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Implications of the Asian Currency Crisis and the Debt Crisis of the 1980s

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Implications of the Asian Currency Crisis and the Debt Crisis of the 1980s

by

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1998 ANNUAL GIBLIN LECTURE

6 pm, Thursday 1st October 1998
Lecture Theatre 2
Commerce and Economics Building

ORDER OF PROCEEDINGS

1. Professor Rudi Lidl, Deputy Vice-Chancellor, University of Tasmania, will welcome the Lecturer and audience.

2. Mr John Pauley, the President of the Tasmanian Branch of the Economic Society, will introduce the Lecturer.

3. Professor Anne O. Krueger, of Stanford University, will speak on "Implications of the Asian Currency Crisis and the Debt Crisis of the 1980s".

4. Dr Bruce Felmingham, of the School of Economics, University of Tasmania, will propose a vote of thanks.

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Implications of the Asian Currency Crisis and the Debt Crisis of the 1980s

1. Introduction

Thank you very much. It is of course a great pleasure to be here, despite your weather, and see the beautiful spring.

Since mid 1997 the news has been full of Asian financial crises, attacks on currencies, drops in exchange rates, insolvencies of financial institutions and IMF actions. The story has been different in each country, which is the theme I will return too.

2. Earlier Crises

IMF bail outs are nothing new: they have been around at least from the 1950s, and in the case of the United Kingdom, 1949. To illustrate, I was in Turkey in January 1980. Turkey has no domestic source of oil whatsoever, and was unable to import anything as it had run out of foreign exchange completely. Nobody would lend it anything further. And it was in arrears in its payments, even its short-term debt. So in a cold winter, buildings (even including parliament), were unheated and attire in most offices included overcoats, scarves and gloves. A large fraction of trucks and cars were idle from lack of gasoline, and the preceding harvest had not been undertaken because there was no petrol to fuel the farmers' machinery. Coffee was non-existent. I brought a suitcase which included two large jars of coffee, which of course was better than gold at that time in a country that loves its coffee. Many factories were idle for lack of imports of parts and the official economy was grinding to a halt. Finally, the authorities in the end of the month announced a stabilisation program in a response to the balance of payments crisis. The next night the temperature in my room was above freezing for the first time in a month.

Turkey was not alone. There have been a lot of other countries at various times, both developed and developing. France had a major crisis in the late 1960s, and the UK had several. Among developing countries there were some notable ones: the Indian devaluation of 1966 which was an end to a foreign exchange crisis; the Chilean crises of 1956, 1962 and 1969; the Argentine crises of 1956 and 1970; Ghana in 1970. It is even forgotten that the United Stated was virtually forced to abandon its commitment to a pegged goal in 1973.

In the 1980s, of course, there was the so called debt crisis, which everybody thought was different, but it was the same thing. It afflicted Latin America, the Middle East and Africa heavily, but seemed to leave (at least at that time), Southeast and east Asia, with the exception of the Philippines, relatively unaffected. In Latin America the only unaffected country was Colombia, and several people thought it would help a great deal explaining this situation if we could just change those two countries and their location.

An important question is whether and how the events of the late 1990s differ from the crisis of earlier years. I want to consider the events in Thailand, Malaysia and

Indonesia, in light of earlier experience. I will not discuss Korea, I think the crisis was rather different and I therefore would like to leave it aside.

Let me summarise the argument quickly. I hope to pursuade you that all of the crises have a common origin, which is a weak economic policy framework within the country. In the period prior to the 1980s most crisis arose in the context of highly restrictive exchange control regimes. So that the trigger to the crisis was when the pain had mounted unacceptably in terms of dwindling imports, for example, as I said no petrol in Turkey.

By the 1980s countries had learned how great that pain was and they began relaxing their foreign trade regimes and so debt crisis arose instead in the context of relatively controlled capital accounts. Those crises arose more rapidly than the earlier ones because a few more days without petrol is easier than holding the creditors at bay for a little while. But they were also more severe, partly because they did involve the capital account more, and partly because the afflicted economies were more integrated with the global economy.

By the 1990s integration and capital account integration had proceeded sufficiently so that the crisis came on more quickly still and were even more focussed on capital account issues.

So let me start by reviewing the point where all this started: the weak fundamentals in the first several decades of development. I am going to argue that it is not really that different from today and give you a list at the end and show how it applies to the Asian countries.

3. Policy and Crises of the 1950's and 1960's

During the 1950s and 1960s the developed countries were almost exclusively under fixed but adjustable exchange rates which increasingly had became a dollar standard. Most prices in internationally traded goods were set in dollars. The American rate of inflation at that time was relatively low. And most indices of international traded goods in dollar terms have been stable if not slightly falling between 1952, which was the end of the Korean War commodity price boom and 1970. Almost all countries were attempting to maintain fixed exchange rates and adjusted them only reluctantly in the event of the foreign exchange crisis. Conventional wisdom with regard to exchange rate policy was in very broad outline along the following lines. In the short run it was possible to cover any foreign exchange deficit by running down foreign exchange reserves, but in the longer run there are three broad approaches you could take to assure external balance with a fixed exchange rate.

First, policy makers might adopt quantitative restrictions, ie importing licensing and control of international purchases or sales of foreign exchange to constrain the actual expenditures in foreign currency to the value to be consistent with the available incoming receipts.

Second, policy makers could tighten monetary and fiscal policy, which would reduce a demand for imports, which was regarded a function of income at that time, and an increase in the supply of exports thus tending to restore external balance.

Third, policy makers could change the exchange rate thus inducing domestic residents to reduce their desired level of imports and make exports more profitable.

In the understanding of that time quantitative restrictions on imports were deemed unacceptable. The economic cost, at least for developed countries, was far too high and the GATT in any event ruled them out.

It was generally thought that monetary and fiscal policy should be used to achieve internal balance while the exchange rate could be changed (or preferably be permitted to a float) to achieve external balance, ie balance in the balance of payments. The case for flexible exchange rates, which most economists brought into in the 1950s and 1960s, rested on the proposition that monetary policy and fiscal policy should or would at least be geared to internal balance, leaving the exchange rate as the only policy instrument that could really deal with external accounts if you wanted to benefit from international trade. Although the developed countries were on a almost dollar standard with a fixed but adjustable exchange rates the majority of economists thought they should go further.

In most developing countries, though, policy makers believed that they had three objectives (remember I said for developed it was just two: internal and external balance). In developing countries they talked about internal balance, external balance and economic growth. In most cases they also fixed their nominal exchange rate in those years, just the same as developed countries. However, they were experiencing much more rapid inflation than the rest of the world and simultaneously greatly increasing their demand for international traded goods, as efforts were made to raise investment levels, which had a high import content. With appreciating real exchange rates (that tended to discourage exports and encourage imports) and high protection through tariffs, and import restrictions pulling resources into import competing industries, exporter earnings failed to grow rapidly, despite the healthy growth of the international economy. Both of these factors contributed to growing excess demand for foreign exchange and fixed nominal exchange rates in almost all developing countries. While they had the same policy choices, policy makers and most developing countries rejected the devaluation alternative. They also rejected tightening monetary and fiscal policy, thinking that that would harm their growth objectives. That left quantitative restrictions as the only way that they believe they could manage their external account.

Since it was at that time widely believed that import substitution, ie encouraging domestic production of imports competing goods, would be desirable as a means to achieve industrialisation and rapid growth, there was a little resistance. But throughout the 1950s and 1960s evidence mounted of the high cost of closed economies' import licensing and the necessary accompanying exchange controls.

Among economists it was increasingly recognised that those costs could be avoided only with the floating exchange rate, or one that kept the exchange rate in real terms at a realistic level for a sustainable current account position.

The things that went wrong in developing countries became recognisable as being something more than an individual curse: they were uniform across countries, including a stop-go pattern of economic growth, a tightening up of import licensing with increasing costly restrictions over time. Then finally the slowing down in economic activity, because there were not spare parts or raw materials or capital goods. Imports would exceed planned levels, debt would mounted finally a balance of payments crises would arise and which the authorities would finally approach the International Monetary Fund and bring out a stabilisation program under which the exchange rate would be devalued and debts would be rescheduled. Credit, and other ceilings would be imposed to bring down the rate of inflation and a stabilisation program would begin. And that's very different from what's happening right now, isn't it?

During its early stages government expenditures would be cut and other measures to increase government revenues would be taken and the domestic interest rate would be raised and as a consequence the domestic economy would be somewhat depressed, because there wasn't the domestic demand. Exports would rise and imports would decline, the balance of payments position would become more comfortable and policy makers would then once again try and accelerate growth by increasing investment in public expenditure and the same cycle would happen all over again. But each time the rate of growth was lower, the expansion phase lasted longer and basically the stop-go pattern repeated itself with less and less growth and more and more lurching around. IMF programs involved not only the measures I've already described but debt rescheduling, and often additional capital inflows, usually financed by official creditors. These cycles did unmask the underlying slowdown in growth rates but four features are most noteworthy for purposes of comparing with the 1990s.

First, the stop-go cycles were blamed for slower growth rather than the true causation, which was the stop-go cycles were caused by the same things that caused slower growth. Second, real exchange rates were abruptly depreciated, then gradually appreciated until the next stabilisation. Third, in the types of situations, which I'm describing, there appears to be no intention in changing the nature of the development strategy: the intent was simply to remove the constraint that was perceived to be binding, ie the foreign exchange constraint. Fourth, although almost no developing country had capital account convertibility at that time, the build up of debt and arrears along with increasing restrictive licensing regime was the classic hallmark of a fixed nominal (and increasingly real) exchange rate. As the cost of these cycles became increasingly evidenced some developing countries began to adopt what is called a crawling peg exchange rate, where they altered it frequently enough at least to maintain its value in real terms and not let it appreciate. In several countries that worked fairly well for several years and developing countries did begin to move away from quantitative restrictions as their increasingly high costs to economic growth and living standards was recognised.

4. The East Asian Tigers and Export Oriented Policy

At the same time, however, four so-called East Asian Tigers, changed their development strategies completely, shifting away from these import substitution policies and focussing on export lead growth. They found that a realistic exchange rate was an essential for this purpose and all four of the Asian Tigers developed or used mechanisms that maintained the real exchange rate at a realistic level during their period of very rapid economic growth. To remind you, Korea averaged 13 percent real growth per year, for well over a decade and doubled its living standards every seven years from 1960 to 1995. Taiwan did just about as well, Hong Kong and Singapore did just about as well and those economies were really transformed in this process of shifting strategies.

The success of the Tigers began raising questions about the overall desirability of inner oriented trade strategy in all the other developing countries, and policy makers began shifting away from the extreme emphasis on their closed economy. In an earlier era, developing countries maintained unrealistic nominal and real exchange rates for sustained periods of time. They were able to do so by imposing quantitative restrictions as a means of maintaining external balance. The costs of the exchange rate policy were high cost of the quantitative restriction, protection of domestic industry was very high and a lack of competition resulted in a very low productivity growth and exports failed to grow.

In the 1990s the overall policy regime could be sustained, despite increasing rate over valuation with capital inflows, just as it could be sustained by quantitative restrictions in the 1960s. While capital inflows in the 1990s may not cause a highly visible excess costs that regime of quantitative restrictions did (when you could say “Hey, a Volkswagen can cost $10,000 in Germany and $100,000 in Chile”) the build up of debt servicing obligations can have similar results over time. The overall economic policy stance in 1990s is more realistic than that of the 1960s. Because it has brought about a higher living standard and more complex economy, the costs of given policy mistakes are greater. Larry Summers, has likened the contrast between the 1990s and the 1960s to the difference between travel by automobile and travel in a jet airlane. The auto travel is slower and less efficient and by the way more dangerous but an accident when it happens is quite a different thing, when it is in a jet, it is disastrous. And as I have already mentioned despite, the absence of capital account convertibility there were debt build-ups earlier on, but they were slow. And with capital ability increasing they have come on increasing rapidly.

It is probably unnecessary to judge whether it was the high cost of quantitative restriction regimes or the experience of the East Asian Tigers that caused one developing country after another to shift policy regimes in the 1970s and 1980s, and gradually open up the capital account. With the oil price increase 1970s and the lessons of the high price of quantitative restrictions regimes being learned, exchange rates were increasingly seen as the policy instrument to provide incentives for exports. With the debt crisis of the early 1980s the trend if anything accelerated. In some instances quantitative restrictions were removed and tariffs reduced, in an effort to shift to a outwards oriented trade regime. Basically, the exchange rate regimes of developing countries shifted from almost all fixed in the 1960s and 1970s to almost all having some degree of flexibility by the 1990s. However, as that happened inflation became more of a problem for many developing countries and finally there came a point at which developing countries perceived inflation to be their primary problem and began trying to use the exchange rate more as, a nominal anchor to hold down the rate of inflation. This then led to difficulties coming back in a different form with increasingly over valued exchange rates, once again emerging at a much slower rate.

As a result capital in-flows can sustain a regime for a while. What can also happen is that a crisis when it occurs can come on much more rapidly than it did in the 1950s and 1960s. Although Turkey in 1960 was shivering from cold and immobile from lack of gasoline the pressure to change policies built up slowly, and a few more days was not of great significance. In the 1990s once capital flows begin to mount pressures increase much faster and the authorities have much less time to react.

When Mexico announced in August 1982 that it could no longer voluntarily continue debt-servicing obligations, it took four months before an agreement with the IMF was reached, and during that time the capital out-flow there was not serious. In 1994 Mexico had about three weeks to react. In Korea in late November and early December 1997 from the time it was officially stated that there were difficulties until foreign exchange would have run out, then had the IMF not intervened, it was three days. The length of time within which the authorities had to respond has fallen drastically.

Now the evidence is strong that overly appreciated real exchange rates were a common factor in the crisis in the 1990s and we will come back to that.

5. Reserves, Fundamentals and Speculators

The crisis can be postponed, and this is part of what confuses people. What you can do if you want to postpone it, and if you think you have got a chance of getting out at the other end, is that you can raise you domestic interest rates. The higher is the domestic interest rate the more costly it is for foreigners and domestic resident to pull out of domestic currency. The domestic economy may slow down; notice the trade off once again. It is the same trade off, but many developing countries not wanting to give in to the pressures that arise have attempted the high interest rate mechanism in a normally futile long-term effort to avoid the necessary adjustment. Take the example of Brazil: the interest rate right now is about 50 percent and the inflation rate about 10 percent per year. The Brazilin Real in real terms appreciated about 40 percent over about the past four years of the program. Obviously there are strong pressures on the current account and the balance of payments. Obviously there are pressures in other directions. So far the authorities are choosing to maintain increasingly high real rate of interest, which of course, rewards those who stay on and makes the penalty for pulling out and betting against the currency much larger. How long that can continue of course, is an interesting question.

Now, a way of thinking about this that is useful, and in a way once you think about it, it is almost obvious, (though wasn't so at the start of things), is that there are really three groups of developing countries. You can think of those with strong fundamentals, you can think of those with medium fundamentals, and those with weak fundamentals. You can think of the direction of change in what's going on in a country and you can think of a countries reserve levels. Now what do higher reserve levels signals to a speculator? If he thinks that currency is unstable and unlikely to be maintained and he wants to sell that currency short or if he wants to get out of that currency and into one of the others. The cost to him if he is wrong is of course foregoing interest and the other transactions cost of betting against the other currency. If reserve levels are high enough, speculators will refrain from attacking until such time as reserve levels are lower. So if your reserves are high enough you can commit any kind of silly economic policy you want to, at least for a while. But, if your reserves are deteriorating as they will if you have large current account deficits, then over time your fundamentals are going to be deteriorating. So in a sense the three fundamentals I will talk about in a moment, are linked to the reserve level because the reserves in a sense indicate something about what has happened over time (reserves are of course also linked, but not terribly closely to outstanding debt servicing obligations).

What they do is they enable a Government to defend its currency and raise the cost of attack on a currency. Now, strong fundamentals are fine and regardless of reserve levels it is highly unlikely that any speculators are going to attack a country if the fundamentals are strong. When they are very, very weak, by definition the country would have already been attacked and you would have to do something. That was the situation in Russia, several weeks ago. In fact, it was interesting how long it took for that to happen.

The interesting cases where the fundamentals are in the medium range, the are not horrible or at least not yet, they may be deteriorating, or they may be slightly improving, but they are not clearly adequate. The speculator's problem then is: when to attack? When is it that the situation will no longer be sustainable? And then what happens is that when one country who has had weak or deteriorating medium level fundamentals, hits the point where it is attacked and cannot defend its exchange rate, At that point, it serves if you like, a coordination mechanism, or more of a wake up call. It affords the currency traders to look around to see who else is there, who is in this same situation. So we tend to see these things in waves. But the evidence is that there has been no currency that has been successfully attacked where there have not been weak fundamentals in the three dimensions that I will now tell you about.

6. The Fundamentals in East Asia

The first basic, and very important one, is the real exchange rate. The second is the growth of domestic credit. As capital mobility has increased, and as countries have increasingly open transactions with the rest of the world, what was not recognised prior to the Asian crisis (although the speculators knew it and it shows up in the data) was that increases in domestic credit are increases in the potential liabilities of the Government. Why? Because Governments attempting to maintain open accounts are going to honour requests for exchanging the currency into foreign exchange to fixed exchange rate. So when domestic banks are increasing domestic credit they are increasing the volume of available currency which can potentially be turned into, or requested to be turned into foreign exchange. In the case of Mexico, and it is well documented, in 1994 that the rush to the door out of pesos and into US dollars primarily, was not led by foreigners, it was led by Mexicans, all who began by trying to go to convert their pesos at the Bank of Mexico, into other currencies, and that began leading the charge.

Now, why is the growth of domestic credit a sign of a weakening fundamental? The answer is fairly simple. The banks cannot very well expand their lending volume in real terms say more than 6 or 8 percent per year, without losing control over the quality of the lending. There is no country in the world where you can get for example a 15 or 20 percent expansion in domestic credit in real terms in a year and not have a deterioration in the quality of the portfolio. Now, what we are then saying is, when domestic credit expands rapidly, the real rate of return on investments is falling, and at the same time your contingent liabilities on the other side of the balance sheet are increasing and the situation is therefore one of deteriorating fundamentals. So expansion of domestic credit is the second one, and we will come back to that, as it is very important in talking about resolution of the problems in East Asia. The problem arises when you are expanding domestic credit and at the same time with a current account deficit you are running down your reserves and your ability to defend against attack diminishes. Let me now look at what happened in South East Asia and show you not only what happened in the crisis in this country, but also what happened in the countries, which did not have crisis.

Malaysia, already by 1994 was running a current account deficit of over 6 percent GDP, 8.6 percent in 1995. Malaysia has not published a final number for 1996, but if I had to guess I think it would be between 7 and 7 ½ percent. Toward the end of the year they were beginning to cut back and trying to get it under control. Look at Thailand, 5 percent already by 1993, 8 percent by 1995, and 8.2 percent in 1996. Another way of saying that, is that the debt to GDP, or the outstanding obligation GDP ratio in Thailand had increased by 30 percent over that period, not to mention the expansion of domestic credit, which we will now turn.

Notice something interesting: Singapore had no crisis. Remember Singapore had a current account surplus. Singapore had a growth of domestic credit of around 9 percent, which is probably at the upper end of the acceptable range. If you looked at the United States last year it has boomed and had a growth of domestic credit of 6 percent. In Malaysia growth in domestic credit as a percent of GDP was in 1995 21 percent, 1996 22 percent, and 1997 28 percent. There is no way those numbers can be met without a great deterioration in the quality of the loans which are counterpart to them. Thailand's numbers started worse earlier on and remained just about as bad. Hong Kong went into a property boom in 1996, as you know, had very, very, high reserves.

Turning to the reserve levels, the situation is a little bit different. And it goes to show what I have been trying to argue in terms of the contingent liability aspect of things. If you look at total reserves in months of imports, basically there were countries where reserves to imports ratio was falling. Korea is notable in that regard, Singapore was not, Singapore was safe throughout. Thailand there was no problem in that way, Indonesia not a problem, Hong Kong was fine; that was not where the action was. The action was in domestic credit and it was simultaneously with respect to the current account deficit.

We will take it just a little bit further. We will take a look at Malaysia and then I will look at Thailand. By 1996 Malaysia's prices had risen by 18 percent since 1990, while US prices had risen by just under 10. So in that sense, just in that account alone, there was a real appreciation of the Ringitt of about 9 percent. On the other hand during that period, nominal exchange rate basically appreciated just a little bit. So if you look down at the real exchange rate for US dollars it appreciated by 11 percent between 1991 and 1996, which is part of what led to the increase of the current account imbalances during that period. If you look at the Japanese Yen its even worse, appreciating by almost 20 percent over a six-year period. That's clearly unsustainable. If I show you the numbers for Thailand, they are very, very similar. And as you can see, the US real appreciation was 6 percent, in Japan in was 15 percent and for Thailand, given their heavy weight than Japan that was again around 10 percent.

What these numbers illustrate was that there was a reason why these particular countries were the ones that were adversely affected in 1997. It is no mystery. And you can go back through the various attacks, on various currencies that have been successful, they have all followed this pattern.

Now, where does that take us? Growth of domestic credit led to a lot of bad paper in the domestic banking systems, because of the slow quality of the lending. Rapid expansion of credit did it, but the trouble is that it is a problem that has to be addressed right now, in addition to what bad paper was in the banks already, the fact of currency depreciation has increased the number of non performing levels. The best number that I can come up with, there is no official number in Malaysia, and if there were, then I can guarantee you that it would be an underestimate, is that the bad paper the Malaysian banking system is problem under the order of 30 percent of GDP. Which is an absolutely a huge number. In Mexico, which was almost unmanageable, it was only 14. And that's after all the effects of Peso depreciation. The Malaysian number is before that. It came from some obvious things, a very weak investment program, even before the Malaysian program. I use to tell my class, that the sign of a country that wasn't doing well, was an investment program full of white elephants. I illustrate it by saying, show me a developing country, with the two tallest office buildings in the world, building a new airport, moving its capital, talking about an information super-highway, you know something is wrong, it doesn't take too much more to figure out that this won't go.

In Thailand more than 15 percent of the paper in the banking system was bad and as I showed you the real exchange rate the current account deficit were as least as bad as in Malaysia.

If the authorities permit the banks to stay open, the banks in effect are rolling over all that bad paper. Interests rates are above the rate of growth of the economy, which means that in the so-called ever-green accounts which are rolled over, the liabilities of the lenders who are not paying are increasing as a proportion of total credit. This means that the banks themselves in order to make any money have to have a very large spread between their deposit and their lending rate on those credit worthy borrowers, there are and by definition the credit worthy borrowers are not going to like that, so that they are going to get their financing elsewhere. And until you get that sorted out, the new entrants who should be coming in to do the new and sound projects are unable to do so. And that is the situation in which Thailand, Malaysia, Indonesia and a lesser extent Korea (but not to a lesser extent Japan) have been caught. The Japanese have for seven years thought that if they could just get the economy growing again then the bad paper would begin diminishing as a percentage of the banks portfolios. Instead, the banks portfolios have had an increasing fraction of bad paper. There is some question as to whether that lesson has been recognised in Japan or not and that makes a big difference.

In Indonesia there was more politics to the situation as you know, but once the situation emerged and once people began looking, the bad paper in the banking system because of cronyism, short-term debt and other things was also a problem. The bad paper problem grows until addressed and there is probably no way out of the Asian situation for any of the Asian countries individually until they take the problem by the throat.

The problem is that there is 30 percent GDP in Malaysia (or more) that has to be somehow swallowed. Somebody has to take that loss up front. It has to be divided between the shareholders of the bank who no doubt has no equity left anyway. Between the taxpayers and the international community and anyone else you find who can cough up part of it. But it has to be absorbed, the banking system has to be made whole, before very much can happen.

7. The Outlook

The outlook, therefore, for the Asian countries is individual, it is not collective. We do not have here something that is in common: the reason that there are similarities is because they followed reasonably similar policies. In Korea there are reports after reports, that exports orders coming in because the exchange rate is now reliable where the potential exporter cannot get domestic credit with which to fill the order. What is happening is that economic activity is slowing down, where it should be because it was inefficient, but the slack is not being taken up where it should be. There is some evidence in Korea that they are beginning to address the banking problem, and in the past two weeks a number of measures have been taken. Certainly there is more sign of action there, than elsewhere.

In the case of Thailand there have been some moves, and they have addressed some parts of their problem, and once again there is probably a fairly reasonable outlook for at least gradual improvement. Although if they went faster, in terms of addressing the problem there is no doubt that there upturn could be faster.

People are pessimistic about Malaysia and about Indonesia. In the Malaysian case because there hasn't even been official recognition of the problem, much less doing anything about it. In the case of Indonesia because they have this very big mess with the loans to those who formally politically connected and so sorting that issue out and maintaining political stability will be, of course, a real challenge.

Will there be a worldwide recession? Well there are enough countries in trouble including Japan, which is important, so the issue cannot be dismissed out of hand. The US economy is strong and does not appear to have taken a very big hit on account of the East Asian or the Southeast Asian situation as of yet and should the US economy continue to grow, as say two percent or more over the next year or so, the likelihood I would have guessed, of a world wide recession from all of this is fairly small.

Europe is in a cyclical up phase and it too is likely to grow almost regardless of what happens in Asia over the next year, which provides a good buff.

If however, you wanted to be more confident that the world economy would be more conducive to rapid turn around when the Asian countries address their issues, the real hope would lie with the Japanese addressing their banking problems and moving their economy out of recession. So far the evidence of that's going to happen is, to say the least, not as good as you would like it to be.

Finally, let me just finish by saying, there are a lot of issues for the international system that arise, there are ways in which the international economic system can be strengthened, and people are beginning to talk about them. These include the issue of moral hazard, where the problem is that the lenders know, or they believe that they know, that the IMF will be in there with so called bail outs. This means that lending is relatively safer than, for example, equity, investment or direct foreign investment; it tilts the composition of capital inflows in undesirable ways. I think there is recognition that that problem will have to be addressed, nobody as yet has thought of good way of doing so.

The next thing that could be done, is to de-politicise IMF lending. The IMF, for example, warned the Thai authorities as early as 1994, that if they continued down their present path it would be difficult. By 1996 they were urging Thailand to take action and for the normally discreet IMF amazingly enough, they were even letting it be known in the newspapers that they were doing so, which is very far out of line, but signals to you how much they felt that the Thai situation was dangerous.

In the case of Russia, it is unlikely that any Fund, staff member or official thought that there was very much chance that there lending would make a difference. The political pressures for them to do so however, were so great that there was really no choice. Now you can argue that maybe putting all that money into Russia was buying at least a slightly improved probability that things would work out. Perhaps! That's a political judgement, but mixing the IMF technocratic judgement with the fundamentals with the political judgement and leaving the IMF in a position where they have to say that this really does make sense really muddies the water as regard economics and international politics and seems to me has to be addressed.

There has to be a way to get the international financial institutions criterion more in line with what we do know about financial crisis. I think all of them are coming, it's coming slowly. The bad news is that Indonesia and Malaysia have not as yet begun to address their very real problems, therefore are likely to be in for a sustained period of difficulty, and Thailand is coming around only slowly and the Japanese still have major issues. The good news is that the situation is still manageable and once people begin to address those issues the turn around could come quite quickly.

Thank you very much.

Question 1:

The capital control that Malaysia has imposed by Prime Minister Mahatir, what is your view on capital control today?

I think there is two issues, and the first one in my mind dominates is can you do it without bringing down your entire real economy? Or to say it differently, given how valuable integration to the world economy is to Korea, to Taiwan, to Malaysia (or has been to Malaysia), can you impose capital controls and still get the rest of the benefits? My view is no! Money is after all the most fungible of commodities, the minute you put any particular reward in for violating the regulations as you do with capital controls if they are to have any effect. The number of ways to evade them is mind boggling. There is any number of countries where that is now documented as exports were in fact shipments of rock, which went three miles, out to sea and got dumped, and why? Because they had a different exchange rate for exports in category 1 and something else. Any of these kinds of measures where you are trying block up one avenue by which things can happen is going to lead to great difficulty. To make it concrete one of the great proposals is, lets control short term capital flows. Now suppose the Mexicans (to take a concrete example), decide that they are going to do that, they say okay, we like equity investments, but we don't want short-term borrowing's by our nationals. My name is Jose, and I live in Mexico City and I would like to borrow from the New York Bank, what will I do? I could walk to the stock market, I could buy some shares of Telmix which is a good Mexican security, and I could walk to the New York Bank, present my Telmix shares and say 'Gentlemen, I would like to sell you my Telmix shares, for $100 and next year I will buy them back for $107. Would you like that transaction?' The New York Bank could say 'yes'. And Jose walks out with his $100 and a year later he buys them back for $107. What do the balance of payments statistics figures show? Equity investment, equity disinvestment? What has happened to short term capital?

Question 2:

Do you have a feel for how much further Asian markets might fall and also, whether or not there might be opportunities at this time for a more stable pace of recovery?

I'm sure there are the opportunities. How much more the Asian markets will fall depends very much on how they address this problem of bad paper and the banking thing. Whether they are really getting their hands around it or not, is fairly crucial. If they do then I think there will be a turn around quite quickly. If what I have enabled to infer from newspapers this past week, as to what has happened in Korea is a generalisable statement, I would guess that by early next year they could have bottomed out. In which case then, there are a lot of good opportunities. If on the other hand, this is just papering over some of the underlying problems then I don't think that are the case. What economic policy is and what incentives are provided and what measures are taken to clean up the mess is really crucial to the future. It is very hard to forecast whether for example, Prime Minister Mahathir stay with his present line. If he stays with it, then will the political difficulties that seem to be surfacing in Malaysia stay there or will they indeed intensify? I can't begin to think out the political economical interactions of that one. I think the same is true of Indonesia, Thailand and Korea.

Question 3:

What about American and Australia, how they going to be affected?

I haven't had a chance to look at them while I've been here. But speaking of America though, most economists are distressed at this bail out of this hedge fund in New York this past week. Precisely on the grounds of that could lead us down this path that we have been arguing so hard shouldn't be there. If that's a sign of things to come in the US then it's very worrisome. At least that fundamental in the US at the moment is not what it should be. Otherwise right now our numbers are wonderful, how long it will last is of course another issue. In the case of Australia, I just haven't looked at the numbers carefully enough.

Question 4:

Is it likely that China will be forced to devalue?

A Chinese devaluation in the next six months would surely be serious for the rest of the Asian countries, and they would have to look seriously at what their own policy response would have to be. As to whether they would be forced to, the answer is no, they won't be forced to, in the sense that they don't have an open capital account. They did just the past few days, announce more stringent capital controls, and even when you don't have an open capital account there are questions as to how much you can control it. Among the people I listen to who follow the Chinese closely, the consensus is that the Chinese will hold the rate. They will do so partly because they are running are very large current account surplus and they don't need to change it, secondly because they are focussing on some internal things which involve the expansion of infrastructure and so on, are therefore not basing their plans for growth over the next year international sector particularly. So my read would be, with probability at point 8, they would not do something unless something else unexpected happens. The uncertainty in all that is quite clear: they have got some major troubles. And if you want to talk about a banking system with bad paper in it, the Chinese can compete with anybody. On the other hand, how much that matters, given the degree of controls they have left is more of a question and the one real risk is that their growth rate is diminishing apparently quite sharply enough to have them worried.

Question 5:

When you mention domestic credit? Many of the banks that are in those countries are local banks, which are in a whole lot of global transactions.

Yes. Once has to get into the nitty gritty which I haven't. But the IMF numbers of domestic credit are suppose to be the bank lending in a country by banks resident in the country which may not be the local banks for purposes within the country. If in fact a bank in Thailand lent to Indonesia that did not show up as an increase in domestic credit but it showed up as an increase in foreign assets held by the banking system. So unless there is something really wrong with the numbers that is not an issue. Because they just show up very separately and in different ways.