Will the Asian Phoenix Rise Again?[1]

Barry Eichengreen

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The title of this session is "Will the Asian Phoenix Rise Again?" Being a brave man, I am prepared to put my neck out and to give an unambiguous one-word answer: yes. You will see that I have followed the economist's first rule of forecasting: give them a prediction, or give them a date, but never give them both. The key issue, as emphasized in the background paper for this session, is *when*.[2] I agree with the authors that the existence of foreign and domestic debt overhangs is a serious obstacle to rapid recovery. I agree that clearing away those overhangs will be difficult and protracted. I agree that simple arithmetic implies that the current state of affairs — tight monetary policy, slow growth, efforts to maintain debt service — is unlikely to remain sustainable and that governments will be forced to turn to looser monetary policies, weaker exchange rates, and various steps to limit the burden of servicing their external debts. Having flattered our hosts, let me now spend a few minutes dwelling on my disagreements.

First, the authors' focus on immediate debt problems causes them to lose sight of, or at least to underplay, strong Asian fundamentals. The high savings rates, the policies friendly to the promotion of manufacturing exports, the high levels of human capital in Singapore, Taiwan and Korea, and the abundance of natural resources in Indonesia, Malaysia and Thailand are all still there. Many of the institutional flaws that we now think are so terribly debilitating are serious

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[1]Remarks delivered to the Deutsche-Morgan-Grenfell Global Emerging Markets Conference, Washington, DC.

[2]Angus Armstrong and Michael Spencer, "Will the Asian Phoenix Rise Again?" *Global Emerging Markets* vol. 1, no. 3 (October 1998).

only because the economies of the region are temporarily mired in depression. Take the inadequacy of bankruptcy codes and absence of independent judiciaries. The absence of an adequate bankruptcy code mattered not a whit so long as growth was fast and bankruptcy was the exception rather than the rule. But when growth stops, what was formerly a non-problem suddenly becomes a serious concern. (When the flow of water ebbs, the rocks lurking below suddenly become a threat to safe navigation.) But the opposite is equally true; what look like big problems now will become less consequential once growth resumes and Asia's strong fundamentals reassert themselves.

Second, there is too little differentiation in the paper between the different prospects of different Asian countries. In my view, the prospects for rapid recovery are considerably better in, say, Thailand than Korea. Corporate restructuring has gone further in the Thai case. The political constraints on downsizing and reducing employment are not as severe. Large amounts of foreign direct investment have flowed into Thailand, on the order of $3 billion in the first half of 1998, in contrast to the situation in Korea, where direct investment flows have been stagnant or negative. Manufacturing production has stopped falling. Thailand has some formidable problems of bank recapitalization, to be sure. But it is one example of the general point that sage investors should not now lump all Asian countries together.

Third, the authors if anything underestimate the difficulty of clearing away debt problems. In Latin America debt meant syndicated bank loans and loans made directly to governments. In Asia, in contrast, much of the lending in question has flowed through bond markets, and much of it is private (or quasi-private) debt of banks and corporates. The difficulty of renegotiation is infinitely more difficult now that thousands of banks and corporates involved, all of whose economic and financial prospects are interdependent. The moral suasion that regulators could apply to commercial banks was surely more effective than whatever arm-twisting governments and regulators can apply to hedge funds, mutual funds, pension funds, and individual investors. The absence of sharing clauses and majority voting provisions in these debt instruments makes holdout and free-rider problems all the more likely. For all these reasons, the Latin American benchmark if anything underestimates the difficulty of clearing away these debt overhangs. Doing so will require initiatives by governments on both the borrowing and lending sides. And there will be strong pressure for these debts to be assumed, de facto or de jure, by Asian governments, if only as a way of centralizing and speeding restructuring negotiations. Completing this process quickly will also require aid from the G-7, the World Bank and the IMF to underwrite (read "subsidize," a la the Brady Plan) debt-equity swaps and the like. This is an optimistic scenario. There is no sign yet that the G-7 and the multilaterals have developed the political will to undertake these policies.

Where the political will *is* likely to develop is on the interest-rate front. **This brings me to my fourth point, that the authors underestimate the prospects for concerted rate cuts in the advanced industrial countries as a engine for growth.** We have already seen the first sign of this on the part of the Fed and the Bank of Canada this week. There is good reason to suspect that more of the same will follow. The U.S. "oasis of stability" is becoming more and more isolated. This implies the likelihood of another such cut later this year, and maybe another matching set early in 1999. Surely the Bank of England and the Club Med countries will follow suit.[3]

And there is reason to be hopeful that the European Central Bank will do the same, not too long after takes control of the reins. Although Europe has been the real oasis of growth and stability, there is now reason to worry that this is changing, what with the series of financial shocks that European banks have now suffered. And the French government, for one, is already pushing hard for monetary measures to boost demand (as evident in their statement on the global economic situation last week). Spokesmen for the new German government are now pushing in the same direction. The two worries that many of us have had about monetary union from the start is, first, that post-EMU Europe will become more of a large closed economy and turn inward, and, second, that the European Central Bank will neglect its responsibility for the stability of the European financial system. Hopefully, we will be able to look back and say that the silver lining of recent shocks to the European financial system is that they reminded the ECB of its lender-of-last-resort responsibilities. They have made the problem of financial stabilization too prominent to ignore. Those shocks will force the ECB, like the Fed before it, to acknowledge that many of the threats to the stability of the financial institutions for which it is responsible are coming from abroad, and that, recent disclaimers by Mssrs. Tietmeyer and Duisenberg notwithstanding, it too must frame monetary policy with the global repercussions in mind.[4]

Concerted rate cuts would go some way toward soothing skittish financial markets.

[3]Indeed, since these remarks were delivered, the Bank of Spain and Bank of England joined the list of central banks cutting interest rates.

[4]Indeed, in the short period between the time when I delivered these remarks and they were revised for publication, there were signs that the Bundesbank and the newly-appointed ECB Board were changing their tune.

Lower money-market yields in North America and, to a lesser extent, Europe would sustain the growth of the crisis countries' critical export markets. They would go some way toward restoring investors' appetite for risk and put downward pressure on emerging-market bond spreads. The authors of the Deutsche Bank report say that it is difficult to isolate the impact of global interest rates on emerging-market capital flows, although they cite the work of Calvo, Leiderman and Reinhart using macroeconomic data as providing some evidence of the operation of this mechanism.[5] I would emphasize that recent work using data on individual bonds, by a number of authors — naturally I am partial to the paper by Ashoka Mody and myself — provides much more precise evidence of this effect.[6] It shows that these earlier authors if anything underestimated the impact of this effect, which has always operated most powerfully for riskier borrowers (historically, Latin American rather than East Asian borrowers, but now if anything the reverse).

To conclude, the authors of our background paper are braver than I. They are willing to provide a date as well as a forecast. They estimate that there will be no recovery from recession in 1999. (It would be more accurate to say that they provide a lower bound; they are not so reckless as to hazard a guess of when recovery will finally commence.) I think that their assessment of the outlook is about right on average. Their two calibration errors -- underestimating the difficulty of clearing away the debt overhang, and overestimating the level of

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[5]Guillermo Calvo, Leonardo Leiderman and Carmen Reinhart, "Capital Inflows and Real Exchange Rate Appreciation in Latin America: The Role of External Factors," *IMF Staff Papers* 40 (March 1993).

[6]Barry Eichengreen and Ashoka Mody, "Interest Rates in the North and Capital Flows to the South: Is There a Missing Link?" *International Finance* (forthcoming).

G7 interest rates — work in opposite directions and more or less cancel out.

What worries me most is not these quibbles and questions of timing. It is that many financial analysts continues to talk about the Asian countries as a group. The most fundamental lesson of the Asian crisis is that not all tigers have the same stripes. Looking forward, different countries in the region have different growth prospects. The task for investors is not to figure out when to jump back in, but to decide where to jump.