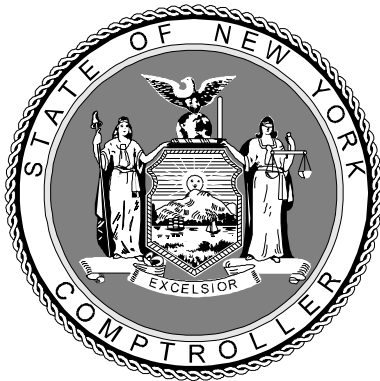


The East Asian Economic Crisis:

A Background Report on the Implications for New York City

April 27, 1998



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TABLE OF CONTENTS

EXECUTIVE SUMMARY	1
INTRODUCTION	5
I. WHAT CAUSED THE CRISIS?	7
A. Chronology of Key Events	7
B. Causes	11
II. WHAT IS THE IMPACT?	17
A. Financial Reforms in East Asian Countries	17
B. Economic Impacts in East Asia	18
C. Financial and Economic Impacts in the U.S. and Europe	20
D. Impact on New York	23
E. What Affects How the Crisis Continues to Evolve?	26
III. WHAT NEEDS TO HAPPEN TO MINIMIZE THE POTENTIAL FOR ANOTHER CRISIS?	31
A. Did the IMF Exacerbate the Crisis?	31
B. Global Reform Initiatives	32
C. What Are the Limits to Export-Led Development?	35
CONCLUDING THOUGHTS	37
BIBLIOGRAPHY	38

EXECUTIVE SUMMARY

The East Asian financial and economic crisis is a forceful reminder that the increasingly global economic and financial system is subject to sudden disturbances that can reverberate rapidly around the world. The East Asian countries most affected — South Korea, Indonesia and Thailand — had long been among the group of Asian newly industrializing countries that were envied around the world for rapid growth sustained over several years. Now, however, despite some recent signs of stability, their currencies are still down by 35-70 percent since last July, and credit-starved productive business sectors struggle to resume normal operations. While the affected countries are far from homogeneous, recessionary conditions prevail in each with business failures and unemployment on the rise, along with the potential for greater political instability. At this stage, it is far from clear whether these economies are firmly on the road to recovery.

While the global repercussions could not be termed monumental, neither are they inconsequential. South Korea is the world's 11th largest economy and Indonesia is the fourth most populous nation in the world. The Asian crisis is expected to reduce world economic output by one percent this year. For New York City and New York State, the economic and fiscal implications of the ongoing crisis are visible through the effects on foreign trade and the pace of U.S. growth, but most importantly, through the consequences for the global financial system. Given the City's increasing dependence on Wall Street for fiscal and economic stimulus, and the growing importance of international financial developments in shaping Wall Street, it is important to understand the background to the Asian crisis and how it is evolving. This need is heightened by the recent deterioration in the Japanese economy since Japanese economic growth is essential to the recovery of the crisis countries. Should the Asian financial and economic crisis intensify, an impact of some magnitude will be felt by U.S. financial markets, and the effect on Wall Street will in turn reverberate through to the City's fiscal fortunes.

What Caused the Crisis?

The current crisis resulted from weak financial oversight, sizable short-term international capital inflows to the private sector, untenable attempts to maintain

dollar-pegged domestic currencies, and a slowdown in growth resulting from overvalued currencies and increased competition from China's expanded productive capacity.

Exuberant growth conditions in the East Asian crisis countries in the 1990s fueled some investment decisions which could be characterized as the product of "crony capitalism". Structural features of the "Asian model" of development, particularly its reliance on high debt-to-equity ratios for both banks and non-financial businesses and the importance of overlapping ownership between banks and vast industrial empires, help account for the severe manner in which disturbances in the financial sector rapidly destabilized production of goods and services. The dependence within these economies on export-led growth at the expense of a sound foundation for domestic consumption and investment heightened the vulnerability to destabilizing currency fluctuations.

When events triggered the inevitable correction in currency markets, the response by government and international officials compounded the problem, and panic-stricken foreign investors pulled out. Investor panic quickly spread to most other Asian economies as well as various emerging markets. Japan's economic paralysis, which played a role in setting the stage for the crisis, has complicated its resolution.

What is the Impact?

In response to the currency crisis, the International Monetary Fund (IMF) has reached financial assistance agreements with Indonesia, Thailand and South Korea to stabilize exchange rates and restore confidence in their financial systems. As a result, these countries have maintained high short-term interest rates to attract foreign capital and have agreed to restructure their banking systems and other fundamental economic institutions. The aggregate size of the IMF bailouts in East Asia — over \$110 billion — far exceeds previous IMF efforts.

While financial markets have stabilized in South Korea and Thailand, and the turbulence in Indonesia should moderate if the most recent IMF agreement is implemented, the adverse impacts on the real economy continue and are expected to be substantial over the next few years. Economies that had been

growing in the high single digits for several years are expected to contract significantly in 1998. The IMF projects that domestic demand will drop by over 20 percent during 1997-1998. The International Labour Organization recently warned about the social implications of sharply higher unemployment in societies without social safety nets.

Western industrial countries are expected to see only about a half percent reduction in growth as a result of the Asian crisis. In the U.S., the Asian-related drag on corporate profits has been offset by lower interest rates as the Federal Reserve has been deterred for the time being from raising interest rates in order to prevent the dollar from rising further, a development that would exacerbate the Asian crisis.

While U.S. exports have already been lowered, the major economic impact will be felt down the road when the affected Asian countries attempt to export their way out of the crisis. The U.S. is expected to absorb the bulk of increased Asian exports, particularly since the Japanese economy is now mired in recession. Overall, the adverse trade effects in the U.S. are likely to outweigh the positive impacts on prices and interest rates. As a result, most gross domestic product (GDP) forecasts have been revised downward for 1998 and even more so for 1999.

The economies of New York City and New York State should fare better than the nation's. Several financial institutions based in New York are well-positioned to benefit from the greater liberalization of international financial markets that is a key condition of the IMF bailout agreements. Exports of professional services from New York, such as legal and consulting services, may also rise as trade barriers come down. On the other hand, the apparel industry, the City's leading manufacturing sector, is very import-sensitive and could be adversely affected, further jeopardizing blue-collar employment opportunities.

For the Asian countries affected, economic recovery prospects are shaped by developments in Japan, China and the Western industrial countries. Japan, as the biggest source of demand and capital for the East Asian region, could play a pivotal role in the recovery if it could get its own economic house in order, stimulating growth and increasing the absorption of exports from its Asian neighbors. The dramatic rise in China's productive capacity and its 1994

currency devaluation undercut the export competitiveness of the crisis countries, particularly Thailand and Indonesia, and was one of the contributing causes of the Asian crisis. The U.S. and Europe, along with Japan, are likely to continue to be the major source of short- and long-term foreign investment for the East Asian region, and macroeconomic and monetary conditions within these countries substantially shape the strength of demand for crisis country exports.

What Needs to Happen to Minimize the Potential for Another Crisis?

The IMF's role in the rescue operation has been criticized for prescribing a fiscal austerity remedy more suited to situations where government policy resulted in rising inflation and bloated public spending. In contrast, the Asian problem is rooted largely in private, not public, borrowing. Some critics argue that financial deregulation imposed by the West contributed to the problem. Few critics, however, see a workable alternative to the IMF's insistence on high interest rates to support a weakened currency.

Led by Treasury Secretary Rubin and Federal Reserve Chairman Greenspan, there is a growing chorus of voices calling for reforming the global financial system. In advocating reform, Secretary Rubin articulates three key objectives:

- ! improving transparency and disclosure;
- ! strengthening emerging market financial regulation; and
- ! ensuring that private lenders bear some of the adjustment burden.

President Clinton's request for \$18 billion for the IMF has met with considerable Congressional resistance, from both the left and the right. While the Senate has given its approval, the measure is stalled in the House.

Many observers argue that the need for re-thinking international financial and economic relationships should extend to the export-led development model. This viewpoint stresses that the simultaneous pursuit by several countries of export-oriented growth inherently leads to situations of excess capacity, intensifying pressure on wages and living standards, as well as increasing vulnerability to potentially destabilizing currency fluctuations.

INTRODUCTION

The crisis that has engulfed several East Asian countries, whose dynamic and rapidly growing economies had long been the envy of many less developed nations, is a forceful reminder that the increasingly global economic and financial system brings with it the potential for sudden disturbances that can reverberate rapidly around the world. The crisis, and the fact that so few saw it coming, also underscores the need for new thinking on reforming the global financial system to more effectively contain destabilizing developments. The globalization of financial markets has far outpaced the capacity of national governments and our multilateral institutions to effectively monitor and efficiently regulate.

The economic and fiscal implications for New York are shaped principally by the consequences of the crisis for the global financial system and the effects on foreign trade and the pace of U.S. growth. Since several New York-based financial institutions are major international players, their performance, and state and city revenues, are affected by the continuing fallout from the East Asian crisis.

As a monitor of New York City's fiscal condition, the Office of the State Deputy Comptroller (OSDC) is particularly mindful of the City's growing reliance in the 1990s on New York-based financial institutions for fiscal and economic stimulus. Although Wall Street represents just 4.5 percent of New York City employment, the industry now accounts for 17 percent of total wages paid in the City, up from less than 11 percent ten years ago. While the City's heavy economic and fiscal dependence on Wall Street has proved a positive given the strong market performance since 1995, the City's fiscal health remains vulnerable to a less favorable environment in the financial markets. Should the Asian financial and economic crisis intensify in some manner, New York City's fiscal fortunes could also be affected. This report has been prepared as part of our ongoing effort to better comprehend developments that shape New York City's fiscal outlook.

This report provides background on three issues:

- ! What caused the crisis?
- ! What is its impact (in East Asia and on the New York, the U.S. and

the global economies)?

- ! What needs to happen to enhance the functioning of the global financial system?

This background report is based on a review of the extensive reporting and business, financial, and economics commentary on the Asian crisis over the nine-month period since July 1997. The International Monetary Fund (IMF) agreements with the crisis countries as well as reports and statements by the IMF and U.S. Treasury officials were utilized, and economic and financial data from official or otherwise authoritative sources were analyzed in the preparation of this report. In citing sources in the text, our convention was to footnote critical statistics and issues subject to interpretation. Summaries of events and widely-accepted facts presented in this report are typically based on news reporting and are not referenced in the text. Newspapers generally relied upon in our research included *The Economist*, *Financial Times*, *New York Times*, and *Wall Street Journal*. As with all O.S.D.C. reports, we have tried to make this review accessible to a more general audience by providing explanations of technical terms.

I. WHAT CAUSED THE CRISIS?

A. Chronology of Key Events

Roots of the Crisis: 1994-97

In many respects, the antecedent to today's East Asian crisis was the 1994 Mexican currency crisis. U.S. financial interests that had made substantial short-term investments in Mexico in the early 1990s were caught off guard when the peso was sharply devalued and investor panic spread through Latin American emerging markets. The U.S. Treasury responded with a sizable bailout package in 1995, which was hailed as a success at the time, but is now criticized for allowing Western banks to downplay potential risk from aggressive short-term international lending.¹

For several years up to and through the mid-1990s, the three East Asian countries now in crisis — South Korea, Indonesia, and Thailand — had relatively sound economic fundamentals: high savings; emphasis on education and skill development; currencies pegged or nearly pegged to the U.S. dollar; low inflation; and balanced or nearly balanced government budgets. They had achieved impressive GDP growth rates of 7 to 8 percent annually for several years (see Figure 1). Attracted by these conditions and higher rates of return than were available in their home countries, investors from the U.S., Western Europe, and Japan poured capital into the region in the form of both bank loans and equity investments. The magnitude of the foreign capital inflows helped fuel a surge in domestic asset prices, particularly real estate prices.

But since these rapidly growing economies were heavily export-dependent, they were undone by a dramatic loss of their export competitiveness in the wake of China dramatically expanding its productive capacity and devaluing the *yuan* by 35 percent in 1994, and by the sharp rise in the value of the U.S. dollar against which their currencies were pegged. Between April of 1995 and April of 1997,

¹ In any event, the Mexican bailout can be considered a success only in a partial sense. It was effective in restoring investor confidence within a relatively short period of time; however, Mexico's economic adjustment involved considerable labor displacement and a substantial decline in real wages.

the dollar rose 60 percent relative to the Japanese *yen*, leaving the export-oriented East Asian nations with currencies that were seriously overvalued. Domestic growth faltered as a result.

Figure 1
Growth Rates of Selected Asian Economies

	Per Capita GDP 1996*	GDP Growth	
		Annual Average Percent Change 1970-1996	Forecast 1998**
Crisis Countries			
Indonesia	\$ 4,280	6.8%	-5.2%
South Korea	12,410	8.4	-2.5
Thailand	8,370	7.5	-4.0
Other Asian Countries			
China	3,120	9.1	6.3
Hong Kong	25,400	7.5	1.8
Malaysia	9,703	7.4	1.6
Philippines	3,060	3.6	1.9
Singapore	25,650	8.2	2.7
Taiwan	17,720	8.3	5.0
Industrial Countries	22,700	2.7	2.6

* At purchasing-power parity

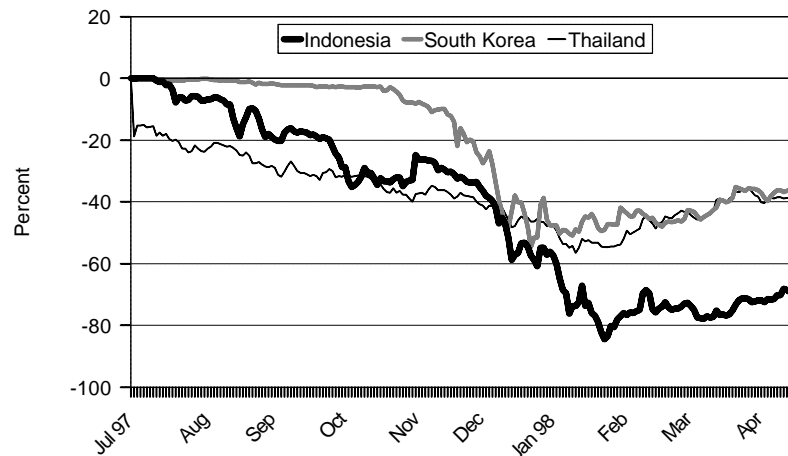
** The latest IMF (April 1998) forecasts for GDP are Indonesia -5.0%; South Korea -0.8%; and Thailand -3.1%.

Data Sources: "East Asian Economies Survey," *The Economist*, March 7, 1998, 5.

The Bubble Bursts and Contagion Spreads

Last summer, Thailand was the first nation to see the asset price “bubble” burst. Its external competitiveness eroded, Thailand’s mounting current account² deficit made its exchange rate peg to the dollar less and less sustainable, as the speculative attacks on the *baht*, begun in 1996, were renewed. International and domestic investors alike took short positions against the baht, exerting strong downward pressure on the currency. On July 2, 1997, Thailand abandoned its peg to the dollar, allowing the *baht* to float. On July 11, the Philippines allowed its *peso*, which was experiencing strong downward pressure, to float. The contagion soon struck Malaysia, and on August 21, Indonesia acted to allow the *rupiah* to float. In the absence of effective steps to counter the currency pressure, international commercial and investment banks, along with domestic investors seeking to limit their foreign currency exposure, withdrew support for these currencies. Between early July and mid-October, the currencies of Thailand and Indonesia had fallen 30 percent relative to the dollar (see Figure 2).

Figure 2
Depreciation of Asian Currencies
Against the U.S.\$ Since July 1997



Data Source: J.P. Morgan & Co.

² A nation’s Current Account is the difference between income derived from the export sale of goods and service, plus royalties and interest income, and the value of imports.

Spillover effects were now being felt in other parts of Asia as exchange market pressures intensified in Hong Kong, Taiwan, and South Korea. Weakness in Asia and a steep drop in the Hong Kong stock market precipitated the 7 percent drop in U.S. equity markets on October 27. With that sell-off, international markets entered a period of extreme volatility. Downward pressure on the South Korean *won*, together with diminishing investor confidence about corporate leverage and difficulties for the financial sector in rolling over external loans, undercut the South Korean government's attempts to support its currency, leading it to request IMF³ assistance on November 20. In November and December, the *won* lost over 40 percent of its value.

The regional crisis exacerbated long-standing problems in the Japanese banking sector, and on November 24, Japan's fourth-largest brokerage failed, sparking a further sell-off in Asian stock markets. In this period, the affected Asian countries experienced equity market declines, the withdrawal of international capital, and severe credit tightening that soon began to jeopardize all economic activities. Emerging market countries in general were also affected as the contagion spread, with Brazil and other Latin American countries hit with particular force.

Financial Restructuring Begins

On November 25, Thailand signed a letter of agreement with the IMF, outlining the fiscal and economic stabilization policies it must pursue in exchange for \$17.2 billion in international support. Seeking \$57 billion in aid, South Korea followed suit on December 24, and Indonesia signed on January 15, 1998, in order to receive \$40 billion in bailout assistance. In keeping with its stabilization measures, in late January, in an agreement with U.S., European and Japanese banks, South Korea restructured \$24 billion in short-term debt owed by its banks.

³ The International Monetary Fund was established at the 1944 Bretton Woods conference to promote international monetary cooperation; to facilitate the expansion and balanced growth of international trade; to promote exchange rate stability; and to make its general resources temporarily available to member countries through credits and loans. There are 182 member countries at present.

Recently, China pledged that it will not “add fuel to the flames” of the Asian crisis by devaluing its currency again. President Clinton, citing U.S. economic and national security interests, has urged Congress to provide the IMF with additional resources.⁴

These and other developments have led to a partial rebound of Asian stock markets this year after reaching lows around the end of 1997 that were roughly 50 percent below July levels. After recording sharp gains in the last half of January this year, stock markets in the affected countries have fallen back as economic conditions deteriorated. As of April 21, Indonesia’s stock market was still down by one-third compared to its peak last July, while South Korea’s market was 44 percent below last July’s peak. For Thailand’s stock market, as of April 21, trading levels were half last year’s peak which occurred in January.⁵

B. Causes

There is considerable consensus on many points regarding the underlying causes of the East Asian crisis.⁶ Despite considerable differences in their economies and political systems, South Korea, Indonesia and Thailand share many features in their economic make-up that are useful to keep in mind in

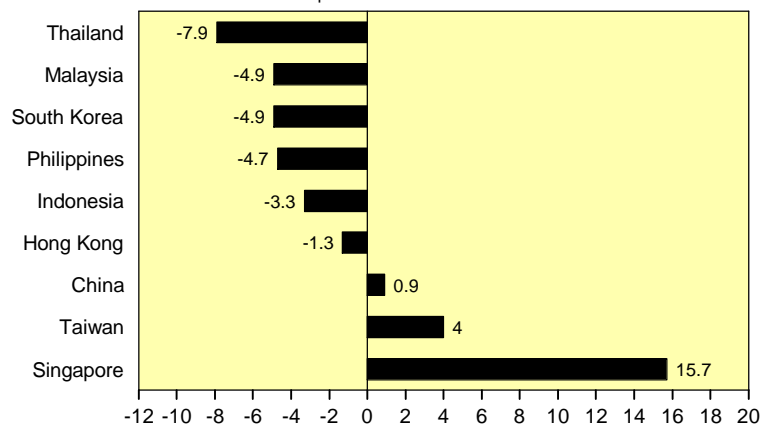
⁴ The Congressional debate on IMF funding is discussed in section III.B. of this report.

⁵ Stock market data provided by J.P. Morgan & Co. Emerging Markets Research. Stock market changes are measured in local currency; in U.S. dollar terms the declines would be significantly greater.

⁶ Among the sources consulted that inform this overview are: “East Asian Economies Survey,” *The Economist*, March 7, 1998; Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1999-2008*, Washington, D.C.: U.S. Government Printing Office, January 1998; Gavyn Davies, *Causes, Cures and Consequences of the Asian Economic Crisis*, New York: Goldman Sachs, February 2, 1998; Robert Wade, “The Asian Debt-And-Development Crisis of 1997-9?: Causes and Consequences,” *World Development*, forthcoming August 1998; Jane Little, “Anatomy of a Currency Crisis,” *Regional Review* [Federal Reserve Bank of Boston] Fall 1997, 10-13; and Alan Greenspan, *Testimony*, Senate Committee on Foreign Relations, February 12, 1998.

understanding the origins of the crisis. While these countries were characterized by relatively strong economic fundamentals (especially high savings, low inflation, and the absence of government budget problems), the crisis was brought on by weak financial oversight, sizable short-term international capital flows, untenable attempts to maintain dollar-pegged domestic currencies, a slowdown in growth resulting from overvalued currencies relative to the Japanese *yen* and the Chinese *yuan*, competition from China's expanded productive capacity, and declining demand in 1996 for semiconductors. Current account deficits soared, both absolutely and as a percentage of GDP (see Figure 3).

Figure 3
Current Account Balances
as a percent of GDP, 1996



Data Source: International Monetary Fund, April 1998.

Another common and telling feature was a degree of “crony capitalism,” with government officials, in some instances, steering bank loans and contracts to relatives, friends or those willing to provide kickbacks. Structural features of the “Asian model” of development, particularly its reliance on high debt-to-equity ratios for both banks and nonfinancial businesses and the importance of overlapping ownership between banks and vast industrial empires, have also been cited by many to account for the severe manner in which disturbances in the financial sector rapidly destabilized the productive sector.

Throughout much of the 1990s, industrial economies generally have been characterized by conditions of ample monetary liquidity, although the proximate sources of this liquidity differ for Europe, Japan and the U.S. Attracted by rapid

growth and the opportunity for higher returns than available in home economies, private sector capital flows from the industrial economies into the Asian crisis economies averaged around 5 percent of GDP throughout the first half of the 1990s, and rose to 7 percent of GDP in 1996. During the crisis, private capital flows rapidly reversed direction. As Figure 4 indicates, net private capital flows to the five countries most affected (Indonesia, South Korea, Thailand, Malaysia and the Philippines) experienced a swing of \$105 billion from inflows of \$93 billion in 1996 to net outflows of an estimated \$12 billion in 1997. Commercial bank lending accounted for most — \$77 billion — of that reversal.

When events triggered the inevitable correction in currency markets, the response by officials compounded the problem, and panic-stricken foreign investors pulled out. Because many foreign investors were ill-informed to begin with, they were caught off guard. Being unable to distinguish risks in various emerging markets, they pulled back indiscriminately. Federal Reserve Chairman Greenspan observed:

The sharp exchange rate changes in East Asia in recent months do not appear to have resulted wholly from a measured judgment that fundamental forces have turned appreciably more adverse. More likely, its root is a process that is neither measured nor rational, one based on a visceral, engulfing, fear. The exchange rate changes appear the consequence not of the accumulation of new knowledge of a deterioration in fundamentals but its opposite: the onset of uncertainties that destroy previous understandings of the way the world works.⁷

Among the causal factors that stand out for particular analysts, Massachusetts Institute of Technology economist Paul Krugman and others emphasize the fact that creditors and investors perceived there to be implicit government guarantees against loan defaults or the bankruptcy of well-connected businesses because of the close association between private sector borrowers and government officials and because foreign capital was protected during the Mexican bailout in 1995. This created a “moral hazard” situation that fostered

⁷ Alan Greenspan, *Testimony*, Senate Committee on Foreign Relations, February 12, 1998.

excessive risk-taking.⁸

Figure 4
Selected External Financing Measures
For Five Asian Economies*
(billions of dollars)

	1994	1995	1996	1997e	1998e
Current Account Balance	-\$24.6	-\$41.3	-\$54.9	-\$26.0	\$17.6
Net Private Capital Flows	\$40.5	\$77.4	\$93.0	-\$12.1	-\$ 9.4
Equity Investment	12.2	15.5	19.1	-4.5	7.9
Commercial Bank Loans	24.0	49.5	55.5	-21.3	-14.1
Other Private Loans	4.2	12.4	18.4	13.7	-3.2

* South Korea, Indonesia, Malaysia, Thailand and the Philippines
e = estimate.

Data Source: Institute of International Finance, Inc.

Capital outflows were central to the currency crisis and to the puncturing of the asset price “bubble,” subjecting banks to what Goldman Sachs analysts have called a “vicious double squeeze.” When short-term international private capital was withdrawn, currency values declined, raising the value of the foreign currency liabilities of the banking sector. At the same time, capital outflows drove down the prices of real estate and domestic equities, which banks held as collateral.⁹

Some analysts, e.g., many at the Washington, D.C.-based Economic Strategy Institute, cite the heightened reliance on export-led growth that characterizes these economies, as well as those of several other Asian countries, including

⁸ Paul Krugman, “What Happened to Asia?” January 1998, Author’s website.

⁹ Gavyn Davies, *Causes, Cures and Consequences of the Asian Economic Crisis*, New York: Goldman Sachs, February 2, 1998.

Japan and China. International and domestic loans were used to vastly expand productive capacity in each of the crisis countries, capacity that could remain viable only to the extent that rapid export growth persisted. Had these economies placed more emphasis on domestic consumption as they expanded in the 1990s, Lawrence Chimerine, Chief Economist at the Economic Strategy Institute, has argued that they would have been far less vulnerable to destabilization triggered by currency fluctuations.¹⁰

World Bank Chief Economist Joseph Stiglitz stresses that these countries poorly managed financial liberalization which was being aggressively encouraged by the IMF, the Organization for Economic Cooperation and Development (OECD)¹¹, and Western governments.¹² For example, reminiscent of the U.S. savings and loan debacle, restrictions were lifted on bank lending for real estate before a sound regulatory framework was put in place.

As noted in Section III.A. below, Harvard economist Jeffrey Sachs is representative of several observers who believe that actions taken by the IMF early on, such as declaring large numbers of banks insolvent, precipitated bank runs leading to the widespread collapse of the banking systems in these countries. In this view, the financial crisis was worsened and nearly paralyzed the private business sector given its heavy reliance on debt.

¹⁰ Lawrence Chimerine, *Testimony*, House Committee on Banking and Financial Services, January 29, 1998.

¹¹ The Organisation for Economic Co-operation and Development (OECD) is a Paris-based intergovernmental organization which serves as a forum for member countries to consult and cooperate to achieve sustainable economic growth and to improve the economic and social well-being of their populations. The OECD currently has 29 member countries from North America, Europe, and Asia.

¹² Joseph Stiglitz, "Bad Private-Sector Decisions," *Wall Street Journal*, February 4, 1998, A22.

II. WHAT IS THE IMPACT?

A. Financial Reforms in East Asian Countries

The first goal of the agreements reached between the IMF and the affected countries has been to stabilize exchange rates and restore confidence in the banking systems. Numerous banks and financial companies have been suspended pending restructuring or liquidation. Viable banks in each country are required to recapitalize or offer acceptable restructuring plans, and central banks will assist in assuring liquidity where appropriate.

A critical component of the IMF agreements with these countries has been measures aimed to achieve economic liberalization. Central to this goal is the restructuring of the banking system to increase competition and reduce the ties between financial institutions and the corporate and government sectors, which had fostered many of the inappropriate lending practices that helped form the basis for the region's difficulties. The South Korean agreement includes measures to prevent the government from intervening in bank management and requires corporations to develop balance sheets in conformity with Generally Accepted Accounting Standards. In Thailand and Indonesia, steps are to be taken to privatize the banking system. In all cases, lending rules are to be tightened.

The collapse of the financial sector in these countries, as well as difficulties faced in other developing countries, also helped lead to the World Trade Organization (WTO)¹³ accord on liberalization of trade in financial services, reached in mid-December. With this agreement, 102 countries will allow (to varying degrees) foreign competition and ownership in banking, securities, and insurance.

Exchange rate stabilization measures in the agreement rely on maintaining high interest rates to attract foreign capital and removing currency restrictions. As a result, throughout much of early 1998, short-term interest rates reached over

¹³ The WTO is the multilateral trade organization formed to promote trade liberalization and to police trade practices.

20 percent in Thailand and South Korea, and stood at over 30 percent in Indonesia. On April 21, Indonesia raised its key short term interest rates to 50 percent. High interest rates and tight money are also expected to constrain the inflation that results from currency devaluations by decreasing domestic demand.

B. Economic Impacts in East Asia

While the financial situation recently has stabilized and improved, at least for the time being, the adverse impacts on the real economy continue and are expected to be substantial over the next few years. Economies that had experienced average annual growth of 7 to 8 percent over the past 25 years are in the midst of recessions to one degree or another. The latest IMF forecasts expect South Korea's economy to contract by 1 percent in 1998, while Thailand is expected to experience a 3 percent GDP decline and Indonesia a more severe 5 percent contraction.

More telling than the figures on total output, however, are the implications for domestic demand — consumption and investment spending — which are better reflections of the impact on living standards, particularly since increasing export production will be the immediate priority. For the five East Asian crisis countries, the IMF projects that domestic demand will drop by over 20 percent on a cumulative basis during 1997-1998 compared to trend growth patterns.¹⁴

The crisis has in many cases put pressure on domestic economies because sharp currency devaluations raise prices for imported goods and greatly increase the value of foreign debt. The IMF expects consumer price inflation of 45 percent in Indonesia this year. In that country, dramatic price increases in

¹⁴ International Monetary Fund, *World Economic Outlook*, April 1998, p. 63. Barton M. Biggs, a veteran international financial analyst, observed recently upon returning from Asia, "Much of Asia is rapidly slipping into what could be a depression (rather than a recession), with significant declines of real GDP in store for many countries in 1998. Retail sales, imports, and industrial production are tumbling in South Korea, the Philippines, Malaysia, Thailand, Indonesia, and even that supposed island of stability, Singapore." Barton M. Biggs, "A Star in the Asian Gloaming", Morgan Stanley Dean Witter, *U.S. and the Americas Investment Perspective*, April 8, 1998, 1.

imported food combined with the effects of *El Niño* on the domestic rice crop have generated a food crisis which is leading to social unrest (see Figure 5 for other indicators of economic duress).

Figure 5
Indicators of Economic and Social Distress

Country	Unemployment	Business Conditions	Social Conditions
Indonesia	<ul style="list-style-type: none"> C Doubled to 10% since 1996, expected to rise from 8.5 to over 11 million this year. C Workers continued to seek employment in Malaysia even as that country began deporting hundreds of thousands of Indonesian guest-workers. 	<ul style="list-style-type: none"> C Government liquidated 16 major banks, throwing much of private sector into technical bankruptcy. 	<ul style="list-style-type: none"> C Rioting to protest food and medicine shortages. C March consumer prices up 39% year-over-year. C Ranks of the poor swelled by nearly 10 million.
South Korea	<ul style="list-style-type: none"> C Projected to double to 6.3% in 1998. C Record 1.2 million already jobless. C 12 of top 30 business conglomerates wish to downsize by 20-50% according to Chamber of Commerce and Industry survey. 	<ul style="list-style-type: none"> C One-third of merchant banks closed. C 15-20% of banks' loans nonperforming. C Small enterprise bankruptcies tripled in January. 	<ul style="list-style-type: none"> C Government forced to triple funds for unemployment insurance. C Inflation expected to more than double to 10.5% in 1998.
Thailand	<ul style="list-style-type: none"> C Increased by more than 700,000 since crisis began. C Expected to reach 5.6%, a record 2 million jobless, by year end. C 300,000 Burmese have been deported to ease employment situation. 	<ul style="list-style-type: none"> C 56 finance companies with \$20 billion in assets forced to close. 	<ul style="list-style-type: none"> C March consumer prices up 9.5% year-over-year. C Farmers demonstrate for more government aid.

Data Sources: Bear Stearns, International Labour Organization, International Monetary Fund, Institute of International Finance Inc., and press reports.

In South Korea, businesses are caught between high interest rates, tight credit availability, and currency devaluation, resulting in further debt defaults and a tripling in the number of companies seeking bankruptcy protection from year-ago levels. Whereas the South Korean unemployment rate remained below 3 percent for a decade prior to the onset of the crisis, it has since risen to nearly 5 percent with the number of unemployed almost tripling from October 1997 to February of this year, reaching a level of 1.24 million.¹⁵ While South Korea had a tradition of lifetime employment, under pressure from the IMF the Korean

¹⁵ International Labour Organization, *The Social Impact of the Asian Financial Crisis*, April 1998.

Confederation of Trade Unions agreed in early February to allow mass layoffs, in return for the establishment of a government unemployment insurance and training fund. As the South Korean *chaebol*, or industrial conglomerates, try to roll over \$40 billion in loans in 1998, creditor banks may insist on downsizing, and unemployment could rise much further.

In a recent report on the social impact of the Asian crisis, the International Labour Organization (ILO) expressed grave concern about the implications of a sharp deterioration in labor market conditions in countries where no meaningful social safety nets exist. The ILO warned: "Indeed this combination of sharp and unexpected social pain on the one hand, and the lack of collectively provided relief on the other, is fertile ground for breeding social unrest."¹⁶

C. Financial and Economic Impacts in the U.S. and Europe

There is little doubt that the lion's share of the economic fallout from the East Asian crisis will be felt in Asia. But the crisis is clearly having a significant impact worldwide. While earlier this year many analysts expected that growth in the Western industrial countries would be reduced by only half of one percent in 1998, more recently, the IMF stated that the Asian crisis is the main factor contributing to a projected falloff of 1 percent this year in growth in the world economy.¹⁷ It is also clear by now that one of the reasons the U.S. and finance ministers from other industrial nations have stepped up pressure on Japan to stimulate its economy is concern that further economic weakness in Japan would probably intensify the Asian crisis and sharply ratchet up export flows to

¹⁶ Ibid. The International Labour Organization (ILO) is the United Nations agency which seeks the promotion of internationally recognized human and labor rights. In cooperation with participating unions, employer associations, and governments, the ILO formulates international labor standards and provides technical assistance on a range of workplace issues.

¹⁷ International Monetary Fund, *World Economic Outlook*, April 1998. Standard & Poor's DRI projects that world GDP growth will slow from 3.2 percent last year to 2.1 percent in 1998, with 0.9 percent of the slowdown resulting from the Asian economic crisis (Sara Johnson, Peter Ellis, and David Stiff, "High-Tech Industries Are Fueling U.S. Regional Growth," *Review of the U.S. Economy [DRI]*, April 1998, 34).

the U.S., Canada and Europe.

East Asian economies as a whole account for 30 percent of world output¹⁸ and have been among the most dynamic in this decade, accounting for 50 percent of world growth and nearly two-thirds of world capital spending.¹⁹ Although the five Asian countries most affected by last year's developments — South Korea, Indonesia, Thailand, Malaysia, and Philippines — account for only a modest share of global economic activity, 3.6 percent of output and about 7 percent of world trade,²⁰ developments that started there quickly rippled around the world.

Some significant financial impacts in the West have already been registered. The Federal Reserve Board estimates Asian equity losses worldwide, excluding Japanese companies, from June 1997 through the end of January 1998, to exceed \$700 billion (largely paper losses), of which more than \$30 billion was lost by U.S. investors. Commercial bank lending by institutions based in the industrial countries had become a major factor in each of the crisis countries in the mid-1990s. By the time the crisis hit in mid-1997, European banks had the greatest exposure, with their losses projected at \$20 billion or more.²¹ For example, Deutsche Bank took a charge of \$773 million against 1997 earnings to cover its more than \$5 billion in loans to East Asia.

The effects of Asia's troubles were certainly a significant drag on U.S. corporate profits in late 1997. Despite offsetting domestic factors such as continued economic strength and low interest rates, corporate profits fell 1.1 percent in the fourth quarter. Export orders and major Asian expansion and construction

¹⁸ Stephen S. Roach, *The Global Economy Turned Inside Out?*, Morgan Stanley Dean Witter, February 1998.

¹⁹ Robert Wade, "The Asian Debt-And-Development Crisis of 1997-9?: Causes and Consequences," *World Development*, forthcoming August 1998, 4.

²⁰ Morgan Stanley Dean Witter, *The Competitive Edge, Update*, April 1998.

²¹ According to data compiled by the Bank for International Settlements, as of mid-1997, banking system exposure to Asian emerging market countries amounted to \$260 billion in the European Union (3.25 percent of GDP), \$210 billion in Japan (5 percent of GDP), and \$40 billion in the U.S. (0.5 percent of GDP). International Monetary Fund, *World Economic Outlook*, April 1998.

projects were canceled and several U.S.-based multinational companies experienced foreign currency-related losses. Forecasters expect fallout from Asia to clip earnings momentum and contribute to flattening margins in both 1998 and 1999.

The storm clouds from Asia may have had a silver lining for the U.S. economy in recent months, however. The role of the crisis in contributing to a cooling of the economy occurred at a propitious moment, according to Federal Reserve Board Chairman Greenspan, forestalling the need to raise interest rates, thus aiding the expansion to surpass the seven-year mark and helping to shift the general bias of the Federal Open Market Committee from tightening to neutral in December to prevent the dollar from rising further.

While the benefit of an extended expansion should not be understated, this storm will still exact its toll on the U.S. economy. The U.S. merchandise trade deficit, which had been rising markedly since 1995, partly as a result of the dollar's increased foreign exchange value, is expected to skyrocket as exports to the affected Asian countries collapse and imports from those countries surge. When the U.S. trade deficit for February worsened, the drop in exports to Asia was the major factor. The expected surge in imports from Asia is just beginning to show up since most locally owned companies in those countries have had difficulty getting the credit needed to purchase inputs. However, most analysts expect much higher imports by midyear, particularly in volume terms if not in dollar terms because of sharp price drops.

Even though the five Asian countries most affected represent modest shares of U.S. merchandise exports and imports — 8.4 percent of exports and 8.6 percent of imports²² — a substantial overall deterioration in our trade deficit is anticipated. In the latest Blue Chip consensus forecast, the U.S. merchandise trade deficit is expected to worsen by one-third in real terms in 1998 compared to last year.²³ According to DRI, a leading forecasting firm, the trade deficit will

²² Morgan Stanley Dean Witter, *The Competitive Edge, Update*, April 1998.

²³ *Blue Chip Economic Indicators*, April 10, 1998.

rise by \$40 billion both this year and next.²⁴

Americans may save as consumer, commodity, and producer input prices drop, reducing inflationary pressures and sustaining low interest rates, but the resulting expansion in the trade deficit will have harsh consequences for those directly impacted. Two-fifths of all U.S. agricultural shipments go to Asian markets. Among manufacturing sectors, computers, semiconductor equipment, industrial machines, power generating equipment, aircraft engines, and apparel will be most affected by fewer exports and more imports. One study suggests that for every \$100 billion deterioration in the merchandise trade deficit, 700,000 manufacturing jobs could be lost.²⁵

For the U.S. economy overall, the adverse trade effects are likely to outweigh the positive impacts on prices and interest rates. As a result, most GDP forecasts have been revised downward for 1998 and even more so for 1999. Three-fourths of the respondents to the February Blue Chip survey believe impacts from Asia will trim between 0.5 and 0.75 of a point off U.S. GDP growth this year. Goldman Sachs estimates that the Asian crisis will reduce growth in the OECD countries by 0.3-0.6 percent this year, and 0.6-1.2 percent next year,²⁶ while Morgan Stanley's Stephen Roach sees slower growth of about one-half percent this year, but less of an impact in 1999.²⁷

D. Impact on New York

While New York City and New York State will also experience mixed effects from the Asian financial and economic crisis, in the long run New York City may fare better than the nation because of its prominent role in international finance.

²⁴ *Review of the U.S. Economy*, [DRI] April 1998.

²⁵ Robert E. Scott and Jesse Rothstein, *American Jobs and the Asian Crisis: The Employment Impact of the Coming Rise in the U.S. Trade Deficit*, Economic Policy Institute, 1998.

²⁶ Gavyn Davies, *Causes, Cures and Consequences of the Asian Economic Crisis*, Goldman Sachs, February 2, 1998.

²⁷ Stephen Roach, Interview with O.S.D.C., New York City, February 26, 1998.

Because New York City is a leading financial center, the earliest waves of the crisis first touched U.S. shores here. Market turmoil in Asia, particularly in Hong Kong, contributed to the October 27, 1997, sell-off that sent the Dow Jones Industrial Index plummeting a record 554 points. Several New York-based money center banks and securities firms have been adversely affected by the turmoil in Asia. J.P. Morgan and Company, for example, has had profit declines for the last two quarters, with a significant portion due to canceled underwritings in Asia and Asian-related derivatives losses. In the fourth quarter, other Asia-related losses included a \$60 million loss on stock derivatives by Salomon Brothers, a \$160 million emerging market debt trading loss by Chase Manhattan Bank, and a \$250 million currency trading loss by Citicorp. Among the large New York City banks, Chase, Morgan and Citicorp all have considerable loan exposure in the region, loans which may have to be stretched out or ultimately written down.²⁸

Although the initial impact on New York City financial institutions may have trimmed 4th quarter profits, the strong spurt in financial markets since late January has heavily diluted Asian-related weaknesses. More importantly, several financial institutions based in New York are well-positioned to benefit from the greater liberalization of international financial markets that is a key condition of the IMF bailout agreements and that is called for by the recent WTO multilateral trade agreement governing trade in financial services. After several years of discussions, the timing of the completion of the WTO agreement was largely due to pressures generated by the Asian crisis.

In addition, with foreign ownership of Asian non-financial corporations likely to rise, New York investment banks and legal firms expert in mergers and acquisitions may also benefit from increased business. For example, New York-based Bankers Trust and American International Group have each put together \$1 billion funds to acquire assets of distressed Asian companies or loan

²⁸ Lawrence H. Summers, *Statement*, Senate Committee on Finance, February 4, 1998; and Herb Greenberg, "Chase Isn't Afraid of Those Asian Loans. But Why Not?," *Fortune*, March 2, 1998, p. 240.

portfolios from troubled banks.²⁹ Exports of professional services from New York, such as legal and consulting services, may also rise as trade barriers come down.

However, the Asian crisis is not without potential adverse consequences for New York City. The apparel industry, the City's leading manufacturing sector and a major employer of blue-collar workers facing limited employment opportunities, is very import-sensitive. Indonesia, Thailand, South Korea, Malaysia, and the Philippines account for 15 percent of all U.S. apparel imports. Other Asian economies, particularly China, Hong Kong and Taiwan, are also major apparel shippers to the U.S.— these three alone account for 25 percent of U.S. apparel imports — and are very sensitive to currency valuation pressures stemming from the crisis countries.³⁰

In general, since New York's economy is dominated by service production and most of the State's merchandise exports are destined for Europe and Canada, the State is much less dependent on merchandise exports to Asia than the U.S. as a whole and other leading industrial states, particularly those on the West Coast. As Figure 6 indicates, about 30 percent of U.S. merchandise exports go to Asia, exports that amounted to 2.4 percent of GDP in 1996. For New York State, Asia was the destination for only 21 percent of merchandise exports, representing only 1.3 percent of state output, or gross state product (GSP). In contrast, California sends 51 percent of its goods exports to Asia, an amount that equaled 5.5 percent of GSP in 1996. Nonetheless, a number of New York-based manufacturers are reporting lower profits as Asian sales weaken.

In sum, the impact of the crisis on the State and the City will be mixed. In employment terms, the majority of the benefits will be distributed to those at the

²⁹ U.S. financial companies are expanding their presence in Japan, particularly in the wake of recent heightened financial distress. For example, last fall, Merrill Lynch acquired the assets of one of the largest Japanese securities firms after it went bankrupt, and Citibank operations in Japan have been inundated this year by depositors fleeing Japanese banks with uncertain futures.

³⁰ U.S. Department of Commerce.

high-wage, high-skill end of the economy — those already doing best in this expansion — while some of those with lower-paying jobs could suffer. Considering the potentially destabilizing effects of global financial developments, the City and the State remain vulnerable given Wall Street's strategic economic and fiscal importance.

Figure 6
U.S. Merchandise Exports to Asia*
New York and Selected States, 1996

	\$ billions	As a Percent of Total Exports	As a Percent of GDP/GSP**
United States	\$183.3	29.7%	2.4%
New York	8.0	20.7	1.3
California	53.6	51.3	5.5
Massachusetts	4.5	27.5	2.2
Texas	14.5	19.6	2.6
Washington	17.0	57.9	10.6

* China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand

** GDP = Gross Domestic Product, GSP = Gross State Product

Data Source: Johnson, Sara, Asieh Mansour and Jerome Williams, "Asia's Financial Crisis Will Alter U.S. Regional Growth Patterns," *Review of the U.S. Economy* [DRI], January 1998, 36.

E. What Affects How the Crisis Continues to Evolve?

With the most recent agreement between the IMF and Indonesia, resolution of the currency crises for the affected countries may be in sight. However, each of the countries faces a difficult economic adjustment process. Within Indonesia, South Korea and Thailand, economic recovery depends in part on how soon financing mechanisms are established to restructure domestic debt

obligations and to restore working capital financing critical to re-starting “normal” business operations. Each country also faces a challenge to maintain popular support as painful economic adjustments cause business failures, higher unemployment, price increases for food and other necessities, and the general erosion of living standards.

Unlike South Korea and Thailand, whose currencies have each strengthened about 20 percent since the start of the year, Indonesia has sent mixed signals regarding its economic policy course. As a result, the Indonesian currency, the *rupiah*, declined about 35 percent between the start of the year and early April when the latest IMF agreement was reached.

Reflecting the rising degree of international economic interdependency, recovery in the crisis country economies also will be shaped in significant measure by developments in Japan, China and the Western industrial countries:

Within Japan

- ! Japan, as the biggest source of demand and capital for the East Asian region, could play a pivotal role in the recovery if it could get its own economic house in order, stimulating growth and making possible a reduction in trade barriers that limit the absorption of exports from its Asian neighbors. However, for the time being, with Japan’s economy headed into recession, Japan is more likely to complicate, rather than alleviate, the East Asian economic crisis.
- ! One of the biggest challenges for Japan is to restructure its financial system following stagnation throughout the 1990s brought on by the bursting of a tremendously speculative real estate bubble.
- ! The Japanese economic model still relies fundamentally on export-led growth, an orientation that limits export market opportunities for the crisis countries. In the last two months, U.S. officials have stepped up pressure on Japan to boost growth, particularly domestic consumption, to re-start the region’s economic engine.

Within China

- ! China's 1994 currency devaluation undercut the export competitiveness of the crisis countries, particularly Thailand and Indonesia, and was one of the contributing causes of the Asian crisis. Although Chinese officials recently pledged to avoid steps that would exacerbate the regional economic crisis, some observers fear that China will come under increasing pressure to devalue again, a development that is widely seen as triggering another round of devaluations, and financial distress, by the crisis countries.

- ! Along with a commitment to support its currency, China announced a plan to recapitalize the state banking sector, which had become crippled by bad debt and jeopardized economic growth. China also indicated its intention to substantially expand infrastructure and public investment spending to help achieve its 8 percent GDP growth target.³¹

- ! Hong Kong, whose economic and political fate is now in the hands of China, has been buffeted by the Asian contagion but has been able to maintain its currency link to the dollar because of substantial foreign exchange reserves. However, real estate values have plummeted, unemployment is rising, and, because Hong Kong financial institutions are major players in countries such as Indonesia, there is potential for further instability.

Within Western Industrial Countries

- ! Macroeconomic and monetary conditions within these countries substantially shape the strength of demand for crisis country exports. While a high dollar aids the export potential of the crisis countries now that their currencies are no longer pegged to the dollar, it increases the burden of dollar-denominated debt.

³¹ Bear Stearns, *Global Notes: International Economics*, April 14, 1998.

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- ! In response to a sharp falloff in export sales to the East Asian countries, government-backed export credit agencies in 18 industrial countries have been working to amass \$10-15 billion in export credits to aid the Asian countries faced with a severe shortage of short-term credit resources.

 - ! Along with Japan, these countries are likely to continue to be the major source of short- and long-term foreign investment.

III. WHAT NEEDS TO HAPPEN TO MINIMIZE THE POTENTIAL FOR ANOTHER CRISIS?

A. Did the IMF Exacerbate the Crisis?

The IMF has frequently come under criticism for making aid conditional on austerity programs, which typically lead to economic contractions and unemployment so that the costs of adjustment fall largely on the poor. In the case of Asia, these criticisms are being voiced again, but have been supplemented by additional critiques of the Fund's performance. Among these are the following:

- C The Fund should have been more proactive in helping the affected nations head off the crisis by early and discreet interventions with the banking systems.
- C The IMF failed to give countries sufficient guidance in stabilizing currencies.
- C By sounding an alarm of crisis, urging steep devaluations, and by moving quickly to close banks, the IMF exacerbated the loss of confidence in the Asian economies, leading to a run on the Asian currencies.

In addition, many prominent critics argue that the IMF remedies deepened the crisis, leading to a much more prolonged and painful contraction in the region than otherwise might have been the case. This view argues that the problem was more one of financial system temporary illiquidity rather than fundamental insolvency, and that the countries affected were victims of a panic exacerbated by the IMF. The World Bank's Stiglitz and Harvard's Jeffrey Sachs argue that the IMF remedies are especially inappropriate for the Asian situation, where governments (particularly South Korea) have generally followed sound macroeconomic policies, inflation is low, national savings rates are high, and in

South Korea, the labor force is well educated.³² The problem is rooted largely in private sector rather than public sector behavior; therefore, the fiscal austerity route is inappropriate. Few critics, however, see an effective alternative to high interest rates to attract foreign capital in order to support a weakened currency.

Martin Feldstein, former chair of the President's Council of Economic Advisers, writing in the prestigious journal *Foreign Affairs*, argues that the IMF went well beyond its traditional role in making far-reaching structural and institutional reforms a condition of financial assistance for the East Asian countries.³³

Going even further, Wade takes the Fund to task for demanding that the Asian countries "westernize" their systems.³⁴ He argues that the high debt-equity ratios experienced in Asian economies are an outgrowth of, and an outlet for, the high levels of household savings and provide a powerful lever for economic growth. Since high debt also makes the system particularly vulnerable to financial instability, critics like Wade argue that close cooperation between banks, corporations and the government is a necessary part of the system, as is tight regulation of foreign capital flows. They argue (as does Stiglitz) that the system broke down as a result of excessive financial deregulation. By demanding the dismantling of the Asian system rather than fixing what is broken in it, they predict that IMF remedies will result in extensive long-term damage to the Asian economies.

B. Global Reform Initiatives

Federal Reserve Board Chairman Alan Greenspan noted recently that the global financial system, while highly beneficial in facilitating cross-border trade in goods and services, "also appears to have facilitated the transmission of financial disturbances far more effectively than ever before". To stave off future vicious cycles, Greenspan urged that we must go beyond the existing

³² Jeffrey Sachs, "The IMF and the Asian Flue," *The American Prospect*, March/April 1998; and Joseph Stiglitz, "Bad Private-Sector Decisions," *Wall Street Journal*, February 4, 1998.

³³ Martin Feldstein, "Refocusing the IMF," *Foreign Affairs*, March/April, 1998.

³⁴ Wade, op. cit.

“patchwork of arrangements and conventions governing the functioning of the international financial system”.³⁵

Echoing the need to “modernize the architecture of the international financial markets”, Treasury Secretary Robert E. Rubin has urged that new multilateral arrangements are needed to foster three key objectives:

- ! improving transparency through more extensive disclosure of financial and economic liabilities and capital flows;
- ! strengthening the regulation of financial institutions in emerging economies; and
- ! developing the role of the private sector in bearing an appropriate share of the burden in times of crisis.³⁶

These issues, and how to institutionalize them, have been discussed in several meetings of finance ministers and central bankers this spring, most recently at the mid-April meetings of the finance ministers of the seven leading industrial nations (the so-called G-7 nations) and the IMF and World Bank policy making bodies. To promote adherence by emerging market economies to tougher financial standards and regulatory system, for example, Secretary Rubin has proposed establishing conditions for access to industrial country financial markets. Access would be limited to banks from countries with tighter standards.

Also, because there has been considerable concern that future bailouts not seem to reward overseas creditors and investors — the moral hazard problem — Rubin has urged the IMF to consider a plan to change its policy of prohibiting IMF loans to debtor nations if they are in arrears to foreign banks in order to create more pressure on banks to restructure debts with borrowers in

³⁵ Alan Greenspan, *Testimony*, House Committee on Banking and Financial Services, January 30, 1998.

³⁶ Robert E. Rubin, *Strengthening the Architecture of the International Financial System*, Remarks to the Brookings Institution, April 14, 1998.

developing nations.³⁷ Many analysts note that the IMF's refusal to press much sooner for the renegotiation of \$70-80 billion in Indonesian private debt owed to creditors in the industrial countries contributed to the extended economic free fall in Indonesia.³⁸

With the backing of Greenspan among others, President Clinton has proposed an \$18 billion increase in the U.S. contribution to the IMF so that it can continue to provide a vehicle for aiding distressed economies that internationalizes the burden and presses for economic management reforms. However, this request is facing an uphill battle in Congress with both liberals and conservatives raising questions about the proper role of the IMF.

According to the *Financial Times*, nearly 150 House Republicans support a libertarian position that stresses the need for total adherence to market forces.³⁹ This view is backed by such influential individuals as George Schultz, William Simon and Walter Wriston, who recently argued in the *Wall Street Journal* that the IMF should be abolished because its "promise of massive intervention has spurred a global meltdown of financial markets".⁴⁰ In their view, there is an emergent "global information standard" that imposes harsh discipline and will reinforce sound financial decisions. The editorial position of the *Wall Street Journal* also has opposed additional funding for the IMF, criticizing the IMF in particular for its relentless pursuit of currency devaluations by the affected countries.⁴¹

For the most part, House Democrats, who led the effort to deny the President "fast-track" trade negotiating authority last year, favor continued support for the IMF, but with reforms to open its operations to public scrutiny and to change its

³⁷ Ibid., and Robert E. Rubin, *Statement*, International Monetary Fund Interim Committee, April 16, 1998.

³⁸ Gerard Baker, "Tea Leaves in Jakarta," *Financial Times*, April 17, 1998, 17.

³⁹ Nancy Dunne, "Battle for the Fund," *Financial Times*, February 18, 1998.

⁴⁰ George P. Schultz, William E. Simon and Walter B. Wriston, "Who Needs the IMF," *Wall Street Journal*, February 3, 1998.

⁴¹ Editorial, *Wall Street Journal*, April 15, 1998.

orientation to promote domestic rather than export growth. They also argue that international institutions should broaden their focus by including the interests of local workers and communities as well as those of foreign investors. While the Senate passed a bill containing the Administration's request for the \$18 billion in IMF funding, as of mid-April the measure is stalled in the House, mainly over language concerning family planning issues the President says he would veto, and further action this session is uncertain.

There is also a growing chorus of voices advocating some restrictions on unfettered short-term international capital flows. Chief among this camp are the World Bank's Stiglitz, *Financial Times* columnist Martin Wolf as well as that paper's editorial page, and Columbia University economics professor Jagdish Bhagwati, a prominent proponent of free trade.⁴² To address the problem of extreme volatility in the currency exchange system, Nobel economics laureate James Tobin has proposed a global tax on currency transactions.⁴³ On the other side, the Treasury's Robert Rubin and Larry Summers and the IMF have steadfastly opposed consideration of any form of capital controls.

C. What Are the Limits to Export-Led Development ?

While the "Asian" model of development is being re-shaped, the emphasis on export-led development is likely to continue. Moreover, in the near term, given the need to restore current account balance, greater emphasis will be placed on exports at the expense of domestic consumption. In turn, this will intensify competitive pressures on other less developed and industrializing countries as they also seek to penetrate industrial country markets.

Many observers link the emergence of excess productive capacity largely to politically directed investments that stem from national industrial targeting

⁴² Joseph Stiglitz, "Boats, Planes and Capital Flows," *Financial Times*, March 25, 1998; Martin Wolf, "Flows and Blows," *Financial Times*, March 3, 1998; Editorial, "Regulating Capital Flows," *Financial Times*, March 25, 1998; and Jagdish Bhagwati, "The Capital Myth: The Difference between Trade in Widgets and Dollars," *Foreign Affairs*, May/June 1998, 7-12.

⁴³ James Tobin, "The Money Changers; Why We Need Sand in the Market's Gears," *Washington Post*, December 21, 1997.

strategies, e.g, in autos, steel or electronics. This view holds that subjecting investment decisions to market discipline will allow competitive forces to adjust imbalances. Another view, articulated by Chalmers Johnson, a well-known expert on Japan, and by the Economic Strategy Institute, stresses that export-oriented economies inherently lead to situations of excess capacity, intensifying downward pressure on wages, and that, instead, such economies should rely more heavily on domestic consumption.⁴⁴

⁴⁴ Chalmers Johnson, "Cold War Economics Melt Asia," *The Nation*, February 23, 1998, and Lawrence Chimerine, *Testimony*, House Committee on Banking and Financial Services, January 29, 1998.

CONCLUDING THOUGHTS

An understanding of the East Asian crisis vividly illustrates the internationalization of finance markets and points up the clear potential for financial and economic developments on the other side of the globe to reverberate through to Wall Street and the New York economy. Short-term international capital flows from banks in industrial countries poured into East Asia in the mid-1990s, and were channeled into both productive and unproductive investments and projects. When perceptions abruptly changed regarding some of the conditions underpinning those capital flows, especially assumptions about currency exchange rates, panic swept investors. Financial collapse occurred in several East Asian countries and a contagion effect spread to emerging market economies everywhere. Although Wall Street has since recovered and gone on to new highs, when Asian stock markets plummeted in late October, the Dow Jones average dropped by 7 percent, a decline of over 500 points in one day.

As international financial authorities debate how to guard against a recurrence of these developments, the economies of most of the affected Asian countries slide into recession or worse, with little prospect of early recovery. Since it is the leading economic force in East Asia, Japan's inability to overcome seven years of stagnation hinders an already fragile economic situation. Wall Street and the U.S. economy also could be affected if, in order to buttress the value of the *yen*, the Japanese decide to sell off more of their immense holdings of U.S. Treasury securities. In that event, U.S. interest rates could rise and possibly slow economic growth. As we monitor developments on Wall Street to see how they affect and determine the City's economic and fiscal picture, we keep one eye on Asia.

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