Dodging the Bullet —This Time

by David D. Hale

The Asian Crisis and U.S. Economic Growth during 199

One of the great surprises of the U.S. economy this year has been its capacity to withstand the trade shocks resulting from the Asian financial crisis.

At the end of 1997, most economists were revising down their forecasts of U.S. output growth by 0.5–1.0 percentage point to adjust for the impact of the crisis on both imports and exports. As the United States sends about one-third of its exports to Asia and is the major market for the exports of Asian countries whose currencies have collapsed, the U.S. trade deficit had been widely expected to increase by about $50–60 billion this year. Concern about export losses was especially great on the U.S. west coast,

David D. Hale is with the Zurich Group headquartered in Chicago.

which depends far more heavily on Asian trade than other regions. Worries about tourism also flourished. Las Vegas baccarat tables, for example, suffered a 25 percent slump because of the loss of high rollers from the overseas Chinese communities of Southeast Asia.

During the first quarter of this year the U.S. trade deficit widened by some 2 percent of real GDP. Exports to Indonesia, Thailand, and South Korea slumped by 37 percent during January and February while exports to Japan fell by 7.6 percent. But the trade deterioration did not dampen the U.S. economy's overall growth momentum because the growth rate of domestic final sales accelerated from 1.9 percent to 6.1 percent during the fourth quarter of 1997 and thus boosted the quarterly growth rate of total output from 3.7 percent to 4.2 percent.

WHAT IS DRIVING U.S. GROWTH?

Three factors explain why U.S. domestic spending has remained so robust in the face of trade shocks resulting from the Asia slump.

The first factor is the reduced risk of Federal Reserve tightening. With the U.S. economy growing so robustly last year and unemployment in decline, the Federal Reserve would likely have raised interest rates late last year or early this year had it not been so concerned about financial stability in East Asia. The passivity of U.S. monetary policy helped produce large gains in residential construction and commercial real estate. New home sales rose to the highest level in several years while the Dun and Bradstreet survey found a sharp upturn in business confidence in the construction industry.

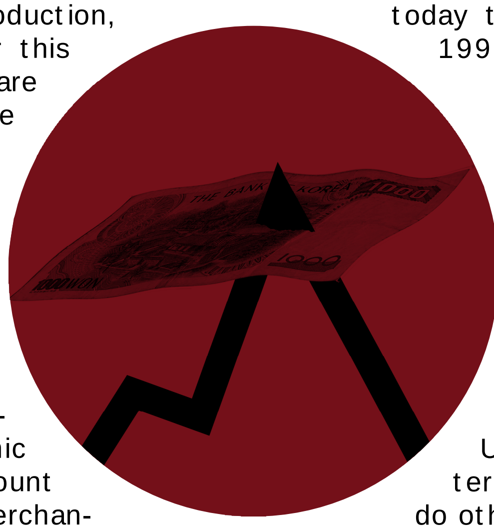
The second factor is the resilience of the U.S. equity market. It rose to new highs during the first five months of this year because of investor optimism about interest rates and confidence that the Asian crisis had been contained. The poor performance of Asia's economies probably also boosted foreign demand for U.S. financial assets still further after two years of unprecedented growth in foreign purchases of U.S. bonds and equities. During 1997, foreign investors bought $66 billion of U.S. equities and $184 billion of Treasury securities, as against $12.5 billion of equity and $232 billion of government securities during 1996. The buoyancy of the U.S. equity market helped bolster household wealth and sent consumer spending rising at a 5.7 percent annual rate during the first quarter of 1998.

The strong capital positions and high profitability of American banks has also helped. According to annual report footnotes, America's leading money center banks have more than $100 billion of exposure to Asia through a mixture of dollar loans, local currency loans, and security investments—nearly as much aggregate lending as went to Latin America during the debt crisis of the early 1980s. But with today's low interest rates and healthy profitability, U.S. banks are competing aggressively to make new loans despite losses in Asia.

The buoyancy of the stock market has become so great in relation to profit growth that market analysts are beginning to worry about the United States creating a "bubble economy." During 1991–97, equity market appreciation was driven equally by profit growth and appreciation of share price multiples. During the past six months, most of the gain in equity prices has come from multiple appreciation. Evidence is also increasing that the stock market boom is spilling over into real estate. House prices are rising sharply in several cities, and commercial construction appears poised for its biggest upturn since the late 1980s. The valuation parameters of U.S. equity and property markets are still far more modest than they were in Japan during the late 1980s, but public involvement in the U.S. equity market is unprecedented: about 45 percent of all American households now own equities. The mutual fund industry has grown to $5 trillion and is now larger than the U.S. banking system. The Federal Reserve has been reluctant to raise interest rates to dampen the equity market, despite sharply declining unemployment, because of the persistence of low inflation and concern about Asia. Just as Japan created its bubble economy during the late 1980s in part because of monetary policy designed to protect the U.S. dollar, so could the United States now experience a period of speculative excess in domestic financial markets because of the need to help Asia.

GLENN PIERCE

The third factor helping to buoy U.S. growth this year has been the impact of the Asian slump on global commodity prices and U.S. import prices. Both have fallen across the board during recent months and thus helped boost consumer real income in the United States by lowering inflation. In fact, it increasingly appears that commodity-producing countries will bear the brunt of the Asian shock. During the past year the trade accounts of commodity-producing countries have deteriorated much more sharply as a result of the Asia crisis than those of industrial countries. Oilexporting countries' trade balance has deteriorated by $61.9 billion, as against only $13 billion for North America. Latin America's trade balance has worsened by nearly $19 billion because two-thirds of its exports still come from commodity-producing sectors. If OPEC reduces production, the price of oil could rise later this year, but other import prices are likely to remain depressed because of capacity gluts in Asia. The income gains in the United States resulting from the decline in nonoil import prices appear likely to be about 0.75 percent of GDP this year.



The resilience of the U.S. economy so far this year demonstrates the need to analyze carefully the impact of an economic shock on a country's capital account and terms of trade, not just its merchandise trade account. In fact, the whole history of the East Asia crisis has been one of economic pundits underestimating the role of the capital account. During the mid-1990s, the IMF had criticized some Asian countries, especially Thailand, for running large current account deficits and encouraged them to devalue. The countries were reluctant to devalue because their private sectors had accumulated large dollar liabilities and thus were vulnerable to an upsurge of bankruptcies if their exchange rates adjusted dramatically. The failure of the IMF and the credit rating agencies to understand the role of Asia's capital account liberalization in the region's corporate development process explains why the Thai devaluation generated so much financial contagion. Once corporations in Southeast Asia saw Thailand violate its long-standing promise of exchange rate stability, they all rushed to hedge their dollar liabilities and generated a wave of selling that became uncontrollable. The exchange rates of Thailand, Indonesia, Malaysia, and other countries fell far more than could be justified by inflation rates, budget deficits, or even trade accounts.

The United States was far better poised to benefit from the Asia crisis than other countries because of the openness of its capital account and asset markets. With few barriers to foreign investment and both the largest and most liquid financial asset markets in the world, the United States is a natural receptacle for the world's surplus liquidity. In the 1980s the liquidity came from Japan. Today it is coming from practically everywhere because North America is the only region of the world with a large current account deficit. Japan and Europe have been running large surpluses for several years. The East Asian financial crisis is now forcing that region to move into surplus while the current account deficits of Latin America are far smaller today than they were during the early 1990s.

In the 1980s the United States ran a large current account deficit in part because of large federal budget deficits. Washington will soon be reporting a budget surplus close to $100 billion. The reemergence of the United States as a large-scale capital importer has resulted purely from private-sector financial developments. The United States now enjoys far better investment opportunities than do other countries and thus can import capital on a large scale. As with East Asia, this trend could go too far and encourage speculative excesses in U.S. asset markets, but in 1998 the United States is still able to play the benign role of global spender of last resort.

AMERICA'S LEADERSHIP ROLE

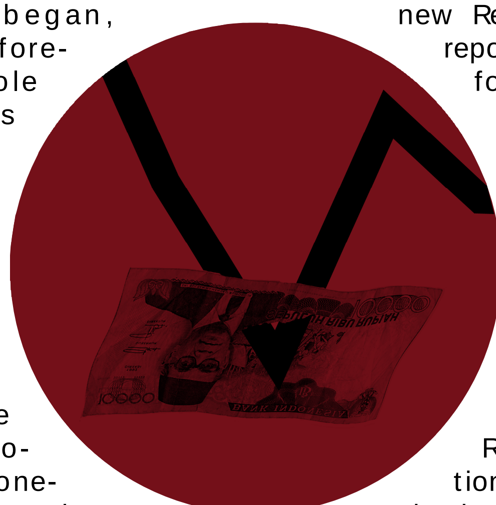
The Asian crisis has reestablished America as the economic superpower in the region. The United States has been dominant in defining the response of the international community to the crisis. Though congressional restrictions made it unable to contribute directly to the Thailand IMF program in July 1997, the United States consulted extensively on the Thai situation through the IMF. When the congressional restrictions expired last September, Washington contributed directly to the IMF programs for Indonesia and Korea.

As a result of U.S. influence, the IMF has focused far more on microeconomic reform and trade liberalization in Asia than it did in Latin America during the 1980s. The Asian programs are modeled more after the IMF experience in Eastern Europe than the programs that preceded the end of the Cold War. Deputy Treasury Secretary Lawrence Summers summarized matters at a recent conference of the Bretton Woods Committee by saying publicly, "The IMF has done more to promote America's trade and investment agenda in East Asia than 30 years of bilateral trade negotiations."

America's decision to use the IMF to promote microeconomic reform could backfire by arousing nationalist sentiment against the IMF and the West in general. But so far the policy has worked. The Asian countries have responded to the crisis by further financial liberalization and by dismantling barriers to investment. There has been no retreat into a siege economy.

If the microeconomic liberalization policies can be sustained, the current crisis could actually accelerate East Asia's transition both to truly open markets and to the Anglo-Saxon form of capitalism. In Korea, for example, foreign trade could expand both because of reduced barriers to imports and because of increased foreign direct investment. Like Japan, Korea has long restricted foreign investment and now has only about $12.5 billion—as against $67 billion in Singapore, $42 billion in Malaysia, $72 billion in Mexico, and $20 billion in Thailand. Because multinational corporations are so important in generating both exports and imports, low foreign investment in Korea and Japan has long been viewed as a de facto trade barrier. IMF programs that enhance foreign access to Korean asset markets should therefore boost trade as well.

When the Asia crisis began, Washington probably did not foresee how crucial its own role would become. Most pundits expected Japan, a large investor and bank lender in East Asia over the past decade, to emerge as a key regional leader. Japan did contribute more financially to the IMF programs than any other country ($18.5 billion, as against $8 billion for the United States), and it did propose establishing a regional monetary fund to complement the resources of the IMF. But Japan's credibility was greatly undermined by its own economic stagnation and banking crisis. As the crisis unfolded, Asian countries turned increasingly to the United States for help while the U.S. Treasury itself rejected Japan's proposals for a regional monetary fund.



The vacuum created by Japan's problems increased American influence dramatically even though the U.S. Treasury was unable to participate directly in the Thai rescue program of July 1997 and did not offer Korea bilateral financial assistance until Korea edged toward default in late December. Unlike the 1995 Mexican rescue, in East Asia the United States was a reluctant superpower—though as the scope of the crisis became apparent, the United States did not hesitate to take on its role.

WILL CONGRESS FUND THE IMF?

Ironically, the major threat to America's leadership in East Asia is the U.S. Congress. The House of Representatives has refused to support the Clinton administration's request for $18 billion of new funding for the IMF. As the United States has an 18 percent shareholding in the IMF's capital and is the only country with unilateral veto power over its decisions, the IMF will be unable to expand its capital without congressional cooperation.

Some left-wing House Democrats view the IMF as a bank rescue agency that does not help ordinary people. Some conservative Republicans believe it encourages bankers to lend to borrowers of dubious credit quality. The IMF is also a victim of "globaphobia." With the Cold War over, many members of Congress believe that the United States should withdraw from its traditional international responsibilities and focus on domestic concerns. Some new Republican members of Congress reportedly do not even have passports for international travel.

The administration still hopes that corporate lobbying will persuade Congress to support IMF funding for the same reason that it accepted GATT and NAFTA: the United States can win both economic and political advantages though international leadership. But left-wing Democrats and right-wing Republicans have joined in opposition to the IMF, suggesting that funding is still very much at risk. The booming U.S. economy has probably also eased concerns among marginal members of Congress about the impact of Asia and foreign trade on the economy. If the economy had faltered early this year, the administration would have been well armed with arguments against opponents of IMF funding. But with the economy booming, isolationists can downplay warnings from the experts about global factors.

What remains to be seen is how other countries will respond to a U.S. failure to provide new IMF funding. Will they propose allowing the IMF to borrow? Will they propose changing member states' capital ratios so that other countries can contribute while the U.S. capital remains static? Will Japan and other Asian countries revive the idea of regional monetary funds? None of these possibilities is by any means certain. There is a real risk that the issue of IMF funding will remain unresolved until another international financial crisis forces some action on the member states.

At this point only one thing is certain. The dynamism of America's economy has reenthroned the United States as the dominant player in the international financial system—while also encouraging a remarkable complacency, if not populism, in Congress about the need to develop institutions for the post–Cold War global economic order. The question now looming over both America and the world is whether Washington will be able to address the political dimensions of the globalization challenge before another great financial accident intrudes on U.S. prosperity. ■