The Asian Crisis: the Return of Growth

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Use the free Adobe Acrobat Reader to view Chart 1 and Table 1.

1. Introduction

Four months ago in Manila I had the pleasure of addressing the Asia Society's Tenth Annual Corporate Conference. My talk on that occasion was entitled "The Asian Crisis: The Beginning of the End?" Tonight we can safely remove the question mark, and talk about the return of growth in Asia—in the Asian crisis countries of Indonesia, Korea, Malaysia and Thailand, in the Philippines, which avoided the worst of the crisis, and, significantly, in Japan.

Like a seismograph, the EMBI spread (Chart 1) provides a good index of the intensity of a crisis. The devaluation of the baht in July 1997 shows up as only a minor tremor. The real start of the crisis is marked on the EMBI index by the attack on Hong Kong in October 1997. The eighteen months since then have been exceptionally difficult for Hong Kong. Nonetheless, the Hong Kong economy has successfully withstood massive external shocks, and the linked exchange rate remains strong. And as the other Asian economies hit by the crisis recover, Hong Kong too, with its policies continuing on the right track, has very good prospects of recovery in the second half of this year.

2. The recovery

The regional outlook has improved markedly in the last few months (Table 1). The countries at the heart of the crisis, Korea, Thailand, Malaysia and Indonesia, are probably past the turning point. Even in Indonesia, where macroeconomic stabilization took longest, economic activity is expected to pick up in the second half of the year. The recent economic stability in Indonesia, supported by generally good macroeconomic policies and foreign official financing, was essential in helping ensure a peaceful background for the elections.

These recoveries are built on expansionary domestic policies, fiscal and monetary, and on the beginnings of the recovery of exports. They have been helped by the return of foreign capital, both financial, which has strengthened stock markets, and foreign direct investment. In Indonesia, Malaysia, and Thailand, the recoveries remain fragile, and depend on the continuation of structural reform policies, as well as on an improving external environment. In Korea too, the structural reform agenda is far from complete, particularly in restructuring the chaebols.

Among the potential victims of the crisis, the Philippines economy performed exceptionally. The Philippines was in an IMF program at the start of the crisis, and it skilfully pursued good policies, both by allowing the exchange rate to adjust when it came under pressure, and by defending it through interest rate policy. As the economy came under pressure, IMF financing for the Philippines was increased. The country benefitted from the composition of its trade, which is more heavily weighted towards the United States than that of the more severely affected countries.

Japan accounts for more than half the output of the region. There could have been no better news for the region than the strong first quarter recovery reported for Japan. While it is yet to be seen whether the recovery is firmly under way, policies are now playing a constructive role to strengthen demand, and bank recapitalization is underway. It will likely be necessary later in the year to ensure that fiscal policy continues to support the expansion.

And China has continued to weather the crisis better than many expected: a well timed fiscal stimulus has helped support activity, and the stability of the yuan has been maintained. A daunting agenda of structural reform of the state sector and the banks remains, but the authorities have made it clear that they are committed to accelerating reforms in these areas.

3. But there are risks

But all this is fragile. The continuation of the recovery depends on domestic policies, which in turn depend on domestic politics, as well as on the external environment.

One important risk is that the burgeoning recovery will reduce the urgency of reform, and allow complacency, or normal politics, to set in. Much structural reform remains to be carried out in the crisis-struck countries, Indonesia, Korea, Malaysia, and Thailand, and also in China and Japan. As stability and growth return, and as the role of the international financial institutions inevitably diminishes, those countries that have had IFI-supported programs are going to have to internalize the ongoing reform process. We will continue to do everything we can to support the continuation of the reform process, through the IMF-supported programs as long as they continue, and then through the surveillance process.

The external environment is also critical. The phenomenal strength of the United States economy during the last three years has been bulwark of the world economy; essential in preventing the Asian and then the Russian crises from generating a worldwide recession. United States monetary policy in October and November 1998, followed a bit later by the co-ordinated cut in European interest rates, was decisive in containing the contagion from the Russian crisis. But the United States economy cannot continue to grow at rates well above any estimate of potential growth, especially when unemployment is so low. We must hope that European and Japanese growth will pick up in time to offset the inevitable slowdown in the United States—note though that while a slowdown is inevitable, a recession is not.

Japan's recovery is naturally more important for this region than is that of Europe. This applies not only to the recovery of output growth—and we must recognize that there has so far been only one quarter of growth, but also to the strengthening of the banking system, to ensure the revival of Japanese private sector capital flows to the region. Fortunately, actions taken to recapitalize the banks in the last year are beginning to pay off. The insurance sector too will need strengthening, and corporate restructuring will have to accelerate.

There are many reasons to feel more confident about the recovery than we did four months ago. But the recovery is not yet deep-seated, and this is not the time for over-confidence. And there are fresh issues to face.

4. The next set of issues

Here are some of the immediate economic issues and questions:

- Can growth resume at pre-crisis rates? The short answer is that we do not know. Many of the characteristics of Asian economies that produced the high growth of earlier decades remain in place, among them highly skilled, hard-working, and high-saving workers and entrepreneurs. Most government policies, and the structures of economies, will be stronger in the post-crisis period than they were before. Capital flows are already returning. It seems now that the very high growth of the last few years before the crisis to some extent reflected overheating. Growth in the higher income economies in the region will in any case slow as they approach the levels of the most advanced economies. Most likely, the stronger Asian economies will recover to growth rates well above the world average, but below the remarkable records of recent decades. Some of the weaker economies are likely to take more years to recover, as they deal with the aftermath of the crisis, particularly in the financial sector.
- How quickly should fiscal consolidation be achieved? Budget deficits have appropriately been widened—though generally by less than planned—during the crisis. But the financial crisis has imposed heavy longer-term burdens on the budget in several countries. Some countries, notably Japan, face large future costs of social safety networks; other countries should improve their social safety nets. Budget deficits will have to be reduced in the medium term, and the efficiency of tax systems enhanced. Fortunately, there is no tradition of large budget deficits in the region, and so governments are likely to seek to restore budget balance within a matter of a very few years. That too is appropriate. The speed at which it needs to be done varies across countries, depending in large part on the size of the explicit and implicit debts that have built up in the last few years.
- Sustaining reforms in the financial and corporate sectors, and in governance. Real progress has been made in improving legal systems, prudential regulations, and supervisory frameworks, but these mechanisms still need to be applied rigorously and effectively—and this includes bankruptcy as an essential mechanism in economic restructuring. Transparency will play a key role in all these areas, and here the IMF can help, including through the experimental transparency reports we are now beginning to prepare in cooperation with the countries concerned.
- Dealing with international capital flows. As international capital returns to the region, the challenge is to ensure that the international and domestic macroeconomic and structural frameworks are strong enough to discourage excessive fluctuations in short-term flows, and adequate to deal with the fluctuations that will inevitably occur. This could include market-based measures to discourage short-term capital inflows. It should certainly include stronger domestic policies and financial systems, strengthened prudential regulations in both the capital-originating and the capital-receiving economies, and much better data on the nature and sources of the flows.

The role of short-term capital flows and how to deal with them is one of the topics now being examined by a working group of the newly-created Financial Stability Forum.

- A word on the exchange rate regime: In the wake of the crisis, we are likely to see more countries adopting flexible exchange rate systems, or, if they fix, doing so in a definitive way, for example, as in Hong Kong, through a currency board. However this simple dichotomy is unlikely to be the last word, and some countries may seek intermediate regimes, for instance a broad target range for the exchange rate, around a central rate that could itself move gradually. Countries that adopt floating rate regimes will have to consider the basis for their monetary policy; increasingly, around the world, the benefits of an inflation targeting regime are being recognized.

5. Final reflections

Let me conclude by reflecting on a few broader issues raised by the crises of the last two years.

- At the height of the crisis, most pundits proclaimed this the crisis of globalization. But it is clear from the responses of policymakers that globalization is here to stay, for virtually unanimously policymakers resisted the siren calls to withdraw from the system, close down their capital markets, and retreat into financial isolation. Of course, their reaction only increases the obligation to reform the international financial system.
- Accordingly a major effort is now under way to strengthen the architecture of the international financial system. The IMF's new Contingent Credit Line, the CCL, is designed to offer assurance to countries by offering them contingent financing, which will become available if they are affected by contagion. The CCL is only for countries pursuing good policies and seeking to meet relevant international standards—and it thus enables the IMF for the first time to lend in a precautionary way, outside the context of a crisis, and to provide incentives for good policies. One key issue in the reform of the system is the role of the private sector in the prevention, mitigation and solution of crises. It is also clear that the activities of highly leveraged institutions—an issue that has justifiably concerned policymakers in Hong Kong—need to be looked at very closely. The new Financial Stability Forum, which is itself an important response to the crisis, has a task force addressing this issue, with some Hong Kong officials taking part.

And ranging a bit wider yet:

- The commitment of the political leadership of a country to reform is essential. Each of the IMF-supported programs in Asia took hold only when the political leadership changed. Public support for the reforms is also essential. This requires both consultation and discussion with a wide spectrum of society, and ensuring adequate social safety nets for the poorest.
- Finally, we need also to reflect on the political aftereffects of a crisis as deep as this one has been. In the 1980s Latin America went through a profound economic crisis, more prolonged than the Asian crisis will be; the 1980s in Latin America are described as the lost decade. But the decade was not entirely lost, for it was during that decade that economic reform finally took hold in Latin America. It was also the decade in which democracy took firm hold in Latin America. Asia is different, for its

economic policies before the crisis were much stronger than those of Latin America before its lost decade. But the crisis has led to a reconsideration of the tight links among business, government, and the financial sector characteristic of several economies, and it is leading to more transparency in the economy and in economic policy-making. And that transparency too will have wider consequences.

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