The World Bank

PREMnotes

MARCH 1998

NUMBER 1

ECONOMIC POLICY

What effect will East Asia's crisis have on developing countries?

East Asia's current crisis has already wreaked havoc on currencies and financial markets inside and outside the region. What lies ahead? This note answers that question using recent projections by the Development Prospects Group.

East Asia's financial crisis has already had a significant effect on developing countries: growth is slower, risks are higher, and patterns and terms of trade and capital flows have changed. This note summarizes recent projections by the World Bank's Development Prospects Group of the longer-term effects of the crisis. The note's key messages:

- Adjustment in the five East Asian countries most affected by the crisis—Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand—will be deep and protracted. Trade will drive the recovery.
- The crisis will affect developing countries more than high-income countries. Reductions in growth will be about twice as large in developing countries because of high trade multipliers, large terms of trade movements, and monetary and fiscal policy tightening in countries that rely on private capital flows.
- Algeria, Brazil, and Russia stand to lose the most. Oil importers, such as Turkey, will benefit from lower oil prices. Outside East Asia, the hardest-hit regions in lost GDP growth will be Latin America, the Middle East and North Africa, and Sub-Saharan Africa.
- The crisis will have a significant effect on the world economy—global output growth will be 0.5 percent less in 1998—but will not be nearly as damaging as earlier global shocks, such as the two oil price rises of the 1970s.
- The risks facing developing countries have increased significantly.

Although these developments are troubling, it is important to maintain a global perspective when assessing East Asia's crisis. In 1997 the United States showed remarkable momentum in its eighth year of noninflationary expansion. In 1995–97 growth averaged nearly 3 percent. Europe was also a favorable surprise, with a broad and robust recovery since mid-1997, especially in France and Germany. (Japan's incipient recovery came to a halt, however, largely because of increases in the value added tax and cuts in public investment.) Helped by growing U.S. and European imports, world trade volumes grew 7.8 percent in 1997, well above expectations and one of the fastest rates in 30 years.

Effect on East Asia

Although the crisis is far from over, financial market indicators in East Asian countries—except Indonesia—show signs of stabilizing. Currencies and stock markets have begun to steady after the plunges of recent months. In Indonesia, however, market rates continue to be volatile. And uncertainty remains high in the region's five hardest-hit countries, with the worst of

Although East Asia's crisis will have a significant effect on the world economy, it will not be nearly as damaging as earlier global shocks

FROM THE DEVELOPMENT ECONOMICS VICE PRESIDENCY AND POVERTY REDUCTION AND ECONOMIC MANAGEMENT NETWORK

Weaknesses in domestic banking and financial sectors will take time and require considerable fiscal resources to resolve

Box 1 Real sector adjustments in Indonesia, Korea, and Thailand

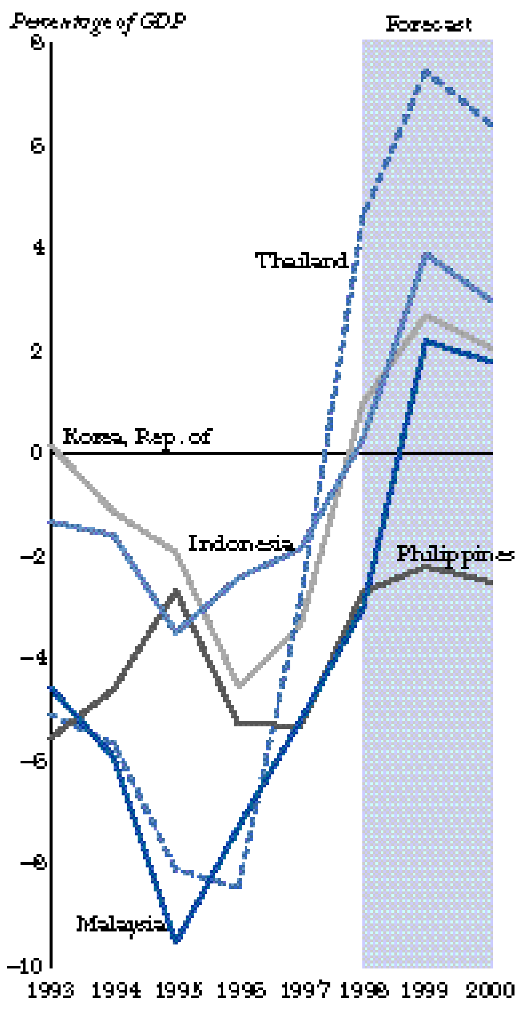
The real effects of the Asian crisis are becoming evident: Poor outcomes in Indonesia because of drought and soaring food prices. Rising unemployment in Korea. And industrial slump in Thailand, mitigated by a strong agricultural response.

INDONESIA. Prices of essential foodstuffs are soaring—increasing 25 percent in a single week in January, for example. The price of rice, a key commodity, has risen 20–25 percent in major urban areas and even more in drought-affected areas (leading to food riots in East Java). Unemployment is rising sharply and will increase poverty—perhaps almost doubling the number of poor, from 23 million to 40 million.

KOREA. Bankruptcies and unemployment are on the rise. Eight of the thirty biggest *chaebol* (industrial conglomerates) have filed for bankruptcy. Unemployment in November showed the highest monthly increase in 15 years, and is expected to reach 5 percent (1.2 million workers, from 0.5 million now).

THAILAND. The slump in industry is severe. Monthly sales of motor vehicles, steel, consumer electronics, and durable goods are down 35–75 percent, and industrial output growth in 1997 was half that in 1996. Urban unemployment is expected to increase to about 6 percent (1.8 million workers), although rural growth—due to bumper harvests and rising prices and exports—is offsetting that.

Figure 1. Current account balances in East Asia, 1993–2000



Source: Development Prospects Group, January 1998.

the downturn in real sector activity still ahead (box 1).

External stabilization in these five countries will require current account balances to swing sharply into surplus in the near future. Indonesia, Korea, and Thailand are expected to recover to surpluses on their current account in 1998, from deficits of 2–8 percent of GDP in 1996 (figure 1). For all five countries the projected change is from a deficit of $35 billion in 1997 to surpluses of $7 billion in 1998 and $30 billion in 1999.

Korea and Thailand have already posted surpluses of $1–2 billion a month. However, these have mainly reflected a slowdown in imports (by as much as 30 percent in dollar terms), and will have to be accompanied by a recovery in exports if growth is to resume. Exports from all five countries are projected to gain a 0.8 percentage point share in world exports—about half the growth rate of Mexico's exports in 1995 after the peso crisis. Lack of available credit for exporters could severely hamper export recovery.

Severe economic downturns and financial restructuring are already in evidence. Reduced capital inflows, higher interest rates, and real exchange rate depreciation (ranging from 35–70 percent) will lower domestic demand and GDP growth in the five most affected countries in 1998.

Overall GDP growth is expected to be about 7 percentage points lower than was projected in mid-1997. Even under optimistic assumptions, recovery to long-term growth trends will probably take two or three years. Interest rates remain high in the five countries (between 18 and 35 percent, except in Malaysia), and fiscal policies are tight.

Weaknesses in domestic banking and financial sectors—which grew rapidly just before the crisis—will take time and require considerable fiscal resources to resolve, further slowing recovery in output. During 1975–94 banking crises in developing countries were followed by an average drop in growth over the next five years of 1.25 percentage points a year. And East Asia's recovery will likely be slower than, say, Mexico's, which benefited from a cyclical upswing in a large, high-income neighbor (the United States) and had less deep-seated banking problems.

Growth will also slow in the rest of East Asia. In China growth is projected to slow by about 1 percentage point, to 7.5 percent, because of reduced demand for exports, increased competition in world markets for manufactures, and some disruption of foreign direct investment flows, much of which come through Hong Kong. Within China, Hong Kong will grow by about 2 percent in 1998, down some 3–4 percentage points. In Singapore and Taiwan, China, the drop will be about 2 percentage points. And Vietnam, which devalued its currency, faces much stronger export competition and a likely slowdown in foreign direct investment.

Effect on other regions

External adjustment by the five hardest-hit East Asian countries will be large in 1998—their combined current account deficit will compress by about $45 billion relative to projections in *Global Economic Prospects 1997* (completed in June 1997). Relative to those projections, this adjustment represents a 12 percent drop in imports and a 9 percent increase in exports. This correction is expected to be partly accommodated by a widening current account deficit in the United States.

GDP growth for all developing countries is now projected to be 3.9 percent in 1998, 4.7 percent in 1999, and 5.1 percent in 2000—1.0, 0.4, and 0.2 percentage points less than was projected in mid-1997 (table 1). Growth in 1998–2000 is still projected to be well above that in 1991–96, thanks to better policy performance, recovery in transition economies, and solid demand in industrial countries. Outside East Asia, the regions with the largest adjustments to the previous forecast are Latin America, Sub-Saharan Africa, and the Middle East and North Africa. The transition economies of Europe and Central Asia also lose significantly—a 0.5 percentage point loss of GDP growth in 1998.

GDP growth for all developing countries is projected to be 3.9 percent in 1998

In Latin America, Brazil's growth is expected to be 2.5 percentage points lower because of recent fiscal consolidation and higher interest rates. In Sub-Saharan Africa, oil- and mineral-exporting countries (Nigeria, South Africa, Zambia) will be hurt by sizable terms of trade losses. In the Middle East and North Africa, lost trade and worsening terms of trade will slow growth in Algeria, Iran, and the Gulf countries. In transition economies, tightening measures to support exchange rates (Russia) or to cool domestic demand (Poland) will slow growth.

East Asia's financial crisis will affect other developing countries in five main ways: by shrinking foreign private capital flows, reducing trade volumes, lowering the prices of traded goods, widening spreads for borrowers, and depressing international interest rates.

Smaller capital flows

The crisis has already limited the availability of foreign private capital. New international market transactions fell about one-third in November and December 1997, and cross-border bank lending is expected to be much lower in 1998. The reduction in private flows has caused macroeconomic tightening in many developing countries, leading to a multiplier

Reduced access to external capital has been exacerbated by domestic capital flight

effect on the slowdown in growth and a reduction in the need for external finance. Brazil, the Czech Republic, Russia, and Poland have raised short-term interest rates and, in some instances, cut budget deficits. Reduced access to external capital has been exacerbated by domestic capital flight. Because most large developing economies depend on private capital flows, these developments have the potential to cause a widespread recession.

Reduced trade volumes

External adjustment and currency devaluations in the five most affected East Asian countries will lower exports from the rest of the world by about 1.5 percent. Combined, reduced import demand in East Asia and export displacement elsewhere will cause growth in world export volumes to drop about 0.7 percent in 1998 relative to previous projections (figure 2). As a result developing country growth should fall about 1.0 percent. Besides East Asia, the two most affected regions are the Middle East and North Africa and Latin America and the Caribbean—each suffers about a 1.0 percent drop. (These data refer to the first-round partial equilibrium effect. In practice, some of the adjustment will come through price.) The direct effect on China and India will be small because of their enormous economies and limited trade ties to East Asia, but they will lose moderately from competition in third markets.

Table 1 Current and Global Economic Prospects 1997 projections for 1998

(percentage change unless otherwise noted)

Indicator	*Current*	*Global Economic Prospects 1997* [a]	*Difference*
GDP growth			
World	2.6	3.1	–0.5
United States	2.4	2.1	0.3
Japan	0.8	3.0	–2.2
Major EU countries[b]	2.8	2.7	0.1
Asian newly industrialized economies[c]	2.2	6.3	–4.1
All developing countries	3.9	4.9	–1.0
Sub-Saharan Africa	3.4	4.1	–0.7
Asia and the Pacific[b]	5.7	7.1	–1.4
East Asia	5.7	7.7	–2.0
Indonesia, Republic of Korea, Malaysia, Philippines, Thailand	–0.2	6.8	–7.0
South Asia	5.8	5.9	–0.1
Europe and Central Asia	3.0	2.9	0.1
Transition economies	3.2	3.7	–0.5
Latin America and the Caribbean	2.7	3.7	–1.0
Middle East and North Africa	2.7	3.6	–0.9
Maghreb	4.6	3.7	0.9
Mashreq	4.6	4.1	0.5
World trade growth	6.3	6.7	–0.4
Commodity and manufactures prices [d]			
Non-oil commodities	–9.8	–2.4	–7.4
Oil	–11.5	0.0	–11.5
G–5 manufactures unit value index	2.5	4.6	–2.1
Six-month dollar LIBOR (percent)	5.7	6.0	–0.3

Note: Forecast reflects all developments since mid-1997, not just the East Asian crisis.
a. June 1997.
b. Includes Central and Eastern European countries and republics of the former Soviet Union.
c. Excludes the Republic of Korea.
d. Change in dollars.
Source: Development Prospects Group, January 1998.

Lower prices

The crisis will have a deflationary effect on the prices of traded goods. Commodity prices (oil, natural rubber, timber, rice, and metals) have already fallen (on top of other factors working in the same direction). The five hardest-hit East Asian countries account for about 7 percent of world trade in manufactures, and the dollar price of their exports is expected to fall about 9 percent. Besides East Asia, the regions suffering the largest terms of trade declines are the Middle East and North Africa, Latin America, and Sub-Saharan Africa.

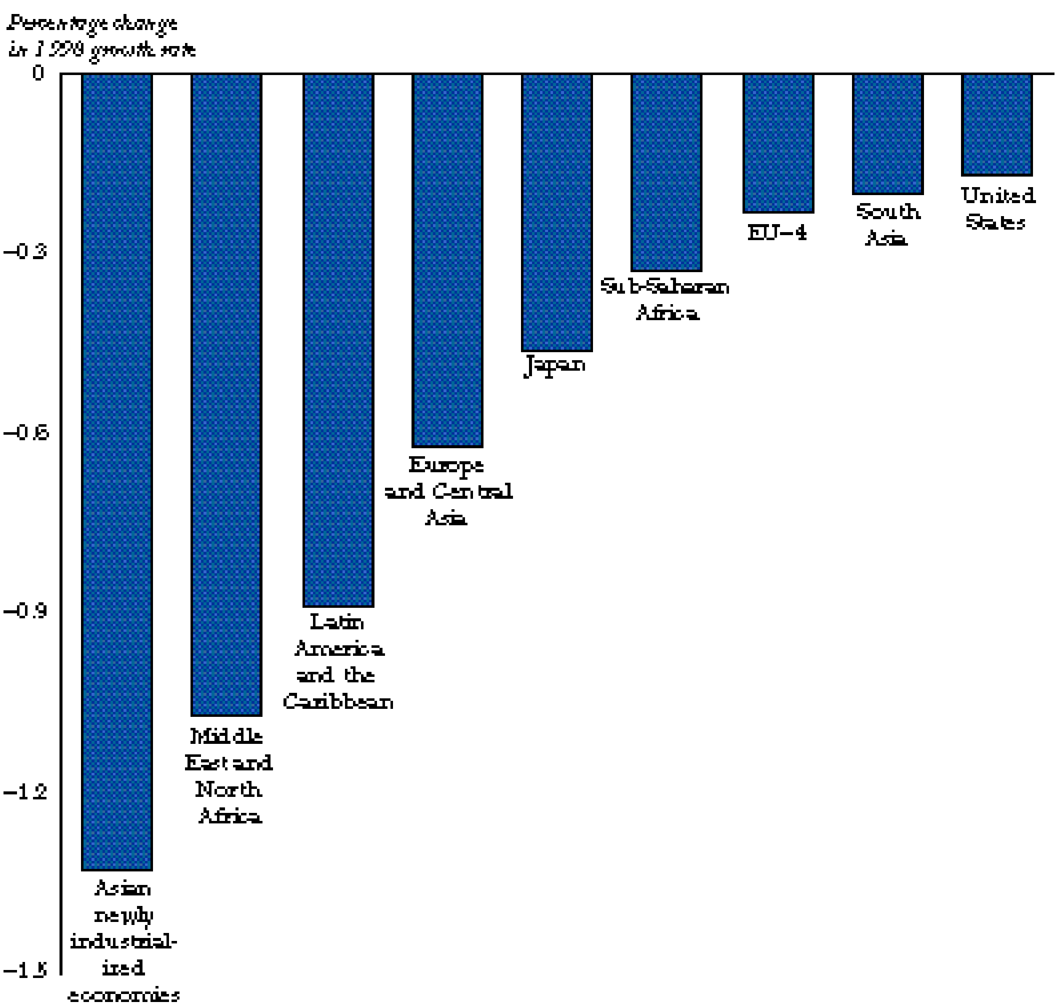
Terms of trade effects vary widely by country (figure 3). The biggest losers are oil exporters—notably Algeria, which in 1998 will suffer a 12.5 percent loss in its terms of trade attributable solely to the crisis. But oil importers, notably Turkey, gain substantially. Among other countries, exporters of metals and primary commodities will fare worse than exporters of manufactures. Many countries that will lose—Colombia, Peru, Russia, South Africa—are exporters of minerals and oil but also have a diversified export base, with significant manufactures. Their terms of trade losses will range from 1–9 percent.

Higher spreads

Developing countries have already seen a steep increase in the cost of borrowing, as evidenced by higher spreads on inter-

Exporters of metals and primary commodities will fare worse than exporters of manufactures

Figure 2. Effect of Asia's external adjustment on global export volumes



a. Relative to projections in *Global Economic Prospects 1997.*
Source: Development Prospects Group, January 1998.

The risks of spillover from the crisis are significant but manageable

national bonds (figure 4). Since July 1997 spreads on East Asian eurobonds have risen from about 100 basis points to about 500 basis points. Latin American spreads have also risen. Markets now view East Asian borrowers as being about as creditworthy as those in Latin America.

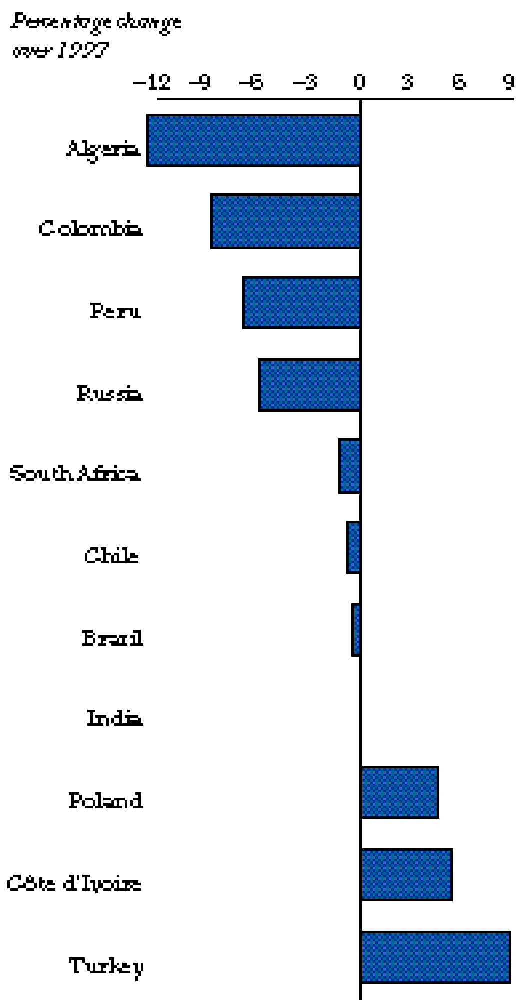
Depressed interest rates

The disinflationary effects of the crisis will lower both short- and long-term interest rates in industrial countries—a trend already in evidence. Central banks will adopt easier monetary policies than they otherwise would have. Investors have engaged in a flight to quality, which has pushed down yields on U.S. Treasury long bonds.

Risks to the baseline scenario

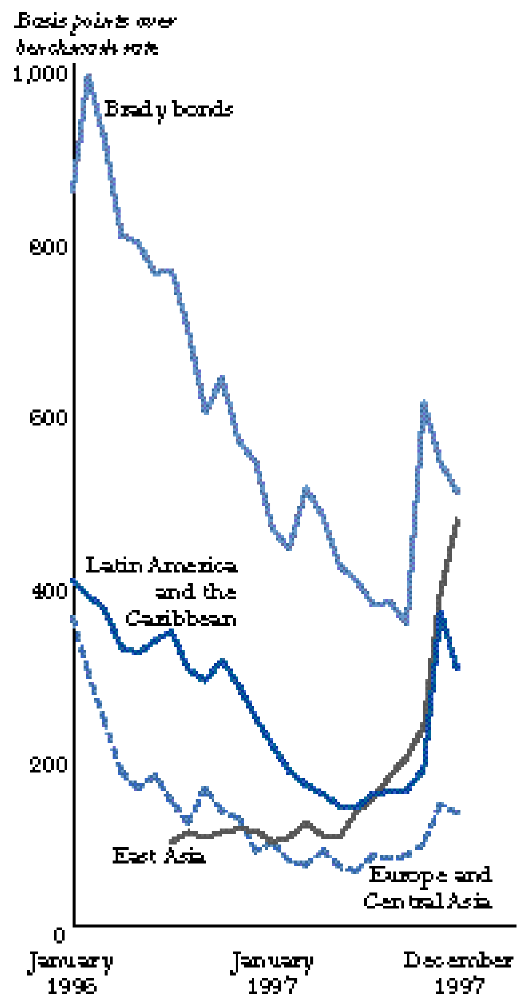
The risks of spillover from the crisis are significant but manageable. One is the risk of a cutoff in credit to Asia and contagion outside the region. Given the intense pressures facing corporate sectors in the five hardest-hit East Asian countries, such developments would be disastrous. Stylized facts for a hypothetical Thai company show that in 1998 it faces an 18 percent drop in domestic demand, a 500 basis point increase in short-term interest rates, up to 100 percent more costly imported inputs, doubled unhedged foreign currency debt, and reduced access to credit. Already, we have seen in Korea a voluntary rescheduling of short-term commercial

Figure 3. Terms of trade in developing countries, 1998



Source: Development Prospects Group, January 1998.

Figure 4. Spreads on Brady bonds and sovereign eurobonds



Source: Development Prospects Group, January 1998.

bank debt, and in Indonesia a quasi-moratorium on private debt. Thus the assumed trade turnaround in East Asia might not materialize quickly, because a debt overhang inhibits exporters' access to credit and causes contagion.

Another risk is a weakening of the capital base of international banks. The systemic risk to international banks is much lower now than in the early 1980s, however. Then, exposure (loans outstanding) to debt-troubled countries (mostly in Latin America) equaled 65 percent of banks' capital. Today exposure to the five hardest-hit East Asian countries is 15–20 percent of the capital base. But Japanese banks are heavily exposed—loans to East Asia account for nearly 40 percent of capital, on top of existing problem loans. The implication is that resolving the problem exposure—that is, cleaning up banks' balance sheets—will further undermine Japanese growth.

This note, based on Global Economic Prospects Update, *January 1998, was written by a Development Prospects Group team led by Uri Dadush, Robert Lynn, Mick Riordan, Dipak Dasgupta, and Ronald Johannes. The Development Prospects Group can generate detailed simulations of the effect East Asia's crisis will have on individual countries. For more details, call Robert Lynn at extension 33961.*