China began its "soft power emergence" by receiving credit for not devaluing the yuan.[22] Accession to the World Trade Organization in December 2001 increased the momentum for China's economic rise, shifting patterns of world trade, particularly in Asia.

16. World Bank, "Thailand: Country Brief," October 2006, at *http://go.worldbank.org/IS43PD1U20* (July 12, 2007).
17. World Bank, *East Asia & Pacific Update*.
18. U.S. Department of State, "Background Note: Indonesia," January 2007, at *www.state.gov/r/pa/ei/bgn/2748.htm* (July 12, 2007).
19. Economist Intelligence Unit, "Country Monitor," November 27, 2006.
20. U.S Department of Commerce, "Doing Business in Indonesia: A Country Commercial Guide," February 2007, at *www.buyusainfo.net/docs/x_6987010.pdf* (July 13, 2007).
21. For a discussion of China's economic growth and economic freedom, see Tim Kane, Ph.D., "The Coming Chinese Slowdown: Resolving the Paradox of Freedom and Growth," Heritage Foundation *WebMemo* No. 1375, February 28, 2007, at *www.heritage.org/Research/TradeandForeignAid/wm1375.cfm*.
22. Joshua Kurlantzick, "China's Charm: Implication of Chinese Soft Power," Carnegie Endowment for International Peace *Policy Brief* No. 47, June 2006, at *www.carnegieendowment.org/files/PB_47_FINAL.pdf* (July 12, 2007).

In this new environment in which some fear that America's economic leadership in Asia is fading, the U.S. should seize the opportunity to reinforce its vision of economic freedom and prosperity in the region. However, growing protectionist sentiment in Congress will only undermine U.S. economic diplomacy in Asia, which is home to many vital U.S. allies. More important, the growing perception that the U.S. is turning against free trade will negatively affect long-term U.S. interests.

To strengthen American leadership in Asia, expand economic freedom in Asia, and counter China's growing economic influence in the region, Washington should:

- **Support countries' efforts to increase their economic freedom.** Economic engagement with South Korea, Malaysia, Thailand, and Indonesia should incorporate the broader goal of upgrading their economic systems with greater economic freedom. While a bold entrepreneurship has played a key role in their tremendous economic success, their systems perpetuate barriers that limit entrepreneurial opportunities. These countries need strong political leadership to address the more difficult issues that keep them from achieving truly free economies.
- **Encourage further trade and investment liberalization by renewing the President's trade promotion authority.** Liberalizing trade and investment would help these countries to upgrade their economic systems with greater economic freedom. Three of the four countries have pursued FTAs with the U.S. in recent years. The U.S. and South Korea recently concluded an FTA, but Congress has not ratified it. The U.S. has been negotiating an FTA with Malaysia and was negotiating an FTA with Thailand until the coup in September 2006. Finally, Indonesia has expressed great interest in negotiating an FTA with the United States.

  Accelerating the liberalization of free trade and investment would help to lock in these countries' reform efforts and to foster continued economic stability. However, by not renewing the President's trade promotion authority,[23] Congress is undermining U.S. economic leadership and missing an opportunity to strengthen economic freedom in the region.

Conclusion

In hindsight, the 1997 Asian crisis was just a regional recession, a temporary setback that spurred reform that created a more open and transparent economic system. Ten years after the financial crisis, the countries that were most affected by it are recovering, but continued economic recovery will depend on further strengthening of the institutional frameworks of their economies to enhance economic freedom.

Improving and maintaining economic freedom is the only reliable way to generate positive cycles of economic growth and enduring prosperity. America should pursue policies that support this progress and reinvigorate U.S. economic leadership by reaffirming its vision of economic freedom and prosperity in this rapidly changing region.

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23. TPA expired on July 1, 2007.