

# No quick patch-up for Asia's burst bubble

Overcooked economies and currencies have pruned the claws of the tiger economies, says Dr Gerard Lyons. The western industrialists that compete with them and the banks that lent them the money may soon start hurting.

Small events in far away places can have a far more dramatic impact than many realise at the time. So it is with recent financial problems in Asia. Thailand, Indonesia and South Korea have all needed bail-outs from the International Monetary Fund, while the Japanese government has had to announce a policy U-turn in order to boost spending and prevent financial meltdown. The policy response throughout Asia holds the key to whether the crisis stabilises or escalates. So far the signs are positive.

Asia's currency crisis is a global, not just a regional problem, and will add to disinflationary pressures elsewhere, resulting in sluggish world growth and low inflation.

Asia's problems stem from a number of factors. While there have been two policy blunders in the UK during the last decade – the credit binge of the Lawson Boom and the wrong exchange rate policy when the pound was in the ERM – some Asian economies have just had both problems at the same time: a credit and property bubble alongside an inappropriate currency peg.

The devaluation of the yuan in 1994 boosted the competitiveness of Chinese goods. Many other Asian countries found this difficult to cope with, particularly as their currencies were pegged to the dollar, which has appreciated in recent years. Their competitiveness suffered.

Meanwhile, domestic economic conditions in southeast Asia were turning sour, as these economies were unable to cope with the vast amount of international capital flowing in. Initially, inflows of direct and portfolio investment were seen as positive developments to be encouraged. Yet, the scale of the inflows, combined with inappropriate policy responses, led to a build-up of excess capacity and a banking and property bubble. This bubble has now burst, and will be followed by deflation throughout Asia as excess capacity contributes to falling prices and there is little or no economic growth.

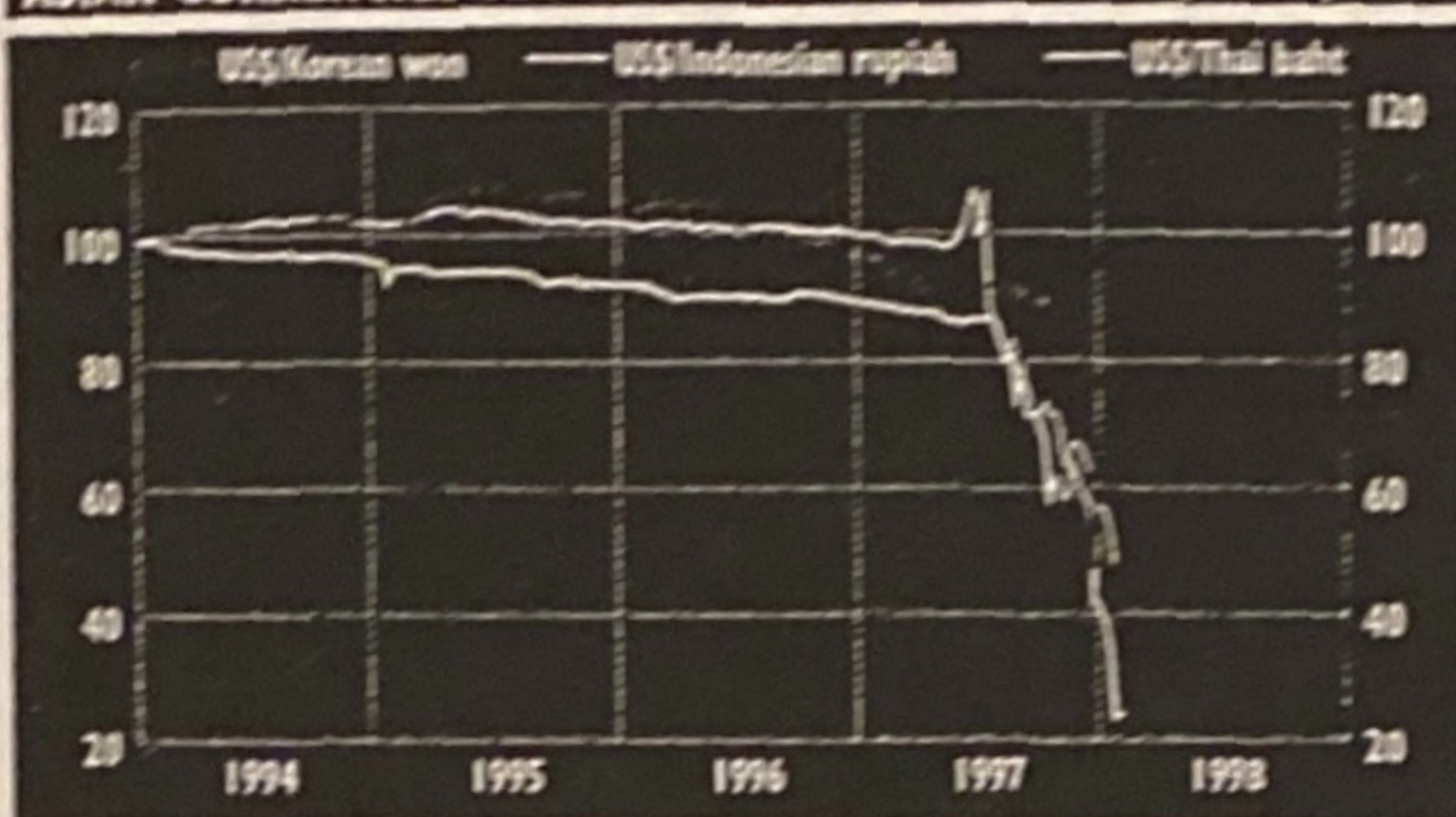
The negative economic impact on the rest of the world will be seen in a number of ways. During the last decade there has been a dramatic acceleration in Asian growth, feeding demand for goods from elsewhere. Asia has

become a lucrative market. Now this is changing sharply, as the Asian slowdown forces a slump in demand for foreign goods and exports to Asia fall.

Competitive pressures arising from Asia's problems will be intense. Domestic demand throughout troubled Asian countries will slump, as people and firms pay off debts. Bankruptcies and unemployment will rise. With domestic demand so weak, many Asian countries will hope to benefit from currency depreciation and export their way out of trouble. This would be fine if the world economy were booming, but it is not. There is no locomotive for world trade. Even though exports will rise strongly enough to lead to a big deterioration in the US trade deficit, possibly triggering protectionist fears, export growth will not be strong enough to prevent economic weakness across Asia.

Over one quarter of world exports come from Asia. So competitive will these goods now be that it will force companies in the West to keep costs down to stay in business. Throughout the 1990s several factors have contributed to low global inflation: tough anti-inflationary policies around the world, domestic cost constraints such as sluggish demand, excess capacity, technological change and price resistance by consumers, and globalisation and competitive pressures from low cost countries in Asia have forced companies around the world to keep costs and wages down. Now, as a result of large devaluations in Asia there will be further competitive pressures. Also, spare capacity and the competitive advantage of the region could encourage multinational firms to move production from higher cost countries and use south-east Asia as a production base.

ASIAN CURRENCIES SLUMP AGAINST THE DOLLAR (rebased)



The financial linkages between Asia and the rest of the world are also crucial. Latest available data shows that last June almost half of all international bank lending was to Asia. The total exposure of international banks to Asia was \$822.9bn. Hardly surprising Japanese banks had lent the most, at \$276.2bn. Yet there was sizeable lending by other countries to Asia, with German banks lending \$117.7bn, US banks \$46.4bn and British banks \$85bn. Yet British banks' exposure to the three troubled economies of Thailand, Indonesia and South Korea is relatively low.

The large exposure of international banks explains the desperate attempts by the IMF to avoid defaults in South Korea and Indonesia. Even though the fear of default has receded, sizeable problems lie ahead. It is difficult to quantify the impact, but a significant portion of loans may be written off, or rescheduled. In turn, this could force banks to adopt a more cautious lending stance elsewhere.

The global interlinkages between economies and companies is also reflected in how problems in Asian stockmarkets have fed instability in global equities.

Japan's economic bubble burst in 1990. Then there was a perception Japan's problems would be short-lived. Eight years later, Japan still has not fully recovered from the bubble bursting. Japan's experience suggests the need to treat with caution talk of early recovery in Asia, even though many export manufacturers could do well.

Overall, Asia faces regional deflation, as prices fall and there is little or no growth. Although Asian governments should adopt much of what the IMF says, deregulating their economies, they should avoid tightening policy now. Weak private demand in coming years points to the need for an active fiscal stance, while the consequences of debt deflation calls for low interest rates. If not, deflation could become depression in Asia. The rest of the world is clearly taking note of Asia's problems which will remove misplaced fears of overheating in the US and UK and result in weak global growth and low inflation. ●

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