COMMENT COLUMN

Asia's difficulties will be a global problem

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Three stages of a crisis

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

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International Monetary Fund (IMF), and the Japanese Government has announced a policy U-turn to boost spending and prevent financial meltdown.

Asia's crisis is far from over, despite the policy response and recovery in financial market confidence. The crisis has merely passed the first stage, where government default has been prevented and contagion halted. As many currencies and equities have fallen sharply there is a natural tendency for international investors to think financial markets have overshot, even providing an opportunity to buy at the bottom. This might well prove to be the case but I doubt it. I recall similar comments in Japan in the early 1990s, after the Nikkei slumped. Since then there have been many false dawns for Japanese equities. So it may prove in those Asian equity markets which have collapsed.

Asia is now entering the second stage of its crisis: prolonged economic weakness. The consequences will be felt around the world, as Asia's currency crisis is a global, not just a regional problem, and will exacerbate disinflationary pressures elsewhere, resulting in sluggish world growth and low inflation.

Many Asian economies face a difficult adjustment phase. Liabilities accumulated in recent years during the economic bubble are now expensive debts that need to be serviced or repaid. Domestic demand throughout troubled Asian countries will slump, as people and firms pay off debts. Bankruptcies and unemployment will rise.

Competitive pressures arising from Asia's problems will be intense. With domestic demand 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 was booming, with healthy demand, but it is not. There is no locomotive for world trade. Even though the rise in Asian exports will 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. Also, there are suggestions that some exporters may not be able to afford expensive imported components, and will thus not be able to take advantage of currency falls.

The third stage of the Asian crisis will only be when economic prospects have genuinely improved, helped by deregulation measures. This stage appears some way off.

Lessons from Japan and for China

There may be relevant lessons for Asia from Japan's experience following the bursting of its economic bubble in 1990. First, the downturn in Japan proved longer and more damaging than was initially expected. The same is likely in Asia. Second, the Japanese Government played a key role by keeping the economy afloat in the early 1990s, through large supplementary budgets. Fiscal policy proved effective. This should send a warning signal to Asia, where there is a temptation for governments to keep fiscal policy tight.

The third lesson from Japan for Asia is the need for low interest rates. The Bank of Japan was slow to cut interest rates to rock bottom levels. Some Asian governments believe they should keep interest rates high to fight inflation. This inflation fear is misplaced in anything other than the very short-term. Recent currency falls will lead to an initial sharp rise in import prices, but this will not feed through the supply process and if it does, higher prices will not be sustainable. Sluggish domestic demand weighed down by debt, and excess capacity means retailers and producers will have to keep prices down to stay in business. Interest rates do not need to rise to fight inflation but will have to eventually fall to ease the burden of debt adjustment.

The rest of the world is looking to Japan, in the hope that it will provide a solution to Asia's problems. Yet Japan has problems of its own. Domestic demand and confidence within Japan is weak. Despite an impressive ¥30 trillion ($240 billion) boost to the financial sector the Japanese government's response may not yet be sufficient. However, by year-end a continued policy of reflation could be bearing fruit. Japan anyway has the resources to boost domestic demand and restore confidence if it will use them.

Prospects in China, too, are uncertain. The successful effort to curb inflation has slowed the domestic economy. If now export growth slows because of competition from devalued currencies and slower growth in China's main markets in the US and Japan, then the decline in job

creation might bring a shift in policy, most likely a devaluation of the renminbi; and if the renminbi goes the Hong Kong peg will fall.

Global impact

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 Asia's slowdown forces a slump in demand for foreign goods and exports to Asia fall.

Over one quarter of world exports come from Asia. Goods from the countries which have massively devalued will now be so competitive 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, including tough anti-inflationary policies around the world, and competitive pressures from low cost countries in Asia which have forced companies around the world to keep costs and wages down. Now, as a result of large devaluations in some key Asian exporters 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.

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 $822.9 billion. Hardly surprisingly Japanese banks had lent the most, at $276.2 billion. Yet there was sizeable lending by other countries to Asia, with German banks lending $117.7 billion, US banks $46.4 billion and British banks $85 billion, although British banks' exposure to the three troubled economies of Thailand, Indonesia and South Korea is relatively low. It is difficult to quantity the impact, but a significant portion of loans may have to 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 are also reflected in how problems in Asian stock markets have fed instability in global equities.

Outlook

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

The policy response holds the key to Asia's problems. Yet an equally important issue is what this implies for policy-making around the world. After the inflationary shocks of the 1970s there has been a sea-change in economic and political thinking. This has successfully helped drive inflation down. Now, there is a danger that policy-makers will behave like First World War generals, fighting yesterday's battle against inflation when the problem ahead may be sluggish world demand. Deregulation and supply changes are important and beneficial, as the US and UK economies are demonstrating, but effective demand management is also a crucial policy objective.