Chapter 3

Economic Freedom and Crisis Performance in Asia

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Economic freedom has moral and practical dimensions. The moral side—that it is better for people to enjoy liberty in their economic lives—applies in the short term, long term, and every term in between. The practical side is famously more complicated.

There are obvious historical examples where planned economies do well for a time. The classic case, of course, is the Soviet Union. It was initially able to mobilize resources from agriculture to bolster industry, thought to be the sole path to modernization. However, both technological innovation and organizational efficiency stagnated because of misunderstanding and misapplication of incentives.

In Asia, India's socialist experiment started to crumble in the early 1980s with pro-business reforms and ended altogether in 1990 after a balance of payments crisis resulting from central planners being unable to match their price-setting and quantity-setting with actual supply and demand.[1] The pro-market reforms that followed led to sustained, rapid growth.

The practical argument for economic freedom is that the state will inevitably make ugly mistakes, partly because of our incapacity to control systems as complex as national economies. In a crisis, a government regulator or manager may be able to respond quickly and even effectively to a particular problem, but they are likely to do a poor job in adjusting all of the myriad production decisions facing individual firms across an entire economy. A centrally managed economy can thereby actually suffer more from unexpected turbulence. This may even be true when only part of the economy is managed if it turns out to be a pivotal part.

1. Dani Rodrik and Arvind Subramanian, "From 'Hindu Growth' to Productivity Surge: The Mystery of the Indian Growth Transition," International Monetary Fund *Working Paper* No. WP/04/77, May 2004, at *http://www.imf.org/external/pubs/ft/wp/2004/wp0477.pdf*.

The *Index of Economic Freedom* is based on the idea that freer economies perform better over the long run. A wealth of data, both from this *Index* and from independent research, backs the idea that economic freedom promotes long-term prosperity and that advancing economic freedom generates higher economic growth, employment creation, and the reduction of poverty.

In light of the recent global financial and economic turbulence, this chapter examines a different and timely question: whether economic freedom predicts performance in a crisis. Do freer, more flexible economies withstand economic turmoil better? Asian economies provide a good test for this hypothesis. They top the rankings in economic freedom but are also represented at the very bottom. That wide variation should make for a wide variation in crisis performance.

Economic freedom should help predict performance in the present crisis: Holding everything else constant, freer and more flexible economies should survive better. For many Asian economies, however, the *Index* freedom score may be somewhat incomplete on two counts. The first is that some economies were consciously distorted by intervention aimed at building official stockpiles of foreign exchange reserves. The second is that the *Index* scores do not yet fully capture the wide range of policy steps taken in response to the global crisis. Taking into consideration two distinctive policy measures not covered by the *Index*—reserve accumulation and interest rate change—this chapter provides an expanded view of Asian economies' economic freedom and crisis performance.

At this point, there are not enough data on either policy measures or performance in the present crisis for a final assessment. A more complete evaluation will be possible next year at this time. However, partial results tentatively affirm that policies which permit greater economic freedom would have served Asia better in the past, in the present, and into the future.

MEASURING ECONOMIC FREEDOM IN A CRISIS

The Heritage Foundation/Wall Street Journal *Index of Economic Freedom* includes 42 Asian economies. Twelve are too small to chart even a nominally independent policy course, and there are insurmountable data problems with eight others.[2] The remaining 22 economies offer comparatively credible gross domestic product of nearly $5 billion or more and generate almost all of Asia's GDP, production, investment, and trade by dollar value. These economies are grouped in Chart 1 by *Index* aggregate scores (2009 scores based on data covering July 2007 through June 2008 are used).

In terms of economic freedom, it turns out that these Asian economies appear to represent global patterns well: The same number of countries lies above and below the global mean. The sample also shows wide variation, with multiple economies within each category ranging from free to unfree. The latter is necessary for the sample to be useful.

Measuring crisis performance is somewhat subjective. The chief goal of economic development is sustainable improvement in per capita incomes. Since the duration of the crisis has to this point been short, population will change only slightly. Per capita income can thus be simplified to sustained improvement in national income. GDP is not an ideal measure of national income, but it is universal. In this study, by necessity a short-term analysis, we rate crisis performance by measuring the change in GDP growth rates in 2008 from those in 2005–2007.[3]

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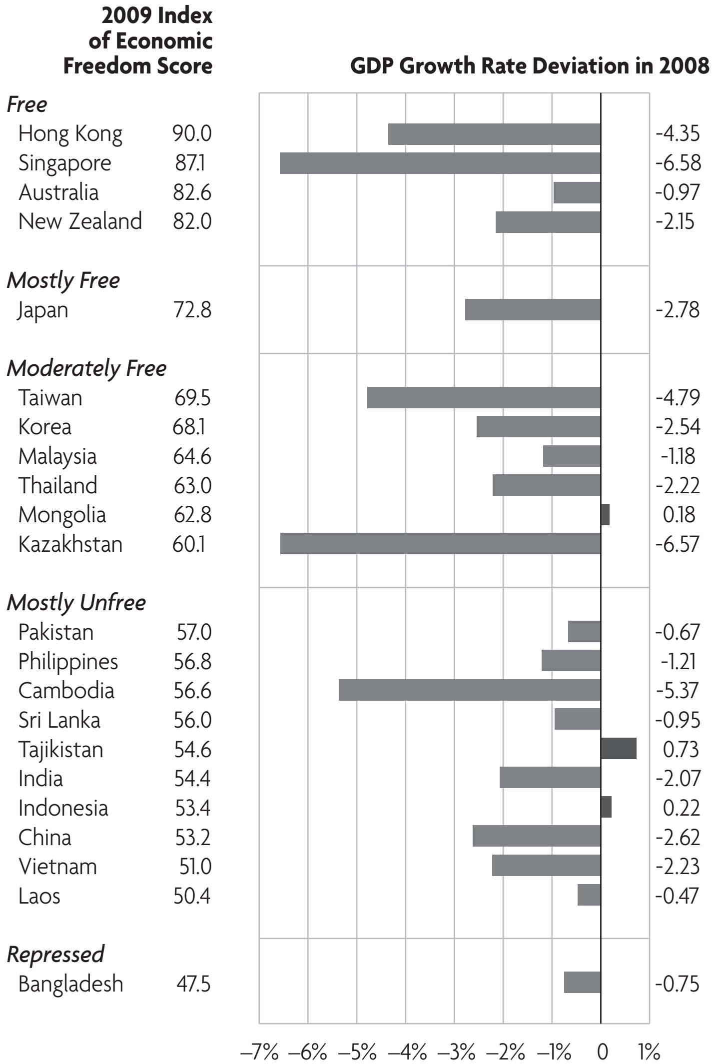
2. Basic data for this study are not available for Afghanistan, Burma, North Korea, and Turkmenistan. Data for the crisis period are as yet wildly inconsistent for Azerbaijan, the Kyrgyz Republic, Papua New Guinea, and Uzbekistan. The excluded countries range from the middle to the bottom in economic freedom, so the remaining sample is biased toward a higher level of economic freedom. However, the study does not assess the level of economic freedom in Asia, so the bias may be benign.

3. Evaluating performance during the downturn suffers from a standard trade-off: Later is when the evaluation will be clearest, but now is when it is most important. Asian economies were weakening throughout 2008, but weakness became acute in September in some countries and November in others. Unfortunately, GDP data from 2009 are incomplete for all countries and not available for some. An assessment of 2009 cannot be comprehensive. In addition, the crisis did not occur in a vacuum; pre-crisis GDP trend must factor into the

Economic Crisis and Reduced Growth



Sources: Terry Miller and Kim R. Holmes, *2010 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2010), at *www.heritage.org/index*, and World Economic Outlook, International Monetary Fund, at *http://www.imf.org/external/ns/cs.aspx?id=28* (October 20, 2009).

Chart 1 heritage.org

These figures are also shown in Chart 1.[4]

With economic freedom scores and a measure of short-term crisis performance in hand, we can ask: Did freer Asian economies respond better in the recent crisis? In Chart 1, the correlation between the level of economic freedom and variations in short-term GDP growth is actually negative. At least among the selected Asian countries, those with less economic freedom suffered a bit less during the 2008 segment of the recent global downturn. This is perhaps not surprising, given the fact that countries with less economic freedom are less engaged with the world economy as a whole.

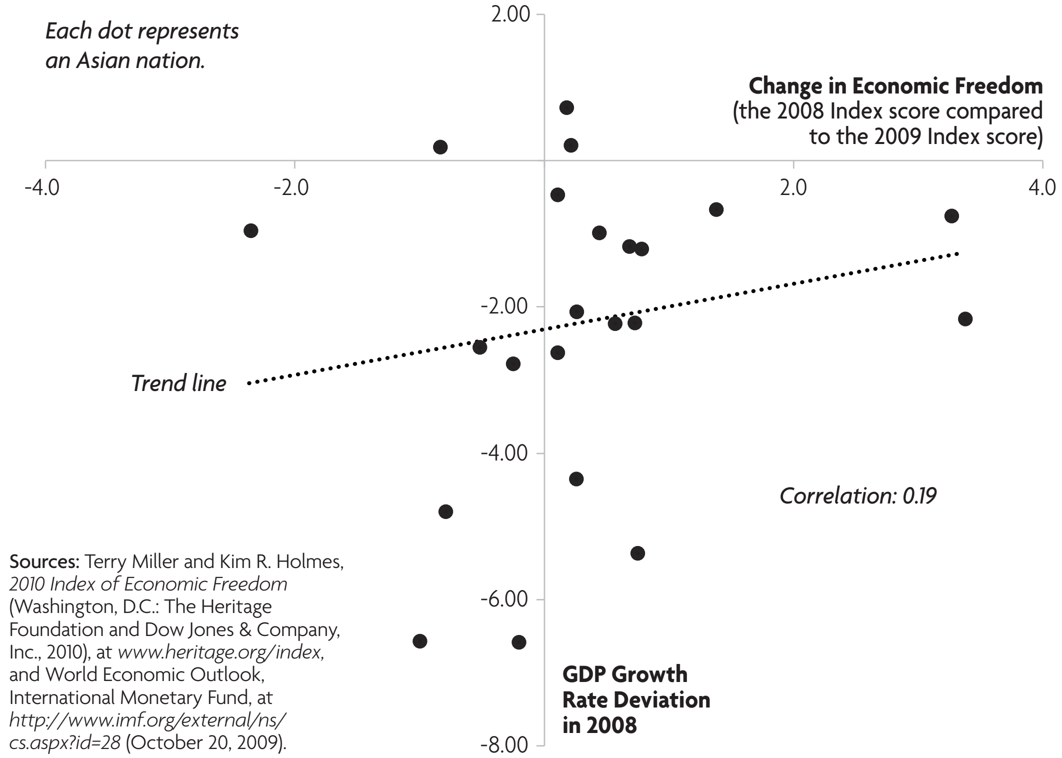
Obviously, one wants to take into consideration comparative performance before a crisis as well as during a crisis. Since countries with greater economic freedom have, on average, much better long-term growth rates than less free countries, any downturn during a crisis must be evaluated against the higher growth previously achieved.

Equally important is that economic freedom is a dynamic, not static, feature. That is, *changes* in economic freedom also have an important impact on a country's crisis

evaluation. This trend will vary by development stage as well as by level of economic freedom. A smaller base and more unexploited opportunities to enhance either efficiency or resource mobilization make it generally easier for less-developed economies to boast high rates of GDP growth. Here, given the small portion of the crisis captured by 2008 data, a narrower trend measurement better conveys the extent of instability. When 2009 results are available, an extended GDP trend may be appropriate.

4. Because of the comparison to trend, the results may clash with conventional views of the crisis. China does worse than perhaps expected because its still-considerable GDP growth has dropped by a substantial amount. Pakistan's earlier economic struggles, on the other hand, make for only a small decline in growth during the crisis.

Boosting Economic Freedom Lessened Economic Slowdown



Sources: Terry Miller and Kim R. Holmes, *2010 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2010), at *www.heritage.org/index*, and World Economic Outlook, International Monetary Fund, at *http://www.imf.org/external/ns/cs.aspx?id=28* (October 20, 2009).

Chart 2 heritage.org

performance and resilience. As shown in Chart 2, the correlation between changes in economic freedom and the variation of GDP growth rates is positive, indicating that advancing economic freedom has enabled some countries to perform better than others during the recent economic turmoil.

Still, the lack of correlation between the level of economic freedom and short-term crisis performance suggests either that economic freedom does not necessarily promote superior crisis performance or that something important has been missed, at least for Asian countries. It turns out that a strong case can be made for the latter explanation.

The *Index of Economic Freedom* ranks a notably large number of countries from every region of the world. The inclusion of so many countries constrains the number of comparable data sets that can be used to measure economic freedom. The *Index* provides a comprehensive picture of economic freedom, yet it cannot be claimed that it is measuring every relevant variable, or even necessarily all of the most important variables. It represents a compromise between the ideal and the possible.

Fortunately, in the case of the larger Asian economies, there are available data relevant to economic freedom that enhance understanding of its effects on crisis performance. In determining what information might be most valuable, it is helpful to consider the recent history of government policies and crises in Asia.

THE ASIAN FINANCIAL CRISIS

In the early and mid-1990s, many Asian states intervened in their economies to mobilize capital and other resources. In light of superficially excellent macroeconomic performance, decision-makers dismissed critics of this intervention. They touted an "Asian" path to prosperity that combined private enterprise's pursuit of profit with an activist state's pursuit of national development goals.[5] The invisible hand needed to be guided by an all too visible government brain. More specifically, the state's economic policy was focused on contemporary rapid growth, ignoring the absence of productivity gains that would make growth rates sustainable indefinitely.[6]

This seemed to work until the Asian financial crisis erupted in 1997. It was inefficient resource allocation, largely due to government influence over interest rates and the financial system,[7] that proved to be the main reason for the attacks on regional currencies in 1997. This resource misallocation incorporated, but was not limited to, the concentration of short-term foreign capital flows in specific sectors. The proximate cause of the attacks was even more government intervention, this time in the currency market in the form of incorrect exchange rate valuation and restrictions on foreign currency trading.[8]

The devastating nature of the ensuing shock is well known. For example, in Korea, Indonesia, Malaysia, and Thailand—the four countries hit directly—from 1996 to 1998, GDP fell an average of 8.9 percent, and the average unemployment rate nearly doubled.[9]

An academic debate continues to this day over whether the harshness of the regional crisis was due primarily to fundamental structural problems or to panic and information distortions associated with the currency runs. This debate overlooks the policy lessons actually drawn.

Some financial-sector reform was undertaken to address structural weakness,[10] but the chief reaction among many policymakers was to move to better protect their exchange rates in the future by accumulating foreign reserves. (See Table 1.) This required another flawed round of state action. The conventional wisdom in Asia became not that state intervention contained hidden and painful costs, but that the state should intervene to accumulate foreign exchange reserves and deter currency attacks.

Reserves as a percentage of GDP captures the extent of exchange rate "protection" being purchased by a government. A value of 0, of course, is unnaturally and perilously low. On the other side, as the value moves higher and higher, it begins to seem wasteful and eventually harmful. When excessive reserve accumulation is forced by government action, which inevitably is distorting to some extent, the process is twice inefficient. In this case, reserve accumulation represents a fundamental imbalance caused by the state and, hence, a sharp deviation from economic freedom.

The interventions in Asia may have started as minor distortions in 1998, but they have since pushed foreign reserves in certain economies to unprecedented levels. On some accounts, these reserves are so large as to become the sin-

5. Nicholas D. Kristof, "Crisis Pushing Asian Capitalism Closer to U.S.-Style Free Market," *The New York Times*, January 17, 1998, at *http://www.nytimes.com/1998/01/17/world/international-business-crisis-pushing-asian-capitalism-closer-us-style-free.html*.

6. Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs*, November/December 1994, at *http://www.foreignaffairs.com/articles/50550/paul-krugman/the-myth-of-asias-miracle*.

7. Beatriz Pont, Liu Lan, Francisco García-Blanch, Clara García, and Iliana Olivié, "The Financial Crisis in East Asia: The Cases of Japan, China, South Korea and Southeast Asia," Complutense Institute for International Studies, Complutense University of Madrid, *Working Paper* No. 11, October 1998, at *http://www.ucm.es/info/eid/pb/ICEIwp11-4.pdf*.

8. Dick K. Nanto, "The 1997–98 Asian Financial Crisis," Congressional Research Service *Report for Congress*, February 6, 1998, at *http://www.fas.org/man/crs/crs-asia2.htm*.

9. Andrew Berg, "The Asia Crisis: Causes, Policy Responses, and Outcomes," International Monetary Fund *Working Paper* No. WP/99/138, October 1999, at *http://www.imf.org/external/pubs/ft/wp/1999/wp99138.pdf*; "A Note on Unemployment in the Wake of the Asian Economic crisis and Some Responses," Economic and Social Commission for Asia and the Pacific, *Bulletin on Asia–Pacific Perspectives*, 2002/03, at *http://www.unescap.org/drpad/publication/bulletin%202002/ch3.pdf*.

10. "The IMF's Response to the Asian Crisis," International Monetary Fund *Factsheet*, January 1999, at *http://www.imf.org/External/np/exr/facts/asia.htm*.

Foreign Reserves and GDP in Asia

Ratio of Foreign Reserves to GDP

Extremely High	Singapore	1.01
	Hong Kong	0.737
	Taiwan	0.702
Very High	Malaysia	0.541
	China	0.477
High	Thailand	0.347
	Vietnam	0.342
	Mongolia	0.304
	Korea	0.27
Above Average	India	0.227
	Japan	0.217
	Cambodia	0.216
	Philippines	0.21
Average	Kazakhstan	0.15
	Laos	0.13
	Indonesia	0.127
	Global Mean	*0.117*
Below Average	New Zealand	0.127
	Sri Lanka	0.109
	Pakistan	0.098
	Tajikistan	0.081
	Bangladesh	0.076
	Australia	0.03

Sources: Terry Miller and Kim R. Holmes, *2010 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2010), at *www.heritage.org/index*, and individual countries' central banks' Web sites.

Table 1 heritage.org

gle most important global economic force.[11]

This dubious accomplishment was made possible by sharply skewing resource allocation toward exports (or supply of exporters) because returns to exporting were artificially enhanced, often by forcefully depressed exchange rates, as the tool for building up reserves. The imbalances caused by the distortion have principally taken the form of unnecessary dependence on foreign demand and corresponding unnecessary weakness in domestic consumption.

Table 1 thus provides an indirect measurement of how much freedom has been lost in Asian economies for the sake of accumulating reserves.[12] If the distortions implied by high reserves/GDP reduce economic freedom, then the sample economies have less freedom than the *Index* would indicate. The Average group lies above the global mean in reserve accumulation. If average levels are taken to be close to ideal, many countries in the sample are far from ideal, having intervened to accumulate seriously excessive reserves. Combining *Index* scores with the lost freedom signified by reserves/GDP provides a more comprehensive version of true economic freedom in the region than is provided by *Index* scores alone.

GOVERNMENT INTERVENTION WITH LASTING CONSEQUENCES

The policies implemented in response to the 1997 crisis did not end with its resolution. They have had an impact during the current crisis as well.

The easiest way to accumulate large quantities of foreign exchange over time is to defend an undervalued currency. This also has the seeming extra advantage of making exports more competitive, thus temporarily boosting employment and GDP. It therefore became standard policy in much of Asia for almost a decade.[13] From the time of their recovery after the regional crisis until the global financial crisis, Asia economies were again praised for their macroeconomic performance, warnings were again raised concerning the unsustainable nature of their policy course, and these warnings were again ignored.[14]

11. "Remarks by Governor Ben S. Bernanke," Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10, 2005, at *http://www.federalreserve.gov/boarddocs/speeches/2005/200503102*.

12. See World Bank, *World Development Indicators 2009*, online database.

13. Hans Genberg, Robert N. McCauley, Yung Chul Park, and Avinash Persaud, *Official Reserves and Currency Management in Asia: Myth, Reality and the Future* (Geneva: International Center for Monetary and Banking Studies, 2005).

14. Charles Adams and Donghyun Park, "Causes and Consequences of Global Imbalances: Perspective from Developing Asia," Asian Development Bank, *Asian Development Review*, Vol. 26, No. 1 (2009), at *http://www.adb.org/Documents/Periodicals/ADR/pdf/ADR-Vol26-1-Adams.pdf*; Yilmaz Akyuz, "The Global Financial Turmoil and Asian Developing Countries," paper presented at meeting of Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, April 29, 2008, at *http://www.twnside.org.sg/title2/finance/twninfofinance20080506.htm*.

As inevitably happens with government intervention, those guiding the state's hands were themselves misguided. One mistake made by Asian policymakers was fighting the last war, believing that the next crisis would look very much like the previous one and foreign reserves would prove decisive.[15] Instead, the mountains of reserves proved irrelevant when the financial system shuddered in September 2008. A year later, the International Monetary Fund found no connection between reserves and economic growth, and IMF chief economist Oliver Blanchard called reserve accumulation "incredibly inefficient" and "very expensive."[16]

The principal mistake, though, was addressing the symptom of currency weakness rather than the disease of structural weakness. Reorientation of economies to accumulate reserves led to greater than necessary dependence on exports and foreign consumption. In particular, undervalued, reserve-accumulating exchange rates fomented Asian dependence on external consumption.

Competitive exports appeared to be the ideal engine for economic expansion when, in fact, this was an artificial construct, reliant primarily on hyperactive American consumers.[17] In protecting against an external blow through currencies, Asian governments engendered vulnerability to an external blow through basic demand and supply. This unnecessary dependence turned intensely harmful when external demand slumped in the fall of 2008.

A very considerable portion of Asia's recovery from its financial crisis was not effective state intervention, as often claimed, but rather playing to the seeds of a similar American financial crisis. Asia's dependence on the U.S. means that it suffered for its own policy mistakes and then for America's. With the collapse of the American financial house of cards and rise in private U.S. saving,[18] Asian economies may now be forced to do what they should have done voluntarily over the past decade: restructure in sustainable fashion.

Alternatively, some Asian governments are again intervening, this time to temporarily boost employment and growth. The argument for economic freedom, twice confirmed already, is that state actions are a double-edged sword and that a third intervention will also have a high price.

THE GLOBAL RECESSION

The financial turmoil that started in the U.S. in 2008 led quickly to a worldwide crisis that saw significant drops in trade, investment, and GDP growth. To respond to the slump, Asian governments have utilized fiscal outlays, trade barriers, financial regulation, and interest rates and money supply. Eventually, all of these should be assessed. Only those actions chosen and implemented very quickly, however, curbed economic freedom in the period covered by this study. For instance, much fiscal expansion promised in late 2008 did not occur until well into 2009.

As in 1997 and its aftermath, crisis-driven state intervention obviously harmed economic freedom across the region, but to a different extent in different countries. To measure the impact of economic freedom on crisis performance accurately, this variance must be assessed.

The assessment presents two timing problems, however. In the crisis, governments chose policies with immediate, positive impacts, accepting or ignoring long-term costs. The superiority of economic freedom is compatible with short-run benefits from state intervention, but these benefits will come with short-run and long-run costs from reduced

15. Wendy Leung, "Hong Kong May Use Foreign Reserves to Prevent Financial Crisis," Bloomberg.com, October 12, 2008, at *http://www.bloomberg.com/apps/news?pid=20601080&sid=alfYZgGWdOqM&refer=asia*.

16. Dow Jones, "IMF Chief Economist: Ctrl-Bk Reserves Haven't Influenced Growth Rates," *The Wall Street Journal*, September 1, 2009, at *http://online.wsj.com/article/BT-CO-20090901-704885.html*.

17. "Asian Economies: Troubled Tigers," *The Economist*, January 29, 2009, at *http://www.economist.com/businessfinance/displayStory.cfm?story_id=13022067*.

18. "Amid Recession, U.S. Savings Rate Hits Highest Mark Since 1993," Online NewsHour, June 26, 2009, at *http://www.pbs.org/newshour/updates/business/jan-june09/savingsrate_06-26.html*.

competition, higher taxes, and/or financial disintermediation.

At the time of this writing, performance data for the full set of countries are available only through the end of 2008. These data are likely to capture a larger portion of the benefits of state actions, which were chosen for immediate impact, compared to their costs. They will therefore undervalue economic freedom. Since government policy plainly cannot be excluded, there is a pro-intervention bias in this first evaluation of Asian economies in the crisis. It will dissipate in future work.

The second problem is more difficult. Currently, only pre-crisis freedom scores are available. The *Index* is beginning to capture crisis policy in the current volume, but the full extent of government interventions will be revealed only in future years. For this study, therefore, policy stances adopted during the crisis must be identified and measured in some fashion that is independent of the *Index*. Fortunately, data are available for Asian economies that can serve as an adequate proxy for overall policy intervention for 2008.

The policy steps with the fastest effect are monetary. Interest rate changes alter prices immediately, and sharp departures in money supply can influence financial market transactions in just a few days. Further, in many cases, monetary policy is telegraphed and has effects through expectations. In contrast, fiscal or regulatory policies, even if announced or adopted in 2008, are not likely to affect GDP growth in the period under study. Monetary policy is also a proxy for broader government response to the crisis, even in the minority of cases (in-sample) where the central bank is supposed to be independent.

Whatever its perceived or actual value as stimulus, strident government intervention in the money market curbs economic freedom. It unavoidably distorts private financial decisions and typically harms existing asset holders. The extent of interest rate changes made in response to the crisis can thus be used to rank policy as more or less free.

In Table 2, interest rate measures are supplemented by changes in broad money supply to give an overall measure of government policy infringement in the recent crisis.[19] The data are limited but instructive. As with other measures in this study, there is a broad distribution of scores, which is welcome. There are also individual idiosyncrasies. Japanese interest rates were so low at the start of the crisis that Japan's crisis behavior appears responsible almost by default. At the other end, Vietnam does not track money supply and, as a result, uses interest rate changes as a blunt instrument.

Policy Intervention in Asia

Change in Interest Rate

Minimal		*Considerable*	
Bangladesh	0.25	Thailand	3.75
Pakistan	1.00	Australia	4.00
Japan	1.30	India	4.00
		Philippines	4.00
Minor		*Heavy*	
Malaysia	1.90	Tajikistan	4.25
Indonesia	2.20	Mongolia	4.30
Singapore	2.25	China	4.45
Korea	2.50	Kazakhstan	4.50
New Zealand	2.50		
Moderate		*Maximal*	
Cambodia	2.80	Taiwan	4.90
Laos	3.00	Hong Kong	5.00
Sri Lanka	3.10	Vietnam	5.50

Sources: Terry Miller and Kim R. Holmes, *2010 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2010), at *www.heritage.org/index*, and individual countries' central banks' Web sites.

Table 2 heritage.org

SHEDDING NEW LIGHT ON ASIAN ECONOMIC FREEDOM

Crisis performance in Asia can now be measured against an economic freedom score augmented with measures of forced reserve accumulation and monetary easing.

Table 3 represents the GDP growth change from Chart 1 alongside an economic freedom score that is now revised to take into account

19. Monetary variables with the same label are not entirely identical across countries. In all cases, though, interest rates are a price for capital, and all governments have tools available to affect interest rates.

GDP and Economic Freedom

	GDP Growth Rate Deviation in 2008	Adjusted Economic Freedom Score*
Tajikistan	0.73	57.7
Indonesia	0.22	68.7
Mongolia	0.18	52.8
Laos	-0.47	62.6
Pakistan	-0.67	78.1
Bangladesh	-0.75	79.8
Sri Lanka	-0.95	65.4
Australia	-0.97	70.3
Malaysia	-1.18	60.1
Philippines	-1.21	55.4
India	-2.07	54.2
New Zealand	-2.15	75.3
Thailand	-2.22	54.4
Vietnam	-2.23	39.5
Korea	-2.54	67.1
China	-2.62	42.5
Japan	-2.78	78.0
Hong Kong	-4.35	42.4
Taiwan	-4.79	37.7
Cambodia	-5.37	62.8
Kazakhstan	-6.57	56.0
Singapore	-6.58	49.7

Correlation: 0.39

* With foreign reserves and interest rate changes.

Sources: Terry Miller and Kim R. Holmes, *2010 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2010), at *www.heritage.org/index,* and World Economic Outlook, International Monetary Fund, at *http://www.imf.org/external/ns/cs.aspx?id=28* (October 20, 2009).

Table 3 heritage.org

the reserve accumulation data from Table 1 and the policy infringement data from Table 2.[20]

The economic freedom scores that take into account monetary easing and foreign reserve accumulation do a better job than the original scores in predicting crisis performance. The correlation between economic freedom and crisis performance is now positive and predictive, though at a modest level.[21] It is important to note that the inclusion of policy intervention and currently limited data means that this measure of freedom applies best only from the onset of the crisis late in the summer of 2008 through the end of that year.

The adjusted freedom scores show a natural correlation with the 2009 *Index* results, but there are also notable changes. For example, due to both excess reserve accumulation and sharp monetary intervention, Hong Kong falls far from its lofty perch as freest Asian economy. At the other end, Bangladesh rises noticeably.

These shifts may be more about capacity than intention to preserve economic freedom. Hong Kong has the technical and financial ability to conduct intervention to accumulate reserves or attempt to preserve jobs and acted accordingly. Bangladesh does not have the same ability to distort the economy and reduce economic freedom, whether the government wished to or not.

DID FREEDOM WORK?

While the limitations of the data are stark, they are also temporary. What will not change is the importance of measuring the efficacy of economic freedom with periods of intense economic stress as a crucial measuring stick. For almost two decades, many Asian policymakers have intervened in their economies, confident in the superiority of state action. That superiority was not borne out in the regional downturn of the late 1990s; has it been borne out thus far in this current and broader slump?

The answer, clearly, is no. In the best case, intervention has no predictive power with respect to changes in growth rates. It may have a negative effect on growth. The contortions that many Asian governments have engaged in—the warping of their economies to accumulate foreign exchange reserves and the hundreds of billions of dollars now being spent in response to the financial shock—either have no measurable effect on economic performance or may actually undermine it.

20. The data from Tables 1 and 2 were converted to a 0–100 scale by the standard maximum-minimum-value–based conversion. These scores were then averaged with the economic freedom score to give the revised and augmented economic freedom score presented in Table 3.

21. The coefficient of correlation is 0.389.

The impact of economic freedom is noticeable and significant in certain countries. Mongolia, singled out in the 2009 *Index* as the Asian economy that has gained the most economic freedom over the life of the *Index*, performed very well in the crisis. Tajikistan, another big gainer of economic freedom, tops the performance rankings. Hong Kong and Singapore, the top performers in the *Index of Economic Freedom*, do much less well when their scores are adjusted for reserve accumulation and interest rate changes, and they wind up near the bottom on our measure of crisis performance. It is worth repeating that the limited period of

China Versus Indonesia

Two important illustrations of the connection between economic performance and freedom are provided by China and Indonesia. Together, these two countries have populations of over 1.5 billion and GDPs of nearly $5 trillion, and were ranked right next to each other at the low end in the 2009 *Index*.

This study, however, reveals striking differences. Indonesia has eschewed the extreme exchange rate manipulations of many of its neighbors, has tolerated current account deficits,[1] and is close to the global average in reserves as a proportion of GDP.

In contrast, China has conducted persistent and powerful monetary intervention to depress its exchange rates, most recently repegging the RMB (renminbi) to the dollar for at least 16 months starting in June 2008.[2] This has led both directly, through purchases by the People's Bank to contain the RMB, and indirectly, by encouraging a larger trade surplus, to by far the world's largest stash of foreign reserves. China has more than four times the global average for reserves as a proportion to GDP.

Due the absence of policy skewing the economy to serving external demand, the global crisis was not as dire threat to Indonesia as it was to some of its neighbors. This made it easier for policymakers to remain restrained, and Indonesian monetary policy loosened only modestly. Also, the original fiscal stimulus proposed was only 1.4 percent of GDP, three quarters of which was tax cuts.[3]

China is again sharply dissimilar. Its announced fiscal program came to about 7 percent of GDP annually,[4] though spending did not commence until mid-November. Monetary stimulus was just as sharp and much faster, among the most powerful in the region in 2008 and intensifying through the first half of 2009 in the form of wildly fast bank lending and money growth.[5]

1. Bank Indonesia, "Indonesia Financial Statistics: Monetary Sector/Government Finance Sector/Real Sector/External Sector," at *http://www.bi.go.id/web/en/Statistik/Statistik+Ekonomi+dan+Keuangan+Indonesia/Versi+HTML/Sektor+Eksternal*; Jittima Tongurai and Kazuo Toritani, "Corners Hypothesis and the Proposals on Foreign Exchange System for East Asia: A Perspective from the Incompatible Trinity," paper presented at Asia–Pacific Economic and Business History Conference, Tokyo, Japan, February 18–20, 2009, at *http://www.uow.edu.au/commerce/econ/ehsanz/Tokyo%20Conference%202009/Papers/Tongurai_Toritani.pdf*.

2. "FX History®: Historical Currency Exchange Rates," OANDA Corporation, at *http://www.oanda.com/convert/fxhistory*.

3. Iyanatul Islam and Anis Chowdhury, "Global Economic Crisis and Indonesia," *The Jakarta Post*, May 5, 2009, at *http://www.thejakartapost.com/news/2009/05/05/global-economic-crisis-and-indonesia.html*. Ostensible stimulus was expanded moderately in 2009, but at the same time, the government budget deficit was rolled back.

4. David Barboza, "China Unveils Sweeping Plan for Economy," *The New York Times*, November 9, 2008, at *http://www.nytimes.com/2008/11/10/world/asia/10china.html*.

5. People's Bank of China, "Money Supply Continues Rapid Growth," August 14, 2009, at *http://www.pbc.gov.cn/english/detail.asp?col=6400&id=1413*.

study introduces a performance bias against economic freedom.

It is reasonable to expect that countries that are highly integrated into the world economy might suffer more quickly and profoundly from a global downturn, but it is also reasonable to expect that they might recover more quickly and strongly when conditions improve. The data to demonstrate that latter point are not yet available.

In the data available for this study, economic freedom is only modestly correlated with success in the crisis, but economic freedom is also free, both materially and morally.

Economic freedom correctly predicts Indonesia's superior crisis performance. Indonesia did not distort its economy accumulating foreign exchange and therefore was less harmed by declining global demand. In the future, its muted monetary response and fiscal responses will neither embed serious inflation nor force crushing taxes.

If intense government action was the proper antidote to the crisis, China should have responded better than nearly every other country in the region and far better than most. Instead, it lagged. China's mountain of foreign exchange reserves was of little use. The financial market repression behind the exchange rate controls that accumulated reserves suppressed domestic consumption, leaving China unnecessarily reliant on foreign consumers.[6] The short-term steps taken to try to offset this reliance are savaging the banking system and worsening long-term overcapacity.[7]

6. Nicholas R. Lardy, "Financial Repression in China," Peter G. Peterson Institute for International Economics *Policy Brief* No. PG08-8, September 2008, at *http://www.iie.com/publications/pb/pb08-8.pdf*.

7. "China's Bank Loan Total Exceeds Full-Year Target," *People's Daily Online*, July 9, 2009, at *http://english.peopledaily.com.cn/90001/90778/90857/90859/6696563.html* (originally published by *China Daily*); Zhou Xin and Jason Subler, "UPDATE 1—China Says to Curb Industrial Overcapacity," Reuters, August 26, 2009, at *http://uk.reuters.com/article/idUKPEK16072820090826*.

An obvious rejoinder is to point to China's economic success before the crisis as justifying statist policies. While a proper debate on this point is far beyond the scope of this study, economic freedom was completely lacking in China in 1978 and largely lacking in 1991. In both cases, Deng Xiaoping believed—and events proved him to be entirely correct—that more economic freedom was the only solution.

In 1999, then-Premier Zhu Rongji responded to the Asian financial crisis by vigorously adopting reform in order to win accession to the WTO. One of the high points of Zhu's reform was liberalizing urban housing, the same sector now viewed by some as the best hope for leading a sustainable recovery.[8]

When China has moved toward economic freedom, it has succeeded in stunning fashion. When it has moved away, as with reserves and the present crisis, it has wasted resources to no good effect.

8. "China's Housing Reform of 10 Years," *World Chinese Weekly*, January 21, 2008, at *http://www.worldchineseweekly.com/weekly_en/article/show.php?itemid=169*; Simon Rabinovitch, "China Goes House Hunting to Rev Up Economy," Reuters, August 18, 2009, at *http://www.reuters.com/article/reutersEdge/idUSTRE57H0Z020090818*.

Governments can permit their citizens freer and less distorted economic choices, including lower taxes and the unrestricted movement of individual savings, and still be no worse off and perhaps slightly better prepared than their interventionist counterparts for the sharp downturns Asia has suffered in each of the past two decades.

THE VALUE OF ECONOMIC FREEDOM

Neither the Asian financial crisis nor the especially sharp downturn in some Asian economies in the global financial crisis a decade later surprised advocates of economic freedom. Both flowed all too predictably from mistaken government intervention to mobilize resources or to orient the economy toward external demand.

The overwhelming reaction to the global crisis has been to call for more government: more spending (implicitly more taxation), more regulation, more trade management. It is widely proclaimed that too much economic freedom caused this crisis or at least made it more severe than it otherwise would have been. This study indicates that, in Asia and through the outset of the present crisis, those who make this claim have it absolutely backward.

A number of Asian governments are accepted to have followed statist paths to disastrous effect before the Asian financial crisis in the late 1990s. Another set of policymakers repeatedly and unapologetically intervened again after the regional crisis to build up foreign reserves and, it was thought, avoid a repeat. These actions distorted many regional economies, leaving them more vulnerable to the global demand slump. In Asia, economic freedom did not lead to this point; avowed statism did.

Nor is statism proving to be any sort of solution to the crisis. While the data are limited, countries that have intervened less have done slightly better than those that have intervened more. The two possible outcomes of public-sector leadership appear to be either accomplishing nothing or actively harming the economy. The crisis interventions are still in category one but were adopted explicitly for short-term benefit, so they may yet move into category two.

Economic freedom is not a panacea. Even undistorted economies with strong internal consumption were hurt by the financial shock. Economic freedom cannot prevent painful slumps, but it does reduce their impact by permitting individuals and firms to make choices that are not warped by misguided state priorities. Freer economies were better situated to survive the crisis. By avoiding mindless economic stimulus, they are also wasting fewer resources and creating fewer long-term problems.

The most important changes in freeing an economy will obviously vary from nation to nation. Identifying the most valuable internal reforms must wait. There must first be an assessment of the comparative efficacy, if any, of the various fiscal and monetary actions taken around the region in 2009. Then, and more ominous, there must a be a longer-term assessment of the inevitable undesired consequences of those actions, such as corruption, asset bubbles, and explicitly higher tax burdens.

On the external side, of particular utility in Asia would be to end the obsession with reserves and the ensuing promotion of undervalued exchange rates and high export growth. The events of the past few years may well make enough of an impression that this will happen—the positive legacy of a difficult time.