Revival of Asian Economies

By Watanabe Toshio

Mechanism of Restoration from the Crisis

Asia (see Note on page 25) has now extricated itself from its economic crisis. Asia holds economies that have growth potential. Therefore, it is only natural that the economies boasting of growth potential should move out of their crises.

Asia is a developing area and has thus incurred deficits in the current account for years. In 1998 and 1999, however, all Asian countries swung into the black. The improvement of the current account is viewed as natural because the steep depreciation of their currencies has helped boost exports and whittle down imports sharply.

The current account surplus in turn leads to a gradual increase in the central banks' foreign currency reserves that have been depleted substantially due to repeated interventions in foreign exchange markets. The swollen foreign currency reserves help bolster international confidence in Asian currencies and put the brake on Asian currencies' slides against the U.S. dollar. This in turn leads to the recovery of Asian economies.

The stabilization of currency rates makes it possible for Asian countries to ease the belt-tightening fiscal and monetary policy they have adopted to arrest the runaway fall of their currencies. They have boosted fiscal expenditures and relaxed monetary policy, resulting in a drop in interest rates. As shown in Figure 1, interest rates in Asian countries are now lower than they were before the outbreak of the economic crisis.

Lower interest rates have helped ease the interest burdens on businesses and encouraged them to make new investment. In this way, investment showed a V-shaped rise. Supported by increased investment, industrial production restored its strength, and wages in turn followed an upward trend after having fallen in the crisis period, with jobless rates showing a downward trend. This led to expansion of consumption. As a result, private consumption expenditures have made a V-shaped recovery in Asia as shown in Figure 2. Obviously, the Asian economy has started moving back on a self-sustained recovery track.

The pickup of the Asian economy is evident, considering the steady recovery of industrial production and Gross Domestic Product (GDP) in each Asian country from what they were before the 1997-1998 crisis. South Korea and Malaysia saw their GDP for the first quarter of 2000 exceed their pre-crisis highs, while Thailand and Indonesia recouped 98% and 92% of the ground lost during the crisis period, respectively. It is certain that the GDP of Thailand and Indonesia have now eclipsed the pre-crisis levels. It can be concluded that Asia has fully moved out of its economic crisis. While the Asian economic crisis was a severe one, the mechanisms of recovery turned out to be simple.

Domestic Savings

Asia comprises nations with abundant growth potential. The most important indicator of a country's potential is its domestic savings rate. Domestic savings are calculated by deducting consumption from the Gross Domestic Product (GDP). Domestic savings are lent to the most efficient, profitable business corporations by way of financial institutions (financial intermediary mechanisms). With the lending, businesses make investments. Domestic savings are thus the resources of investment. A country moves on the recovery track on a progressive scale

Photo : Itochu Corporation

Asian economies have tremendous growth potential - an overview of Karawang International Industrial City in Indonesia

Figure 1

Trend of Short-Term Interest Rates

Note: Interest rate for each country is at end of term. South Korea=3-month CD, Taiwan and the Philippines=3-month government bonds, Singapore=prime rate, Indonesia=13-month SB, and Hong Kong, Thailand and Malaysia=3-month TTB.

Source: International Monetary Fund, International Financial Statistics, Washington, D. C., Various Versions; Bank of Republic of China, International Financial Statistics, Taipei, Various Versions.

through investments, leading to the maximization of future incomes and consumption. Domestic savings are a dynamic human activity, in which they minimize "current consumption" and maximize "future incomes" and "future consumption."

The domestic savings rate is high in countries where people do not maximize consumption for current enjoyment but curb the "current consumption" for their own future, families, communities and societies. It seems natural that domestic savings rates are high in countries with people who have a strong will to work and grow.

The crisis-plagued Asian countries boast some of the highest savings rates in the world. They are capable of achieving the world's highest investment rates and thus growth rates by relying only on domestic savings without depending on foreign capital.

The incremental capital output ratio (ICOR) – investment rate (I) divided by the economic growth rate (G) – shows how many units of investment are required for one unit of growth. Therefore, the inverse figure (1/ICOR) of ICOR shows to what extent growth can be attained with one unit of investment. The figure calculated by multiplying the inverse figure by a domestic savings rate shows the growth rate that can be achieved with domestic savings alone. In the first half of the 1990s, the figure was nearly 7% in Thailand, Malaysia, Indonesia and South Korea. Potential growth rates of the four countries are projected to be 7% in the next 10 years.

Asian countries are capable of achieving the world's highest investment rates and thus growth rates by relying only on domestic savings. The problem is that Asian countries have kept on investing beyond their domestic savings rates, with the difference between domestic savings rates and investment rates (savings/investment gap) covered by foreign savings, or introduction of foreign capital, in order to follow an unusually high growth path. Asian countries took in foreign capital, notably short-term international funds, to fill the gap. And the massive outflow of such funds, triggered by some factors, gave rise to the economic crisis.

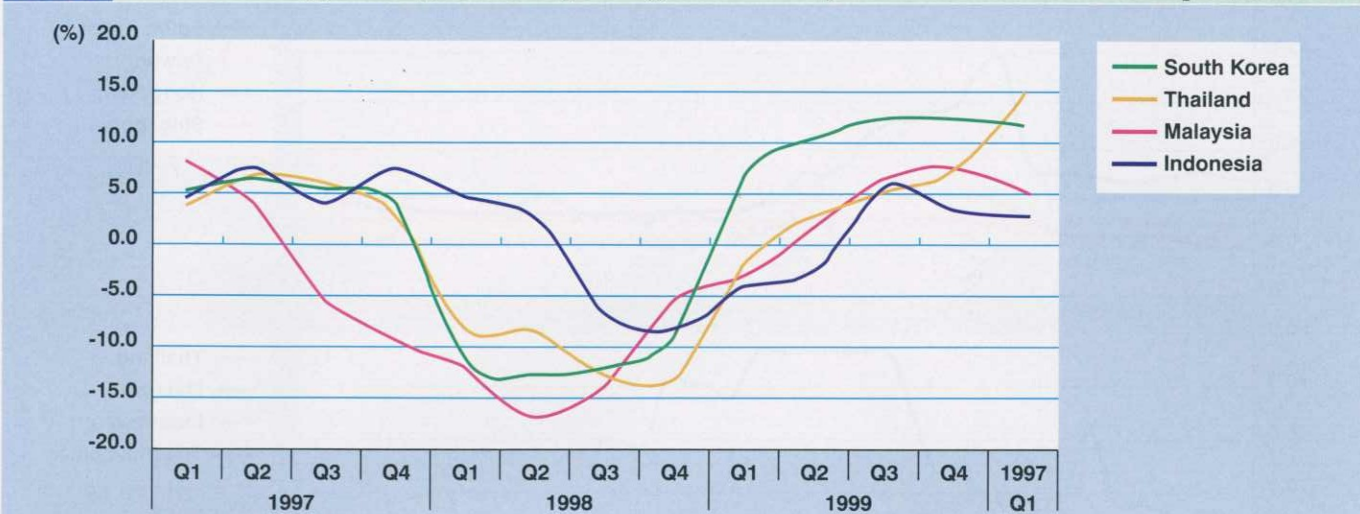
Asian countries were dissatisfied with growth rates that can be achieved only by reliance on domestic savings rates. The Asian economic crisis was caused largely by Asian countries' excessively ambitious growth strategy of seeking still higher growth with the introduction of foreign capital. The most important lesson Asian countries should take from the economic crisis in the wake of the burst of the super-high growth dream is that it is imperative for Asian countries to pursue the growth strategy that is fitted to their real capabilities.

Unreasonable Pessimistic Views

Asia has extricated itself from its severe economic crisis in only three years. This fact raises the question of whether a number of pessimistic views on Asia that were expressed following the outbreak of the crisis were reasonable.

At that time, many economists did not believe that the Asian economic crisis would be resolved if Asian

Figure 2 **Changes in year-on-year growth of private final consumption**



Source: International Monetary Fund, International Financial Statistics, Washington, D.C., Various Versions.

countries chose reasonable policy options and implemented them. They attributed the economic crisis to such pessimistic factors as structural discrepancies, outmoded political systems and the exhaustion of economic muscle. Some economists took the extremely pessimistic view that the Asian economic crisis brought into bold relief the structural discrepancies and outmoded social systems in Asia and that the crisis was caused by "crony capitalism" and the meltdown of "development dictatorship."

An economic crisis similar to the Asian one could happen anytime, anyplace in the world because each nation acts in volatile international markets in a whirl of human desire. Many researchers and journalists may believe they have looked deeply into the factors behind the Asian economic crisis and identified them as "crony capitalism" and "development dictatorship." But it cannot be concluded that they have clarified the real aspects of the Asian crisis. The Asian crisis should be interpreted along the lines of the crisis itself.

The mechanism of the Asian economic crisis can be fully clarified by employing a basic knowledge of economics. The deficit in the current account needs to be covered by the surplus in the balance of the capital account, or the introduction of foreign capital. In the 1990s, long-term foreign capital was replaced by short-term foreign capital. And Asian countries relied heavily on risky short-term foreign capital for their development. That is the main factor behind the Asian economic crisis. The crisis was not caused by structural discrepancies or outmoded social systems. This can be proven by the fact that the Asian economy has weathered the crisis in only three years.

What was the Asian Crisis?

The mechanisms of the Asian crisis proved simple. It is only natural that Asian developing countries should adopt a high-growth strategy to promote industrialization. In the process of industrialization, imports unavoidably exceed exports, thereby boosting a current account deficit. In order to spur industrialization, developing nations need to import machinery, equipment, parts and other goods as well as production technology. And it takes time for them to start exporting the goods they have manufactured with imported goods and technology.

The current account deficit is covered by foreign capital. Investor nations pinned great expectations on Asian countries, which had adopted a high-growth strategy, and made various forms of investment in Asia.

Previously, investments in Asia had been made largely in such forms as Official Development Assistance (ODA) and foreign direct investment (business presence). Added to the investment in Asia in recent years were securities investments and bank lending. International funds have begun to be managed in East Asia after having focused on the United States in the form of Treasury bond holdings and stock acquisitions. Moreover, the collapse of the bubble economy has forced Japanese banks to enhance a shift of lending to Asian countries away from domestic customers.

Meanwhile, Southeast Asian countries eased or lifted restrictions on foreign capital in the belief that they would be able to take in a massive amount of foreign capital by linking their domestic financial markets to major international markets. What is more, they have sought to maintain a currency system, in which their currencies are pegged to the U.S. dollar, so as to secure international confidence in their currencies, because such a system poses fewer risks to foreign investors. Such efforts have greatly helped Asian countries to introduce foreign capital.

Under such circumstances, the Asian monetary authorities had no choice but to buy dollars against their domestic currencies in repeated market interventions as long as they wanted to maintain the pegging system. The repeated market interventions stirred domestic inflation. To avert inflation, the Asian monetary authorities adopted a policy of high interest rates, which in turn widened the gap in interest rates between their nations and other regions. The widening of the gap spurred an inflow of short-term capital. A combination of these factors resulted in the concentration of short-term foreign funds in growth nations in Asia. And the abrupt flight of such funds from Asia brought about the Asian economic crisis. The Asian crisis brought into a bold relief the risk of dependence on short-term capital to cover the current account deficit. The crisis was triggered by the rapid outflow of short-term funds. The outflow of funds was caused by the well-known factor of the bursting of economic bubbles.

The bubbles were caused by the inflow of short-term capital in asset markets, where quick recovery of invested money is possible. Short-term funds seek quick profits on a maximum scale. Reflecting strong expectations of high profits, the inflow of short-term funds becomes active, which further spurs the inflow of funds. Thus the asset boom pops in a spiral of soaring asset prices and high profits. Investors usually become extremely spirited and believe they will be able to obtain high levels of profits forever amid the asset boom. These illusions are destined to vanish, however. Bubbles easily burst when they have reached their limits.

The collapse of economic bubbles is a common phenomenon that can be observed in any marketplace in the world because market economies are in a whirl of unleashed human desire. Such a phenomenon is not confined to Asia. It is similar to the bursting of the bubble economy in Japan. The sole difference is that economic bubbles in Asia were mainly caused by foreign capital. The flight of capital from Asia was unavoidable. It is only natural that Asian economies plunged into negative growth after enjoying strong growth on the back of foreign capital. Whatever the situation is severe, there is nothing to deny our reasonable analysis. There are no convincing reasons to attribute the Asian economic crisis to what are called Asian characteristics such as "crony capitalism" and "development dictatorship."


Photo : Mainichi Photo Bank

Asian economies have regained their strength since the currency crises - an automaker in Thailand

Asian Growth Potential

Asia should not be discussed on the same grounds as those for developing countries with low savings rates in other parts of the world. Asian countries, dissatisfied with growth rates that can be achieved only by domestic savings rates, sought an excessively ambitious super-high growth strategy. As a result, the Asian economic crisis occurred. A subsequent review of the crisis has led Asian economies to rectify the strategy and come back to a more suitable economic growth rate of around 7%. Such a trend should be highly evaluated.

It is certainly inappropriate to discuss a nation's growth potential by taking into account its domestic savings rate alone. The development of Asia has been attained by the will and capability that had been irreversibly accumulated in each society. Finally, I will discuss how this real growth potential is possible in Asia.

First, the pace of skill formation of workers in Asia is much faster than that in other developing areas. Moreover, the layer of skilled labor force that has been accumulated so far is thicker. Behind this fact lies Asia's traditional culture of putting importance on labor and savings and the "explosion of education" as one of the characteristics peculiar to Asia.

Second, the number of entrepreneurs centering on overseas Chinese merchants in Asia is much larger than those in other developing areas. They are largely family-based businesses, but some of them are strong enough to compete well with business corporations in industrialized nations.

Third, bureaucrats in Asian countries stand at the top of society and boast of high capabilities. Reflecting these factors, bureaucratic systems are more solid than those in other developing areas. Bureaucrats and bureaucratic systems in Southeast Asian countries that have once been regarded as fragile seem to have gathered strength significantly in the process of development for the last 50 years.

The fact that Asia has abundantly strong growth potential relative to other developing areas remains unchanged even after the Asian economic crisis. Obviously, Asia is superior to other developing regions in terms of production costs and potential demand. Foreign direct investment in Asia is showing signs of recovery. Foreign direct investment brings about a transition of balance of production on a global scale. Such a dynamic phenomenon should not be discussed in the context of adjustment phenomena such as the monetary and financial crises. Undoubtedly, East Asia will come back as a strong "magnetic field" for foreign direct investment. JJTI

Note: In this article, the author intends that "Asia" includes 1) Newly Industrializing Economies: South Korea, Taiwan, Hong Kong and Singapore, 2) some ASEAN countries: Thailand, Indonesia and the Philippines and 3) China.

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