Simon Johnson: One Page Summary

15.015, class #8: Crisis in Asia, 1997-98

RECAP: BBNN, with a focus on the NN curve (and inflation)

Inflation is a sustained increase in wages and prices – think of it as an upwards and self-reinforcing “spiral”. A one-off adjustment in the price level is not inflation; inflation means that wages increase and prices continue to rise.

An increase in the price of specific goods – for example, commodity prices – is not inflation. For a country that imports oil, for example, higher oil prices represent an adverse movement in the “terms of trade” – meaning that the country needs to export more in order to afford the same amount of oil. In BBNN space, this is a shift up and to the left of the BB curve, which is likely to result in a current account deficit. But this is not the same as inflation.

There are two ways for inflation to appear in a developed economy, (a) through overheating, i.e., attempting to run the economy with unemployment below the “full employment” level, (b) because inflation expectations lose their anchor, so people expect a lot more inflation than has been the case in the recent past.

“Full employment” is sometimes called the “natural rate of unemployment” or the “non-accelerating inflation rate of unemployment” (or NAIRU). Overheating means that the economy is above the full employment level, so wages tend to rise – and this pushes up prices, thus creating inflation.

The NN curve slopes down because it shows combinations of the real exchange rate (e/w) and domestic spending (C+I+G) for which the economy has full employment. If there is a real depreciation (a nominal depreciation or lower nominal wages or both), this will increase exports and reduce imports – both of which will tend to reduce unemployment. The economy has become “more competitive”.

Such a real depreciation is often a good thing but if the economy starts at full employment, there will be overheating. The economy will stay at full employment – without overheating – only if domestic spending contracts, i.e., creating an offsetting increase in unemployment.

In a small open economy, depreciation can create inflationary pressure – because it pushes up the price of goods. But this will only become inflation if (a) there is overheating, or (b) people’s expectations are not anchored, so they expect inflation.

In the 1950s and 1960s policymakers believed there was a stable tradeoff between unemployment and inflation, i.e., they could “buy” lower unemployment through allowing higher inflation – with stable parameters in this calculation. This idea is called the simple Phillips Curve.

In the 1970s, this idea proved wrong or even dangerous. As commodity prices rose – particularly oil but also more generally – policy makers “accommodated” the increase with loose monetary and fiscal policy (i.e., stimulating the economy), which only encouraged higher wages.

Central bank credibility is very important. Do you believe that the central bank will tighten monetary policy in order to prevent overheating, or will it cave in to political pressure of some kind? Central banks work hard to communicate that inflation will remain low and stable – preferably around 2 percent for most industrialized countries.

Korea and the Asian Crisis, 1997-98

In 1997 Korea had a current account deficit, financed by inflows of capital – mostly in the form of borrowing by large business groups (chaebol). There was not a significant budget deficit. There was little or no overheating, so inflation was under control.

There was a "shock" in the form of changed expectations about Korea's ability to pay – and perhaps also regarding what kind of financial support would be available from the IMF and on what terms. Mostly this was based on events in South-East Asia, which is a long way from Korea.

Korea was vulnerable in part because of its current account deficit but also because its corporate governance was opaque. In a crisis, investors fear the worst – this also happened in the US in 2008-09 and in Europe 2010-11.

The Korean corporate sector was heavily indebted ("high leverage": a great deal of debt relative to equity and relative to cash flow), with much of this debt in US dollars and at short-term maturity. Much of this was borrowed from Korean banks, which had been an instrument of government development policy – but by the mid-1990s were much more likely to do what chaebol asked.

The depreciation of the Korean won created financial distress in the corporate sector – and created expectations of further depreciation. This could have caused an acceleration of inflation by removing the anchor for expectations.

A package of financial support from the IMF helped to stabilize the exchange rate – by providing a large amount of reserves. Monetary policy was tightened – raising interest rates to keep capital in the country, which also had the effect of contracting demand (investment in particular fell sharply).

The IMF also recommend tighter fiscal policy, i.e., moving the IS curve down and to the left. In retrospect, the IMF's initial suggestions were too tight – a relatively large budget deficit appeared, because tax revenues fell so much, and this was not destabilizing.

Employment perhaps could have been kept higher in 1998 – although this might also have been difficult, given how much deleveraging the corporate sector was doing (i.e., paying down debt or restructuring debt through some form of bankruptcy).

Inflation expectations were kept under control and the nominal depreciation became a real depreciation (i.e., lower real wages, measured in dollar terms). As a result, the Korean corporate sector became very competitive – exports boomed while imports stayed down.

This "export-led" recovery brought Korea out of recession quickly. Many other emerging markets have experienced similar fast turnarounds – although there can be complications, including an acceleration of inflation in some cases. Ultimately, the medium-term growth prospects require more than avoiding crisis; this is about investing to build physical capital and human capital, as well as adopting new technology and finding ways to innovate. On these dimensions, Korea has done very well over 50 years.

Can Greece, Portugal or any other part of the eurozone follow a Korea-type path to economic recovery – and from there to sustainable growth?

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