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Dealing with the Asian Crisis

IMF Conditionality and Implications in Asia and Beyond

Analysts broadly agree on the causes of recent crises in East Asia. Nevertheless, deep controversy exists on appropriate therapy. Especially the International Monetary Fund is under attack. The way of dealing with financial turbulence may have important repercussions on countries within and outside Asia. Risks for the world economy as a whole tend to be underrated so far.

Until recently, East Asia was widely believed to show the way of how to be among the winners of globalization. In industrial countries, the "Asian tigers" were considered a threat. High unemployment in Europe was frequently attributed to Asia's attractiveness for foreign capital and the inroads of Asian suppliers into world goods markets. Development economists, including the present author, repeatedly advised Latin America to learn from East Asia how to sustain macroeconomic stability, how to integrate successfully into the worldwide division of labor, and how to attract foreign capital and gain access to internationally available technologies.[1]

Enthusiasm about East Asia's economic performance has been replaced by panic. Some observers interpret currency crises and financial turbulence as indicating that East Asia is the first victim of the globalization of markets and production.[2] Such verdicts suggest that overshooting is a phenomenon prevailing not only in international financial markets, but also in the commenting upon acute crises. The affected Asian economies may suffer from a considerable setback in catching up economically with advanced industrial countries; but the tremendous rise in per-capita income achieved in the past decades will not be wiped out. Annual GDP growth was about 8 percent since the mid-1980s. During the 30 years preceding the crisis, per-capita income increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia.[3] Yet, it was obviously false to assume that almost everything was different in Asia and that this region was not prone to crisis.

Latin American Lessons

Developments that led to present difficulties in East Asia should have been well known from previous episodes of financial distress in Latin America. East Asian governments, including external advisors, essentially made the same mistake as Latin American governments in the 1970s, namely not to look beyond the national or regional domain. Ex post, it is quite clear that governments could have prevented repeating the same mistakes made elsewhere before.

Asia now has to go the hard way to learn some Latin American lessons.[4] Most evidently, the risk of speculative attacks increases if financial markets consider a country's currency to be overvalued. In Latin America, real appreciation of the domestic currency frequently resulted from inconsistent economic policies. Exchange rates were fixed as a nominal anchor, while persistent fiscal laxity drove up prices of non-traded goods. In several East Asian countries, over-

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[1] See, for example, Erich Gundlach, Peter Nunnenkamp: Some Consequences of Globalization for Developing Countries, Institute of World Economics, Kiel Working Papers 753, Kiel, July 1996.

[2] "Schockwellen aus Fernost", in: Der Spiegel, January 19, 1998, pp. 76-86.

[3] Stanley Fischer: The Asian Crisis: A View from the IMF. Address at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, January 22, 1998.

[4] For a detailed analysis of currency crises in Asian, European and Latin American countries, see Markus Diehl, Rainer Schweickert: Currency Crises: Is Asia Different?, Institute of World Economics, Kiel Discussion Papers 309, Kiel, January 1998.

valuation became an issue when governments maintained the peg to the US-$, although the US-$ appreciated against other major currencies and East Asia's export growth slowed down significantly in 1996.

Fragility of domestic financial systems adds to vulnerability if speculative attacks occur. The concrete manifestation of financial weakness may differ from country to country. In Thailand, for example, essentially unregulated operations of (non-bank) finance companies constituted a major problem. In Korea, government-directed bank lending and lack of transparency resulted in nonperforming debt. The common factor ignored by various Asian governments is that financial liberalization per se does not ensure efficient financial intermediation. To the contrary, financial institutions are inclined to take excessive risk unless independent supervisory bodies are established, prudential standards are enforced, and the government is credibly committed against guaranteeing private sector liabilities.

Moral hazard problems, though well known from previous financial liberalization episodes in Latin America, were largely neglected until the crisis broke out in Thailand.[5] High domestic investment caught the eye of many analysts and was – rightly – considered an asset of East Asia relative to other regions. By contrast, speculative investment ensuing from incentive problems escaped professional scrutiny. Imprudent lending fuelled booming real estate prices in particular. Inflated real estate served as collateral for further credit. The bubble burst when vacancy rates for office space turned out to be considerable. This was the beginning of a downward spiral. The shrinking value of collateral exposed highly leveraged financial institutions to liquidity problems. The following credit crunch triggered a sharp fall in real estate prices. For instance, prices of office space in Thailand declined by about 30 percent during the second half of 1997.[6]

Furthermore, the structure of external financing matters for currency risk and may add to financial distress. The Mexican "tequila" crisis of 1994/95 bears witness to the volatility of short-term capital flows. Short-term capital is most easily withdrawn from a country once foreign investors consider current account deficits to be unsustainable. The expectation of depreciation by some large investors may turn out to be a self-fulfilling prophecy, particularly if the ratio of short-term debt to foreign reserves is high. This ratio approached 100 percent in Thailand and 150 percent in Indonesia, signaling a high vulnerability to sudden changes in short-term capital flows.[7]

Once foreign investors started to withdraw from Asian host countries, another vicious circle set in. Looming depreciation revealed the exposure of local firms and banks to currency risk. Many banks had raised short-term loans on international financial markets for longer-term onlending to speculative domestic investors. Anticipating that depreciation would render the servicing of external debt more difficult, borrowers tried to hedge liabilities by selling local currency for foreign exchange. This added to exchange rate pressure and further undermined the ability to service foreign debt. Panic has resulted in a degree of devaluation far exceeding "any reasonable estimate of what might have been required to correct the initial overvaluation" of Asian currencies.[8]

Managing the Crisis: The IMF Approach

All in all, Asian turbulences reveal striking similarities to previous crises in Latin America. Exchange rate pegs induced real appreciation and unsustainable current account deficits. The sudden reversal of short-term capital flows disclosed the fragility of domestic financial systems. Collective action problems led markets to overreact.

However, there are two important differences between Asia and Latin America. First, except the Philippines, East Asia cannot be blamed for unsound macroeconomic management in the pre-crisis period. In contrast to the Latin American syndrome of fiscal laxity, fiscal policy in most East Asian countries is well reputed for maintaining macroeconomic balance. Public deficits were gradually reduced and converted into surpluses in the early 1990s.[9] Second, savings rates in East Asia were, on average, twice as high as in Latin America in 1995 (Table 1). Among the Asian economies mostly affected by the current crisis, savings were low and declining only in the Philippines. By contrast, among major Latin American economies, only Chile reported a savings rate approaching the 30 percent mark.

[5] Paul Krugman: What Happened to Asia?, January 1998, mimeo.

[6] Estimates by Cushman & Wakefield, a Hong Kong-based real estate consultant, as quoted in: Der Spiegel, January 12, 1998, p. 77.

[7] Markus Diehl, Rainer Schweickert, op. cit., p. 27.

[8] Stanley Fischer, op. cit., p. 2.

[9] Markus Diehl, Rainer Schweickert op. cit., p. 23.

Table 1
Gross Domestic Savings in East Asia and Latin America, 1980 and 1995
(percent of GDP)

	1980	1995		1980	1995
East Asia			Latin America		
average[1]	28	38	average	23	19
Indonesia	37	36	Argentina	24	18
Korea	25	36	Brazil	21	21
Malaysia	33	37	Chile	20	29
Philippines	24	15	Mexico	25	19
Thailand	23	36	Venezuela	33	21

[1] High-income economies (Hong Kong, Korea and Singapore) not included.

Source: World Bank: World Development Report 1997, Selected World Development Indicators, Table 13, Oxford 1997.

The controversial issue is whether these differences call for a cure to the East Asian crisis that is fundamentally different from traditional IMF conditions imposed on countries in need of financial assistance for overcoming internal and external imbalances. The IMF argues that restoring confidence in the currencies of East Asian countries was of first priority in designing adjustment programs. To this end, the IMF has asked for higher interest rates, fiscal restraint, and financial sector restructuring:

☐ Higher interest rates shall stop the downward spiral of currency depreciation. Korea, for example, had to agree to an inflation target of 5.2 percent for 1998, which is just slightly higher than the inflation rate in 1997. This requires "a brutal monetary squeeze",[10] considering that depreciation of the Won means rising prices of traded goods. Short-term interest rates in Korea jumped from 12.5 percent to 21 percent upon the signing of the IMF program.

☐ Fiscal restraint is said to be necessary for compensating the expected costs of financial sector restructuring, and for restoring a sustainable current account balance. Initial fiscal adjustment amounted to 3 percent of GDP in Thailand, 1.5 percent of GDP in Korea and 1 percent of GDP in Indonesia.[11] Fiscal programs comprised higher taxes and reduced public investment.

☐ Financial sector restructuring involves institutional changes to strengthen financial regulation and supervision, and to increase transparency. Internationally accepted practices related to capital adequacy standards, accounting procedures and disclosure rules shall be adhered to. Moreover, the IMF has insisted on closing down non-viable financial institutions, which is to let shareholders take their losses and to prevent moral hazard in the future.

Critics of the IMF agree that the solution to the Asian crisis is to restore confidence. However, it is open to question whether IMF conditionality, as outlined above, helps achieving this aim. Some measures may even turn out to be counterproductive.

Appropriate Therapy: IMF under Attack

The IMF has met with considerable resistance in Asia, notably in Korea. The IMF has imposed conditionality, rather than aiming for "ownership" of adjustment programs by countries in need of financial assistance. Some of the measures forced on Asian governments are beside the IMF's principal business of restoring stability and stopping the drain on foreign reserves.[12] For instance, Korea had to agree to liberalize the import regime for cars. In the longer run, this step may well be in Korea's own interest; but it is hard to see how it helps to overcome acute balance of payments troubles. It is suspected that the IMF raised the issue of Korean car imports because it figured high on the US administration's bilateral agenda. As a matter of fact, the IMF's position in negotiations with Korea was refined repeatedly after consulting US officials.

Another delicate issue concerns the deregulation of foreign banking in Asian financial markets. Again controversy is mainly on the timing of reforms. Foreign participation in banking may support financial restructuring and help achieving internationally accepted best practices. However, under conditions of financial turmoil, foreign banks, if allowed in immediately, may acquire local assets at seriously depressed prices. This may add to public resentment against foreign investors taking over domestic industries. The IMF would have been well advised to take Asian preferences into account in deciding on how to deal with this dilemma. By insisting on quick financial liberalization, the IMF nourished Asian feelings that the hidden agenda in negotiations was to open doors for foreign business.

[10] Jeffrey Sachs: IMF is a power unto itself, in: Financial Times, December 11, 1997.

[11] Stanley Fischer, op. cit.

[12] "New illness, same old medicine", in: The Economist, December 13, 1997, pp. 79-80.

Apart from failures in "selling" adjustment programs to Asian countries, major elements of the IMF's approach are under attack for economic reasons. Debate centers on how to overcome the collective active problem, since "there is no 'fundamental' reason for Asia's financial calamity except financial panic itself".[13]

Wade and Veneroso suggest a solution that is radically opposed to IMF remedies.[14] Instead of containing inflation and raising interest rates, these authors consider domestic inflation, causing real interest rates to turn negative, to be the least costly way of reducing current levels of debt. Their approach requires a closed capital account. Wade and Veneroso argue that foreign savings are not needed in Asian economies with high domestic savings rates. Governments are advised to declare a moratorium on foreign debt, and to spread the remaining costs of financial cleanup among domestic savers. Rather than letting local banks fail, governments are urged to inject capital into the banks so that the latter can resume lending to their customers.

This proposal rests on two questionable assumptions. First, the observation that Asian "household savers have been content with the low rates they have been getting"[15] is obviously meant to imply that savings behavior will remain unaffected if real interest rates turn negative. However, domestic agents would have strong incentives to shift savings abroad in order to avoid sharing the cost of financial consolidation. Experience in various countries suggests that capital flight may reach significant dimensions, even if capital outflows are subject to control. Second, domestic and foreign savings are far from being perfect substitutes. In almost all East Asian economies, foreign direct investment (FDI) accounts for a significant share in overall capital inflows.[16] FDI tends to provide host countries with a package of capital, market access, managerial know-how and, most importantly, technology. This means that closing the capital account is

[13] Stanley Sachs, op. cit.

[14] Robert Wade, Frank Veneroso: The Asian Financial Crisis: The Unrecognized Risk of the IMF's Asia Package, New York, January 1998, mimeo.

[15] Robert Wade, Frank Veneroso, op. cit.

[16] For East Asia as a whole, (net) FDI inflows accounted for more than half of total net resource inflows in 1995-1996; the corresponding share was 39 percent for all developing countries; World Bank, Global Development Finance 1997, Washington 1997.

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Industrial and Trade Policy in Germany

The present study is part of a collaborative research project under the title "International Joint Research on the Market Systems of the Three Economies", i.e. Japan, the United States and Germany. Project partners are the Japan Research Institute, the Centre for Strategic and International Studies, Washington DC, the HWWA Institute for Economic Research, Hamburg, and the Royal Institute of International Affairs, London. The project aims at providing countries in transition and developing countries with a map of alternative routes for their burdensome journey towards a well working market economy.
The focus of the project was on two major features of the market systems: Corporate Governance (Schmidt/Drukarczyk/Honold/Prigge/Schüler/Tetens, Corporate Governance in Germany, 1997, ISBN 3-7890-4623-X) and Industrial and Trade Policies. The present study deals with German industrial and trade policy against the background of the current debate on Germany's quality as a business location, the country's underlying philosophy of »Ordnungspolitik« and market competition, Germany's membership in the European Community, and the challenges posed by German unification.

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not without cost, even if domestic savings are high. Rather, it would become more difficult for Asian economies to resume the process of catching up with industrial countries, which critically depends on access to technological innovations.

It appears more reasonable to involve all major participants, including foreign investors, in a cooperative solution to the collective action problem. This approach calls for mutually agreed debt restructuring, e.g., by means of prolongation of repayment profiles, bridging finance and debt-equity swaps, rather than unilaterally decreed debt moratoria. Actually, external debt restructuring is now under way in the Asian countries most seriously affected by the crisis. However, the IMF could have contained panic much earlier, by encouraging foreign creditors, both private and public, to provide bridging finance when crisis was looming. The fundamental strength of most East Asian economies should have alleviated cooperation along these lines.[17]

While the IMF's crisis management has been weak and delayed on the part of foreign creditors, IMF action is too strong on the part of domestic financial institutions. Most critics concede the need for financial sector reform in Asia. However, in the midst of financial turmoil, it is difficult to decide which financial institution should go under because of imprudent lending. By definition, the panic-induced liquidity squeeze has affected prudent banks, too. Hence, the question is how to strike the balance in preventing financial institutions that are in principle viable from failing, while not protecting non-viable institutions from the consequences of excessively risky lending. Injecting capital into distressed banks, or creating public agencies that take over non-performing loans carries the risk of supporting all banks, whether viable or not. Moral hazard may then continue. However, pushing bankruptcy and, at the same time, calling for monetary restraint, as done by the IMF, clearly exacerbates the collective action problem rather than solving it. The IMF approach is likely to send new shock waves through financial systems in Asia.[18]

An orderly dealing with domestic debt might have been possible within a reasonable period of time, considering that most East Asian governments followed sound fiscal policies. In these circumstances, austerity measures tend to result in recessionary overkill. This view is widely shared among economists outside the IMF. Even the chief economist of the World Bank, Josef Stiglitz, has criticized the IMF for forcing East Asian countries deeper into recession.[19] Higher interest rates, higher taxes and reduced public investment are counterproductive if recession is looming anyway.

In defending its case, the IMF maintains that higher interest rates were necessary to reverse the process of currency depreciation.[20] In principle, there is nothing wrong with the idea to raise interest rates temporarily in order to make it more attractive to hold domestic currency. It is also true that companies with substantial foreign debt are likely to suffer more from persistent currency depreciation than from a temporary rise in domestic interest rates. As it seems, however, the "debt mountain" largely consists of local currency debt, the recent increase in short-term foreign indebtedness notwithstanding.[21]

More importantly still, recent exchange-rate developments suggest that the IMF strategy has not worked in major problem countries in East Asia. The currencies of Indonesia, Korea and Thailand continued to plummet after these countries had agreed to IMF adjustment programs (Table 2).[22] As a consequence, the return of interest rates to pre-crisis levels is not in sight. With the rise in interest rates turning out to be long-lasting, rather than temporary, Asian debtors are in the most uncomfortable situation: the servicing of both foreign and domestic debt is rendered extremely difficult. In other words, more Asian firms and banks could have survived the crisis, if the IMF had not insisted on harsh austerity measures.

[17] In this context, Jeffrey Sachs (op. cit.) argues: "A better approach would have been for the IMF to stress the strengths rather than the weaknesses of the Korean economy, thereby calming the markets rather than further convincing them of the need to flee the country".

[18] IMF reasoning on moral hazard appears to be inconsistent. Pushing bankruptcy of financial institutions in Asia implicitly means that the IMF considers it "better simply to let the chips fall where they may" (Stanley Fischer, op. cit., p. 5), and, thereby, discourage moral hazard in the future. By contrast, the IMF is opposed to such a solution when it comes to dealing with moral hazard of foreign creditors. To quote Fischer again: "We could ... possibly teach international lenders a lesson in the process; alternatively we can step in to do what we can to mitigate the effects of the crisis ..., although possibly with some undesired side effects. The latter approach ... makes more sense".

[19] Frankfurter Allgemeine Zeitung, January 9, 1998.

[20] Stanley Fischer, op. cit.

[21] Robert Wade, Frank Veneroso, op. cit.

[22] This may be partly because uncertainty remains whether Asian governments will adhere to IMF conditions (Indonesia). Moreover, one may argue that currency depreciation would have been even more pronounced in the absence of IMF programs. Nevertheless, the verdict on the IMF's approach is quite clear: the aim of halting the downward spiral was not achieved.

Risk of Contagion

Restoring confidence, the principal aim of the IMF's crisis management, seems to be a good way off. Problem countries in East Asia are the first to suffer, if crisis is deepened and prolonged due to the remedies applied. Yet, delayed recovery in these countries may have far-reaching repercussions on other countries. Contagion may spread to Asian neighbors that were less affected so far, and possibly also to Latin America. If so, the Asian crisis may have more serious implications for the world economy as a whole than currently expected.

Further contagion within East Asia may result from close intra-regional trade and investment relations. Trade among ten developing and newly industrializing countries in East Asia accounted for 36 percent of their total exports in 1995, compared with 23 percent in 1985 (Table 3). Foreign direct investment (FDI) relations among these economies expanded by similar dimensions.[23] The increasing division of labor among Asian neighbors, according to the so-called "flying geese" pattern, supported East Asia's catching up with more advanced economies in the past. Lower-income countries participated in this process since newly industrializing economies (NIEs) of the first generation (Hong Kong, Korea, Singapore and Taiwan) restructured production from labor intensive and technologically standardized manufacturing to more sophisticated industries. Second-generation NIEs such as Malaysia and Thailand, but also countries such as China and Vietnam, benefited from relocation of industries in which the frontrunners were no longer competitive.

The intra-regional division of labor is likely to be disrupted if the countries in crisis will not recover quickly. Developments in Korea are most relevant in this regard. In terms of FDI outflows, Korea ranked third (behind Hong Kong and Taiwan) among foreign investor countries in developing Asia in the first half of the 1990s.[24] Almost half of Korean FDI outflows were invested in East Asia. In China, for instance, Korean investments exceed investments made by Germany or the United Kingdom.[25] Relocation of Korean manufacturing to neighboring countries with lower per-capita income will probably be interrupted, if not reversed, as long as the dramatic devaluation of the Won persists. Though to a lesser extent, the same applies to outward FDI by Malaysia and Thailand.[26]

Trade represents the second channel through which currency crises affect the intra-Asian division of labor. Devaluation in today's problem countries amounts to a pronounced shift in price competitiveness to the detriment of neighboring countries. The latter are facing depressed export prospects in trading with problem countries, and will become subject to fiercer competition in both home and third markets. The critical question concerns the policy reaction of neighboring countries to deteriorating trade balances. China is the crucially important player in this respect.

Table 2

Indonesia, Korea and Thailand: Nominal Exchange Rates before and after IMF Agreement[1]

	before	January 21, 1998
Indonesia	8100[a]	11350
Korea	1197[b]	1724
Thailand	31.0[c]	52.4

[1] Currency units per US-$. [a] January 7, 1998. [b] December 3, 1997. [c] August 8, 1997.

Source: The Economist, Emerging Market Indicators, various issues.

Table 3

Trade Relations within East Asia,[1] 1985 and 1995

(per cent)

Exporting country	1985	1995
China	36.8	37.2
Hong Kong	16.8	41.7
Indonesia	18.4	24.7
Korea	10.8	33.1
Malaysia	36.1	40.8
Philippines	20.7	25.4
Singapore	30.8	40.3
Taiwan	18.3	39.3
Thailand	25.6	31.5
Vietnam	48.5	24.1
All 10 countries	23.0	36.0

[1] Share of exports to ten developing and newly industrializing countries in East Asia in total exports of the countries listed; see source for details of calculation.

Source: Sangkyom Kim: Europe-East Asia Trade Relations: An East Asian Perspective, Korea Institute for International Economic Policy, Seoul, October 1997, mimeo.

[23] UNCTAD: World Investment Report 1995, New York and Geneva 1995, p. 53, Table II.3.

[24] Inkyo Cheong: The Patterns for Europe-Korea Investment, Korea Institute for International Economic Policy, Seoul, October 1997, mimeo.

[25] Wen Hai: Europe-China Investment Relations, China Center for Economic Research, Beijing, October 1997, mimeo.

[26] For the pattern of outward FDI by various Asian countries, see UNCTAD: Sharing Asia's Dynamism: Asian Direct Investment in the European Union, New York and Geneva 1996.

At first sight, it seems far-fetched to argue that China may react by devaluing the Renminbi. GDP growth, though considerably reduced, is expected to remain fairly strong (around 7 percent) in 1998.[27] China is less prone to speculative attacks since convertibility of the Renminbi is restricted, the trade balance is in surplus (1997: about 4 percent of GDP), foreign reserves are high (about US-$ 140 billion), and short-term foreign debt is rather low. However, China suffers from serious internal problems that may ultimately lead authorities to renege on earlier commitments not to devalue. Restructuring of non-viable state enterprises will add to unemployment in the short run. Concerns are that this process may result in social unrest, if GDP growth falls considerably short of 8 percent. Furthermore, reduced GDP and export growth will reveal the fundamental weakness of China's financial system. Banks are burdened by non-performing loans; the dimension of this problem is estimated to exceed internal debt problems in most of the Asian countries that are currently in financial trouble.[28] Another similarity to today's problem countries seems to prevail in the real estate sector. Vacancy rates in major business centers are expected to increase to 25 percent. As soon as real estate bubbles burst, liquidity problems of banks and companies will mount and China may experience a credit crunch as did other Asian countries before.

Serious repercussions on other economies within and outside Asia are almost certain, if internal tension increases in China and the government changes course by devaluing. India may be the next to devalue, in order to avoid losing markets in which China is a major competitor. Expectations are that Hong Kong will have no choice but to abandon the peg to the US-$ once China devalues.[29] Financial turbulence in Hong Kong would possibly erode foreign investors' confidence in all emerging market economies. Internationally mobile capital will then seek for the few remaining "safe havens" in industrial countries.

It is mainly in this way that contagion may spread to Latin America. Low and declining savings rates in major Latin American economies (Table 1) suggest that dependence on foreign capital inflows is higher in this region than in Asia. FDI inflows, for example, represented more than 10 percent of gross fixed capital formation in Latin America in 1985-1995, compared with about 8 percent in developing Asia.[30] In contrast to Asia, foreign savings have tended to replace, rather than supplemented, domestic savings in Latin America.[31]

In comparison with external financing, trade effects of the Asian crisis on Latin America are likely to be modest. Direct trade effects would amount to about 0.4 percent of Latin America's GDP, assuming that *all* developing Asia will expand exports to Latin America by 20 percent and reduce imports from Latin America by 20 percent.[32] However, particular industries, such as labor intensive production of footwear and textiles in Brazil, will face increasing adjustment pressure if China devalues.[33]

Financial repercussions of further Asian turbulences on Latin America are most likely in Brazil.[34] This country had to fight a first speculative attack in October 1997. In defending the exchange rate of the Real, Brazilian authorities sold almost 15 percent of foreign reserves and raised interest rates to almost 40 percent in *real* terms (on an annual basis). Another attack may occur at any time, although inflation is down to 5 percent, the domestic financial system appears to be relatively stable, FDI inflows are booming, and foreign reserves are still high (end-1997: about US-$ 52 billion). The Real is widely considered to be overvalued by about 20 percent, and Brazil runs a twin deficit in the public budget and the current account in the order of 4-5 percent of GDP. International financial markets may anticipate that the Brazilian government will change course and allow for

[27] IMF: World Economic Outlook. Interim Assessment, Washington, December 1997, p. 58; Deutsche Bank Research: Die Währungskrise in Asien. Wachstumsdelle oder Ende des Wirtschaftswunders?, Frankfurt a.M., December 1997, p. 10.

[28] Deutsche Bank Research, op. cit., p. 10. In addition to non-performing bank loans in the order of US-$ 200 billion, inter-enterprise debt among Chinese state firms is estimated at US-$ 100 billion.

[29] Deutsche Bank Research, op. cit., p. 11.

[30] UNCTAD: World Investment Report 1997, New York and Geneva 1997, Annex Table B.5.

[31] "Latin American Finance", in: The Economist, December 9, 1995.

[32] This is a fairly pessimistic scenario, even though indirect trade effects ensuing from improved competitiveness of Asian competitors in third markets are ignored. Note that the "tequila" crisis reduced Mexico's imports by just 10 percent. Moreover, the assumed changes include trade with Asian countries that do not have major difficulties so far. The calculation is based on GDP and trade figures for 1995; cf. IMF: Direction of Trade Statistics Yearbook, Washington 1996.

[33] Ricardo Pacheco, Peter Nunnenkamp: Wirtschaftliche Integration auf Kosten peripherer Regionen? Chancen und Risiken für den brasilianischen Nordosten im Mercosur, Institute of World Economics, Kiel Working Papers 827, Kiel, August 1997, pp. 21-22.

[34] This paragraph draws on Peter Nunnenkamp: Brasilien – das "Land der Zukunft" vor der Krise?, Institute of World Economics, Kiel, January 1998, mimeo; see also Deutsche Bank Research: Lateinamerika und die asiatische Finanzkrise, Frankfurt a.M., December 1997.

a larger devaluation of the Real after the elections in October 1998.

Growth forecasts for Brazil in 1998 have been reduced already to approximately 1 percent of GDP.[35] Under present conditions, growth prospects appear to be much better for neighboring countries in Latin America. But Brazil will drag its neighbors down, if the country is pushed into a major devaluation. Argentina will be affected in the first place since trade relations with Brazil have further increased with proceeding Mercosur integration.

Implications for Industrial Countries

Significant contagion within and outside Asia clearly represents a worst-case scenario. But the course of events must not be exactly the way sketched out above for the Asian crisis having considerable worldwide effects. For instance, foreign investors may turn their back on emerging markets as a whole, even if China stays on course and the Hong Kong-Dollar remains pegged to the US-$. After their enthusiasm was frustrated in East Asia, foreign investors may reconsider similar risks in other regions and reveal a preference for "safe havens".[36]

This implies that assessments according to which the Asian crisis will affect industrial countries only moderately, are subject to considerable downside risk. Simulations run by the IMF support this view. Baseline projections take a "cautiously optimistic view" on the depth and duration of the Asian crisis and its world trade effects.[37] Accordingly, deviations between post-crisis and pre-crisis projections on GDP growth in 1998 remain modest (Table 4).[38] Among industrial countries, only Japan would be affected significantly since trade with developing Asia accounts for a higher share of GDP in Japan than in Europe and the United States. In the case of "a substantially more pronounced and prolonged cutback in capital flows to emerging markets", however, output in industrial countries is expected to decline, relative to the baseline projection, by about 0.7 percentage points;[39] i.e., GDP growth in 1998 would be further reduced from 2.4 to 1.7 percent. Moreover, adverse GDP effects would no longer be concentrated in Japan, but rather evenly distributed among Triad members.[40]

Table 4
IMF Projections of GDP Growth in 1998
(percent)

	Dec. 1997 projection	Difference from Oct. 1997 projection
World	3.5	–0.8
Industrial countries	2.4	–0.3
EU	2.7	–0.1
Japan	1.1	–1.0
United States	2.4	–0.2
Developing countries	4.9	–1.3

Source: IMF: World Economic Outlook, December 1997, p. 52.

In addition to trade effects, the Asian crisis affects creditor banks in industrial countries. Japan's fragile financial system, in particular, is expected to receive another blow from non-performing loans in developing Asia.[41] Concerns mounted when Japanese authorities found out in January 1998 that the burden of non-performing loans is almost three times larger than estimated before.[42] In an attempt to ease liquidity constraints, Japanese financial institutions may sell assets held abroad, primarily US bonds, thereby sending new shock waves to international financial markets.[43]

The vulnerability of Japanese banks to credit risk in Asia is particularly large since 56 percent of their claims vis-à-vis all foreign borrowers (outside the reporting area of the Bank for International Settlements) is concentrated in the five major crisis countries (Indonesia, Korea, Malaysia, Philippines and Thailand), compared with slightly less than 20 percent in the case of European and US banks (Table 5). With concerns being focused on Japan, the strong involvement of European banks in East Asia escaped attention until recently. Outstanding claims of Euro-

[35] The Economist Intelligence Unit: Country Report: Brazil, 4th Quarter 1997, London 1997, p. 8; Deutsche Bank Research, op. cit. (note 34), p. 2.

[36] For a similar line of reasoning, see IMF, op. cit. (note 27), p. 76.

[37] For details on different scenarios and underlying assumptions, see IMF, op. cit. (note 27), pp. 51 ff.

[38] The financial press has reported projections by other institutions, including OECD and Goldman Sachs, suggesting similar conclusions.

[39] The additional reduction in capital flows is assumed to reach a magnitude of US-$ 100 billion, i.e., almost 2 percent of GDP of all emerging market economies.

[40] Europe, Japan and the United States would be affected to a similar extent in this scenario since trade with *non-Asian* emerging markets accounts for a higher share of GDP in Europe and the United States than in Japan.

[41] Deutsche Bank Research, op. cit. (note 27), p. 13.

[42] *"Faule Kredite in Japan fast dreimal so hoch wie angenommen"*, in: Frankfurter Allgemeine Zeitung, January 14, 1998.

[43] Robert Wade, Frank Veneroso, op. cit.., p. 11. However, this factor may be cushioned, or even overcompensated, by foreign investors revealing a stronger preference for placing capital in "save havens".

Table 5
International Bank Exposure, mid-1997

	European banks[1]		Japanese banks		US banks	
	(1)	(2)	(1)	(2)	(1)	(2)
Developing Asia[2]	40.7	30.0	31.8	71.7	8.3	24.6
China	48.5	5.3	32.3	10.8	5.1	2.2
Indonesia	38.3	4.2	39.4	13.4	7.8	3.5
Korea	35.1	6.9	22.9	13.7	9.6	7.6
Malaysia	44.0	2.4	36.4	6.1	8.3	1.8
Philippines	48.1	1.3	14.9	1.2	20.0	2.1
Taiwan	57.4	2.7	12.0	1.7	10.0	1.9
Thailand	28.5	3.7	54.4	21.9	5.8	3.1

(1) percent of claims of *all reporting banks* vis-à-vis borrowers listed in the front column;
(2) percent of claims of European, Japanese and US banks, respectively, vis-à-vis *all borrowers* outside the reporting area.

[1] Comprising banks from Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Spain, Sweden, and United Kingdom. [2] Offshore banking centers (Hong Kong and Singapore) not included.

Source: Bank für internationalen Zahlungsausgleich, Gliederung der internationalen Bankkredite nach Fälligkeiten, Sektoren und Nationalität der berichtenden Banken. Erstes Halbjahr 1997, Basle, January 1998, Table 2.

pean banks in the five crisis countries indeed slightly exceeded outstanding claims of Japanese banks in mid-1997.[44] French, German and UK banks financed in large part the rise in developing Asia's foreign debt from US-$ 338 billion in mid-1996 to US-$ 389 billion in mid-1997. The decision of Deutsche Bank in late January 1998 to write off about 15 percent of claims outstanding in Indonesia, Korea, Malaysia and Thailand indicates that bank profits in Europe may deteriorate significantly if Asia does not recover quickly.[45]

In summary, the Asian crisis and possible contagion within and outside the region involves considerable risk for the world economy as a whole. The depth of the crisis has to be attributed to the sudden shift from enthusiasm to panic. Hence, the critical issue is to restore confidence. Of course, the Asian countries mostly affected have to play their part in this regard. Domestic financial systems have to be put on a sound footing, by improving supervision and enforcing prudential standards. In addition, Asian governments may offer better opportunities for debt-equity swaps and may encourage FDI inflows. At present, the recessionary impact of IMF conditionality constrains Asian governments in overcoming the crisis. Countries are rather pushed deeper into crisis. This verdict, which is widely shared by professional economists, leads to the conclusion that the IMF must overhaul and revise its approach in dealing with Asia.

Governments of industrial countries, too, have an important role to play in restoring confidence. Simulations suggest that downside risk can be reduced substantially by larger international financial support (i.e., limiting the cutback in capital flows to emerging markets) and with monetary policy in industrial countries responding "with a somewhat more accommodative stance".[46] In these circumstances, the decline in GDP growth in both emerging markets and industrial countries is likely to diminish considerably and economic recovery could be expected to occur more rapidly.

In any case, industrial countries have to accept a deterioration in their current account for some time. Put differently, they must not impede Asia's adjustment process. Especially the United States should refrain from reducing bilateral trade deficits with countries in crisis, by extorting trade concessions from these countries. Protectionist demands will intensify once Asia starts economizing on devalued currencies and expands exports to industrial countries. While writing these conclusions, news are that German shipbuilders are complaining about impaired price competitiveness ensuing from the Asian crisis, and are requesting from Asia to reduce production capacity in shipbuilding. Such demands have to be firmly resisted. The Asian crisis *per se* may not drag the world economy into deep and prolonged recession. A revival of protectionism almost certainly would.

[44] European and Japanese banks held 36 and 35 percent, respectively, of all reporting bank's claims vis-à-vis this group of countries, whereas the share of US banks was below 10 percent.

[45] The write-off of claims in the order of DM 1.4 billion represents almost a quarter of Deutsche Bank's profits in 1996; cf. "Deutsche Bank trifft milliardenschwere Vorsorge für Krisenländer in Asien", in: Süddeutsche Zeitung, January 29, 1998, p. 19.

[43] IMF, op. cit. (note 27), p. 59.