

**CHALLENGES & OPPORTUNITIES OF THE SOUTHEAST ASIA CRISIS:**  
Implications for American and Japanese Business

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Before I start with my main points, let me describe to you the confusing economic and political situation in Asia at the moment. According to one of my professor friends, “the economic situation in Asia is serious but not really hopeless; the political situation is hopeless, but not really serious.” If you understand that statement than you understand the whole of Asia’s economic condition at the moment.

Before I discuss the prospects of Asia coming out of this ongoing financial crisis, let me highlight seven important issues which will provide a clearer understanding of the present economic and political situation in Asia.

First, I would like to start by emphasizing that this is not going to be the end of Asia. I am sure this is a message you will be hearing time and time again, but I think it is important for me to emphasize it too. A lot of people are talking about a meltdown from the Asian miracle and wondering how fast it will happen. But it has never been a miracle, and it is not going to be a

meltdown. It has never been a miracle because many of the substantial economic and social achievements that Asia has posted over the past few decades came as a result of blood, sweat and tears -- a lot of hard work, a lot of savings, large doses of the correct macroeconomic policy, openness, export-driven competition, fiscal and monetary discipline, deregulation, liberalization. All of these ingredients have gone into the right blend of economic policy that has made Asia a successful place. And I would like to assure you that all of these fundamental ingredients are not going to evaporate instantly just because we have to cope with some changes in the exchange rates.

We only have to realize that the Asia crisis did not arise because of the wholesale mismanagement of fiscal policy or the misdirection of the macroeconomy, but mainly because of the overenthusiasm of the private sector to expand. This lust to expand by the private sector was allowed to persist for too long by governments in Asia and is essentially the heart of the Asia crisis at the moment. It was not because of overconsumption or budget deficits, but because of overinvestment, over and above a substantial rate of savings. Savings in Asia amount to 34% or 35% on average, but our investment rates have amounted to 41% or 42% of GDP. Among countries with high levels of savings, Thailand used to be ranked number three or four in the world, following Japan, Singapore, and China. This will remain, though we anticipate a slight drop in the savings rate from 34% to 30% of our GDP. When things return to normal, I am sure the saving rate will also return to a normal level.

Second, I think we should be worried about the quality of our early warning system. Problems

such as this can reoccur time and time again in the future if we do not have the right kind of early warning system in place. Although there have been some early warning signals, such as rising rates of inflation in some parts of Asia (up to 7% in 1995-1996 in Thailand), substantial current account deficits in Thailand of 8% for two consecutive years, and a drop in Thailand's export growth from 15% to 20% in 1996 to 0% in 1997, all of these signs have been witnessed before in the history of economic development in Thailand. We saw an 8% current account deficit more than a decade ago in Thailand; we have seen higher rates of inflation, beyond 7% a decade ago; and export earnings used to be stagnant. So these warning signs were not significant enough in the eyes of policy makers to take drastic action.

The last straw to break the camel's back, however, was the pegging of the baht to a basket of currencies, or the de facto pegging of the baht to the U.S. dollar (the weight of the U.S. dollar in our basket of currencies was about 85%). Of course, by pegging the baht to the dollar we profited tremendously during the decade of the 1980s and the beginning of the 1990s, when the U.S. dollar was showing signs of weakening. The baht was at that time a bit undervalued, which led to substantial export expansion in Thailand. Even in those days, though, we realized we could not do this forever, that is tie the Thai currency to the U.S. dollar to exploit weakening tendencies of the U.S. currency. We knew we should switch to a more neutral basket or unpeg the baht altogether from the basket of currencies, but the timing was never right -- not even when the new government came in at the end of 1996. At that time, it was early in the day, and there was hope that the rising exchange rate of the U.S. dollar to the Japanese yen could not be maintained. The Thai Parliament expected the dollar to come down vis-a-vis the Japanese yen by

the middle of last year. This is where we misjudged the early signals.

Our mistake in delaying the unpegging of the baht from the dollar would have been all right perhaps a decade ago, at a time when we did not have a borderless world, and at a time when there were only a few hedge funds and only a few fund managers interested in investing in Asia. However, since Asia moved into the limelight over the last five to ten years, investors have been watching very carefully every move of the governments in Asia. In fact, in many ways the market has been able to dictate terms to the government. So the early warning signs were there, but the ultimate error was in the delay of the unpegging of the currency.

Third, all of these problems came in 1996 at a down time in the Asian economic cycle, which was aggravated even further by the down cycle of the electronics industry. In most Southeast Asian nations, exports of electrical and electronic goods vary from 20% to 30% of total exports, which is rather substantial. In the case of Thailand, roughly 25%, or one-fourth of exports, could be ascribed to the export of electronics. So when the down cycle came in 1996, this, in combination with the increase in real exchange rates in Asia, created a severe loss of competitiveness for the Asian economies.

Fourth, we talk these days a lot about mismanagement, particularly in the financial sector, and the need for financial reforms. With hindsight, it does appear that the financial system in Asia has not been a particularly efficient intermediary. Although it has absorbed a lot of funds from abroad at very low rates, many of those funds have actually been misallocated. Asian economies, for

example, have been chiefly mobilizing foreign funds into nontradeable sectors, such as real estate development and condominiums, or things that cannot be traded. Less funds have gone into tradeable sectors even though this type of investment could have helped to repay interest and principal on foreign borrowings.

At the same time, I do not think we should blame our problems on the lack of an appropriate supervisory framework. In many countries, including Thailand, supervisors have been carefully working to identify ailing banks and finance companies which have high levels of nonperforming loans on their books. However, it is a matter of debate how far central banks can go in announcing full-fledged rescue operations since such announcements can create a loss of credibility, a loss of confidence, and a run on the banks. Consequently, central banks usually opt for less public ways to strengthen the financial system, preferring quietly and gradually to write down some of the debts and to allow time to pass for banks to mobilize more funds and improve their systems of management.

Unfortunately in Thailand in the beginning of 1997 there was no time for problems to be solved in a gradual manner. Inter-bank interest rates were jacked up from 8% or 9% to 40% all in a week's time, and then remained at 30% for some months. Those were the months of January and February and April and May when the baht was heavily attacked. The government fought all the way, spending a full third of its reserves and hiking interest rates to exorbitant levels. But these attempts to shore up the baht value invariably led to the expansion of nonperforming loans in banks' portfolios. With interest rates at 25% or 30%, banks and finance companies simply could

not mobilize enough funds to relend. As a result, the portion of nonperforming loans in total loan portfolios increased from 7% to 10% in 1995-1996 to 15% in 1997. That portion now stands between 20% and 25%, and for some banks even at 30%. Some of those banks have already been taken over by the Thai government.

Fifth, there seems to be an exaggeration of the fluctuation of currency changes that have taken place in Asia, in particular a gross overshooting of the rates in the countries that are now in the hands of the IMF – Korea, Thailand, and Indonesia. At the beginning of 1997, the Thai currency was overvalued at the most by 15%. Therefore, if the baht would have dropped from 25 baht/per dollar to 30 or 35 baht/dollar, most of our problems would have been solved. Of course, because of the delay in unpegging, this drop did not occur, and the baht remained at 25 baht/dollar until July 2. Then with the floating of the baht under the IMF package, the exchange rate was generally expected to remain at 35 baht/dollar, but with each successive crisis it kept going further and further down, reaching as low as 57 baht/dollar. In November, Yamaichi Securities Company in Japan failed. In December, President Soeharto was taken ill just one day before the convening of the annual ASEAN informal summit in Kuala Lumpur and announced that he would not be attending. On that day alone, there was a drop of 3 baht per dollar. In January, when the Japanese yen was attacked, dropping from 129 yen/dollar to 132/yen to dollar, the rate dropped by another 3 baht/dollar. Clearly, with each negative news release came an overreaction in the market.

To my mind, financial markets have too strong a hold on the mood of confidence that determines

today's exchange rates. Financial flows, rather than trade flows, have taken on the predominant role in exchange rate determination. In the case of Thailand, for example, for five consecutive months, from September through January last year, we achieved both a trade surplus and a current account surplus on the Thai balance of payments, and yet this does not show in our exchange rates at all.

Sixth, trade theory suggests that following significant devaluation and the resulting J-curve effect, we should see a return to a normal trade surplus because of expansion in exports and slowing down of imports. However, I can report that this time around the improvement on our current account will not be so much the result of export expansion as of the slowdown in imports due to deep deflationary trends in the Southeast Asia economies. Exports are rising in Thailand by the rate of 3% to 4% annually, but imports are declining in U.S. dollar terms at an annual rate of 13% to 14%. And in some months, particularly in January, imports showed a sharp decline of 20%, which was quite alarming.

As is feared by many countries throughout the world, it will be difficult for the Asian economies which have devalued their currencies at similar rates to increase their exports since gains in price level will be offset by competing countries' devaluations. Further, expansion in worldwide trade is much slower now than it was in the beginning of the 1990s when the Mexican economy was in crisis. NAFTA was also conceived at that time so, in effect, Mexico was able to tap into the entire North American economy. In the case of Asia, our biggest neighbor is Japan which is at present expanding at very low rates, with economic growth between 1% and 2%. As a result,

Asia is in a much tighter bind in terms of being unable to export so easily its way out of the current difficulties.

Lastly, agricultural products and our agri-based industry fortunately will do exceptionally well this year. Agricultural prices have gone up in Thailand by between 40% and 100%, in part because of the baht devaluation and in part because of the drought in the rest of Asia. While we have profited from this pressure on agricultural prices, we have also had to bear the brunt of the resulting inflation as food prices went up. The IMF has predicted we would reach a peak of about 14% by July, with an average for 1998 of about 11%. This rate of inflation, though bearable when compared to the 50% rates seen in Mexico during its crisis years, is still double the level of 4% to 5% to which we have been accustomed. In February, both Korea and Indonesia also have had to sustain high rates of inflation at 10% and 30% respectively, although Thailand may be in a slightly more advantageous position since it is a net exporter of food.

Of course, to survive this crisis, correct measures will have to be implemented. The key to the whole issue is gaining confidence by restoring financial stability. In this respect, I recommend the following strategies.

One is determined action for overhauling the financial system. In the case of Thailand, there has been a mix of liquidation of the financial institutions that are insolvent and takeovers by the government. We have liquidated 56 finance companies and taken over four banks. We also have to open up the financial sector to full participation by foreign entities. Therefore, we have

amended our laws to allow a 100% share of ownership by foreign financial institutions. Although we have already adopted the rigorous BIS standards, we now have to prescribe even stronger medicine, such as tighter provisioning requirements for banks. Specifically, we are requiring banks to classify loans as doubtful after three rather than six months of nonpayment of interest and principal and to put up enough provisions for that. We are also working very diligently to reform some of our basic laws, such as the bankruptcy law and the civil and commercial codes, to allow more transparent treatment of foreclosure and bankruptcy cases. We are trying also to be as transparent and reliable as possible in terms of accounting standards for the disclosure of crucial information.

A second strategy is continuing Thailand's efforts at trade and investment liberalization. I believe that even during difficult times there should be no backtracking of commitments on trade and investment liberalization. We have made proposals at the ASEAN summit to expedite the final date for the completion of AFTA from the year 2003 to the year 2000. This would mean an earlier reduction of tariffs in ASEAN. While countries such as Singapore and Malaysia and most of the regional ASEAN nations are in agreement with this proposal, we do have objections coming from newer members such as Vietnam, so we will have to postpone this initiative for the time being. Nevertheless, there is an ongoing effort to maintain liberalization in ASEAN. We have agreed at the informal summit in Kuala Lumpur in December last year to put up what we call an ASEAN investment area. The ASEAN investment area would promote investment throughout the whole region in a more equitable manner, and eliminate any impediments or conditionalities that are normally attached to those investments. We would do that for ASEAN-owned

investment first and then subsequently for foreign-owned investment throughout the ASEAN region.

Third, I do not think we can be successful at regaining confidence and achieving financial stability by applying only austerity measures. This explains the ongoing debates between Jeffrey Sachs and Stanley Fisher as to whether the IMF package was right or wrong. To my mind, in the case of Thailand and some of the other countries that have taken up the IMF measures, there was no choice. It was either let the country “go down the drain” by depleting all of its reserves or take up the IMF measures. So it was inevitable that we would implement the IMF’s austerity measures for the first few months thereby signaling to foreign investors that we would not be soft on austerity. But austerity, if pursued as a sole measure, would create excessively depressed and deflationary conditions in these countries, especially on top of the already substantial depreciation we have seen in Asia. By simultaneously increasing interest rates to exorbitantly high levels and reducing tremendously our budget expenditures we would kill off any initiatives to reinvest in Thailand. That is why the IMF’s prediction was a bit off target last year, when it assumed Thailand would come back and grow at a rate of 1% to 2% in 1998. The new IMF assessment has the Thai economy this year at a negative growth rate of 3.5%, one of the results of this confluence of deflationary trends.

Thus, to regain confidence and stability, we need to supplement austerity measures with efforts to restructure our industrial concerns, allowing them the opportunity to change from labor-based to more technology-based industry, to switch into subcontracting modes, and to create component

and spare parts industries. We should also invest in enhancing our agricultural productivity, since we will be able to absorb some of the rising prices because of the devalued currency. We also have to reduce state ownership in some of our key state-owned enterprises, such as the airlines, some of our major energy concerns, and power producers, so that they depend less on government subsidies. Although the IMF has asked that we present by the middle of the year a clearcut program to reduce state ownership from 90% to below 50% of only two state enterprises, namely Thai International (the airline) and one petroleum company, we will try to do better than that. I have put up a list of at least 10 state enterprises that we would first cooperatize and then move into private hands by reducing government ownership to below 50%, meaning that they would no longer be state enterprises.

Fourth, there is a need for clearcut policies to enhance our competitive position. Heavy investment is needed in human resources, in key infrastructure such as seaports and power plants, and in rationalization of customs evaluation and procedures. All of these ingredients for competitiveness will need to be enhanced in order to sustain a new round of growth. We should take advantage of the current slow-growth situation to put more time, effort and funds into training, R&D and infrastructure. Where will we find the money to do this? Well, in spite of the substantial reductions in the 1998 budget for Thailand of some 20% from the previous year, funds for key infrastructural projects remain intact. We have also asked for special loans from the World Bank and the ADB so that there will be enough funds for projects designed to enhance our competitive position.

Fifth, and this is a key issue, we plan to maintain our fiscal discipline at all times. Although pressure to reduce interest rates in Thailand is strong, the government is resisting and will try to keep interest rates at a high level at least until the end of the year. So there will not be a reduction of interest rates in Thailand in the foreseeable future, at least not before there is a prolonged spell of capital inflow into the country.

I would like to end by commenting on the effects of the Southeast Asian crisis on businesses throughout the world. Certainly the present crisis in Asia is not specific to Thailand, Indonesia or Korea. It is a region-wide problem that can easily become contagious to the rest of the world, especially since the world is so intertwined. Therefore, I would not be surprised to see sharp deterioration in the trade figures for the United States and Europe. According to an announcement by the U.S. Commerce Department, the 1997 U.S. deficit amounted to some U.S. \$114 billion. This is one of the worst deficits that has been seen here since the U.S. \$116 billion deficit in 1988. One of the major contributing factors was the increase in the trade deficit with the newly industrialized countries of Asia. And I would expect that trend to continue, with the U.S. trade deficit rising even more sharply this year. Further, a number of major multinationals have reported lower earnings or are predicting lower earnings for the coming months, mainly because a substantial portion of their earnings has been coming from investments/businesses in Asia. American heavyweights such as IBM, Microsoft, Merrill Lynch, Procter and Gamble, Philip Morris, and Motorola will all announce lower earnings. This is not only because they are able to sell less in Asia but because the competitiveness of Asian businesses is increasing with the devaluation trends.

With regard to foreign investors that presently have joint ventures in Asia, this is the time to be recuperating and perhaps switching to more export-oriented activities. Japanese automobile firms in Thailand, for example, have been haunted by the slowdown in the Thai economy, with sales dropping by some 40% last year alone. This is in sharp contrast to previous increases in automobile sales of 30% annually. So we will be seeing from Thailand quite a substantial expansion in the export of automobiles to places such as Europe and Oceania. I have also been told that American investments in Thailand, particularly by major auto producers such as General Motors, will go ahead. This is mainly because Thailand plans to keep its promise of removing local content requirements for automobile producers one full year earlier than scheduled.

Opportunities actually abound for foreign companies interested in acquiring a strategic position in Thailand. Major state-owned enterprises such as Thai International will be sold down, but not straight onto the stock exchange. We would like to sell out some blocks of shares to a major strategic partner for this company, as well as other major state-owned enterprises and banks.

Of course, all of our efforts to revitalize the Asian economies will go to naught if we cannot mobilize adequate international cooperation. Any moves by foreign investors to resist export expansion from Asia will kill off any opportunity we might have to find permanent corrective measures for the problems in Asia. While we can reflate our domestic economies by allowing more foreign investment to come in, and indeed many countries are doing that, this will not be sufficient because for most countries in the region, foreign indebtedness is quite exorbitant. This means we really have to export our way out of the difficulties. There is also a real need for the

World Trade Organization to be part of the package of international organizations assisting the countries in Asia so that we can move forward on the same track of trade liberalization we won through the Uruguay Round and thus prevent the recurrence of both tariff and nontariff barriers.

Thank you.