

Recent problems in Asia

After noting recent favourable economic developments in the United Kingdom and the United States, the Governor⁽¹⁾ discusses the causes of the recent problems in Asia and the lessons for the future. He notes that progress towards stabilisation is being made, and that this is an important first step towards achieving a balance between market and macroeconomic policy adjustment and official and private financing. The Governor concludes by reviewing estimates of the impact of the Asian problems on world growth. He argues that it is in the interests of the industrialised countries, as well as the Asian economies themselves, that the latter recover as quickly as possible and that they receive help towards that end.

The role of the Chamber is to promote Anglo-American trade and investment, and you're doing a pretty good job. Two-way trade in goods and services is running at around \$50 billion in each direction, and has grown at an annual average rate of about 8% during the past five years. In the same period, the United States has accounted for just over half of all inward direct investment into this country and close to one third of all UK outward direct investment. These examples suggest that our commercial relationships are in good shape.

Economic developments in our two countries have provided a favourable backdrop to British-American commercial relationships. In the United States, Goldilocks continues to tiptoe through the tulips. Total output has been growing for seven years, at an average annual rate of around 2½%. Unemployment has fallen from a peak of 7.4% to 4.7%, and consumer price inflation has averaged 3%.

In this country, output has been growing for the best part of six years, at an average annual rate of close to 3%. Unemployment on a comparable basis has fallen from a peak of 10.7% to below 7%, and underlying consumer price inflation has averaged around 2¼%. If that's not Goldilocks exactly, it is surely her younger sister! And while, in this country in particular, we are having to work harder to keep her from tasting Father Bear's porridge, there are now signs that the porridge itself may be beginning to cool down—as it needs to do, quite soon and quite quickly, if we are not to see inflation pick up.

Some US business people—and certainly some British business people—engaged in international trade are understandably uncomfortable at the recent strength of our respective exchange rates—not *vis-à-vis* each other, because the dollar-sterling rate has been relatively stable, but against the rest of the world. The domestic environment, here and in the United States, remains—actually and prospectively—relatively benign.

We are, though, both exposed to the chilly winds now blowing from Asia. And I should like to devote the rest of

my remarks to discussing the problems in Asia and considering just how serious a threat they pose to the global economy.

I emphasise 'problems' in this context because it is important to recognise that the situation in Asia differs materially from one country to another, even though they are all inevitably affected to varying degrees (through their close commercial links with each other) by the present economic weakness in the region as a whole.

Let me begin with a few words on Japan. Japan is of course much the largest economy in Asia. After a spectacular period of sustained growth during the 1980s, the Japanese economy has stagnated during the past six years, as Japan has struggled to overcome the fragility of its financial system in the aftermath of the infamous Japanese financial bubble. A constraining factor for much of this time has been a widespread resistance to the use of public funds to strengthen the financial system, which has, in turn, constrained the financial system in its extension of domestic credit. Japan has been reluctant, too, given the size of its public debt, to use fiscal policy to stimulate the domestic economy. There is now evidence of a change of heart on both these fronts. Japan—which has an extraordinarily strong external position—was never at the eye of the storm that struck Asia around the middle of last year. But if, as I expect, these policy changes now lead to somewhat stronger domestic demand growth, and greater confidence in Japanese financial institutions, that will make a crucial contribution to the stabilisation of the region as a whole.

The storm mainly struck the ASEAN-4 (Thailand, the Philippines, Malaysia and Indonesia), spreading subsequently to South Korea, and intermittently battering Hong Kong and elsewhere.

It is still not wholly clear—to me at least—quite why the storm suddenly struck. Most crises of this sort have their origins in some evident macroeconomic policy failure. At least in hindsight, there are usually fairly clear tell-tale

(1) In a speech at the British-American Chamber of Commerce lunch on Thursday, 22 January 1998.

signs of expanding fiscal deficits and/or lax monetary policies, classically accompanied by evidence of imbalance in the form of accelerating inflation or a rapidly deteriorating balance of payments. There were such signs, perhaps most notably in Thailand, but they were not for the most part particularly pronounced in Asia. In fact, through the first half of the 1990s, and in some cases for much longer, the countries in question were remarkably successful. They attracted, by their very success, huge inflows of capital from the rest of the world in search of higher returns.

The capital inflow made a major contribution to sustaining the economic expansion in Asia, but, with the benefit of hindsight, the increasing scale of the inflow, and particularly the form that it took, became an important part of the problem. It was not all effectively employed. There was overinvestment in some production sectors; much went into ambitious property development; and much went into financial rather than real assets. The hoped-for higher returns could not be maintained.

Again with the benefit of hindsight, it is possible to identify a number of structural weaknesses in the mechanisms for financial resource allocation in the recipient countries. There was, for example, a general lack of reliable financial information, and a lack of transparency in relation to the financial position, in both public and private sectors. Complex and opaque links between government, financial institutions and non-financial companies made it difficult for outsiders to understand the real nature of their exposures. Financial markets were not well developed, leaving the system heavily dependent upon the banks. There was inadequate regulatory or supervisory oversight. There was widespread government influence over financial flows, which importantly also contributed to a perception that much of the borrowing was effectively underwritten by the government. The list could go on.

The problem was compounded by the absence of any real perception of exchange rate risk. Borrowers were evidently confident that governments would maintain their exchange rate pegs against the dollar, so that unhedged foreign currency debt, much of it short term, appeared a cheap alternative to domestic currency borrowing. The result was a build-up of short-term private sector foreign currency liabilities, by banks and non-banks, which was not fully appreciated, and which left the Asian economies especially vulnerable to a flight of capital in the event of a change in sentiment. The problem is that national authorities can create their domestic currency if they choose to do so, even if it leads to inflation, but they cannot simply create foreign currencies in the same way.

So once the run started, it was violent and contagious.

There are certainly all sorts of lessons for the future to be drawn from Asia's experience, relating to the structural weaknesses in the financial system that allowed the problem to emerge. These weaknesses certainly need to be addressed

in the borrowing countries' own interests, if they are to continue to reap the great benefits of the free international movement of capital without similar extreme volatility in the future. But the immediate question was, and is, how to contain the present problem.

There are two broad options. One is simply to allow financial markets (exchange markets, interest rates, and stock and bond prices) to take the strain, and to seek to restore confidence and moderate the impact of market movements by restrictive macroeconomic policy adjustment. The second is to limit the financial market impact and the extent of the associated macroeconomic adjustment by providing or arranging alternative external financing. In practice these options are not, of course, mutually exclusive, and the real question is the appropriate balance between them.

Where a country has transparently been pursuing an undisciplined and unsustainable macroeconomic policy, most people find it easy to accept that that country should bear the burden and adjust, painful though that may be. Many people find that harder to accept where, as in the present case, conventional macroeconomic policies have, for the most part, been relatively responsible. There were certainly adjustments to macroeconomic policy that needed to be made—a more flexible exchange rate regime in some cases, for example, or a somewhat tighter overall macroeconomic stance, with perhaps some adjustment between fiscal and monetary policy. And once the capital outflow had started, adjustment needed to be more abrupt than might otherwise have been necessary, in order to re-establish confidence. But there are real dangers in extreme market movements, or in excessively severe macroeconomic adjustment to contain them. That could cause a vicious circle of domestic default and systemic financial weakness in the affected country. And it would have seriously adverse implications—in terms of both financial and economic knock-on-effects—for the global economy.

That is why it is in the self-interest of the international community to attempt to mitigate the market and macroeconomic adjustment pressures in Asia by providing financial support. It is why the international community responded to the crisis in Asia by promptly offering very large amounts of official assistance—\$17 billion in the case of Thailand, \$43 billion for Indonesia and \$57 billion for South Korea.

But such official financial help cannot be unlimited, and it cannot be provided without strings. It, too, has real dangers. If it were too readily forthcoming it could encourage 'moral hazard', partly by encouraging macroeconomic laxity in other potential borrowing countries, but especially by encouraging commercial lenders—particularly foreign currency creditors—in the belief that they will be bailed out if things go wrong. That would be likely to add to the problem of potentially volatile capital inflows next time around. Not surprisingly, too, there is also strong political

resistance in many countries, including notably the United States, to the idea that public—taxpayers'—money should be used to bail out private creditors, especially foreign creditors.

Alternative external financing need not come solely from the public sector. Private finance would, in principle, serve the same purpose, and in many situations market price adjustments may be sufficient to stem the capital outflow. But given the extent of the loss of confidence in the present case, it would be optimistic to think that other private lenders were queuing up to volunteer to stand in place of those that are rushing for the exit. In practice, in the present situation private support means persuading existing creditors that their assets will be better protected if they are prepared to leave them in place. And they may be prepared to do so, if all other major creditors agree to do the same, especially if official support is being made available in parallel. But in this case too, difficult judgments have to be made. There is a danger that, if private creditors have to be in effect coerced into staying put, they will immediately cut their positions elsewhere while they can, adding to the international contagion.

Achieving a reasonable balance between market and macroeconomic policy adjustment and official and private financing was never going to be easy. It depends upon the good sense and judgment of key players all around the world—the governments, central banks and major market participants in both the major creditor and the debtor countries, as well as the international organisations. My impression is that after the initial shocks, in which market adjustments have been massively overdone, the key players are now co-operating more effectively to bring about stabilisation. Within the constraints imposed upon it, the IMF in particular is playing a very positive leading role. And I particularly welcome the constructive part that the major commercial banks, from all the main creditor countries, are now playing in rolling over their loans to Korea. This has already helped to begin to stabilise the situation there, and it has provided a breathing space while new market financing is organised. Together with the availability of the further official support already committed, this, I am reasonably confident, will enable Korea to regain control of its external position, and go on to rebuild confidence on the back of the underlying strengths of its economy and an already rapidly improving current account.

That, in turn, would do more than anything to help to re-establish stability elsewhere.

Stabilisation, of course, is not the end of the story—it is simply the necessary first step.

Even assuming, as I do, that we are able in fact to contain the immediate financial turmoil, there is bound to be a substantial economic aftershock. Domestic economic activity in much of Asia will inevitably be subdued, with knock-on effects elsewhere, and major imbalances are likely to emerge in international trading patterns.

It is too soon to have any very clear view about the likely scale or duration of these economic effects. The IMF, in its interim *World Economic Outlook*, based on information available up to early December, has tentatively estimated that world GDP growth this year—at 3½%—might be around 1% lower than it had expected in the autumn. They expected much of the impact to fall on the Asian economies themselves—with forecast growth in the newly industrialised Asian economies falling by 2½%, whereas growth in the G7 countries was expected to be only about ½% lower (at 2½%), with a substantially larger impact on Japan. My impression is that, notwithstanding these revisions, most analysts would still see the risks as being quite heavily on the downside.

There have been suggestions that the dampening of activity, particularly in this country and in the United States, as a result of these developments is welcome insofar as it will help to prevent the re-emergence of inflationary pressures. And that is true—up to a point. It is clearly not desirable that the necessary moderation of demand should be narrowly concentrated on those sectors that are exposed to international competition. And while some of the industrial countries can certainly tolerate significant external deficits for a time, persistent large deficits would not be sustainable indefinitely. So it is clearly in our own interests as well as theirs that the Asian economies recover as rapidly as possible and that we help them towards that end. That represents a difficult international economic and financial agenda for the future—which, given the time, is perhaps the subject for another occasion. The immediate first step is financial stabilisation in Asia, and my message to you today is that we are making progress towards that end.