

The End of the “Japan Model” AND the “Washington Consensus
Model?”

The Current Financial Crisis and South Korea's Financial Crisis of 1997

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Introduction

The “Japan Model” (JM) and the “Washington Consensus Model” (WCM) are names given to two approaches to economic development.¹ The Washington Consensus “represents a package of neoliberal policies agreed mainly by US officials, the IMF and the World Bank.”² The belief behind it is that governments can best help their countries develop by “getting the prices right”³ and staying out of the economy as much as possible. The Japan Model, on the other hand, also represents a market- and export-oriented approach that nonetheless foresees a larger role for government in the economy in steering the market to overcome certain feared inefficiencies. It is also known as the “developmental state” model.⁴ Governments such as Japan, who first developed the model, as well as South Korea, Taiwan, and other newly industrialized countries (NICs) in Asia, selected strategic industries in their economies that they supported with cheap financing, guarantees, subsidies, and tariff protections.

The 1990s in general, and the Asian financial crisis of 1997 in particular, were heralded by many neoliberal economists as marking the end of the Japan Model and proving the Washington Consensus to be correct. Japan suffered its own financial crisis at the beginning of the decade. This led to deflation and retrenchment, and later on to Japan's “lost decade” of stagnant growth. In 1997, the Asian financial crisis, starting in Thailand, swept through the Asian “Tiger States,” including South Korea. “Crony capitalism” and the high amounts of debt it encouraged were blamed for the crisis, particularly among western (neoliberal) economists. A writer for the Wall Street Journal wrote of South Korea's “intrinsic economic instability.”⁵

1 Albala-Betrand, J.M. “Industrial interdependence change in Chile: 1960-90 a comparison with Taiwan and South Korea.” International Review of Applied Economics, May 1999: 161+. Gale Group Databases. Webster University Library, MO. 27 April 2009.

2 Ibid.

3 Gilpin, Robert. Global Political Economy: Understanding the International Economic Order. Princeton: Princeton University Press, 2001. P 312.

4 Ibid.

5 Woo-Cummings, Meredith. “How Industrial Policy Caused South Korea's Collapse.” The Wall Street Journal 8 Dec. 1997, Eastern edition: 1. Proquest (database). Webster University Library, MO.

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However, 2008 is now considered by some to mark the end of the Washington Consensus, or even of capitalism itself. The collapse of the U.S. real estate market and the later collapse of Lehman Brothers, an investment bank that was heavily entwined in America's subprime mortgage markets, sparked a credit crunch and financial crisis that have led today to a global economic slowdown.⁶

It is therefore obvious that both systems contained flaws. They both followed different ideologies, and yet both led to similar conditions of panic, credit crunch, financial crisis, and economic crisis. Are both models wrong? What were their mistakes?

The Japan Model and some criticisms of the Washington Consensus Model

The Japan Model of a developmental state is a market-oriented approach that does not try to go against the forces of the market outright. Instead, policymakers attempt to steer the market into investment in areas they deem essential to growth and security. They do so because of “market failures” that may lead to a lack of investment, if the market is left to its own devices, in areas that are important to development. Evidence does indeed show that foreign investors often were “unwilling to invest in key heavy industrial sectors where capital requirements [were] high and rates of return low.”⁷ In addition, realist concerns with national security convinced some countries to ensure that some industries existed domestically. Thus, South Korea raised interest rates to encourage domestic savings while simultaneously lowering them for exporting firms to encourage exports. South Korea even encouraged firms to take on domestic and foreign debt to boost growth, while offering subsidies and even a medal of honor for top exporters.⁸

The necessity of this intervention was believed to stem from South Korea's status as a “late,

6 Leonard, Devin. “How Lehman Brothers Got Its Real Estate Fix.” *The New York Times* 2 May 2009, online edition. 8 May 2009 <<http://www.nytimes.com/2009/05/03/business/03real.html>>.

7 Frieden, Jeff. “Third World Indebted Industrialization: International Finance and State Capitalism in Mexico, Brazil, Algeria, and South Korea.” *International Organization*. 35 (1981): 407-431. PAIS International. Webster University Library. 29 Apr. 2009.

8 Ibid.

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late industrializer.”⁹ Proponents of the JM model argue that infant industries first require a period of protection and aid before they can become competitive on global markets and that, without government assistance, these industries would never take root, therefore never providing the spillover effects of supply networks and “economies of experience.”¹⁰ The WCM model, therefore, would never lead to full parity with industrialized countries, or would lead to it too slowly.

Washington Consensus criticisms of the Japan Model

Many economists claim, however, that if financial and capital markets are functioning properly, there is no reason for a government to step in to make an investment. To paraphrase Kenen: If private investors are wary of an investment, then “the market is essentially saying that this industry is not the best place to invest society's scarce resources”¹¹ and they'd be more sensibly invested elsewhere. In other words: if investors can't pick winning businesses, how can governments expect to be so enlightened? On the other hand, it can be argued that capital markets in South Korea were nearly nonexistent, necessitating government involvement to drive growth. Although South Korea has certainly had a great deal of economic success since the 1950s, there is some evidence that the government's picks were not always good. For example, Samsung started a car company division in 1995 in an already saturated market, just as another company (Ssangzong Motor Corp.) had to be rescued via a sale to Daewoo, and a third company, Kia, was being kept alive by court protection.¹² There are also many other examples that suggest that low interest rates and government support have not always led to efficient investment in Korea. The Commercial Bank of Korea reported in 1998 (a year after the crisis had hit) that there were too many

9 Gilpin, Robert. Global Political Economy: Understanding the International Economic Order. Princeton: Princeton University Press, 2001. P 318.

10 Oatley, Thomas. International Political Economy: Interests and Institutions in the Global Economy. London: Pearson Education, Inc., 2008.

11 Ibid.

12 Graham, Keith. “South Korea; Finding the Balance.” The Atlanta Journal-Constitution 8 March 1998. Gale Group Databases. Webster University Library, MO. 29 April 2009.

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overlapping investments in a great number of industries, including petrochemicals, steel, electronics, oil refining, and shipbuilding.¹³

Nonetheless, if we assume government involvement is necessary and that a government can have success at picking winners and critical companies for economic development, there are still other problems with the model. The model essentially condones cronyism, a close link between industry leaders and politicians or bureaucrats. Although countries that adhere to the Washington Consensus are not free of cronyism either, the close links explicitly encouraged between politicians and industry in JM countries like South Korea almost certainly present conflicts of interest. Finally, there is a last problem: scaling back government involvement later on. The “fledgling industry” argument certainly no longer applies to Japan and Korea, and as their economies have grown more complex, they seem to have become less adept at picking winners. Japan and Korea both began to liberalize their economies and reduce the role of government in them, but they seem to be having difficulties in doing so, probably because their governments are so intertwined with their economies. This involvement is claimed to be partly to blame for Japan's “lost decade.”

Finally, there are exceptions among late, late industrializers, like Taiwan and, especially, Hong Kong. Taiwan's government has played a smaller role in its economy (and has been less adept at choosing winning industries), yet Taiwan has been similarly successful to South Korea due to a number of small companies (which were generally completely unsupported by the government), rather than the big conglomerates supported by South Korea. It also escaped much of the fury of the Asian financial crisis, but this was mainly due to its underdeveloped financial sector.¹⁴ Another, perhaps even more potent example, is Hong Kong. Hong Kong has been rated the freest economy in the world for the last 15 years.¹⁵ At the same time, it enjoys a higher per capita GDP than does

¹³ Ibid.

¹⁴ Clark, Cal, and Changhoon Jung. “Implications of the Asian Flu for Developmental State Thoery: The Cases of South Korea and Taiwan.” *Asian Affairs* 29 (2002): 15-42. Academic Search Premier. EBSCOhost. Webster University Library, MO. 29 April 2009 <<http://web.ebscohost.com.library3.webster.edu/ehost/pdf?vid=8&hid=14&sid=e9c20f07-e409-40b1-807d-302d99dcdebc%40SRCSM1>>.

¹⁵ Index of Economic Freedom. 2009. The Heritage Foundation. 8 May 2009 <<http://www.heritage.org>>.

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South Korea.¹⁶ Although an unfair comparison due to Korea's history (it was destroyed by the Korean war), it nonetheless serves as evidence that the JM model is not necessarily the only model for development.

The end of the Japan Model?

In 1997, it appeared that the Japan Model of the developmental state was seeing its last days. Japan, where the model was conceived, had been in an economic slump since the early 90s, and the Asian financial crisis now required the IMF to bail out a number of Asian states, including South Korea. The IMF bailout of South Korea was made on the condition (among other things) that it liberalize trade, end the close relationships between financial institutions and government officials, break up monopolies, and privatize state-owned enterprises.¹⁷ In effect, South Korea was forced to embrace the WCM. Since then, however, South Korea has continued on the path to liberalization and increased transparency, with a good deal of success. Of the four Asian countries hit by the financial crisis of 1997-98, South Korea had grown the most five years later and was also the country that had reformed the most, largely in line with the WCM.¹⁸

The irony of the whole situation, however, is that Korea had begun the first reforms to its economy before the crisis struck. The main reform that it had begun was financial market liberalization. This led to an influx of so-called “hot money” (short-term bond and stock investments that can be withdrawn quickly). Corporate debt, already high before the crisis, soared during this time, and current accounts went into deficit. At the first sign of danger (triggered by Thailand's central bank's announcement that it had fewer foreign exchange reserves than previously stated), this hot money was withdrawn. The sudden capital account deficit caused a balance of

16 The World Factbook, Central Intelligence Agency. 8 May 2009 <<https://www.cia.gov/library/publications/the-world-factbook>>.

17 Oatley, Thomas. International Political Economy: Interests and Institutions in the Global Economy. London: Pearson Education Inc., 2008.

18 “East Asian Economies: The Lost (Half) Decade.” The Economist 4 July 2002, online edition.

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payments crisis that eventually required IMF intervention.¹⁹ In this way, financial deregulation (more closely associated with the WCM) actually played as much of a role in South Korea's crisis as did its industrial development policies (the JM).

The end of the Washington Consensus Model?

Now, in 2009, many are claiming the end of the “Washington Consensus.” Real estate prices in America began to fall nationwide in 2007.²⁰ This brought with it a reduction in consumer spending as consumers began to feel less rich. The losses in construction and other housing-related areas led to a rise in unemployment. At the same time, a sliding dollar and a continuing boom in the rest of the world fueled a new commodity boom, which kept inflation high in the United States, even as unemployment rose. For a while, it seemed as though the U.S. might be saved by its booming exports, which held America's GDP growth positive for a while, despite the souring conditions in its domestic market. Then, in September 2008, Lehman Brothers, a large investment bank, filed for bankruptcy. This unleashed a panic that led to a credit crunch as banks stopped lending and creditors called in their debts. The credit crunch spread around the world and governments everywhere scrambled to prop up failing banks and financial institutions. Now, eight months later, the world is experiencing its first global downturn since WWII.²¹ In addition, the scare also led to a move back into dollar assets, driving up the price of the dollar and providing further downward pressure on American exports and prices.

Is the Washington Consensus Model forever discredited? There is no doubt that a lack of good regulation of America's financial sector is largely to blame for the crisis, and deregulation is

19 Oatley, Thomas. International Political Economy: Interests and Institutions in the Global Economy. London: Pearson Education Inc., 2008.

20 “Median and Average Sales Prices of New Homes Sold in United States.” U.S. Census Bureau. 20 Feb. 2009 <<http://www.census.gov/const/uspricemon.pdf>>.

21 Stewart, Heather. “World economy to shrink for first time since second world war.” The Guardian 22 April 2009, online edition. 9 May 2009 <<http://www.guardian.co.uk/business/2009/apr/22/imf-world-economic-outlook-recession>>.

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generally a feature of the Washington Consensus. However, one of the conditions of the IMF's bailout of South Korea in 1997 was that it reform its financial institutions to provide better oversight,²² so it cannot be said that the Washington Consensus always favors deregulation over regulation.

Nevertheless, it is interesting to note the similarities between the current rich-world crisis (with its epicenter in America) and the financial crisis of 1997-98 (with its epicenter in four Asian “tiger” states). As mentioned earlier, South Korea had already begun to liberalize its financial sector in the years leading up to the crisis. This deregulation of the financial markets led to flows of hot money that was then often invested unwisely.²³ A loss of government control over the financial sector, therefore, is largely to blame for the crisis, at least in the medium term. Similarly, lack of financial regulation in the United States led to overly risky investments (especially in unregulated subprime mortgages) that inflated the property bubble there and led to a consumer spending boom. It is therefore valid to ask if a little more JM-style control of the financial markets might have prevented both crises or limited the havoc they have wreaked.

Still, another similarity is also striking. This time, the similarity has more in common with the Japan Model than the Washington Consensus Model, at least when taken in their purest forms. The role of government in the current crisis cannot be overlooked. The U.S. government also tweaked markets to funnel investment into one specific area that it felt was particularly important: housing. Fannie Mae and Freddie Mac, two large U.S. mortgage institutions, have enjoyed an implicit government guarantee as well as several forms of indirect subsidies.²⁴ This has allowed them to loan more money to mortgage borrowers while having lower capital reserves and access to cheap capital themselves. This has made them hugely successful, but is without a doubt partly

22 Oatley, Thomas. International Political Economy: Interests and Institutions in the Global Economy. London: Pearson Education Inc., 2008.

23 Ibid.

24 “A Brief Family History: Toxic Fudge.” The Economist 17 July 2008, online edition. 9 May 2009 <http://www.economist.com/finance/displaystory.cfm?story_id=11751146>.

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responsible for the boom in housing. In addition, U.S. policies like tax exemptions on mortgage debt further encourage indebtedness in housing. Could it be that Washington should perhaps have followed its own advice better?

Conclusion

In conclusion, it seems that states following both models made similar mistakes that lead to financial crises. It is interesting to note, however, that both the United States and South Korea each made some mistakes that were completely inconsistent with their models. These mistakes, combined with their models, seemed to form a toxic mixture that led to financial and economic disaster. Lack of financial market regulation, more to be associated with the WCM than the JM, can be blamed for driving both systems over the edge and precipitating their collapses.

At the same time, the criticisms of the JM still hold and certainly did not help South Korea in the run up to its crisis. South Korea sought to deregulate in the 90s to prevent Japan's fate becoming its own. It is perhaps unfortunate that its deregulation began with its financial markets (at the behest of the United States, following the WCM). Nonetheless, its further privatization and liberalization after the crisis seems to have saved its large companies and made them highly profitable again. Another liberalization has probably also gone a long way in providing stability: a move to floating exchange rates. Fixed exchange rates provide an incentive to bet against a currency (if the bet is lost, nothing is lost, if the bet is won, the trader gains). They also encourage borrowing in foreign currencies as it is assumed the peg will hold. If the currency is forced to devalue, foreign debt, denominated in the domestic currency, rises. This causes a very dangerous situation. Fixed exchange rates, government funneling of cheap funds into specific sectors encouraging over-indebtedness and inefficiency, and the deregulation of the financial market allowing massive debt flows and currency speculation combined to cause the crisis in South Korea, even though it was

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triggered elsewhere (in Thailand).

Similarly, the application of policies in the United States that were more consistent with the Japan Model than the Washington Consensus Model also set the stage there for disaster. As mentioned earlier, the U.S. government actively and tacitly encouraged housing lending and artificially high levels of debt that would not have been achieved in a completely free market. Some, like Pierre Lemieux of the Department of Management Sciences of the Université du Québec en Outaouais (a conservative, Austrian School economist), go so far as to say that the 2008 crisis was due to too little free market, not too much.²⁵ However, it was the combination of this with an intentional avoidance of financial market regulation (Alan Greenspan was given the authority by Congress to regulate subprime mortgage lending, he chose not to)²⁶ that eventually led the system to over-extension and collapse.

Both countries therefore made the same mistakes of over-indebtedness, fueled by lacking financial regulation and funneled disproportionately into specific areas by misguided government interventionist policies. It seems that both models get some things right and both have flaws. However, neither the Japan Model, nor the Washington Consensus Model, have by any means been definitively disproved by either crisis, although the “consensus” might be significantly weakened politically by the crisis. The intellectual battle between the two is sure to continue for some time to come. In the meantime, keeping a better eye on debt, risk, capital flows, and imbalances caused by government policies seems to be a good idea. How to weight the risks and benefits of each, however, will surely also remain a subject of debate as intense as that between models of state involvement.

25 Lemieux, Pierre. “A Crisis of Global Statism.” 25 Sept. 2008. Ludwig von Mises Institute. 1 May 2009
<<http://mises.org/story/3120>>.

26 “Greenspan's Legacy?” Frontline: Inside the Meltdown. 17 Feb. 2009. PBS. 9 May 2009
<<http://www.pbs.org/wgbh/pages/frontline/meltdown/themes/greenspan.html>>.

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