

Mr. Sherwin reviews economic prospects and challenges for Asia and the Pacific region Address by the Deputy Governor of the Reserve Bank of New Zealand, Mr. Murray Sherwin, to the New Zealand Institute of International Affairs in Wellington on 15/10/98.

I was asked to discuss the economic prospects for Asia and the Pacific. I'm going to take a fairly liberal interpretation of the topic. You will not be surprised that my comments are framed within a high degree of uncertainty about the direction of the global economy. Events of the past year or more have been dominated by a growing sense of contagion spreading from the initial Thai problems, and now affecting most parts of the world. Even over the last couple of months, we have seen Russia and Latin America faltering, and a substantial re-rating of corporate profit prospects in the USA and Europe. As we look forward to 1999 and 2000, we can do no better than guess at when these downward influences will run their course, and when robust, sustainable, recovery will commence within the Asian region.

However, I will offer a few guesses on Asia's prospects. I will also offer some observations on the nature of the adjustments and transitions now being worked through in Asia, especially within the financial sectors of the affected countries.

The Asian Growth Story

The Asian growth story, over three decades or more, has been extraordinary, with sustained annual expansions of the order of 7 to 10 percent. That is more than just a statistical nicety. Not only has Asian economic success supported growth in the rest of the world, it has been the driving force in the most profound process of poverty alleviation in human history. By World Bank estimates, where 60 percent of East Asians lived in absolute poverty (i.e. less than US\$1 per day) in 1975, 20 percent were living in absolute poverty in 1995. The numbers living in poverty have declined, the severity of poverty has declined, life expectancy has climbed, infant mortality rates and literacy indicators have all improved in tandem with economic growth. Growth created jobs for the poor, and provided opportunities to expand their productivity. The Asian miracle was real and tangible.

Of course, Paul Krugman made himself famous, and unpopular in some parts, by arguing that while Asia had generated extraordinary growth over an extended period, there was no magic formula that the rest of us could borrow in order to imitate that growth performance. To use Krugman's now-famous line, perspiration, rather than inspiration, was the Asian secret. In tolerably well-organised economies, simply adding more inputs will lead to more outputs. Certainly, lots of Asians became wealthier, and were able to enjoy rapidly improving material well-being. But there was, in Krugman's view, no miracle. There was no productivity steroid.

The last year or so has generally given strength to Krugman's analysis. In crude, and rather simplistic terms, the Asian formula worked so long as those new inputs were directed into areas where the real value added, at the micro level, was sufficient to support real growth at the macro level. Asia was able to generate high savings rates, and to maintain similarly high levels of investment. But as investment increased, to 30 or 40 percent of GDP in many cases, the quality of that investment began to deteriorate. Returns on investment were driven below the cost of capital. The legacy is a huge amount of surplus, and essentially redundant, capital stock.

Inevitably, that surplus capacity has been repriced. The internationally tradable capacity has been repriced by way of local currency depreciations in most cases. As currencies fall, output becomes more competitive in foreign currency terms. The non-tradable component, largely surplus real estate investment, emerges in the form of sharply reduced asset prices, and in an enormous stock of bad debts.

The Asian crisis has so far appeared largely as a financial crisis, at least in the eyes of casual observers from abroad. The volatility in financial asset prices - exchange rates, interest rates, equity prices - has been spectacular, and it is not surprising that attention has been attracted in that direction. Perhaps less visible, and certainly less reported, is the still emerging 'real' impact. Industries throughout the region now face declining markets, after years of unrelenting rapid growth. As already noted, the surplus capacity in many industries implies that asset values must decline. Companies will fail, or will if they are allowed to. Unemployment is rising, and will rise further. Poverty levels will rise again, and the welfare of, quite literally, hundreds of millions of people will deteriorate. Many will return to the absolute poverty that, a year ago, was a rapidly fading memory.

That will not be a permanent deterioration. But the next couple of years promise to be harsh.

Prospects

In the longer term, I have no doubt that the region will return to robust growth - almost certainly not as rapid as has been experienced in the past two or three decades, but still the sorts of growth rates that the rest of the world envies. As a guess, and it is no more than that, I would suggest a future of something closer to 4 to 6 percent annual growth rather than the 7 to 10 percent rates of old. Lower debt levels, and closer attention to risk, will likely feature in this slower growing Asia, and desirably so.

What gives me confidence of resumed growth?

Firstly, one of the largest investments, and without doubt the most important, made in Asia in recent decades has been in human capital. The Asian commitment to education has been immense, and the benefits of that will be durable. To put it crudely, the wheels may have fallen off the Asian economy for now, but the engine and chassis are still there, willing and able to move again. It is the human capital base that will provide the engine for recovery.

Secondly, despite the vast strides made in the past, Asia still has some 'catch-up' to do. Average per capita incomes remain well below OECD levels in most of non-Japan Asia, and there remains scope for technology transfer into the region. Macro-economic management is likely to remain sound, and that provides the basis for believing that the process of catch-up can resume.

But the short-term economic prospects are more difficult.

At the Reserve Bank, we do not undertake independent forecasts of the economies of our trading partners. Rather, we look to the local experts, and rely on Consensus Forecasts - which are essentially a survey of local forecasters' views for each country.

Table 1 summarises the Consensus view of industrial production for the region's economies. For 1998, I have included the results of the latest Consensus survey (September 1998) along with the corresponding forecasts of a year earlier. For 1999, the table shows the latest numbers, plus the results of the first survey of 1999, which was taken in January of this year.

Table 1

Consensus forecasts of industrial production
annual average

Calendar Country	1998 Share of NZ Exports	1999 Forecast as at:		Forecast as at:	
		Sep-97	Sep-98	Jan-98	Sep-98
Australia	19.3	4.3	2.9	3.3	2.4
United States	11.0	2.8	3.3	2.2	2.4
Japan	14.4	2.4	-6.4	1.6	-1.9
TWI Weighted	53.5	3.2	0.7	2.6	1.3
South Korea	3.9	7.9	-8.1	4.3	1.6
Taiwan	2.6	6.4	4.6	6.0	4.7
Hong Kong*	2.8	5.4	-4.7	4.0	-2.8
China	2.8	15.1	9.4	12.8	9.9
Indonesia	1.3	9.8	-16.2	5.9	-0.3
Malaysia	2.2	10.1	-5.1	7.1	0.5
Thailand	1.2	4.8	-13.1	3.0	0.3
14 countries Export Weighted	71.7	4.4	-0.5	3.4	1.4

* GDP

Two points are striking. Firstly, the extent and pervasiveness of the reduction in expected output over the course of the last year are enormous. By any historical standards, the region has suffered a very serious growth shock.

Secondly, the current Consensus view for 1999 does not envisage any substantive recovery for the region. At best, it is suggestive of stabilisation at the new, lower, levels of activity. Note that the track of the past year or so has been one in which the Consensus growth forecasts have been repeatedly revised downward as they incorporated emerging news and data. There is no clear sense yet that that process has run its course. Note also that the latest growth outlook still assumes a fairly benign, and frankly implausibly optimistic, growth path for China, the USA and Europe.

As noted earlier, it is impossible to get a firm grip on the near-term prospects while the contagion unleashed in Thailand in July of 1998 is still working its way around the globe. All going well, China, the USA and Europe will be able to sustain their positive growth paths, and will provide the pillars around which the affected countries can resume their growth. I think that is still the most likely scenario. But other, realistic, and much less comforting, scenarios can be conjured up with disturbing ease. Developments in financial markets over the past couple of weeks tip the balance even more in the direction of the pessimists.

Even the scenario of continued modest growth involves some very harsh transitions for Asia. I will focus on primarily one aspect of that transition - namely the enormous damage that has been wrought to balance sheets in the region and what will be required to remedy that.

Financial Sector Adjustments

What has been highlighted by the Asian crash is the extent to which Asian growth has been debt fuelled and has proceeded on structures that were inherently risky. Assumptions were made about the ability of Asian governments to shelter entrepreneurs from those risks. Those assumptions proved ill-founded.

Deals that involved borrowing in low-interest foreign currency terms to invest in rapidly inflating domestic property assets, for example, were premised on exchange rates remaining fixed, and property prices continuing to inflate. Other investments in manufacturing capacity were

based around assumptions of continued rapid growth in demand, continued access to loan funding, plus stable interest and exchange rates. It was a good formula while it lasted, but it could not last.

Estimates of the extent of balance sheet damage done in the Asian collapse carry wide margins of error, largely because asset prices remain uncertain and accounting and auditing conventions do not always provide reliable guidance as to the health of entities. However, even in accepting those wide margins of error, it seems plausible that, within the region's financial sectors alone, losses have been incurred which are equivalent to something of the order of 25 to 50 percent of GDP. Even for Japan, non-performing assets of the banking system (not all of which will become 'losses') are estimated by one of the credit rating agencies at 30 percent of GDP. The USA Treasury estimates for total non-performing assets of Japan's banks run to a more modest 20 percent of GDP.

By comparison, the USA savings and loan problems of the early 1990's involved losses of around 3 percent of USA GDP, and the Scandinavian financial sector collapses of the same period ran closer to 6 to 8 percent of GDP. To find anything comparable to what has happened to Asia, we have to look to the Argentinian crisis of the early 1980's which led to loan losses of the order of 50 percent of GDP.

It is difficult to see how robust growth can resume in Asia before these equity holes are filled. The obvious question is how to achieve that. Specifically, where will the money come from?

First, we need to recognise that not all such losses need to be 'replaced'. The financial sectors in much of Asia were almost certainly rather larger than needed and therefore don't need to be fully 'replaced'. Indonesia, for example, had something like 240 banks servicing an economy which, at its peak, was little more than three times the size of New Zealand's. As in other parts of the region, most of those banks are insolvent. But it will not be necessary to rebuild the capital base of each to BIS standards. Without wishing to diminish the magnitude of the task, many, if not most, of those banks can probably be allowed to disappear, through mergers or closures, without impairing the effective functioning of the economy. Indeed, the priority throughout the region is to quickly resurrect functioning and trustworthy financial systems around a small core of robust institutions.

Even that will require enormous equity injections. Where will that equity be found?

The options are reasonably clear cut:

- shareholders of banks
- creditors (i.e. depositors) of banks
- the public purse
- domestic investors
- foreign investors

But those options are somewhat constrained.

In essence, existing shareholders have, to use the vernacular, 'lost their shirts'. Some private shareholders may be able to contribute additional capital, but most will not.

For the most part, the depositors of banks in the region have already received public guarantees on their deposits. There seems little prospect that they will be obliged or allowed to share directly in the losses accrued.

The public purse is the mostly likely source of substantial, and early, new equity. Most countries in the region went into this crash with relatively light public debt loads. Most could probably absorb an additional debt burden of, say, 10 to 20 percent of GDP equivalent in order to recapitalise banks and deal, at least in part, with the bad debts. In so doing, they would, in effect, socialise the losses, and spread the impact of the economic collapse over the next decade or two. Of course, as conditions improve, and perceptions grow that the worst of the shock is over, private investors will be increasingly willing and able to reinvest, enabling the governments to withdraw from direct ownership and retire at least some of that debt.

Whatever view one takes of the desirability of public investment in financial institutions, it is difficult to see how this particular option can be avoided given the magnitude of the problems that have emerged, and the profound lack of confidence on the part of private investors which now exists. Indeed, this process of public capital injections is already well under way in Korea, Thailand and Indonesia. Japan, it seems, is still struggling with the concept.

Asia's domestic private investors, for the most part, have taken such an enormous hit to net worth that it is difficult to imagine them being an early or substantial source of new capital for banks. In any event, the need for new equity extends well into the non-financial business sector also, and even with Asia's renowned savings capacity, the short-term need for private savings well exceeds the local capacity to supply.

That leaves only foreign investment in Asian financial systems and industry as a substantial and available avenue for prompt recapitalisation and rapid economic recovery. Foreign investment would bring more than just capital. The region needs skills, experience, risk management systems, accounting and auditing systems, diversification of ownership risk and, perhaps beyond all else, high reputation and confidence in creditworthiness. Foreign investors can provide all of that.

Certainly, foreign investment in the region's financial systems is already occurring. However, my impression is that it is not always openly welcomed. I am well aware of all of the national reservations about foreign investment, and I don't approach this issue with a strongly ideological view of the subject. But it does seem that without a more liberal and welcoming approach to foreign investment, the recovery will be slower because the region's equity needs far exceed the capacity of domestic sources - public and private - to provide.

Before private investors, of either domestic or foreign origin, are enticed into recapitalising the region's banks, there will have to be substantial progress on issues of accounting standards, audit standards, transparency, and legal underpinning of bankruptcy proceedings and commercial law more generally. Investors will not invest unless reasonably confident that they understand the risks they are accepting (which, as recent events prove, isn't the same as saying that investors will assess those risks accurately). Reducing those risks is one of the most productive activities that governments in the region can now engage themselves in.

Concluding Comments

Asia has suffered a shock which, by any historical comparison, is severe. Recovery from that shock will take time and perhaps the most useful thing that can come from the experience now is to extract the available lessons and try to ensure that recovery is sound, durable and less susceptible to such crises in future.

Asia 2000 Executive Director Philip Gibson in a recent speech pointed to the fundamental strengths of Asian countries, in terms of their cohesiveness, willingness to save and invest, commitment to improvement, especially through education, and commitment to recovery. All

of those qualities are evident, and all will be necessary over the next couple of years as recovery takes root.

To my mind, there are two key lessons emerging from the Asian experience, and these are now being reinforced by events elsewhere around the world.

- The crucial importance of a strong, well-capitalised financial sector, with robust systems for recognising and managing risk. The experience is showing us again just how financial system stress can amplify difficulties in the rest of the economy.
- Asset price booms may be enjoyable on the way up, but are terribly destructive when the bubble finally pops.

If those two lessons are well-learnt, and applied in future policy making, Asia's future will be even more robust and durable than its past.