

Developing Trends

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Asian Markets - Danger and Opportunity

The Chinese word for crisis means both danger and opportunity. Looking around the carnage visited upon emerging economies in the last one year, there has been precious little returns to the seeming abundance of opportunity. However, *Developing Trends* believes that the time is indeed **now** to invest in emerging markets. Obviously, a blind approach of buying all markets is not recommended. Indeed, a selective approach - buying some markets while exiting (or shorting) others is recommended. In order of preference, the best emerging markets are in Asia, followed by Eastern Europe, and Latin America.

This **double** edition of *Developing Trends* (DT) is a crisis anniversary issue. It was on July 2, 1997 that the Thai baht floated. It was not until September that the first whiffs of contagion were observed, and by end-1997, it was a full blown crisis.

What happened in East Asia was both exceptional and unforeseen. It has been a humbling experience for all concerned with Crisis '97 - international organizations e.g. International Monetary Fund and the World Bank; investment trading firms in New York, London, Tokyo; credit rating agencies like Moody's and S&P; international economists around the world; central bankers - the FED, Bundesbank, Bank of England to name a few. The list can be expanded, but it is obvious that everybody missed the fire until it was raging across all of East Asia. The whole class failed.

This anniversary issue contains an *ex-post* analysis of the crisis. Various arguments explaining the crisis are examined. The asset bubble (Jeffrey Sachs and Paul Krugman),

Japanese devaluation (IMF), or an excess of capital account liberalization (Joseph Stiglitz) are examined - and found wanting. Instead, two major causes for the East Asian Crisis '97 are offered - *incomplete* capital account liberalization (i.e. managed exchange rates) and Chinese mercantilist trade policy. Details on this partially "academic view" are contained in the text.

First, and most importantly, the forecasts and trade recommendations. These are trying times for forecasters, and analysts, and traders. Nothing sustains, not even hard earned profits. Profits have been more in the nature of "here today, gone tomorrow". This is the danger part of the crisis. The opportunity is present in much higher proportions than the danger - indeed, the risk today of entering most Asian markets is terribly small.

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TRADES:

So what are the trades ? Before the details, a major point of information - these are long-term (three months and above) forecasts. In some order of importance, trading boldly, *Oxus, Developing Trends* (DT), believes that:

1. **China will not devalue its currency in the near future.** Contrary to most estimates in the market place, *Developing Trends* believes that the Chinese yuan is

not over-valued but **under-valued** by about 10 percent. In other words, the “fair” value of the yuan is closer to 7.5 rather than 8.28 where it is currently trading. The second reason China is not expected to devalue is because of its past mercantilist policies. These policies meant that China devalued in the early nineties (and throughout the eighties) and was able to obtain a significant trade advantage over its east Asian neighbors. While China accrued trade surpluses, the east Asians sank deeper into overvaluation. The role of the US in aiding and abetting the mercantilist policy cannot be ignored. But it is precisely this partnership, and the implicit *quid pro quo*, which will help ensure that China does not devalue anytime soon.

2. The **dollar has topped against the Asian currencies**, and by the end of the year should be significantly lower than today's levels.
3. The **dollar has also topped against the majors**, though its depreciation is likely to be more gradual. The wildest card here is Japan. Only they can mess up the forecast - and history suggests that they are eminently capable of continuing, *ad nauseam*, to do the wrong thing. While a sharp depreciation of the yen from the present 145 level is not considered unlikely, it is nevertheless not worth betting for - and is likely to be short-lived. The yen beyond 145 is likely to be not different than the yen below 85 i.e. turbulent and characteristic of an extreme.
4. The **world economy is likely to emerge from its trough soon**. While America is slowing down, Europe is trending upwards. Remarkably, and providing fuel to this optimistic view, is the fact that individually and collectively, the East Asian economies are performing considerably better, **at this post-crisis stage**, than Mexico performed in 1995 and 1996. And Mexico was considerably helped by NAFTA, and its Big Brother in the north.

5. **No matter what the criteria, and several are offered, Asian equity values (in dollar terms) are at extremely attractive, and yes, rock bottom levels.** Typically, equities are available at **20-40 percent of the prices observed in end-1991!** Further, Asian equity prices today are at 10-20 percent of “fair value”. Several markets are at eight year (and beyond) lows. And most Asian markets are about 70-90 percent off their highs. History suggests that such bargains do not remain for long. As an indicator, the US market, at 8500 is two and half times higher than its 1991 value and about 50 % higher than “fair value”.
6. The conclusion does not follow that the US and European stock markets are in for a dive. Nor does it follow that these markets will make new highs in the near term. A recovering world economy is good fundamentals; “irrational exuberance” is bad technicals. The two contrasting forces should sustain a prolonged period of consolidation. The US market is likely getting close to the bottom of the (future) trading range.
7. What about India ? The economy, the rupee, and the stock market should soon emerge from their own crisis. India is likely to sign the CTBT, the government is showing signs of stability (even if the government falls, the opposition is likely to be even more pro-reform, so it has become a win-win game for reforms) and the stock market is setting itself for a rally. The rupee is likely to be a non-event, as it becomes boxed in a 41.50 to 44 range. **Buy Indian debt and the Indian stock market.**
8. *What could go wrong ? In these turbulent times, almost any spark will unleash a fire. But it is also getting to the point that there is not much left to burn - at least in Asia. Two of the more important “bad” events would be Japan remaining at sea and China devaluing. Both are considered unlikely, and especially the latter.*

(The conclusions above were e-mailed to clients on Aug. 24, 1998 at noon; the rest of the text was e-mailed, also at noon, on Sunday Aug. 30, 1998. Time is in US, EST.)

Whither US dollar ?

Several bits and pieces of evidence suggest that the dollar is very close to its highs for this cycle. Trends in the dollar tend to last for several months if not years, so if this turning point does occur, it will be a major event. In the next few pages, a mixture of technical and fundamental evidence is presented.

The most important bit of evidence is perhaps the almost universal wisdom that the yen is going to 200 (it was today trading at 145). This is completely analogous to the equally outlandish calls that the yen was going to 40 when it was trading at 80. But there are more tell-tale signs, much more.

The replay is eerie; or as President Menem of Argentina said in a different context "I have seen this movie before". Over the last week, articles have appeared about China reducing the size of its reserves held in yen. "Despite China's recent calls for Japan to shore up its ailing economy and currency in order to enhance stability in the Asia region, Hong Kong's Economic Journal newspaper Thursday (Aug. 20) reported that China sold \$ 2.5 bln worth of JPY earlier this month because it believes that JPY could remain weak and could even hit 180 against the USD" (Bridge News, Aug. 21). Elsewhere it was stated that China's yen reserves had declined, due to this conscious sell yen policy, to only 25 % of reserves from a pre-crisis level of 33 percent.

Have the Chinese been selling yen and reducing yen reserves ? Unlikely. Then what about the evidence that yen reserves have fallen ? *It is an accounting identity.* Assume that the pre-crisis level is June 1997 - the yen was then trading at 115. Assume further that at that time, the composition of yen in China's reserves was 33 percent. The yen has depreciated to 145 or a 26 percent decline. If China had followed a completely passive policy in the management of its reserves, what would be the yen share today - almost exactly 25 percent, or the share that is being attributed to an active yen selling policy!

Now for the **old** movie. In a Deutsche Bank *Developing Trends* issue dated April 12, 1995 and entitled *Asian Central Banks - Followers or Leaders ?* (yes, the origin of DT was at Deutsche), I wrote the following:

"The last few weeks have been filled with rumors (facts?) of Asian central banks' selling of U.S. dollars. Yesterday, April 11, Bloomberg carried a long story entitled "Asian Central banks Sell Dollars, Buy Yen in Policy Shift". Today, *The Wall Street Journal* carried an equally long story entitled "Asia's Central Banks Unloading Dollars in Shift Toward Yen as Trade Currency". What have the Asian Central Bank's done to date?According to the *Wall Street Journal*, Taiwan's share of US \$ in total reserves in Dec. '93 was 58.2 percent. At that time (end of period) the yen was "marked to market" at 111.85 and the deutsche mark at 1.7263. Assume for a moment that the remaining 41.8 percent was equally denominated in yen and marks. Assume also that there was NO active management of reserves; i.e., no decisions were made by Taiwan's central bank to sell or buy any currency, or alternatively that everybody was asleep at the trading post. If the Taiwanese Central Bank were to now calculate the dollar composition of its reserves as at the end of March 1995, it would find that the currency depreciation alone (\$ at 86.55 yen and 1.3723 as of the end of March 1995) on a **conservative** estimate ("average" depreciation of 20 percent vs. an actual estimate of 23 percent) would have meant a reduction in the share of US \$ reserves to 54 percent. The share of US \$ reserves for Taiwan now as reported by the Journal - 54 percent! "

The article went on to conclude:

- i) As a rule, Asian Central Banks do not actively manage a significant portion of their reserves. While this policy might have changed, it is considered unlikely. Further, data (to date) on composition of

reserves does not suggest that the policy has changed.

- ii) If reserve management policy has not changed, reasons for the dollar's decline lie elsewhere. Further, that an "overhang" of supply of dollars from this source does not exist.
- iii) In late 1984 and early 1985, similar "panic" changes in reserves were attributed to various central banks' buying dollars to catch up with an appreciating currency. Is it just a coincidence that there is now a panic selling of dollars? If not a coincidence, does it suggest that a major bottom of the dollar is in place? "

Wrongful attribution of panic selling (or buying) to central banks have occurred at mega turning points. It happened in 1985, in 1995, and is likely to happen again in 1998.

This the first, and most important *technical* evidence in favor of the thesis that the dollar has topped against the majors. There are several other pieces of *fundamental* evidence.

Measurement of Over/Under Valuation: Trade Deficits ? How does one measure whether a currency is over-valued or not ? Traditionally, trade (or current account) deficits were supposed to be the signal. Most econometric models, however, fail to show any relationship between such deficits and exchange rates, especially for developed countries. There were models that showed that the appreciation of the yen was due to its large trade surpluses - and sure enough, there was a large correlation between Japan's trade surpluses and the \$/yen exchange rate from 1987 to 1995. Critics of this model pointed out that there was a severe identification problem - an equally good correlation was obtained with a slowing of Japan's growth rate, decline in Nikkei, banking problems, and any time-trending variable with the "trending" yen. These critics have been proven right with a continuation of Japanese trade surpluses and a massive yen devaluation! Things are always topsy-turvy with \$/yen - it is not a

currency, it is a nightmare (and by derivation, mark/yen is not a currency, it is a migraine !). However, there is one forecast that emanates from the above. Excluding, the structural problem with \$/yen, it is likely that as the world moves increasingly towards floating exchange rates (Yes, Virginia, even India and China are likely to be there by the year 2000) , so will the trade account increasingly determine floating exchange rate values. The (old) past will be the (new) future.

Measurement of Over/Under Valuation: PPP and PPP+: If not trade data, then what fundamentals provide clues about currency direction ? Economists, analysts and traders have found succor in purchasing power parity (PPP) exchange rates. PPP calculations require the choice of an "equilibrium" year; bilateral (or trade-weighted) inflation differences are then used to assess whether a currency is over or under valued. Most economists stop at a PPP rate. However, just as important is the calculation which adjusts for *differences* in *productivity* growth. Such differences are often minor and even out over the long-run; hence, stopping at a PPP adjustment maybe justified.

But the macro-performance of Asia over the last three decades suggests that productivity growth can be consistently larger (or smaller) than the "norm". For example, China's productivity growth has been highly unusual. According to IMF economists Hu-Khan (1997), Chinese productivity growth has averaged 3.7 percent per annum for the reform period 1979-1994, and 5.4 percent for the period 1990-1994. The US, in contrast, has barely averaged 1 percent during the last two decades. For "fair" currency values, what matters are differences in productivity growth *between* countries. And if China's productivity growth exceeds US by 4 % a year, then this is *equivalent* to its inflation rate being *less* than US by 4 % a year; hence, according to PPP, the yuan should have been **appreciating** by 4 percent a year since the eighties, *ceteris paribus*. As soon as one subscribes to a PPP determinant of exchange rates; (and the *Economist*, via its popular Big Mac index,

most central banks with managed exchange rate regimes, most leading investment banks, and traders, do subscribe to PPP) one is logically forced to subscribe to a PPP+ (inflation plus productivity differences) determination of exchange rates. Reasons of convenience may make one prefer PPP to PPP+, but not reasons of logic.

It is not easy to measure productivity growth, but that does not mean that productivity effects are irrelevant. Establishing whether China pursued an under-valued exchange rate policy requires that calculations of productivity growth be done for a large set of countries. One short-cut is to assume that productivity growth is equal to the growth in per-capita income; however, this leads to vast over-estimates of productivity growth. *Developing Trends* has developed, on a proprietary basis, estimates of productivity growth for various countries. Adjustment for such differences allows a more accurate determination of “fair” or “equilibrium” or

“target” exchange rates. (The proprietary Oxus model also adjusts its forecasts according to some additional criteria).

PPP and PPP+ Estimates: What evidence is there that the PPP+ estimates work, and work better, than PPP? Some evidence is provided by the perusal of forecasts contained in the very first issue of *Developing Trends*, dated Jan. 6, 1997. Forecasts based on Oxus’s PPP+ model were presented for end-June 1997 and are reproduced in Table 1. It was stated there that the dmark would depreciate from its 1.55 level; that the yen would depreciate “hesitatingly” from 115 ; that the pound would appreciate “hesitatingly” from 1.69; that the Mexican peso would stay flat at 7.85; that the Singapore dollar would depreciate from 1.4 . Details as to what actually happened are given in Table 1. The fact remains that the forecasts turned out to be uncannily right, not least because they were dated for June 30, 1997 and the financial crisis started afterwards!

Table 1: Accuracy of *Developing Trends* Predictions in 1997

	Exchange Rates			Expected Direction	Forecast Correct?
	Actual Dec 1996	PPP X-Rate June '97	Actual June '97		
Developed Economies					
Australia	0.79	0.69	0.75	Down	Yes
Canada	1.37	1.30	1.38	Up	?
Germany	1.55	1.65	1.75	Down	Yes
Japan	115	116	114.43	Hesitatingly Down	?
New Zealand	0.69	0.62	0.68	Down	?
Switzerland	1.35	1.40	1.46	Down	Yes
U.K.	1.69	1.60	1.67	Hesitatingly up	
Emerging Markets					
Brazil	1.05	1.25	1.08	Down	Yes
Chile	425	485	416	Down	No
Czech Republic	27.50	31.00	32.44	Down	Yes
India	35.90	33.00	35.80	Flat, to Down	Yes
Indonesia	2362	2441	2431		
Korea	845	900	886		
Malaysia	2.50	2.50	2.52	Flat	
Mexico	7.85	7.00	7.94	Flat	Yes
Philippines	26.30	33.00	26.35	Down	?
Poland	2.86	3.40	3.29	Down	Yes
Singapore	1.40	1.60	1.43	Down	Yes
South Africa	4.70	4.30	4.52		

Thailand	25.61	27.85	24.90	Down	Yes
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Notes: 1) The first, second and fourth columns are reproduced from Developing Trends, Volume 1, Number 1, Jan 6th, 1997..

Like all forecasts, DT missed the contagion, but Oxus's PPP+ model was frightfully right with the Thai baht : “ The Thai baht may just be the currency which surprises, with volatility, in 1997. It has been “tied” to the dollar at 25 since 1987. It is unclear as to what further benefits accrue to Thailand with a “fixed” exchange rate, and continued high deficits on the current account suggest that there is more to lose than gain with a constant baht policy. Competition from other East Asian, and South Asian economies, may perhaps be the final reason for Thai authorities to let go. The TERM (Oxus's target exchange rate model based on PPP+) model suggests that the target exchange rate is close to 28 baht/US\$” **(DT 1.1, Jan. 6, 1997)**

The PPP+ model was also right with the prediction of a Mexico peso devaluation on Dec. 8, 1994, just two weeks prior to the “explosion” on Dec. 21. This was contained in the first issue of *Developing Trends* at Deutsche Bank: “The value of the peso is likely to be of greatest concern to Zedillo's government. Both economics (competitiveness and exports) and politics (Chiapas; social concerns; lack of fast growth) argue for a further 25 to 50 percent devaluation.” **(DT, Deutsche Bank, Dec. 8, 1994)**

The PPP+ model was also able to identify the turning point of the dollar in 1995, via the Asian Central Bank article referred to above and an article entitled “US \$ and Singapore \$: Moving Together” (*Developing Trends*, Deutsche Bank, June 1995) “Quite coincidentally and through independent calculations, a strong result emerging from the above S\$ crosses (in particular, long US\$/short S\$/short yen and long S\$/short Dmark) is that the US dollar is at historically high undervaluation levels. This is additional evidence pointing to a major rally for the US dollar, on medium-term basis, against the major currencies.” **(DT, Deutsche Bank June 30, 95)**

However, the PPP+ model missed the contagion. The same Jan. 1997 DT issue that forecast a dollar rally, and a Thai Baht devaluation, also said this about the ringgit: “The Malaysian ringgit seems to be the perennial favorite every year for a big (usually upwards) move – and each year it seems to disappoint. 1997 should be another typical year..... the overvaluation of the currency is zero at 2.5 ringgit/US\$.”

Oxus's PPP+ calculations have turned out to be mostly right at previous turning points, for both developed and developing economies. The above evidence has been provided to suggest that the model does seem to “work”; it remains to be seen whether this accuracy is retained in the future.

East Asian Devaluations: The PPP+ model comes reasonably close (and a lot closer than PPP) in even “forecasting” the observed East Asian devaluations. For the ASEAN6 (i.e. Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand; Indonesia excluded because its currency was moved by Suharto politics) the PPP method anticipated a mean devaluation of 10 % while PPP+ method anticipated a much larger devaluation of 25 percent..(see Table 2). The actual devaluation in June '98 (mean of 48 % for the ASEAN6) is reasonably close to the PPP+ calculation. Similar results are observed for India and Japan. Devaluation by June'98 for India was 18 % compared to 22% (11 %) forecast by PPP+ (PPP); for Japan, devaluation was 21 % compared to 16 % (PPP+) and 9 % (PPP method). The markets obviously went into an overkill zone. Table 2 also reports on an additional measure, PPP++, which is PPP+ modified for the Chinese undervaluation during 1991-93. As discussed in Part II, the competitiveness of east Asia was severely affected by the large (fifty percent) Chinese 1991 to 1993 devaluation. A conservative 12 % adjustment for China's large “unfair” devaluation advantage (devaluation averaged

50 % over three years) helps approximate the “fair” exchange rate in June 1997 and yields estimates within “striking” distance of the

actual devaluations. All in all, the PPP+ model does seem to work.

Table 2: East Asian Crisis Foretold

1997	“Fair” Exchange Rates, June					Devaluations Forecast		
	Exch Rate June,1997	Exch Rate June,1998	PPP (Incorrect)	PPP+ (Correct)	PPP++ China Adj.	PPP Method	PPP++ Method	Actual Deval. June97/June98
India	35.8	42.4	40.1	45.9	51.4	12.1	43.7	18.4
Indonesia	2431	14500	2722	3127	3502	12.0	44.1	496.5
Philippines	26.4	41.8	33.5	46.8	52.4	27.1	98.8	58.6
Malaysia	2.5	4.1	2.9	3.5	3.9	16.4	55.0	65.6
Thailand	24.9	42.2	29.5	34.3	38.5	18.4	54.5	69.5
Korea	886	1373	843	975	1092	-4.9	23.3	55.0
Singapore	1.4	1.7	1.7	2.0	2.2	23.6	58.4	20.7
Taiwan	27.8	34.4	27.7	32.0	35.9	-0.3	29.0	23.7
Japan	114	139	127	136		10.6		21.2

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Notes:

- 1) PPP+ represents productivity adjustments to purchasing power parity (PPP) or inflation adjusted exchange rates.
- 2) PPP++ China Adj. represents adjustments to PPP+ for undervaluation of Chinese Yuan during its devaluation period, 1991-93. The yuan was undervalued, according to PPP+, at an average rate of 30% during this period. The PPP++ adjusts PPP+ exchange rates by only 12% to conservatively account for the “excess” China devaluation/undervaluation.

Currency Forecasts : Oxus’s PPP+ Model :

Two clear medium-term forecasts emerge from calculations as of late August 1998.

- First, the dollar is close to a major top against the majors.
- Second, the dollar is close to a major top against the Asian currencies.

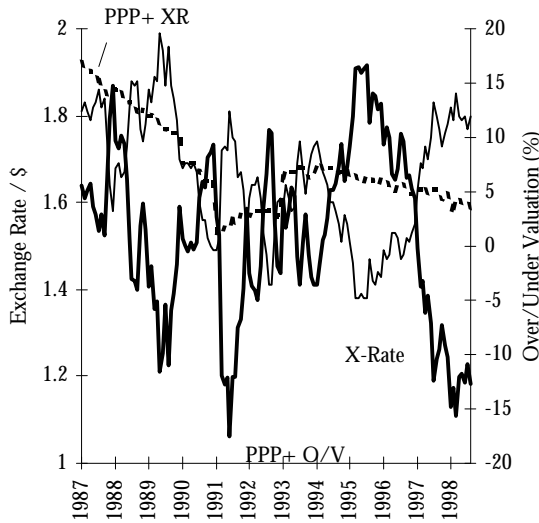
It is *not* the case that there is a one to one correspondence between overvaluation and expected depreciation for the currency majors (that correlation holds to a much greater degree for the currencies of the emerging economies). The majors have a tendency to yield large trends; these trends mean that a currency can be overvalued, or undervalued, for long periods of time. These cycles are illustrated below for two such currencies:

\$/dmark and \$/aussie. (\$/swiss reveals a pattern similar to \$/mark, while the yen reveals somewhat longer trends).

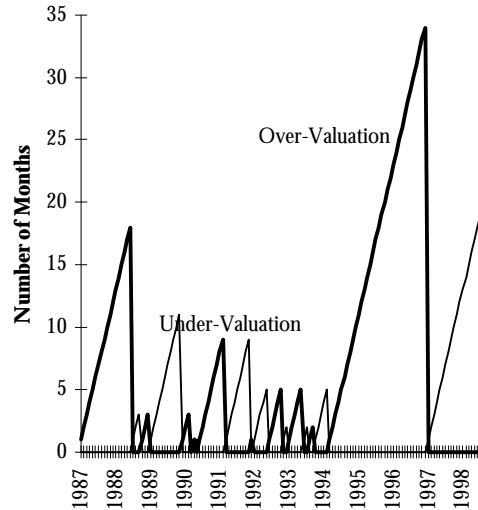
\$/Dmark: Chart 1a. Pronounced trends since 1987 are observed. The largest such trend was the one which ended in Dec. 1996, when \$/dmark crossed 1.55 after reaching a low almost nine months earlier. This lasted for almost 35 months. The present under-valuation trend is already more than 18 months old with “fair” or target PPP+ value at around 1.6 dm/\$. Note that the currency begins to appreciate long before the target exchange rate is reached. The deutsche mark is presently under-valued by 13 percent - since 1987, such undervaluation levels have only been witnessed about 5 percent of the time. History is more likely to repeat itself than not.

Chart 1a: Germany

Germany: Exchange Rate Movements & Over/Under Valuation



Number of months of Continuous Over/Under Valuation

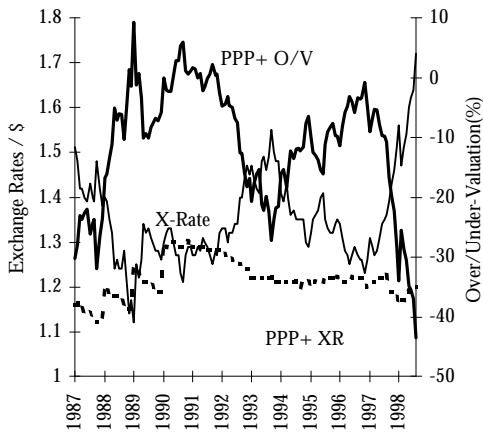


\$/Aussie: Commodity prices have collapsed in recent months as financial markets witness one crash after another in quick succession. The Aussie is consistently making new lows, and as of Aug. 21, 1998, at 58.00, the Aussie was undervalued by a whopping 44 percent -

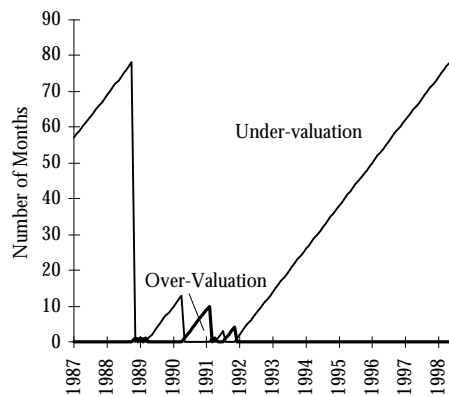
the largest such undervaluation on record (see chart). In terms of months, the present trend exceeds the previous record of 78 months by 3 months. How long can this trend last? If history is any guide, not much longer.

Chart 1b: Australia

Australia: Exchange Rate Movements & UnderValuation, 1987 onwards



Number of Months of Continuous Over/Under Valuation



Oxus's PPP+ Model: Forecasting the \$:

There have been two major turning points for the dollar in the nineties: June 1991 and March 1995. The same PPP+ over/under valuation (O/U) pattern observed at the previous two turning points are observed today, Aug. 21, 1998.. Table 3 also reports the "percentile" of O/U for each currency. The percentile reveals how often a currency is observed in a particular O/U zone; for example, the percentile "bottom 5%" associated with the dmark O/U of -13 percent represents the fact that for only 7 months (since 1987) has the dmark been *more* undervalued or cheap relative to fair value. Thus, unless one believes that a "structural" change has occurred, one should not expect, based on past history, for the dmark to stay

under-valued for much longer i.e. it should appreciate towards its fair PPP+ value of around 1.6 dm/\$

The O/U pattern at the different turning points is revealing and confirms the use of PPP+ as an important "predictor". At both the previous turning points (and though not reported, the same pattern is observed prior to 1987) both \$/mark and \$/yen were observed near their respective peaks. Note that the absolute level of O/U is not as important as the percentile. Note also that the Canadian \$ moved together with the US \$ in 1991 and 1995; in August 1998, the US\$ is "super strong", and extremely overvalued against all currencies. Yet another piece of evidence suggesting a dollar top.

Table 3: History Repeats Itself?

	\$ Top? - August, 1998			\$ Bottom - March, 1995			\$ Top - June, 1991		
	X. Rate	O/U%	%Tile	X Rate	O/U%	%Tile	X Rate	O/U %	%Tile
Germany	1.80	-12.7	Bottom 5%	1.38	16.4	3rd Highest	1.81	-17.6	Lowest
Japan	145	-2.5	3rd Lowest	87	38.4	Top 1%	138	3.3	Bottom 7%
Australia	0.58	-43.5	Lowest	0.74	-13.0	Bottom 30%	0.77	-1.5	Top 25%
Canada	1.54	-39.6	Lowest	1.4	-23.3	Top 10%	1.14	2.0	Top 1%

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Notes:

- 1) O/U% refers to Over/Under valuation with respect to its PPP+ value.. A negative sign indicates that a currency is "cheap." PPP+ represents productivity adjustments to Purchasing Power Parity (PPP) adjustments.
- 2) Both PPP and PPP+ require base year adjustments, but the important percentile rankings are unaffected by these adjustments.

PPP+ forecasts: Table 4 contains the forecasts for various currencies for end-1998. The O/U percentile is also reported for each currency. Except for the British pound (no clear PPP+ signal) all the major currencies suggest a dollar top. Note that the yen at 145 is the third lowest (since 1987) undervaluation on record. In other words, only in two other months in the last 11 years has the yen been more undervalued. The commodity producers (Australia, New Zealand and Canada) are at

historical extremes, and should rally sharply from these levels. Even the decimated East Asian currencies (excepting Indonesia) are less undervalued than the commodity producers whose under-valuation is in the 35-45 % range.

Emerging currencies: China remains undervalued by 12 % and therefore is not expected to devalue. Philippines and Singapore are expected to be flat (or weak)

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while the rest of East Asia should rally. Latin American currencies are also expected to be flat (or weak). Note that these currencies are near the center of their percentile ranking i.e. no clear direction is suggested. Eastern

Europe (Poland and Hungary) are also near the center; hence, no convincing direction is discernible. The Indian rupee is expected to be flat (around 43) for the next several months.

Table 4: Forecast for Exchange Rates, End 1998

	Exchange Rates		PPP+ % Over Val	PPP+ Over Val Percentiles	Expected Direction
	Actual	PPP+ Equiv.			
Developed Countries					
U.K.	1.64	1.8	-9.5	50%	Flat
Germany	1.8	1.6	-12.7	5%	Up
Switzerland	1.5	1.5	-1.4	50%	Up
Canada	1.54	1.1	-39.6	Lowest	Up
Japan	145	141	-2.5	3 rd Lowest	Up
Australia	0.58	0.8	-43.5	Lowest	Up
New Zealand	0.50	0.6	-29.9	Lowest	Up
Developing Countries					
Latin America					
Brazil	1.17	1.5	22.7	50%	Flat, to Down
Chile	472	513	8.0	65%	Flat, to Down
Mexico	9.3	10.0	6.6	75%	Flat, to Down
East Asia					
China	8.27	7.4	-12.3	30%	Flat
Indonesia	11350	5710	-98.8	3%	Up
Korea	1297	1094	-18.5	10%	Up
Malaysia	4.21	3.8	-10.6	3 rd Lowest	Up
Philippines	42.5	53.9	21.1	60%	Flat, to Down
Singapore	1.75	2.0	12.1	50%	Flat, to Down
Taiwan	34.7	32.5	-6.8	5%	Flat, to Up
Thailand	41.1	38.9	-5.7	5%	Up
Other					
Hungary	225	259	13.2	50%	Down
Poland	3.61	5.3	32.1	75%	Down
South Africa	6.34	5.8	-8.9	10%	Flat, to Up
India	42.56	51.9	17.9	50%	Flat

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Notes:

- 1) Exchange rates are as of August 21, 1998
- 2) PPP+ represents productivity adjustments to Purchasing Power Parity (PPP), or inflation adjustments.
- 3) The percentile represents the level of overvaluation since Jan, 1987. For example, the -12.7% undervaluation for Germany means that the Dmark was under valued by more than this amount for only 5% of the time, or 7 months
- 4) Up corresponds to an appreciation of the currency.

Whither Asia's Real Economy:

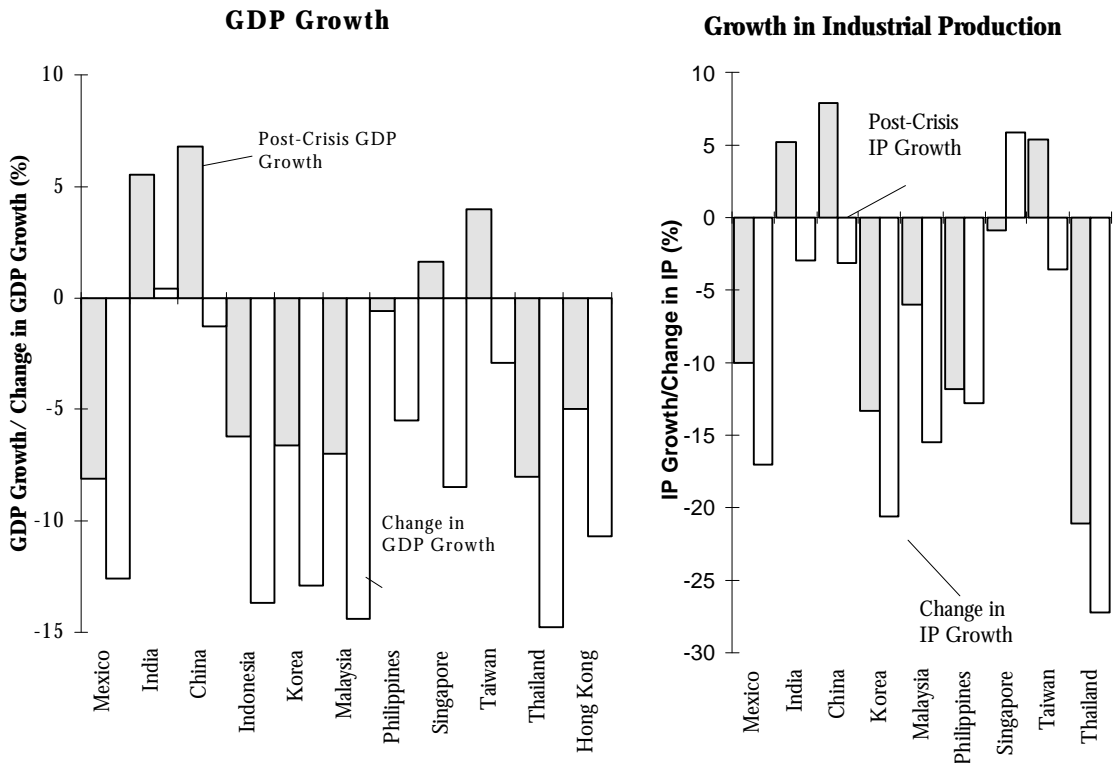
How deep was the crisis wound last year ? In 1995, after a short Tequila shock, only Mexico remained in the doldrums. It faced a relatively robust, and expanding, world economy for its exports. Further, Mexico was helped indirectly via membership in NAFTA and a strong US economy. Thus, one benchmark for the East Asian *recovery* is via a comparison with the Mexican recovery, 1994-95. For most indicators, data are available till end-June 1998; i.e. nine months after the crisis which is dated as Sept. 1997 for all countries except Thailand which is dated June 1997.

in 1998 . The results are much “better” than expected i.e. with the political exception of Indonesia, for all indicators, most Asian economies are performing no worse than Mexico did in 1995, and for several indicators, the Asian economies performance is better.

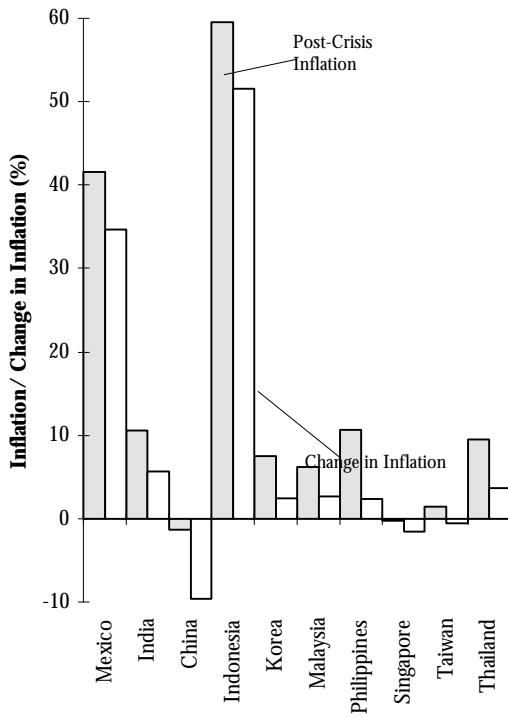
The charts on the next two pages document the Mexican performance in 1995 with the Asian performance as of June 1998. For reasons mentioned above, the Asian economies are *expected* to have done considerably *worse* i.e. larger contagion than 1995 and a more crisis prone world economy

Interestingly, for both GDP and industrial production, some East Asian economies show performance which is almost identical to that observed for (best case) Mexico. For example, by the third quarter of 1995, Mexican GDP growth was -8.1 %, a decline of almost 13 % from the level of growth (4.5 %) just before the crisis. Second quarter GDP growth in Korea has come in at -6.6 percent and with a 7 percent GDP growth prior to the crisis, the decline in Korean growth is also approximately equal to -13 percent, as is the decline for Thailand and Malaysia. (As mentioned above, Indonesia is ignored).

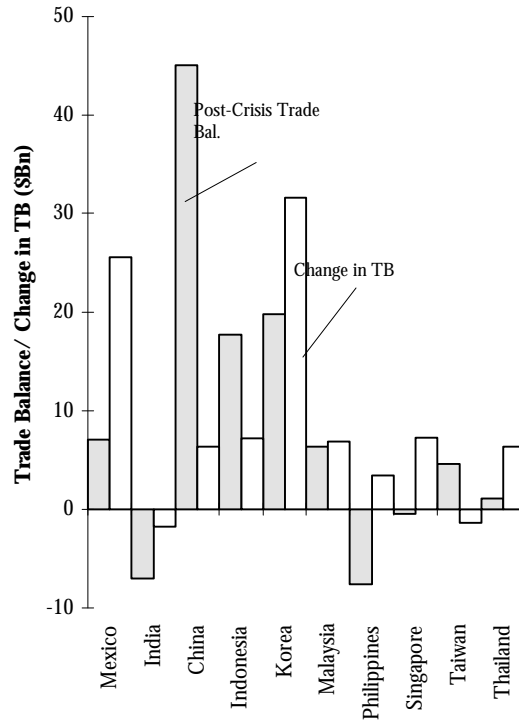
Chart 2: How are Economies Recovering? Snapshot, June 1998



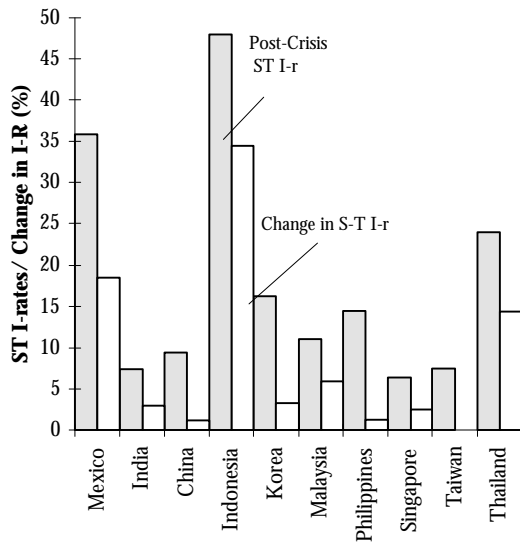
Consumer Price Inflation



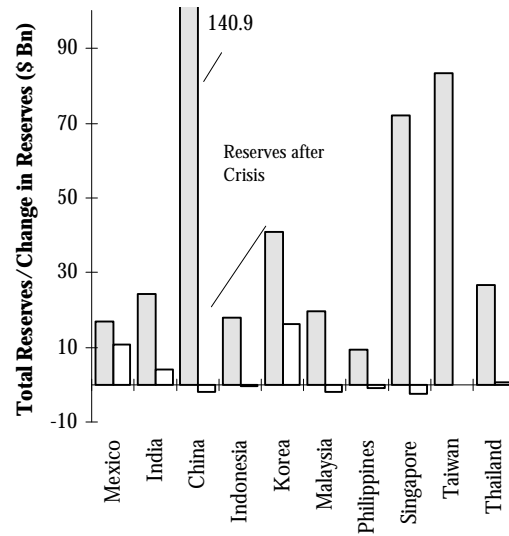
Trade Balances (\$ Bn)



Short-Term Interest Rates



Total Reserves (\$ Bn)



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Notes:

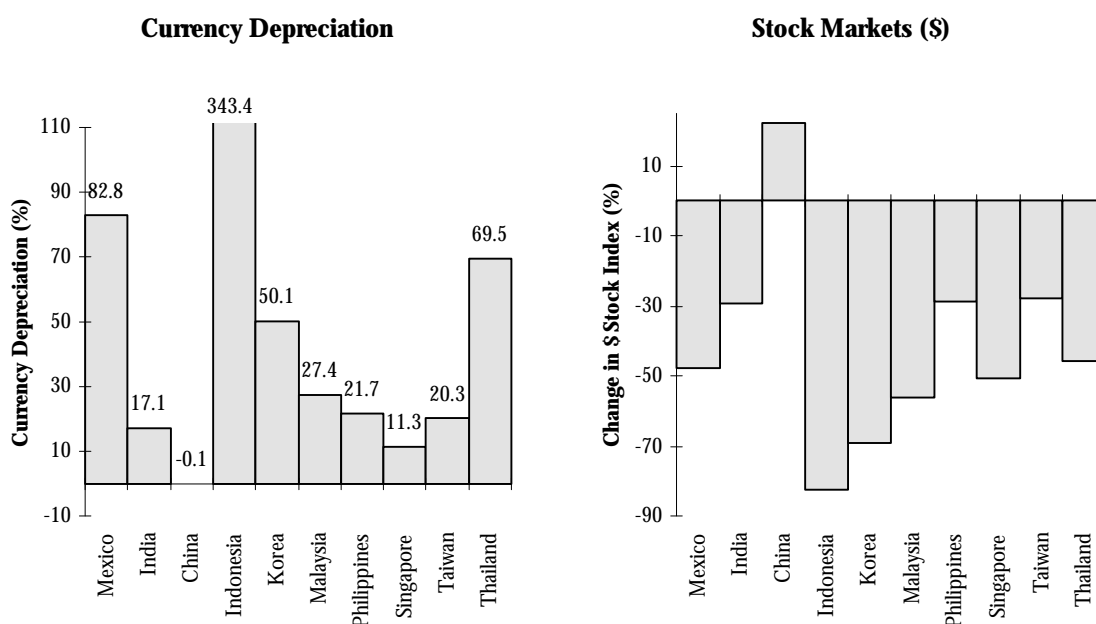
1) For each indicator, two columns are shown: the first column represents the level of the indicator nine months after the crisis (Mexico: September, 1995; Thailand: March, 1998; all others: June, 1998), and the second column represents the change in the indicator since the month preceding the crisis.

While declines in growth are similar, trade balances, reserves accumulation and inflation are much better in east Asia in June 1998 than Mexico in Sept. 1995 (both 9 months after the crisis). With currency depreciations of similar magnitude (around 50 percent), inflation in Asia is averaging less than 10 percent compared to more than 40 percent for Mexico. This is a real surprise - such a large depreciation, and a muted response in inflation. Correspondingly, interest rates (and therefore prospects for future recovery) are also considerably lower in Asia - around 10

to 20 percent compared to above 40 percent for Mexico.

The Mexican economy bottomed out (according to industrial production and GDP data) about 9-12 months after the crisis. The production indicators reached their pre-crisis levels a year later. In other words, the crisis induced a V, with both sides measuring approximately a year. The fact that history might repeat itself (and the first part of the V it has done so, and in a "better than expected" fashion) is another reason to be bullish on Asia.

Chart 3: Currency and Stock Depreciation: Moving Together



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Notes:

- 1) These charts represent the percentage change in Exchange Rates and Stock Indices (in \$ terms) from the month preceding the crisis to nine months later (Mexico: September, 1995; Thailand: March, 1998; All others: June, 1998).
- 2) Column for Indonesia is not drawn to scale. Numbers shown are the levels of currency depreciation as of June, 1998 over levels observed before crisis (9 months earlier).

Whither Asian Stock markets ?

It is not an exaggeration to state that the Asian stock markets have been battered beyond any recognizable shape. Given the fact that the fundamentals are not *that* bad, it is nevertheless a tribute to market over-kill that stock market declines in dollar terms have exceeded those of Mexico for four

countries - Korea, Malaysia, Singapore and Thailand. Only Philippines and Taiwan have been spared - but for how long ?

Table 5 reports on various measures of stock market performance and whether these markets are "cheap". Capital flows accelerated in 1993; and helped fuel a stock market boom

in the emerging economies. Hence, a point two years earlier (end-Dec. 1991) is a convenient beginning point for evaluating stock markets. Oxus has developed an indicator of "potential" stock market levels; this indicator is analogous to Tobin's Q measure of determining the "fair" (replacement value) stock market price. It is constructed using nominal GDP levels and estimates of productivity growth. Four indicators of stock price (in \$) are presented -

the "potential" price, and three prices today *relative to*: end-1991 price, minimum since 1991 and maximum since 1991. The picture is an extremely sorry one. emerging markets are close to their 8 year lows, and several are *at their lows* (i.e. "relative to minimum" price is equal to 100). Most Asian markets are only a fraction of their highs of the last eight years - less than 10 percent for Thailand and less than 30 percent for most other countries.

Table 5: How Cheap are the Stock Markets?

	Exchange Rate	Stock Index (Local Currency)	Where are Stock Prices (in \$) Relative to:			
			Potential	End 1991	Minimum since 1991	Maximum since 1991
Developed Countries						
Australia	0.58	2635	68.9	121.9	155.0	75.3
France	6.03	4088	147.1	198.9	208.8	96.3
Germany	1.80	5596	205.8	299.1	325.2	94.1
Italy	1771	35860	108.2	168.8	248.7	97.1
Japan	145	15298	54	57.6	100.0	50.0
U.K	1.64	5460	124.8	191.6	218.5	89.1
USA		1052	154.8	252.1	260.5	96.1
Developing Countries						
Latin America						
Argentina	1.00	471	40.8	92.8	153.0	54.4
Brazil	1.17	8542	73.7	141.5	208.5	60.6
Chile	472	3754	33.2	121.8	121.8	48.9
Mexico	9.30	3604	17.8	77.8	158.6	41.0
Mexico (Sept. '95)	6.40	2381	38.3	74.9	152.7	39.5
East Asia						
China	8.27	1197	49.4	250.1	301.1	71.9
Hong Kong	7.75	7527	76.2	175.9	175.9	46.0
Indonesia	11350	388	5.7	26.8	111.3	11.5
Korea	1297	317	11.8	27.2	112.5	16.8
Malaysia	4.21	324	15.8	38.9	100.0	15.0
Philippines	42.50	1373	31	76.2	100.0	24.9
Singapore	1.75	933	25.6	58.2	100.0	30.8
Taiwan	34.70	7213	54.4	126.1	174.8	59.3
Thailand	41.10	239	10.4	25.9	100.0	9.7
Other						
Poland	3.61	14907	56.7	492.3	631.5	49.2
South Africa	6.34	7800	48.1	98.1	120.7	9.8
India	42.56	2923	26.8	83.5	100.0	41.1

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Notes:

- 1) "Potential" Stock value is analogous to Tobin's Q. and given by a formula which relates stock prices to growth in nominal GDP and productivity growth. The latter is estimated by Oxus for each country.
- 2) All calculations are based on stock market levels as of Friday, August 21, 1998.

The row for Mexico labeled Sept. '95 in Table 5 reports the stock market indicators for Mexico 9 months after its 1994 crisis. And Mexico in Sept 1995, in spite of worse economic fundamentals, was in "seventh heaven" compared to the sorry plight of the east Asians.

Two additional charts (4 & 5) document the magnitude of the extreme carnage that is the East Asian stock market today - and why it should not get much cheaper. Chart 4 relates stock prices to potential in Dec. '93 (approximate peak) and today. Chart 5

documents prices at their **peak** (boom) and today (bust). The boom was hardly a boom as most markets, at their irrational exuberant peak, were only 20 to 40 percent above their potential. And the bust has been much more than mere destruction - even the descriptive term of nightmare would be flattering. Stock market values in east Asia are a long distance away from potential or "fair" values - about 200 percent in many cases i.e. values would have to quadruple to get to what was considered normal only a year earlier.

Chart 4: Stock Markets: Deviation from Potential



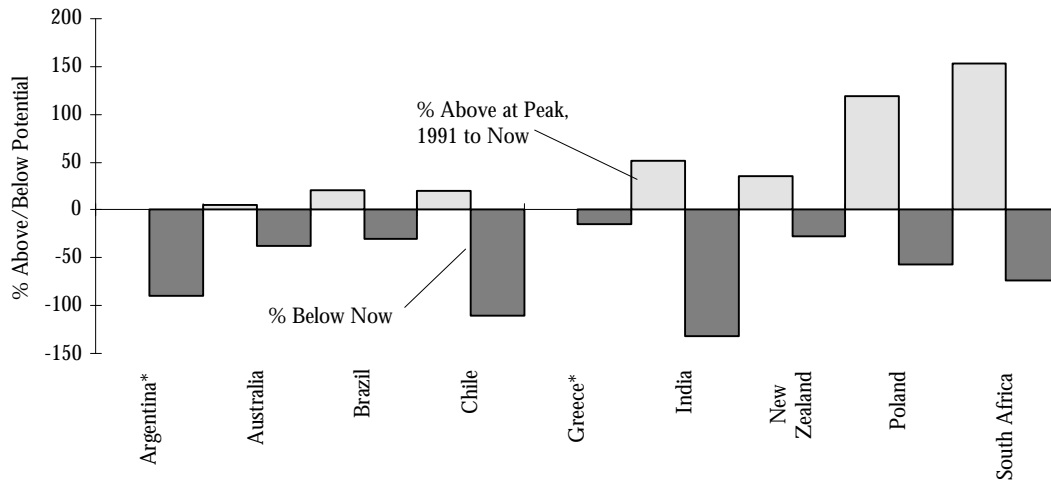
Oxus Fund Management

Notes:

- 1) The first column for each country represents the value of the stock market relative to potential in December, 1993 (at a likely "peak" of emerging market stocks); the second column represents the same on Aug. 21, 1998 (at a possible "trough" for Asian stock markets); for definition of potential, see text. A value of 100 represents price equal to potential.
- 2) "Potential" Stock value is analogous to Tobin's Q. and given by a formula which relates stock prices to positive growth in nominal GDP and productivity growth. The latter are estimated by O[x]us for each country.

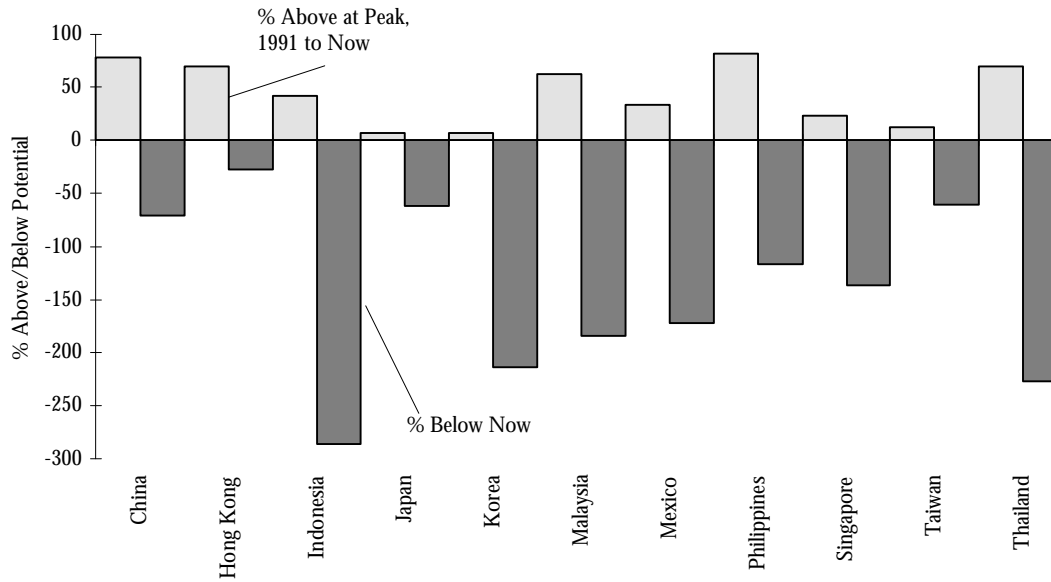
Chart 5: Performance of Stock Markets Relative to Potential

A) Select Countries: Booms and Busts



Notes: 1) * Implies that stock markets in Argentina and Greece were at their potential level when they reached their peak.

B) Select Countries: Booms and Busts



Oxus Fund Management

Notes:

- 1) The first column represents the peak value of each stock market relative to its potential; the second column represents the value of the market, relative to its potential, on August 21, 1998.
- 2) "Potential" Stock value is analogous to Tobin's Q, and given by a formula which relates stock prices to positive growth in nominal GDP and productivity growth. The latter are estimated by Oxus for each country.

Summary: No matter what fundamental, or technical indicators are used, the story is the same - the Asian currency and stock markets are signaling a historical **BUY**. This recommendation is obviously not for the faint hearted or for those looking for a quick return, or a quick fix to past losses! In Oxus's view, one of the most important attribute of a trade is the potential *downside*. (Upside is important but not so much in today's trying times). It is in this regard that the Asian stock markets (and to a limited extent the currency markets) score the most, especially relative to other emerging markets. In trading, often considerations of the potential downside are much more important than upside gains.

Stock Market Intervention by HKMA: The Hong Kong Monetary Authority made news, and history, when it started intervening in the *stock market* i.e. buying and selling shares. This has sent shockwaves through the financial markets - how can maintenance of a currency board involve stock trading ?

Maintenance of a currency board is complicated, and different, in a mobile capital financial engineering world. Capital flows dominate trade flows, and the use of derivatives allows for magnitudes to flow through the system which the "creators" of currency boards could not possibly have envisioned. In today's world, a currency board, in Oxus's view, may require transparent interventions in the stock market -

and these are to be eminently preferred to the other option - foreign exchange controls.

The Wall Street Journal has criticized the intervention, which already means that it was a good policy! Other traders, and investment bankers (presumably those who were caught heavily short !) have also criticized the policy. This is another eerie replay of Dec. 1994 when the WSJ stridently argued against the devaluation of the highly over-valued Mexican peso, and the movement of the peso towards a floating rate. So did investment bankers caught long.

For some time now, the following very successful no-brainer trade has been employed - simultaneously sell the Hong Kong dollar (via forwards) **and** the Hang Sen index, via futures. Leverage is huge. This "artificial" (i.e. non trade related which after all is the purpose of the peg) trade forces the HKMA to defend the peg, thereby causing interest rates to go up, which causes the stock market (and futures) to decline. Hedge funds and traders have made enormous profit, and on both sides, on this trade. By intervening in the stock market, the HKMA is effectively intervening in the FX market - something critics like the WSJ (and traders who lost money) should endorse since it is defending a "fixed" exchange rate, and the currency board. So not only is the HKMA intervention not anti-market, it is very much pro-market. It is now a level playing field. "Set a thief to catch a thief" Let the best market player win

Chinese Mercantilism - Currency Wars and How the East Was Lost

Conclusion: What caused the East Asian crisis? Managed exchange rates and a mercantilist China, whose trade policies had the active encouragement of the US. It was the response to an unfair China, and an equally myopic US, that may have been the driving force behind the readjustment of Asian currencies in 1997. Simply put, if China would not revalue, the rest of the currencies would devalue. It would have been a lot simpler if China had played by the rules, and perhaps grown at only 9 % an annum rather than 13 percent. For details, see below.

East Asian Crisis: The Future:

The most talked about issue in international financial markets during the last several months has been the question of a Chinese yuan devaluation - will they or won't they? From the Chinese premier to the US president, the answer is the same - no, not now anyway. But the threat lingers.

The Chinese yuan is today **under-valued** by 12 % with respect to the dollar. There is economic reason for the yuan to appreciate, not devalue. This forecast of a "no devaluation" of the Chinese yuan (the Hong Kong peg is a different issue and the Chinese may under the guise of exchange rate unification (again!) devalue the Hong Kong dollar to the \$-yuan rate of 8.3 from the 7.75 HKD/US at present) incorporates political realities. As the discussion in the next few pages illustrates, international politics (particularly US) are an important force in determining exchange rate policies in developing countries. And it is precisely an extension of this politics which leads to the conclusion that China will not devalue. The reason: a quid-pro-quo to the US for allowing it to pursue a mercantilist policy in the nineties.

Other implications also follow from this forecast. Without a Chinese devaluation, the East Asian economies will be able to recover faster, and the world will move towards a

more level playing field. Capital account convertibility will accelerate, and bring with it reduced real interest rates, and higher growth in developing countries. And all without the imposition of old-new schemes to control capital flows (Tobin tax) and without new global institutions to supplant or replace the IMF.

East Asian Crisis: The Past

The world changed on July 2, 1997 when Thailand floated the baht. Financial markets tumbled in East Asia, and the tremors are being felt today, a year later, in Eastern Europe. (This newsletter does not cover Russia, but Poland, Czech Republic and Hungary, yes, to a limited degree). Explanations abound on the origins of the crisis - indeed it is a growth industry. In two articles, "*Domestic Follies, Investment Crises: East Asian Lessons for India*" and "*Chinese Mercantilism - Currency Wars and How the East Was Lost*", Bhalla(1998a,b) examines the various causes, and consequences, of this mega event.. What follows is an attempt at a summary

Seven Steps Towards the Crisis:

1) **Capital flows and fixed exchange rates:** The nineties were witness to a boom in private capital flows to emerging markets. From nascent levels (around \$ 25- \$ 50 billion) in the early years, such flows accelerated to around \$ 300 billion at the time of the crisis in mid-1997. **None** of the East Asian (hereafter EA) economies had a floating or market determined exchange rate. Central Banks intervened, and intervened often, to restrict movements of capital . Most, if not all, the Central banks had either an implicit or explicit FX band - lines in the sand which were not allowed to be crossed. (As events of 1997 showed, lines in the sand only serve to ensure that the ensuing dust storm is a blinding one). All participants - domestic central bankers, international central bankers, and private bankers - knew about the bands, and their "sanctity".

2) **Zero hedging costs:** In a managed fixed exchange rate regime, there is considerable incentive to *not* indulge in hedging. The currency might appreciate, in nominal terms, as indeed it did in many developing countries during 1991 to 1996. The exchange rate might depreciate *less* than interest rate differentials. And the “smart money” would exit early i.e. most investment bankers felt that they would be able to exit before any large discrete devaluation, the experience of Mexico 1994 notwithstanding.

3) **Floating exchange rates would have avoided the crisis:** If exchange rates had been floating (as they now are), exchange rates would have quickly appreciated (or depreciate) in response to profitability perceptions. For example, as more capital flows in, the more the exchange rate appreciates, and the less excess returns the last entrant obtains i.e. a self-regulating system that does not need bureaucratic or central bank control. In contrast, with a managed exchange rate the inward capital flows can be limitless.

4) **Efficient Excess Capacity Creation:** These unhindered capital flows helped generate the creation of a large amount of capacity in emerging, especially Asian economies. The popularity of economic reforms everywhere (Argentina, Brazil, China, India, Eastern Europe) meant not only capacity, but relatively *efficient* capacity was being generated. And the capacity was similar, if not identical. It was created by similarly educated domestic manpower in collaboration with world capital, world technology and world management. This excess efficient capacity and production has likely been *the* reason why the death of inflation occurred - and not because of “tight” and/or “appropriate” monetary policies in countries as diverse as the US, Germany, China, or India.

5) **How to Compete ?** The brave new world required lean and mean competitive machines. Profit margins were significantly reduced, as the new virtuous cycle was in full operation. Given this competitive environment, where was the “edge” ? Most emerging markets, and particularly those in

East Asia, could not follow the old mercantilist model of an under-valued currency. Most of these countries were relatively open to foreign capital so devaluation could no longer be achieved by fiat. Further, any such devaluation would have been met by an extremely hostile response from foreign investors and international banks.

6) **China does compete - via large devaluations:** In the context of this boom in worldwide capacity, and production, and the inability of east Asians to devalue, China decided to make growth its first priority and an *under-valued* currency its primary instrument. This was “predictable” especially given the time-tested Japanese (later Korea, Singapore, Taiwan, Malaysia, Indonesia, Thailand) model of growth. China devalued by an extra large 220 percent (1980 to 1990), and then followed it with a large (54 percent) devaluation from end-1990 to end 1993. This ultra-competitive devaluation had the active support of the World Bank, which had this to say in its glowing China 2020 report published just before the crisis in mid-1997: **“Perhaps most important, the government maintained a realistic exchange rate policy. It almost halved the exchange rate at the outset of reforms and devalued the currency on four later occasions”** (1997,p. 10).

7) **Mega devaluations in China: correction of earlier overvaluation ?** . Perhaps the 1990-93 Chinese devaluation was as a response to balance of payments problems and “forced” upon China by World Bank-IMF ? The answer seems an overwhelming NO. The preceding five years (1985 to 1989) the Chinese economy grew at an *average* growth rate of 9.5 % per annum with inflation at a high 14 percent; inflation then collapsed to a 4 % rate 1991-1993, and economic growth remained high at 9 percent. Trade surpluses were reflecting a large *under-valuation*; such surpluses had exactly doubled from \$ 40 billion per year 1985-89 to an average of \$ 80 billion during 1990-1993. It is doubtful that any IMF or World Bank economist would have advocated an expansionary devaluation with these statistics

in 1990. But they did, and congratulated themselves afterwards for doing so.

China's Mercantilist Trade Policy

1) **Rules do not apply to China:** The "fair" or appropriate value of a currency is a controversial issue. But most agree that one of the consequences of under-valuation is a persistent trade surplus, and that of over-valuation, a persistent trade deficit. The evidence presented in Table 6 confirms what China's competitors have known all along. Sweat shops, and lack of political representation, do make a difference. In three short years (1990 to 1992), by actively devaluing its currency, China gained in competitiveness by 30 percent relative to ASEAN7 countries (the difference in PPP+ over-valuation has a one-to-one correspondence with *dollar* prices and competitiveness). Gains in "competitiveness" is the correct way to evaluate whether a country is playing by the rules of the fixed exchange rate game. (In a floating exchange rate world, the market "rewards" gains via an appreciation of the currency, thus limiting perpetual gains, and perpetual surpluses.)

2) **Predictable Effects of China's devaluation:** It took a communist economy devaluing to reveal, text-book style, the consequences of devaluation. China's exports to industrialized countries grew at a 17 percent annual rate in the nineties, more than *double* the rate of the best exporters, the ASEAN7 economies. Exports of China's competitors (ASEAN7) still grew faster than the rest of the world (7.8 percent vs. 4.1) and this statistic is often used (mostly by we-did-not-do-any-wrong World Bank economists) to suggest that the Chinese devaluation did not hurt the ASEAN7 since ASEAN7 exports still grew, right? What this argument ignores is that crises occur when production, exports etc. grow significantly **less** than planned, and China, by stealing the Asian lunch, caused severe indigestion of large scale capital flows i.e. EA exports to industrialized countries *grew at significantly lower rates than if China had not devalued*. Recall that in 1994, Mexican exports were growing at double-digit rates yet that was neither necessary, or sufficient, to

indicate that the peso was extremely overvalued. Similarly, the fact that EA market share was increasing is not half as important as the fact that ASEAN7 exports were growing considerably less than capacity investments had "planned", and at half the rate of their main competitor, China.

3) **Was Chinese Trade Policy Mercantilist?** Webster's dictionary defines mercantilism as follows: "an economic system developing during the decay of feudalism to unify and increase the power and especially the monetary wealth of a nation by strict governmental regulation of the entire national economy usually through policies designed to secure an accumulation of bullion, a favorable balance of trade, the development of agriculture and manufactures, and the establishment of foreign trading monopolies". As shown in Table 6, a key feature of mercantilism, accumulation of trade surpluses, did seem to occur in China. Only China's trade surplus shows a quantum jump - with respect to the all important market (industrialized countries) China's trade surplus almost **quadruples** from "only" \$ 24 billion in 1990 to an average of \$ 87 billion in 1996-97. No movement of the surplus is observed for Japan, and the trade surpluses become *deficits* for the ASEAN7 (decline is from \$ 17 billion in 1990 to minus \$16 billion in June 1997).

4) **Mercantilism Index says YES:** Table 6 also reports on a mercantilism index constructed by Oxus. This index attempts to capture "excess exports" and is defined as the ratio of such excess (X-M) to export levels. Both China and Japan appear as the major mercantilists, and since 1996, China appears as the most mercantilist in the world, even more than recession battered Japan. The figures for Japan today vastly overstate mercantilism because the depression there vastly understates imports, a problem not present in booming China.

5) **But China's trade surpluses are different - US:** Since the 1985 Plaza agreement, US policy-makers from the President downwards have been obsessed with the large trade surpluses that mercantilist Japan has been able to enjoy. However, the

political economy of U.S. - China relations dictated that US actually encouraged the development of equally large trade surpluses of China. In 1997, China's trade surplus with the US was almost **equal** to the "horrendous" figure for Japan - \$ 45 billion vs. \$ 54 billion. The US, for economic and political reasons, was in a help China mode. In the 1992 campaign, Bill Clinton stated that he would take China to task over human rights abuses. ("From Rangoon to Beijing was the battle cry"). After the election, all was forgotten. Most favored nation status was rapidly renewed each year, human rights abuses were forgiven, and the Democratic party became China's biggest supporter (and apparently vice-versa). China's huge trade surpluses are apparently "no problem" but Japan's surpluses signified deep rooted structural problems.

6) **Why Can't We All be Mercantilist ?** In a democratic set-up, there will be demands for a revaluation of the currency, an outlet not available in Communist regimes like China. Workers, and consumers, lose out with an undervalued currency with the gainer being the mercantilist state. However, the post-War experience of Japan has shown that a democratic polity is only a necessary and not sufficient condition for providing a "checks and balances" to mercantilism. Nor does the international financial system help. Various mechanisms to identify and punish dumping are in place. Unfortunately, the structure does not allow vigilance over under-valuation while over-valuation gets corrected automatically - large current account deficits need to be financed and lenders are unwilling to lend. Trade surpluses, however, are self-correcting only if the domestic political system allows representation, or if IMF plays its appointed role.

7) **What about IMF-World Bank as an umpire ?** Could the IMF and World Bank have acted to stop China's mercantilist march ? The former did not have the clout (because US was in control) and it was not in the World Bank's interest to act against its biggest client.

Consequences of the Crisis:

1) **Response of East Asia:** What are policy makers (especially of export-oriented economies) to do when they are competed out of markets by their big neighbor ? They can complain to the international authorities about a genuine non level-playing field, but this for political reasons (US-China bond) was not possible. The other alternative was to devalue. But this would have met with wrath from the foreign investors, or from other neighbors, about not playing by the rules.

2) **Plaza is the parallel:** While most analyses of the crisis have centered on parallels with the Mexican devaluation of 1994, it is likely that the closest parallel was the Plaza agreement, an agreement undertaken to stop the undervaluation of the Japanese yen. This "deal" was hammered out under the leadership of the US government in Sept. 1985; its purpose was to devalue the dollar in general, and revalue the yen, in particular. The Bretton Woods fixed exchange rate system had been dismantled more than a decade earlier. Yet, the yen remained strangely fixed, (the yen/\$ exchange rate was 260 yen just before Plaza in 1985 - it was the same five years earlier) and under-valued, in a floating rate world. Japan also continued to run up huge trade surpluses - a factor which had not gone unnoticed in the American corporate, and political, circles.

.Replace Japan with China in the above paragraph and the parallels become striking. China was also running huge trade surpluses; also rapidly growing; also rapidly approaching East Asian productivity levels; and also continuously operating an under-valued currency. The competitor(s) hurt in this instance by a mercantilist policy were the East Asian neighbors, the very same set of countries that took part in the Asian crisis.

3) **East Asia Responds:** A suggestion which comes out of the analysis is that East Asian policymakers *welcomed* the Thai crisis because it allowed them to get out of the straitjacket of fixed exchange rates - and, like US with Japan a decade earlier, allowed them to be competitive once again. A twenty something devaluation was common in the previous three decades and these

policymakers probably felt that the devaluation could be beneficial, and handled without a crisis. Indeed, Taiwan stated as much when they said that for “competitive” reasons it was going to let the currency depreciate from its managed level of 28 NT/dollar. However, markets are difficult to control, much more so in today’s capital flow world. The situation got out of hand and a “welcome” devaluation turned into a crisis.

4) **Who is to blame ?** : Everybody’s favorite whipping boy is the “market” and the bad boys on Wall Street. They caused the crisis, so let us regulate them further. They allowed capital to flow freely, so let us discontinue efforts at capital account liberalization. Stock prices in these markets were in a bubble, so it was the fault of investors in these economies. Japan needed to be helped, so it was Japanese devaluation that destroyed these economies. The list goes on , and on. Most of it does not stand the test of data, or scrutiny. See below.

Six alternative-to-China-devaluation explanations for the crisis - and why none of them count:

Financial markets, and policy makers around the world (including in China and the US), take it for granted that the Chinese devaluation of end-1993 was important in generating the crisis of 1997. The common belief is that the East Asian crisis would take a significant turn for the worse if the Chinese were to devalue anytime soon. Oxus agrees, and its reasons have been outlined above. Yet, a curious literature has developed in the policy wonk/academic world. The past devaluation experts and advocates of open trade policy are in a denial mode. After having advocated the benefits of devaluation to the entire developing world for five decades, it is now stated that China’s devaluation was **irrelevant** for the crisis. Let us examine this argument just a little bit. Devaluation helps exports, it did help China’s exports and trade surplus (from high to even higher) yet it did not affect the competitor economies of east Asia ? It does not get nuttier than this.

1) **Crony Capitalism and Non-Performing Assets of Banks:** Analysts have

identified causes of the crisis which are really *subsets* of a managed exchange rate regime. The example of “crony capitalism” is one such “derived” primary cause. The access to rents i.e. cheaper foreign credit, is rationed by the government to preferred customers (cronies). Hence, cronyism helps obtain rents. If exchange rates are floating, the rents also float away. Now consider the example of non-performing assets, or banking sector problems. Suddenly, in late 1997, academic economists and bureaucrats at international organizations were touting their latest find - non-performing assets in East Asia were large and were *the* cause of the *crisis*. This was a surprise, since the conventional wisdom was that the much more developed financial sector, and realistic interest rates, were the cause of the East Asian *miracle*. How do non-performing assets occur ? When bad investments occur. How do bad investments occur ? When the returns to investments are not high. What happens if foreign borrowing rates are almost 3 to 5 percent less than risk-free domestic deposits ? Excess borrowing occurs which results in excess investments which results in an excess of non-performing assets. In other words, the banking sector problems in east Asia were an **outcome** of the managed exchange rate regime, and therefore not a **cause** of the crisis.

2) **Equity and Property Markets:** The leading indicator of the economy in both developed and developing markets is the stock market. Especially in developing countries where the policy makers “control” the workings of other financial markets - interest rates and exchange rates. This makes the stock market the *residual* shock absorber. Perhaps because of this acknowledged role of the stock market, the first conventional wisdom culprit cause of the crisis was - an “asset bubble”. (See Sachs(1998), Krugman(1998) among various others). The evidence does not support this glib conclusion. In end 1996 and/or June 1997, the dollar based indices with 1990 equal to a 100 were as follows: Indonesia at 135, Korea at 79, Malaysia at 236, Philippines at 397, Singapore at 210, Taiwan at 195 and Thailand at 111. Excepting the Philippines, the “best”

bubble was Malaysia with stock market prices twice those six and a half years earlier. The Malaysian economy, like the rest of East Asia, was growing at an average of 7+ GDP growth rate during this period. According to “fair” value index reported earlier (Table 5) the Malaysian stock market was trading at a 17 percent *discount* in June 1997, the Philippines at a premium of 60 percent and Thailand and Korea both at discounts exceeding 60 percent! Little, rather no evidence, of a stock market bubble. Indeed, the stock market was giving more than adequate notice that something was wrong with the investments that were being undertaken in these economies.

In contrast, however, the property market in all the East Asian economies was in the midst of a property asset bubble. According to So-Kanatunga(1998), in both Hong Kong and Singapore, property lending (as a percent of total loans) had zoomed to 35 percent; the “capital value index” of real estate in major cities was at its peak in all the East Asian economies in June 1997. However, while this bubble was present, it was so in only the capital cities of these economies, and could not possibly have absorbed the billions of dollars of excess borrowing.

3) **The perverse role of fiscal surpluses**

Instead of fiscal deficits, the East Asian economies were running *surpluses* for several years prior to the crisis in 1997. This is indeed fortunate. If they had been running deficits, everyone would have identified the culprit and the emerging economies would still have been left with bad exchange rate policies ! Indeed, Bhalla(1997b) makes the point that possibly the *worst* policy for a developing country is good fiscal policy and managed exchange rates. This occurs because of the signaling effect. Foreign investors, and yuppie traders, need to make quick, and hopefully not very taxing, decisions on where to invest. The menu is the world, and the senior management will not approve of investments in “irresponsible” economies. The best indicator of an economy’s health is the fiscal deficit. Why ? Because the World Bank, the

IMF and Greenspan say so - and they obviously know better. How can it be wrong to invest in a country which has 8 percent growth and fiscal surpluses ? Nobody has ever lost a job on a lemming investment. Hence, the flood of money into East Asia, aided and abetted by the guarantee that things could not go wrong i.e. a “fixed” exchange rate. More the fiscal surplus, better the economy, more capital came in , and the exchange rate became more over-valued. A virtuous cycle became a vicious cycle. Hence, the over-capacity, the decline in the rate of return to investment, and the denouement of the crisis . It is a moot question whether senior managers know more or less than yuppie traders about what the determinants of growth are in an emerging economy. What is clear is that both are heavily influenced by the latest fashion (literally) on Wall Street.

4) **Did Capital Account Liberalization (CAL) cause the problem ?** The East Asian crisis was a financial crisis, and one involving foreign capital inflows and outflows. This fact has led several economists to conclude that “unregulated” inflows were the problem. Hence, they should be regulated (Sachs (1998) or that capital account liberalization has no gains for the developing economies. (Stiglitz(1998)). Indeed, Stiglitz argues that capital account liberalization (CAL) increases risk, and does not increase growth.

There are at least six problems with the Stiglitz view. First, there is no evidence to support the contention that CAL increases risk even though Stiglitz claims that “I think the statement that capital account liberalization increases risk is uncontroversial” In the nineties, real interest rates in LDC’s were lower, and had lower volatility than corresponding rates in the less CAL eighties. Second, any extra risk that occurred with CAL was the risk associated with the managed exchange rate system breaking down - a non-market system with the public sector in control. Third, excessive short term foreign borrowing was the result of a managed exchange rate system and could not have occurred with floating exchange rates. (Hence, the only regulation needed is one pertaining to the un-fixing of exchange

rates, rather than the “fixing” of the market). Fourth, the advent of CAL has meant that domestic savings rates and investment rates are no longer correlated in the nineties - a statistic that implies that capital is seeking its highest level, and therefore its use has become more efficient. Fifth, economic growth in the nineties was significantly above those observed in the eighties. And finally, If all of the above is not accepted (but on what basis ?), then, as argued in Bhalla(1997b), a necessary and sufficient condition for full capital account liberalization is a floating exchange rate regime, or currency board regimes as in Hong Kong. If this definition of CAL is adopted, then it follows that the managed exchange rate regimes of East Asia were economies *without* appropriate CAL; hence, the presence of CAL cannot be a cause for the crisis.

5) **Did Japan De-valuation Cause the Crisis ?** The yen devaluation of nearly 40 percent between mid-June 1995 and end-June 1997 may have been responsible for the financial crisis (IMF(1997)). Apparently, the view is that the yen devaluation mattered, but not China’s devaluation - an inconsistency also enthusiastically endorsed by the *Economist* (1998) ! Japanese exports, and trade surpluses peaked in 1995 and in 1997 were barely above 1995 levels, even though the yen had devalued. It is interesting to note that the IMF mentions the yen devaluation as a contributory cause with no evidence from exports data, and does not acknowledge the possibility of Chinese devaluation with significant data about Chinese exports and trade surpluses. The World Bank (1998) in its official response to the crisis goes one step further - nowhere in the text does it even mention the large Chinese devaluation! Indeed, it does not even mention overvaluation as a significant cause of the crisis.

6) **China and Hong Kong data should be combined** : In a recent article (Fernald et. al, 1998, or FEL) three US FED economists attempt to document the irrelevancy of the China devaluation hypothesis. They reach this US politically correct conclusion by use of the bizarre assumption that China and Hong

Kong data should be looked at in a combined fashion, **even prior to the handover!** “It makes economic sense to combine China and Hong Kong trade data (even before the handover) because it is conceptually difficult to differentiate between the contributions of Chinese and Hong Kong firms” (p. 7). The authors appeal to Krugman(1997) to support their absurd reasoning: “Krugman also argues that we should combine China and Hong Kong, on the grounds that conceptually, it is like separating the trade statistics for New York city and the rest of the United States”. The FEL-Krugman argument is less than convincing. Even for data after the handover (June 1997) it is not clear that the trade statistics for China and Hong Kong should be combined. The two regions have different exchange rate regimes, different costs, different tax structures, and different comparative advantages. The data for the two regions tell a different story. At the margin, it is the case that taking the extreme step of combining Hong Kong and China data helps the FEL argument because Hong Kong exports grew at a considerably lower rate than Chinese exports. But could it be that the growth rates differ by the extent they do because China had a large devaluation and Hong Kong did not ? If one is trying to prove that Chinese devaluation did not have an effect, is it not a trifle disingenuous to base the analysis only on export data for Greater China, rather than just mainland China ?

Table 6: Mercantilism and East Asian Competitiveness

	1990	1991-93	1994-95	1996-97*	1990-97*
PPP+ Over-valuation (%)					
China	-0.1	-23.0	-26.0	-5.4	-17.2
Asean 4	-3.2	7.3	21.3	27.3	13.6
Asean 7	-2.0	7.0	19.5	23.3	12.4
Japan	4.3	13.2	31.6	16.1	17.5
PPP Overvaluation(%)					
China	-0.1	-11.4	-5.5	16.4	-2.8
Asean 4	-3.2	1.2	9.3	13.1	5.1
Asean 7	-2.0	1.8	8.7	10.1	4.8
Japan	0.04	12.7	27.8	12.0	14.9
Exports to Industrialized Countries (IC's, %)*					
China	45	20.2	21.4	6.9	16.8
Asean 4	62	11.9	16.2	5.6	11.3
Asean 7	179	5.7	16.3	2.6	7.8
Japan	183	2.9	6.8	-1.9	2.6
US	268	1.5	12.8	7.5	6.5
IC-(US+Japan)	2127	-1.3	15.6	3.3	4.8
IC-(Set)	1878	-2.8	15.3	3.2	4.1
Trade Surplus with IC's (\$ Bn)					
China	23.6	38.8	61.1	86.1	54.3
Asean 4	10.3	13.8	11.8	12.9	12.7
Asean 7	16.6	4.7	-16.7	-15.6	-4.2
Japan	81.3	97.4	99.5	80.4	91.7
Mercantilist Index					
China	44.7	38.9	37.5	40.2	39.6
Asean 4	-1.1	3.2	-4.8	2.3	0.4
Asean 7	-0.03	1.5	-3.1	1.0	0.03
Japan	32.9	41.8	40.2	31.9	37.8

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Notes:

- 1) Recipient country data (IMF - Department of Trade Statistics) data are used for exports and imports e.g. China's exports to US are taken from US data on imports, rather than China's data on exports.
- 2) Figures for 1990 represent levels, while other columns represent averages. For exports, 1990 represents levels, (in \$ Bn) while other columns represent average of growth rates. Data for 1997 is end-June 1997 data annualized.
- 3) All growth rates are computed as 100 times the first differences in logs.
- 4) The mercantilist index reflects capacity for "excess" exports and is given by the ratio of excess exports (X-M) to export capacity.

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- **Track Record:** Trades mentioned in **Developing Trends**. The current issue (vol. 2, Nos. 7 & 8) has documented the accuracy of Oxus's currency forecasts. Other markets: *Indian Stock Market*: Nine recommendations were made over the last 20 months, out of which seven were profitable, for an average total unleveraged profit of 79.6%. *\$/Rupee*: Seven trades, six profitable for a total unleveraged return of 21%.
- **Track Record:** *Mulberry Fund*: From February, 1997 to end-Aug. 1998, one of the directors (Surjit S. Bhalla) operated a private fund of Rs.40 lacs (approximately \$ 100,000) with investments in the Indian stock market. The fund returns were greater than 40 %, and it yielded an excess return of 37% (over the "benchmark" Sensex). This broad-based fund had no more than 20 securities in its portfolio at any one time (the average was less than ten securities) and had an aggregate turnover of less than 200%, i.e., no more than an annual average of 2 round-trip trades. The reasoning behind stock selection was stated in **Developing Trends**, Vol. 1, No.3, May 26, 1997, page 8: "...considerations of catch-up and differential productivity levels dictate that service industries – e.g., advertising, software, banking, will do relatively well in India." The fund has now moved to OFM and new portfolio management investments are planned after receipt of license from the Securities and Exchange Board of India..

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