The Asian Economic Crisis*

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Abstract

The Asian financial crisis was not a unique event; it had roots in other developments such as the Mexican financial crisis of 1994 and the world debt crisis of the 1980s. It has been feared that a world crisis could envelope all economies at once, but the United States, the European Union, and China have so far avoided crisis situations although they could experience slower expansion and some serious economic im-balances. They feel the effects of the East Asian crisis. Many diverse reasons are responsible for the Asian crisis, and no single issue carries all the blame. Policies for reform must recognize this fact and deal with institutional defects, adequate regulation of newly liberalized markets, speculative practices, and exchange rate mechanisms. In particular, the attempts to link currencies to the US dollar were ill-advised, and more flexible patterns should be put in place for the future. Broadly speaking, crisis-ridden countries should learn from past situations that have generated unstable economic conditions and adopt policies that prevent their recurrence or avoid them by other means.

1 . Defining the Issue

What began in 1996-97 as a localized economic crisis in a few countries of South East Asia and East Asia (ASEAN nations plus the Republic of Korea) has become a world phenomenon in 1998. The usual dating of the start of the problem has been July 1997 in Thailand, where the baht jumped from 25.8/\$ to 32.1/\$ (monthly averages). Actually a slowing of growth in these countries was noticeable as early as 1995, and bankruptcies were prominent in Korea at the end of 1996 or very early in 1997. The economic events that we now find very disturbing were thought in 1997 to be signs of maturation and slippage - not deep recessions.

The economic situation in Asia was likened to that in Latin America, and Mexico's case was considered to provide a guideline. In 1995, at more than one international gathering, we heard the question "Can a Mexican-type crisis occur in Asia?" The answer was usually "yes, it can, but it is not likely".

It is interesting that the Mexican crisis that began in December 1994 did not spread in a contagious fashion throughout the Latin American area. Argentina had a recession, and Latin stock markets reflected the losses in

the Mexican market, but such “tequila effects” lasted a very short time (weeks, at most) and did not spread far and wide.

The Asian collapse after 1997 was severe and fed back to Latin America, causing a secondary fall in Mexico, both in the real economy and in the stock market, and by 1998 became almost a world wide problem. It is not presently a world recession, but it definitely is a world slowdown.

The strong deflation in primary commodity prices is a world market phenomenon, and Russia has been added to the group of crisis countries; so it is evident that we have a global problem on our hands. Among industrial countries, where we expect to find strength and support for the world economy, as a whole, there is outright recession in Japan and a slowing elsewhere.

The main question that we face is: Will the world economy stop falling or slowing, and when will a visible upturn occur? Synchronized global recessions or depressions are unusual. One occurred in the 1930s, before World War II, another in 1958, and again at the beginning of the 1970s. Present forecasts do not project a global recession, with most of the world in decline, but the international economy has come to a position that is uncomfortably near to such a recession.

2 . The Present Outlook

Two summaries of the world outlook are provided in Tables 1 and 2, one is from Project LINK (UN) and the other from the International Monetary Fund. There are others of this genre, but they are both very recent tabulations that reflect consensus views and were completed during September. ⁽¹⁾

In the columns for GDP growth for 1998, we find a number of significant negative entries, and they are mainly for Asian economies, but Russia is prominent in both. In the LINK forecast, Russia is included with other transition countries, but it is quite large in absolute value, by itself, just under -4%.

There are three other important features of these two forecasts, namely

(i) For the world, 1998 shows much lower growth than in 1997, and 1999 is expected to be a weak recovery year. ⁽²⁾

(ii) World trade has also slowed considerably. There is usually a fixed relation between world trade and world production, but the estimates for 1998 and 1999 are quite depressing.

(iii) Commodity prices have fallen drastically in 1998 and are not projected to recover very strongly. This is burdensome for developing countries, who are primary producers.

The slowing of world trade and the weakness of world commodity prices have many diverse causes, but the Asian economic crisis has had a significant effect on both.

In the general outlook, the industrial countries of North America and Western Europe are affected by the crisis, but they are still quite prosperous. The economy of the United States has been unusually strong for the past few years and benefited from the Asian problems during the first six months. The crisis induced a flight to safety, and the resulting demand for US treasury bonds brought down long term interest rates by more than 100 basis points. This has stimulated residential construction and enabled US borrowers (home owners and busi-

Table 1 Gross Domestic Product and World Trade
(Annual rates of growth)

	1997	1998	1999	2000
World GDP	3.1	1.9	2.5	2.6
Developed market economies	2.6	2.0	2.3	2.1
Canada	3.5	3.0	2.3	2.1
France	2.6	3.0	2.8	3.1
Germany	2.3	2.6	2.8	2.4
Italy	1.5	2.2	2.6	2.9
Japan	0.8	-1.6	1.5	1.7
United Kingdom	3.4	2.2	1.3	2.2
United States	3.9	3.4	2.5	1.8
Developing countries	5.3	2.0	3.8	4.6
Latin America	5.0	2.9	2.8	3.9
Argentina	8.4	5.0	4.6	4.6
Brazil	3.0	1.1	1.2	3.4
Mexico	7.0	4.5	4.0	4.0
Africa	3.1	3.6	3.6	4.0
North Africa	3.0	4.6	4.4	5.0
Sub-Saharan Africa	3.8	4.1	3.5	3.8
Nigeria	3.0	2.8	3.4	3.3
South Africa	1.7	1.5	2.8	3.4
South and East Asia	5.0	*-1.1	3.1	4.6
India	5.3	5.4	5.8	6.3
Indonesia	4.5	-16.8	-2.7	0.4
Korea, Republic of	4.9	-6.2	1.4	3.8
Malaysia	7.8	-2.3	2.1	3.5
Philippines	5.2	1.3	4.0	4.5
Singapore	7.6	1.2	0.7	2.4
Taiwan Province	6.8	4.8	5.6	6.0
Thailand	-0.4	-7.8	-0.7	3.5
China	8.8	7.4	7.5	7.2
West Asia	3.9	-0.4	2.0	3.3
Economics in transition	1.7	-0.2	0.8	1.3
World exports volume	10.6	6.3	5.1	4.5
Export prices (Annual percentage change)				
All goods	-5.7	-6.8	1.3	3.1
Agricultural commodities	1.4	-11.4	-2.0	2.1
Raw materials and ores	-7.3	-9.5	1.7	3.2
Oil	-7.9	-28.9	4.0	8.0

* Pre-meeting forecasts, September 1998; weights used are in 1988 U.S. dollars.

(Source) UN, Project LINK.

Table 2 Overview of the World Economic Outlook Projections
(Annual percent change unless otherwise noted)

	1996	1997	Current Projections		Differences from May 1998 Projections	
			1998	1999	1998	1999
World output	4.2	4.1	2.0	2.5	-1.1	-1.2
Advanced economies	3.0	3.1	2.0	1.9	-0.4	-0.6
Major industrial countles	2.8	2.9	2.1	1.9	-0.2	-0.3
United States	3.4	3.9	3.5	2.0	0.6	-0.2
Japan	3.9	0.8	-2.5	0.5	-2.5	-0.8
Germany	1.3	2.2	2.6	2.5	0.1	-0.3
France	1.6	2.3	3.1	2.8	0.2	-0.2
Italy	0.7	1.5	2.1	2.5	-0.2	-0.2
United Kingdom	2.2	3.4	2.3	1.2	0.0	-0.9
Canada	1.2	3.7	3.0	2.5	-0.2	-0.3
Other advanced economies	3.8	4.2	1.4	2.3	-1.5	-1.3
<i>Memorandum</i>						
Industrial countries	2.8	2.9	2.3	2.0	-0.1	-0.4
European Union	1.7	2.7	2.9	2.5	0.1	-0.3
Euro area	1.6	2.5	3.0	2.8	0.1	-0.2
Newly industrialized Asian economies	6.3	6.0	-2.9	0.7	-4.7	-3.8
Developing countries	6.6	5.8	2.3	3.6	-1.8	-1.7
Africa	5.8	3.2	3.7	4.7	-0.9	-0.2
Asia	8.2	6.6	1.8	3.9	-2.6	-2.0
ASEAN-4	7.1	3.7	-10.4	-0.1	-7.7	-2.6
Middle East and Europe	4.7	4.7	2.3	2.7	-1.0	-1.3
Western Hemisphere	3.5	5.1	2.8	2.7	-0.6	-1.6
Countries in transition	-1.0	2.0	-0.2	-0.2	-3.1	-3.6
Central and eastern Europe	1.6	2.8	3.4	3.6	-0.5	-0.6
Excluding Belarus and Ukraine	3.7	3.2	3.7	4.1	-0.7	-0.5
Russia	-5.0	0.9	-6.0	-6.0	-7.0	-7.9
Transcaucasus and central Asia	1.6	2.1	4.1	3.8	-0.4	-1.3
World trade volume (goods and services)	6.8	9.7	3.7	4.6	-2.7	-1.5
Imports						
Advanced economies	6.4	9.0	4.5	4.7	-2.3	-0.9
Developing countries	9.3	9.8	1.0	4.6	-4.2	-3.2
Countries in transition	10.0	8.2	3.5	3.5	-1.6	-2.1
Exports						
Advanced economies	6.0	10.3	3.6	4.2	-2.6	-1.8
Developing countries	8.8	10.9	3.9	5.5	-3.5	-1.2
Countries in transition	7.0	6.9	5.3	5.9	1.1	-0.7
Commodity prices						
Oil ¹						
In SDRs	23.7	-0.2	-29.2	10.4	-6.4	1.3
In U.S. dollars	18.4	-5.4	-31.1	9.3	-7.2	0.1
Nonfuel ²						
In SDRs	3.3	2.0	-11.6	1.4	-5.6	0.6
In U.S. dollars	-1.2	-3.3	-13.9	0.4	-6.5	-0.5
Consumer prices						
Advanced economies	2.4	2.1	1.7	1.7	-0.4	-0.3
Developing countries	14.1	9.1	10.3	8.3	0.1	-0.2
Countries in transition	41.4	27.9	29.5	34.6	15.7	25.9
Six-month LIBOR (In percent) ³						
On U.S. dollar deposits	5.6	5.9	5.7	5.7	-0.4	-0.4
On Japanese yen deposits	0.7	0.7	0.7	0.6	0.0	-0.6
On deutsche mark deposits	3.3	3.4	3.7	...	-0.2	-0.8
On Euro deposits	...	...	...	3.7	...	...

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 27-August 24, 1998, except for the bilateral rates among ERM currencies, which are assumed to remain constant in nominal terms.

¹ Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was \$19.27 in 1997; the assumed price is \$13.28 in 1998 and \$14.51 in 1999.

² Average, based on world commodity export weights.

³ London interbank offered rates.

(Source) IMF, World Economic Outlook.

nesses) to enjoy cheap credit. Also, the currency depreciation against the US dollar has brought low import prices for US consumers, in addition to the low commodity prices that are partly the result of weak Asian demand.

Now the US economy has down-shifted to a much lower real growth rate and is feeling the effect of the Asian recession. Exports are not growing well; the trade balance is deeply in deficit; and multinational corporations have experienced weak profits. Even firms tied more to the domestic market are having slower profit growth because some costs are rising. Labor is more aggressive than in the last decade or more; so profit margins are not as generous as they used to be. Weak material prices offset the cost squeeze, but not fully. In addition, high degrees of competition are restraining the use of price increases to improve profit positions.

In Western Europe, economic expansion, particularly in labor markets, has been disappointing. Unemployment rates have been generally high, but that situation is changing. Fiscal and monetary restraint have gone far enough to permit a core group of countries to meet the Maastricht targets for the establishment of a common central bank, overseeing a common currency; therefore European countries are at a stage of cyclical activity, where they can be less restrictive and more stimulative. The prognosis for European expansion is more favorable. That is not to say that European economies have escaped the contagious effects of Asian, Latin American, and Russian financial crises.

In 1997, there was a great deal of denial in Europe, stating that the problems in Asian markets were too remote and too small to have significant effects, but that oversight has come to an end. Also, the added problems of Latin America in 1998 plus the fresh outbreak, close to home, of financial and other problems in Russia have contributed to some trimming of prospects in Europe. A smaller setback for 1999, than is apparent in North America, seems to be probable for Western Europe now; nevertheless this setback does not look like the onset of recession.

A feature of the economic landscape in recent years has been that overall expansion in developing countries was more vigorous than that of industrial countries. In these troubled times for large portions of the developing world, the margin of superiority in growth rates has considerably narrowed, but the forecast of the LINK project, and also of the IMF, show higher growth rates for total output in developing than in industrial economies.

On a per capita basis the margin is very small and not uniform from year to year, held down by Africa and other areas of very high population growth rates.

Not all Asian countries are in or near to recession. The two largest countries, China and India, are above the danger points of recession. They both have extremely large domestic markets and can offset some degree of loss of export markets by relying more on domestic demand. In fact, Chinese economic policy has been quite deliberate in promoting domestic development, after having gone through a long period of technology transfer, high foreign investment, and some degree of export-led growth. There is a noticeable difference in the international projections of project LINK and the IMF concerning the prospects for Chinese economic activity in the near term. The IMF's World Economic Outlook estimates China's GDP growth for this year, 1998, at just 5.5%. There was some slippage in the first half of this year, but reports assembled by the LINK team, and reported at

their semi-annual meeting of mid-September, indicate that stronger performance during the second half would bring the yearly average up to 7.5%. Some Chinese statisticians and econometricians at the September meeting held to approximately 8%, with growth in future years remaining above 7%.

The Asian financial crisis did not, at first in 1997, affect the Asian NIEs, except the Republic of Korea. Hong Kong, Singapore, and Taiwan showed continuing expansion, albeit much slower in Singapore. During 1998, however, recession reached Hong Kong. It is not an economy in acute distress, but there will be a downturn for 1998 as a whole, followed by an expected upturn in 1999. Taiwan, on the other hand, has had only a slowing of growth - not a genuine recession.

3 . Analysis of the Crisis

The forecasts that are submitted with this presentation do not portray a world recession, but it is a close call. They do show recession in some countries, especially Japan, Korea, Hong Kong, Indonesia, Malaysia, and Thailand. It is then expected that world expansion will shift to a higher rate again, but not necessarily as high as it was before 1997. When it has run its course, it will have been a very unpleasant experience, yet we should try to learn as much as possible about it in order to restore stability and also to avoid such events in the future. Of course, we should have learned some of these things from the World Debt Crisis of the 1980s, the US Savings & Loan Crisis of the 1980s, and the Mexican Crisis of 1994-95. In a sense, the Asian Crisis is an extension of the Mexican Crisis of 1994-95.

First, let me say that the Asian Crisis was a financial crisis. The Asian economies had many good macroeconomic fundamentals. They had good real growth., low inflation, moderate interest rates, and ability to produce a good, world-class output in many, if not all, lines of production. One flaw in their macroeconomic situation was, in some cases, large and growing current account deficits. Their rates of expansion of export earnings were beginning to sag in 1996 and 1997. This ought to have been remedied, however, without resorting to financial collapse and severe recession.

It has been claimed that East Asian economies failed to innovate and simply used more of existing capital or labor to produce increased levels of output. The econometric evidence of this, coming to a large extent from Lawrence Lau of Stanford University, has been re-examined. He reported healthy rates of technical progress in east Asian economies at LINK meetings in Malaysia, just one year ago. ⁽³⁾

The United States has had a persistent and growing current account deficit, but it has not brought down the real economy. That is because the world, at large, has been willing to tolerate and offset the US deficit by showing a deep willingness to invest in US dollar assets. This situation did not prevail for Asian countries.

In addition to the growing current account deficits in Asia, , there were:

- (a) Ill-considered credit extensions to unworthy borrowers who were not servicing their loans. This could be called bad banking.
- (b) Inadequate institutions to provide a good legal basis for bankruptcy and the working out of bankruptcy situations.

- (c) Inadequate regulations for the financial systems (banks, brokers, stock exchanges)
- (d) Poor accounting practices for meeting accepted world standards
- (e) Uncontrolled incursions by speculators
- (f) Imbalances in composition of capital inflows
- (g) Unrealistic exchange rates - pegged to the \$US, especially at a time when the dollar was bid to very high levels.

These items do not account for the totality of the present financial problems, but they are all very important.

(a) There was knowledge, prior to the outbreak of the crisis, that many financial businesses were carrying non-performing loans. The excessive granting of credit to friends, relatives or politically powerful people must, of course, be stopped, unless such borrowers or investment-hosts are carefully chosen by objective standards. There is no room for what has come to be called "crony capitalism". It must be replaced by objective approaches.

When non-performing or under-performing assets are discovered, there must be an institution like the Resolution Trust Co., to handle bankruptcies - repositioning performing credit and auctioning-off non-performing loans. This process took a few years, but worked well for the US economy in the 1980s for our S&L Crisis. We did not have a recession then.

(b) The institutions that are needed for the financial sector are an entity to deal with non-performing loans (as in the answer to (a)), bankruptcy courts, and more legal professionals who are well-trained in dealing with bankruptcy. In an open system, there will surely be bankruptcies.

(c) Security markets, banks, insurance companies, brokers, and others in the financial sector need regulation; liberalism, for its own sake, has been pushed too fast, and the financial infrastructure has not been put into place yet. In addition to regulation, as such, the state must for the longer period ahead send more people to good law schools in order to build a cadre of people who can be depended upon to regulate the various parts of the financial sector of an economy.

(d) Accounting rules should be standardized across countries if we are to have an understandable and transparent system of financial measures. The rating agencies must review the accounting records on a consistent basis across countries in order to know how to grade securities for the global marketplaces.

(e) Liberals want transparency, but they want free-ranging conditions for all players in world markets. This is particularly dangerous when there are many amateurs who are allowed to make disastrous mistakes (Barings-failure) and professionals who do the same (Long-Term). The technological change in banking and finance, the speed of telecommunications, and the huge volume of daily, leveraged turnover cannot be left to unregulated individuals who do not, or cannot, fully understand the intricate workings of the modern global financial markets.

(f) Following the world debt crisis of the early 1980s, developing countries should have learned enough about the dangers of heavy reliance on imported debt capital. Steady demands for debt service may be exceptionally onerous. In spite of assertions of some economists that the composition of capital inflows do not matter.

The choices among

sovereign debt,
private debt,
foreign direct investment,
portfolio investment,
joint ventures,
and other means of capital transfer,

can be decisive for smooth as opposed to rough development progress. There is much to be said for as much reliance as possible on equity capital, on some direct basis. This makes for timely continuity and sustainability of development progress. Of course, developing countries must give up something for pursuing the equity route, but sharing ownership in today's world, on a firm contractual basis, does not imply a return to colonialism of the past. Those days are behind us, in civilized partnerships. Some debt, especially in the form of long term obligations has a place in any diversified combination of capital types, but direct investment and joint ventures should be predominant in any country's development program.

(g) A strict peg to a single currency may be suitable in some specific, short-run situations, but it is too inflexible. Developing countries can get "whipsawed" when the foreign currency in the peg appreciates markedly, as the dollar has done in the past two or three years. It is practically as dangerous as heavy reliance on debt capital, at variable interest rates. When industrial countries raise rates to very high levels to deal with their own inflation problems, as in 1979-82, a similar kind of squeeze is placed on developing countries who have borrowed heavily.

Added degrees of freedom may be obtained by using a currency basket for a peg rather than a single currency, but floating rates or membership in a well-managed regional or fully multilateral exchange rate system is to be preferred.

Had the East Asian developing economies devalued their currencies, three or four years ago, they would very likely have held their exports steadier and not suffered the large jumps in current account deficits that appeared in two years of run-up to the events of summer, 1997.

4 . Concluding Remarks

The World economy is in a precarious state at the present time, and some countries are already in recession. The areas of relative strength, however, are expected to prevail and help save the system from going into a state of synchronized recession. These are the implications of the numerical estimates in the tables above, from project LINK (UN) and from the World Economic Outlook (IMF).

Activity is projected to be weak but not to the point of a full recession in nearly all countries in a synchronized downturn. It is a close call, but there does appear to be no genuine global recession on the immediate horizon.

Postscript

The presentation of October, 1998 has not been changed, but one year later, the following comments are relevant:

The forecasts of LINK and the IMF were too pessimistic for North America and too optimistic for Western Europe. In 1999, the economies of the United States and Canada have been much more vigorous, by a full percentage point or more and several major European economies have been correspondingly weaker, after the seemingly successful introduction of the Euro.

The IMF revised their projection for China by estimating more growth in 1999, although somewhat slower growth is projected for 2000. Recovery has actually begun in East Asia in 1999, and the estimated expansion may be somewhat stronger than originally anticipated. Oil prices have risen to greater heights than are apparent in either the LINK or IMF projections for 1999.

These amendments, and others too, to the world outlook are all quite significant, but they do not alter the main lines of analysis.

* This paper was presented at the Symposium and Conference of the Japan Society of International Economics at Kanto-gakuin University, October 23-25, 1998. The assessment of the international economy was given, as of the conditions that prevailed at that time. I append a note to the paper to indicate where changed conditions have a bearing on the resolution or evolution of problem issues that prevailed in October, 1998.

Notes

- (1) Last year, projections made at this time of the year had to be revised (in a pessimistic direction) by December.
- (2) The IMF global totals are computed using PPP weights and tend, for this reason, to be somewhat higher than the LINK world averages.
- (3) It was Professor Lau who pointed out, at LINK meetings in 1995 (Pretoria) that if any Asian economies were to be singled out for Mexican-type problems it would be Thailand and Korea. Unfortunately, he followed-up by saying that such a crisis was not likely at that time.