The Wrong Medicine for Asia

By JEFFREY D. SACHS CAMBRIDGE, Mass.

In a matter of just a few months, the Asian economies went from being the darlings of the investment community to being virtual pariahs. There was a touch of the absurd in the unfolding drama, as international money managers harshly castigated the very same Asian governments they were praising just months before. The International Monetary Fund has just announced a second bailout package for the region, about $20 billion for Indonesia. That should, in principal, boost confidence. But if it is tied to orthodox financial conditions, including budget cuts and sharply higher interest rates, the package could do more harm than good, transforming a currency crisis into a rip-roaring economic downturn. In the Great Depression, panicked investors fled from weak banks in the United States and abroad. Since banks borrow short term in order to lend long term, they can be thrown into crisis when a large number of depositors suddenly line up to withdraw money. In the days before deposit insurance, individual depositors would all try to be first in line for withdrawals.

In 1933, the Federal Reserve played it disastrously wrong. Rather than lending money to the banks to calm the panic and to show the depositors that they could indeed still get their money out, the Fed tightened credit, as financial orthodoxy prescribed. Confidence sank, and the banking system crumbled. The Asian crisis is akin to a bank run. Investors are lining up to be the first out of the region. Much of the panic is a self-feeding frenzy: even if the economies were fundamentally healthy at the start of the panic, nobody wants to be the last one out when currencies are weakening and banks are tottering because of the rapid drain of foreign loans. I t is somehow comforting, as in a good morality tale, to blame corruption and mismanagement in Asia for the crisis. Yes, these exist, and they weaken economic life. But the crisis itself is more pedestrian: no economy can easily weather a panicked withdrawal of confidence, especially if the money was flooding in just months before.

The I.M.F. has arrived quickly on the scene, but the East Asian financial crisis is very different from the set of problems that the I.M.F. typically aims to solve. The I.M.F.'s usual target is a government living beyond its means, financing budget deficits by printing money at the central bank. The result is inflation, together with a weakening currency and a drain of foreign exchange reserves. In these circumstances, financial orthodoxy makes sense: cut the budget deficit and restrict central bank credits to the government. The result will be to cut inflation and end the weakening of the currency and loss of foreign exchange reserves.

In Southeast Asia, this story simply doesn't apply. Indonesia, Malaysia, the Philippines and Thailand have all been running budget surpluses, not deficits. Inflation has been low in all of the countries. Foreign exchange reserves, until this past year, were stable or rising, not falling. The problems emerged in the private sector. In all of the countries, international money market managers and investment banks went on a lending binge from 1993 to 1996. To a varying extent in all of the countries, the short-term borrowing from abroad was used, unwisely, to support long-term investments in real estate and other non-exporting sectors. This year, the bubble burst. Investors woke up to the weakening in Asia's export growth. A combination of rising wage costs, competition from China and lower demand for Asia's exports (especially electronics) caused exports to stagnate in 1996 and the first part of 1997.

It became clear that if the Asians were going to compete, their currencies would need to fall against the dollar so their costs of production would be lower. It also became clear that with foreign lending diverted into real estate ventures, there was some risk that the borrowers, especially banks and finance companies, would be unable to service the debts if the exchange rates weakened. After all, rentals on real estate developments would be earned in local currency, while the debts would have to be repaid in dollars. The weaknesses in the Asian economies were real, but far from fatal. The deeper strengths -- high savings, budget surpluses, flexible labor markets, low taxation -- remain in place, and long-term growth prospects are solid. But, as often happens in financial markets, euphoria turned to panic without missing a beat. Suddenly, Asia's leaders could do no right. The money fled. In this maelstrom, the I.M.F. is now reportedly pressing the Asian countries to raise existing budget surpluses still higher and to tighten domestic bank credit.

In the Philippines recently, short-term interest rates were briefly pushed above 100 percent a year to meet I.M.F. credit targets. And, in a move that is supposed to engender confidence but almost surely does the opposite, the I.M.F. has reportedly called on Thailand and Indonesia to close down several weak banks that have been caught up in the boom-bust cycle of foreign lending. Since the treatment of depositors in such cases is open to doubt (as deposit insurance is implicit rather than explicit), these calls for bank closings also worsen the investor flight from the region. Of course, one can't be absolutely sure what the I.M.F. is advising, since I.M.F. programs and supporting documents are hidden from public view. This secrecy itself gravely undermines confidence. The Asian region needs more creative policies than these.

The first step would be for the international investment community to tell the truth: the currency crisis is not the result of Asian government profligacy. This is a crisis made mainly in the private, albeit under-regulated, financial markets. The next step would be to let the Asian currencies float downward, so that these countries' exports will be cheaper and therefore more competitive. Once export growth starts to pick up, then panicked money market managers will begin to remember why they were until recently singing the praises of the region. This is what happened in the aftermath of the 1994 Mexican crisis, when money managers who swore they had left Mexico for good quickly reconsidered in the wake of an export boom. Floating the exchange rate would have two more advantages: foreign reserves would not be squandered in a failed attempt to defend the currency, and interest rates would not need to be raised in an illusory quest to keep the currency strong.

The third step would be to moderate the strong forces pushing Asia into a recession, rather than adding to them. The region does not need wanton budget cutting, credit tightening and emergency bank closures. It needs stable or even slightly expansionary monetary and fiscal policies to counterbalance the decline in foreign loans. Interest rates will drift higher as foreign investors withdraw their money, but those rates do not need to be artificially jacked up by a squeeze on domestic credit. The regulation of the banking sector should be strengthened not by hasty bank closures, but by pushing weak banks to merge with stronger ones and by pushing the banks to raise their capital bases. Southeast Asia surely needed a correction to restore its competitiveness. A moderate cut in foreign lending was needed; the panic was not. If the currency crisis is well managed, Asia will be able to resume its rapid economic growth. If it is managed with unthinking orthodoxy, the costs could be very high, for Asia and the rest of the world.

Jeffrey D. Sachs is director of the Harvard Institute for International Development and an economic adviser to governments in Asia and other parts of the world.