4
Outlook on Asia

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Good morning, ladies and gentlemen, and thank you, Dr. SaKong, for the invitation to speak here. I was asked to speak about the outlook for Asia in 1999 and I think I should precede my remarks with a little caveat. We live in a world where things are quite volatile and change sometimes abruptly so that a forecast that may seem reasonable and plausible today could be overtaken by events in a few months' time. I think it is for that reason that the economics profession hasn't been very successful in its forecasting activities lately, so you should take my own remarks within this context.

Now, when we talk about the outlook for Asia, we should first look at the global context, because Asia is not developing in an isolated way. First, and very important, are financial markets. Now, as you know, financial markets have experienced a number of shocks. First, the Asian crisis itself, then, last summer, the breakdown of policymaking in Russia and Russia's default, the speculation about the Brazilian major economic problem, and of course, the near collapse of one of the hedge funds based in New York. Now, these events had a very detrimental effect on financial markets. In particular, and that's crucial for Asia, they led to a withdrawal of investors from emerging markets. However, since about October 1998, these market tensions have eased significantly. Again, various elements contributed. One is the improved outlook for Asia. By and

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by, it has sunk in that the Asian crisis countries have overcome the first phase of the financial crisis.

Second, the new policy initiatives in Japan, a major fiscal stimulus package, and a major attempt to restructure the financial system have improved the outlook for Japan. And very importantly, the U.S. and European countries have gradually lowered interest rates. Also, a package has been arranged for Brazil, suggesting that the danger there is about to be overcome. The spreads for emerging market countries in the international markets, which were very high in September and October 1998, have come down since then.

Now, while the danger of a global credit crunch has receded, private financing flows to emerging countries remain nevertheless seriously constrained. Interest spreads, although coming down, are still substantially high, and in any case substantially higher than before the summer of '97. The world economy is currently expected to continue its moderate growth of around two percent. Inflation will continue to be low almost everywhere, partly because commodity prices will further decline. Europe is expected to continue its recovery while growth in the U.S. is expected to be maintained, although at a somewhat more moderate rate, closer to the U.S. economy's growth potential. Activity in Asia will remain depressed, but growth is expected to turn around in the course of 1999. Now, before going into the forecast, let's take stock of where Asia was at the end of 1998.

I would roughly divide Asia into three units: Japan, the crisis countries, i.e. Thailand, Malaysia, the Philippines, Indonesia, plus Korea, and thirdly, China, Hong Kong and India. Now, though the recession in Japan has deepened, strong action has been put in place both to support domestic demand through fiscal policy and an aggressively expansionary monetary policy and also to rehabilitate the financial system by provision of substantial public money.

In the crisis countries, the decline in output is continuing, although the pace is moderating. In almost all countries, third quarter results for 1998 are significantly better than first and second quarter results. Nevertheless, the total decline in GNP in 1998 will be, on average, about 8%. It is highest in Indonesia with about 15%. It is lowest in the Philippines. Korea and Thailand are at around 5~7%. In all countries, the current account surpluses are large, so adjustment to the crisis has been rapid. Exchange rates have been appreciating nearly universally, even in Indonesia, and foreign exchange reserves have been replenished. Inflation has been kept under control and is coming down and so are interest rates in most countries, except in Indonesia, where interest rates have reached pre-crisis levels or have even fallen below. That shows that the initial policy measures undertaken in the various economic programs, despite several criticisms, have been effective. They have achieved the first objective, namely, to stabilize the financial situation and to adjust the balance of payments. The recession, however, is still with us, and to get out of the recession, fiscal policies in all countries have shifted towards expansion and monetary policy has become progressively easier. That's the situation in the crisis countries.

Now, in China and India, growth has remained robust, although increasingly affected by slower demand in Asia and the world economy. So, export growth in these countries has lowered, and the inflow of direct investment, some of which has come from Asian countries, has declined. Hong Kong's growth has been most seriously affected by declining world demand and also by tighter domestic demand policies which were necessary to maintain the currency for the system.

Let's now turn to the outlook for 1999, starting from the situation I have described. First, Japan. Growth in Japan is likely to hit bottom in 1999 as the fiscal stimulus takes effect and progress in banking reform is achieved and raises confidence. For the year as a whole, despite a turnaround, growth may still be slightly negative but definitely less so than in 1998, where growth declined by close to 3%. Inflation will be practically absent. Now, much of the pattern of growth will depend on how well the fiscal stimulus works, what the exchange rate will do—that's important for export growth—and how the confidence of Japanese consumers will fare. So, there are uncertainties.

In the crisis countries, one can combine them all and predict that growth will turn around, probably in the first half of 1999, and be positive in the second half. This is happening under the impact of the expansionary fiscal policy that was started in 1998 and which should spill over into 1999, by the easing of monetary policy, which is now possible since financial markets have been stabilised, and by an expansion of exports in response to the devaluation that has occurred since the middle of 1997. Roughly, the real exchange depreciation in these countries is about 25%. That should allow these countries to gain market shares. Inflation will remain under control. It has remained under control because of the tight monetary policy that was generally pursued in all countries after the outbreak of the crisis. Even in Indonesia, where the depreciation was much larger than in the other crisis countries, inflation could slowly be rolled back. On a year to year basis, it's now down to 80%, but in October and November 1998, inflation in Indonesia was practically zero. So, I think the danger of hyper-inflation in Asia has passed.

As far as growth is concerned, probably the Philippines and Thailand will be most advanced in achieving a turnaround. Korea is certainly expected to follow. We are not sure what will happen in Malaysia. It's still too early to judge the experiment which they are making with a new approach involving capital controls, fixing of the exchange rate and domestic reflation. However, as can be seen so far, Malaysia is unlikely to fare significantly better than the other crisis countries. Now, the outlook for Indonesia would also be for further stabilisation and a slight improvement in growth.

However, we have to be cautious because there is significant political uncertainty in Indonesia. 1999 is an election year for Indonesia. There will be parliamentary elections in May or June followed by the election of the president and the vice-president, and that, of course, implies some political instability. We hope that instability can be kept within limits and will not interfere with economic policymaking because economic policies so far have been well on track and should be continued in order to deal with the most serious crisis in Asia.

Certainly, the pace of recovery—and that's why we cannot be very precise when the turnaround comes—will also depend on the rebuilding of the financial system and the restructuring of the corporations. And also, we can expect that all countries will continue to run sizable current account surpluses. Private foreign investment, as things get better, may slowly return. Substantial inflows of official capital are nevertheless required to cover any emerging balance of payments gap and make the recovery sustainable. So, while the crisis countries will be significantly better off in 1999, we cannot say they are out of the woods yet. It will still be a difficult year, but a significant step towards further normalisation.

China's economy is still expected to expand at a relatively fast rate as the effects of slower export growth and slower growth of foreign investment are offset by a large government stimulus package that contains mostly expenditures for infrastructure. At the same time, inflation will remain low. Again, in China, it is important to make progress in reforming state enterprises and state banks in order to maintain the basis for sustained and fast growth.

Hong Kong probably will not do as well and growth may further drop slightly, but the falling growth will be cushioned by a more expansionary fiscal policy. The Indian economy was relatively little affected at the beginning of the crisis. But in the course of 1998, declining demand for exports has also reduced growth prospects. The current account deficit is rising, the fiscal position is under pressure and progress in structural reform is slow. This makes the economy a bit vulnerable. We nevertheless expect that growth will be maintained in 1999 at a satisfactory base and that inflation, although somewhat higher than in other Asian countries, at 7~7.5%, will be contained.

This roughly concludes the overview of what one could expect in 1999 for Asia. I would like to conclude by stressing that all forecasts are, of course, off if one of two things happens: 1) if the global environment changes significantly—and there are always dominant risks; or 2) if policy implementation in Asian countries goes seriously off track. We cannot expect policies always to proceed perfectly and smoothly. That is part of the reality. But we would expect that policies stay basically on track. If they don't, the forecasts would have to be revised.

Now, this underlines the seriousness of the challenges to policymakers during a still very difficult period for Asia. I would enumerate four such challenges to policymakers: 1) to keep trade and payment systems open so as to sustain confidence and to continue to reap the benefits from international economic cooperation; 2) to restore the viability of the banking system as quickly as possible in order to put banks in a position where they are able and willing to lend and thereby support needed expansion in investment, exports and outputs; 3) to restructure enterprises, private corporations in most countries, state enterprises in China. They should be restructured operationally as well as financially to increase their adaptability in the global market and to increase their productivity. Both ways of restructuring are necessary to remain competitive and to reap the benefits of international exchange and the global economy and; 4) I think it is important to continue to implement an expansionary fiscal policy throughout 1999 to support domestic demand and help the economy to get out of the recession as quickly as possible. The additional benefit is that these extra public expenditures can be channeled into needed infrastructure and into a social safety net that in all Asian countries needs to be expanded. Of course, once the economies are back on the medium term path, the fiscal position has to be changed and consolidated again.

Question & Answer

Q Don't you think the IMF itself needs a certain restructuring to better serve its member countries?

A The answer is a clear yes. As I said at the beginning, we live in an economic environment where things change almost on a weekly basis. The IMF as well as any other institution, public or private, has to keep pace with those developments and continuously adapt itself in a way to best serve its member countries. This has been happening, and one can debate whether it's happening to your satisfaction or not. But certainly, the effort is being made. The executive board of the IMF, which consists of the representatives of all member countries, almost continuously discusses needed changes in the IMF's approach to policies, to member countries and to financing issues. So, reform is happening, and it definitely is needed. Now, from time to time, some major changes are needed and there seems to be an international consensus that this is the time when more than mere routine adaptation is necessary. Therefore, in the discussions about the new financial architecture, in which the IMF plays an important part, the role of the IMF will have to be further redefined.

Q What are your views on the idea of the AMF, the Asian Monetary Fund, and what are the merits and demerits of the AMF concept?

A I have no particular view on the proposal itself because I don't know its details. But it is clear that Asian countries need ever-closer cooperation and coordination of their policies. And it will be up to the governments and to the international community to define the best framework for this cooperation.

Q You mentioned that the Philippines and Thailand would recover from the financial crisis earlier than Korea. What leads you to conclude that Korea's resumption of growth will only follow the resumption of growth in the Philippines and Thailand?

A They are not causally related. It's a chronological issue. Thailand, as you know, was the country where the crisis broke out first and therefore Thailand had somewhat more time to set the stage for a recovery. Anyway, I don't see a significant difference in the recovery pattern of Thailand or Korea. Now, the Philippines was lucky in the sense that it entered the crisis after already having gone through an IMF program. Therefore, it was in a somewhat better position and its growth was less affected than growth in the other crisis countries.

Q Well, here come tough ones. The first question is regarding the IMF's policy prescriptions of very high interest rates and tight fiscal policies. In particular, the prescription applied to the Korean economy at the very beginning of the crisis, which called for high interest rate policies, may have been a kind of overkill. The prescription may have been more relevant to countries in other parts of the world but not especially for Korea. Do you think you could have done things differently and do you think the first prescription may not have been an appropriate one? The second question is regarding the current structural adjustments for the Korean chaebols. Are there any "factors", though not on the level of conspiracy, such as U.S. business lobbying to the U.S. government, which might have played some role in encouraging Vice President Al Gore in Kuala Lumpur and President Clinton in Seoul to emphasize chaebol restructuring? What is your view on this?

A Well, I was expecting the first question with 100% certainty. Let me say that different people can have different views. I can only give you my view that when the IMF economic program was worked out between the Korean government and the IMF, it was in a very late stage of the crisis. There was financial panic, there was chaos in the market and at this stage there is no other prescription than to tighten monetary policy in order to restore stability.

Now, let's look at it in a more abstract sense. When a country gets into a balance of payments crisis, there are theoretically two possibilities. One is to maintain the exchange rate, not let it drop, by intervening as much as you can and by raising interest rates as much as it takes. This is basically the system of a currency board. The second theoretical possibility is to lower interest rates and let the exchange rate fall wherever it falls. Both are very extreme. In any case, the fixed exchange rate solution was not feasible, neither for Korea, nor for any other crisis country. Most countries had already lost their reserves, so they couldn't intervene much. And none of these countries would have been prepared to let interest rates go wherever it was needed to keep the rates stable.

The other extreme, ignoring the exchange rate and letting it go where it may, would also be unacceptable because first, it would trigger hyper-inflation. This is not an Asian tradition. There are very few instances in Asia where there has been hyper-inflation. I only know Indonesia in the late sixties and Vietnam in the seventies. So that was unacceptable. Also, with a very depreciated exchange rate, corporations would be crushed because their obligations in foreign exchange, which usually were unhedged, would have put an enormous burden on the corporations. They would have to default.

So, the agreement reached in the discussions between the IMF and the government was an in-between solution. You let the exchange rate fall somewhat, to take off some of the pressure, but limit the fall by raising the interest rates, again in a limited way. Money market rates in Korea reached a peak of 30% for a couple of weeks at the end of 1997. This was the interim solution. Of course, it had a cost. The cost was that the recession was made somewhat worse. But it didn't cause the recession. The recession would have come in any case. But if somebody looks for a painless cure when a country is in the midst of a foreign exchange crisis, he will not find one. Those people who criticize high interest rates haven't told us what they would have done instead. That's the first part of my answer.

The second part is that it was worthwhile going through this because the medicine succeeded. Markets did stabilize. The won stabilized and started to appreciate. Foreign exchange reserves of Korea, which were close to zero, are now close to US$50 billion. Korea could now go back and borrow in the international capital market. And interest rates, which for a short period were very high, have gradually come down. Money market rates at the end of 1998 were at 7%. I think it's lower than before the crisis, and there's still room to go down further, provided that markets remain stable. It was unavoidable in a crisis that you have to use the interest rate weapon temporarily, and I don't know of any country that hasn't done so.

As for the second question, there is not much I can say on the conspiracy theory. Certainly, the discussions between the government and the IMF with regard to better governance in the chaebols and to chaebol restructuring were not guided by any conspiracy theory but were guided by the best advice we could get from experts from all over the world, including Korean experts. Now, what was decided and discussed is transparently available. You just go out and buy a copy of the letter of intent and read up what was the content of the chaebol discussions.

Q These next questions are also related to the previous one. The first one is about the de-leveraging target for the corporate sector, in other words, the equity ratio. What is your view of raising the target of the equity ratio of the Korean corporate sector from five times to two times in 1999? Is it achievable? The second question is related to the fiscal deficit. What is the IMF's tolerance level for the fiscal deficit, particularly since the social safety has to be strengthened because of high employment? I'm sure this is spelled out in the government-IMF agreement. Nevertheless, could you elaborate on these two issues?

A Yes. On the first question, whether or not the target for reducing the debt to equity ratio is achievable, I don't know. But I think it's good and necessary to have a target. One doesn't have to have a completely rigid attitude in economic policy. In all other areas, one has to be realistic and pragmatic. If it turns out that there are good and compelling reasons to modify a target, a target will be modified. But it's not bad to start out with an ambitious objective.

Second, what's the limit of the fiscal deficit? Well, it depends on the cyclical situation and it depends on the country. What I mean is that, if the situation is very severe, it calls for a larger economic stimulus. Look at Japan, where the situation is quite severe and where therefore, the stimulus is very big. Now, in Korea, the recession that we experienced in 1998 is much more severe than we had forecast in 1997. We have to be flexible in policymaking and answer that change in the outlook by increasing the fiscal deficit.

Second, it depends on the country, because some governments are already very highly indebted. In that case, one has to be very cautious to add to this debt because it could lead to a very unstable situation. Other countries, like Korea, are fortunate because they have a very long tradition of conservative fiscal policy. That is true for almost all Asian countries. Therefore, there is room, in a time of need, when there is a recession, to temporarily boost the budget deficit. Afterwards, in the medium term, you go back to balance. So, there is enough tolerance for the deficit that the Korean government is proposing, which is about 5% of GDP. It's not extreme by international comparison, anyway.

Q Please elaborate on the issue of Korea's repayment of its debt. Also, didn't the IMF or the Korean government make policy mistakes? Finally, please discuss the IMF's interest rate policies.

A Because it was expected that the financial crisis in Korea would be overcome very quickly, most of Korea's credit from the IMF was short-term, for one year. So, what was accepted in December 1997 came due at the end of 1998. But there is some flexibility. The government can propose to the IMF executive board to choose a later repayment. Now, this flexibility is something the government has to decide. It is an issue of that management and I would expect the government will take a decision soon and also announce it. I don't think the Korean balance of payments is a momentous issue.

The second question: didn't the IMF or the Korean government make policy mistakes? Certainly. The program was not perfect. The designing of a program and its implementation are never perfect.

Also, remember that this economic program started in 1997 had to be drawn up in great haste, within days, plus nights, because there was a danger that, with such a low level of reserves and continued chaos in the markets, Korea would have to default. That's something that both sides were adamant to avoid. It would have had disastrous consequences, not only for the Korean economy and its recovery prospects and its integration with the international market, but it would also have had grave consequences for the region, because if one country would default there would be contagion. Markets might expect that other countries were up to the same thing and they would withdraw and therefore precipitate a default. It was very important to prevent that, and therefore, speed was very important. And if you do something speedily, you cannot do everything perfectly. So, I would be the first one to admit that the program wasn't perfect.

Second, you cannot expect a government that is subject to all kinds of pressures and checks and balances—and that's so anywhere in the world—to implement a program exactly to the dot and to the utmost perfection. That is not even what is required. What is required is that the government steadfastly follow a basic strategy and react in a timely way to any changes in the external environment. And Korea has done that, as has been certified by the IMF Executive Board, which has reviewed the Korean program frequently. At the beginning, the Korean program was reviewed by the Executive Board every two weeks. Then later, when things calmed down, the program has been reviewed every three months. That's the standard. And so far, at every review, the Executive Board has certified that the Korean program is on track and that therefore, the IMF will disburse the next installment. In short, the answer is that while things were not perfect, they were basically all right. And as I have tried to show, the strategy also paid off. I mean, there is no doubt that today in Korea we live in quite a different world than we did at the end of 1997.

Third, interest rates. One cannot pre-plan and pinpoint the ideal number for interest rates. You cannot say you have to have the interest rate down to x or y. But it is quite clear that under the present circumstances, when the economy is in a recession and when financial markets are stable, the balance of payments is strong and the exchange rate is strengthening, that there is further room for reduction in interest rates. Now, as in the past, this reduction has to be done slowly and cautiously, always looking at the reaction of the market. If interest rates come down, and the market takes it well, you can continue lowering them. If markets get uneasy, well, you wait a bit. Sometimes, you may even temporarily tighten a bit. I mean, that's the art of monetary policy. It is not a science. But the clear indication is that at this point in Korea there is scope for further reduction in interest rates, and it is desirable to use this scope.

Q First, what was the reason for the IMF not correctly forecasting the seriousness of the economic downturn in the crisis countries at the very beginning of the crisis? Second, what is the current status of the restructuring of international financial architecture and the IMF's role in this context?

A Yes, we did underestimate the seriousness of the downturn, not only in Korea but also in the other crisis countries, with the possible exception of the Philippines. Now, when I said we, I do not mean just the IMF, I mean everybody who was engaged in the business of forecasting. There was nobody who, in the middle or even towards the end of 1997, would have predicted the seriousness of the situation in Asia. Now, why was it not foreseen? There may be various reasons and I don't pretend to give you a definitive answer. One reason is that the difficulties in the banking systems in these countries, which had accumulated over years, one bad loan after the other, were not fully seen and appreciated. It was known that these banks were in difficulties. The IMF even provided technical assistance for better supervision and for deposit insurance and other things. But it probably was not fully known how serious they were. It couldn't have been fully known because full information on the status of the banking system was not disclosed or was not available to the governments themselves. That's one reason. But once these difficulties came to the surface, it was a sudden shock which had a detrimental effect on domestic and international confidence.

The second reason is that the investment boom, which in some countries was basically a real estate boom, came to an end in most countries and the decline in asset prices was more serious than one may have assumed. Again, this is a shock to the economy.

The third reason is that the panic in the markets that led to a sudden withdrawal of capital, plus capital flight, quickly drained the resources in the economy. This in turn led to a precipitate fall in investment.

There may be a further factor that Asian countries were not used to having their economies disrupted by a serious recession that causes unemployment. This shock to consumers reduced consumer confidence and led to a contraction in consumption which again, we can explain afterwards, though it wasn't quite foreseen. I think these are some of the elements which delayed our grasp of the magnitude of the economic downturn.

As for the second question, though the IMF can play a role in global financial restructuring, in the end, the many institutions and all the governments who bear the ultimate responsibility for the new system will be involved.

Q In that connection, let me ask you this question. You mentioned Mahathir's policy regarding short-term capital flows. The

Malaysians put controls on outflow of short-term capital. What the Chileans used to do was control the inflow of short-term capital. There is a big difference here. The Chilean scheme, which required a 30% reserve requirement for all incoming capital, reduced its reserve requirement to 10% after the Asian financial crisis occurred. Now, I understand the inflow-control scheme has been postponed in its implementation. In your view, when a crisis occurs or when you see a crisis coming, is there a necessity of having some kind of control on the inflow side, if not on the outflow side? Or, in a time of crisis, is there any justifiable reason for putting controls on outflow as the Malaysians did? What's your personal opinion on this?

A There is not yet a universally accepted view, except that in the IMF, we think that countries should avoid policies that close their markets, whether that means markets for goods, for services or for capital because, in the long run, they will deprive themselves of the benefits of a globalized economy. Now, the problem with capital flows was mostly on the short end. In Korea, most of the capital inflow came through the short-term window. Why? Because Korea closed, or mostly closed the markets for the long-term inflow, be it direct investment or long-term portfolio investment. That proved to be a disadvantage. So, one lesson is that countries should liberalize the capital markets by starting on the long-term end and only then go to the short-term end. Korea did it the other way. A second lesson that has been learned is that before countries open the short-term capital market, they must be sure that their banking system is strong and transparent. That means it can be well supervised and it can be held to stick to prudential regulations. So, I think with better monitoring of capital flows—many countries just don't have the data to know what is going on—with better monitoring and better prudential supervision of banks, part of the problem can be resolved.

Q One of the issues which often arises in regard to the role of the IMF and international financial institutions, including private institutions, is "lenders' moral hazard". Now, of course, the moral hazards of borrowers as well as lenders are important, but there are more serious discussions on lenders' moral hazards nowadays.

Do you think that in the very early stages of a crisis or even before a crisis, the IMF can play a more active role in intermediating between creditors and debtors so that they can come up with some reasonable agreement which would reduce the so-called lenders' moral hazard problem?

A I think this is a difficult issue in practice. It is one part of the new financial architecture, namely, to find a way and a mechanism to draw in private lenders at a very early stage. Now, the lenders are drawn in at a later stage, after a crisis has broken out.

In Korea, it was only at the end of December 1997, that discussions, informal discussions with commercial banks, were started to maintain the rollover of short-term debt. And later, in January 1998, this was formalized by an agreement. The IMF was certainly quite instrumental in facilitating these discussions. But it is difficult to see how this could have been done before the crisis because the mere approach to banks before a crisis breaks out may in fact precipitate a crisis. It's a very delicate issue. If, say, in November 1997, all commercial banks had been called to a meeting to discuss Korea, they would have thought, "Something is going to happen, I'd better pull out quickly." So, how this can be done has yet to be evolved. No way has yet been found to do this most effectively. But clearly, bringing in commercial banks and other private lenders only after the crisis is not satisfactory. It would be much better to get them involved in a cooperative and voluntary way beforehand, as both parties would benefit.

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