



Economic Developments and Prospects

The world economy moved down two divergent tracks in 1998. Many developing economies contracted, as currency chaos buffeted markets on several continents. Contrary to their experience in recent decades, the more open and dynamic developing economies fared badly, with many having to confront panicked investors and large capital outflows. In marked contrast, Europe and North America continued to grow strongly. In the United States, low inflation and seemingly limitless faith in the expansion of corporate earnings drove equity markets to record heights.

World output growth fell sharply to 2.2 percent in 1998, from a strong 4.2 percent in 1997. The slowdown had several causes, including the crisis-induced contraction of many Asian developing economies, the Russian devaluation and default, the fiscal problems and currency instability in Brazil, and the deepening recession in Japan. Spells of turmoil in Russia, Asia, and Latin America reverberated throughout world trade and financial networks as international flows of private capital slowed.

After many years of progress, globalization took a step backward in 1998. Total world trade, measured in value terms, fell from 1997 to 1998 after several years of near double-digit annual increases. International capital flows to emerging markets continued to drop precipitously as private lenders moved to reduce their exposure to the turbulence prevailing in many developing economies.

Yet despite these developments, few now doubt the inevitability of increasing integration in world trade and finance. Even after the upheavals of 1997 and 1998, most governments still regard trends toward globalization as desirable. However, the recent economic turbulence has brought with it a healthy awareness of the risks involved in financial integration and the problems inherent in relying heavily on short-term private capital to fund development.

Industrial Countries

With the exception of Japan, growth in the industrial countries was strong in 1998. The United Kingdom and the United States maintained growth rates of 2.5 and 3.9 percent, respectively, despite some reduction in external demand because of recession in Asia and Latin America. Growth in the countries joining the euro common currency scheme ("Euroland") varied from 1.5 percent in Italy to 3.8 percent in Spain, with an average for the group of 2.8 percent. Meanwhile, Japan's troubles with weak domestic demand and banking sector insolvency worsened, contributing to an economic contraction of 2.8 percent.

The industrial economies generally fared well in the face of the Asian financial crisis. For a time that did not seem to be a likely outcome. Russia's default in August prompted a wave of panic selling in both developing and industrial country stock markets, as investors shunned assets they deemed to be risky, but US Federal Reserve intervention in September and October calmed the markets. On the trade side, estimates indicate that lower Asian demand for industrial country exports reduced output in the United States and Europe by 0.5 percent. The impact on Japan has been somewhat greater.

Asian and Pacific Developing Economies

The slowdown in Asian growth that began with the export deceleration of 1996 and worsened with the 1997 currency crisis turned into a widespread regional contraction in 1998. Growth in the developing economies of East and Southeast Asia, excluding the People's Republic of China (PRC), was the lowest since World War II, averaging -6.9 percent in the economies of Southeast Asia and -1.4 percent in the newly industrialized economies (NIEs) (see table). Private capital flows to emerging Asia turned negative as foreign investors scrambled to move money out of supposedly risky markets.

The richer and traditionally more dynamic Asian economies generally fared the worst during the year. Southeast Asia remained at the center of the crisis, with Indonesia suffering a huge contraction and Malaysia and Thailand hit by substantial declines. Of the four newly industrialized economies, only Taipei, China weathered the storm with little damage. The Republic of Korea (henceforth referred to as Korea) suffered a major contraction, while Hong Kong, China and Singapore were unable to avoid the impact of the regional slowdown on their trade- and financial service-based economies.

Currency devaluations drove up inflation rates in several crisis-affected Asian countries. Across Asia, the average rate of consumer price inflation rose

**Selected Economic Indicators: Developing Asia,
1996-2000**
(percent)

Indicator and subregion	1996	1997	1998	1999	2000
Gross domestic product growth					
Developing Asia	7.4	6.2	2.6	4.4	5.1
NIEs	6.3	6.0	-1.4	2.3	4.3
PRC and Mongolia	9.6	8.7	7.8	7.0	6.5
Central Asian republics	1.1	3.5	0.4	—	—
Southeast Asia	7.1	4.0	-6.9	0.8	2.8
South Asia	7.2	4.7	5.7	5.5	5.8
The Pacific	3.1	-3.4	0.1	—	—
Inflation rate					
Developing Asia	7.3	4.6	6.5	3.7	4.1
NIEs	4.3	3.5	3.8	1.1	2.3
PRC and Mongolia	8.4	2.8	-0.8	2.0	3.0
Central Asian republics	42.3	21.6	10.1	—	—
Southeast Asia	6.6	5.6	21.0	8.3	6.4
South Asia	9.5	7.3	13.0	7.6	7.2
The Pacific	8.6	4.0	8.6	—	—
Current account balance (relative to GDP)					
Developing Asia	-1.3	0.5	3.6	2.5	1.4
NIEs	0.3	1.7	9.2	4.9	2.8
PRC and Mongolia	0.9	3.2	2.5	0.9	0.4
Central Asian republics	-6.0	-4.2	-7.2	—	—
Southeast Asia	-5.5	-3.3	5.2	4.4	3.2
South Asia	-2.3	-2.2	-2.0	-3.1	-2.5
The Pacific	4.4	-1.1	-1.6	—	—
Debt-service ratio					
Developing Asia	14.2	16.0	19.2	17.7	13.5
NIEs	—	—	—	—	—
PRC and Mongolia	6.7	9.8	—	—	—
Central Asian republics	15.7	22.2	—	—	—
Southeast Asia	15.6	17.6	17.0	15.9	11.1
South Asia	30.2	29.6	29.0	25.3	23.9
The Pacific	10.7	12.2	0.6	—	—

— Not available.

Source: Asian Development Outlook 1999.

to 6.5 percent from 4.6 percent in 1997. Average inflation should moderate to about 3.7 percent in 1999 as the shock of the late 1997 depreciations dies out. Current accounts improved throughout the region as capital flowed out. From approximate balance in 1997, Asia's aggregate current account moved to a surplus of 3.6 percent of GDP in 1998. Most of that improvement came from import reductions, while overall exports failed to increase as expected. The region's aggregate current account should remain in surplus in 1999.

Weak and ill-regulated banking systems contributed heavily to Asia's initial vulnerability to capital flow reversals. Although many of the worst hit countries—including Korea, Thailand, and to some extent Indonesia—have instituted significant financial sector reforms since the crisis began, the ratio of nonperforming loans to total lending continued to rise in 1998. The regional nonperforming loan ratio of 20 to 30 percent represented an equivalent share of output, as financial leverage in Asian economies remained at about 100 percent of gross domestic production (GDP).

Newly Industrialized Economies. The crisis engulfed emerging Asia's richest economies in 1998, spilling over to the financial centers of Hong Kong, China and Singapore. Steep drops in regional trade, tourism, and financial activity slowed both economies and prompted Hong Kong, China's monetary authority to intervene in the equity market. Korea took firm steps to pull its way out of the late 1997 financial chaos, causing the won to stabilize and then strengthen. Taipei, China reaped the benefits of a strong financial system, a large stock of foreign reserves, and flexible factor markets in resisting the regional contagion.

Aggregate growth for the NIEs was negative, and two of the four economies suffered recessions in 1998. Only Taipei, China managed to achieve substantial growth. At the same time, inflation in the NIEs rose in 1998, primarily because of price increases in Korea stemming from the won's steep depreciation.

World capital flows will continue to exert a major influence on the NIEs in 1999. Recovery of the Japanese economy and a stronger yen would help stimulate recovery in this group of economies. The web of close trade and investment ties in the region also makes recovery in the NIEs partly dependent on Southeast Asia. Projections indicate that Korea will grow by 2 percent in 1999; Hong Kong, China will experience a contraction of 0.5 percent in GDP; Singapore should recover some of its momentum and post 1 percent GDP growth; while growth in Taipei, China will remain stable at around 5 percent. Current account balances should remain in surplus in 1999.

People's Republic of China and Mongolia. The PRC's growth slowed in 1998, largely because of a drop in foreign export demand. Nevertheless, the PRC fared substantially better than most of its neighbors, with 7.8 percent GDP growth. Domestic investment demand remained strong, as the country's exchange restrictions allowed the economy to resist the high domestic interest rates forced on many other Asian countries by world capital flows. Domestic consumption grew more slowly than in previous years. Government spending stayed under control, with the consolidated budget deficit remaining close to balance.

Domestic savings remained at more than 40 percent of GDP, providing the PRC with adequate investment capital to maintain positive growth. The country made limited progress on its structural reform agenda in 1998, but some financial reform took place in 1998, as evidenced by the introduction of a new loan classification scheme for commercial banks. The Asian crisis gave the PRC little incentive to reduce trade barriers or eliminate its still extensive exchange restrictions. Export growth, which averaged 20 percent annually over the last five years, registered a mere 0.5 percent increase in 1998. The slowdown reflected sharply lower demand from Japan and the rest of Asia. Although the drop in export demand reduced the PRC's trade surplus from the previous year, it still managed a surplus on the current account for the fifth consecutive year. The PRC's unwillingness to rely on short-term capital flows and its strict regulations controlling capital movements helped save it from the large capital outflows experienced elsewhere in Asia.

The outlook for the PRC in 1999 is positive, with continued growth of about 7 percent. Inflation will remain under control and the current account will stay positive. The combination of large reserves and stringent restrictions on foreign capital movements means that the PRC is unlikely to face a financial panic of the kind that struck so many of its neighbors. Over the next few years, however, to maintain high growth rates the PRC will need to accelerate the pace of privatization and financial reform.

Mongolia's GDP grew moderately in 1998, by 3.5 percent, despite lower international prices for the country's two main exports, copper and cashmere. Economic reform has proceeded well since 1991, but Mongolia still needs to privatize several state-owned enterprises and strengthen its financial sector. Growth is expected to remain relatively strong in 1999.

Central Asian Republics. Aggregate growth in the four Central Asian member countries of the Asian Development Bank slowed in 1998 because of the Russian economic crisis and the depreciation of the ruble. To achieve sustained growth these nations will need to make further progress on structural

reform and macroeconomic stabilization. They will also need some relief from external shocks, as economic ties left over from the former Soviet Union make this group of countries highly dependent on events in Russia.

Southeast Asian Economies. Southeast Asia's economies remained at the vortex of the Asian financial crisis in 1998. Civil unrest and an unexpected change of government in Indonesia heightened the sense of instability as the subregion's largest country struggled to regain its economic footing. The first to be struck by speculative attack in 1997, Thailand moved decisively to reverse capital outflows in 1998 through financial and other structural reforms. Malaysia chose a different path, introducing capital controls and expanding the government's economic role in an attempt to shield the domestic economy from the volatility of international capital flows. Having participated less in the economic boom than its neighbors, the Philippines was proportionately less affected, while the countries of Indo-China were even less affected, but did suffer export demand shocks.

After 4 percent growth in 1997, the region contracted by about 7 percent, underperforming even the most pessimistic expectations for the year. More than \$30 billion fled Indonesia, Malaysia, Philippines, and Thailand in 1997 and 1998. Indonesia continued to bear the brunt of the crisis as exports and investment collapsed, reducing output by 13.7 percent. Thailand implemented a series of financial reforms, but still suffered an 8 percent contraction. Malaysia at first appeared to avoid the worst effects of the crisis, but capital outflows late in the year brought growth down to -6.2 percent. In the Philippines tight monetary policy to defend the peso constrained investment demand, while poor agricultural performance caused by bad weather limited growth from the supply side. However, the Philippines' relatively low level of financial leverage and continued strong export demand helped save it from some of the worst effects of the crisis. Growth in the Lao People's Democratic Republic and Viet Nam slowed from the previous year, as the former was hurt by the baht's depreciation and the dropoff in Thai investment, and the latter suffered from a fall in foreign direct investment from the NIEs. Cambodian growth was flat in 1998 from 2 percent in the previous year.

Inflation in 1998 increased fourfold from the previous year, driven by currency devaluations and, in some cases, food price increases arising from the impact of the El Niño drought. Indonesia—stricken by shortages of basic products and import price increases—contributed most to the regional price increase. Fiscal constraints limited governments' ability to cushion the effects of depreciation, resulting in higher food, gas, and electricity prices.

The situation of the corporate and banking sectors continued to deteriorate, particularly in Indonesia and Malaysia. The proportion of nonperforming loans rose and more financial institutions found themselves insolvent. At the end of 1998, of Indonesia, Malaysia, Philippines, and Thailand, Indonesia had the highest level of nonperforming loans at 35 percent or more of loans outstanding, followed by Thailand at upwards of 30 percent, Malaysia at 25 percent, and the Philippines at 10 percent or more.

The economic slowdown caused a significant import contraction, which bolstered current accounts throughout Southeast Asia. For the first time in a decade the aggregate current account for the region registered a surplus. While export revenues weakened as some creditors refused to roll over trade loans, export volumes started to pick up in the second quarter of 1998, possibly pointing the way to an export recovery.

Of the four crisis-affected economies, Malaysia and the Philippines are the most likely to grow in 1999, albeit at a modest rate. Indonesia will continue to perform the worst among the group. On the assumption that currencies will stabilize and aggregate demand will remain weak, inflation rates should drop. With the exception of Cambodia, Indonesia, and the Lao People's Democratic Republic, Southeast Asian countries will experience single-digit inflation. Reduced domestic demand will bring continued improvements to trade and current account balances in 1999.

South Asia. Together with the PRC, South Asia managed to evade the main impact of the Asian financial crisis. India's growth was slightly higher than in 1997, while growth picked up in Pakistan in 1998. As a result of the impact of massive flooding on agricultural and manufacturing output, Bangladesh's 5.7 percent growth was slightly lower than expected for the year. Sri Lanka managed a fairly robust 5.3 percent growth rate, down slightly from 1997.

Restrictions on trade finance lines imposed as part of the nuclear test sanctions reduced the amount of capital available to fund current account deficits in the region. Exports contracted, but imports grew little as the fall in world oil prices reduced India's import bill for oil by 25 percent. India's current account deficit expanded slightly to 1.8 percent of GDP. With new reluctance from foreign lenders to provide financing, Pakistan had little choice but to reduce its current account deficit by more than half, to about 3 percent of GDP. Bangladesh—relatively unaffected by either the Asian crisis or the impact of nuclear test sanctions—continued to run a current account deficit of about 1 percent of GDP. Sri Lanka's current account deficit was 3.1 percent of GDP in 1998.

Pakistan's budget deficit expanded with the loss of aid flows that had made up as much as 6 percent of government expenditures in previous years. The higher deficit weakened market confidence in the country. India also had a large budget deficit, yet its more positive external position and conservative monetary policy helped it increase its reserves to the relatively comfortable level of \$22 billion, or about 15 percent of GDP. Despite an extensive network of licensing rules and regulations, India made some progress in structural reform, which gave the economy a supply-side boost.

Severe flooding struck most of Bangladesh in 1998, damaging rice production and reducing livestock herds. The flooding took out much of the country's infrastructure, destroying more than 6,500 bridges and washing out 11,000 miles of roads. Food production in this largely agricultural country fell by about 10 percent as a result. Although the flooding had a strong adverse impact on fiscal accounts, emergency loans from aid donors bridged much of the gap.

Aggregate growth in South Asia in 1999 is forecast at 5.5 percent, about the same as in 1998. In the short run, weather fluctuations of the kind that the La Niña phenomenon might cause will have a large impact on actual growth results in South Asia. Over the longer run, growth will depend on accelerated progress in privatization, deregulation, and trade liberalization. Inflation will fall and current account deficits will be fairly low at 3.1 percent of GDP.

The Pacific. Most Pacific countries were mired in slow growth even before the Asian financial crisis, and on average, the crisis itself had little effect on them. However, Papua New Guinea, the largest economy in the group, was an exception on both counts: it managed to achieve relatively strong growth despite falling commodity demand from Asia. Elsewhere in the Pacific, the shock waves from Asia hit the Solomon Islands the hardest, while Fiji, Nauru, and Vanuatu felt some adverse effects. The remaining countries had limited direct exposure to Asia, and so received little fallout from the crisis.

Risks and Uncertainties

The financial and exchange rate crisis remains the main source of uncertainty in Asia. While some currency and equity markets staged partial recoveries in 1998 and current accounts moved into surplus, conditions continued to deteriorate in most economic sectors. For example, bad loan rates kept rising in 1998 as corporate failures exacerbated banking sector problems, even as many Asian countries initiated significant financial sector reforms.

The speed and volatility of the Asian crisis makes it difficult to forecast how soon fresh portfolio capital and banking credit will begin to flow to developing economies again. The danger of predicting a rapid recovery became clear in August, when Russia's devaluation and default prompted a new round of capital flight and falls in stock markets around the world. International bond markets again demanded huge spreads for emerging market debt over "safe" issues, and bank credits contracted. As in 1997, shocks from financial markets quickly spread to economies at large as governments tightened their fiscal and monetary policies to constrict the capital outflows. As long as international capital markets remain shaky, developing countries in Asia and the world will be vulnerable to investor panic.

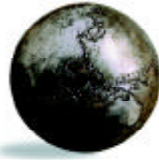
Brazil and Russia are two developing economies outside Asia with demonstrated potential to disrupt Asian markets. While the initial impact on Asia of Brazil's large devaluation in January 1999 was less severe than many had feared, continuing financial turmoil in Brazil and the rest of Latin America could increase volatility in Asian currency markets. Worse, if Brazil were to default on its sovereign debt, risk premiums on emerging market debt would rise again and capital flows to many developing countries would evaporate.

Developments in the industrial countries are also likely to affect Asia's prospects for recovery. A large enough stock price drop in the United States would damage consumer confidence and reduce US import demand. With the United States being the first or second largest market for many export-dependent Asian countries, a US recession could spark another round of contagion in the region. A recession in Europe could have the same impact, though perhaps a smaller one. Asia's crisis-driven trade surplus could also provoke a protectionist response in the United States or Europe, with potentially severe consequences for Asian exporters.

In Asia, if Japan could pull itself out of its current recession, higher growth would raise import demand, which would provide a large trade boost to the region. Given the large volume of Japanese lending to the region before the crisis, substantial progress in resolving Japan's banking difficulties under the current financial sector rescue package would increase the flow of private capital to Asian banks and firms. The Miyazawa initiative to create a \$30 billion Asian recovery fund may increase official capital flows to make up for lost private capital.

The economic crisis has spawned political uncertainties. Salient among these is the possibility of social unrest leading to regime changes, as happened in Indonesia. However, even when a government's survival is not at stake, political forces arising from the crisis may determine policy. For example, to

cushion the social costs of recession, inflation, and unemployment, governments have been tempted to resort to higher subsidies, increased regulation, and other direct government interventions. Such responses are inevitable, and in some cases are desirable. However, governments need to be careful that emergency measures do not slow the adoption of needed structural reforms or, in an extreme case, lead to fiscal insolvency.



The Financial Crisis in Asia

The financial turmoil that began in Thailand in July 1997 spread with a ferocity that none foresaw. Asia's once vibrant economies, used to decades of rapid growth, were plunged into deep recession. This economic collapse has forced an unprecedented reappraisal of policies in many Asian economies from corporate governance to exchange rate management. In addition, the crisis managers, particularly the International Monetary Fund (IMF), have come under criticism. Intense debate continues about whether IMF policies helped or hindered economic recovery. Finally, Asia's crisis has spawned wide-ranging discussion about the basic design of today's international financial system. Suggestions for reform and blueprints for improving the "international financial architecture" abound.

The Evolution of the Crisis in 1998

Asian financial markets began 1998 on a pessimistic note. With confidence eroded by Korea's near default in December 1997, the region's financial markets reached record lows in January 1998. However, by early February markets had bounced back, largely on the hope that foreign confidence in the region was returning. But this optimism did not last long, partly because of turmoil in Indonesia, and partly because of increasingly poor economic performance in Japan. Indonesia's economic crisis began to worsen sharply in February. Eventually, the combination of soaring prices, civil protests, sharply rising unemployment rates, and widespread corporate defaults precipitated a major political crisis. On 21 May President Suharto resigned; however, this did little to rally the markets.

Japan's woes compounded the region's troubles. In early February 1998, the Japanese government declared the economy "stagnant" in a monthly report

that offered the bleakest assessment of the country's business climate in more than 20 years. Responding to the turmoil in Asian markets in mid-February, the government unveiled a long-awaited package of stimulus measures designed to support the stock market and boost the economy. It proved insufficient. The economy continued to contract, despite an increase in the fiscal stimulus package in April. The tumbling yen triggered declines in other Asian currencies in June, including the Malaysian ringgit, the Thai baht, the Korean won, and the New Taiwan dollar.

Worried by the regional impact of a plummeting yen, Japan and the United States turned to official intervention. On 17 June, in coordination with the Bank of Japan, the United States spent an estimated \$2 billion to bolster the value of the yen. Asian markets rallied, but unfortunately, the rally did not last. By mid-August the yen had fallen to a new low. Another major shock hit financial markets on 17 August: the Russian central bank devalued the ruble and the government effectively defaulted on its internal debt. This action had a dramatic and deleterious impact on all financial markets. Investors fled all types of risk, from emerging market bonds to noninvestment-grade corporate bonds in developed markets.

As capital fled policymakers were forced to resort to unorthodox responses. The Hong Kong, China authorities intervened directly in the stock market to counter what they saw as market manipulation. On 1 September Malaysia's government made the decision to impose exchange controls to counter speculative attacks on the ringgit. The near collapse of the Connecticut-based hedge fund, Long Term Capital Management, and its rescue organized by the Federal Reserve Bank of New York, showed that by the end of September 1998 the crisis had moved well beyond Asia.

The US Federal Reserve cut interest rates three times between September and December 1998, and European central banks cut their benchmark rates. Markets were also reassured by the decision to enhance the IMF's capital base or "quotas" in October, which had been held up by political opposition in the US Congress. Since October 1998, conditions in Asia have improved substantially. Japan has made progress on the much needed reform of its banking sector and is implementing the fiscal stimulus package. Buoyed by progress in Japan, by interest rate cuts in the industrial countries, and especially by the gradual implementation of their own reform programs, other Asian markets began to recover.

By the beginning of 1999 one could say that Asia's economies seemed to have stabilized. In Korea and Thailand especially, the bitter economic medicine was beginning to work. While emerging markets remained fragile—

as evidenced by the collapse of Brazil's currency, the real, in late January 1999—the worst in Asia seemed to be over.

Interpreting the Crisis

Two general interpretations dominate the debate on the cause of the crisis. One blames poor economic fundamentals and policy inconsistencies. The other argues that Asia fell victim to a financial panic, where negative sentiment became self-fulfilling.

According to the “fundamentalist” view, the Asian crisis was caused by serious structural problems along with policy inconsistencies. Many Asian governments provided implicit guarantees to the banking system, which often engaged in lending practices that favored financially unqualified borrowers. This meant that the governments' implicit guarantees created a sizable “contingent fiscal liability.”

By contrast, the panic interpretation views the self-fulfilling pessimism of international lenders as the root cause of the crisis. The most sophisticated version of this argument interprets Asia's crisis as a classic bank run. In a bank run, if enough investors are suddenly seized with panic and demand immediate payment, then financial intermediaries are forced to destructively liquidate long-term assets at a great loss. The problem in an international context is that there is no lender of last resort who can step in to provide the necessary liquidity that will end the panic. In Indonesia, Korea, and Thailand short-term external debt exceeded international reserves immediately prior to the crisis. Economic fundamentals, such as inflation, unemployment, and the budget deficit, are unimportant in this interpretation, although fears about economic weaknesses might cause the initial investor shift from optimism to pessimism.

Which Explanation Fits Asia the Best?

At first sight, the past stellar economic record of the Asian economies does not support the fundamentalist interpretation. However, closer inspection shows that these countries' economic success was built on a particular kind of economic strategy that emphasized export orientation, centralized coordination of production activities, and implicit (or even explicit) government guarantees of private investment projects, as well as intimate relationships between banks and firms. During the 1990s several factors combined to worsen the fundamental outlook for the region. The rapid appreciation of the US dollar

since 1995, to which most of the region's currencies were pegged; the increasing competition from the PRC in export markets; and the prolonged slowdown of the Japanese economy were all reflected in slower export growth, rising current account deficits, depressed stock markets, and widespread corporate difficulties long before the outbreak of the crisis.

The financial sector was also exhibiting significant problems. Weak prudential regulation, lax and inexperienced supervision, low capital adequacy ratios, lack of incentive-compatible deposit insurance schemes, distorted incentives for project selection, and sometimes outright corruption all rendered the region's financial systems weaker than they appeared. This did not present a major problem until the 1990s, when closed capital markets were gradually opened.

The 1990s also saw a dramatic increase in foreign borrowing. Asian companies maintained a strong bias in favor of foreign short-term debt financing. Although specific characteristics varied, a pattern of increasing vulnerability to external shocks emerged in all the region's economies prior to the crisis.

In the first half of 1997, despite the worsening financial environment, capital inflows did not slow down, but increasingly took the form of short-term, interbank loans that could be readily withdrawn and could count on formal guarantees in the interbank markets. However, once the crisis began, international banks suddenly stopped lending and began to call in their loans. A huge amount of private foreign capital fled the region in the second half of 1997.

The suddenness and speed with which capital fled the region in the second half of 1997 give credence to the panic interpretation of the crisis. However, it was the region's structural weaknesses that initially created the vulnerability to shocks.

Policy Responses to the Crisis: An Overview of the Debate

The IMF, the institution charged with safeguarding the stability of the international financial system, assumed the principal responsibility for dealing with the Asian crisis at the international level. The IMF's goal was to quickly restore confidence in the three hardest hit Asian economies—Korea, Indonesia, and Thailand—through a combination of tough economic conditionalities and substantial financial support.

The IMF's economic strategy had two key components. The first, in keeping with its usual practice, concentrated on macroeconomic policy, the

main component of which was to be tighter monetary policy. The second, complementary, component of the strategy was substantial structural reform. The IMF demanded deep reform of the region's banking systems, breakup of monopolies, removal of barriers to trade, and substantial improvements in corporate transparency. This marked a significant departure from usual IMF practice, when conditions are more closely confined to macroeconomic policies alone. The IMF saw the structural reforms as essential for a long-term solution to Asia's financial crisis.

Did Tight Monetary Policy Exacerbate the Crisis? Critics of the IMF argue that the tight monetary policy approach was misconceived and counterproductive. They point out that high interest rates forced highly leveraged corporations into bankruptcy. Widespread bankruptcies in the corporate sector led to bank insolvencies as the banks' corporate customers failed to repay their loans. Lower interest rates would have made it easier for firms to maintain production, thereby restoring investors' confidence that the economy would recover quickly, and would thus have caused currencies to appreciate. That would have created a virtuous circle. Many of the critics point out that Japan followed just such a policy when dealing with its domestic crisis.

The IMF, however, feared that a lower interest rate policy would cause a vicious downward spiral. As currencies plummeted, so the real burden of debt denominated in foreign currency would rise. Because the Asian firms had high leverage ratios, a much higher foreign debt burden could have forced insolvencies and caused even larger collapses in production. If lower interest rates did not work, countries' only alternative would have been to suspend service on their external debt and impose exchange control measures. However, with the exception of Malaysia, governments did not pursue this option.

Available empirical evidence does not necessarily support the view that interest rates were persistently high. Indeed, several of the crisis-affected countries pursued low interest rate policies well into the crisis without any success. The IMF estimates that in Korea and Thailand, the effects of the monetary tightening may account for less than a quarter of the expected decline in economic growth rates between 1997 and 1998.

Did the IMF Force Unnecessary Fiscal Adjustment? Unlike many other crises that have required IMF intervention, the Asian crisis was not caused by profligate government spending. Thus fiscal imbalances were not a major concern in the initial IMF programs. Nonetheless, the IMF's approach in the crisis-affected countries was to demand a tightening of fiscal policy based on

two arguments. First, it argued that in the presence of rapid capital flight, these countries needed to reduce domestic demand to narrow their current account deficits. Tightening fiscal policy was an effective way to do this. Second, and more subtle, was the argument that government spending needed to be cut to make room for the expected expenditure necessary to bail out insolvent banks.

Critics, however, claim that the fiscal tightening simply exacerbated the enormous economic contraction that was already taking place in the region. In the face of collapsing output, they argue, fiscal expansion, that is, a small budget deficit, would have been more appropriate. However, this is an easy criticism to make with hindsight.

Did the Closure of Insolvent Bank Precipitate Runs on Solvent Banks?

Given the parlous state of the financial sector in the crisis-affected countries, there is little doubt that many banks in Indonesia, Korea, and Thailand needed to be restructured, merged, or simply closed. The IMF believed that speedy and concerted action in this direction would, by weeding out the bad financial apples, help restore investors' confidence. In all three countries, therefore, the operations of a number of clearly insolvent financial institutions were suspended or closed early on.

The IMF's critics charge that this abrupt closure of insolvent banks panicked the public and precipitated a run on sound banks. Concerned that their banks might be closed next, depositors withdrew their money from healthy banks in a classic banking panic. Thus, the critics argue, the IMF's policy made matters much worse.

Clearly in Indonesia the decision to close banks did precipitate a public panic. However, the IMF's supporters argue that the lack of clear government policy caused the panic, not the bank closures themselves. The Indonesian government promised only a small deposit guarantee, did not publicize it widely, and did not explain publicly how depositors in banks that had not yet been closed would be treated. Similarly, the IMF's defenders point out, the closure of banks in Korea and Thailand did not result in such severe runs. That is true, but it is also true that the financial institutions that were closed in these two countries were mainly merchant banks that did not take personal deposits.

Was the IMF too Intrusive? Some critics question the IMF's insistence on far-reaching structural reforms in Asia's economies. They have suggested that the IMF went well beyond its usual role of ensuring prudent macroeconomic

policies. Instead it was intervening excessively in the domestic affairs of sovereign governments by demanding large-scale restructuring in the corporate and financial sector, as well as improvements in governance, labor markets, and competition policy.

This criticism does not sit well with the facts of the Asian crisis, the IMF proponents argue. If reckless monetary and fiscal expansion was not at the root of the problem of the Asian financial crisis, devising a response focusing on these areas made no sense. Continued financial and corporate weakness would have undermined macroeconomic policy, investors would have continued to flee, and the IMF's ultimate goal—a quick return to economic growth—would have been impossible.

Did IMF Bailouts Increase Global Moral Hazard? While much of the criticism directed at the IMF has focused on its strategy in Asia, some criticize the very existence of IMF support. This argument is based on the concept of moral hazard. Moral hazard implies that investors and borrowers behave imprudently because they believe they will be bailed out if their investments go sour. IMF loans, argue some critics, exacerbate moral hazard in two ways: they absolve governments from the consequences of profligate policies, thereby encouraging them to continue the profligacy in the future, and they reward reckless investors. Because the IMF's loans to the crisis-affected Asian countries were unusually large, the critics argue that they set a dangerous precedent that will increase moral hazard worldwide.

However this argument is not convincing for three reasons. First, most investors in Asia, whether foreign or domestic, suffered substantial losses. Second, it is hard to believe that governments relish the tough conditions the IMF imposes on them. Third, the costs of not intervening in Asia's crisis would have been extraordinarily high. Investors would have fled even more quickly, countries would have been forced to default on their debts, and the region (and perhaps the world) could have been plunged into an even more serious crisis.

Strengthening the International Financial Architecture

The severity of Asia's financial crisis, the speed with which it spread, and the shortcomings of the international response have all contributed to a wide-ranging debate on the basic rules and institutions that govern global finance. How can this global financial architecture be improved so that crises can be

avoided or can be better managed when they do occur? Many proposals have been put forward. The major ones are discussed below.

Controlling Capital Flows. Some commentators question the very goal of free capital flows, arguing that free trade alone should be the main objective of development and growth policies. They often put forward two arguments to support this view. First, countries can reap the benefits of free trade in goods and services without simultaneously opening up their financial markets to foreign competition. According to this view, capital mobility is an optional extra. Second, several commentators argue that the theoretical benefits of free capital flows, such as increased investment and more efficient use of funds, do not occur in reality, because the efficiency gains that a country reaps from opening up to foreign capital are more than offset by increasing uncertainty and greater risk of financial crises.

History shows that countries that try to pursue free trade while maintaining capital controls suffer a number of problems as people try to evade the capital controls. As economies develop and become more open, capital controls not only foster corruption, but also restrict the growth of trade. While increasing global integration does increase uncertainty, this also occurs as trade is liberalized. Terms of trade shocks—sudden rises or falls in a key export or import price—are potentially as unsettling as the contagious spread of financial crises.

However, this does not imply that all capital account liberalization is beneficial. The record of financial crises, especially in Asia, shows that ill-planned liberalization of capital flows—without appropriate market reforms—can result in financial instability and large economic costs. This suggests that financial liberalization must be carefully sequenced. A number of proposals are designed to assist that process. Some concentrate on improving market regulation, bank supervision, and transparency standards. Others concentrate on minimizing the risks associated with capital flows, focusing on measures to discourage short-term borrowing in foreign currency, which is widely regarded as the most dangerous form of foreign capital.

Improving Regulatory Standards. One of the main causes of the Asian financial crisis was poor regulation and supervision of financial institutions. Hence it is not surprising that much of the effort to improve the international financial architecture has concentrated on finding ways to improve international standards of financial regulation and supervision.

The Basle Capital Accords are widely regarded as a model for international supervisory standards. One way to encourage countries to adopt such standards is through IMF surveillance. Another approach is to improve coordination between regulatory bodies, or even to introduce a system of peer review, whereby national regulators could supervise each other. Improved regional surveillance would be another option. An alternative set of reform proposals focuses on improving existing regulatory standards. Some suggestions concentrate on tightening the rules on foreign borrowing in developing countries. Others focus on changing the incentives lending banks face, in particular, by updating the Basle accords.

More radical regulatory reform ideas include the creation of global regulatory institutions. Proposals include a world financial authority that would be the equivalent of the World Trade Organization for financial institutions and a board of overseers of international financial markets. In each case, given that the goal is to create a global supervisor and regulator consistent with global capital markets, countries would have to surrender substantial amounts of national sovereignty. That requirement renders these ideas unrealistic, at least for the moment.

Rethinking Exchange Rate Regimes. The Asian crisis has shown that pegged, but adjustable, exchange rates are difficult to sustain in a world of increasing capital mobility. Sooner or later they are likely to be tested by a speculative attack, forcing—at the very least—high interest rates and budget cuts. The Asian crisis has also buttressed another traditional argument against fixed, but adjustable, exchange rates: by creating an illusion of permanent currency stability, they reinforce the incentive for financial institutions and firms to borrow from abroad without hedging. Today's conventional wisdom suggests that countries must either rigidly tie their currency to another by adopting a currency board or entering into a currency union, or they must allow their currency to float.

Some economists have recently advocated the need for strong coordination of exchange rates among Asian currencies. According to this view, recovery from this crisis could be strongly facilitated if the crisis-affected countries could re-adopt a dollar exchange rate target, as they did before mid-1997. While exchange rate policy does have international spillover effects, it does not mean that explicit coordination is required to achieve stability. In addition, the root cause of the current crisis was largely domestic and structural. Therefore any attempt at international exchange rate coordination without first addressing

those structural problems will be based on shaky foundations and is likely to be counterproductive. Moreover, the crisis-affected countries differ significantly in terms of their history of exchange rate regimes.

Creating an International Lender of Last Resort. The argument in favor of an international lender of last resort is based on an analogy with the role central banks play in national economies. When a banking panic hits a domestic financial system, the central bank can limit contagion by providing liquidity to the system. In a world of integrated capital markets, many argue that a similar institution is needed at the international level. By providing limited liquidity in return for policy conditionality, the IMF already plays a similar, if highly circumscribed, role. Most advocates of an international lender of last resort suggest that the IMF should play this role. However, the proposal to create this type of lender is plagued with conceptual and practical difficulties.

The lender of last resort must be able to distinguish between healthy and insolvent institutions, intervening only to stop unwarranted panics and leaving insolvent institutions to fail. Extending these conditions from banks to countries and from national authorities to international institutions is extremely difficult. The first problem is that of distinguishing between illiquidity and insolvency. The second problem is that of moral hazard. National central banks put in place prudential regulations on domestic financial institutions to limit reckless behavior. They also retain the power to close or merge insolvent or weak financial institutions. Neither capacity exists at the international level. As yet, no binding global rules of financial behavior exist, and the IMF certainly cannot close down a recalcitrant country. The final issue is that of resources. If necessary, a domestic central bank can provide limitless liquidity simply by printing money (unless it is constrained by a fixed exchange rate regime). The IMF has no capacity to issue fiat money and its resources are limited.

Japan has recently proposed the creation of regional currency support mechanisms to complement the role and function of the IMF. This idea of regional currency support mechanisms, which found an earlier articulation in the proposal for establishing an Asian Monetary Fund, is in the initial stage of discussion and development.

“Bailing In” the Private Sector. Another popular goal among the architects of international financial reform is bailing in the private sector. The idea is to minimize moral hazard and spread the burden of financial crisis by ensuring that private investors and banks bear some of the cost.

One approach that Argentina and Mexico have successfully pioneered is to set up private sector credit lines before a crisis. These are, in effect, a limited form of private lender of last resort. Such arrangements have considerable potential, particularly if multilateral development banks guarantee some portion of the risk involved, and thereby encourage more private banks to participate in such schemes.

More controversial are proposals to forcibly bail in private investors once a crisis has struck. One proposal, advocated by the G22, is to encourage “lending into arrears” by the IMF. Since the 1980s the IMF has been able, in certain circumstances, to lend to a country that was in arrears on its commercial bank debt. Now this idea has been extended to countries that are in default to other private creditors, including bondholders. The goal behind this approach is to encourage recalcitrant creditors to negotiate, and thereby to promote orderly and responsible debt restructuring, rather than chaotic default.

More radical proposals along similar lines include imposing “haircuts” (mandatory losses) on investors if they flee during a financial crisis. However, this proposal might simply raise the cost of capital for borrowing countries.

The most radical ideas for bailing in the private sector focus on creating an international bankruptcy court. Just as domestic bankruptcy courts can prevent creditor grab-races; decide on a hierarchy of claimants; and allow an insolvent, but viable, firm access to new financing, so some commentators suggest there should be an international bankruptcy court to restructure countries’ debts. This idea stands little chance of being implemented, however. First, it would demand a huge surrender of national sovereignty. Second, national bankruptcy codes differ enormously, and reaching international agreement on a single code is highly unlikely.

A Minimum Necessary Set of Reforms for the Architecture

In the aftermath of every crisis, whether a war or a currency collapse, a soul-searching effort to build a better world ensues. The Asian financial crisis is no exception. It has prompted scores of proposals for a new international financial architecture. However, effective reforms can take place within the existing institutional system. These include the following:

- *Negotiating minimum international standards of financial practice.* Despite considerable progress at creating international norms, auditing and accounting practices still vary considerably across countries. This makes gauging the financial condition of borrower banks and corporations difficult for lenders. While individual countries should implement reforms in these areas as they

deem appropriate, minimum international standards would help prevent national problems spilling over to the international level.

■ *Introducing prudent regulation of capital accounts.* While developing countries should aim for integration into the international financial system, this should not imply a reckless rush to capital account convertibility. The gradual and cautious removal of capital controls may be appropriate for countries whose domestic capital markets are underdeveloped and whose capacity to regulate excessive risk taking by domestic institutions is limited. For many developing countries, Chilean-style taxes on capital flows may be helpful.

■ *Reforming exchange rate regimes.* Large unexpected swings in the exchange rate can bring serious financial distress to domestic banks and corporations with unhedged debt exposure. This problem can be minimized in two ways. First, a floating exchange rate will induce banks and corporations to hedge their foreign currency debt. Second, a currency board or currency union will permanently eliminate unexpected currency fluctuations. International financial institutions, particularly the IMF, can push the agenda of an appropriate exchange rate regime without any fundamental institutional change.

■ *Creating the framework for an orderly restructuring of problem debts.* Debt restructuring is a difficult, protracted process. Modest changes—including clauses for majority voting and the provision of a trustee to represent and coordinate creditors—could easily be introduced. If industrial countries included such provisions in their bond contracts, they could become standard practice, then developing countries would not incur a price penalty when they introduced them.

■ *Encouraging private sector credit lines.* Given the IMF's limited resources and the conceptual difficulties surrounding the concept of an official international lender of last resort, limited credit lines with the private sector appear promising. Argentina's contingency finance arrangements with private banks seem to have served it well. With multilateral guarantees this approach might prove useful for more countries.

These modest proposals do not constitute a new Bretton Woods. They do not call for a massive new bureaucracy nor a huge investment of public funds. However, they could help to reduce the risk of financial crises and reduce their severity should they occur. That alone would bolster, rather than hinder, the process of financial integration from which both industrial and developing countries have so much to gain.



Economic Openness: Growth and Recovery in Asia

Openness matters. By offering countries opportunities to trade with the outside world, openness stimulates growth through easier access to new technologies and skills and to international capital markets. Furthermore, it promotes market discipline. Among developing regions, Asia has taken the lead in adopting outward-oriented development policies. However, the recent financial crisis in Asia has raised a number of serious questions about the role of openness in promoting sustainable growth. While the case for openness with regard to trade, labor movement, and direct investment remains strong, developing Asia faces the challenge of ensuring that the global trading system continues to evolve fairly and takes into account the interests of developing countries. To meet this challenge, developing Asia will have to play a more proactive role in future multilateral trade negotiations.

As regards openness to financial flows, the case seems compelling, yet at the same time, it is complex and depends on the strength of domestic financial systems. However, rather than providing a reason to postpone financial integration, this means that reform of financial systems is imperative.

How open are the Asian developing economies (ADEs)? Individual ADEs have adopted different degrees of openness, and different country groups are characterized by varying degrees of openness in trade, investment, and other factor flows. The Asian Development Bank publication *Emerging Asia* calculates trade openness indexes based on four important aspects of trade policy. A fully closed economy scores zero and a fully open economy scores one. On this set of indexes East Asia scores 0.97, Southeast Asia scores 0.73, and South Asia scores 0.06. The growth of the East and Southeast Asian countries has been particularly strong until recently, reflecting their openness to trade.

Policies toward Foreign Trade

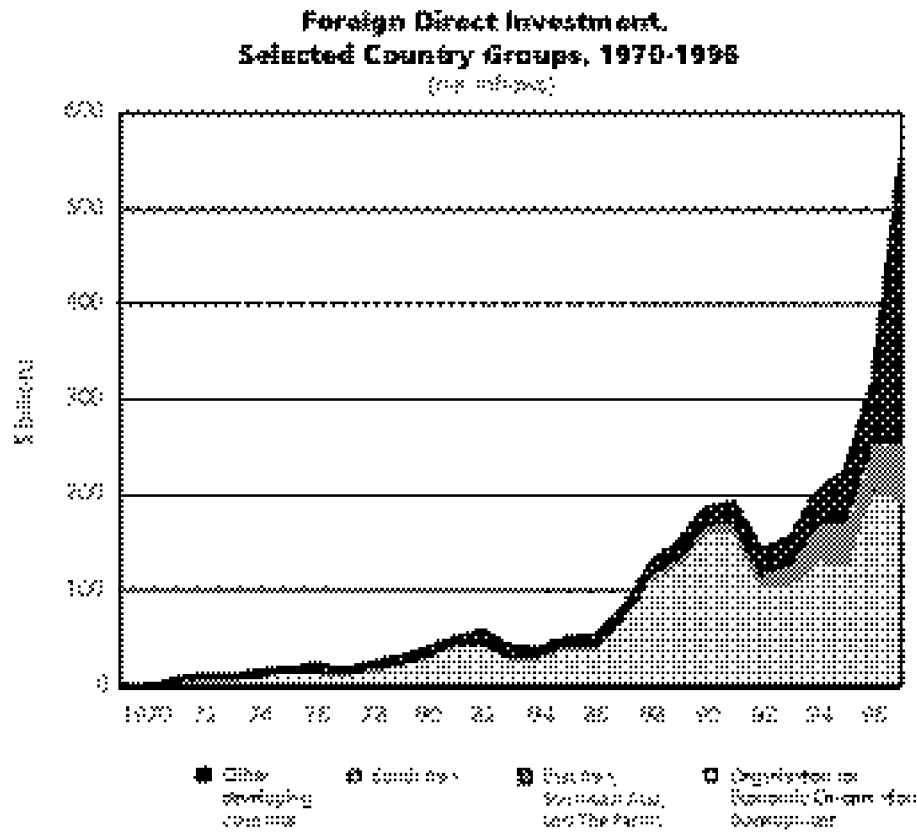
The average growth of trade in goods in the PRC, the NIEs, and Southeast Asia outpaced that in South Asian countries, and even in the world as a whole. The NIEs and the Southeast Asian countries maintained much lower average rates of protection than South Asia and other non-Asian developing economies in the 1980s, and so their spectacular economic performance is hardly surprising.

However, in the 1990s many developing countries—including the PRC and most South Asian countries—have attempted to emulate the trade and growth performance of the NIEs and Southeast Asian economies by gradually adopting economic policy reforms, of which the most important is trade liberalization. Thus the leadership of the East Asian economies in maintaining more open trading regimes than other developing countries has been eroded in recent years, particularly when judged against non-Asian developing economies.

Trade in services has been increasing in the ADEs, reflecting a global trend. Transport, travel, and insurance have long been associated with the growth of goods trade and tourism in Asia. Nevertheless, widespread restrictions on international trade in services remain in effect, and services were subject to separate negotiations during the Uruguay Round.

Foreign direct investment (FDI) is among the major forces propelling the globalization of the world economy, and it is integral to the growth prospects of developing countries in the modern global economy. During 1985-1995, FDI in East and Southeast Asia represented a growing share of total FDI in developing countries (see figure). The main source of FDI in East and Southeast Asia has been the region itself. The four NIEs were the largest single source of FDI for the PRC, Indonesia, and Malaysia between 1986 and 1992. In the case of Thailand, the NIEs were a close second to Japan during the same period. In recent years, FDI flows to developing countries outside Asia have begun to match those to the ADEs. An important question for development in Asia is whether the declining dominance of developing Asian countries in FDI flows observed during the early to mid-1990s represents a permanent shift.

With the exception of East Asian NIEs, foreign investment regimes in developing Asia are not substantially more liberal than in other developing regions. Foreign investment regimes in PRC; Malaysia; Philippines; and Taipei, China are all substantially more restrictive than in some of the more dynamic non-Asian developing economies. In South Asia only Pakistan has a relatively liberal foreign investment regime.



Source: World Bank, 1999, *World Development Indicators*, Washington, DC.

The rapid growth of private capital flows, and of portfolio flows in particular, to developing Asia in the last decade or so reflects the increasing financial integration of the ADEs internationally. This growth has been propelled and facilitated by technological progress, which has reduced the transaction costs of buying and selling financial assets. However, the liberalization of policies on international capital flows in both industrial and developing countries has also been critically important.

Hong Kong, China and Singapore are now ranked among the most open economies in the world in terms of capital account convertibility. By the early 1990s, Indonesia, Philippines, Thailand, and even Pakistan had joined Korea and Malaysia as economies with a high degree of financial integration. Given the small extent of financial integration in Pakistan and the Philippines in the mid-1980s, the process of opening up to financial flows accelerated sharply in

these economies. This also seems to be the case for the PRC, which started from a low degree of financial integration in the 1980s, but had caught up with India by the early 1990s.

Gains from Trade: Theory

Free trade in goods can lead to significant efficiency gains in resource allocation in trading countries. Moreover, it can lead to large dynamic gains by increasing incentives to innovate, thereby enhancing growth and welfare in the global economy.

The fundamental idea of trade theory—the theory of comparative advantage—is both simple and compelling. Countries trade so as to benefit from their differences in factor endowments. Countries will specialize producing those goods and services that best suit their natural resources and physical and human capital endowments. They will trade the goods and services produced at home for goods and services produced abroad. According to the theory, free trade, with trade flows determined by comparative advantage, will yield the most efficient allocation of the world's resources, and thereby maximize global welfare, while restrictions on trade will reduce efficiency, and hence welfare.

Foreign Direct Investment and Labor. FDI brings benefits through four main channels:

- For the host country, FDI is an additional source of capital. By adding to domestic savings, it can help increase the rate of growth of output.
- If the return to capital is higher in the host country than in the source country, FDI will improve the international allocation of capital.
- FDI can serve as a vehicle for technology transfer. Multinationals often bring in new production technologies, which generate benefits for both host and source countries.
- In the area of services, such as banking, insurance, and telecommunications, FDI is the main instrument for promoting trade.

Trade barriers undermine the benefits of FDI. In this case, some FDI may represent tariff-jumping rather than efficient investment decisions, particularly if the import-competing sector already has excess capacity because of protection.

The benefits of international labor mobility parallel those of FDI. In the host country it can alleviate labor shortages. It also permits efficient allocation of world resources and can help facilitate the flow of new technology through knowledge embodied in skilled workers.

Financial Capital. The case for international financial capital mobility is based on four simple arguments as follows:

- As capital is more productive in capital-scarce countries, capital mobility will increase income in both capital-rich and capital-scarce economies. In a world of capital mobility, a lack of domestic savings need not constrain countries with profitable investment opportunities.

- Capital mobility allows households and firms to hold an internationally diversified portfolio of assets. This reduces the vulnerability of income streams and wealth to real and financial shocks that may hit the domestic economy.

- Liberalization of capital flows can lead to efficiency gains because of increasing returns to scale. The production of many wholesale financial services is subject to increasing returns to scale that may be exploited through specialization.

- As the domestic capital market becomes integrated with the international capital market, domestic policymakers become subject to scrutiny by global investors. Thus capital market integration is a powerful disciplining device for policymakers to pursue policies that are conducive to macroeconomic stability and ensure growth.

The foregoing points all seem to support a favorable view of international financial integration. However, experience during the 1920s and 1930s and the recent Asian financial crisis indicates that private capital flows, particularly those relating to short-term debt, can be unreliable and excessively volatile. Depending on an economy's stage of financial sector development, for many developing countries the cost of financial integration may exceed its benefits.

Gains from Trade: Empirical Evidence

The empirical evidence suggests that there are substantial gains from trade in goods and services, from technology, from FDI, and from labor mobility. The only exception is financial flows, for which the evidence is inconclusive.

The gains from trade can be measured using two broad approaches: assessing static gains from trade and assessing dynamic gains from trade. Standard estimates in the international trade literature suggest that in most cases, static gains from trade are equal to 1 to 2 percent of GDP, but in highly distorted economies these gains can be as much as 5 to 6 percent of GDP. Such gains are far from insignificant. However, the performance of economies over time clearly shows that the largest impacts of openness are dynamic in nature. Overall, the evidence establishes a strong link between openness and

economic performance as measured by economic growth or total factor productivity growth.

A clear benefit of economic openness is that it gives a country access to technology developed elsewhere in the world. New technology can be embodied in the capital goods used in actual production. A recent study shows that countries with a higher ratio of capital goods imports to investment grow faster in terms of GDP per capita. The implication is clear. Economies that have erected barriers to the importation of capital goods have done so at a significant cost to their economic growth.

A recent empirical study investigates whether FDI has promoted growth in developing countries and, if so, the necessary conditions under which it has done so. The key finding is that the higher the stock of human capital in an economy (proxied by education levels), the greater the impact of FDI on economic growth. For the average developing country, the benefits of a dollar of FDI have exceeded those of a dollar of domestic investment. A number of surveys of companies in Southeast and East Asia have found that in terms of positive growth effects, the diffusion of knowledge through FDI is more important than its general contribution to raising investment levels.

While the benefits of international mobility of financial capital are widely acknowledged, surprisingly, rigorous quantitative estimates of these benefits are lacking. However, historical evidence suggests that a number of European countries benefited substantially from foreign financial flows. Two recent studies have attempted to investigate the impact of capital account convertibility on an economy's macroeconomic performance, but come to contradictory conclusions. This demonstrates the urgent need for more rigorous empirical studies in this area.

The results of a simulation study that estimates the impact of international labor movement in the world economy are dramatic. It shows that removing global controls on the free movement of labor and allowing labor to move from poor to rich countries could double world output. The calculations show that the efficiency gains from a marginal increase in labor mobility are likely to outweigh the corresponding efficiency gains from either trade or investment liberalization. Thus the relaxation of controls on labor mobility is one of the most crucial policy issues facing the global economy.

Most of these efficiency gains result from labor movements between poor and rich regions, not between particular countries. For political reasons, the chance of large increases in labor movements from developing to industrial countries in the foreseeable future is minimal. However, the simulations suggest that even minor increases in labor mobility could confer substantial gains.

**Openness, the World Trade Organization,
and Developing Countries' Interests**

International trade and open world markets are vital for the growth of Asian economies. Notwithstanding the Asian financial crisis, regional commitment to open trade policies is strong. However, for the most part, the ADEs have played a reactive rather than a proactive part in multilateral trade negotiations. Given the importance of openness and economic growth, it is time the ADEs took a more proactive role in such negotiations.

A Comprehensive Round of Trade Liberalization. The General Agreement on Tariffs and Trade, now administered by the World Trade Organization (WTO), was designed to liberalize cross-border trade restrictions such as tariffs and quotas. It is in this area that multilateral trade agreements have been the most successful and the least controversial. The most important aspect of a more proactive ADE approach toward multilateral negotiations must be to keep the process of trade liberalization moving forward. This could be accomplished through a comprehensive, multilateral round of trade negotiations.

Even though average tariffs in industrial countries are coming down to levels of 3 or 4 percent following the Uruguay Round, there is still a long way to go before free world trade in goods is achieved. While the ADEs have made great strides toward liberalization in recent years, they continue to have sufficiently high tariffs to give them the bargaining power to engage the industrial countries in a new round of multilateral trade negotiations. Tariffs in South Asia remain extremely high. Tariffs in East and Southeast Asia are lower, but remain still high by industrial country standards.

Multilateral Agreements on Investment and on Labor Mobility. The establishment of relatively open goods markets in the products that industrial countries export means that they have shifted their attention from liberalizing goods markets to liberalizing service and factor markets. The phenomenal expansion of FDI has created a powerful lobby in industrial countries for introducing an international regime to smooth the flow of FDI.

The following four priorities should guide the ADEs in any future discussion of multilateral investment agreements:

- The ADEs should ensure that any agreement is strictly limited to FDI. Trade and FDI are indisputably beneficial for developing countries, while the benefits of other capital flows differ across countries.

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- The ADEs should ensure that negotiations on investment include the PRC, which is the world's second largest recipient of FDI, and among developing countries is by far the largest recipient. The ADEs would limit their bargaining power in negotiating on FDI without the PRC.
 - The ADEs should insist that any agreement contain provisions to end subsidies for FDI.
 - The ADEs should link an investment agreement to one on labor mobility. Labor mobility is the area in which market access has, for obvious political reasons, been most restricted.

Competition Policy. Competition policy is concerned with restrictive business practices. A consensus has emerged between industrial and developing countries in favor of initiating the work necessary for possible inclusion of competition policy into the WTO. FDI by multinationals makes competition policy both more important and more difficult. When the size of a national market is small, large multinationals can exert market power and engage in restrictive business practices.

Nevertheless, despite the possibility of international restrictive business practices, whether the WTO needs a competition policy mechanism is debatable. A mechanism to regulate goods exports from developing countries is unlikely to be needed, as most developing countries are too small to have much market power in world markets. Therefore, as long as the distribution system is competitive, free trade can largely substitute for a competition policy, as demonstrated by Singapore, which has no competition policy.

Antidumping. With the hands of WTO members increasingly tied with respect to conventional instruments of protection such as tariffs and quotas, the use of safeguard measures, especially antidumping measures, has intensified. From the perspective of the ADEs, there are a number of concerns as follows:

- The incidence of antidumping measures against ADEs is rising. From July 1994 to July 1995, of 153 antidumping and countervailing investigations initiated or measures imposed, as reported to the WTO, nearly half were targeted at the ADEs.
- The industrial countries can use the sunset clause in the Antidumping Code to legitimize antidumping duties for five years, even though the industry concerned may have recovered far more quickly from the injury that led to the duties.
- The prohibition by the Uruguay Round against using voluntary export restraints could lead to increased antidumping actions that might be more

damaging than voluntary export restraints, and might fall disproportionately on developing countries.

■ The complexities of the system and the cost of compliance with anti-dumping investigation proceedings may result in small and medium firms in the ADEs encountering difficulties in defending their interests. ADE governments can provide at best limited assistance to these firms. This helps explain why a larger share of cases result in prosecution for ADE firms than for industrial country firms.

■ The anticircumvention measures are of particular concern for the ADEs. Circumvention occurs when firms subject to antidumping duties bring components rather than the final product into the importing country and assemble the final product there, thereby circumventing antidumping duties. Alternatively, the same firms may take the components to a third country, assemble them there, and then export to the country where they face antidumping duties on direct exports from their home countries. The concern for ADEs is that anticircumvention measures could become a highly potent instrument of protection.

Regionalism. The global trading environment has been characterized by a trend toward regionalism. If this trend continues, then the ADEs stand to lose considerable market access and export demand, especially if the European Union and the North American Free Trade Agreement expand to include more countries. Therefore, ADEs should push for a sunset clause on regional arrangements that would discourage the formation of trade blocs that intend to stay closed.

Conclusion

The ADEs' best route for ensuring economic growth and prosperity is through openness and liberal economic policies.

Economic theory and empirical evidence clearly demonstrate that outward-oriented trade policies should be a central part of development strategies in poor countries. The financial crisis does not change this; however, it does raise questions about the desirability of completely free capital movement and full capital account convertibility.

ADEs should take a proactive rather than a reactive approach to multilateral trade negotiations. To maximize the benefits of economic openness as East and Southeast Asia emerge from the financial crisis, the ADEs should push collectively for a comprehensive round of multilateral trade negotiations

and develop a common negotiating strategy to promote Asian interests. Many of the products that the ADEs export still remain subject to high tariffs.

Empirical studies suggest that the European Union and the North American Free Trade Agreement have a large and increasing effect on trade diversion at the expense of the ADEs. Therefore, it is in Asia's interests to push for a sunset clause on regional arrangements in the next round of multilateral trade negotiations.

Finally, as the world nears the start of the new millennium, the global economy faces a number of issues, and the ADEs, the traditional high performers in the global context, are still in the throes of an ongoing economic turmoil.

Ironically, while the ADEs, in the face of tremendous economic difficulties, remain resolute in their commitment to trade liberalization and openness, the industrial countries vacillate and engage in restrictive trade practices. These negative protectionist tendencies in the industrial countries must be checked. If global markets are kept open, the impending slowdown in the global economy will be short-lived, but if these negative tendencies triumph and markets are closed, the global slowdown is likely to be long, arduous, and painful. Indeed, the path to continued global prosperity—and recovery from the ongoing economic crisis—lies in an open global environment and not in a move away from it. This is an important lesson the global economic leadership would be well advised to heed.

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