Trade and investment in the light of the Asian crisis

In this speech,(1) Dr DeAnne Julius, a member of the Bank's Monetary Policy Committee, assesses possible economic and political consequences of the Asian financial crisis. After outlining a downside scenario, she sets out a number of practical steps that leaders of the G7 countries and others might take to avoid or at least mitigate such an outcome.

I am delighted to have the opportunity to participate in this important conference on the eve of the G8 Summit.(2) I am also delighted to be sharing the platform with my colleague on the Monetary Policy Committee. We have planned quite a strict division of labour on this topic, but it still may give us a chance to disagree with each other without being labelled as hawks or doves!

In fact, when I used to work on Asia in my previous incarnations at the World Bank and as a corporate economist, the predominant ornithological metaphor was of flying geese. Japan, of course, was the lead goose in the formation, with the rest of the Asian economies forming the V behind. I always felt that there were a few avionics problems with that metaphor, since nearly all of the smaller and poorer economies were flying much faster than Japan. And since about 1990, when the Japanese economy began to suffer from the burst of its equity and land price bubbles, the formation seemed to be flying in reverse, with the rest of Asia providing the strongest source of demand for Japan's output.

Now the whole formation has slowed precipitously, and is in danger of stalling. My central message to the G7 in their Economic Summit deliberations this weekend is that globalisation means mutual structural adjustment. There is a risk of complacency, not to mention closing the barn door after the horse has fled, in focusing too heavily on the financial aspects of the Asian crisis. Certainly, we should take advantage of whatever lessons can be learned for international financial reporting and regulation. But the financial eruptions in Asia are (we hope) mostly behind us, while the economic and political fallout is yet to come. And the longer-term effect of those on the real economy—through the channels of world trade and direct investment—could be aggravated if they are not well anticipated and accepted by all of us.

To make the case for this message, I would like first to consider the background to the Asian crisis, and then to discuss what I shall call a downside scenario in three phases—financial, economic and political.

First, the build-up. The period from 1990–97 was a remarkably auspicious time in recent economic history. World growth was stronger than it had been in the previous two decades, despite domestic recessions early in the 1990s in some of the largest economies. There were no synchronised downturns across the OECD, and there seemed to be a new delinkage of growth between the OECD economies—which were growing at around their long-term trend rates—and the developing world, where growth seemed to be accelerating. Some commentators speculated that this was due to 'the end of history', or at least the discrediting of the old socialist models of economic planning and state-owned production. While the philosophical shift that followed the fall of the Berlin Wall in 1989 certainly brought fundamental changes to the central European economies, it would be too much to claim, in my view, that they shifted world economic growth onto a new, higher track.

What has changed, however, is the scope, and therefore the pace, of globalisation. Since the beginning of this decade, world GDP has grown, in real terms, by 30%, at an average rate of 3.8% per annum. During that same period, world trade has increased by 40%, rising in volume terms by almost 6% per annum. This pattern of trade growing around 50% faster than GDP has been one of the salient features of the post-war period. It reflects the critical role of trade in stimulating economic growth through increased specialisation, and the additional competitive spur of the larger international market. But from a strictly domestic standpoint, it also shifts the balance of forces that drive national economic growth more and more towards the external sector. And for all but the largest world economies (by which I mean essentially only the United States and Japan), it makes the exchange rate an increasingly important determinant of domestic economic growth and stability.

This increasing importance of the external sector has been given a greater spur, as well as a new twist, by the phenomenal growth of foreign direct investment (FDI). The step change in FDI flows was actually in the late 1980s, when Japanese companies became important players. Then the wave of privatisations began, initially here in Britain,

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(2) The Birmingham Summit meeting on economic issues involved the G7 countries: the United States, Japan, Germany, France, Italy, Canada and the United Kingdom. Russia joined the Summit meetings on political issues as a full participant, making it the first G8 Summit. Mentions of the G7 in this paper refer to the seven countries listed above, while G8 refers to the Summit conference as a whole.

but then in Latin America, Asia and elsewhere. These were often managed by foreign merchant banks and consultancies, which were very effective in mobilising foreign capital for investment in large segments of developing country businesses that had formerly been on the states' books. At a global level, after a brief dip around 1990 associated with the US recession and the slowdown in Japan, FDI flows resumed apace. Since 1990, they have more than doubled, growing at an average annual rate, in real terms, of 14%. That is more than twice as fast as the growth of world trade.

The 'new twist' to globalisation provided by FDI is important to understanding the current situation in Asia. Unlike portfolio flows into emerging market funds, direct investment cannot be quickly withdrawn. Direct investment decisions are taken carefully, weighing up the macroeconomic, commercial and political risks, before capital is committed. Those risks have risen dramatically since the Asian currency collapses of 1997. Macroeconomic assumptions on which past investments were made have been proven wrong. In currency markets, as we all know, overshoots and reversals are to be expected. But even if many of these currencies appreciate from their troughs to more appropriate levels, the private sector's view of macroeconomic risk over the next five to ten years has been permanently changed by this experience. If these macroeconomic shocks turn out to have negative political repercussions, a possibility that I shall come to later, then FDI into those countries could take a number of years to recover.

So my own view is that the Asian financial crisis will have more severe and longer-term economic consequences for those countries than is yet widely appreciated. Indeed, the IMF seems to be edging towards the same conclusion. Its successive forecasts for this year's economic growth have been getting progressively gloomier. For the developing countries as a whole, including Asia, the IMF now forecasts growth of just over 4% this year, compared with its forecast of more than 6% back in October. It now foresees serious recessions, in the sense of a year-on-year decline in output, in Indonesia, Thailand and Korea. Many other forecasters expect a year-on-year recession in Japan this year. We may see further downward revisions in IMF and other official forecasts for 1999 as we move closer to that date.

But what does this growing pessimism on Asian growth imply for the rest of us, and specifically for the G8 heads of governments meeting this weekend in Birmingham? Well, again according to the IMF forecasts, very little. Despite the major downgrading of developing country growth prospects, they have made almost no change in their forecasts for growth in the G7. The reason for this is that domestically led demand growth in the United States in particular, but also in some of the geographically peripheral economies of Europe, is very robust. So the IMF is making the perfectly defensible economic judgment that, despite the increase in globalisation during the past decade—which was most evident in Asia—the linkages between those countries and ours have not significantly changed.

I am a bit more sceptical. As I pointed out earlier, the world economy went into this Asian currency crisis in remarkably good shape. We had had nearly a decade of strong growth, led by buoyant trade and direct investment flows. World inflation had come down significantly, not only in the OECD countries, but also in many parts of the developing world. But when we look behind the aggregates, it becomes clear that the strong performance of the Asian countries themselves was a significant contributor to the growth we were all enjoying. Asian growth was significantly higher, and Asian inflation lower, than world aggregates for this period. The result was that in just six years (full 1997 data are not yet available), Asia's share of world economic output grew from 20% to 25%. In terms of world exports, Asia's share increased by 3 percentage points to 19% by 1996. And most striking of all, Asia's share of FDI inflows doubled during that period, from 12% to just over 24%. The Asian countries were a disproportionate contributor to—and beneficiary of—world growth during this decade. Now the tables are turned. It seems to me at least conceivable that a serious economic setback in Asia may similarly have a disproportionate impact on world growth over the next few years.

Let me stress, however, that this is not a prediction. It is rather a scenario, offered in the spirit of a self-denying (rather than a self-fulfilling) prophecy. By recognising and warning against what is possible, we may be able to take steps that make it less probable, and avoid the sort of actions that could make it inevitable.

How would a downside scenario come about? It would be through a combination of economic impacts and political reactions—both in Asia and in the G7 countries—to the financial shocks that have occurred. The main features of such a scenario might run as follows. On the financial front (1997–98), as currency pegs break in Asia and asset prices fall, bank failures would proliferate. In the G7 countries, credit lines to Asia would tighten, portfolio investment would be withdrawn, and new lending to the region would be reduced. On the economic front (1998–2000), many Asian countries would experience a credit crunch, causing companies to fail, imports to plummet, and unemployment to rise. Japan, already weakened domestically by banking problems and fragile consumer confidence, would fall back into recession as its Asian export markets collapsed. These developments would spell export losses in the rest of the G7, sharp falls in FDI profitability, downward price pressures on tradable goods at home and ballooning external deficits. Significant exchange rate swings could follow.

But the most damaging phase of this downside scenario could be yet to come on the political front, where effects are often much more long-lasting (1998–2008). In Asian countries with weak democracies, the economic strains could generate social unrest, strikes and sudden political upsets. This would greatly increase the political risk premium on FDI as perceived by companies in the G7, and could also rekindle protectionist pressures and anti-dumping actions, as the cheap imports resulting from excess capacity and undervalued exchange rates flood into G7 markets.

And of course, if one wants to paint a truly gloomy scenario, then the sequence feeds back upon itself, with the economic and political developments generating further financial shocks both in Asia and in other vulnerable developing countries.

Now the point I am trying to make is not that this description of future developments in Asia and here is the most likely prospect. (I have done enough scenario planning in my time to resist attaching probabilities to any one outcome.) Rather, I am trying to illustrate the complex of economic, political and social linkages that come into play in a globalised world economy. While the financial crisis in Asia is, or soon will be, over, I expect its economic and political legacy to linger.

Let me conclude with a list of practical steps that the G7 leaders and others may take to avoid, or at least, mitigate, the kind of downside scenario that I have presented. First, the most obvious lesson for G7 investors is that there needs to be greater scrutiny of commercial risks. To some extent this will happen automatically, as companies lick their wounds from the damage already incurred. But there is also a role for the OECD in standardising disclosure rules and promoting best practice in corporate governance.

Second, political risk insurance (PRI) should be expanded. The private sector markets for political risk insurance are rather new and limited in depth, while the traditional bilateral agencies lack capacity to expand their coverage. With demand increasing for PRI, and the size of private involvement in infrastructure projects growing, this is an area where the World Bank could help. MIGA, the World Bank arm that provides PRI, has limits on the cover it can provide (both in aggregate and per project) that are too low in relation to the needs of the market.

Third, joint IMF/World Bank country assessments should be initiated and required as a condition of future bail-outs. The role of the IMF in this crisis has attracted much criticism, as well as a recognition from most participants and observers that its role is both difficult and essential. Few would doubt its credentials in macroeconomic analysis. A practical step that would strengthen analysis in the microeconomic, private sector and social dimensions of reform would be to use a joint IMF/World Bank team. The depth of structural knowledge possessed by the Bank's country experts would help both in diagnosing weaknesses that originate in the private sector, and in developing solutions that are tailored to each country's situation.

Fourth, Japanese efforts at economic revival should be supported. Berating Japan for not playing a more active role in this crisis is unproductive. Japan is in a difficult situation. Both fiscal and monetary stimulus is being applied, but there are legitimate uncertainties about how the economy will respond. Given the weakness of domestic demand, the inevitable rise in unemployment leading to further precautionary savings, and the effect on Japanese banks and exporters of the downturn in the rest of Asia, it is probably unrealistic to look to Japan to do much more. Its own road to recovery is likely to be a long one.

Fifth, we in Europe and North America need to be ready to tolerate substantial current account deterioration over the next few years. We should expect, and we can afford to allow, our external accounts to adjust to the new global capacity overhang and increased competitiveness of Asian exports. The Director General of the World Trade Association, Renato Ruggiero, recently predicted that this adjustment could amount to a $70 billion deterioration across the OECD in 1998. We at the Bank of England are forecasting a shift of the UK external position amounting to 3% of GDP over the next two years. These kinds of shifts could well lead to protectionist pressures, which need to be firmly opposed.

And finally, the most important contribution that the G7 can make to a rapid recovery in Asia is to keep our own economic houses in good order—with stable prices and sustainably high rates of economic growth.

That, together with an open door for trade and investment, can shorten the painful period of adjustment that lies ahead for Asian firms and households. And for my part, I would be more than willing, with the hindsight of a year hence, to consign my downside scenario to the overflowing dustbin of unfulfilled forecasts.