Department of Economic and Social Affairs,
in conjunction with the
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EXPERT GROUP MEETING:
WHAT HAVE WE LEARNED ONE YEAR INTO THE
FINANCIAL CRISIS IN EMERGING-MARKET ECONOMIES?

New York, 21-23 July 1998

Papers for Discussion

THE ASIAN CRISIS: TOWARD RECOVERY AND REFORM

DESA/Project LINK Expert Group
of Economists from the Asian Region
Byron Gangnes, Rapporteur

UNITED

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The Asian Crisis: Toward Recovery and Reform

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Preface and Executive Summary

The United Nations Department of Economic and Social Affairs convened an expert group of economists from the Asian region to meet at the United Nations in New York on March 17 and 18, 1998 to take stock of the Asian economic crisis that began in mid-1997. The meeting participants took as their charge four goals: first, to summarize what is now known about the causes of the crisis, and its propagation through Asia; second, to discuss the likely short-run adverse impact of the crisis on affected economies, other economies in the region, and the global economy; third, to evaluate the prospects for recovery in the region and barriers to recover that must be addressed. Finally, participants asked what policy lessons have emerging from the crisis, both for policymakers in the economies and for the international community.

We report here the outcome of the expert group deliberations and participant forecasts for developments in their economies over the next several years. These forecasts have been revised for the final report to reflect changing conditions in several economies since the time of our March meeting.

In its work, the expert group was able to draw on the forecasts and analysis of Project LINK, a global economic forecasting and policy evaluation program coordinated by the United Nations and the Project LINK Research Centre at the University of Toronto. The expert group also benefited from the reaction of Project LINK participants to analyses presented at the Project's semi-annual meeting held during the week of March 16 at the UN. Expert group members include:

Byron Gangnes, University of Hawaii at Manoa, rapporteur
Iwan Azis, University of Indonesia and Cornell University
Ji Chou, Chung-Hua Institute for Economic Research, Taiwan Province, China
Win-Lin Chou, Chinese University of Hong Kong, Hong Kong SAR, China
Malcolm Dowling, University of Melbourne
Janet Farooq, Economic and Social Commission for Asia and the Pacific, United Nations, Bangkok
Pichit Patrawimolpon, Bank of Thailand, Bangkok
Muthi Samudram, MBF Northern Securities, Kuala Lumpur
Inseok Shin, Korea Development Institute, Seoul
Wang Tongsan, Chinese Academy of Social Sciences, Beijing
Socorro Zingapan, National Economic Development Agency, Manila

Key findings of the group include:

The Asian crisis was precipitated by large-scale capital outflows from Southeast Asian economies, prompted by concerns about over-borrowing and mounting debt burdens. The grounds for the crisis were laid mid-decade, when there was a substantial increase in the flow of capital to liberalizing Asian financial markets without a commensurate improvement in their capacity to manage these resources. Weaknesses in financial sector regulation, over-investment in speculative real property, and mismatches in the currency composition and maturity of borrowing and lending were among systemic problems that made these economies vulnerable to crisis. Triggering the crisis was current account worsening due in part to real appreciation of regional currencies and a falloff in demand in key industries such as electronic components.

Once begun, the crisis spread throughout Southeast Asia as investors retreated from Asian assets generally. Currency devaluations further undermined balance sheets of Asian companies and financial institutions, leading to additional rounds of portfolio outflows and rising debt burdens. Governments in the region in some cases contributed to the spread of the crisis by resisting calls for quick action to shore up investor confidence.

In the wake of the crisis, affected economies can expect at least a year or two of stagnant or negative growth, both because of the direct adverse effects of the crisis on wealth and the terms of trade and the macroeconomic austerity measures needed to support currency stabilization. Inflation and rising unemployment may pose severe social problems in some economies. Events in the region are already affecting other developing economies through higher interest rate premiums, and the slowdown in the region will spill over modestly to the global economy through lower import demand.

To facilitate recovery, it is necessary to reduce the debt overhang created by the past over-borrowing and the revaluing of debt from currency devaluation. Heavy debt burdens are making it difficult for firms to obtain needed working capital.. While there are no quick and painless solutions to this problem, we consider a number of potential strategies for debt relief. Other impediments to rapid recovery include structural labor market rigidities, insufficient social safety nets to permit rapid reform, and a mixed external environment. In time, favorable economic fundamentals suggest a likely return to healthy—but not torrid—growth rates.

It is already possible to draw several policy lessons from the crisis. First, an appropriate macroeconomic policy mix must be maintained during periods of rapid growth to limit incentives for over-investment. Second, macroeconomic policy following a crisis must balance the need to restore currency stability with the goal of reestablishing expectations of economic growth. Third, domestic financial market reforms must continue, particularly improved prudential regulation of banks and other financial institutions, introduction of hedging instruments, encouragement of direct investment and possibly more flexible exchange rate regimes. Fourth, the international community may play a useful role in monitoring capital flows, improving the availability and quality of investment information, and providing short-term liquidity. Finally, countries that are planning to liberalize financial markets must take great care in determining the optimal rate and sequencing of liberalization.

1. The Asian Economic Crisis

When the Thai baht was devalued in July of last year, few would have predicted the fallout soon to follow. By October, what had started as a national setback had become a regional crisis, and had raised concerns about global financial stability. Today, the most affected Asian economies face at least a year or two of very low or negative growth and a painful adjustment to a new economic regime. Economies throughout the region can expect varying degrees of economic slowdown, with effects spilling over to the global economy.

Thailand's balance of payment's situation had been weakening long before the July 2 decision to adopt a managed floating exchange rate system. Since the early 1990s, Thai current account deficits had grown from about 5% of GDP in 1993 to over 8% in 1996 (Sussangkarn, 1998), aggravated by a global slump in export demand in 1996. Resulting high levels of foreign debt, much of it short-term, led to speculative attacks on the baht in the first half of 1997. The Bank of Thailand abandoned efforts to support the baht in July, and the currency rapidly depreciated, by more than 20% in July alone.

Concerns about currency and financial system stability soon spread beyond Thailand to the other dynamic Asian economies. Financial markets in Malaysia, Hong Kong SAR China, Singapore and the Philippines all suffered setbacks, with the deepest reaction occurring in Indonesia, where a dramatic collapse of confidence by domestic and foreign investors led to an 80% depreciation of the rupiah and a similar decline in stock markets. The extent of foreign exchange losses further undermined credit positions of lenders and banks in the region. As concerns grew about generalized regional financial sector weakness, attention turned to Korea. Deteriorating balance sheet positions—and a number of high-profile bankruptcies of Korean *chaebol*—severely weakened major financial institutions, leading to credit downgrading and a deepening credit crunch in that country.

Economies throughout the region are now struggling to put in place policies to stabilize currencies and financial markets, and to set the stage for renewed growth. Thailand, Indonesia and Korea are moving forward with economic restructuring plans under IMF stand-by credit arrangements (IMF, 1997). The agreements spell out macroeconomic and fiscal policy changes, as well as financial reforms and further real sector liberalization measures. Other countries, particularly Malaysia, the Philippines, and China have undertaken similar—if less austere—packages of liberalization and adjustment, in an attempt to shore up confidence in their economic prospects and financial systems. China has implemented expansionary economic measures to forestall a slowdown and pressure for devaluation.

It is now clear that there will be a significant short-term slowdown in these economies as new economic policies are implemented, confidence is restored and normal capital flows resume. Because of the size and dynamism of developing Asia, there will also be some spillover to other countries, especially those like Japan and the United States that have large trade and financial links to the region. Prospects for rapid recovery in the region depend on a timely adoption of appropriate economic reforms, but also on a favorable external environment, and the ability rapidly to "work down" the excessive debt overhang accumulated in recent years. Over the long term, economic stability for these and other developing countries will depend in part on the adoption of national and international policies to address the fundamental sources of the crisis.

The recent developments in Southeast Asia came as a surprise in part because of the region's long record of outstanding performance. The Asian "tigers" have been the darlings of development economics, and the region as a whole has growth far faster than other regions, driven by high rates of savings and investment. Governments in the region have been credited with generally sound macroeconomic policies that largely avoided the common development pitfalls of excessive money-financed fiscal expansion, currency overvaluation and debt. Recent events demonstrate that even the best-performing developing countries are not immune to financial crisis.

Not all of Asia's current economic woes fall within the purview of this expert group.. As the discussion above suggests, our analysis is limited to the string of financial crises that have occurred in Southeast Asian economies as the large-scale capital inflows of the early 1990s disappeared in 1997-98. The worst effects of this crisis were felt in Thailand and Indonesia and to a lesser extent throughout Southeast Asia. Korea's economic condition was somewhat different from the smaller Asian developing economies, but it was pulled into the crisis when problems in the region led to heightened scrutiny of Korea's debt burdens. The economic problems of Japan—by far the greatest concern from a global standpoint—have very little to do with the "Asian Crisis," stemming instead from long-standing structural barriers to growth. We must leave Japan's problems for another expert group to tackle.

2. Birth of a Crisis

Triggering events and contagion

The immediate cause of the Asian crisis was the reversal of large-scale short-term international capital flows in 1997. Capital flows to the region soared in the 1990s. Private flows to Thailand reached 13% of GDP in 1995; they were 19% of GDP in Malaysia in 1993. By 1996, there was evidence that these flows had been excessive. Current account deficits as a percent of GDP had risen to the 4% to 8% range throughout the region, and the accumulated debt burdens were very high. In Thailand, foreign debt rose from $29 billion to $94 billion between 1990 and 1996. There was anecdotal evidence that rates of return on capital investments were falling. In many Southeast

Asian economies, the inflows had fueled strong investment in the real estate sector. The end of the property bubble and worsening balance sheets led to crisis.

Contributing to the fall in perceived returns to capital was a falloff in export performance, which accelerated in 1996. There appear to have been several factors behind this. First, there were adverse terms of trade shocks in key industries, particularly in electronics and steel. Relatively high inflation rates along with fixed exchange rate regimes caused real appreciation of some currencies. The gradual rise in the value of the dollar from its historic low in early 1995 also reduced price competitiveness, since the region's currencies were pegged to varying degrees to the dollar. The Chinese devaluation of 1994 may also have contributed to the eroding competitive position of Asian economies, although the real exchange rate changes associated with this event were fairly modest (Hong, 1998). Because export price elasticities for these countries can be very large (Barrell, 1998), these term of trade changes led to falloffs in exports. Export weakness was further deepened by the weakness of Japan's economy, an important export market for the region.

Investors responded to worsening return prospects by dumping local financial assets and currencies, precipitating additional balance sheet problems for banks and concerns about the security of loan principle. The crisis was propagated across national borders both because of common systemic weakness and a growing loss of confidence in Asian financial assets as a whole. The common systemic weaknesses included financial market weakness, over-investment, and perhaps some competitiveness problems. We will turn to these issues in more detail below. But it is also clear that the depth and breadth of the crisis owed something to psychological contagion among investors. Investors began to fear huge losses from unhedged risky investments in these economies, and as they dumped assets, they precipitated a tumble in regional stock markets and currencies, which developed into a broader panic. Currency devaluations caused additional rounds of balance sheet deterioration and rising foreign debt burdens. This kind of "self-fulfilling loss of confidence" amplified the initial market weakness.

The round of currency attacks that occurred can also be understood as a sequence of "competitive devaluations," not engineered by central banks, but rather demanded by financial markets. (Corsetti et al. , 1998) With a much lower baht, markets might rationally have anticipated a fall in the rupiah or in the won in order to maintain sustainable current account paths for Indonesia and Korea.

Inappropriate government response may also have played a role in the growth of the crisis and its propagation across national borders. Efforts by the Bank of Thailand to defend the baht cost the central bank an estimated $10 billion in foreign exchange reserves, and subsidized capital flight by guaranteeing the official rate on capital outflows (Williams, 1998). In Indonesia, political uncertainty clouded the official response from the start, presumably contributing to the depth of the financial collapse there. (Azis, 1998). Decisive action by Thailand after July 2 and by Korea, which moved rapidly to renegotiate foreign debt obligations, appear to have been rewarded with more rapid market and economic recovery.

Systemic weakness

While the generalized currency collapse of 1997 can be viewed as the result of a sharp turnaround in investor confidence and capital flows, there are clearly systemic weaknesses in many of the region's economies that made them vulnerable to crisis. Not surprisingly, these weaknesses center in the financial markets of the economies, but there are also real sector problems.

Financial markets in developing Asia had undergone considerable liberalization in the 1980s and 1990s. Introduction of new securities, deregulation of lending and freeing of international capital flows promise long-run increases in efficiency in these economies. But the incomplete nature of reforms allowed a massive increase in bank lending and capital inflows without a corresponding increase in the quality of lending oversight. Annual rates of growth of bank credit were above 20% for several years in Thailand and Indonesia, and even higher in China and the Philippines, with only slightly lower rates of growth in Korea and Malaysia. (Corsetti et al. , 1998). While credit growth was also high in Singapore and Hong Kong SAR China, the former economies lacked the well-developed banking systems enjoyed by the latter.

Analysts throughout the region have sighted a lack of prudential regulation over lending that permitted increased bank exposure in risky property investments. In countries such as Indonesia a tradition of lending based on family ties ("crony capitalism") may have encouraged a channeling of funds to dubious investment projects. In other countries, such as Korea, lending based on long-term corporate ties appears to have similarly inhibited appropriate lending scrutiny. Countries also had inadequate capital requirements for banks, allowing liabilities to far outstrip real bank assets. As an indication of bank quality, Corsetti et al. (1998) report estimates of non-performing loans (pre-crisis) ranging from 14% in the Philippines to 19% in Thailand.

The lack of prudential oversight of bank lending resulted in classic mismatches in the maturity and currency composition of bank assets and liabilities. By the mid-1990s, most of the capital flowing in to Asian developing economies was short-term lending and portfolio equity investment, but these funds were used to finance speculative property and physical capital projects with long return horizons. Returns for many investments were denominated in local currency, while the bulk of the debt was in dollars. The currency and maturity mismatch threatened bank solvency when currency depreciation increased dollar liabilities and short-term outflows accelerated.

The currency mismatch of assets and liabilities was made worse by the lack of foreign exchange hedging facilities. Markets for forward exchange either did not exist or were very limited in these countries. In fairness, it is not clear that investors would have paid to hedge their positions in any event, since they appear to have expected no possibility of currency devaluation.

By mid-decade, there was evidence of over-investment in risky, low-return projects, especially in real property development (Thailand, Malaysia, Indonesia), and in a few large industries like semiconductors and petrochemicals (Korea). Financial sector weakness provided the supply-side of funds for this investment boom. Excessive demand for investment may be attributed both to exchange rate and capital market policies and to myopia of foreign investors.

Many writers (Dooley, 1996, Williams, 1998, Corsetti et al., 1998) have cited the fatal combination in these economies of fixed exchange rates and near perfect capital mobility. As long as national governments appeared certain to protect the fixed dollar peg, investors could be comfortable that there was little foreign exchange risk, and could pour vast amounts of financing into Asian economies. The success of these countries in sterilizing domestic monetary effects of massive inflows through open market operations meant that the normal dampening effect of interest rate and price movements would not limit returns in these economies. According to this story, the monetary policy stance created severe moral hazard problem by implicitly guaranteeing the dollar returns of foreign investors.

While there is certainly merit to this view, this expert group believes that investor overconfidence played at least as large a role in Asian over-investment. The past history of extraordinary returns led investors to be overly optimistic about future prospects. The real question is why investors did not realize that the return experience was extraordinary, or that the monetary policy stance was unsustainable. Some of the blame must be laid at the feet of mutual fund managers, individual investors and the rating agencies that failed to monitor lending behavior more rigorously. In any event, the result of investor exuberance was the emergence of an asset bubble in property and other stocks that left banks badly exposed and vulnerable to the collapse that finally occurred last year.

There was also a real component to Asian economic weakness. In addition to the well-known over-building in real property, many economies have also become heavily specialized in a few production sectors, such as semiconductors and consumer electronics. This lack of diversity in industrial structure left the economies exposed to adverse terms of trade shocks in these sectors, such as the fallback in the semiconductor market in 1996. We have also cited the declining export competitiveness associated with the dollar peg, but perhaps also with the emergence of new low-cost producers of many labor-intensive products.

The discussion above paints a picture in broad brush strokes of a region with systemic problems and perhaps some bad luck. How common are the roots of the national crises? Clearly not all countries shared the large and growing current account deficits of Thailand, or the large-scale solvency problems of the Korean *chaebol*. The extent of dependence on short-term “high flight risk” capital was much larger in Thailand than in the Philippines, where less than 20% of debt was short-term. Prime Minister Mahathir of Malaysia is not alone among Asians in his view that all are being unfairly painted with the same brush, regardless of economic fundamentals. To some extent, the markets have made distinctions among Asian economies, treating Malaysia, the Philippines, and especially Singapore and Taiwan Province of China better than the more financially precarious countries like Thailand and Indonesia. But it is also true that there are elements of over-investment and poor lending throughout the region, and all economies with or without the IMF's oversight are finding it necessary to take fiscal and regulatory steps to restore confidence.

3. The Costs of Crisis

The rapid flight of capital from Asian financial markets precipitated dramatic declines in asset values and national currencies in the crisis economies. Table 1 shows the extent of currency and equity market declines. The currencies of Malaysia, the Philippines, Thailand, and South Korea fell by 35-46% by the end of 1997, and the Indonesian rupiah declined by 56% by December 31st.. Currencies fell further in January before rebounding somewhat in February and March. At one point in January, the rupiah was off 80% against the dollar. Stock markets in the region dropped 40-60% by the end of the year, as domestic and foreign investors dumped local stocks. All stock markets have recovered some lost ground since January.

The direct effects of asset market and currency collapse, the cessation of lending, and the indirect effects of macroeconomic medicine all mean that these countries are in for a period of much slower growth. Asian weakness will spill over to principal trading partners and to a lesser extent to the global economy.

Table 1. Exchange Rate and Stock Market Movements, Selected Asian Economies

	Exchange Rate (LC/$)			Stock Market Index		
	25-Jun-97	30-Dec-97	1-Apr-98	25-Jun-97	30-Dec-97	1-Apr-98
Indonesia	2,432	5,570	8,600	637	401	523.9
Republic of Korea	888	1,635	1,391	651	376	468.2
Malaysia	2.52	3.89	3.7	1,238	589	700.1
Philippines	26.4	41	38.3	3,171	1,869	2,209.40
Thailand	25.3	47	39.7	832	366	456.6

Source: Farooq (1998) and *The Economist*

The depth of the slowdown in crisis economies

A reduction in economic activity is the inevitable result of a sharp turnaround in a country's current account. Massive capital outflows require an immediate shift from current account deficit to surplus; by definition this requires a reduction in expenditures relative to domestic income. This is accomplished through increases in interest rates, credit constraints that limit borrowing and investment, and negative terms of trade effects of devaluation that reduce real domestic purchasing power.

Along with automatic market adjustments, macroeconomic policies have been tightened in an effort to restore financial market stability. The three economies operating under IMF stabilization agreements have agreed to restrain fiscal policy through combinations of spending cutbacks and revenue increases, and to maintain relatively tight monetary policy conditions with high interest rates to restore demand for domestic currencies. IMF requirements to close insolvent banks and to end the practice of subsidizing favored projects and loans will further restrict credit and repress economic growth. While the IMF has indicated some flexibility about the extent of policy contraction required by each country, it is clear that the overall policy stance will be contractionary for the next year or two.

Economies not subject to IMF letters of agreement are still sharing in the move to contractionary macroeconomic policies. Monetary contraction has been forced on these economies by their determination to avoid massive devaluations. Perhaps the clearest case of this has been Hong Kong SAR China, where the mechanics of the currency board worked to raise three-month Honk Kong interbank offer rates (HIBOR) from 6% to 12% between June and November 1997. (Three-month rates soared to 25% at the height of the crisis on October 23, and overnight rates went to 100%!) In Malaysia, the government has announced the delay of public projects and even changes in the Bumiputra policy of favoring indigenous peoples to improve government finances and restore investor confidence. The Philippines has also undertaken monetary and fiscal belt tightening and closer scrutiny of lending. Malaysia and the Philippines have encouraged financial sector consolidation and enhanced prudential regulations.

The result of these adjustments is a forecast of significantly slower growth over the next two years than the Asian developing economies have come to expect. The outlook for key macroeconomic indicators is shown in Table 2. Except where indicated, these are the forecasts of expert group members, revised in early May 1998. Similar forecasts have been made by Project LINK using its global econometric model framework. (See Project LINK, 1998b.) The country experts expect negative growth in Indonesia, Korea and Thailand for 1998, with only modest growth of 1.7% to 3.1% for these economies in 1999. This is down from GDP growth rates of six to eight percent per year mid-decade. For Malaysia and the Philippines, the outlook is for a more modest growth slowdown, to the two to two-and-one-half percent range, with faster recovery in 1999. In Hong Kong SAR China, the monetary contraction necessary to maintain the dollar peg will cause a marked slowdown in consumption and investment, with GDP expected to grow less than 4% in 1998.

Table 2. Gross Domestic Product Growth for Selected Asian Economies

	1996	1997	1998	1999
Indonesia	8.0	4.8	-5.1	1.7
Republic of Korea	7.1	5.3	-1.4	3.1
Malaysia	8.6	7.1	2.0	4.0
Philippines	5.7	5.1	2.4	4.5
Thailand	6.4	0.6	-3.4	1.8
Hong Kong SAR China	4.8	5.1	3.7	4.2
Taiwan Province of China	5.7	6.7	6.0	6.4
Singapore	7.0	7.6	4.0	6.0
China	9.7	8.8	8.0	8.2

Source: Estimates provided by expert group members from each economy; Thai estimate are from Sussangkarn (1998); 1996-97 figures are from Project LINK.

Behind the expected 1998 slowdowns in these economies is a sharp drop in investment spending and in consumer confidence and expenditure. Exports eventually are expected to lead the recovery, as devaluation raises price competitiveness. The export resurgence has begun more rapidly in some countries than in others. This is reflected in differing forecasts for trade recovery in Table 3, below. Korean exports are expected to post significant gains this year, while those of Indonesia may take the longest to make a recovery. The figures in Table 3 also show that by far the bulk of the trade adjustment in 1997 and 1998 will come from reductions in imports. The problem of lagging export growth is discussed further below.

The large devaluations experienced by these countries will spark increases in inflation in 1998. As shown in Table 4, the experts generally predict inflation rates two to three times higher than those experienced in 1997. Thai inflation is expected to top 11% for 1998, and Indonesia can expect to see 50% higher prices this year. In addition to directly raising import prices, devaluation has increased competition between exporters and the domestic market for some agricultural staples, further raising product prices. And because of heavy reliance of industry on imported inputs, devaluation creates a significant supply shock that contributes to output declines.

Recovery in Asian economies is hindered by external factors beyond the current crisis. El Ninõ weather patterns have reduced agricultural yields in the region and created the

Table 3. Real Exports and Imports of Selected Asian Economies (Growth Rates)

		1997	1998	1999
Indonesia	Exports	3.9	2.5	5.6
	Imports	4.5	-15.4	7.4
Republic of Korea	Exports	21.8	22.9	6.3
	Imports	4.3	-4.7	17.1
Malaysia	Exports	7.3	4.6	5.3
	Imports	6.8	-3.3	2.9
Thailand	Exports	5.2	4.6	8.4
	Imports	-15.5	-12.5	7.6
Philippines	Exports	8.9	11.2	12.6
	Imports	8.7	6.7	8.6
Hong Kong SAR China	Exports	6.0	4.6	5.1
	Imports	6.9	6.3	6.7
Taiwan Province of China	Exports	8.9	6.4	8.0
	Imports	12.5	7.0	7.8
Singapore	Exports	5.0	1.4	4.2
	Imports	5.3	7.6	4.6
China	Exports	21.6	11.0	5.5
	Imports	2.4	17.7	8.8

Source: Estimates provided by expert group members from each economy; Thai Estimates are merchandise trade in current US dollars from Sussangkarn (1998); 1997 figures are from Project LINK.

Table 4. Consumer Price Inflation for Selected Asian Economies

	1997	1998	1999
Indonesia	11.1	50.0	15.5
Republic of Korea	4.5	8.7	4.5
Malaysia	3.0	8.0	3.1
Philippines	7.2	8.5	7.0
Thailand	6.1	11.2	6.1
Hong Kong SAR China	5.3	5.2	4.8
Taiwan Province of China	1.4	2.8	2.4
Singapore	2.8	2.5	2.2
China	2.8	3.6	4.6

Source: Estimates provided by expert group members from each economy; Thai estimates are from Sussangkarn (1998); 1997 figures are from Project LINK.

smog problems in Indonesia, Malaysia and Singapore. For Indonesia, and to a lesser extent Malaysia, falling world oil prices represent an additional drag on export earnings. Of course these terms of trade changes will help cushion economic adjustment for oil importing countries. Finally, the systemic weakness in Japan reduces demand from an important market.

Within the Asian developing economies, the effects of recession and inflation are not uniformly distributed, but are likely to lead to changes in income distribution that may have profound social and political implications. The income distribution may actually improve, in the sense that those most harmed by the crisis are middle-income workers who are employed in export industries and buy substantial amounts of imports. Layoffs and devaluation will fall much harder on this group than on poor rural residents. The high burden on the middle class raises the possibility of political problems from this important segment of the population. General austerity also threatens to force cutbacks of public services and, in some cases, to create food shortages for the poorest residents, layoffs of guest workers, and rekindling of social problems and ethnic frictions in some countries.

The expert group recognizes that there is considerable uncertainty surrounding the forecasts for growth in the coming years. Sources of uncertainty include the pace of export response to relative price changes, the resumption of capital flows to restructured financial enterprises and firms, and the external environment for trade. Also important are uncertainties about the political response of governments. These forecasts have been made assuming adherence to IMF agreements and existing macroeconomic plans. Departure from these plans may alter the depth and duration of the adjustment periods. (See Dowling, 1998.) Policy uncertainty is particularly acute in Indonesia. In the week before this final draft was prepared, widespread rioting had left at least 500 dead, and the government's hold on power appeared increasingly tenuous. Clearly a much deeper downturn for Indonesia cannot be ruled out.

Transmission to other developing economies

The economic crisis in Asia is being transmitted to other developing economies through declining trade and financial market contagion. Among developing countries, China is among the most dependent on exports to these countries. China's exports may be reduced by as much as five percent as a result of weaker demand in the crisis economies and the loss of competitiveness from devaluations in these countries. (Wang, 1998) There is some concern that this loss of competitiveness could prompt an additional Chinese devaluation. Still, the Chinese economy is expected to grow by about 8% in 1998.

Sharply lower export growth is also expected to bring Singapore's growth rate down from the five to eight percent range to the four to six percent range for the next two years. At this point, Taiwan Province expects to see only modest adverse economic effects of the crisis on exports and overall activity.

For developing economies outside of Asia the direct trade effects will be small, since there are generally only limited trade linkages to the region. One exception are the Middle East oil exporting countries, where demand weakness in Asia is one factor blamed for the recent oil price weakness. The more direct effect on other developing countries is the "pure contagion" effect of the crisis on loan premiums for developing country debt. Interest rate spreads on Latin American bonds rose about 250 basis points in Fall 1997, but have declined a bit since then. (World Bank, 1998)

Effects on the global economy

The effects on developed market economies and world regions depends largely on the degree of dependence on Asian trade. The US, Japan, Australia, and New Zealand will be most affected by the slowdown in Asian import demand. For the US, the risks include not only a decline in exports to the region (Asia as a whole accounted for 30% of US exports in 1996), but also in an expected sharp rise in imports from Asia. The Federal Reserve and others (See Greenspan, 1998) have noted the salutary effects of a net export slowdown on a US economy that was probably growing beyond its sustainable pace in 1997. But the experience of the 1980s also tells us to expect political fallout as imported goods crowd out domestic US production.

In the months since the crisis developed, economic forecasters have reduced their projections for global growth significantly—generally by about one percent compared with pre-crisis forecasts. In their May 1998 World Economic Outlook, which just became available, the IMF forecasts a reduction in 1998 world GDP from the 4.3% projection of October 1997 to 3.1%. The World Bank (1998) similarly expects developing economies to grow at a rate of 3.9% in 1998, down once percentage point from a projection made in mid-1997. But only a fraction of this slowdown is attributable to the financial crisis in Southeast Asia. According to Project LINK estimates, perhaps three-tenths to four-tenths of a percent comes from the slowdown in the ASEAN 5 countries and Korea; the bulk of the downward revisions come from unexpected weakness in Japan, which, as discussed above, derives from a largely different set of problems.

Because of Japanese weakness, the US market will have to absorb the lion's share of any Asian export recovery. The direct risk to Japan of the Asian financial crisis are limited, because Japanese lending exposure in Asia is not as great as commonly thought. (And much is within firm lending. Moriguchi, 1998.) In any event, Japanese weakness contributes significantly to expected weakness throughout the global economy.

European economies stand to be hurt much less by developments in Asia. Much of European trade occurs within the region, a handicap when Europe is in recession but an advantage in the current situation. In fact, Europe may benefit from lower world interest rates that some foresee as a consequence of the capital retreat from Asia. (Barrell, 1998)

The Project LINK growth forecast for the global economy is summarized in Table 5. Overall, the world economy is expected to continue to grow at a moderate pace in 1998. World real GDP is expected to expand by 2.6% in 1998, down from the healthy 3.1% rate of 1997.

Table 5. Real Gross Domestic Product Growth for Major Countries and Regions

	1996	1997	1998	1999
World Total	3.0	3.1	2.6	3.0
Developed Market Economies	2.5	2.5	2.1	2.3
United States	2.8	3.8	2.7	2.3
Japan	4.0	0.6	0.0	1.6
United Kingdom	2.3	3.6	2.3	1.9
Germany	1.4	2.2	2.6	2.8
Developing Country Regions	5.9	5.5	4.1	5.2
Latin America	3.5	5.2	3.7	4.3
Africa	4.4	3.1	3.4	3.8
South and East Asia	6.7	5.3	3.2	5.3
India	6.7	5.7	6.0	6.6
West Asia	4.2	4.4	3.1	3.3
Eastern Europe and Russia	-1.9	1.7	3.0	3.7

Source: Project LINK World Economic Outlook, May 1998.

4. Barriers to Recovery

While medium-term forecasts are for a return to a moderate growth path, the road to recovery is strewn with obstacles. Already, there is concern that the expected pace of export growth may not materialize. Renewed investment depends on a resumption of capital flows to the region, and consumer spending on a renewal of consumer confidence. While this is uncharted territory (at least for Asia), the expert group sees several potential impediments to recovery.

The biggest impediment to renewed growth is the debt overhang created by the buildup of lending and the revaluation of debt caused by currency realignments. Aside from the burden of negative net resource transfers to finance the debt, the countries face limits on access to lending needed to restore growth. All of the affected countries have noted a difficulty in obtaining working capital, including financing for the imported inputs integral to their manufactured exports. This represents a major factor holding back export growth and industrial recovery more generally. Weak export earnings in turn make it difficult to undertake debt repayments. Completing the vicious circle, lenders with large Asian debt exposure are unwilling to resume lending without a clear indication that repayment is underway.

As noted above, the bulk of current account rebalancing to date has come through a decline in imports. For renewed growth, the Asian economies are counting on a strong resurgence of exports. But some country experts question how strong the response of exports to devaluation will be. For countries like Malaysia and Thailand, much of their export are intermediate manufactured goods, such as computer disk drives or electronic components, and such trade flows may not be very price sensitive. And gains in relative competitiveness are limited, since devaluation occurred in most of their major competitors.

Devaluation adjustment requires a redirection of resources from nontradable to tradable sectors of the region's economies. Structural rigidities limit the speed and extent of the needed adjustments. In Korea, for example, the power of labor unions is an important barrier to the layoffs needed to transfer labor resources across industrial sectors. One meeting participant observed that laid-off Thai finance industry workers inevitably end up in other finance industry jobs These rigidities mean that significant short-term unemployment is likely to accompany restructuring, but the lack of an adequate social safety net, especially in the poorest country, Indonesia, makes such adjustment difficult.

The adverse social implications of economic restructuring explain a further impediment to reform, a lack of political will to make painful choices. This has been particularly evident in the waffling of Indonesia over acceptance of IMF conditions, but it is a problem in other countries, where fragile democracies face a potentially explosive situation if living standards dive. Political uncertainty both delays needed reforms and prevents a timely renewal of capital flows by delaying a rebuilding of investor and consumer confidence.

We have already mentioned the importance of the external market environment for export recovery. The external environment is a mixed bag for export-led recovery. The continuing weakness in Japan will limit its value as a final goods market, although a Japan bent on exporting its way out of recession could create strong demand for Asian components. Strength in the US market bodes well for these countries, and we have already seen increases in US imports from the region. Whether strong imports can hold up in the face of a possible US political backlash is another matter.

Dealing with Debt

In the view of the expert group, it is crucial to address the primary problem of the debt overhang. A satisfactory solution may be more difficult than was the case for Latin America in the 1980s because of composition of the debt. In the Latin American crisis, much of the lending was syndicated, and carried official guarantees. This facilitated re-negotiation of the debt terms. In the present crisis, there are a much larger number of creditors, with little formal organization, and there are no explicit government lending guarantees, making a quick negotiated settlement difficult.

Nevertheless, some reduction of debt financing burdens seems necessary for a resumption of growth. One approach is the Korean model of wholesale government loan guarantees, that would bring the debt under a single umbrella, reduce perceived default risk, and encourage new lending and lower debt premiums. The costs of such action are clear: it establishes a precedent for government bailouts that may reinforce the dubious lending practices one is trying to cure (the "moral hazard" problem). The unilateral action also deposits the debt problem resolution squarely on the backs of the Korean people, rather than sharing the burden with the international lending community.

The expert group members would like to see exploration of alternative debt restructuring arrangements that would share debt burdens between borrowers and lenders. These might include some combination of debt-for-equity swaps (although the very high debt/equity ratios are a barrier), and debt write-offs by foreign banks. One approach to the latter might be the conversion of dollar debts to local currency at existing market exchange rates. Assuming current rates have overshot long-run equilibrium levels, this gives some relief to borrowers, helps to solve the currency composition problem, and by reducing financing burdens will increase the probability of principle repayment. Again, the difficulty is finding a mechanism for administering the largely disaggregated debt. One possibility would be a Paris Club-type arrangement for private loans that would automatically mark down debt as an accompaniment to IMF agreements.

A more ambitious approach would be to implement an international reconstruction finance corporation institution that could use international funds to work down debt exposures through bankruptcy, asset sales, and recapitalization of fundamentally sound enterprises. This is a way of bringing international resources into the process of domestic financial restructuring. It is not clear how such an entity would be organized.

In the mean time, there is an urgent need for additional short-term trade financing. The Asian Development Bank has extended some loans along these lines, as have the United States and Japan through Ex-Im bank facilities. There is room for additional concerted lending to help get exports on a stable recovery path.

Signs of Life and Long-Run Prospects

Despite the drag of the debt overhang, countries in the region are moving forward with reform. Thailand has moved the fastest to close insolvent financial institutions and to set up more transparent regulation, and the economy is beginning to show signs of recovery. Korea expects 23% export growth this year. In the Philippines, semiconductor exports were up 50% in the fourth quarter of 1997, in part due to fundamental improves in labor productivity in recent years. Some economies appear fundamentally better positioned for recovery than others. Korea, with its strong manufacturing base, and its decisive action to restore confidence in banks, may bounce back relatively quickly. Social and political uncertainty in Indonesia cloud prospects for rapid recovery there.

The current crisis has provoked an inevitable discussion of the Asian growth model, and whether this episode spells the end for the post-war Asian development boom. Without entering the debate on the Asian "Miracle", we can say that economic fundamentals still appear supportive of good long-run economic performance in Asia, if not at the torrid pace of the past few years.

As others have noted (Krugman, 1998), the occurrence of crisis is an issue separate from the region's long-run growth. While it is clear that policy errors and unsustainable inflows contributed to the Asian financial meltdown, these problems are largely separate from the question of whether Asia suffers a structural growth problem. This panel does see growth problems in the region. The high-growth Asian economies now face stiff competition from China and, in the future perhaps, from countries of South Asia in low-end manufacturing markets. So far, it is not clear that countries are investing enough in research and development activities needed to maintain productivity growth and move up the development ladder. If anything, the recent round of devaluation may postpone what the regional experts see as needed reforms in this area. Some question whether trade can continue to be the engine for Asian growth that it has in the past.

But the structural characteristics that forged Asian development success are still largely in place: high savings rates, widespread educational opportunity, rising living standards and social equity, appropriate macroeconomic policies. And financial market reforms growing out of the current crisis should enhance financial efficiency important for future development. Overall, long-term growth prospects look good. For the most part, policymakers in the region realize that growth cannot be sustained at 8% per year levels on into the future, but are confident that they can live with more modest growth in the 4-5% range.

5. Policy Prescriptions

While the effects of the Asian Crisis are far from over, it appears to this group that we can already glean some policy lessons from the current crisis. Prescriptions can be written for improved policy both before and during a crisis, and guidelines for a more healthy international financial regime can be explored.

Responsible macroeconomic policy is needed before and after crises

The dynamic Asian economies have been credited properly with maintaining responsible macroeconomic policies during their several-decades-long period of rapid growth. Through favorable initial conditions and prudent policy choice, these countries were largely able to avoid the chronic fiscal deficits and monetization that have plagued other developing regions. (Gangnes and Naya, 1997).

Still, the period of the 1990s saw rates of growth for Asian economies, fueled by massive capital inflows, that we now know to have been unsustainable. One can argue that these growth rates were clearly unsustainable long before the unset of the current crisis. (Although precious few observers noted this.) In retrospect, macroeconomic policy should have been used, perhaps with microeconomic regulation, to restrain excessive growth. Fiscal stance was contractionary, but could have been more so to reduce domestic spending and prevent ballooning trade deficits.

It is also important to assess the consistency and sustainability of policies. The policy of monetary sterilization with fixed exchange rates, while it had the laudable goal of restricting inflationary pressure, actually encouraged over-investment by preventing automatic price, interest rate and exchange rate adjustment that would have restrained inflows. The path of current account balances developing in Thailand was a clear warning sign that the existing policy path could not be sustained indefinitely.

Now that the crisis has occurred, affected countries face the choice of macroeconomic policies to restore confidence and growth. There has been a lively debate about the merits of the macroeconomic policy package included in IMF agreements. Some have questioned whether the standard IMF prescription of fiscal and monetary austerity is being inappropriately applied in the Asian case, where there is no history of government profligacy. (See for example Sachs, 1997, and Wade and Veneroso, 1998. For the view from the IMF trenches, see Fischer, 1998.) To this expert group, it is clear that some degree of monetary tightening and fiscal restraint is needed to stem outflows of capital and halt further devaluation. Interest rates must rise to increase relative returns and aggregate demand must fall relative to supply to generate the necessary current account surpluses. Even countries outside the formal IMF process, like Malaysia and the Philippines, are undertaking such steps. But there does exist a danger of imposing overly restricting macroeconomic policies.

Trying to end the Asian crisis is a confidence game. The primary barrier to renewed growth is the debt overhang and the difficulty this poses for renewed capital flows to the region. Excessively contractionary monetary and fiscal policies can undermine confidence building by reducing expected profits of enterprises within the affected economies, signaling to investors the likelihood of delayed debt repayment. Confidence may be increased most effectively by accelerating the needed microeconomic reform of financial institutions, banking systems and industrial structure. Macroeconomic flexibility may be needed to accommodate this restructuring, particularly considering the potential for social and political instability if a severe recession were to occur. Panel members note some evidence of IMF willingness to adjust macroeconomic guidelines to local conditions, but they remain concerned that the IMF balancing act may fall too heavily on the side of macroeconomic austerity.

Financial market reforms must continue

We have noted above that a primary systemic problem of the dynamic Asian economies has been liberalized financial markets with important weaknesses in regulatory oversight, unsustainable exchange rate policies and incomplete markets for hedging. Malaysia and the Philippines were among the countries that had begun to improve oversight even before the crisis. Soon after the crisis, tighter securities and banking regulations were installed in Thailand, and other countries are following suit. These efforts need to continue.

Most important is the need for improvements in prudential regulation of lending. Balance sheet standards must be suitably rigorous, including appropriate overall capital adequacy ratios, loan loss provisions, and limits on the composition of lending to speculative sectors. More careful scrutiny of accounting standards and lending practices must be maintained.. Because of potential conflicts of interest, countries might be well served by introduction of oversight agencies independent of their central banks.

Most investors failed to hedge their Asian investments, and then, when they wanted to, found that hedging opportunities did not exist. Establishment of derivatives markets would help to limit foreign exchange exposure and perhaps the pace of capital reversals. In Thailand, we know there is reluctance to introduce such markets in the wake of the huge losses taken by the Bank of Thailand during 1997. In the Philippines an alternative "non-deliverable forward" contract model has been implemented on a limited scale. It is also possible that hedging markets will emerge from the private sector in foreign economies.

One theme running through discussions of the crisis is the excessive dependence on short-term foreign financing for long-term investment projects, particularly in infrastructure and real property investments with speculative local currency-denominated returns. Policies that encourage more direct foreign investment would help reduce the dependence on short-maturity funds and should also improve investment monitoring.. Changes in ownership rules included in IMF agreements may help to achieve this, and additional direct foreign investment may occur naturally as lower currency values reduce the prices of productive assets in these economies. There is a potential for nationalistic backlash that may limit this expansion.

The role of fixed exchange rates in the acceleration of crisis has led to speculation that more flexible exchange rate regimes may be a superior choice for these economies. This panel is of mixed opinions on the matter. The dangers of inflexible pegging to the dollar are clear, and countries will at least need to rethink their basket or dollar peg arrangements. The creation of the Economic and Monetary Union in Europe can be expected to lead to a declining importance of the dollar. Generalized floating might help insulate countries against terms of trade changes flowing from differential inflation experience and from realignments of major currency exchange rates. But the current crisis was not limited to countries with fixed exchange rates. Korea, which has had managed floating rates suffered a particularly severe financial crisis. Despite Indonesia's expression of interest, the currency board system of Hong Kong SAR China is probably not a feasible choice for a large country with poor initial economic conditions.

Regulators in developed countries also need to do a better job overseeing the quality of bank lending. It is disturbing that fifteen years after the Latin American debt crisis and a decade after the US Savings and Loan bailout it is still possible for Western banks to build up large balances of poor quality, poorly diversified foreign assets.

A clear lesson of the crisis is the need for better systems within the economies to deal with economic emergencies. This will not be the last financial crisis in Asia. (The US has had dozens of crises over its history.) Governments must be prepared to deal with a crisis quickly and efficiently. One important element of a financial emergency plan is a system of deposit insurance to protect purchasing power of depositors and permit rapid consolidation of troubled institutions. Because of the moral hazard and adverse selection problems that deposit insurance entails, clear rules must be established regarding capital adequacy, bankruptcy and bank bailouts. Blanket bailouts cannot become the rule. At a macro level, Asian countries are now at a development stage where they should begin to build an adequate social safety net. As Indonesia's experience indicates, without programs to protect living standards, it is very difficult to undertake the fundamental restructuring needed to recover from the crisis.

The International Community should play a bigger role

The contagion of the Asian Flu to other countries shows that there are considerable externalities to international capital flows. This justifies an international role in monitoring and perhaps regulating international capital markets. Of course this is not a new notion, but we may need more than the IMF short-term credit facilities in this age of large-scale international capital interrelationships. A simple first step might be to provide a deeper buffer against crisis by creating an enhanced international contingency fund that could supply rapid, pre-approved access to credit for countries suffering balance of payments problems. Countries would need to meet strict macroeconomic criteria in order to be eligible to draw on the fund. The establishment of a regional "Asia Fund" to supplement IMF resources has been discussed, but concerns have been expressed that it might undermine the role of multilateral international institutions.

An alternative mechanism to support financial stability would be an international or regional insurance program for cross-border financial claims. Such a system could serve an insurance role similar to domestic deposit insurance while pooling international risk. Multilateral insurance schemes for some types of foreign direct investment risk already exist, and might serve as a model for expansion of protection to other types of international financial flows.

Perhaps the most glaring shortcoming of the existing international financial regime is the lack of common regulatory standards and generally accepted principles for the provision of corporate and government financial information. Some of the risk inherent in international investments could be mitigated by the adoption of a uniform international bankruptcy regime. International securities rules could ensure transparency of international investments and more satisfactory disclosure of investment information. Some expert group members favored the creation of an international public "rating agency" that could supplement or replace the private Western rating agencies. This organization could provide an early warning system for future financial crises. Common standards for training of financial industry professionals would support uniform practice and more effective cross-border communication.

The high volatility of international capital flows raises the possibility that efficiency gains might be achieved by "throwing sand in the wheels" of international finance through the implementation of a "Tobin tax" on international financial transactions. These would presumably be imposed by individual developing country governments. The Chilean experiment requiring holding periods for foreign inflows might be looked at as another possible solution to the problems posed by flight capital.

Countries should liberalize their financial markets carefully

While it is not clear that any of the affected countries would benefit from backtracking on financial liberalization, the Asian crisis experience suggests that caution should be taken by other countries contemplating financial liberalization. In fact, this is precisely the lesson begin drawn by China and the countries of South Asia. One thing that is clear is that there must be well-defined rules on information disclosure and financial transparency before countries are encouraged to liberalize. Also, careful thought needs to be given to the optimal sequencing of liberalization. Considerable development of domestic financial markets is important before opening up the country to international capital flows.

That is not to say that financial liberalization should be avoided at all costs. There are clear gains from access to international capital markets that must be weighed against costs. These gains include not only the standard gains from intertemporal trade, but also the possibility to improve overall financial sector performance through exposure to foreign competition. In Thailand, financial markets were opened to external flows in part to reduce the monopoly power of the few large domestic banks. The policy did in part have the intended effect, but also exposed the economy to a huge inflow of funds and subsequent outflow for which it was ill prepared. The improvements in financial regulations implemented by the Philippines and Malaysia—spurred in part by financial problems during the 1980s—appear to have been important in their relative success in dealing with this most recent crisis.

6. Conclusions

The developing economies of South-East Asia are digging out from the debris of the 1997 financial crisis. The next few years will be a period of painful adjustment as they undertake needed domestic financial reforms and maintain austere macroeconomic policies to restore investor confidence. There will be adverse spillovers from the crisis economies to other regional economies and the global economy. In the long run there is no reason to conclude that Asian performance will be badly eroded. On the contrary, ongoing reforms may pave the way for more secure growth, if not at the break neck pace of the past half-dozen years.

Successful recovery from the current crisis and prevention of the next requires appropriate policy decisions both within countries and in the international community. Macroeconomic policies must be maintained in a way that restores confidence without extinguishing hope of economic recovery. Progress must be made in working down debt burdens and restoring financial flows to the region. Looking toward the future, changes should be made to national and multilateral institutions to improve regulatory oversight, to increase the flow of information needed for effective financial market operation, and to minimize the likelihood and adverse impact of future crises.

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