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BIOGRAPHY

Reuven Glick is a Vice President at the Federal Reserve Bank of San Francisco, where he serves as Chief of the International Studies Section in the Economic Research Department and also as Director of the Bank's Center for Pacific Basin Monetary and Economic Studies.

Prior to joining the Bank staff in 1985, Dr. Glick was a professor of Economics and International Business in the Graduate School of Business at New York University. He has also taught in the Economics Department at the University of California at Berkeley, served as a consultant to the World Bank on international debt issues, and worked as an economist in the Research Department at the Federal Reserve Bank of New York. Dr. Glick received a Ph.D. degree in economics from Princeton University and a B.A. degree in economics from the University of Chicago.

He is the author of many journal articles and other professional writings. In addition, he edited ***Managing Capital Flows and Exchange Rates: Perspectives from the Pacific Basin*** (Cambridge University Press, 1998) and coedited (with Michael Hutchison) ***Exchange Rate Policy and Interdependence: Perspectives from the Pacific Basin*** (Cambridge University Press, 1994). His current research interests include Pacific Basin economic developments and international macroeconomic policy.

9/99

Prospects for East Asia Growth and Financial Reform

Statement by
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Briefing for the U.S. Trade Deficit Review Commission
November 15, 1999

Thank you very much for the opportunity to address the commission. I will begin with the standard disclaimer that the remarks I will make to you are mine alone and do not represent the views of the Federal Reserve Bank of San Francisco, nor the Federal Reserve Board, etc.

It is my understanding that you have previously received statements on the effect of the Asia financial crisis on the U.S. economy in general and the U.S. trade balance in particular. At the risk of treading over some of the same ground, let me say that the United States has enjoyed strong economic growth before the onset of the Asia crisis and has continued to do so since. But the crisis has had an impact, both real and financial.

One consequence, of course, has been a decline in U.S. net exports. The impact on net exports has come through declining income growth abroad that has reduced demand for U.S. exports. It has also come from the effect of depreciating Asian currency values that reduced U.S. exports as well as boosted U.S. imports from Asia, though trade financing constraints dampened the ability of some Asian countries to increase their exports in the early stages of the crisis.

U.S. financial markets also felt some impact. To varying degrees, U.S. financial institutions – banks, mutual funds, and other investors – suffered losses on their emerging market investments and loans. It should be noted, however, that direct U.S. bank exposure to Asia was modest on the eve of the crisis; emerging Asia loans amounted to about $24 billion and only accounted for 20 percent of all U.S. bank lending to developing countries. In contrast, Japanese banks were lending four times as much as U.S. banks (i.e., $97 billion) to emerging Asia.

My comments are divided into three parts. First, I will give a brief plug for the role of financial sector weaknesses as the main cause of the crisis in Asia, Second, I will discuss the near term outlook for Asia. Third, I will discuss the risks to this outlook, concentrating in particular on assessing the prospects for cleaning up the financial sector problems which provides the basis for a sustained long-run recovery in Asia.

Financial Sector Weakness

Many factors may have contributed to the onset and spread of the Asian crisis, but there is a consensus that a major, if not the principal, ingredient was financial fragility. While the Asian miracle was "real" in the sense that for the last 30 years East Asia has been the fastest growing region in the world, the Achilles heel of the so-called "Asian model" of development was financial sector weakness.

This weakness manifested itself in several related ways:

- Credit was often poorly allocated, contributing-to increasingly visible problems at banks and other financial institutions before the crisis hit.

- Equity and real estate prices in these countries rose substantially before the crisis, increasing the likelihood of sharp declines in asset prices.

- Much of the debt was short-term and mismatched with assets that tended to be longer-term, creating vulnerability to liquidity attacks and bank runs.

- Many financial institutions and corporations in the affected countries borrowed in foreign currencies without adequate hedging, making them vulnerable to currency depreciation.

What created these financial weaknesses?:

- Domestic financial liberalization and monetary policies allowed domestic credit to expand excessively.

- Capital account liberalization encouraged short-term borrowing abroad, while limited exchange rate flexibility led borrowers to underestimate exchange risk.

- Ineffective financial supervision and regulation allowed to go unchecked fundamental weaknesses in loan portfolios and risk management, insufficient loan-loss provisioning, violations of restrictions on related-party lending, and in some cases corruption and collusion.

Given these vulnerabilities, a crisis once it started was difficult to stop. As domestic and foreign investors rushed for the exits, a vicious circle was created: asset values fell and currencies depreciated, pushing more institutions into insolvency, further undermining creditors' prospects of repayment, and accelerating the fall in asset prices and outflow of capital. While some may argue that the loss of domestic as well as foreign confidence that struck Asian asset and currency markets was unexpected and excessive, it was not irrational, given the state of financial and corporate practices in the affected countries.

To apply a metaphor, the weaknesses of Asian financial systems can be thought of equivalent to an insect infestation that over time weakens the roots of a tall, outwardly healthy redwood tree (redwoods have shallow root systems). The tree may look fine for a long time, even as it becomes increasingly vulnerable to being uprooted and blown over by a succession of storms. It may in fact survive many windstorms, but at some point in time a windstorm will come along, maybe even a relatively weak storm, which will be sufficient to blow the tree down.

Outlook for **East Asia**

With that background, what is the near-term economic outlook for East Asia? More than two years after the collapse of the Thai baht set off the East Asia crisis in 1997, the economies throughout the region are at last showing signs of recovery. This is evidenced by the stabilization of currency values, rising equity prices, and incipient positive real output growth.

- The dollar value of currencies in the region are rebounding from their crisis period lows, though they are well below their pre-crisis levels (see figure 1, where note that a decrease denotes a depreciation of the local currency against the dollar).

- Stock prices also have turned up across the region, and are well above their crisis-induced low points (see figure 2). In Korea and Singapore, stock prices are now above where they were before the crisis.

- Real output is expanding, albeit at varying rates, in virtually all of the region's economies (see figure 3). Growth in Korea is projected to top 8% in 1999, (measured on a year over year basis), then ease back to 6% in 2000; as recently as 6 months ago only 2% growth was forecast. The economies of Thailand and Malaysia are also turning around quickly, with growth estimated to be roughly 4% in 1999. At the other extreme, Indonesia, which sustained a 20% drop in output in 1998, is now expected to record slightly positive growth.

Thus, contrary to expectations at the end of last year, Asia appears to be experiencing a "V-shaped" recovery – that is a very deep, very severe recession, followed by a rapid rebound. Some of the output recovery is driven by rising export volumes, especially in countries whose currencies depreciated sharply. Additional stimulus has come from increasingly stimulatory domestic fiscal policies as well as the robust U.S. economy. The sharp rebound may also reflect the financial aspect of the crisis. To the extent that the crisis was financial in nature and a loss in investor confidence magnified the severity of the crisis, once conditions stabilized, restored confidence can almost as quickly raise asset values and boost economic activity.

This leads to the question of whether the recent upturn implies a full recovery. Here there is real cause for concern. The short-term and medium-term situation is still quite fragile and depends on external events and domestic policies. Much is still to be done to ensure that the recovery is sustained and the region is less vulnerable to disruptions in the future.

Role of Japan and China

The outlook for the emerging markets in East Asia depends at least in part on what happens in Japan and China.

There are incipient signs of growth in Japan, where we have now seen two quarters of positive GDP growth in 1999, in part attributable to considerable fiscal stimulus since late 1998. Growth in the first quarter was a very strong at 8%, while growth in the second quarter was a better than expected 0.9% (quarter over quarter, seasonally adjusted annual rate).

Though a Japanese recovery now seems underway? the 1999 forecast is still only for growth of 0.9% (year over year), and there are risks that the recovery could be knocked off course. A substantial appreciation of the yen from recent levels might undermine business and consumer confidence. Lingering weakness in the financial sector and the adverse effects of corporate restructuring on consumer demand may also dampen growth.

In China, which has been largely insulated from the crisis so far, growth is expected to slow from 7.8% in 1998 to a still high 7.2% in 1999. Given uncertainty about Chinese statistics and the continuing fragility of the financial sector, there is some downside risk to this forecast. If China were to have a crisis of its own, with a sharp devaluation of its currency, confidence in the rest of Asia might falter.

Cleanup and Reform of the Financial Sector

Continuation of the recovery as well as reduction of the long-run vulnerability of the region to future crises also depends on structural reform of the financial sector.

The structural reform needed in the financial sector has two strands. The first is to clear up the fallout from the crisis – close unviable institutions and strengthen potentially viable ones. The second is to put the system on a sound footing – most importantly by improving supervision and regulation – to minimize the likelihood that problems would recur.

The magnitude of the task of cleaning up and repairing the financial sector is enormous. Figure 4 reports estimates of nonperforming loan rates across Asia. In Indonesia and Thailand roughly 50% of loans are regarded as nonperforming. It is clear that sizable public sector funds raised either through taxation or government-backed bond issues will be needed in the crisis countries to recapitalize banks and provide guarantees to depositors. Official estimates of the costs of financial sector restructuring range from 15% of GDP in Korea to 41% in Thailand and 45% in Indonesia.

But recapitalizing banks and buying up bad loans alone will not cure the underlying problems of Asia's financial sectors. Improving regulation and supervision and making banks operate more professionally and reliably are also important. The economic crisis in Asia exposed major weaknesses not just in the balance sheets and operations of the region's financial institutions but also in the supervisory and regulatory regimes under which they functioned. Improving regulatory frameworks is therefore a key element in the reform process. In this respect, the authority and independence of supervisory authorities needs to be strengthened. Prudential regulations, including minimum capital adequacy ratios, rules for classifying and provisioning against non-performing loans, and exposure limits, must be improved in terms of their stringency, coverage, and enforcement.

Some progress has been made in this area, although it is still too early to judge ultimate success.

- In Korea, the government has bought a large chunk of the bad loans and forced many banks to merge or close. In addition, the Financial Supervisory Commission (FSC) was established in 1998 to take full responsibility for the supervision, restructuring and (more recently) licensing of all bank and non-bank financial institutions. However, while the merger of smaller, weaker banks into larger banks gives the appearance of a stronger financial sector, it does not necessarily create a stronger institutional culture for future lending and credit discipline. Morever, disposal of problem assets acquired by the government has been slow, in part because of concerns about the effect on investment trusts which hold a significant amount of these assets.

- In Thailand, the government has taken a less pro-active role after the initial closure of many finance companies, instead leaving it more to the private sector to sort out the problems. As a result, the non-performing loan rate on bank books still remains high. Because of lags in debt restructuring deals, the Bank of Thailand has stepped in to facilitate the process, though still without the use of public funds. In addition, a string of negative news revelations, including the under-reporting of bad loans in the country's second largest bank, have dampened investor confidence.

- Malaysia only started to set up bank restructuring agencies in the middle of 1998. Its approach largely follows the Korean model and it has made progress in getting bad debts of bank books. It has encouraged consolidation in the financial system through forced mergers into as few as six anchor groups. However, the government is also trying to boost bank lending by setting loan growth targets, risking the possibility of a new round of misallocated lending.

- Indonesia also has taken a more hands-on approach, and roughly three fourths of its banking system is now in the hands of the Indonesian Bank Restructuring Agency (IBRA). While necessary in the short run to prevent the collapse of the banking system, this is neither desirable nor healthy for the long-run development of a sound and efficient banking system. Indonesia is seriously handicapped, however, by the government's limited fiscal revenues and by political uncertainties. For example, it was recently revealed that Bank Bali made a $80 million payment to officials of the ruling party. Well-connected borrowers and their lenders still appear to have power to protect their interests.

Corporate Restructuring

Corporate restructuring is intimately linked with financial sector restructuring. But in contrast to progress in the financial sector, corporate restructuring is at a relatively early stage in most countries. Reform efforts to date have focused on improving legal and institutional frameworks for financial and operational restructuring, particularly through bankruptcy procedures. The absence of adequate bankruptcy laws and procedures has in many cases meant there was no established mechanism for allocating the burden of excessive debt burdens among the borrowers and lenders. To be sure, many countries have bankruptcy laws on the books or have strengthened their bankruptcy regimes since the crisis broke out, in part through measures to increase the independence of courts. However, the ultimate effectiveness of these changes in unclear.

- In Korea, for example, almost a thousand companies, generally small firms and lower tier chaebols, filed for bankruptcy in 1998, a tenfold increase from before the crisis. But the bankruptcy law does not require appointment of new managers to restructure or liquidate assets. In fact, most firms in bankruptcy can carry on business as usual, with original managers in place, able to reschedule existing debt service and even to engage in new borrowing. In other cases, limited restructuring has occurred through voluntary debt workouts with bank creditors. Under these plans, banks agree to provide relief in the form debt rescheduling in return for promises to reduce assets, cut debt, and streamline operations. For the top five chaebol, however, reform has been less visible. While on average they have reduced their debt-equity ratios from more than 400 percent in 1997 to 300 percent in mid-1999, they have actually increased their borrowing since the onset of the financial crisis. However, following the emergence of severe difficulties at Daewoo, Korea's second largest conglomerate, pressure for reform of the largest chaebol has begun to accelerate.

- In Thailand, the pace of corporate restructuring has increased in recent months, particularly through voluntary workouts facilitated by the Corporate Debt Restructuring Committee (CDRAC). Nevertheless, concerns exist about willingness of banks to take necessary restructuring losses and of firms to dispose of unprofitable businesses. It is generally presumed that the most viable firms are being restructured first. However, many banks are merely lowering repayment terms and extending payment deadlines in hopes that firms will return to profitability as the economy recovers. Over time, restructuring cases will require deeper creditor write-downs and operational restructuring and will be more difficult to negotiate.

- In Malaysia, corporate reform is being carried out through voluntary debt restructuring arrangements, actions by the national asset management corporation (Danaharta), and by bankruptcy reorganizations. Thus far, most restructuring has been primarily through rescheduling of debt. The challenge of operational restructuring – reallocating capital, selling assets, and changing management – still remains. Morever, it remains to be seen how much restructuring will occur in corporations which have benefitted previously from preferential government policies.

- In Indonesia, corporate restructuring has moved particularly slowly. As the largest holder of corporate debt, the IBRA holds the key to progress. Slow progress has been in part deliberate, as there was a decision made to not have the government actively involved in restructuring firms which had close links in many cases to political and government officials. Presumably progress will go faster once the IBRA pushes ahead with asset sales and the economy starts to recover.

Strengthening Financial Intermediation

While the immediate task in the crisis countries is to restore the health of the banking system and restructure private corporations, there is also a longer-term need to strengthen financial intermediation by expanding non-bank channels of finance. The availability of more long-term financing through securities markets, particularly bond markets, would reduce the mismatch between the short maturity of financing for long-term investment projects. The development of bond markets would also reduce the concentration of financial risk in the banking system and allow the dispersion of risk across savers. This dispersion would reduce systemic risk and enhance the ability of the financial system to cope with shocks.

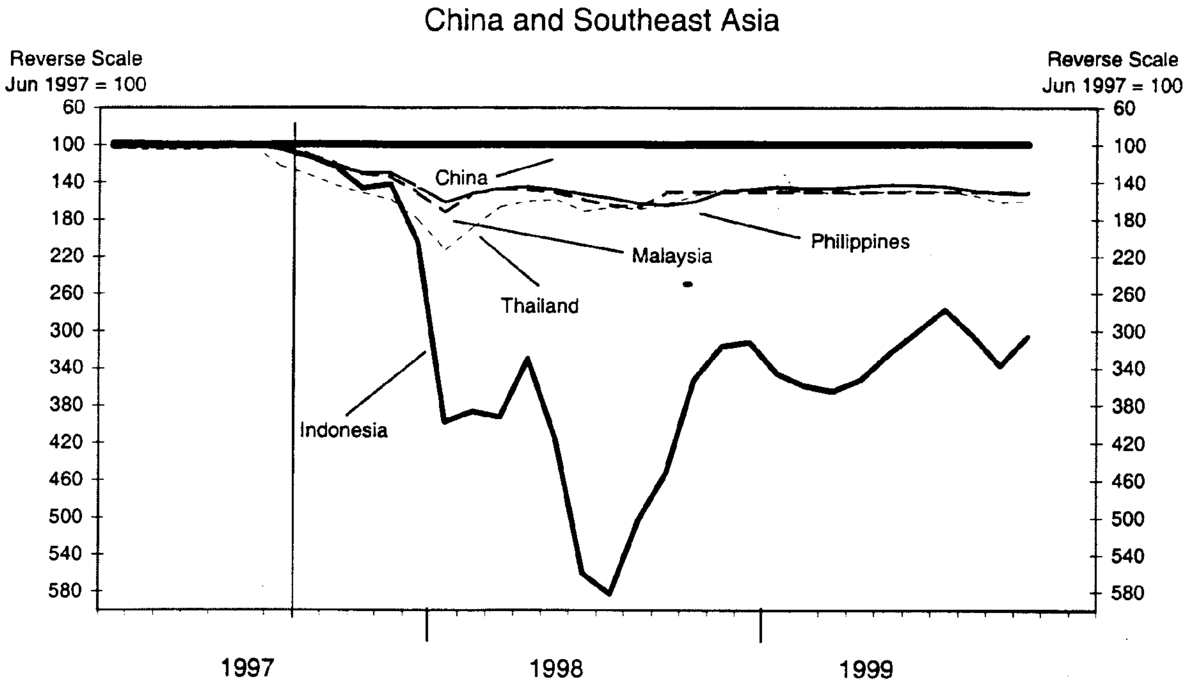
There is considerable potential for the development of East Asian bond markets, as East Asian bond markets appear fairly underdeveloped even compared with bond markets in emerging markets in other regions. This will require action on a number of fronts. The development of a stronger institutional investor base, for instance through the establishment of pension funds could play a key role. The removal of restrictions on foreign investment in these markets would be equally important. The upgrading of market infrastructure – rating agencies, trading rules, clearing and settlements systems, disclosure requirements and other regulations – will also be necessary.

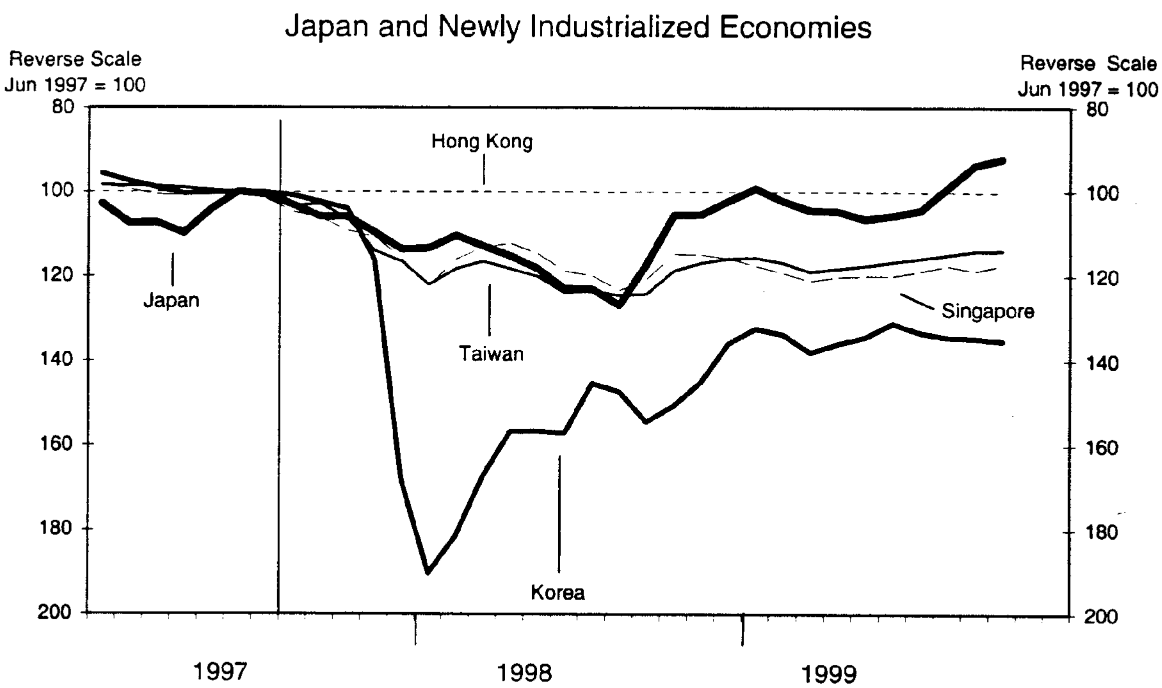
Conclusion

To conclude, East Asia is achieving a rapid recovery from the financial crises of 1997-1998. However, the adoption of financial and corporate structural reforms is essential to ensure a lasting recovery and make economies in the region less vulnerable to future crises.

Full implementation of the needed reforms is by no means certain. Clearly structural reforms take time to legislate and to implement. In most of Asia, the slow rebuilding of financial systems proceeds against a backdrop of political infighting among competing interest groups over who is to blame for the crisis and who should pay. Of particular concern is that the current favorable economic upturn could actually weaken support for the reform agenda and leave poor banking and corporate sector practices at the root of the crisis in place. This in turn could shake the fragile confidence that markets have in the region and dampen Asia's long-term prospect.

FIGURE 1. U.S. BILATERAL EXCHANGE RATES (NC/US $)

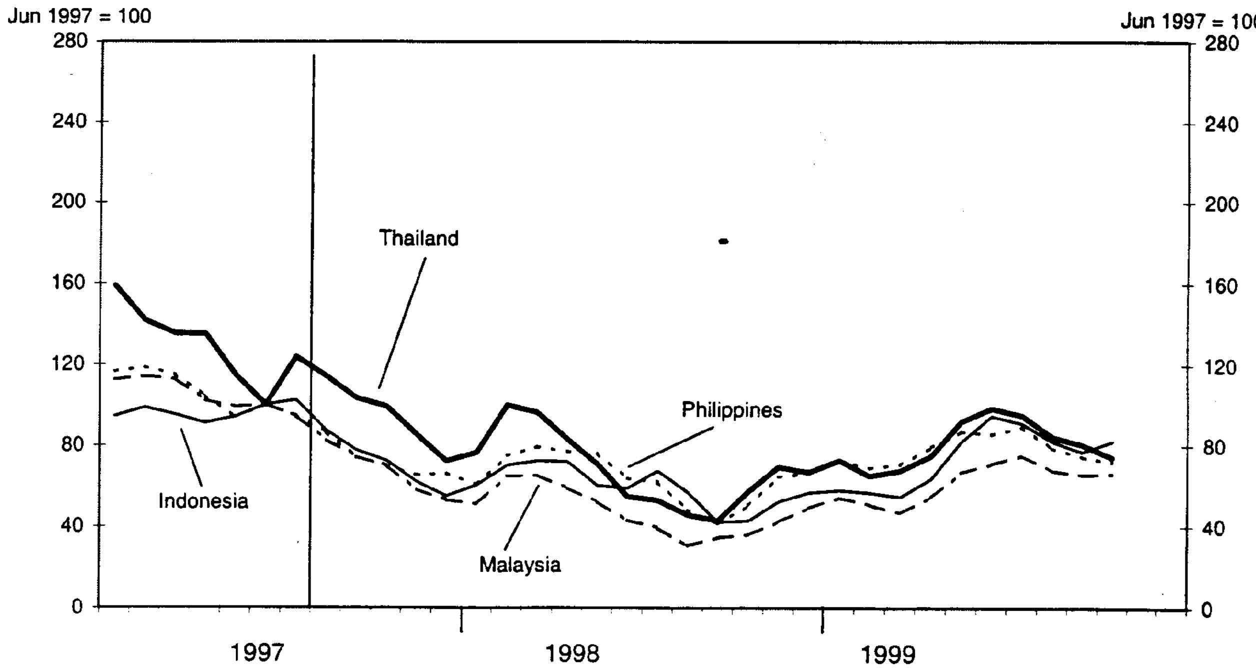




Note: A decline indicates a depreciation of the national currency against the US $.

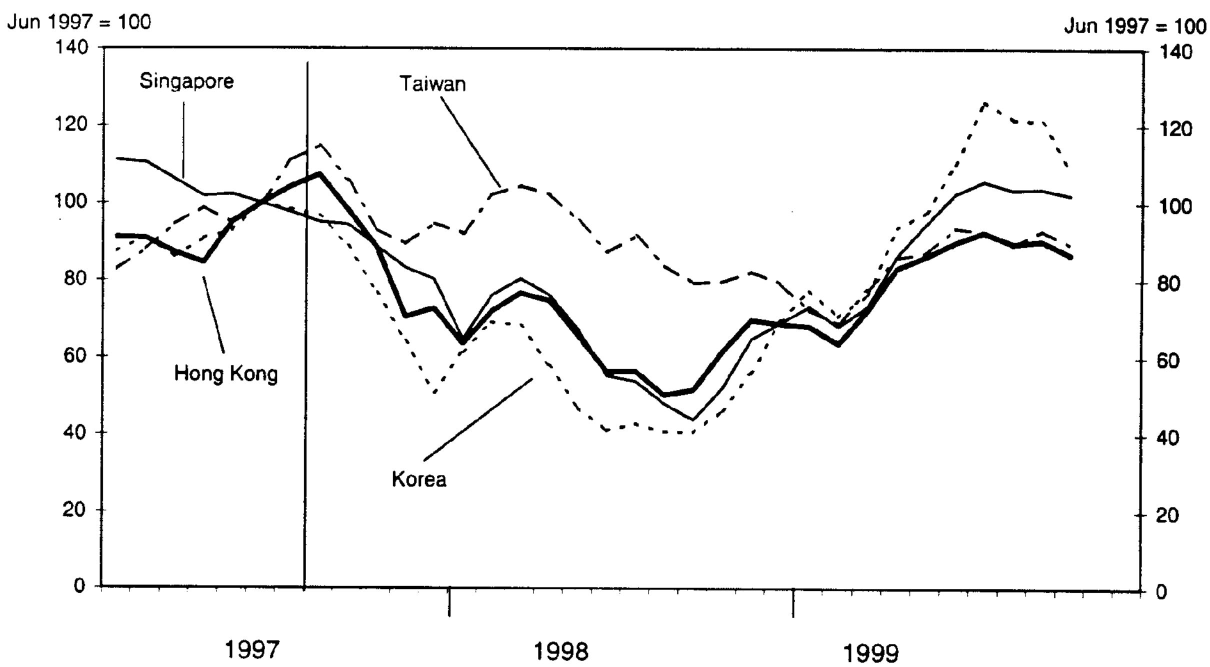
FIGURE 2. STOCK PRICES (In Local Currency)

Southeast Asia



Indexes: Thailand: SET; Philippines: Manila Composite; Malaysia: KL Composite; Indonesia: JKSE

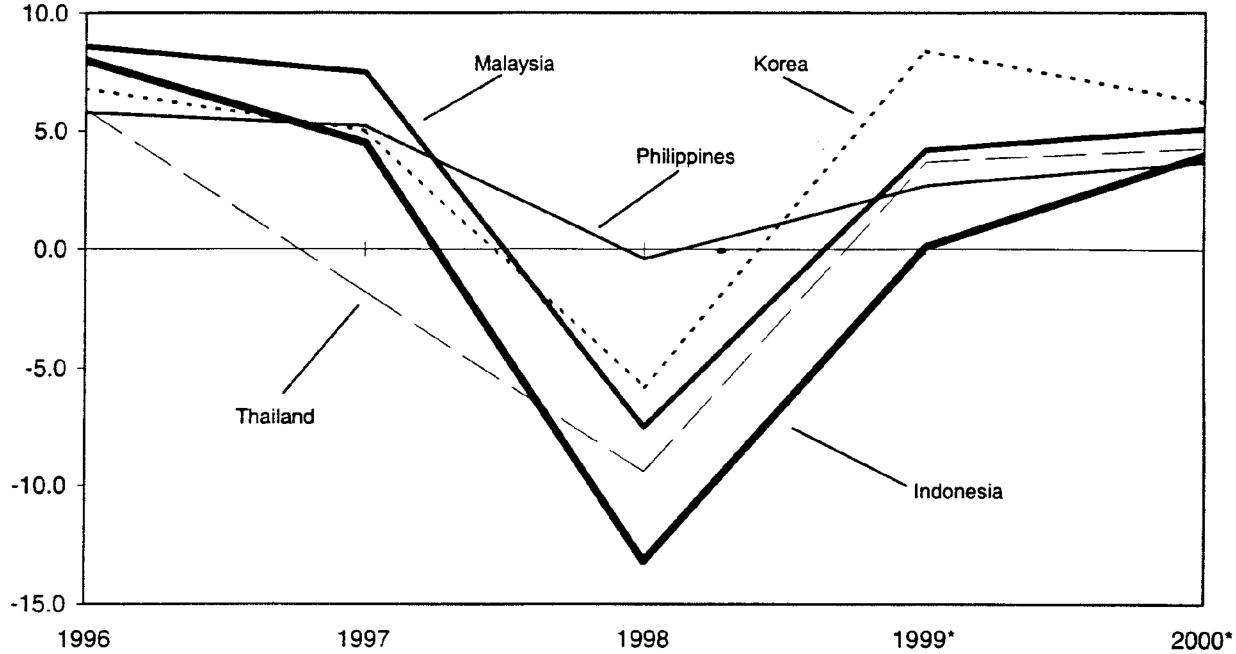
Newly Industrialized Economies



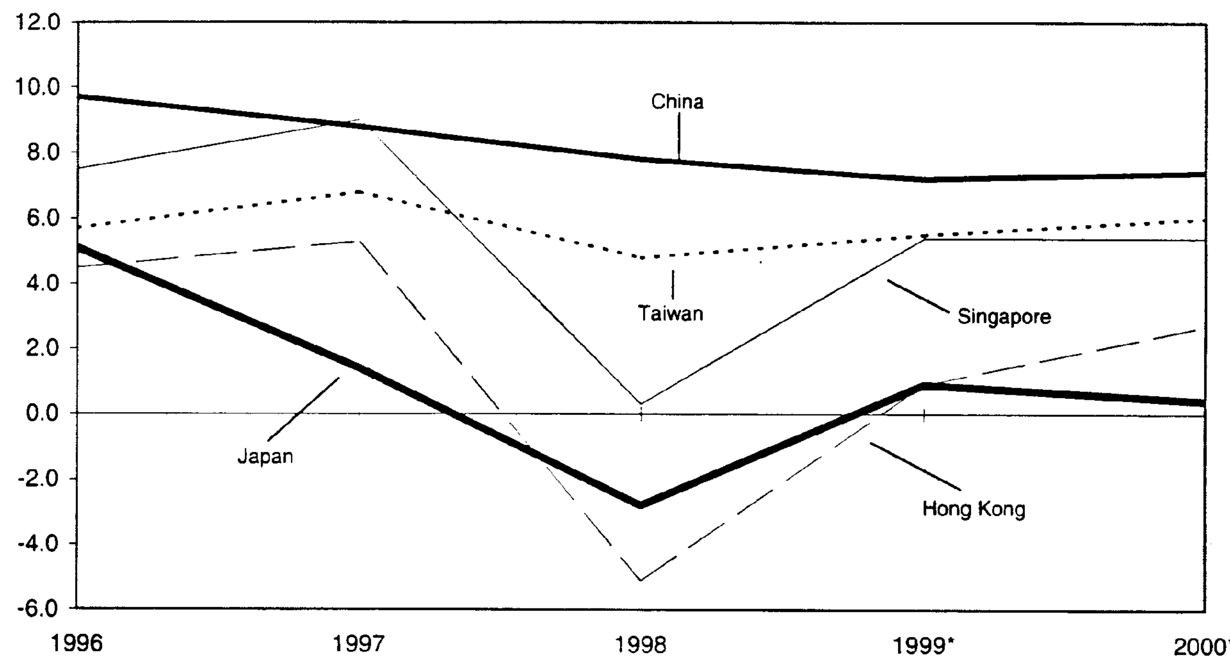
Indexes: Singapore: Strait Times; Taiwan: Weighted Index; Hong Kong: Hang Seng; Korea: Korea Composite

FIGURE 3. REAL GDP GROWTH (Percent, Year On Year)

Korea and Southeast Asia



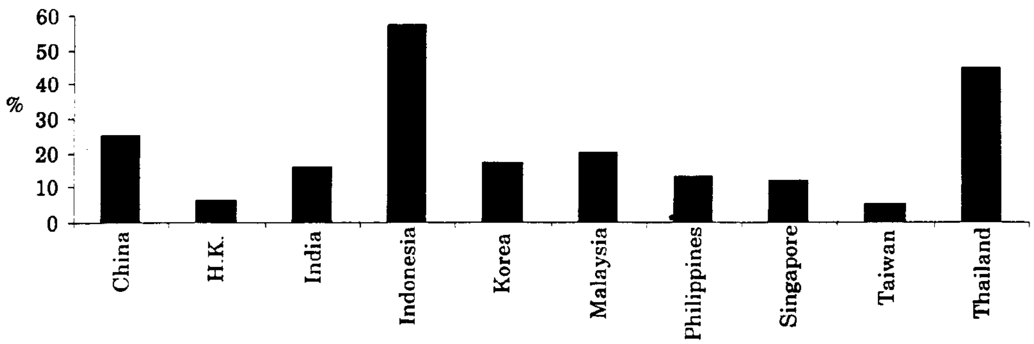
Japan, China, and Other Newly Industrialized Economies



* Denotes Forecast

Source: Consensus Forecast (October 1999)

Figure 4. Comparative Non-Performing Loan Ratios across Asia



Source: Fitch IBCA, April 1999

Data as end-1998 (as published, with some estimates)