ECONOMIC ORIGINS OF ASIA’S FINANCIAL CRISIES

ARE THEY REALLY BEING FIXED?
The Purpose of This Presentation is to Provoke Discussion on Asian Financial Crisis in a Focused Manner that:

First Analyzes Its Economic Origins

Second Avoids Issues Relating to Regulatory Reform or "Crony Capitalism"

Third Questions If the Current Recovery and Related IMF Programs Address Potential Flaws in the Asian Growth Model
It also introduces Kindleberger’s Paradigm for Financial Crises to Assess Whether a Similar Crisis Could Occur Again Soon as several interrelated factors have driven the current financial situation in Asia from high growth to financial and economic crisis:

- Large Japanese Firms’ FDI combined with the Bubble, its Aftermath, and International Portfolio Flows

- China’s growth targets and inefficient state owned firms

- Local issues impacting Korea, Thailand and Indonesia combined with Export-Led Growth Model (ELG)
Leading firms have a disproportionate and leveraged influence on Japan’s economy:

- keiretsu relationships - over 60% of small firms are subcontractors

- 2000 listed companies account for 45% of GNP

- "Competitive Compulsion" lends weight large firm actions

- Steel and Electronics Chains are over 80% exports and FDI

- Global successful firms set competition, especially abroad
COMPETITIVE CULTURE

Top management is still wedded to

Long-term employment and corporate survival by process innovation, cost improvement, price declines, exports, and FDI

Chasing Growth and Global Share in Emerging Markets using FDI to Secure Technology and Markets

Because world market for manufactured goods is growing faster than US or Japanese markets and cost advantage is expected to shift (ELG).
This is part of a worldwide system that reduces prices and increases production.

Asian FDI is part of strategy to maintain position as low cost global producer while preempting growth and competition in those countries. But FDI shifts with changes in growth and exchange rates. This can, has and will affect trade and capital accounts.

Success FDI weakens yen while contributing to Asian boom and bust with large trade & investment swings
THE BUBBLE ECONOMY

Scenario is complex due congruence and collapse of Japan’s Bubble economy. But it is useful to note Bubble is one outcome of success of these strategies.

Trade surplus, increased liquidity & financial liberalization of 80s combined with impact ¥ appreciation portfolio investors who turned inward after 85 due FX losses.

This resulted in over-investment, asset inflation, FDI stimulus
GAINERS AND LOSERS

Losers are arguably:

Banks, lenders and investors: due to loan loses, capital losses, weaker customer relations, lower land prices & drop stocks

Securities firms (market crash and reputation)

M O F loss of credibility (crisis mismanagement, scandals, and economic aftermath)
seem to be the large MNCs through redistribution power and assets:

Financial independence with access to global markets and ¥50 trillion in cheap equity;

Increased power relative to government

Reduced influence banks, large lenders, and securities firms while own finance improved.
GAINERS CONTINUED

Achieved experience, freedom and resources to pursue global strategies and interests;

New plant & equipment, improved technology, more global reach via FDI and exports while recover economically and maintain or expand global market share.

This led to rapid expansion after 1985 and again after 1990 into Asia. Capital exports soared followed by portfolio investment
CONTRIBUTING FACTORS

Domestic market saturated plus strong $ & oil bust

Current Account Surplus rose –$2.1 bil in ’80 to + $50 bil in ’85.
  Total 81–85 = $117 bil, then 86–89 $309.6 bil

Portfolio investors over cycled surplus to weaken ¥, raise surplus,
  lower ¥ rates relative high $ rates

¥ appreciation sharply reversed capital flows ’85.

Bank capital deleveraged while loan assets lost value due 60 %
  market drop (over $2 trillion). Capital problem and bad loans
  worse over time
Internationally, defined by MNCs pursuing global markets.

Domestic economic growth 3% or less as demand many products is saturated and many industries are mature.

Competitive advantage is migrating to other countries while potential yen appreciation is constant (ELG).

Labor force is not expanding and productivity increases in services may be structurally difficult.

Firms will seek growth abroad while economy undergoes major structural change, focusing politics at home.
SUMMARY ASIAN IMPACTS

Leading Japanese MNCs set global competitive agenda due FDI and exports affecting other Asian countries’ trade, capital flows, FX, interest rates, and fiscal & monetary policies.

Domestic politics and economy limit “national initiatives” or Japan as growth engine for Asia.

Japanese banks targeted Asia for growth but now must retrench so benefits recent devaluations depend shift FDI towards Asia as ¥ appreciates.
'94 devaluation response success FDI strategy Japanese shifting exports to lower cost Asia as China needs export growth support state firms

But this made rest Asia less competitive reducing Japan’s FDI incentives. Also, depreciation ¥ due Bubble collapse and success FDI strategy led $ appreciation and overvalued “tied” currencies leading reduction FDI and export growth led asset deflation and sequential economic collapse, affecting employment and politics

Competitive devaluation thus key US-Japan policy concern but ELG connection is ignored
As first and most heavily dependent Japanese FDI and bank loans perhaps not surprising first collapse. But it was drop FDI and exports that led decline FX reserves & possibility devaluation triggering rapid collapse stock and real estate values coupled substantial FX devaluation

$ borrowing and currency stability compounded problem compared US or Japan that only owe dollars or is net creditor

First IMF bailout package has led recovery but not reconsidered ELG or role Japanese companies
Larger and more complex due:

Larger economy & population, state ownership very weak banks, relatively closed economy, chaebols & intra-chaebol loans/guarantees, especially of dollar debts coupled large devaluation, limited FDI, and difficulty establishing “value”

Politics right direction plus security interests US and Japan. Some manufacturing very efficient

2d AFC IMF package with union support key; but ELG and next wave only partially addressed
Arguably worst situation:

Large economy and very large population with bad politics and reforms uncertain. Further security interests US and Japan limited.

Difficulties arranging, implementing IMF package compounded inefficient manufacturing, weak banks.

However, recovery oil market and rest Asia provides some basis growth but still vulnerable Asian economic downturn or financial crisis.
EXPORT LED GROWTH

The ELG Model has been adopted by most Asian countries to emulate Japanese economic success and the four Tigers.

It proposes countries evolve successfully first in labor intensive industries, then grow into constantly more capital and skill intensive ones on inter-industry and intra-industry basis as accumulate capital and technology. But growth depends on becoming globally efficient. Protection must thus be limited to next wave industries and evolving development pace.

Japan’s MNCs use it to allocate FDI while portfolio “mania” for “Emerging Markets” applies it to predict future high growth countries, markets and industries.
ELG SOURCE INSTABILITY?

1) If economy is small relative to import market, it can grow faster than import market. But if aggregate supply is large, it will depend on import market growth! Aggregate of all Asian ELG suppliers is now large relative to US market with US growth about 3+ %

2) ELG success depends older firms in advanced countries leaving business (e.g. cotton textiles, US integrated steel producers, etc.). Japanese firms are not leaving steel, autos, consumer electronics but are extending competitive life via FDI.

3) This limits migration and makes development pace FX dependent, exacerbating effect periodic exchange swings
4) MNCs’ FDI and Portfolio Investors’ ELG strategies still apply. Strong ¥ and Asian “recovery” will lead financial and FDI flows. But capacity additions by nature are limited. Also US and Japanese market growth is limited. Could this lead new “mania” and subsequent “displacement”?

5) Role of China? Devaluation would be unwise, but effect of GITIC bankruptcy on capital flows could impact.

6) Daewoo result of “forcing” ELG; micro validation Krugman analysis of rapid Asian ELG as reallocation of resources rather than from productivity improvements.
Manias start as logical responses to economics and income incentives, sometimes generated by a displacement (e.g. 1981-85 $ investment boom followed by ¥ boom after Plaza Accord followed by FDI and Asian boom after Accord and Bubble Collapse). Current recovery?

Manias are usually fueled by leverage and innovation (e.g. foreign borrowing, portfolio diversification and derivatives in case of AFC). This leads to capital gains supporting leverage, further leverage and more capital gains. Inherent risks of Emerging Markets or higher returns seem suspended, fueling mania (e.g. no FX cover of baht assets with higher returns.) Gains recent recovery and expected growth?
Panics come when assumptions and/or expectations challenged

Displacement (e.g. baht will not be devalued, Korea will be competitive in automobiles, etc.)

Then investors try to cover risks, exacerbating displacement effect, e.g. sell baht or rupiah forward. So Crash!

If mania involved multiple markets, e.g. “Emerging Markets”, displacement can affect all—e.g. AFC. Thus see long term instability Thai, Korean, etc. recovery if ELG limits not addressed due swings FX and capital flows. This requires developing efficient industries relative to resources and domestic consumption. Opening inefficient Japanese markets (e.g. paper, clothing, & petroleum) would also help.