

# Developing Trends

Oxus Research & Investments

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## In Defense of the IMF

This is *Developing Trends (DT)* second anniversary issue of the Asian financial crisis. In the issue dated August 24, 1998 we stated: "The Chinese word for crisis means both danger and opportunity...China will not devalue its currency in the near future...The dollar has topped against the Asian currencies...the dollar has also topped against the majors...the world economy is likely to emerge from its trough soon...No matter what the criteria, Asian equity values are at extremely attractive, and yes, rock bottom levels...the Indian rupee is likely to be a non-event – buy Indian debt and stock market ". Oxus was just a trifle bit early, as the Long Term Capital Management crisis hit the markets in September 1998.

The Asian markets soon made us right by rallying, by shocking amounts, in both currency and stock markets, from Oct. to Dec. 1998. In late December 1998, *Developing Trends* again issued a strong recommendation to stay long, and buy, the Asian financial markets. In addition, we made a case for becoming overweight the Indian stock market, and remaining flat \$/rupee. "Oxus now believes that clients should not only go long the Indian market, but that they should do so aggressively."

The events in the *financial* markets have vindicated our recommendations. But what about the *real* economy? Are not markets going through irrational exuberance again? Were not the markets wrong about East Asia in 1996 and early 1997? Why won't they be wrong again?

The *DT* issue of August 1998 had documented how the markets were *not* wrong in 1997; indeed, about how the stock markets

of Korea and Thailand had signaled well in advance (in 1995 and 1996) that all was not right in East Asia. Equity markets had gone nowhere (indeed declined) in these economies for several years prior to the crisis month of July 1997.

As it turns out, the financial markets are liable to be right again about the real economy of Asia. The world seems to be recovering at a much more rapid pace than those forecast in end 1998 by the severest critics of the IMF - the World Bank, OECD, Economist Intelligence Unit, and high brow economics faculty at Harvard and MIT. (Note that *DT* itself had issued a forecast on Dec. 28, 1998 that the world economy would grow at a robust 2.7 % pace in 1999, rather than the below 2 % growth forecast by the critics.)

In keeping with the *DT* tradition of market analysis with a (rigorous) economics face, this double issue documents the nature of the world recovery in 1999 – and whether the IMF, or its critics, will emerge the winners of the ideological battle of (prudential!) state intervention (dictation!) vs. individuals pursuing economic freedom, in this birth centenary year of Hayek.

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### **IMF - A Recipe for (What) Disaster?**

Almost simultaneous with the start of the Asian crisis were criticisms of the IMF policy to ameliorate the crisis! The criticisms (mostly from policy wonk economists, but not market economists) centered on the IMF recommendation of raising interest rates in the middle of a financial crisis. The contention was that this was unnecessary addition of fuel to an already raging fire. In addition, the IMF wanted to put in place “balancing the budget” type of policies. This meant that both monetary and fiscal policies were to be restrictive in nature.

The IMF (rather quickly for the staid institution) recognized its error and backtracked on the restrictive fiscal component. But it stuck to its recommendation of high interest rates. The detractors, however, continued with their criticisms, stating that the IMF recommendations were a recipe for disaster.

As confirmation of this view (circular reasoning?), the critics produced forecasts that the recovery would be a prolonged L-shaped one, somewhat like the response to the debt crisis of 1982. And not the U (or V) shaped recovery that the IMF was anticipating in response to its policies. The criticism was that the IMF “just didn’t get it”; this was no ordinary crisis was the chorus.

The crisis was like 1982, rather than the 1994 Mexican crisis, said the critics. Different policies were needed for the brave new world of financial crises was the refrain. “IMF recommended capital account liberalization had led to the crisis” became the rallying cry. And the dire conclusion/forecast: because of gross IMF mismanagement, the world was condemned to sub-par below 2 percent growth for several years into the doomed future.

Thus, according to the critics, the East Asian crisis highlighted two important “facts”; first, that it was an outcome of too much capital

account liberalization; and second, that the world needed a new financial architecture

since clearly the IMF was not upto the task. “Not upto” because it had misdiagnosed the cause of the crisis and then compounded the illness by prescribing the wrong “cure”. A double whammy of most serious dimensions. If true, then surely the critics were right and the world needed a new order.

Thus, a lot rides on the nature of the Asian recovery (at least for the IMF and its critics!). The alphabet nature of the recovery will be the decider. If it is U or V shaped, the IMF will be right; if L-shaped, the critics would be attributed with considerable economic sense, and acumen. Unfortunately for the IMF, the bets are hugely asymmetric – if the critics are wrong, they will attribute it to just another forecast gone awry – and as all of us forecasters know, that is merely an affirmation of one’s humanity.

As this **DT** issue documents, the reason for several forecasts being caught flat-footed was because of a simple, some would say ideological, belief: that the IMF policies were bound to fail. Leading academic economists had joined in the clarion call challenging the IMF policies for exchange rate stabilization.

In contrast to the critics of IMF, Oxus had contended, as early as late 1997 that the IMF was correct in keeping to its “new” policy of high interest rates and a relatively non-stringent fiscal policy. This policy response was correct because of the nature of the crisis i.e. a crisis brought about due to a movement - transition - from a fixed exchange rate regime to a floating exchange rate regime.

This assessment followed from Oxus’ recognition of how currency markets worked. When a country moves from an overvalued fixed, to an eventual fairly valued floating exchange rate, a huge asymmetric bet arises.

The shift in the exchange rate regime changes the rules of the game as exchange rate

determination is now done by market forces rather than the central bank. This causes speculation to increase on the currency with seemingly no bottom in insight. Although long run exchange rate values are most likely a function of PPP (Purchasing Power Parity), essentially a mean reverting process, it may take some time for the exchange rate to correct to its “fair” value.

In the immediate short-term, what is the likelihood of the currency appreciating? Very small – try zero. So it pays for domestic residents, and all and sundry, to indulge in capital flight and bet against the domestic currency. Participation in capital flight yields the “investor” almost a risk-free profit of 5 to 10 percent *over a few days!* Why shouldn't savvy domestic residents indulge in these asymmetric investments?

What can the authorities do to stem the rot? They can remove the asymmetry, and do so in a convincing manner, and instill confidence in the market, and *change the psychology of speculators.*

The above goals may be attained by defending the value of the currency - but ever since Britain lost over a billion pounds to a single speculator (savvy investor) in 1992, this policy does not come with a “Good Housekeeping” seal. Or the authorities can raise short-term interest rates by thirty plus percent – and hope to hurt the speculators.

Raising of short-term rates maybe the only *correct* policy response to an exchange rate crisis. (And some luck). The speculators are banking on the fact that the government will *not* call their bluff by raising interest rates to make an economic situation worse. If the bluff is not called, the exchange rate would continue to depreciate, and the speculators would continue to accumulate (obscene) profits. Capital flight would continue, and the crisis deepen.

Note that there is an identity of views between the speculators and the IMF critics. The similarity may be co-incidental – but it

does point to the fact that the government (and the IMF) have few options to an exchange rate transition crisis.

But there is a radically different response than that of the IMF. Exchange controls, (and indeed this is what was advocated), in varying forms, by the varied IMF critics! The recommendations crisscrossed the spectrum from the imposition of a capital flows tax (Tobin tax), Chilean type taxes on short-term flows to strict, and somewhat anachronistic, exchange controls a la Malaysia.

It is mandatory that the performance of the economies to the two different policy prescriptions – high short term interest rates and exchange controls – be examined in detail. Such an examination will shed light on some of the important policy issues of the day – as well as determine whether the IMF, or its critics, are right. This is attempted in the subsequent pages of this issue of *Developing Trends.*

**What about fiscal policy?** The increase in short-term interest rates is likely to hurt the economy (in the short run); the effect could be lessened to some certain extent by coupling it with an expansionary fiscal policy.

This then is the (only) policy package possible to an exchange rate transition economy – high short-term interest rates to combat the speculators, and to bring about stability in the exchange rate; and an expansionary fiscal policy to ameliorate the pain! If it sounds paradoxical, it is. Note what is being recommended is that the economy move to a floating exchange rate regime from a fixed exchange rate regime - and the only way to achieve a successful transition is to have a fixed exchange rate, *without exchange rate intervention*, for the few crucial transition months. The alternative, IMF critic policy has (perhaps) the same goal – with the crucial difference that it wants to do so through exchange controls i.e. a policy no different, and perhaps a lot worse, than what was being left behind. But the proof is in the reality – for that read the evidence in the following

pages.

**The World Economy in 1999: Boom or Bust?** In the Dec. 1998 issue of *World Economic Outlook*, the IMF downgraded its previous gloomy forecast for world economic growth for 1999, to 2 % from 2.5 percent. The slowing down of the American economy (expected to grow by 1.8% as against 3.6% in 1998) and the contraction of the Japanese economy by 0.5% were seen as major threats to higher global growth.

In the same issue, the IMF warned that the “balance of risks remains on the downside”, citing the possibility of the resurgence of trade protectionism, a stock market correction (seen as a distinct possibility in the US) and an appreciating yen as factors that could prevent the global economy from coming out of the trough. For the crisis-ridden economies of East Asia, prospects for 1999 were perceived to be better, with small *declines* in output for all countries except Indonesia. The document stated that “beyond the financial markets, however, there are few signs of incipient recovery, although there are some signs of bottoming out.”

The World Bank in *Global Economic Prospects 1998/99*, also shared the depressing IMF scenario. It said “There is a substantial risk that the world economy will plunge into recession in 1999 rather than experiencing sluggish growth.” It pinpointed a worsening recession in Japan; a “shutdown” in private capital flows to developing countries, particularly Latin America, and an equity market correction (of 20-30%), and depressing growth in the US and Europe as contingencies fuelling the recession.

The World Bank saw the world economy growing at 1.9%, with the two major economies, the US and Japan, one (US) doing worse than IMF estimates, expanding by 1.6% and the other faring better, contracting by

only 0.2% in 1999. A significant point of departure between the Washington sisters was the perceived performance of the East-Asian economies; the World Bank was considerably more pessimistic.

Oxus also had a forecast at the same time (end 1998). In its year-end issue, *Developing Trends* (Vol.2, No.10, December 28, 1998) predicted a stronger-than-consensus rate of growth for the world economy: “The conventional, and considered, wisdom of leading organizations like the World Bank, and IMF, is for world growth in '99 to equal this years tepid growth of about 2.2 percent. Of the two, the World Bank is more pessimistic; it even perceives significant chances of a worldwide recession next year. Investment houses are cautious, if not fearful for '99. Oxus's calculations suggest a fair chance of a significantly more optimistic outcome. The mean estimate for world growth is projected to be 2.8 percent, with about a 25 percent chance that it will top 3 percent.”

Oxus' latest estimate for 1999 – the same as end-1998 i.e. about 2.8 percent, significantly more than the detractors, and perhaps reaching 3 percent.

Table 1 documents the basis for our calculations. Briefly, the US is forecast to grow at above 3 percent, rather than the tepid 1.6 percent forecast by the World Bank, or the marginally higher 1.8 percent IMF figure. Japan remains the wild card for a possibility that world growth might approach 3 percent. If Japan were to grow at above 0.5 percent (versus the predicted forecast of -0.3 percent) the Asian, and world economy, would get a substantial boost. But the world has been waiting for more than a decade now for Japan to do something right.

**Table 1: World Growth – Actual & Forecast**

|                            | 1998 GDP (1995 base) |       | Predicted Growth Rates -- 1999(%) |            |             | Change in Contribution to Growth |       |
|----------------------------|----------------------|-------|-----------------------------------|------------|-------------|----------------------------------|-------|
|                            | % of World GDP       | \$Bn  | Growth Rate (%)                   | IMF        | World Bank  |                                  | Oxus  |
| USA                        | 29.2                 | 7656  | 3.6                               | 1.8        | 1.6         | 3.2                              | -0.12 |
| UK                         | 4.5                  | 1190  | 2.4                               | 0.9        |             | 0.9                              | -0.07 |
| Euro 9                     | 27.2                 | 7125  | 2.6                               | 2.3        | 1.6+        | 2.1                              | -0.14 |
| Other Europe               | 1.7                  | 448   | 2.9                               | 2.5        | 1.6+        | 1.9                              | -0.02 |
| Japan                      | 19.9                 | 5208  | -3.0                              | -0.5       | -0.2        | -0.3                             | 0.53  |
| India                      | 1.5                  | 385   | 5.8                               | 4.8        |             | 6.0                              | 0.00  |
| China                      | 3.4                  | 903   | 7.8                               | 6.6        |             | 7.0                              | -0.03 |
| East Asia                  | 6                    | 1574  | -4.3                              | 0.0        | 4.8 / -0.5* | 2.0                              | 0.38  |
| Eastern Europe             | 0.9                  | 235   | 3.3                               | 4.2        | 4#          | 3.0                              | 0.00  |
| Latin America              | 5.6                  | 1474  | 2.0                               | 0.9        | 0.6Ψ        | 0.9                              | -0.06 |
| World (Above Regions Only) | 100                  | 26198 | 1.6                               |            |             | 2.2                              | 0.49  |
| World                      |                      |       | 2.2                               | <b>2.0</b> | <b>1.8</b>  | <b>2.8</b>                       |       |

Source: O[x]us Research & Investments database.

Notes:

1. The World is taken to be the above given regions and countries. To correct for the absence of other economies, we adjust 1998 and predicted 1999 growth rates by a factor equaling world output growth (actual)/ world output growth (Oxus' "World").
2. Growth rates are weighted by the country/region's share of world output to give an estimate for world output growth. IMF "predictions" for regions are obtained by summing IMF-estimated growth rates by Oxus' definition of the region.
3. Euro 9 consists of Germany, Italy, France, Spain, Portugal, Netherlands, Austria, Belgium, and Finland; Other Europe comprises Denmark and Sweden; East Asia comprises Indonesia, Hong Kong, the Philippines, Malaysia, Singapore, Korea, Thailand, and Taiwan; Eastern Europe comprises Hungary, Poland and the Czech Republic; Latin America is Argentina, Brazil, Chile, and Mexico.
4. World Bank Definitions are as follows:  
+ OECD Countries Average; \* East Asia & Pacific/East Asia 4; # Central & Eastern Europe; Ψ Latin America and the Caribbean.

**East Asian Recovery – Mirroring (Chile, Mexico) 1982 or (Mexico) 1994?**

With the worst of the East Asian crisis arguably behind us, it is appropriate to speak of recovery, and its likely shape. Analysts have compared the 1997 crisis to (alternately) Mexico in 1994 and Latin America (i.e., Mexico and Chile) during the 1982 debt crisis. We argue that East Asia has some parallels with 1994, yet has distinguished itself in important ways, following an altogether different path towards recovery.

The method of analysis, and definitions of the regions, are outlined in the box below. The variables considered are both real and financial e.g. GDP and industrial production data, interest rates, inflation, and stock market. For special reasons, “Asia” excludes Indonesia, Malaysia and Hong Kong. Note that the inclusion of these countries does not materially change the conclusions, though the numbers obviously vary.

First, therefore, our **conclusions**: The Asian crisis has been **much shallower** than the other crises considered. At its trough, Asian output was **less than 2 percent lower** than it was before the crisis. By contrast, Mexico in 1994 experienced a full 6 percent decline, and Chile in 1982, almost 8 percent. At present, Taiwan and Singapore are leading the Asian

recovery, with some help from Korea, and mixed signals from Thailand and the Philippines. Following current patterns, we should see “Asian” GDP at pre-crisis levels by the end of 1999, or sooner. It took Mexico approximately eight quarters to get back to pre-crisis levels; it will be no different for Asia. Even in Indonesia there is remarkable progress; a democratic regime has replaced an autocratic one, and predictions of mass starvation and massive crisis have been proved to be hysterical.

While the recovery path with Mexico is comparable, note that Mexico had several advantages – Big Neighbor to the North, a booming world economy, a recently signed NAFTA agreement. In contrast, Asia faced a declining world, demands for wholesale overhaul of the financial system, one crisis after another, and then Russia and then Brazil; and Cassandras to doom any remaining optimist. Yet, the invisible hand recovery is there to be seen.

Oxus’ optimistic reading of the world economy bolsters this conclusion. Asia’s imminent return to health is both a cause and a result of higher-than-expected global output growth.

**How to compare Crises, Regions & States**

This analysis follows an ex-ante, ex-post, before & after, and then & now approach to the Asian crisis. We study both regions and individual states, and define “Asia” as a composite of Korea, Taiwan, Singapore, Thailand, and the Philippines. We exclude politically-troubled Indonesia, capital-controlled Malaysia, and currency board Hong Kong, each an outlier in its own respect. (These economies are discussed elsewhere in this issue.) Quarterly data are presented, both for the sake of completeness, and to filter out the noise and see regional trends more clearly. Countries within Asia are weighted by their GDP in 1996: Korea, for instance, has a hefty 44% share of “Asian” GDP, Taiwan about 24%, and Thailand 16%.

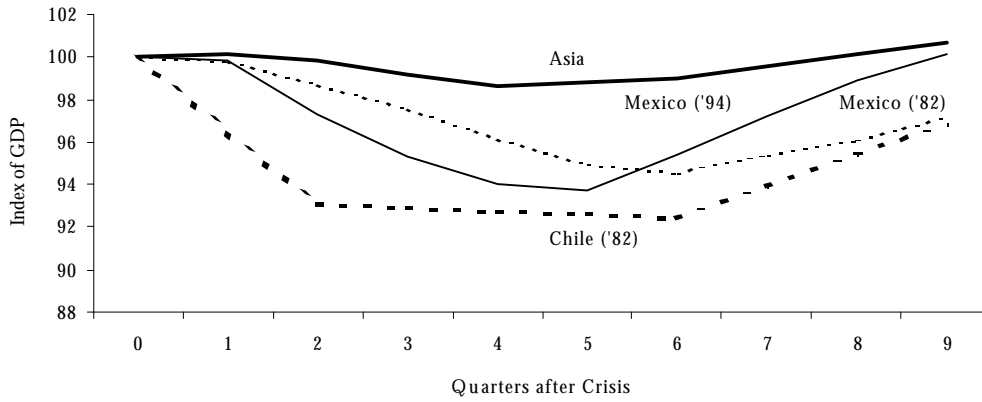
Quarterly data gives a sense of the broad contours of the recovery process. We define the pre-crisis month as the start of Q0, 3 months later as Q1, and so on. Each country had a different starting point – e.g., Thailand’s crisis “began” in July, 1997, while Korea was afflicted several months later. For the sake of comparison, we look at countries not at absolute points in time, but at X number of quarters after the crisis began. Hence “Q5” for Thailand and Korea will represent two different time periods, but *will* represent comparable stages in recovery.

**Charting Asia's Recovery (See pages 7-10):**

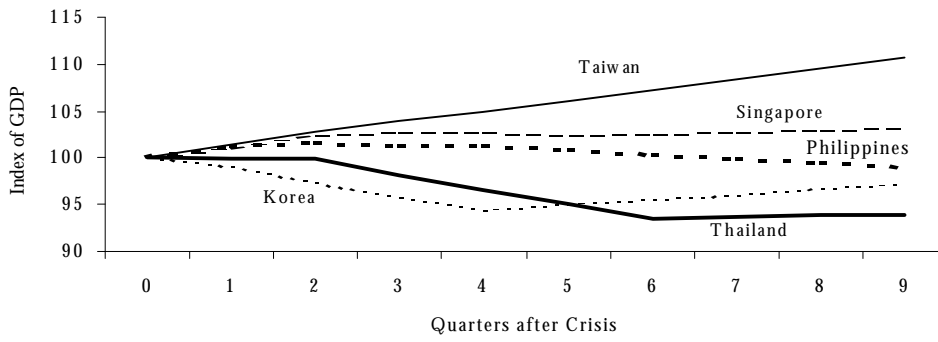
- **Real GDP:** A V-shaped pattern, like Mexico '94. Recovery on track and Asia should reach its pre-crisis output levels by Q8 after the crisis. Mexico also reached pre-crisis GDP level in the eighth quarter. (For Korea, the eighth quarter is Oct-Dec '99; for Thailand July-Sept. '99; for Taiwan, Oct. – Dec. '99.). Give individual country details.
- **Industrial Production:** Mexico '94 had a sharp 8<sup>th</sup> quarter when its output rose by more than 20 percent. Asia's recovery is more continuous but on track to reach pre-crisis levels by the eighth quarter.
- **Capital Controls Malaysia:** It continues to lag the IMF economies – by the end of the sixth quarter (Jan. – Mar. '99) its GDP was still 6 percent below its pre-crisis output, and its industrial production some 10 % below. Most investment houses are forecasting a less than 3 percent growth in both GDP and industrial production by end 1999. Thus this Mahathir given (and leading economists endorsed) laboratory experiment is not turning out to be that favorable to capital controls.
- **Politically Different Indonesia:** The crisis in Indonesia was different, and its output decline, and inflation increase, considerably greater. Nevertheless, with elections in the next few months, Indonesia is well on the road to political and economic recovery. While at the end of the sixth quarter post-crisis (Jan. – Mar. '99) Indonesian output is still more than 10 percent below the pre-crisis level, it has recently recorded the first y-o-y increase in GDP. The bottom has therefore been reached, and the recovery could be sharp – and much sharper than most analysts are forecasting. Correspondingly, inflation could fall to the low teens by the end of the year. In other words, the price of democracy is likely to be surprisingly low – an extra quarter or two than it's East Asian neighbors.
- **Consumer Prices:** The major surprise for East Asia, and several analysts, is that inflation did not take off with currency depreciation. Inflation is already back to pre-crisis levels for most of East Asia. This is in stark contrast to Mexico '94 when inflation ratcheted upward to 50 percent and above.
- **Exchange Rates:** Overshooting, followed by rapid recovery, and quite unlike other crises. The net depreciation for most of East Asia is a respectable, non-crisis level of 20 to 30 percent. In stark contrast to Mexico '94, all the Asian economies show a sharp appreciation from the over-shot troughs.
- **Stock Markets (Local Currency):** That East Asia was a liquidity crisis induced by a transition to a “floating” rate currency is best indicated by the behavior of stock prices. The recovery in prices has been sharper than Mexico, and higher. Most crisis economies are close to or above pre-crisis levels.
- **Stock Markets (\$):** The weighted Asian dollar index is exactly back to pre-crisis levels at Q6; Mexico, at a similar point, had retained less than 60 percent of its value. It is estimated that stock market recovery precedes “real” recovery by about 6 months. The continued rally in Asian markets is a strong indicator that recovery is imminent, and is likely to be at least as strong as that of Mexico '94.



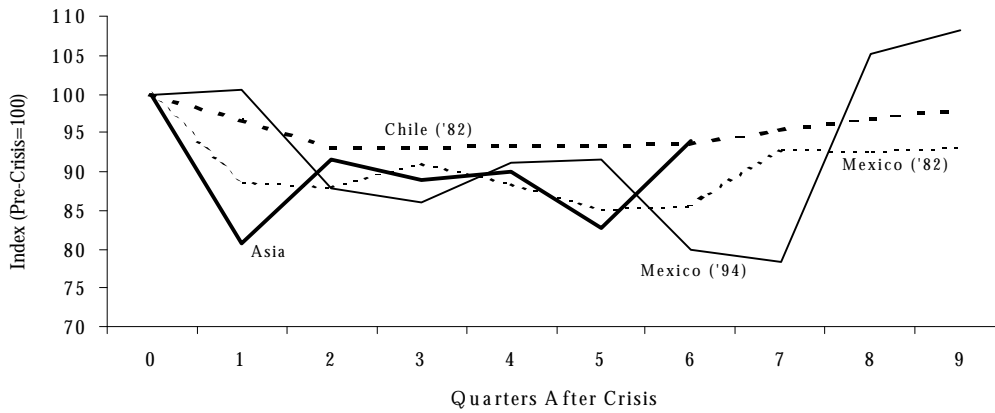
**Real GDP**



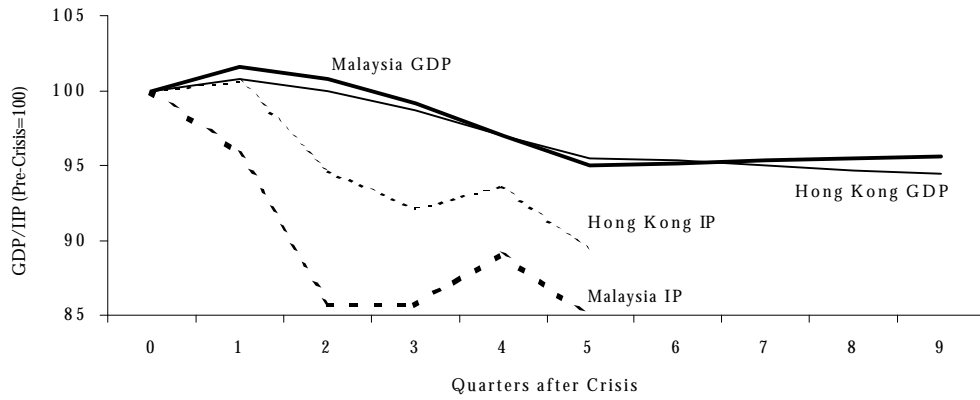
**Real GDP: Individual Countries**



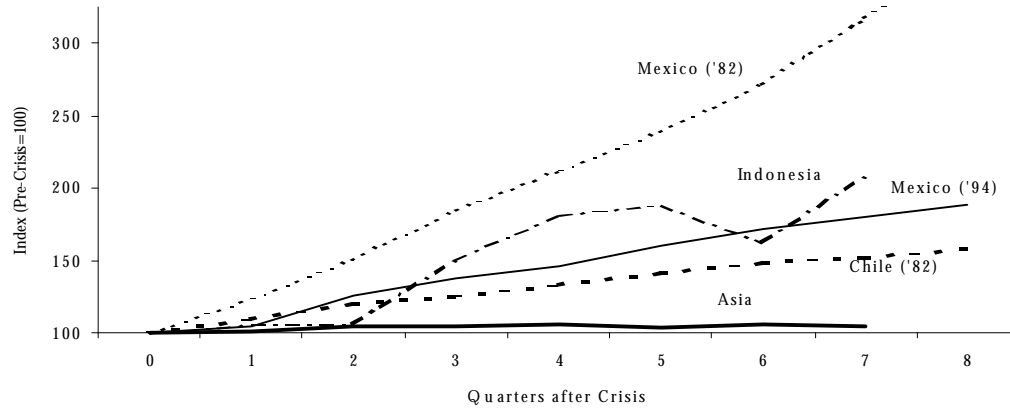
**Industrial Production**



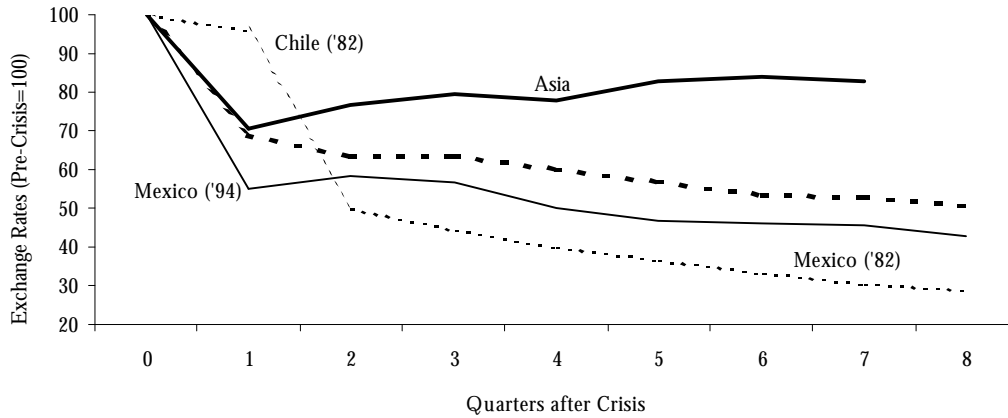
**Malaysia & Hong Kong: GDP & Industrial Production**



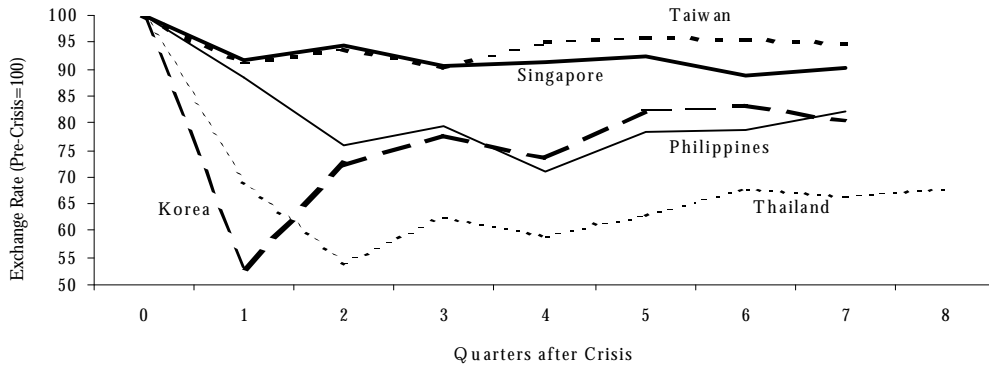
**Consumer Prices**



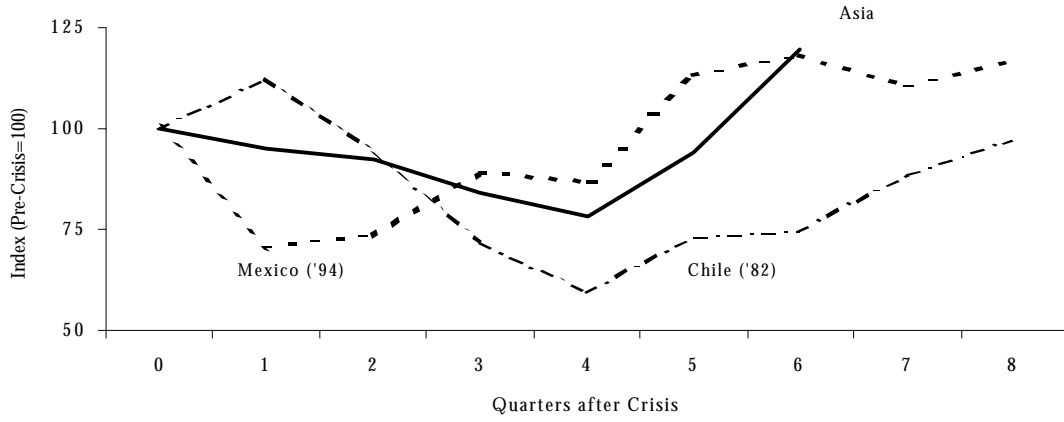
**Exchange Rates**



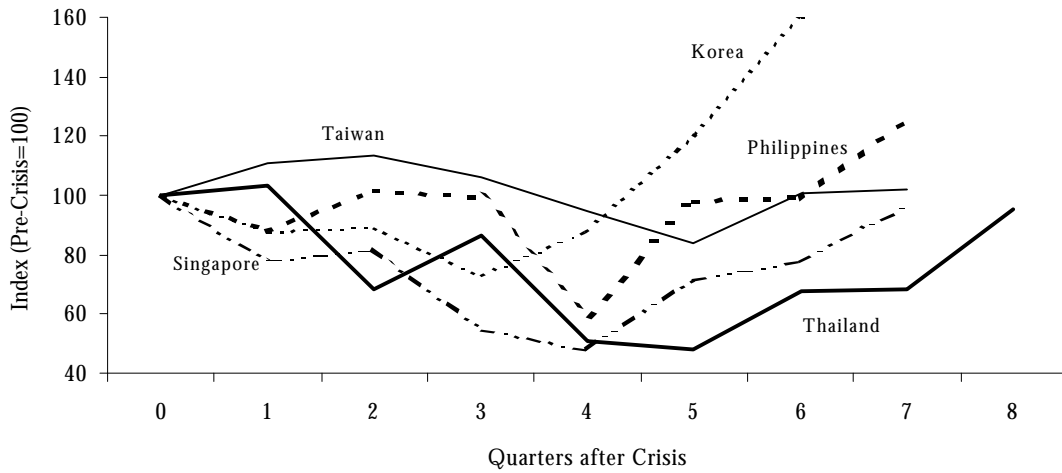
**Exchange Rates: Individual Countries**



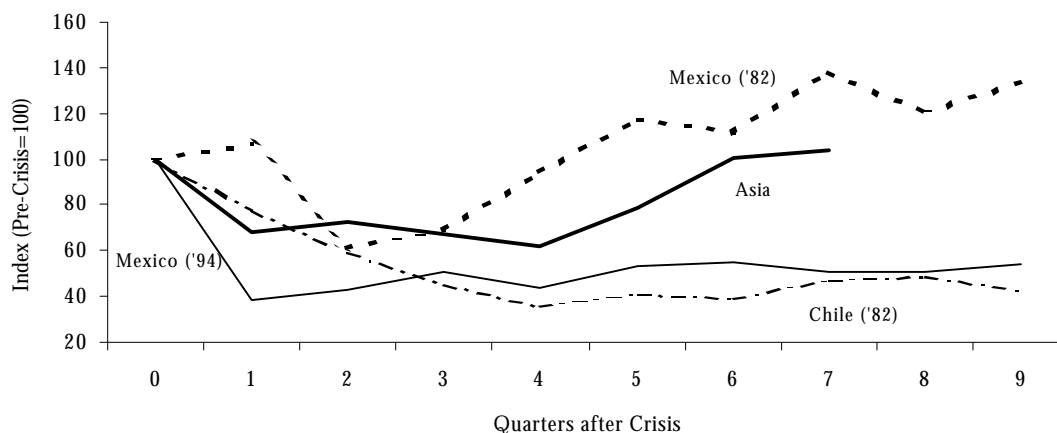
**Stock Markets (LC)**



**Stock Markets: Individual Countries**



**Stock Markets (\$ Terms)**



Source: O[x]us Research & Investments Database.

Notes:

1. GDP values for Asian economies are extrapolated for Q8-9, based on current growth rates.
2. "Asia" comprises Thailand, the Philippines, Singapore, Korea, and Taiwan. Hong Kong, Malaysia and Indonesia are not considered, for reasons given below.
3. Industrial Production data is seasonally-adjusted. Data for Taiwan is unavailable. "Asian" Industrial Production therefore excludes Taiwan.

**Outliers: Malaysia, Hong Kong & Indonesia**

Capital-controlled Malaysia is examined in a separate section; it is, for numerous reasons, a distinct case from the rest of East Asia. We exclude, as well, from our "Asian" analysis Indonesia and Hong Kong. Oxus, in earlier issues of *Developing Trends* and in opinion pieces in *The Economic Times* had pointed out that Indonesia's crisis was greatly heightened by the country's *political* problems. With its open capital market, and a regularly adjusted exchange rate, Indonesia was not a "traditional" candidate for financial meltdown. The crisis occurred, in our view, because it was seen as the only chance to oust Suharto, and to bring in democracy. Hence, local residents, and those desirous of a democracy (a large segment of the population), saw in capital flight out an opportunity for democracy flight in. The price at that time was an unknown; the analysis in this issue of *Developing Trends* suggests that it was only about two quarters of delay in reaching pre-crisis output levels, *in comparison with other democratic, non capital control Asian economies*.

Hong Kong is excluded for different reasons. With its strong economic ties to Mainland China, it is less tied to East Asia's fortunes. Further, its currency board maintains the Hong Kong dollar's value, differentiating it from other countries, with their previously fixed, and (now) floating exchange rates.

### **Asian V-shaped Recovery – In Words:**

Mexico, as *Developing Trends* argued in its crisis anniversary issue (Volume 2, Nos. 7&8, August, 1998), followed a V-shaped pattern of recovery. Its output (note: **NOT** output growth) bottomed out within four quarters of the December, 1994 devaluation, and had recovered to its pre-crisis level by Q9. Industrial output, far more volatile, zigzagged its way to higher-than-initial levels in the same time span. Chile and Mexico followed a more L-shaped recovery during the 1982 debt crisis, taking longer to bottom out and longer to arrive back at square one. An L-shaped recovery is characterized by several years of stagnation at a lower level of output, followed by a **very** gradual recovery. Output in Mexico took almost 3 years to recover to its mid-1982 level and industrial output more than 6 years.

The World Bank has compared Asia's crisis to 1982 by pointing out similarly unfavorable conditions – declining world output growth; a “deep-rooted” financial crisis across these countries, the need for structural adjustment. Mexico, with its relatively quick recovery post-1994 is, in Oxus' view, a more appropriate benchmark. Asia, six (or seven, depending on the country) quarters later, is revealing a similar pattern, in both the output and financial variables.

**Does Asia diverge from Mexico?** We look at several indicators of recovery, from exchange rates and stock indices to real interest rates, industrial production and inflation. All indicators bar one (industrial production, with its confused signals) point to a strong recovery and to an over-rated, and misunderstood crisis. It is likely that the crisis was nothing more than a liquidity crisis, and *not* the structural crisis the demanders of a new international order, and capital controls, would have us believe.

**Exchange rates.** In each of the “Latin Crises”, currencies lost a full fifty percent (or more) of their value, and continued to head south through the seventh quarter. Asia's

weighted exchange rate, in striking contrast, picked itself up by the second quarter, and at rock-bottom (Q1, on a quarterly basis), was just forty percent below its pre-crisis level. It has trended northwards and is currently less than 20 percent below the pre-crisis level. Excepting Russia's “scare” of September, 1998 (Q4), there has been a steady trend upwards in Thailand, Korea, and the Philippines, the former two having endured some of the worst “over-kill” during the crisis' initial months. Korea provides the starkest example: having lost almost half its value by Q1, the won is currently just 18 percent below pre-crisis levels. This lends credence to the assertion that 1997 was, above all else, an exchange rate crisis; a liquidity crisis; once the systems were corrected (as they were), recovery, and currency appreciation, was inevitable.

**Consumer price inflation** is another important piece in the puzzle. Unlike Chile and Mexico (twice), Asia has not been afflicted with highly-accelerated inflation. Six quarters post-crisis, prices stood 50 percent (Chile in 1982) to 175 percent (Mexico in 1982) higher than at Q0. The change in Asia: 5.3 percent. Prices in Singapore and Taiwan remain at, or below, their 1997 levels; those in Thailand and Korea are a mere 2 to 3 percent above.

Part of the explanation for this no-inflation shock comes from the structure of global markets. In a world with excess capacity, exporters to East Asia most likely choose to take a (dollar) cut in prices, while maintaining local currency prices. For example, a Thai exporter selling shirts pre-crisis at \$5, most likely cut his margins by selling the same shirt post-crisis at \$3.5. Thus, the price of the shirt in baht remained unchanged. Controlled inflation is evidence that what Asia witnessed fell short of a full-scale structural-crisis (ala Mexico and Chile in 1982). It is further proof, too, of the weak (non-existent?) link between devaluation and inflation (see box below). Finally, and most importantly, it goes to show that the Asian crisis was essentially an

exchange rate liquidity crisis, thereby implying a faster-than-expected recovery without

significant “structural” change.

### **Devaluation, Inflation, and Real Interest Rates:**

Contrary to popular perception, there is scant evidence of a strong correlation between currency devaluation and inflation. The Swedish krona was devalued, and the UK and Italy allowed their currencies to float free of the ERM bands in 1992, yet inflation in the UK and Italy 12 months later was 1-2 percentage points *lower* than it was just prior to the devaluation. (Sweden experienced higher inflation rates the following year, but inflation fell rapidly to pre-devaluation levels by the beginning of 1994.) East Asian countries witnessed a spike in inflation following the crisis, followed by a gradual easing down. As a result, inflation is well under control throughout the region. Brazilian inflation following the real's recent depreciation, has failed to register more than a 1.5 percentage points increase – a shockingly small change in that hyperinflation-prone country. Mexico is the one exception: following the 1994 devaluation, inflation shot through the roof, yet stabilized in the medium-term. Even in this case, inflation rapidly retreated to the 20-30% per annum rate after briefly (2 months) touching the 50% level. Indonesia shows a similar pattern: following several months (May, 1998-January, 1999) of 50%+ levels of inflation, recent indications make it likely that this rate will continue to fall below its current level of 38%. Forecasts are for the inflation rate to fall to the low teens by end 1999 in Indonesia.

Real short term interest rates have moved in tandem: a sharp spike following the crisis, rapid decline over the next 5-6 months, and a gradual movement towards lower levels. Real short term rates throughout East Asia are presently at historically low levels. In Malaysia, the inflation-adjusted rate stands at just below 1%, having come down from a pre-crisis level of about 2.7%. Similarly, rates in Korea (9% then, 5.3% now), Thailand (5.4%, 3.7%), and the Philippines (5.9%, 2.1%) have all declined. Indonesia's real short term rates parallel Mexico's after the 1994 crisis: a peak within 3-4 months (62% in Mexico, 23% in Indonesia), followed by rapid decline to negative (-5.6%, -26%) within 9 months, and gradual stabilization thereafter. The IMF's policies, heavily criticized at the time for requiring crisis-hit countries to raise interest rates, have at least in part been vindicated. Indeed, perhaps the only method of effectively handling a currency crisis is to raise interest rates in the short term. (Using reserves to shore up a currency is futile – the considerable weight of speculators makes a relatively small intervention by central banks ineffective.) Interest rates (real and nominal) return to their market-determined levels shortly enough, having controlled the speculative tide at the moment of impact. At this point (as is the case with East Asia at present), investment picks up in a safer business environment, spurring recovery.

**Mexico '94 and Asia '97 are similar.** Asia is like the Mexico of 1994 in its V-shaped recovery (shallower though it may be). It is also like Mexico in the behavior of its **stock markets**: both Mexican stocks and Asian markets (dominated again by the weighty Korea) appreciated 19 percent six quarters after their respective crises. In the latest quarter, Asian stocks have pulled ahead of Mexico's 1994 “post crisis” index. (Mexico after 1982 is ignored, since hyper-inflation left stock indices meaningless.) **As importantly, Asian markets have far outperformed Mexico in dollar terms.** The weighted Asian dollar index is exactly back to pre-crisis levels at Q6; Mexico's had retained less than 60

percent of its value. Korea, with a 30 percent appreciation over 1997, has pulled the region up, while the weak Thai and Singaporean markets halted an outright boom by Q7. Thailand's market index has trended upwards in the last few weeks, reaching a 13-month high on May 4 – an event that will contribute significantly to “Asia's” Q8 index. Stock prices are a leading indicator of recovery, and signal a renewed confidence in the region.

It is estimated that stock market recovery precedes “real” recovery by about 6 months. The continued rally in Asian markets is a strong indicator that recovery is imminent, and if anything, is likely to come sooner –

perhaps by Q8 – than Mexico’s did following

**Malaysia’s Capital Controls: Did they Work?** Our analysis has so far excluded Malaysia, Indonesia and Hong Kong, for varied reasons. Indonesia’s continuing crisis is more politics than economics; Hong Kong’s pegged currency makes it very different from the rest of East Asia. Malaysia, though, is an interesting case that disproves several explanations for the crisis.

The World Bank has argued that capital account convertibility greatly exacerbated the situation, allowing capital to fly out just as freely as it had earlier flown in. Malaysia, however, imposed capital controls and pegged the ringgit within a year of the crisis. The country’s performance relative to other emerging markets, and especially with the crisis countries, yields important results. One would expect, following the “capital controls” school of thought, that controls would help to pull up growth and industrial production, and to prevent the import of inflation. Yet exactly the opposite is true in Malaysia’s case.

How does one compare performance across countries and across time? By “ranking” each country (“best” performance first, “worst” performance last) in terms of several macro indicators, at two distinct points: before the crisis hit **any** country (i.e., June, 1997), and at

the 1994 debacle.

present (plenty of time to gain lost ground). For each indicator, we compare **relative** performance at both points in time. (If a country ranks last in GDP growth at both times, its relative performance has not changed.) Comparing the country’s “ranks” then-and-now, with respect to East Asian and Latin American countries, Malaysia’s performance comes out looking poor – a sign that capital controls have little positive impact on macro-economic performance, and may indeed cause greater harm than good. Malaysia’s story might one day prove a good case study **against** capital controls.

Pre-crisis, Malaysia enjoyed the third highest GDP growth rate in relation to 11 other countries; now it stands eleventh. Its place in the inflation rankings has dropped from 4<sup>th</sup> lowest to 7<sup>th</sup> lowest. Further, Malaysian stocks have shown the lowest returns in local currency terms, and the second-lowest in dollar terms. It has seen the 3<sup>rd</sup> smallest currency appreciation (due in large part to its pegged rate), and its real short term interest rates have shown a small relative decline. Interestingly, its trade balance as a share of GDP is at present the lowest among the 12 countries considered.

### Capital Controls in Malaysia: Have they Worked?

|             | GDP Growth |        | Industrial Production |        | CPI Inflation |        | Stock Market Returns |    | Currency Appreciation | Decline in Real S-Term Interest Rates |
|-------------|------------|--------|-----------------------|--------|---------------|--------|----------------------|----|-----------------------|---------------------------------------|
|             | June, 1997 | Latest | June, 1997            | Latest | June, 1997    | Latest | LC                   | \$ |                       |                                       |
| Malaysia    | 3          | 11     | 4                     | 4      | 4             | 7      | 12                   | 11 | 10                    | 4                                     |
| Hong Kong   | 5          | 10     | 11                    | 12     | 10            | 1      | 7                    | 2  | 1                     | .                                     |
| Indonesia   | 6          | 12     | 1                     | 10     | 7             | 12     | 10                   | 12 | 12                    | 1                                     |
| Korea       | 8          | 9      | 7                     | 1      | 5             | 5      | 2                    | 4  | 7                     | 3                                     |
| Philippines | 11         | 7      | 8                     | 8      | 8             | 10     | 6                    | 10 | 8                     | .                                     |
| Singapore   | 2          | 5      | 12                    | 3      | 3             | 3      | 5                    | 3  | 6                     | 6                                     |
| Taiwan      | 9          | 1      | 9                     | 2      | 2             | 4      | 8                    | 6  | 5                     | .                                     |
| Thailand    | 7          | 3      | 6                     | 5      | 6             | 6      | 4                    | 8  | 9                     | 5                                     |
| Argentina   | 4          | 4      | 3                     | 11     | 1             | 2      | 11                   | 5  | 1                     | 7                                     |
| Brazil      | 12         | 6      | 5                     | 7      | 11            | 8      | 3                    | 9  | 11                    | .                                     |
| Chile       | 10         | 8      | 10                    | 9      | 9             | 9      | 9                    | 7  | 3                     | .                                     |
| Mexico      | 1          | 2      | 2                     | 6      | 12            | 11     | 1                    | 1  | 4                     | 2                                     |

Source: O[x]us Research & Investments Database.

Notes:

## Developing Trends

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1. Ranks represent a comparison between countries' performances with respect to each indicator considered.

**The East Asian Crisis: FAQ**

The world changed on July 2, 1997 when Thailand floated the bhat. Financial markets tumbled in East Asia, and the tremors are being felt today, a year later, around the world. Explanations abound on the origins of the crisis- indeed it is a growth industry. This study is part of that explosion.

**Fixed Exchange Rates and the Private Capital Boom**

Fixed capital boom and fixed exchange rate regimes were at the heart of the crisis.

“The nineties were witness to a boom in the private capital flows to emerging markets. From the nascent levels of around \$25-\$50 billion in early years, such flows accelerated to around \$300 billion at the time of the crisis in mid -1997. None of the East Asian economies had a floating or market determined exchange rate. Central bank intervened, and intervened often to restrict movement of capital so that the currency does not trade... outside the implicit but managed FX band”. (DT Aug 24&30, 1998 pp 15)

**Managed exchange rates and the art of hedge free borrowing**

In a fixed exchange rate regime the psychology of the borrower is to believe that the current exchange rate would be more or less maintained and therefore, there is considerable incentive to not indulge in hedging. Therefore, as the differential between foreign borrowing fell the incentive to borrow abroad increased resulting in a considerably high exposure of foreign borrowing.

**Fiscal surplus plus managed exchange rate = A financial crises?**

Literature on currency crises is replete with studies which indicate fiscal deficit as one of the main determinants of an exchange rate collapse. This argument did not work in the case of Mexico in 1994. Mexico did have a large current account deficit (about 7 per cent), but it had responsible fiscal policy, and fiscal surpluses in each of the preceding years. Moreover, The East Asian economies were running surpluses. The table given below gives the fiscal balance figures for 1990-96 for Mexico and EA economies.

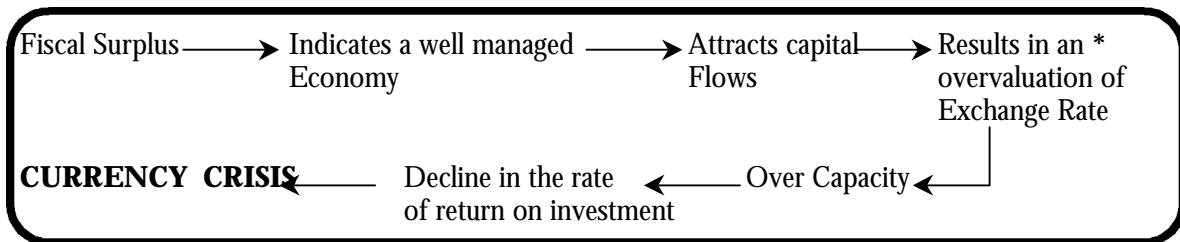
**Fiscal Deficits in Crisis Countries, 1990-1996**

|                                  | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|----------------------------------|------|------|------|------|------|------|------|
| <b>Fiscal Deficit</b><br>(% GDP) |      |      |      |      |      |      |      |
| Asean-7                          | 1.7  | 1.7  | 2.4  | 3.2  | 1.5  | 0.2  | 0.5  |
| Mexico                           | -2.8 | -0.2 | 1.5  | 0.3  | -0.7 | -0.6 |      |

**Good fiscal policy is a Bad Signal:** There is a perverse relationship between good fiscal policy and over-valuation of the exchange rate. This results from signaling and is indicated by the flow chart below. Investors

flock to a country with “good” fiscal policy; the exchange rate remains constant; over-valuation results; the rest (as they say in Mexico and East Asia) is history.

### Fiscal Surpluses: Flowing into Crisis?



\* The most important part of the entire cycle is the overvaluation, because had the exchange rate been flexible, the overvaluation of exchange rate wouldn't have occurred and it would have appreciated to correct for the capital flows imbalance. *Based on the theory of increased capital inflows and managed exchange rate, a similar crisis was predicted for Brazil in June, 1998 (see Domestic Follies...), almost eight months before the actual crisis occurred. "Where is the next crisis? History maybe repeating itself with capital flowing into Brazil with 46 per cent short term rates and a managed exchange rate".*

Therefore, data shows that managed exchange rates and fiscal surpluses were the cause of the crisis, which could have been prevented had exchange rates been market determined. This is one of the main reasons for the initial crisis developing into a widespread contagion as well, as the common thing amongst the countries hit by the crisis is that **none** of them had a floating or market determined exchange rate.

- "China's exports to industrialized countries grew at a 17 per cent annual rate in the nineties, more than double the rate of the best exporters, the ASEAN7 economies... East Asian exports to industrialized countries grew at significantly lower rates than if China had not devalued". (DT Aug 24 & 30, 1998 pp 17).

#### Efficient Excess Capacity Creation

The increase in private capital flows to East Asian countries resulted in an increase in capacity. The capacity increase was efficient as it was financed by foreign capital flows and foreign technology. The piling up of inventory resulted in a decline on return on investment thereby resulting in financial problems to the borrowers.

#### China Devaluation Hurt the Competitors:

Sharp devaluations by China from 1990-93 (50 percent) substantially increased China's exports, and decreased its imports, *at the expense of its neighbors.*

At Oxus, we have constructed a mercantilism index which attempts to capture "excess" exports and is given by the ratio of the excess exports (X-M) to export levels. The following is the finding from our research work:

One may ask as to whether the Chinese needed this devaluation or not? The answer is a straightforward No! Adjusted for productivity differences, the yuan was undervalued by about 25 per cent during the early nineties. Therefore, there was no justification for a mega devaluation. It would have been a lot simpler if China had played by the rules and perhaps grown at only 9 per cent per annum than devaluing, growing at 13 per cent, and causing a crisis. Had the Chinese been following a flexible exchange rate regime, things might have been different.

#### Is there any similarity between the Plaza agreement of 1985 and the East Asian crisis of 1997?

- Lots!. "Replace Japan with China... and the parallels become striking. China was also running huge trade surpluses; also rapidly growing; also 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". ".(DT Aug 24&30, 1998 pp 18).

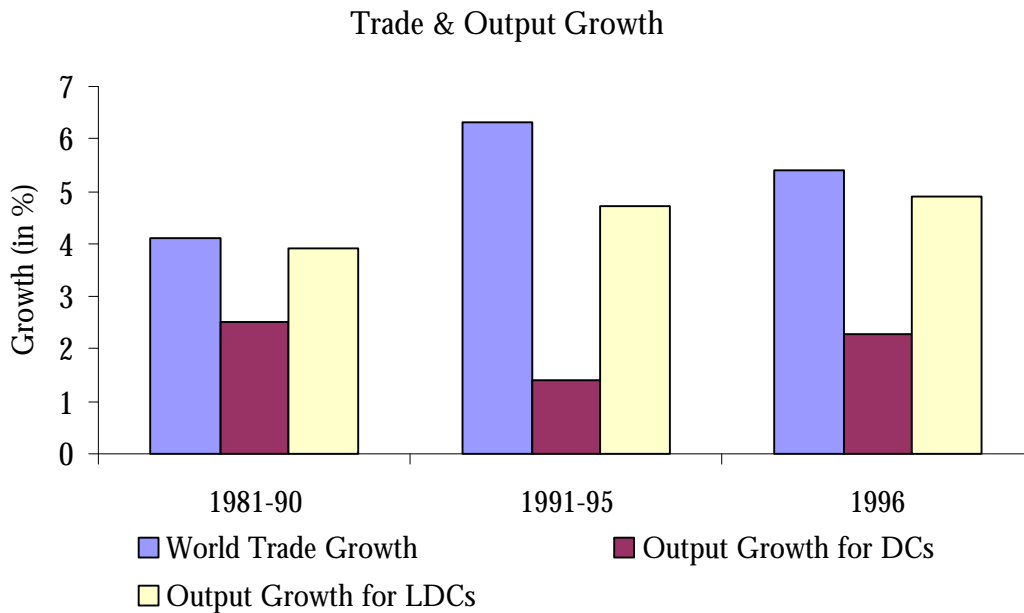
**Trade Flows- a zero sum game.**

Undue advantage derived by a country over the others through exchange rate management cannot occur with capital account convertibility. BOP problems (both surpluses and deficits) are automatically corrected by an open capital account, "the necessary and sufficient condition for which is a floating rate regime".(DT Aug 24&30, 1998 pp 20)

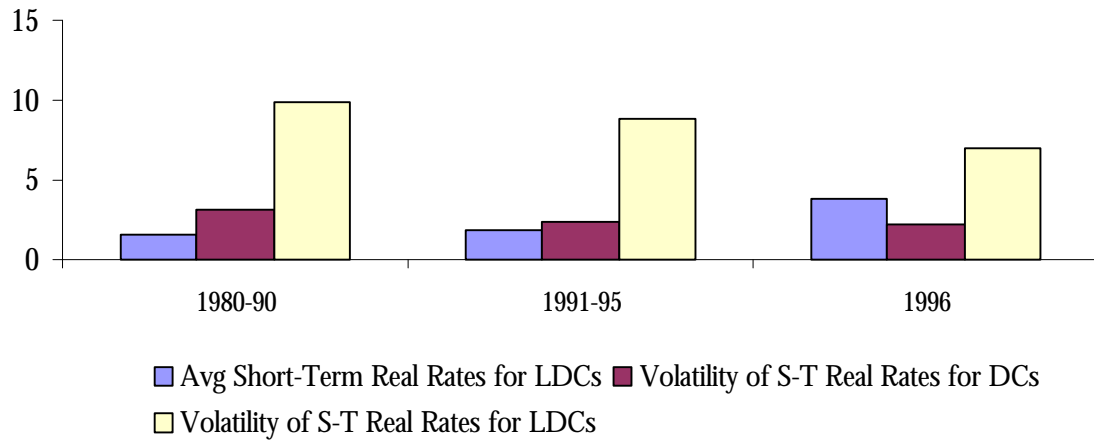
**Was the Capital Account Liberalization, a source of risk?**

There have been claims by leading economists (Stiglitz of the World Bank) that capital account convertibility leads to an increase in risk.

The behavior of interest rates does not support this (risky) argument. In the 1990s, with large capital flows, real interest rates were both lower and had lower volatility. (Bhalla 1997; see references). The table below gives the volatility of output and interest rates during the capital starved 80's and the capital flow rich 90's.



### Real Interest Rates



As the charts reveal, economic growth in 1990s was significantly above that observed in the 1980s. Further, interest rates were lower, as was the volatility in such rates. Considerable evidence, therefore, that capital account liberalization is associated with less risk, and higher growth; the evidence is contrary to those asking for a new international order based on capital controls, and/or restrictions and/or taxes to such flows.

### **What can one conclude from the East Asian crisis ?**

Analysis shows that the East Asian crisis occurred mainly due to managed exchange rate regimes in countries having free capital controls and good signals via fiscal surpluses. . The main source of the crisis was a managed exchange rate; a necessary and sufficient condition for capital account liberalization is a *market determined* exchange rate. Hence, the countries that had the crisis did not have capital account liberalization (CAL); so too much of CAL did not, and could not, have caused the crisis!

### **Oxus and *Developing Trends* – Our 3<sup>rd</sup> Year, and Going Strong**

Our clients have asked as to how we got “the Asian crisis right”. This double issue of **DT** is an attempt to answer that question. As is the tenet of every forecaster, you make several forecasts, and always remind people when you are right! However, that is not the purpose here. Rather, it is to thank our clients for supporting an endeavor that many thought would not last a year – and here we are in the third year of operation, with a staff of five, and going strong. The skepticism arose because **DT** was an attempt to be a newsletter with a difference; as one wag put it, it was a BMW (subscription price of **DT** is \$ 5000 a year for twelve monthly issues) in market filled with VW Rabbits. The difference arose because of the quasi-academic bent of **DT**; our newsletters often indulged in rather serious economic research (see partial list of articles related to the Asian crisis which have been published). However, true to the market nature of the newsletter, every **DT** was religious in outlining trades for investors; indeed, our year end 1998 issue was entitled “Conclusions and Trades for 1999”.

*Arrivals and Departures:* Oxus would like to welcome Rohit Chawdhry, who joined us earlier this month after working with RR Financial Consultants. Suraj Saigal will be leaving for the greener pastures of Princeton University where he has been admitted to a Masters in Public Affairs program at the Woodrow Wilson School.

### **Background Articles on the Asian Crisis**

#### **Academic:**

- “Chinese Mercantilism: Currency Wars and How the East was Lost”, ICRIER Discussion Paper, March 1999.
- “Domestic Follies, Investment Crises: East Asian Lessons for India”, Chapter 5, in Karl Jackson, ed., “Asian Contagion – The Causes & Consequences of a Financial Crisis”, Westview Press, 1998.
- “Eureka : KAC and the Laws of Flotation”, Draft for World Bank Conference on “India: A financial Sector for the 21<sup>st</sup> Century”, Goa, India. December, 1997.
- “Economic Freedom and Growth Miracles: India is Next”, Draft prepared for a panel discussion on South Asia: The Next Miracle?. World Bank - IMF Annual Meeting, Hong Kong 1997.
- “When will the Thai baht float? Waiting for Godot, Armageddon or the inevitable?”, Conference on “Investing and Trading in Emerging Market Currencies”, New York. June 19-20<sup>th</sup>, 1997.
- “Report of the Committee on Capital Account Convertibility”, May 31, 1997; member of RBI’s Mr. S. S. Tarapore committee which prepared this report.
- “Freedom and Economic Growth : A Virtuous Cycle?”, in Democracy’s Victory and Crisis: Nobel Symposium 1994 ed. Axel Hadenius. Cambridge University Press, 1997.

#### **Issues of *Developing Trends*:**

- *The Times they are A’Changin’*, Feb.24, 1999, V3, No.1
- *Conclusions & Trades for 1999*, Dec. 28, 1998, V2 No.10
- *FED too Tight – Curve to Steepen*, Nov.16, 1998, V2 No.9
- *Asian Markets: Danger and Opportunity*, Aug.24, 1998, V2, Nos. 7&8

#### **Columns in Newspapers, Magazines:**

“End of Economy Blues”, *Outlook*, March 22, 1999.  
“DOT, JET & BSE – Triplets separated at Birth”, *Economic Times*,  
“In the Name of the Small Investor”, *Economic Times*, Feb.16, 1999.  
“The Most Kindest Cut of All”, *Economic Times*, Feb.4,1999.

“Money Markets and Madness?”, *Economic Times*, Nov 3<sup>rd</sup>, 1997

# Developing Trends

**Developing Trends** is a monthly newsletter published by Oxus Fund Management (OFM). Fund managers and investment banks, both in India and around the world, are its clients.

The most recent three issues of **Developing Trends** had the following trade recommendations:

**Developing Trends Vol.3., Nos.2&3, dated April 7, 1999:**

- *DT* recommended the following **currency market** trades: “Developing Trends now believes that dollar/yen should range between 116 and 130 and therefore at present levels (\$/yen at 120) one should be a buyer of dollars. The Euro, one should wait and only go long if it closes above 1.095. The Brazilian Real – fair value close to 1.55.”
- On India’s **economy and politics**: “The good news is in the fact that the Indian economy, and policy making, is maturing – and there is unanimity in economic views between the BJP and the Congress...India is going to increasingly look like Italy – with or without Sonia Gandhi as Prime Minister. ...the markets will learn to ignore the politicians, and concentrate on economic fundamentals.”

**Developing Trends Vol.3, No.1, dated Feb. 24, 1999:**

- On Indian **economic reforms**: “What are the prospects for the BJP to implement even half of the reforms outlined above? Quite high – if only because the BJP today, due to its own mistakes, finds itself with its back to the wall – and economic reform is the only bullet left. A **necessary** condition for the BJP to survive politically is for it to implement economic reforms.”

**Developing Trends Vol.2, No.10, dated Dec. 28, 1998:**

- There were several “bold” trades that were mentioned in the double *Developing Trends* issue of end August '98. Incredibly, almost all trades have turned out to be highly profitable. Except one trade – going long the Indian stock market. The rest of the world rallied, and India dived. ...Oxus now believes that clients should not only go long the Indian market, but that they should do so aggressively. Instead of our normal 1 unit trade, clients should be long 2 units.

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Subscription to **Developing Trends** is only \$ 5000 (£ 3200 pounds) a year for twelve monthly issues and special issues on newsbreaking events. For Indian subscribers, the rate is a reduced \$ 2,500 a year, or Rs. 1 lac. Make checks payable to Oxus Fund Management

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