The Road to a Sustainable Recovery in Asia

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1. It is a pleasure to be here in Singapore, at this World Economic Forum meeting of so many of the important economic actors in Asia, and to be able to strike an optimistic tone about the outlook for the Asian economies. That would certainly not have been possible a year ago, when the outlook was dominated by very real fears of a global credit crunch and recession. Now the world economy appears to be on the mend, the Asian economies are reviving, financial market confidence has returned, and-most important for the Asian recovery-Japan is showing signs of growth. However, while we are certainly entitled to several sighs of relief, we must not become exuberant, for there are very real risks out there, some of which I will discuss shortly.

2. Much of the credit for the turnaround during the last year goes to the U.S. Federal Reserve, which took decisive action to stabilize United States financial markets last fall, and thereby-together with subsequent European interest rate cuts-helped stabilize global financial markets. The IMF loan to Brazil, and responsible policies in several other Latin American countries, also contributed to the improvement in global financial conditions. So did the actions of many policymakers in Asia, who stayed the course despite its difficulties. However, the financial situation for most emerging market countries is not yet back to normal, for bond spreads remain very high, and capital flows to developing countries are much lower than they were two years ago.

3. In the IMF's most recent forecast, in this fall's *World Economic Outlook (WEO)*, **world output growth** is set to accelerate from 2 ½ percent in 1998 to 3 percent in 1999 and 3 ½ percent in 2000. Compared to the May 1999 projections, this implies an upward revision of 0.7 percentage point for 1999 and 0.1 percentage point for 2000.

4. The brighter outlook for 1999 results in part from continued growth in United States, a gradual pickup in Europe, and a recovery in Latin America. Most importantly, however, it reflects substantial recoveries and upward revisions for growth across Asia. Asia as a whole is expected to grow by 4.1 percent in 1999 and 4.3 percent in 2000, up 1.4 percentage points and 0.2 percentage point respectively from the May 1999 *WEO*-with a particularly brighter outlook for Japan.

5. These recoveries have been built on supportive fiscal and monetary policies; the initiation of much-needed structural reforms; an associated return of financial confidence and foreign capital which has stabilized exchange rates and strengthened stock markets; a

recovery in non-oil commodity prices, which has helped several countries; and improved prospects in the global semiconductor market (reflecting the impact of a pickup in internet and electronic commerce on equipment demand, as well as a working off of unused capacity and excessive inventories). The electronics recovery has contributed to stronger manufacturing activity in Singapore, Taiwan Province of China, Malaysia, and Thailand.

6. **With Japan accounting for over half the output of the Asian region, there could be no better news for the region than the strengthening of growth in Japan, based on a recovery in private demand**. Private consumption and residential investment have been strong, and the recent news from the Bank of Japan's *Tankan* survey suggests an improvement in business confidence and investment prospects. Widespread concerns about deflation and the health of the financial system have abated. But here too risks of course remain, with particular attention focusing on the appreciation of the yen and monetary policy.

7. According to the *WEO*, Japan is now expected to grow by 1 percent in 1999 and 1.5 percent in 2000; these represent large upward revisions from the May *WEO* of 2.4 percentage points and 1.1 percentage points for the respective two years. And it would not be a surprise if the final results for both this year and 2000 exceed the current IMF forecasts.

8. **A recovery in the crisis economies is also now under way**. The Asia-5 crisis countries-Indonesia, Malaysia, Philippines, Thailand and Korea-are together now expected to grow on average by almost 3 percent in 1999 and 4 percent in 2000. Unfortunately, in Indonesia, renewed uncertainties over both the economic program-resulting in large part from the Bank Bali case-and the political situation present risks to the recovery that was so clearly getting under way. With the presidential election to be held later this week, some of the political uncertainties could be resolved soon. An IMF team, together with colleagues from the World Bank and Asian Development Bank, has been consulting in the last week with technical representatives of government and opposition parties and independent experts in Indonesia. We see no major disagreements among them on economic policies-and that surely is both important and encouraging.

9. **China** has continued to weather the crisis better than many expected: a well timed fiscal stimulus has helped support activity, and the stability of the yuan has been maintained. The appreciation of regional currencies, including the yen, has helped to reverse the real effective appreciation of the yuan in the initial stage of the crisis. A daunting agenda of structural reform of the state sector and the banks remains, but the authorities have made it clear that they are committed to accelerating reforms in these areas.

10. **Singapore**, despite its strong economic fundamentals and long tradition of prudent macroeconomic policies was not immune from the Asian crisis in 1998. But the recovery in the first half of 1999 was strong, and we expect growth of 4 ½ percent in 1999 and 5 percent in 2000, reflecting the effects of fiscal stimulus and a recovery in electronics exports. The Government has taken a number of policy initiatives aimed at strengthening the financial sector, such as raising bank disclosure standards and measures to increase foreign participation in the banking sector. Efforts to raise financial sector transparency and improve supervision, combined with liberalization of certain burdensome regulations, will help position Singapore's financial sector for the next phase of growth in the ASEAN

region.

11. **So the news is much better. But the situation is fragile, and there are risks and important challenges to meet to ensure sustainable growth.**

12. **A critical short term risk lies in the external environment.** The phenomenal strength of the United States economy during the last three years has been the bulwark of the world economy, essential in preventing the Asian and then the Russian crises from generating a worldwide recession. It is clear that the U.S. economy cannot continue to grow at rates well above any estimate of potential growth, especially when unemployment is so low. Skillful policymaking by the Fed together with a strong fiscal policy has managed to prevent both the emergence of inflation and a sharp slowdown. The Fund's projections assume a soft landing to a more moderate rate of growth in the U.S., and that process could be under way now. Further skilled management will likely be needed to achieve a soft landing in the face of concerns about stock prices and the current account deficit. For the global recovery to continue, European and Japanese growth will need to pick up sufficiently to offset the inevitable slowing of growth in the United States.

13. **While growth in European economies is gathering pace after a slowdown in 1998 and early 1999, and the outlook is generally favorable, Japan's recovery-which is absolutely critical for Asia-is still subject to significant risks, notwithstanding, all the recent positive news.** Household confidence is fragile, with fears of job losses, and businesses still need to restructure to reduce excess capacity. Monetary conditions have tightened significantly with the recent marked appreciation of the yen. In such circumstances, to avoid a contractionary falloff in public spending, fiscal policy needs to remain expansionary by introducing a supplementary budget. On the monetary side, the recent rise in the yen has made clear the need for a more expansionary stance. With interest rates at zero, there is the question of what more the Central Bank can do. The answer is that it remains possible to inject more liquidity into the system, and thereby reduce long-term rates and the value of the yen.

14. **Turning to structural policy reforms, an early resolution to Japan's banking sector problems remains a key**. The framework for dealing with the sector's problems is now in place, and the emphasis must be on implementation. There is a need for rapid restructuring to fully resolve balance sheet problems, downsize the sector, and restore profitability. The position of smaller regional banks requires strengthening ahead of the return to partial deposit insurance in April 2001. In addition, there is a need to strengthen supervision and reforms in the life insurance industry; implement various plans under consideration to promote the flip side of the strengthening of financial sector balance sheets, i.e. corporate restructuring, including bankruptcy code improvements, tax reforms; and move forward boldly with deregulation and liberalization of sectors largely shielded from foreign competition, among them transportation, telecommunications, and agriculture.

15. Despite recent encouraging developments, **the rest of Asia also needs to do much more if it is to restore its position as one of the fastest growing regions in the world while at the same time reducing its vulnerability to future crises**. The first priority must be to solidify the recoveries that are already under way. To this end, macroeconomic policies need to remain accommodative. However, once it is clear that the recoveries have

become self-sustaining, it will be necessary to begin the process of **fiscal consolidation**, to reestablish more balanced budgetary positions and relieve some of the burden of maintaining price stability now placed on monetary policy. On the structural side, it is widely understood, but nonetheless necessary to repeat, that it is essential to step up efforts to restore the health of balance sheets and promote restructuring in both the financial and corporate sectors. Social safety nets need to be further strengthened to lessen the impact of restructuring on the most vulnerable sections of society.

16. **Still deeper reforms will be needed to ensure that the revival of growth becomes a reality in the coming decade.** Recent experience has demonstrated the risks of relying on rapid increases in capacity to spur growth, since this often results in unsustainable rates of capital accumulation and unhealthy debt levels. These risks have intensified with the increased globalization of capital and product markets. In this new environment, Asian economies should seek to spur growth by **promoting productivity growth.** This means more open and freer financial, goods, and labor markets as well as liberal trade and exchange systems-in other words, a move away from the highly centrally directed systems of the past, toward a new more market-oriented model. At the same time, substantial investment in education will be required for those economies to keep pace with, and reap the maximum benefit from, worldwide technological advances.

17. **Measures to improve risk management and reduce vulnerability must play a central part in the region's longer-term strategy**. Prudential and supervisory systems will need to evolve quickly in the face of rapid innovation in capital markets. Care will also have to be taken to avoid macroeconomic imbalances, including unsound fiscal positions and current account positions, excessive external debt (particularly with short maturities), and unsustainable exchange rate policies. In this regard, the emerging international consensus is that for countries integrated into the global financial markets-and there should be no mistake about the fact that countries will have to integrate into the global financial system as they develop-the two extremes of floating rates or a very hard peg are the only viable longer term options. That applies in this region no less than elsewhere. With the development of the Euro, the possibilities of a regional currency as a very hard peg will no doubt receive renewed attention; in considering that possibility, the length, depth, and complexity of the transition process towards the introduction of the Euro will have to be borne in mind.

18. **While the basic strategy outlined above is immediately relevant for the economies most affected by the Asian crisis, it is no less important for the rest of the region, particularly for low-income countries and countries that are moving toward market-oriented systems**. Even two economies that have already implemented this approach with considerable success, Australia and New Zealand, face the continued challenges of large current account deficits and adverse demographic trends, which will require them to hold fast to their strong fiscal and structural policies.

19. I would like to touch briefly on the much-discussed **question of the liberalization of international capital flows**. At the height of the recent crisis, many called this the crisis of globalization. But the response of countries throughout the world has made it clear that globalization is here to stay. Virtually unanimously, policy makers resisted the siren calls to withdraw from the system, close down capital markets, and retreat into isolation. **That is all the more reason we must seek to deal better with international capital flows**. As

those flows revive, the challenge is both to discourage excessive fluctuations in short-term flows, and to ensure that economies are strong enough to withstand the fluctuations in capital flows that will inevitably occur. Policy requirements in this regard certainly include stronger domestic policies and financial systems, consistency between exchange rate and macro policies, strengthened prudential regulations in both the capital-originating and the capital-receiving economies, and an improved monitoring mechanism based on much better data on the nature and sources of the flows. In addition, until financial systems and macroeconomic policies are strong enough, price-based measures to discourage short-term capital inflows could be appropriate. But nothing should be done to discourage longer-term inflows, especially of foreign direct investment.

20. A controversial issue here is **the approach taken by Malaysia** during the crisis. The effects of the controls on capital outflows imposed in September 1998, is difficult to assess, since they were imposed at the time that capital flows to the region in general began to strengthen, and they were never tested against severe downward pressures. It is important that the controls were not used , as many had feared they would be, to delay financial sector reforms in Malaysia, though corporate restructuring still should remain high on the agenda. It is also significant that the controls have been relaxed substantially and are now price-based. I believe that the controls introduced a year ago are not a good way to operate in the international financial system, particularly for a country anxious to attract foreign investors.

21. As the lessons of the recent crisis continue to be drawn, the question of how to maximize the benefits of international capital flows while minimizing their potential adverse effects is certain to remain high on the agenda. Indeed, the role of short-term capital flows and how to deal with them is one of the topics now being examined by the Financial Stability Forum, whose establishment itself is part of the international community's broader response to the crisis.

22. **Surveillance and policy coordination at regional levels can help reduce the risk of future crises and promote regional dynamism.** Such mutual surveillance is already taking place in many regional fora, including the Asian-Pacific Economic Cooperation, the Manila Framework Group, and the Association of South East Asian Nations. The IMF conducts surveillance on individual countries and at the global level, and we provide the basic economic analysis for surveillance discussions at a variety of global and regional meetings and fora. We are also working in this way with the different regional groupings in Asia, presenting surveillance papers, and papers on special issues-and we are of course willing to do more if that would prove useful.

23. In concluding, let me look both backward and forward. This has been a terrible crisis, which has taken a high toll on many people. As we look back we should express our thanks to the many in the crisis countries-the politicians and the bureaucrats who took and implemented the necessary decisions, despite the difficulties, and those in the private sector, especially the poorest and most vulnerable members of society, who have struggled to deal with the unexpected difficulties and challenges that they faced. They, and we, are now seeing the early fruits of their efforts. We should not overlook the fact that this crisis has revealed the underlying strengths of most of the societies affected by it, as well as the resiliency of their economies. We in the IMF are grateful to have been able to contribute to the turnaround, which has arrived far sooner than most had expected, and we are especially

pleased that the more fundamental processes of structural reform embodied in IMF-supported programs are well under way in most of the region.

24. Looking forward, let me point to one of the main risks that clouds the outlook for the region-that of complacency. In recent months the IMF's unofficial motto, "Complacency must be avoided", has been working overtime-unfortunately, justifiably so. In principle, everyone accepts that much structural reform remains to be carried out, not only in the crisis-struck countries, but also in China, India, Japan, and many others, and that it will be crucial to press ahead with the key reforms. Given this consensus, I had thought until recently that the concern about complacency was being overdone. But unfortunately it is not, and the risk that the strengthening recovery will reduce the urgency of reform, and allow a business-as-usual attitude to set in is very real.

25. This crisis has sent an important warning. It would be an unforgivable mistake, one with great costs to many who have already paid a high price, to ignore its lessons.

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