

Chronicle of an unexpected recovery

EMERGING FROM CRISIS

Pedro Videla

A year ago, few would have predicted the recovery that the Asian and Latin American economies are currently undergoing. The crisis of 1998, which seemed to mark the beginning of the end of the prosperity of both regions, galvanized the governments of Asia and Latin America into introducing certain structural reforms which are, somewhat surprisingly, bearing fruit

EXECUTIVE SUMMARY

The author describes the different reasons, both internal and external, for the recovery of the emerging economies; outlining his principal conclusions. Pedro Videla proposes flexible exchange systems which remove the possibility of balance of payments crises and inflation. He also suggests the application of transparent and effective financial systems as a replacement for regulatory frameworks, and the implementation of sensible regulations. Although the prospects for Asia and Latin America are encouraging, there are still countries such as Ecuador which continue to stagnate in poverty.

RESUMEN DEL ARTÍCULO

El autor describe las diferentes razones, internas y externas, para la recuperación de las economías emergentes, y extrae las principales conclusiones. Pedro Videla propone sistemas de cambio flexibles que eliminen la posibilidad de crisis de balanza de pagos e inflación, así como la aplicación de sistemas financieros transparentes y eficaces que sustituyan los deficientes marcos regulatorios y de normas prudenciales. Aunque las perspectivas para Asia y América Latina son alentadoras, todavía existen países, como Ecuador, que siguen estancados en la miseria.

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In 1998, the majority of press reports were indicating that the Asian economies needed far-reaching financial reforms and that, as a result, the region's recovery was some years away. However, looking at the current economic situation in Asia, no-one would be able to tell that the region suffered such a profound crisis only two years ago.

The first economic and political reforms are now starting to emerge, and circumstances have disproved the expectations of the pessimists. The continent is growing steadily, showing rates that were seen at the time of the original Asian miracle. According to the latest figures released by the International Monetary Fund (IMF), growth in Asia for the year 2000 will reach levels of around 6%, three times the levels predicted by analysts a year ago and double the level expected for the industrialized nations.

Heading this recovery is the Republic of **Korea**, which will show growth of more than 6% this year after a drop of 5.8% in 1998 and a strong expansion of 10.7% in 1999. GDP in **Korea** is currently running at pre-crisis levels. It is also expected that pre-crisis economic levels will have been exceeded by the end of the year in both **Malaysia** and **Thailand**, which saw their economies grow by more than 6% during 1999. GDP in **Indonesia** has increased by 6% over the last six months. In this particular case, recovery



AS A RESULT OF THE EXCEPTIONAL GROWTH EXPERIENCED BY THE US ECONOMY, DEMAND FOR EXPORTS FROM EMERGING ECONOMIES HAS RISEN BY MORE THAN 6% OVER THE PAST TWO YEARS, INCREASING THE AVAILABILITY OF INTERNATIONAL RESERVES THAT ASSIST IN CONFRONTING BALANCE OF PAYMENTS CRISES

has not been so spectacular, due fundamentally to the country's political problems.

Asia's rapid recovery has weakened those who criticized the measures taken by the IMF in the face of the crisis. The macro-economic discipline proposed by the Fund in order to combat the crisis has borne positive fruit and become the institution's main shield against its critics.

Latin America

The prospects for Latin America are similar. Following zero growth in 1999, it is calculated that the region's GDP will grow this year by about 4%.

The 'economic star' of the region is **Mexico**, which has benefited from the strength of the **USA** (more than 80% of Mexican exports go to its neighbor) and from the high price of oil. Mexican GDP grew by 3.7% in 1999 and could reach 4% by the end of 2000.

Brazil, the other Latin American giant, has experienced an expected recovery and also seems to be

heading for growth levels of 4% by the end of the year. The country is one of the main targets for foreign investment with some 30 billion dollars flowing in during 1999, an amount exceeded only by **China** in the list of emerging economies.

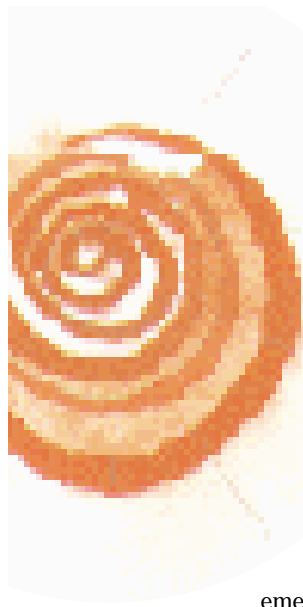
In spite of this environment of optimism, some countries remain deep in recession, such as **Ecuador**, which continues to sink deeper and deeper into poverty as a result of its political and economic problems.

Reasons for recovery

The rapid development of these economies has surprised even the most optimistic of economists. What have the reasons been for this unexpected recovery? Such developments could be explained by two external circumstances that have had a positive effect on all the emerging nations:

1] The exceptional growth experienced by the US economy. As a result, demand for exports from emerging economies has risen by more than 6% over the past two years, increasing the availability





MOST ANALYSES OF THE CAUSES OF THE CRISIS POINTED OUT TWO WEAKNESSES IN THE EMERGING ECONOMIES: THE FIXED EXCHANGE RATE SYSTEM AND THE DEFECTIVE REGULATORY FRAMEWORKS

of international reserves that assist in confronting balance of payments crises.

2] The return of private capital following the mass exodus during the crisis. The flow of private net capital into the main emerging economies reached 150 billion dollars in 1999 and is expected to rise to 200 billion this year. Although this figure is lower than the 330 billion dollars reached in 1996 –the boom year for investment in the emerging economies– it still indicates a recovery of pre-crisis trends.

The greatest growth during the post-crisis period has been in stock investment, which at the end of this year will reach the record figure of 40 billion dollars. This has given a new boost to the stock markets of emerging nations, lifting both prices –the IFC/**Standard & Poor's** shareholders' index grew by more than 60% in 1999– and trading volumes.

LOOKING AT THE CURRENT ECONOMIC SITUATION IN ASIA, NO-ONE WOULD BE ABLE TO TELL THAT THE REGION SUFFERED SUCH A PROFOUND CRISIS ONLY TWO YEARS AGO

In addition, the flow of private capital into Latin America has exceeded the amounts directed towards Asia for two years, by 92 billion dollars and 59 billion dollars respectively. The main reason for this has been foreign investment, attracted by privatization, particularly in **Brazil**, where it rose from 36 billion dollars in 1996 to 67 billion in 1999.

The internal reasons that have proved to be key to the recovery of the emerging economies include:

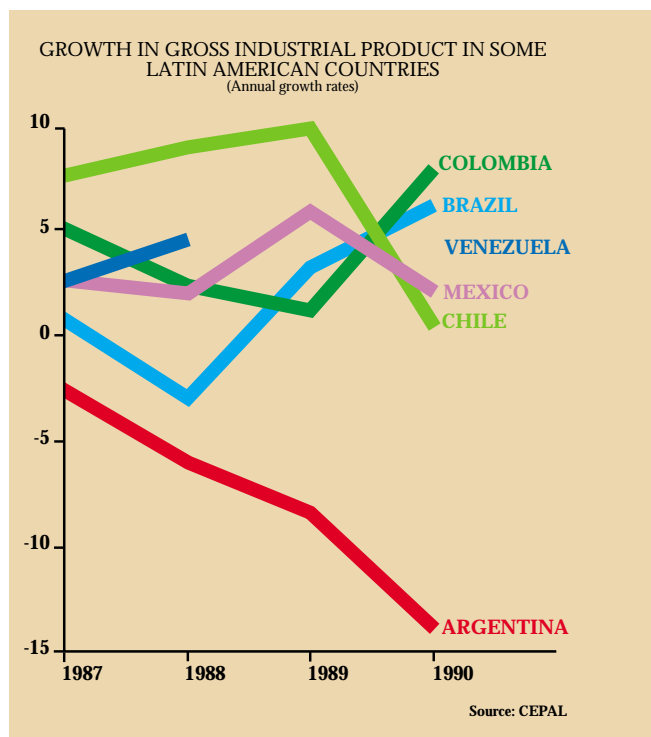
1] The recovery in oil prices. In countries such as **Indonesia, Mexico, Russia** and **Venezuela**, this has allowed an increase in exports, which provide funds for public expenditure, domestic payments and the payment of external debt. Other countries such as **Brazil, Korea** and **Thailand** have benefited by the devaluation in real terms of their currencies, a factor which has improved the competitiveness of their exports, at least in the short term.

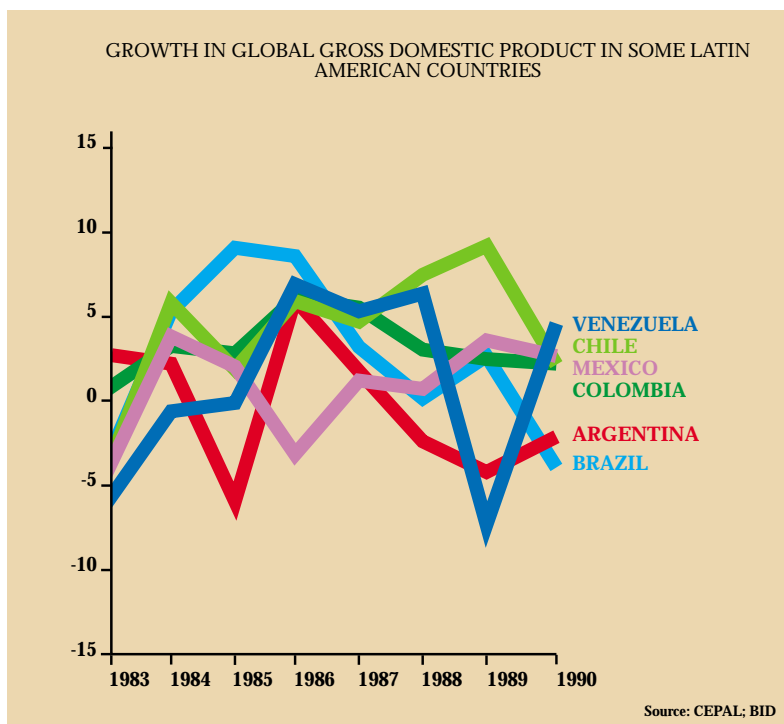
2] The adjustment policies implemented by the emerging nations following the crisis. In contrast to the events that occurred following the crisis of 1980, this time countries have avoided short-term populism and have instead adopted policies leading to macro-economic discipline and the management of foreign debt, renegotiating payment conditions and extending maturity. At the present time, fiscal deficit does not exceed 3% of GDP, there is no external imbalance and the money supply is under control. As a result, average inflation in Latin America during 2000 will be in single figures for the first time since reliable records have been kept.

Is this current recovery in the emerging economies built on firm foundations or is it just transitory? The reply depends on all the lessons learned during the crisis.

Lessons of the crisis

Most analyses of the causes of the crisis pointed out two weaknesses in the emerging economies: the fixed exchange rate system and the defective regulatory frameworks and precautionary regulations in their financial systems. In addition, it was argued that excessive flows of external investment meant a serious loss of competitiveness and a current account deficit that was unsustainable over the long term.





Why blame rigid exchange rates? Because a country that is faced with capital investment from the outside will experience an increase in aggregate demand, forcing domestic prices and salaries higher. This internal inflation causes losses in company competitiveness, and with a fixed exchange rate this translates into a current account deficit.

THE GREATEST GROWTH DURING THE POST-CRISIS PERIOD HAS BEEN IN STOCK INVESTMENT. THIS HAS GIVEN A NEW BOOST TO THE STOCK MARKETS OF EMERGING NATIONS

Flexible exchange systems

These problems would have been moderated if the country had had a flexible exchange rate. A flexible exchange rate system eliminates the possibility of balance of payments crises, allowing currency supply and demand to determine the level of parity which will balance the external sector.

Flexible exchange rates will not prevent a loss of competitiveness in the presence of a large capital inflow, but they do allow for a more comfortable adjustment. The reasons for this are twofold:

- Where there is a flexible exchange rate, the inward flow of capital tends to be lower due to the existence of an explicit exchange rate risk, preventing countries from over-borrowing.
- Once capital starts to flow out from a country, adjustment occurs automatically through a depreciation in the exchange rate.

By contrast, with a fixed exchange rate, the country will suffer internal deflation (prices and salaries are forced downwards), which may result in a prolonged recession if rates are not free to fall.

As a result, a great many countries adopted flexible exchange rates following the crisis. These included **Thailand, South Korea and Indonesia** in Asia, **Brazil, Chile, Colombia, Peru and Mexico** in Latin America and **Poland** in Eastern Europe. These countries have undergone a rapid recovery and, though suffering significant falls in currency values, have maintained inflation at manageable levels.

Parity levels, in spite of an initial depreciation, have shown a good level of stability in recent months. The reason for this is that floating exchange rates have not behaved as such in practice. For example, the current account surplus shown by far-eastern economies at present has not translated into significant increases in currency values in the region. On the other hand, one can see an important accumulation of international reserves held by the central banks. The purchase of dollars, invested mainly in US treasury bonds, meant an increase of 78 billion dollars in the official reserves of the countries of the far east (excluding **Japan**) during 1999. An exceptional case is that of **South Korea**, where international reserves have risen from 9 billion dollars in 1997 to more than 80 billion dollars at present.

The policy of currency accumulation by the central banks is intended to prevent the appreciation of currency levels and to increase liquidity, but it may in itself endanger recovery. In the first place, it creates inflationary pressures and, as a result, future exchange rate instability. In the second place, it creates a false sense of stability which may once again encourage high levels of external borrowing. Flexible exchange rates are only useful for crisis prevention if one allows rates to reflect market conditions. Finally, the accumulation of US treasury bonds makes countries more vulnerable to any future consequences of the economic bubble being experienced at present in the **United States**.

Transparent financial systems

The second great lesson of the crisis was the importance of having an efficient and transparent financial system. Financial systems in the emerging economies were characterized by the assignment of credit on the basis of non-economic criteria, an imbalance between the maturity and denomination of loans and investment, weak

financial supervision and an absence of sensible regulation.

The emerging nations are now slowly beginning to reform their financial systems. This is the case in **Argentina** and **Mexico**, which currently boast high levels of both liquidity and capital. In Asia, **South Korea** had one of the worst financial systems before the crisis. Although it has taken great strides in the direction of reform, restructuring loans that were in arrears and diversifying its loan portfolio, it still has a long way to go, particularly in the restructuring of the Chaebols.

It is significant that the emerging nations have made an effort to improve their financial systems, instead of opting for the easier route of establishing controls on international capital flows. In spite of the large amount of press coverage regarding the risks associated with short-term capital flows, only **Malaysia** has actually placed restrictions on them. **Chile**, the country that was always mentioned for its heavy taxes on

short-term capital prior to the crisis, decided to eliminate them in 1998.

The progressive growth being experienced by the emerging nations at present will be affected if this rapid economic and capital recovery causes complacency in these countries and the processes of reform and restructuring are not assiduously continued. A weak financial system is synonymous with a vulnerable economy, particularly in a world of free capital flows, where mistakes are costly.

At present, more than 90% of private capital flow towards the emerging nations takes the form of direct investment. For many, this is good news, since direct investment is more stable and does not take rapid flight at times of difficulty. But a body of capital that is so biased towards direct investment is also a sign of weakness. It indicates that the financial markets in the emerging economies are not working efficiently, with an absence of the relevant institutions that allow a reduction in the risks associated with other types of investments.
