ECONOMIC OUTLOOK IN THE REGION

AND ASIAN FINANCIAL TURMOIL

Comments by

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The U.S. economy has just completed another stellar year, marked by strong growth and declining inflation. Indeed, the low inflation of recent years has been instrumental in reinvigorating the U.S. economy, helping unleash a new vibrancy and confidence across the country.

Economic fundamentals suggest that growth will remain solid well into this year. However, the shock wave working its way toward us from the Western Pacific will likely be a countervailing force against an otherwise dynamic economy. Combining a strong domestic economy with a weaker external sector, I expect U.S. growth to eventually slow this year while inflation should remain near its current level of 2 percent. In discussing the U.S. outlook today, I want to spend some time reviewing the reasons for the Asian financial crisis and the role of the IMF and the international community in dealing with it.

The economic outlook

With real GDP growing almost 4 percent in 1997, it was the fastest annual increase experienced in 10 years. As a result, the unemployment rate fell to 43/4 percent-the lowest sustained level since the late 1960s. CPI inflation, led by a decline in food and energy prices, dropped from 3.3 percent in 1996 (measured from December 1995 to December 1996) to 1.7 percent in 1997. Inflation in the so-called *core* CPI, which excludes food and energy prices, declined from 3.0 percent in 1995 to 2.2 percent in 1997.

This momentum and other economic fundamentals should help propel the domestic economy forward this year. Consumers remain confident, with both the Conference Board's and University of Michigan's indices of consumer confidence near, or at, all-time highs. Increases in household wealth resulting from the impressive rise in the stock market over the last few years should keep consumer spending on an upward trajectory. Finally, strong corporate profits in an environment of low capital costs will spur continued strong investments, helping maintain favorable U.S. economic growth.

Economic effects of the Asian turmoil

As I said, however, the Asian financial turmoil will be a countervailing force to strong U.S. growth and will have a slowing effect on world economic activity. The IMF expects that the Asian financial turmoil will cause growth in the newly industrialized Asian economies to fall from 6 1/4 percent in 1996-97 to 3 1/2 percent in 1998. The shock wave will then be felt throughout the world. For example, the IMF expects world growth to fall from about 4 percent in 1996-97 to 3 1/2 percent in 1998.

As the shock wave from Asia reaches our shores, we should experience a slowdown in exports and therefore some slowing in an otherwise strong domestic economy. On balance, most economists, and I would include myself in this group, are suggesting that reduced demand for our exports will trim perhaps a half percentage point off this year's overall growth rate. Of course, the degree of uncertainty surrounding this estimate is large. The actual slowdown will depend on how developments in Asia play out--including the policy response there and abroad, a point to which I will return shortly.

Even those of us in the western and midwestern United States are not immune from events in Asia. Many local industries--such as agriculture, technology, and manufacturing--are global competitors and will be affected by these events.

Concern regarding the effect of Asia is particularly apparent here in Wyoming because of its already sluggish economy, in contrast to the national economy. In 1997, for example, nonagricultural employment rose only 1 percent in Wyoming (measured from the fourth quarter of 1996 to the fourth quarter of 1997) compared with 2 1/2 percent in the nation. The sluggish performance was broad-based. Employment in wholesale and retail trade--with one-quarter of Wyoming's total employment--was flat and government employment--with another one-quarter of total employment--fell 1 percent. Moreover, natural gas production was virtually unchanged, and oil production continued to fall, with a decline of nearly 15 percent in the first nine months of last year (compared with the same period the year before). In contrast, manufacturing employment rose 3 percent, but it accounts for only 5 percent of Wyoming employment. And, mining and construction employment rose 5 1/2 percent in 1997.

In this context, then, Asia is likely to have some impact on the Wyoming economy. The domestic market for trona is flat. And, although export growth in the past has been strong, with half of trona exports going to Asia, I expect these exports will slow this year. Thus, the turmoil in Asia, along with a slump in demand, will likely have a negative impact on the trona market. Finally, the direct effect of Asian turmoil on Wyoming manufacturing is a concern to many in Wyoming. However, manufacturing is a small part of the Wyoming economy, and only about 6 percent of manufacturing is shipped to countries in Southeast Asia.

Agricultural firms are certainly concerned about weakening demand for U.S. food exports. Forty percent of U.S. agricultural exports go to Asia.[1] These countries have been important buyers of added-value food products, the highest margin and fastest growing portion of the world food market. For example, about 50 percent of wheat is exported, and one-third of the exports go to Asia. In contrast, 6 percent of red meat is exported, but two-thirds go to Asia. There have been some reports from business people in this region that orders from South Korea and Thailand have been canceled. And some companies have been hesitant to accept orders in the Asian market for fear that they will not be paid.

Finally, the drop in oil prices--due in part to a slump in demand from Asia--is obviously hurting the profitability of Wyoming oil producers.

The IMF and Asian turmoil

As you can see, Asian financial turmoil will affect growth in the world, in the United States, and in Wyoming. Whatever the final effect, understanding the underlying reasons for the crisis and the policy response to it is worthwhile.

The underlying problems facing Asia. Three elements lay at the foundation of the Asian crisis.

First, to finance growth in their economies, some Asian countries relied on a large amount of short-term debt relative to equity. While debt plays an important role in the efficiency of a market economy, carrying a large amount of debt also involves high risk. In times of economic stress, short-term debt is an unstable source of funding. In today's global financial marketplace, investors can quickly move their capital out of an economy, causing enormous liquidity problems and further worsening an already tenuous set of circumstances. This is what happened in Asia.

Second, each of the countries with a large debt load maintained a fixed exchange rate. The fixed exchange rate tended to give businesses and financial institutions in these countries a false sense of security with regard to exchange rate risk, leading them to hold a significant part of their short-term debt in dollars. The volatile nature of dollar-denominated short-term debt made these economies especially vulnerable to a crisis in the event of a sudden loss of confidence by investors or an unexpected exchange rate depreciation.

Third, the banking system in each economy was subject to lax lending standards and weak supervision. With short-term foreign capital flowing into a country, a weak banking system allowed loans to be diverted to questionable investment projects and real estate deals. When the Asian crisis hit, the questionable loans threatened to bankrupt a sizable number of firms and domestic financial institutions.

Thailand provides a good example of how these forces came together to cause a crisis. After many years of strong growth, Thailand's economy suffered a slowdown in 1996 and the first half of 1997. As a result, many marginal investments became unprofitable. When Thailand floated the baht on July 2, the belief that there was no foreign exchange rate risk quickly disappeared. Investors lost confidence in the baht and quickly tried to convert their bahts to dollars. When the local currency rapidly depreciated, the cost to Thai businesses of servicing their dollar-denominated debt increased. Then, as domestic residents rushed to hedge their external exposure, exchange rate pressures intensified and the crisis spread to other countries in the region.

Some of the contagion was rational since the depreciation of the Thai baht reduced the competitiveness of Thailand's trade competitors. In addition, investors saw the same three elements of high debt, fixed exchange rates, and weak financial systems in other Asian countries, such as Indonesia and South Korea. Against this backdrop, the crisis erupted and the IMF led an international response that attempted to regain economic order by systematically addressing the underlying elements of the crisis.

International response to the crisis. The first aim of the IMF-led response has been to restore investor confidence. The IMF agreed to make loans to these countries contingent on the implementation of needed economic reforms. The IMF program first required these countries to stabilize their exchange rates by temporarily raising domestic interest rates. At the same time, these countries, in consultation with the IMF, agreed to implement longer term structural reforms necessary to put their economies back on the path to more permanent stability.

The most important reform is to start the process of placing their financial systems on a sound footing. This requires closing insolvent financial institutions; recapitalizing weak, but solvent, institutions; strengthening financial regulation and supervision; increasing transparency in corporate and government sectors; and opening markets to international trade.

Also, an important part of the IMF-led program has been to ensure that all parties involved in the creation of the crisis share in its negative effects and the cost of reform. Each government must find and set aside funds to help pay the cost of the economic restructuring. These costs can be large. For example, the cost of resolving the U.S. S&L crisis in the 1980s is estimated to have been 3 percent of our GDP. Moreover, as the necessary restructuring occurs, economic growth will slow. In this instance, Asian stock markets have already fallen about 50 percent, causing sizable losses for investors. Also, many firms and financial institutions have gone bankrupt. And yes, large money center banks in the United States have seen earnings drop, as they have incurred trading losses on currency swaps and have had to increase reserves against future currency and loan losses.

The role of the IMF

Given the impact of the shock on Asia, and the role played by the IMF, there has been a great deal of discussion about the IMF. Such discussions play an integral role in democratic societies. In fact, Congress is now debating whether to increase funding for the IMF. As suggested in my remarks, I believe the IMF has played an important role in managing and controlling the impact of the shock on the world economy. The IMF-led response has helped the crisis-ridden countries to stabilize their economies and take their first steps toward financial recovery. More important, from my point of view, the IMF-led effort appears to have contained the crisis and lessened its impact on the rest of the world.

With upheaval in Asia, there have come renewed calls for dismantling the IMF. While certainly we should review the IMF's role in Asia, I would suggest we not seriously consider abolishing it. There is no question that our world in 1998 is very different from that in 1944 when the IMF was created. All organizations must continually evaluate their goals, objectives, missions, and methods of operation. The IMF is no different. Moreover, the IMF recognizes the need for changes, as do Treasury Secretary Rubin and Deputy Treasury Secretary Summers.

But, we must also confront today's crisis with the mechanisms and institutions we have in place. It is important to keep in mind that the IMF is the best institution in place to play an important and useful role *when* the next financial crisis occurs--not *if* another crisis occurs. In this context, I believe it important that additional funding for the IMF be provided. Indeed, the IMF and the international community must continue to work together to modify and update the mechanisms and institutions needed to reduce the risk of future crises, a risk that is inherent in today's complex, global economy.

Conclusion

In closing, let me repeat that I believe the economy currently is in excellent shape. We expect to see some moderation in the economy's growth rate this year relative to last year, but with continued high employment and low inflation. I believe that the IMF has performed a valuable role in dealing with the Asian crisis by coordinating the efforts of international agencies and governments to deal with a complex and unfolding crisis. Allowing the Asian crisis to go unchecked would surely have had an increasingly harmful effect on the world economy, the U.S. economy, and the Wyoming economy.

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[1] U.S. 1997 agricultural exports to Asia include Indonesia (1.3 percent), Philippines (1.6 percent), Taiwan (4.5 percent), Thailand (1.0 percent), Korea (5.6 percent), Malaysia (1.0 percent), China (6.0 percent), and Japan (19.0 percent). Latin America received 18.0 percent of U.S. agricultural exports, the EU received 15.0 percent, and other countries received 27.0 percent.