

# The East Asian Recovery

---

Lawrence J. Lau

Kwoh-Ting Li Professor of Economic Development

Department of Economics

Stanford University

Stanford, CA 94305-6072, U.S.A.

January 2000

Phone: 1-650-723-3708; Fax: 1-650-723-7145

Email: [ljlau@stanford.edu](mailto:ljlau@stanford.edu); Website: <http://www.stanford.edu/~ljlau>

# The Basic Questions

---

- ◆ Is a real recovery in sight?
- ◆ Is a recurrence possible?
- ◆ What are the prospects of future economic growth?

# Leading Indicators of Recovery

---

- ◆ Stabilization of the exchange rate
  - ◆ Capital controls have been instituted in Malaysia
  - ◆ Hedge funds are no longer active
- ◆ Decline in the rate of interest
- ◆ Rise in the stock market
- ◆ Improvement in the balance of payments
- ◆ Rise in the official foreign exchange reserves
- ◆ Deceleration in the rate of decline of real GDP
- ◆ Leveling of the unemployment rate
- ◆ Narrowing of yield spread on U.S. dollar-denominated sovereign debt relative to U.S. Treasury securities
- ◆ Upgrading of credit ratings by rating agencies such as Moody's, Standard & Poor and Fitch IBCA

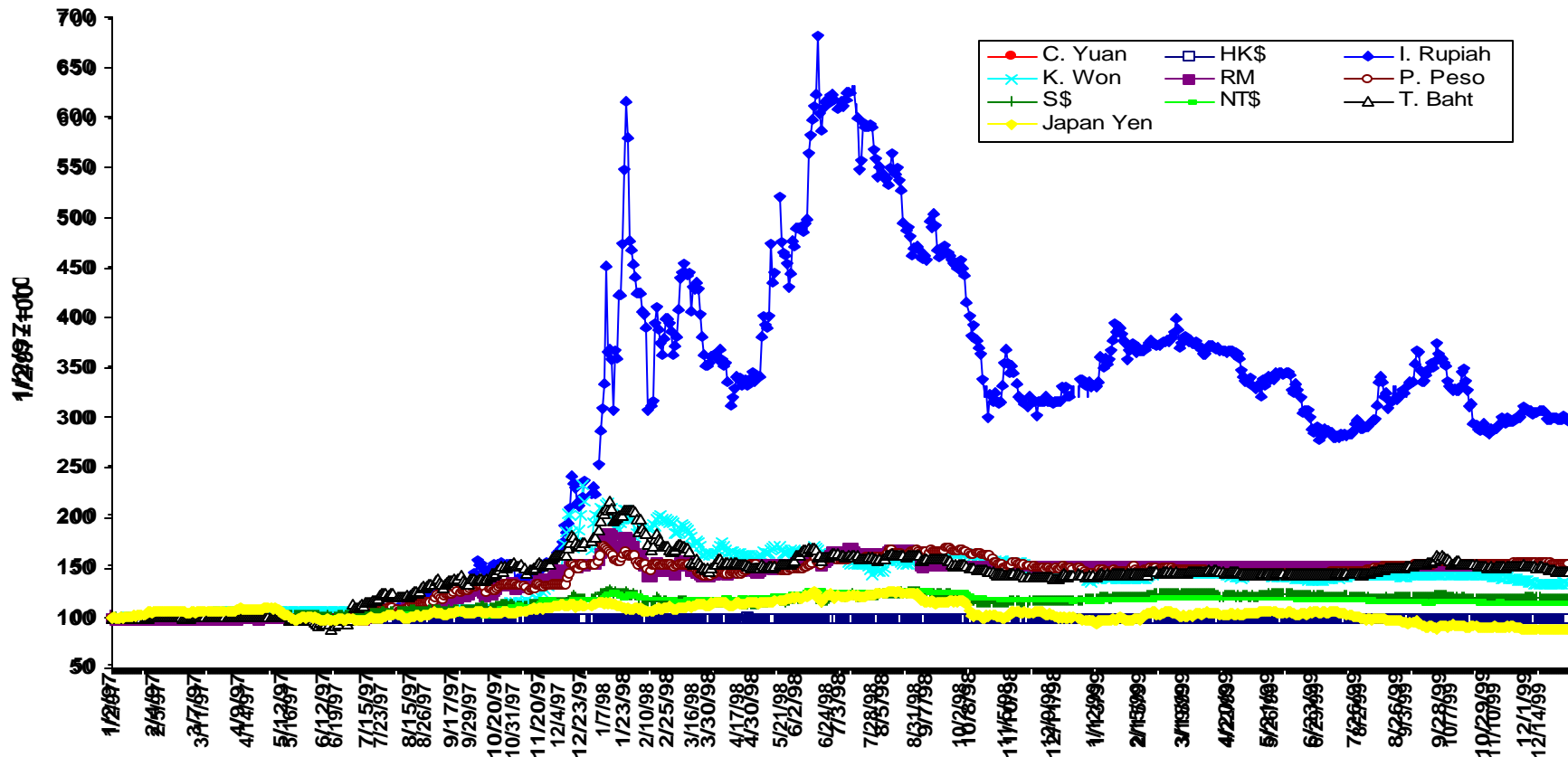
# Prospects for Recovery

---

- ◆ For most of the East Asian economies, the bottom has been reached (0% rate of growth) in 2Q/1999
- ◆ The recovery is most tentative in Indonesia, with its political problems
- ◆ In quantity terms, exports have been growing very rapidly
- ◆ Foreign exchange reserves have been largely replenished
- ◆ Inflation caused by the devaluation has largely subsided
- ◆ The stock markets have recovered
- ◆ The recovery has been much stronger than expected because of synchronization across the East Asian economies

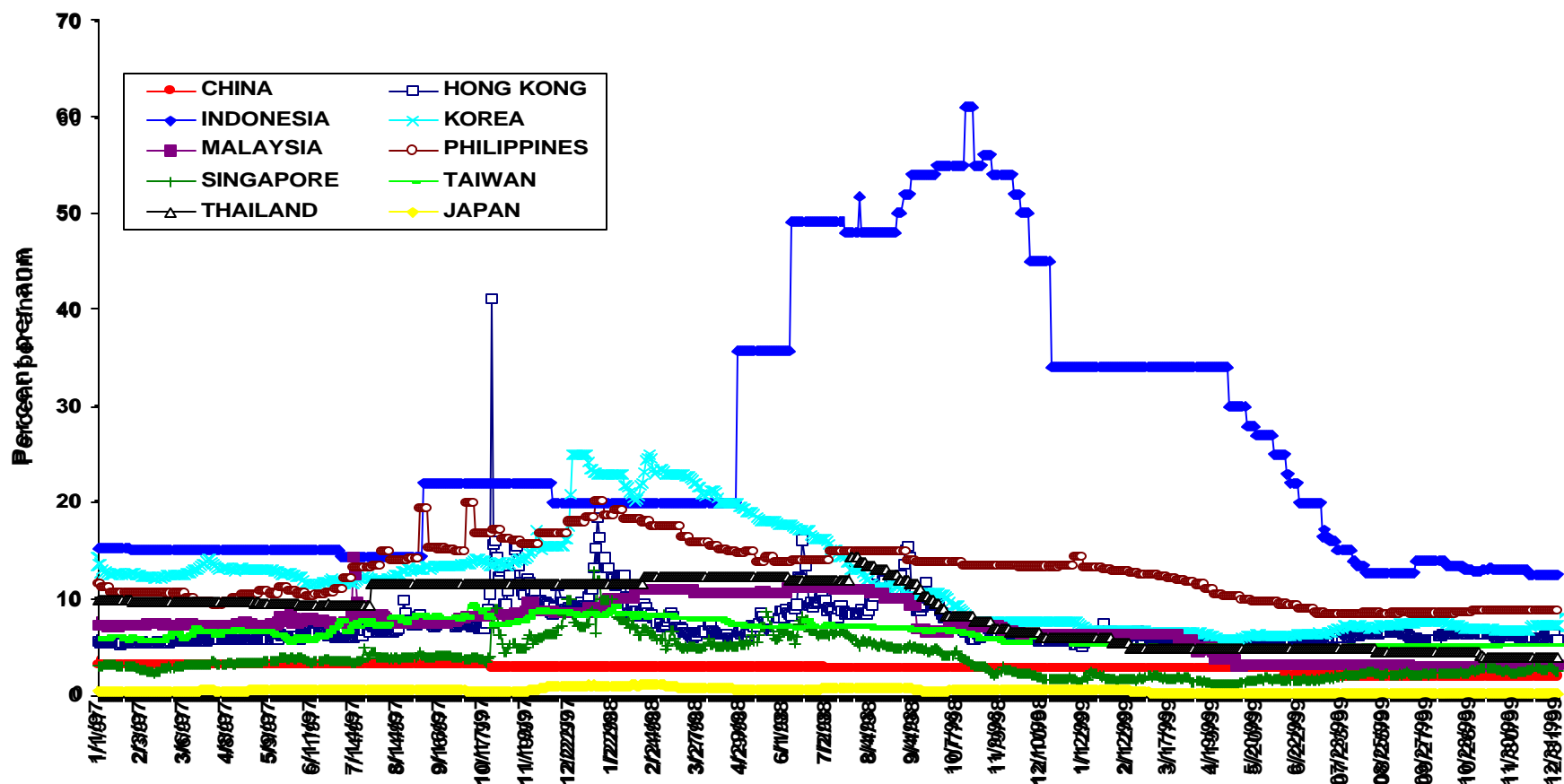
# Indexes of East Asian Exchange Rates: Local Currency per US\$ (January 2, 1997=100)

**Indices of East Asian Exchange Rates  
(Local Currency per U.S. Dollar, 1/2/1997=1000)**



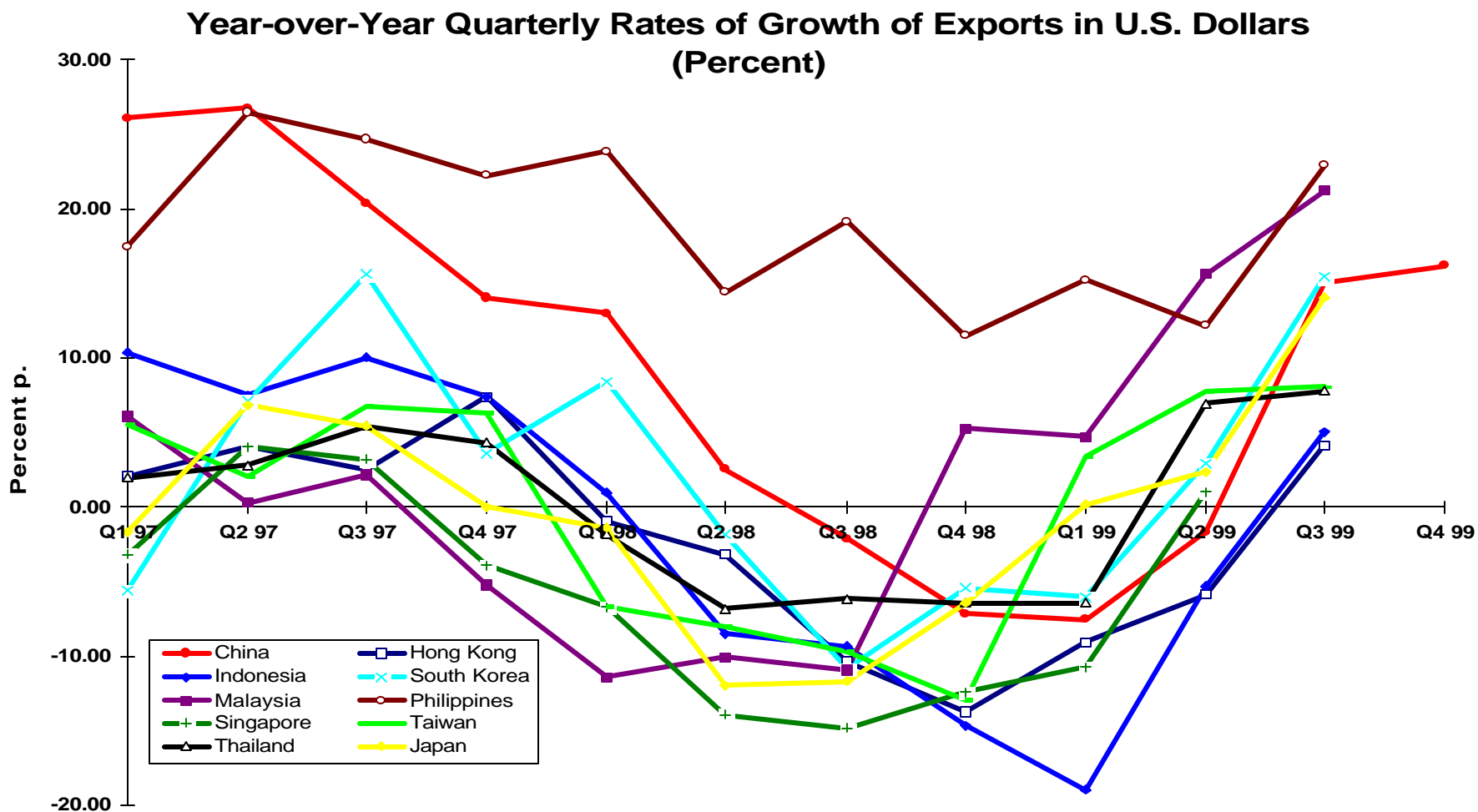
# Short-Term Rates of Interest

**Short-Term Rates of Interest, Selected East Asian Countries  
(percent p.a.)**



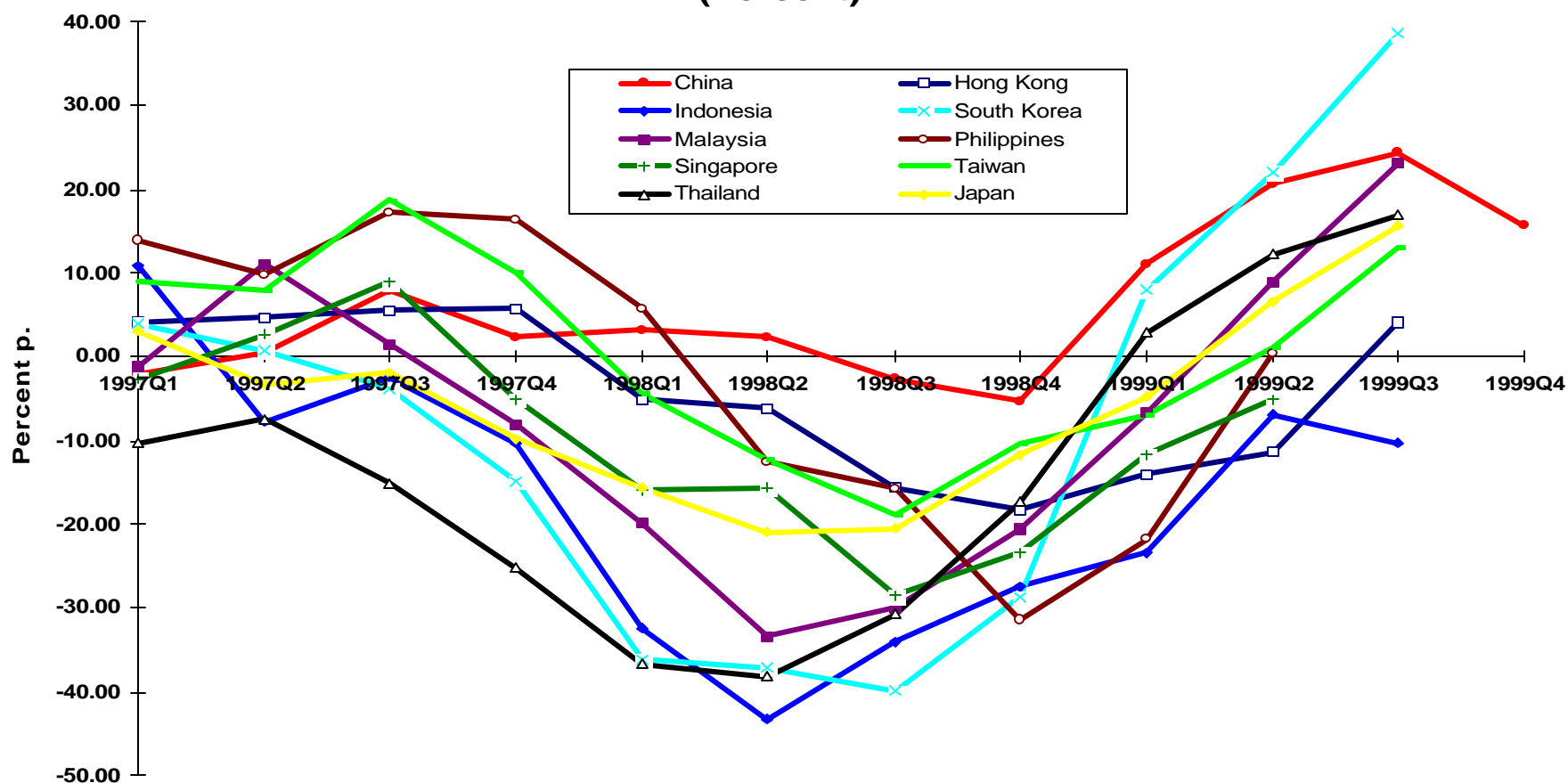
Lawrence J. Lau, Stanford University

# Quarterly Rates of Growth of Exports



# Quarterly Rates of Growth of Imports

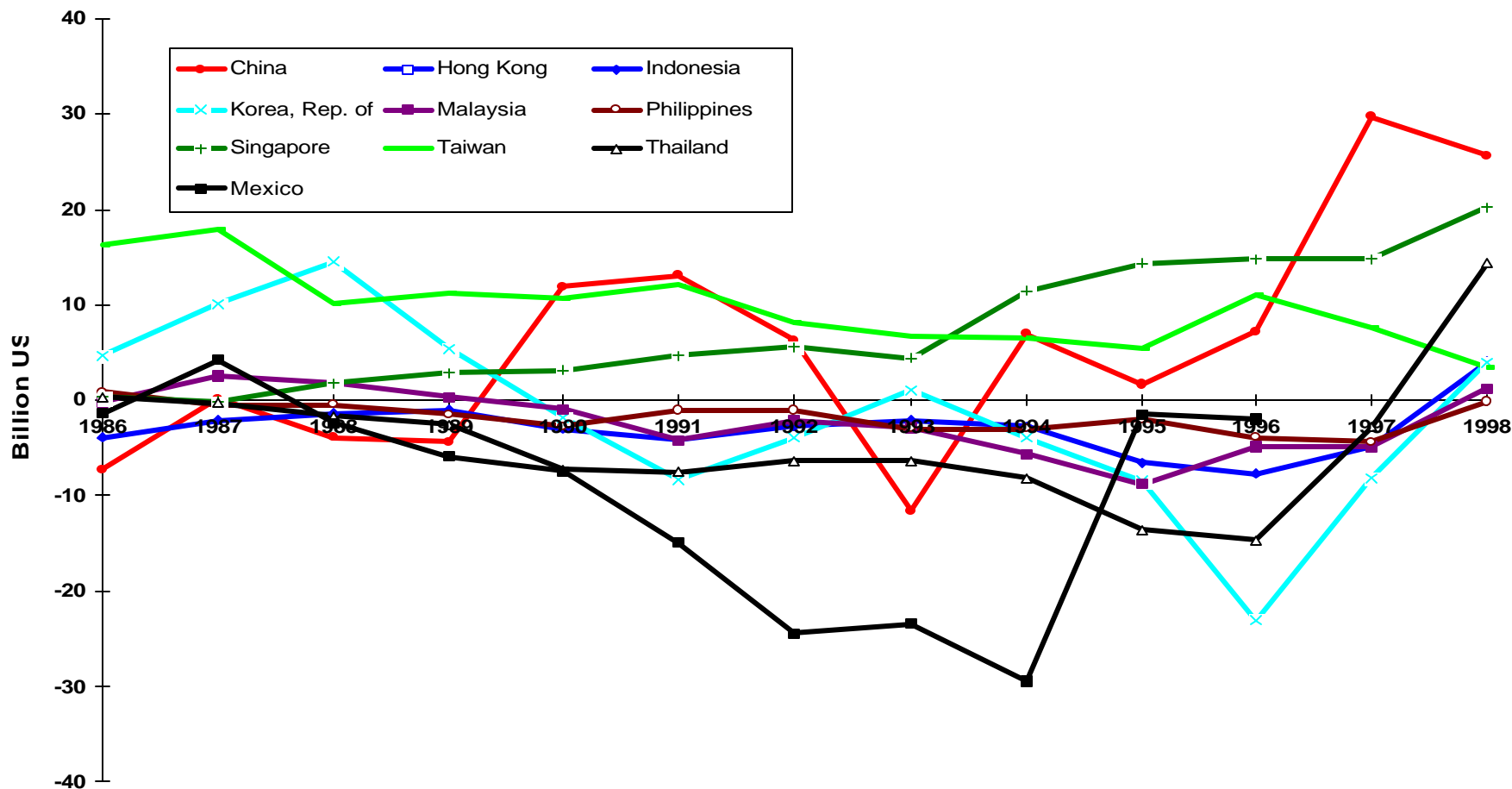
Year-over-Year Quarterly Rates of Growth of Imports in U.S. Dollars  
(Percent)





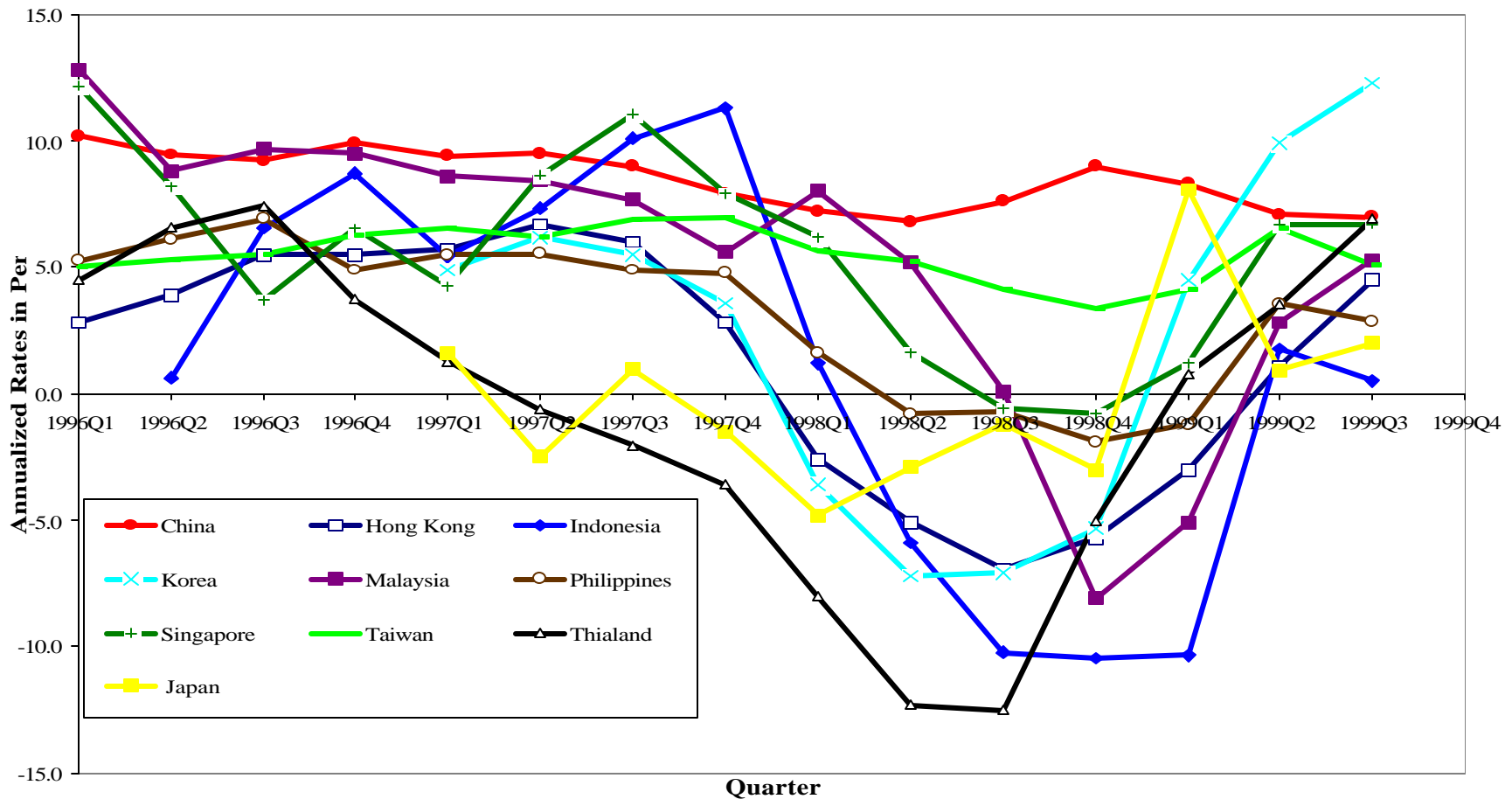
# The Current Account Balance

The Current Account Balance, Billion US\$



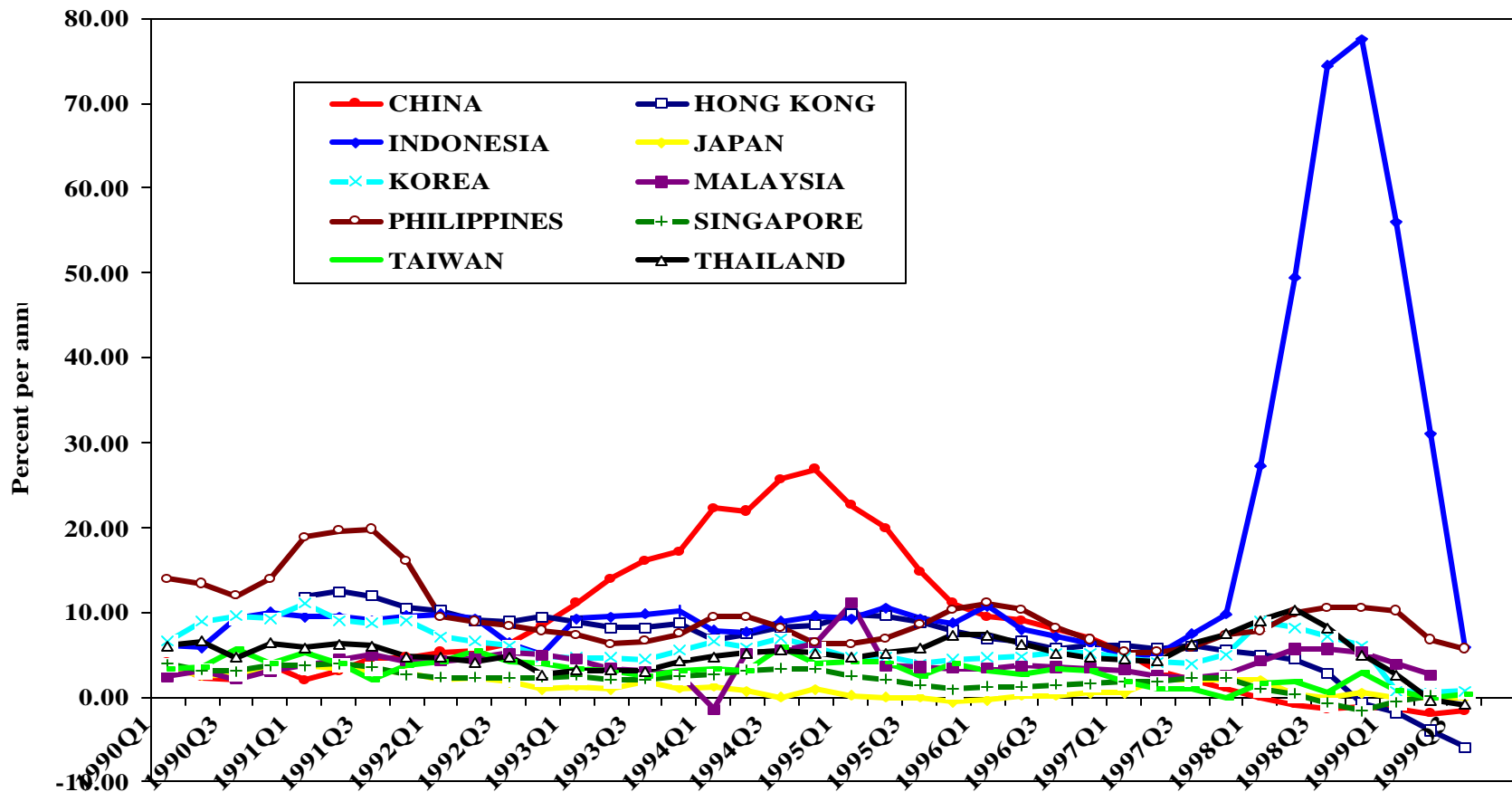
# Quarterly Rates of Growth of Real GDP Selected East Asian Economies

Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



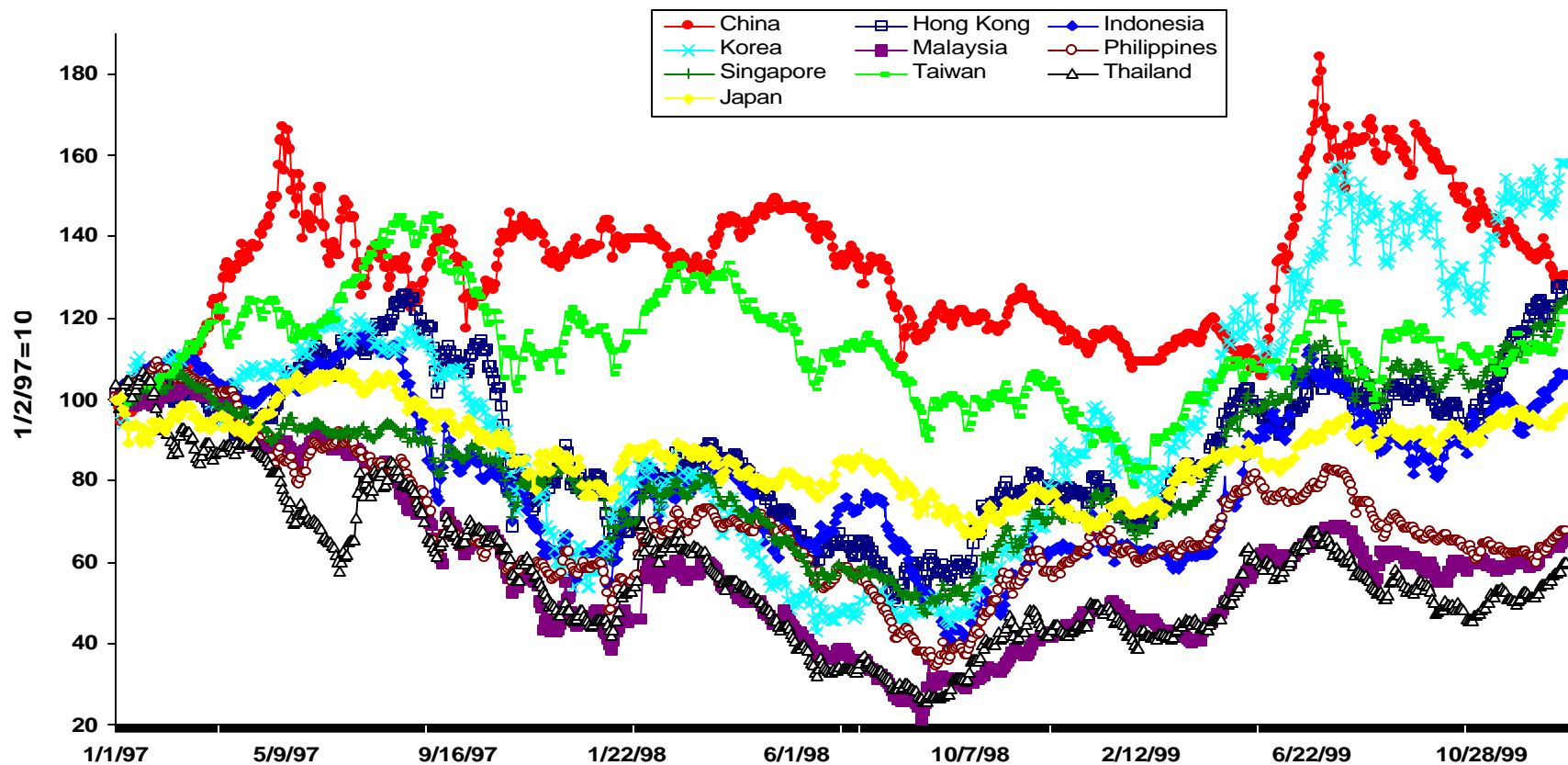
# Rate of Inflation (Consumer Price Index)

Rate of Change of the Consumer Price Index (Year-over-Year)



# Indexes of East Asian Stock Market Indexes: Local Currency (January 2, 1997=100)

Indexes of East Asian Stock Exchange Indexes  
(Local Currency, 1/2/97=100)



# How Robust is the Recovery?

## External environment

---

- ◆ Since 3Q/1998, hedge funds had a “credit crunch” due to losses, net redemption and curtailment of available credit lines in the third quarter of 1998--the collapse of the Russian ruble and the “Long-Term Capital Management” crisis
- ◆ The U.S. economy has been exceptionally strong but an asset-price bubble appears to be in the making and the economy may be heading towards a slowdown
- ◆ The recovery of the Japanese economy is not imminent and likely to take some time; however, the Yen has recovered from its low of almost 150 Yen/US\$ to stabilize around 100 Yen/US\$
- ◆ The Chinese economy grew 7.8% in 1998 and 7.1% in 1999. Chinese exports have resumed its growth. The Renminbi should not need to be devalued

# Prospects for Recovery?

## What Needs to be Done (1)

---

- ◆ The recovery is supported by the growth in public investment and in exports
- ◆ Private consumption demand has gradually revived because of lower rates of interest and stabilization of unemployment
- ◆ Domestic fiscal stimulus necessary because of weak domestic investment demand--International Monetary Fund conditions notwithstanding (IMF position on deficit financing by the affected East Asian countries has changed), e.g., South Korea, Thailand
- ◆ Turning around expectations and providing incentives are the keys to stimulating private consumption and new private investment

# Prospects for Recovery?

## What Needs to be Done (2)

---

- ◆ Recapitalizing the domestic banks so that new loans to new projects are possible
  - ◆ Bailing out of old failed projects should be avoided
  - ◆ Recapitalization by the government should require capital contribution and risk-sharing by new or existing shareholders to avoid moral hazard
- ◆ Maintaining domestic political and social stability

## Prospects for Recovery?

---

- ◆ The real devaluation in the East Asian currencies present new opportunities for profitable investments (both for exports and for domestic consumption) once they are stabilized
- ◆ The real risk is excessive tightness--the East Asian central banks must walk a tight rope between not bailing out bad projects and choking off new projects
- ◆ The political economy--who will bear the costs--may prove to be the most difficult problem

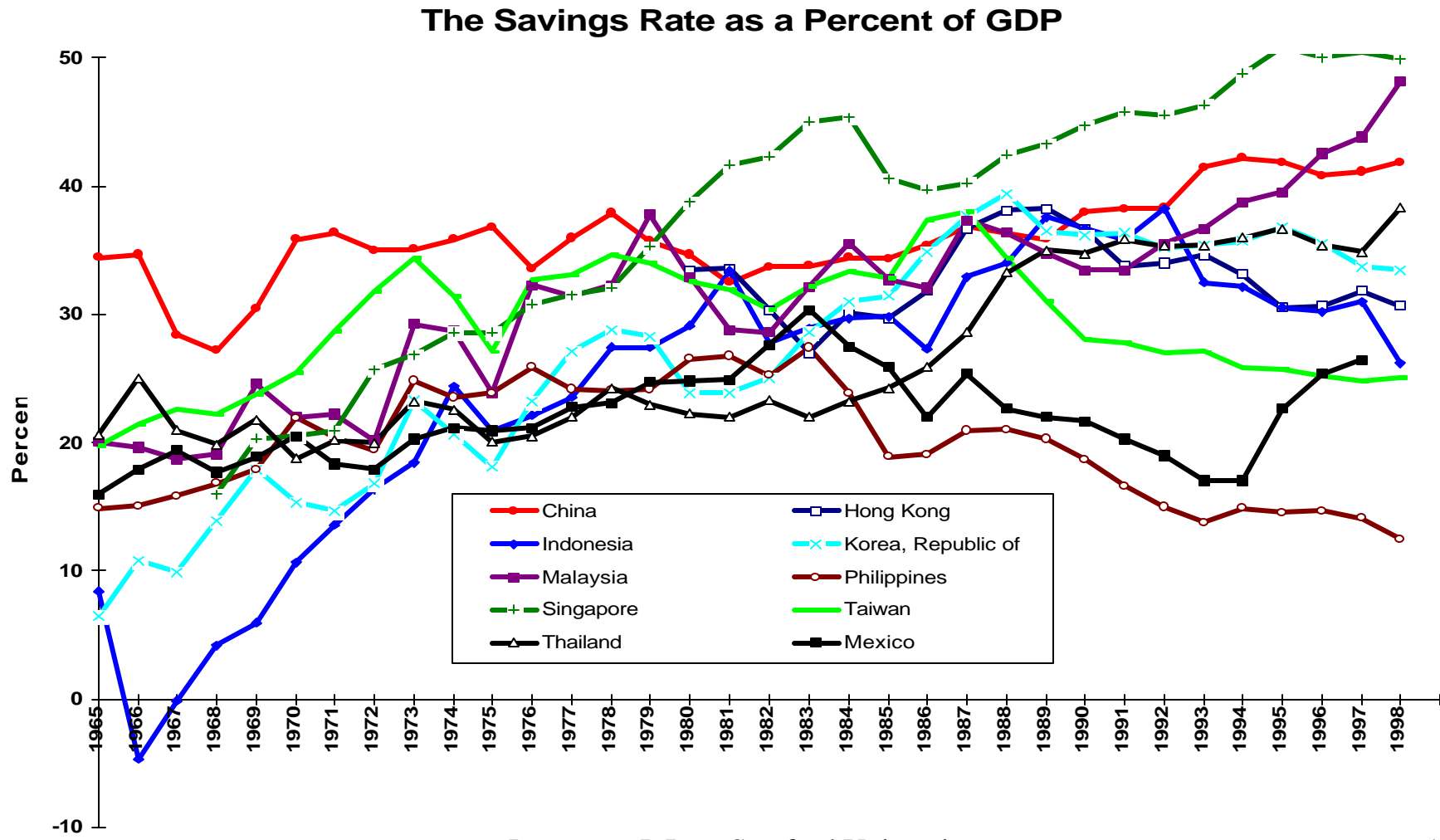


# Fundamental Macroeconomic Causes of the East Asian Currency Crisis

---

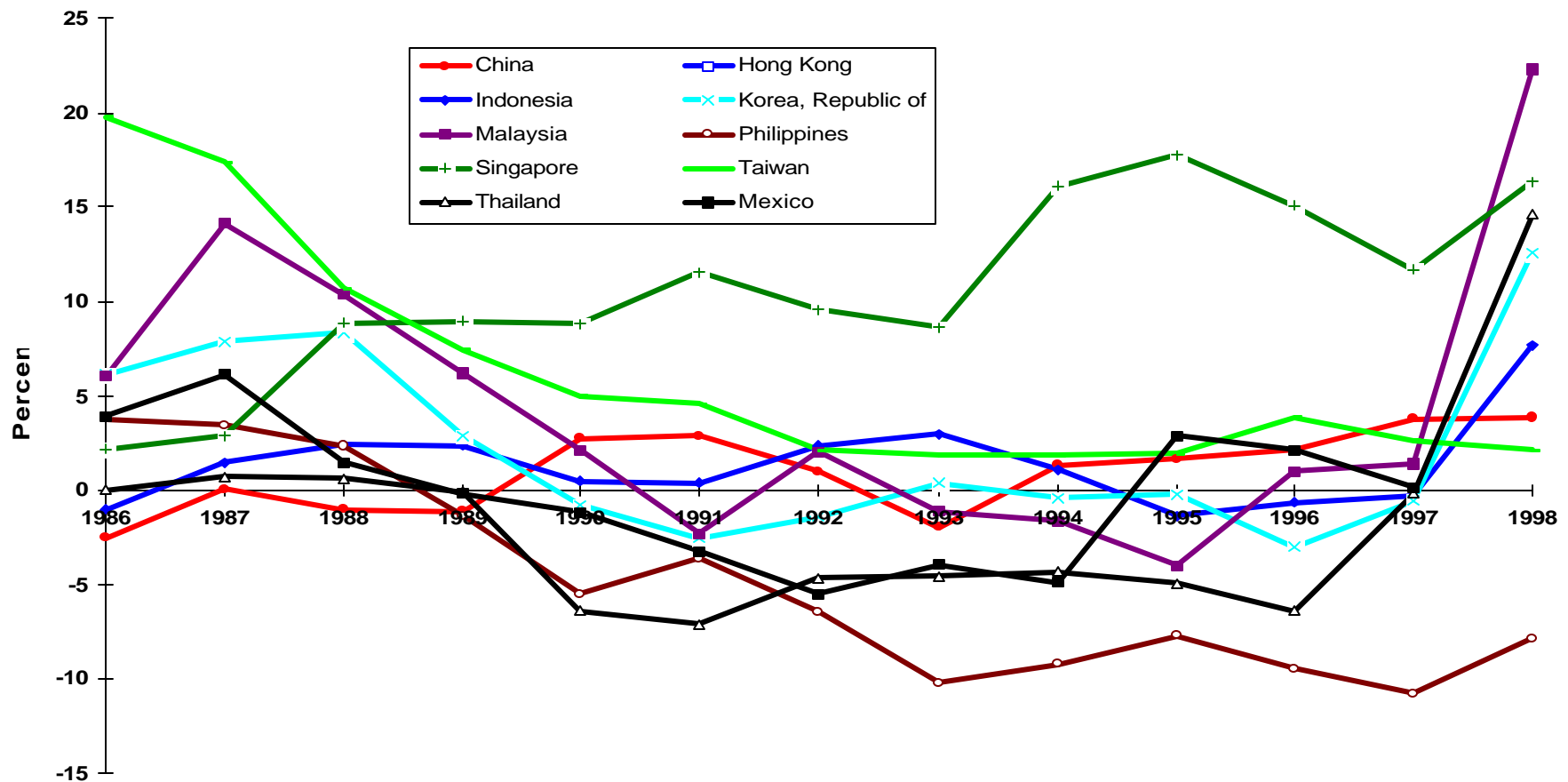
- ◆ Savings-investment imbalance--also reflected as current account imbalance
- ◆ Dependence on short-term foreign capital (portfolio investment--both equity and debt instruments--and loans) by private investors
  - ◆ Insolvency caused by the revaluation of foreign-currency denominated debts and the rise in the rate of interest
  - ◆ Domino effects of insolvency and bankruptcy
  - ◆ Problems magnified by high leverage (or high debt to equity ratio)
- ◆ Inadequacy of foreign exchange reserves for supporting imports, debt service, and (potential) net short-term capital outflows
- ◆ Real exchange rate appreciation (loss of competitiveness) due to a domestic rate of inflation higher than the U.S. rate of inflation

# The Savings Rates of Selected East Asian Economies



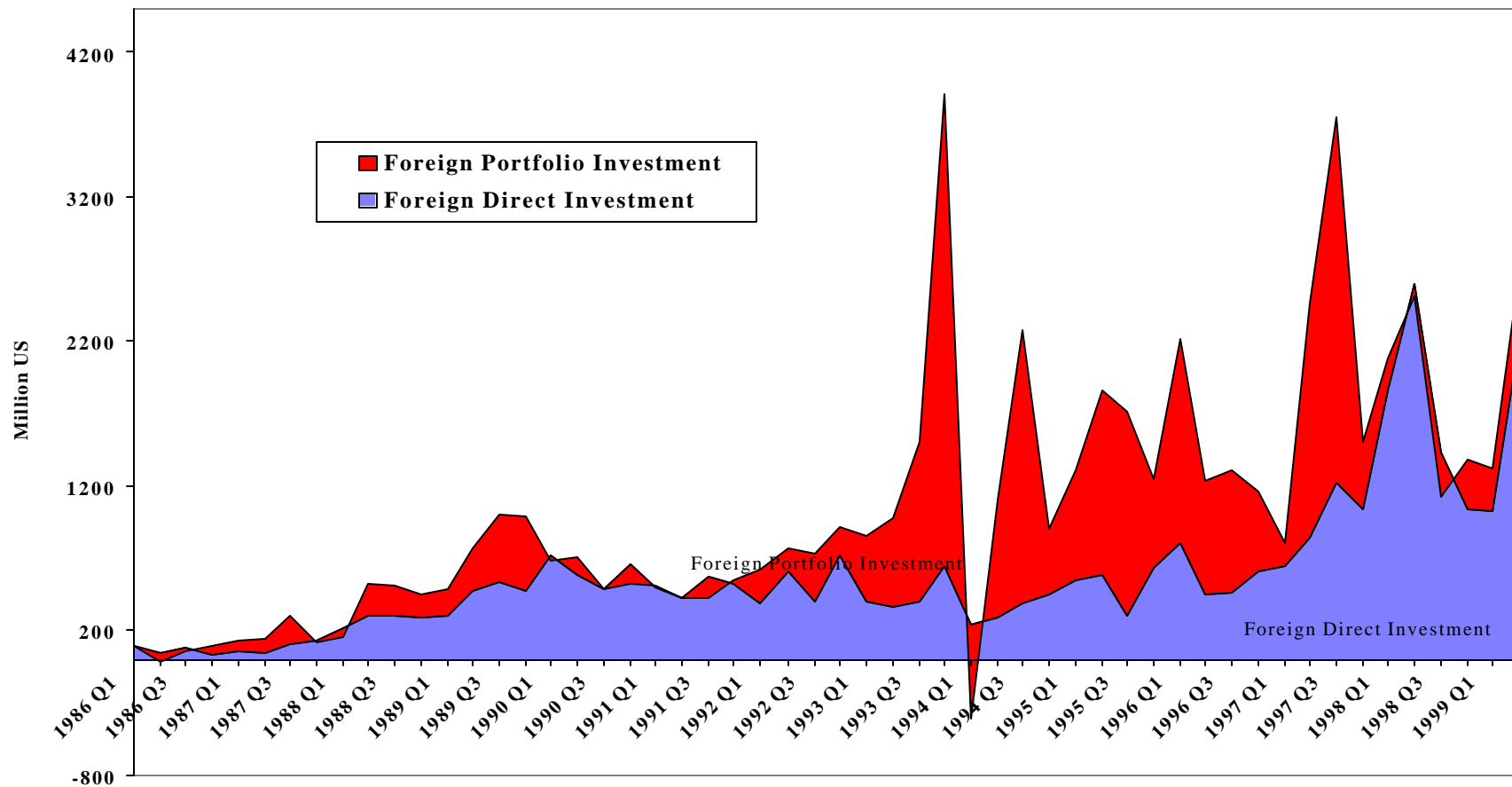
# The Savings-Investment Gap Selected East Asian Economies

The Savings-Investment Gap as a Percent of GDP



# Composition of Foreign Investment: Thailand (Quarterly Data)

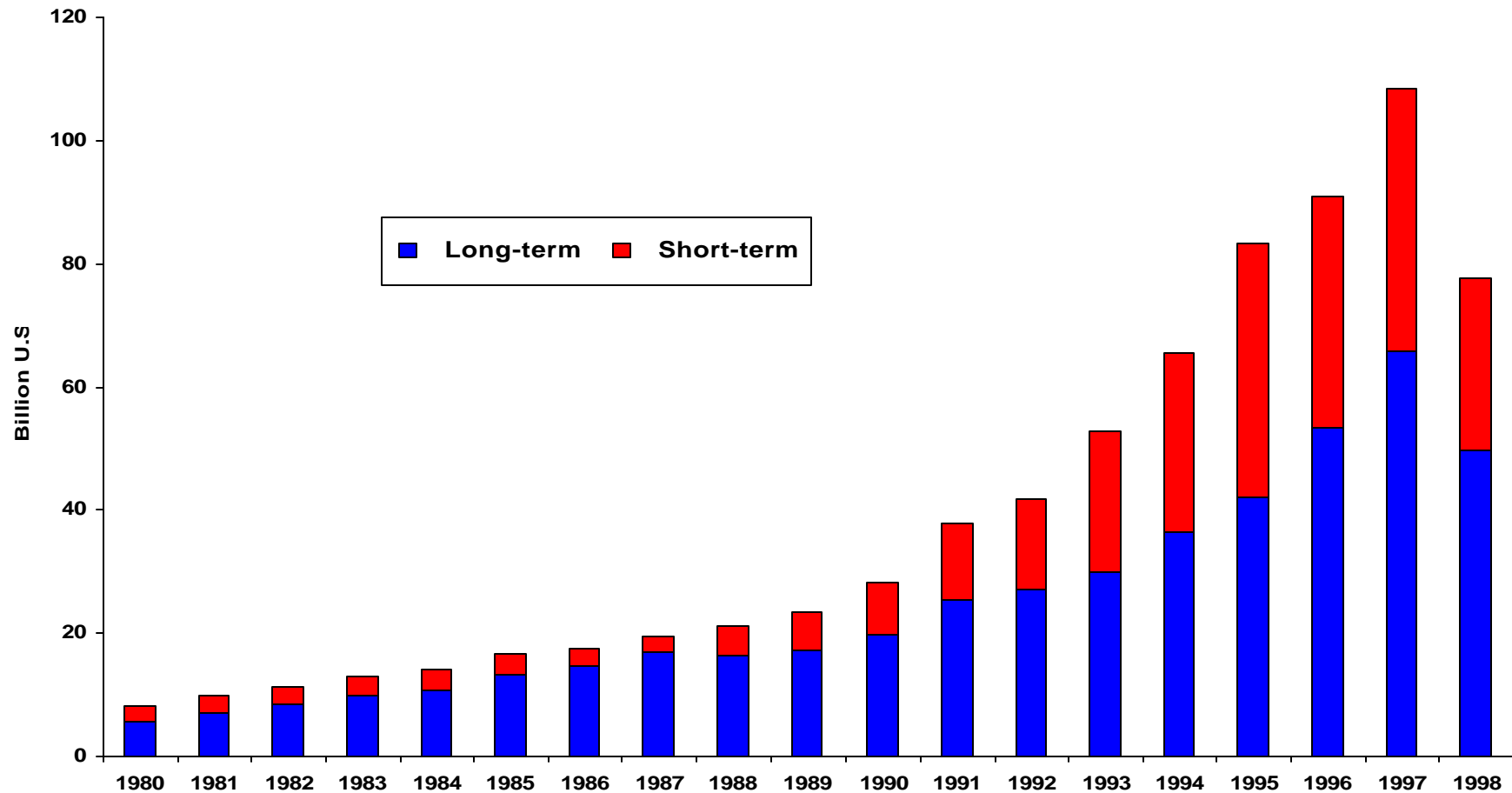
Composition of Foreign Investment: Thailand



# Composition of External Debt Thailand

---

Stock of External Debt: Thailand

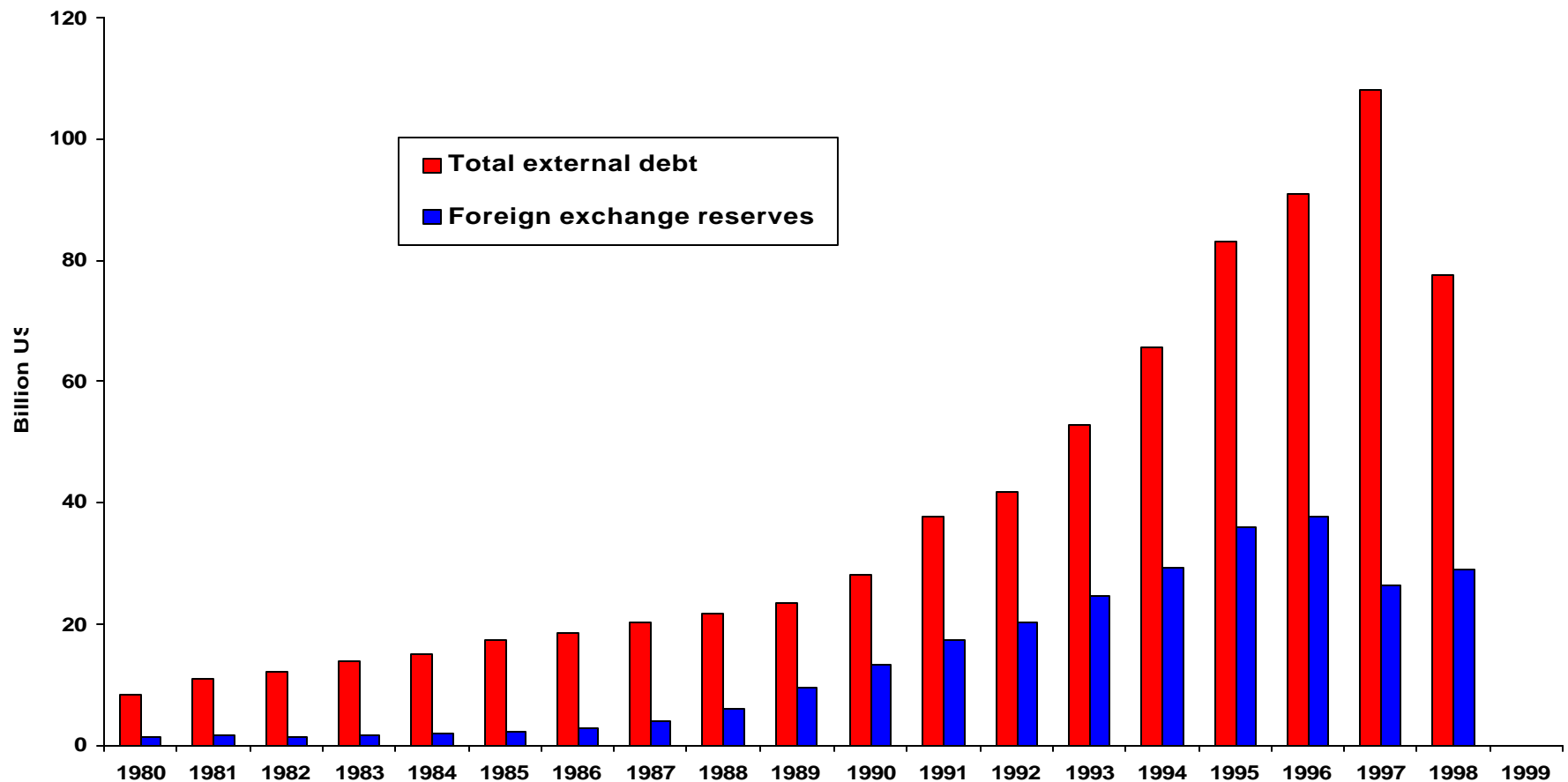


Lawrence J. Lau, Stanford University

# External Debt and Foreign Exchange Reserves Thailand

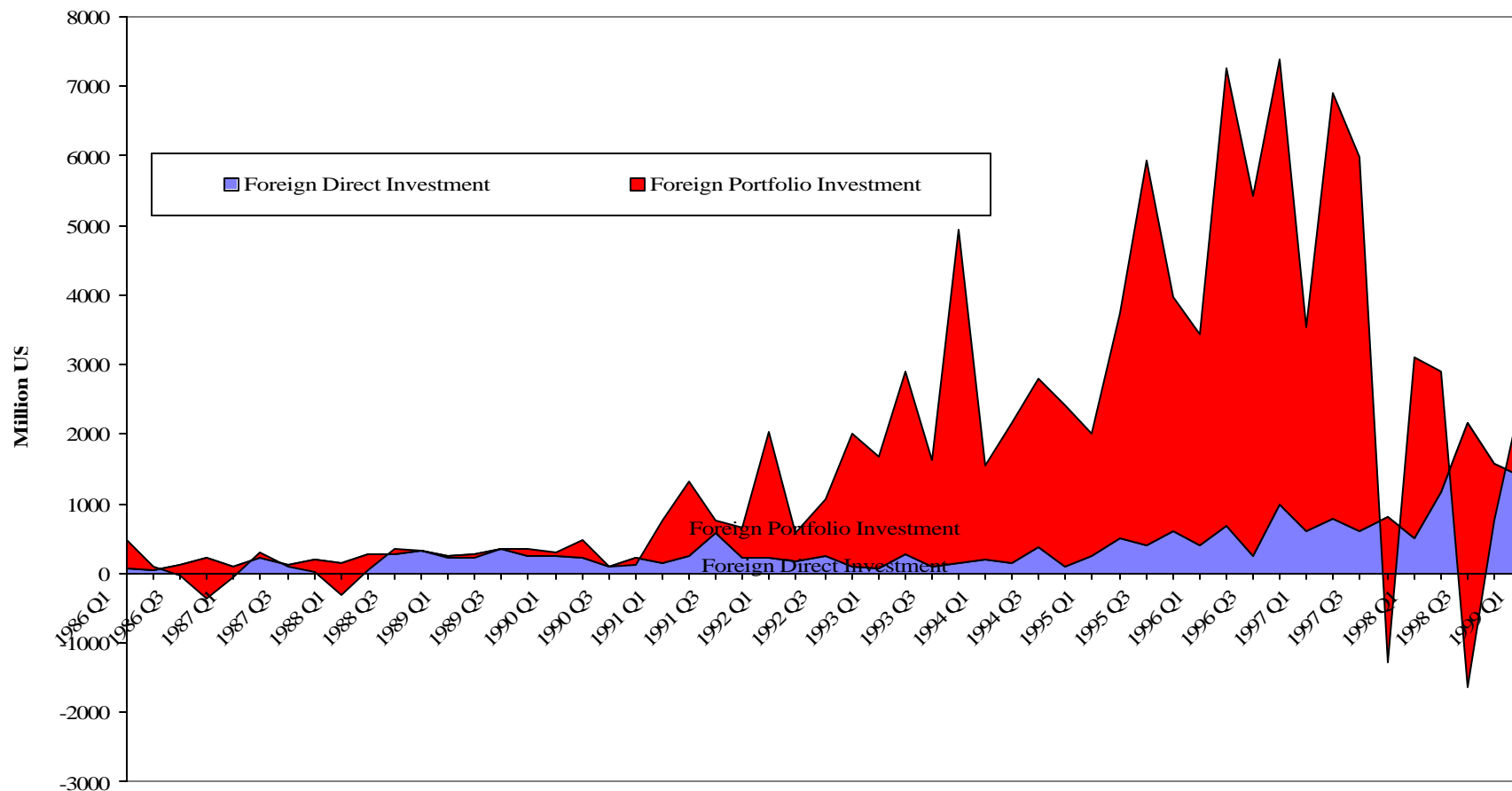
---

Thailand's External Debt vs. Foreign Exchange Reserves



# Composition of Foreign Investment: South Korea (Quarterly Data)

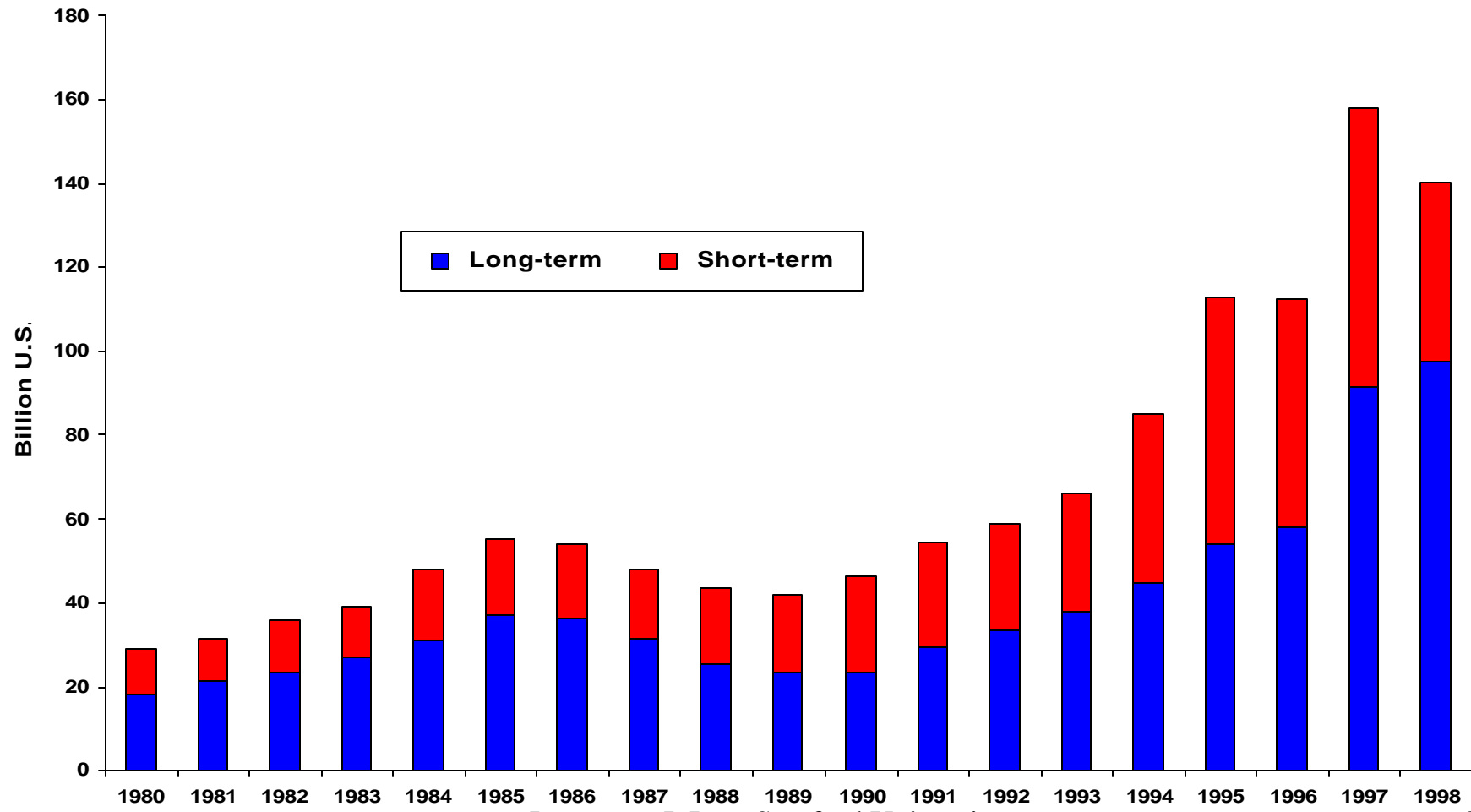
Composition of Foreign Investment: Republic of Korea



# Composition of External Debt South Korea

---

Stock of External Debt: Korea



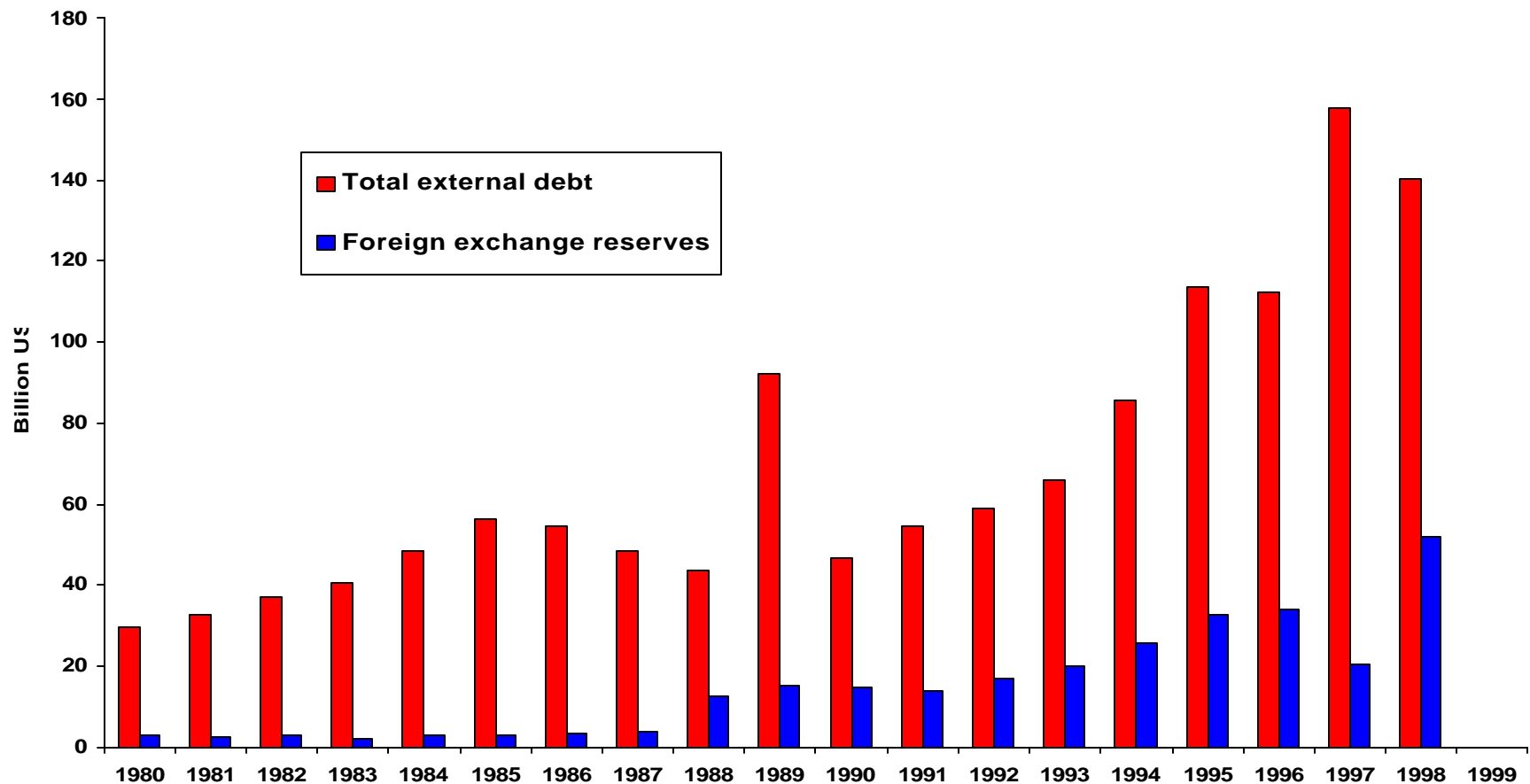
Lawrence J. Lau, Stanford University



# External Debt and Foreign Exchange Reserves South Korea

---

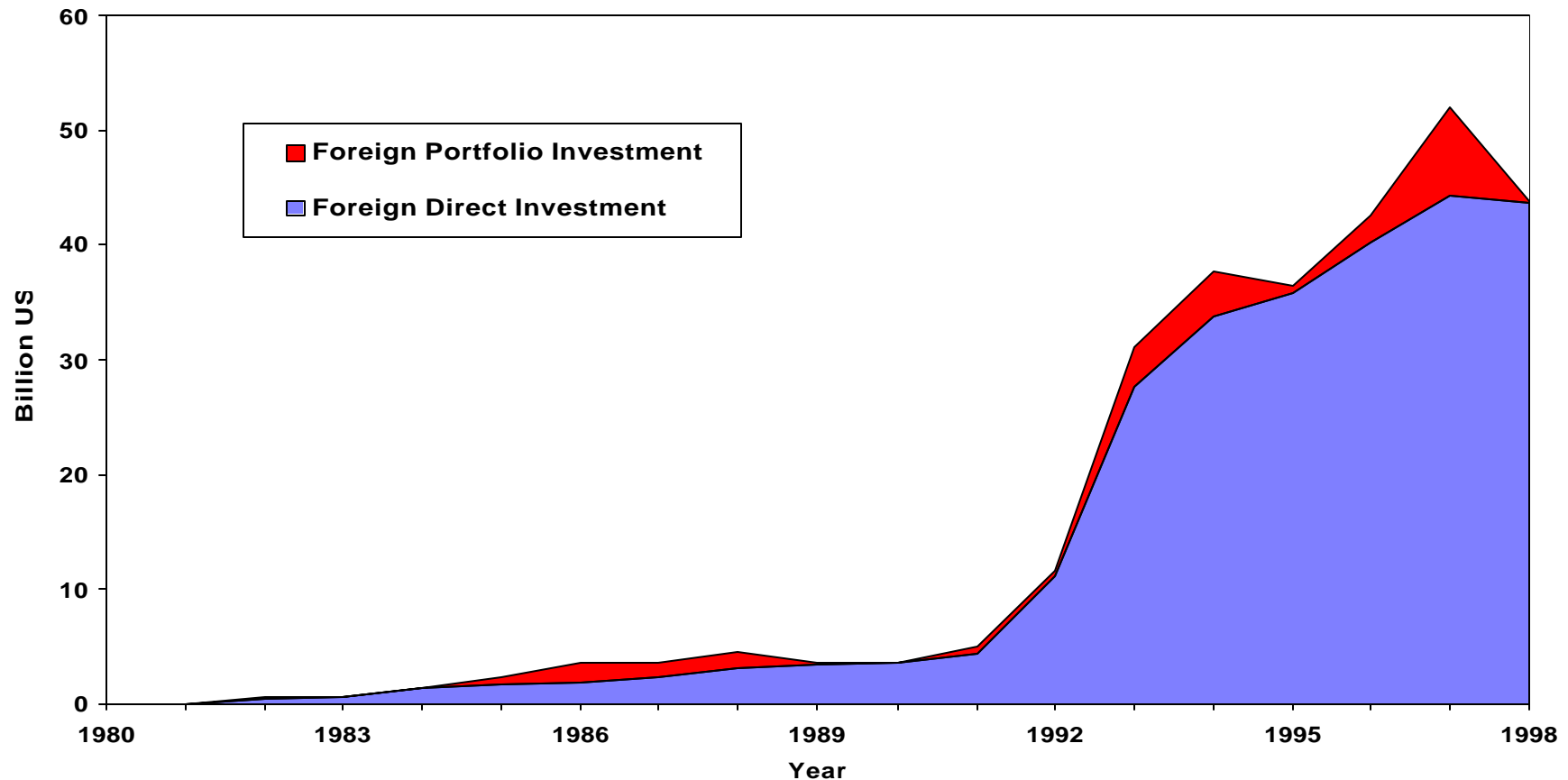
Korea's External Debt vs. Foreign Exchange Reserves



# Composition of Foreign Investment: China

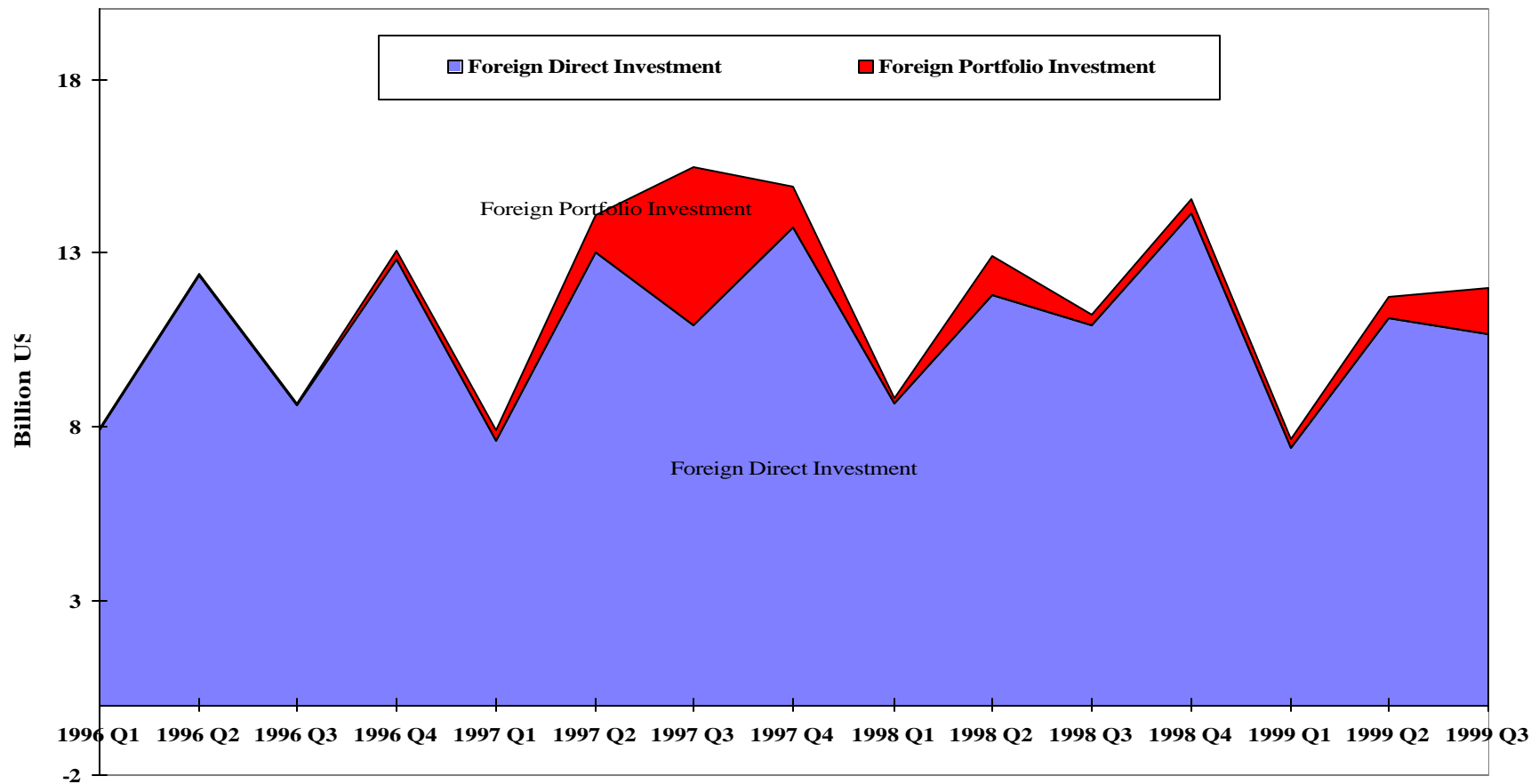
---

Composition of Foreign Investment, China



# Composition of Foreign Investment: China (Quarterly Data)

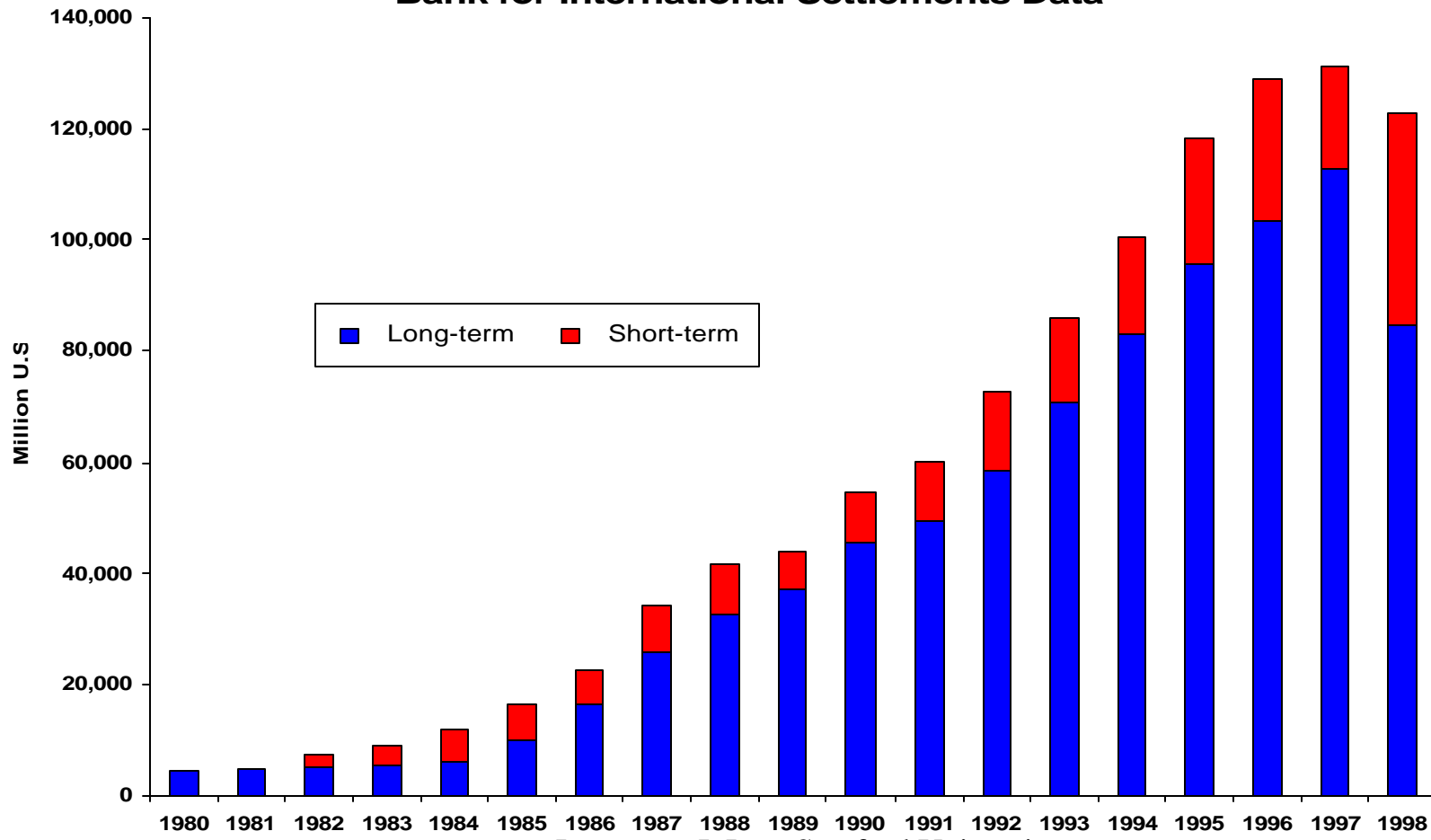
Composition of Foreign Investment: China



# Composition of External Debt China

---

**Stock of External Debt: China**  
**Bank for International Settlements Data**

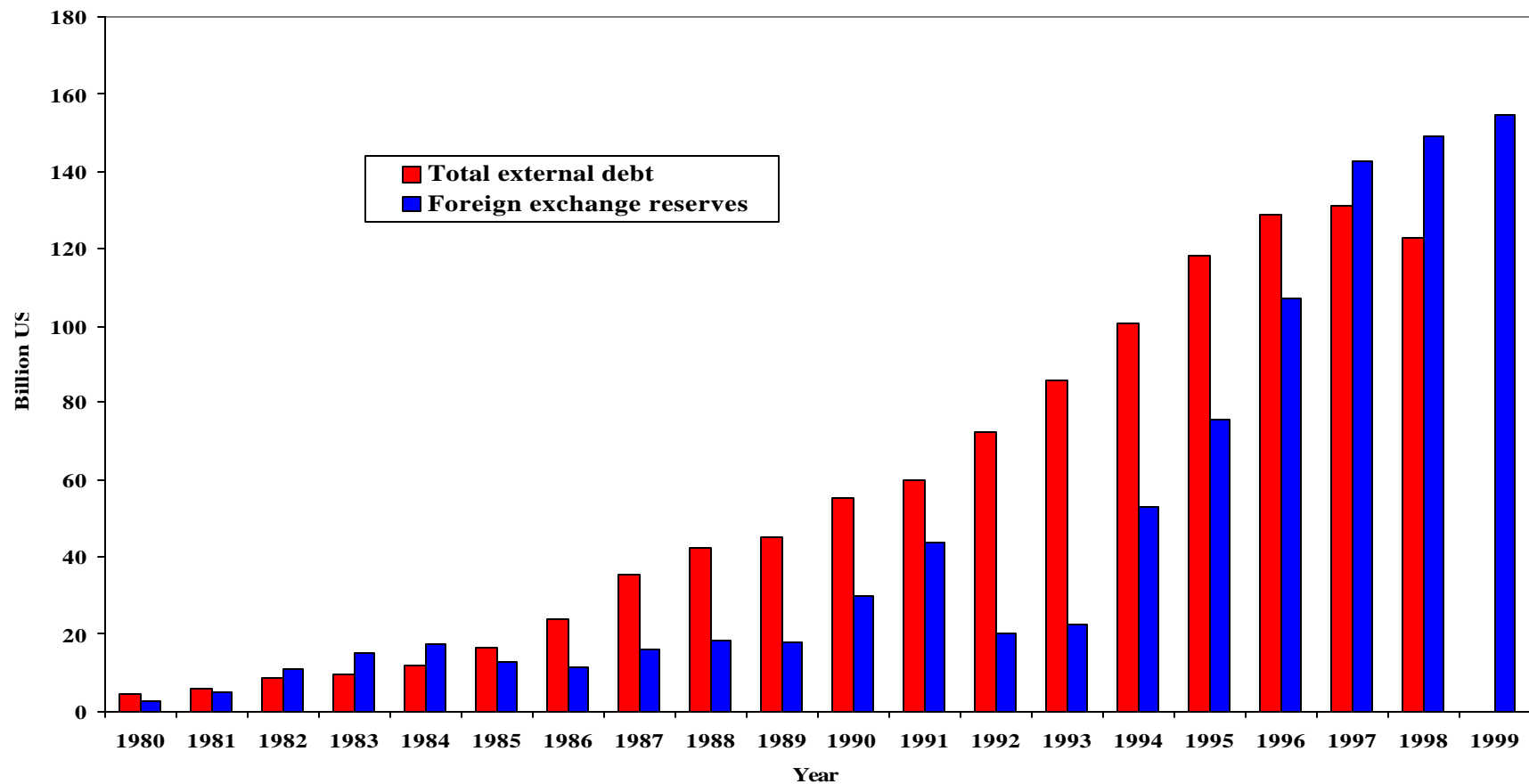


Lawrence J. Lau, Stanford University

# External Debt and Foreign Exchange Reserves China

---

China's External Debt vs Foreign Exchange Reserves



# Lessons:

---

- ◆ A currency crisis inducing a financial crisis
- ◆ The hazards of short-term foreign capital
- ◆ An adequate level of foreign exchange reserves should be maintained (10 months of imports)
- ◆ A fixed exchange rate and chronically higher relative inflation cannot be compatible in the long run
- ◆ Excessive leverage should be discouraged
- ◆ Containing contagion
- ◆ Post-crisis options for exchange rate regimes

# The Major Uncertainties

---

- ◆ The movements of the Yen-Dollar and Yuan-Dollar exchange rates
- ◆ The rates of growth of the U.S. and Japanese economies
- ◆ The U.S. rate of interest (one instrument, two targets--the prices of goods and the prices of assets)
- ◆ The possibility of a bursting of the U.S. asset prices bubble (Could the reliance on an accommodative easing by the Federal Reserve Board after such an event create its own moral hazard?)
- ◆ The return of the hedge funds (are bubbles building in the East Asian stock markets again?)

# Rates of Growth of Inputs & Outputs of the East Asian Developing & the G-7 Countries

**Table 3.1: Average Annual Rates of Growth of Real GDP, Capital, Labor and Human Capital (percent)**

(Extended sample period)

Country	Period	GDP	Capital Stock	Utilized Capital	Employment	Labor Hours	Human Capital	Average Human Capital
Hong Kong	66-95	7.4	8.8	8.6	2.6	2.4	4.8	2.1
S. Korea	60-95	8.5	12.3	12.3	3.1	3.3	6.2	4.0
Singapore	64-95	8.8	10.3	10.3	4.3	4.7	5.9	3.5
Taiwan	53-95	8.4	11.8	11.8	2.7	2.3	5.3	2.8
Indonesia	70-94	6.7	8.9	9.8	3.1	3.1	9.6	7.7
Malaysia	70-95	7.3	11.8	11.8	3.7	3.7	7.7	4.9
Philippines	66-95	4.0	5.8	5.9	3.2	3.2	10.8	8.5
Thailand	66-94	7.6	9.1	9.4	2.8	2.8	8.5	5.8
China	65-95	8.4	10.3	10.3	3.0	3.0	5.9	3.3
Japan	57-94	5.9	8.1	8.0	1.1	0.6	2.1	0.9
Canada	57-94	3.8	4.8	4.7	2.3	1.9	3.0	1.1
France	57-94	3.3	3.9	3.9	0.4	-0.2	2.0	1.1
W. Germany	57-94	3.2	3.3	3.1	0.1	-0.3	1.5	1.0
Italy	59-94	3.5	5.2	5.3	0.0	-0.3	1.8	1.3
UK	57-94	2.4	3.9	3.8	0.2	-0.1	1.2	0.8
US	49-94	3.1	3.0	3.3	1.7	1.3	2.1	0.8



# Is East Asian Economic Growth Sustainable?

---

- ◆ Neither miracle nor a mere bubble
  - ◆ Economic growth experience replicated in different East Asian economies
  - ◆ Sustained economic growth over decades
  - ◆ Recent crisis due to many factors, of which “irrational exuberance” is only one
  - ◆ Economic fundamentals remain sound--high savings rates, investment in human capital, entrepreneurship
- ◆ Past economic growth attributable to growth in inputs, particularly the efficient and rapid accumulation of physical capital
- ◆ Considerable room for continuation of rapid tangible inputs-driven economic growth--tangible capital per unit labor still lags behind the developed economies
- ◆ Intangible capital per unit labor lags even further behind
- ◆ Because of its complementarity with tangible capital, investments in intangible capital can retard the decline in the marginal productivity of tangible capital