MEXICO'S AND ASIA'S RECOVERIES COMPARED

In many aspects, Mexico's recovery from the Tequila crisis six years ago is comparable to the recovery of the four Asian crisis economies (Indonesia, Korea, Malaysia and Thailand) from the Asian financial turmoil. In both cases the economies managed to achieve a relatively short and sharp V-shaped rebound. However, the four Asian economies seem to have fared worse than Mexico in returning to their pre-crisis growth paths.

While the much higher growth rates in Asia compared with Mexico in the pre-crisis period set a more stringent benchmark to catch up with, relatively sluggish investment during the crisis and in the early recovery period might have also impeded growth.

This, in turn, could be attributed to over-investment in the pre-crisis period, socio-political instability, the region's relatively large but weak banking sector, and Japan's protracted economic malaise.

To the extent that the above factors are responsible for Asia's sub-potential performance, the outlook of Asia's recovery is likely to remain clouded given the rather slow progress on these fronts.

I. Introduction

The Tequila crisis in Mexico six years ago and Asia's financial turmoil over the past $3^{1}/_{2}$ years offer interesting comparisons in many aspects. Without underestimating the diversity among Asian crisis economies (Indonesia, Korea, Malaysia and Thailand), this paper tries to assess their prospects for sustained economic recovery by drawing upon the Mexican experience.

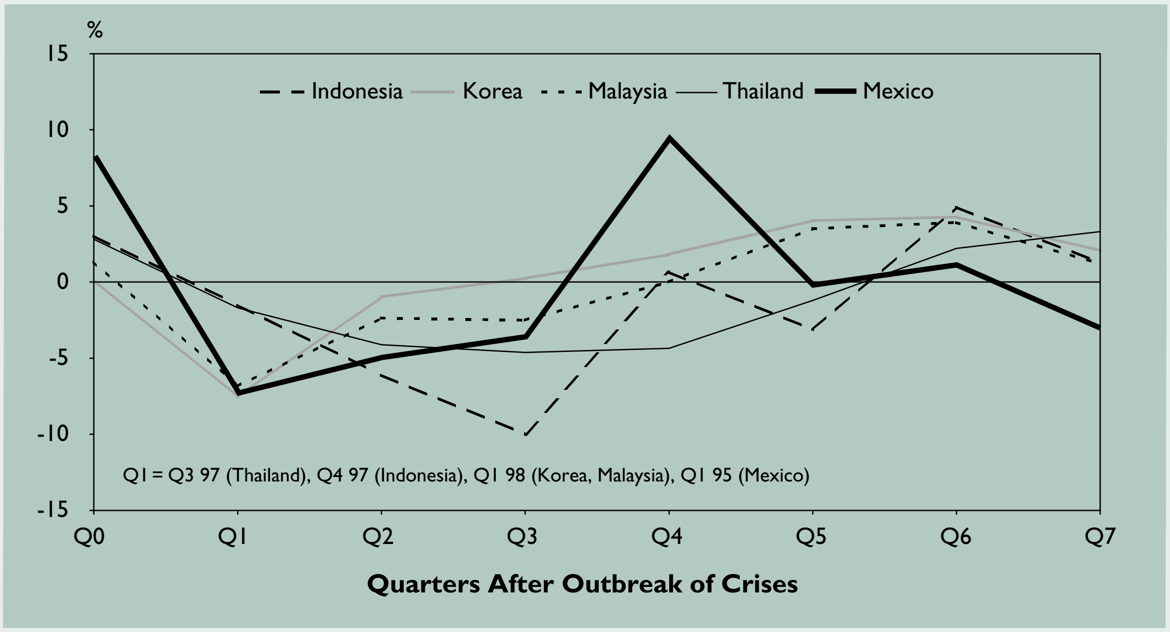
Part II of this paper identifies the key similarities and differences in the recovery paths of Mexico and Asia. Part III outlines the major driving forces behind their recoveries, while part IV examines the reasons for the key differences between their recovery processes. Part V discusses the implications for Asia's recovery outlook and part VI concludes.

II. Recessions Compared

Many analysts have an impression that Asia's financial turmoil between 1997 and 1998 has been more severe than the Tequila crisis experienced by Mexico in 1995-1996. This is probably because the Asian turmoil came more as a surprise than the Tequila crisis, given Asia's near-miracle growth record and Latin America's crisis-ridden economic history over the past few decades. Also, in terms of geographic and demographic impacts, the extensive contagion suffered by a population of about 400 million spreading over a region of 3 million square km in Asia was arguably more pronounced than that of the Tequila crisis, which covered a population of one-quarter the size with an area one-third smaller than that of the Asian crisis.

According to our analysis, Asia has suffered more protracted losses than Mexico when assessed against the pre-crisis growth trend. However, other measures of assessment are less conclusive. In terms of the length of recession, with the exception of Thailand, most crisis countries managed to return to positive economic growth within four quarters after they fell into recession

Chart 1
Real GDP Growth
(seasonally adjusted quarter-on-quarter change)



(Chart 1).[1] The recovery took a sharp V-shaped pattern, with the real GDP growth rate rebounding by 8-17 percentage points within a span of 3-4 quarters. In terms of the depth of the recession, Mexico lost about the same as the Asian crisis countries during the recession both in terms of nominal GDP in US dollar terms and in real GDP terms. The following paragraphs discuss various measures to compare the severity of the recession and the recovery performance across countries.

Given that the economies under study are at different stages of economic development with different growth potentials, a relevant measure is the gap between **their actual and potential output levels**. A broad-brush approach is to estimate the deviation of actual output level from that projected by the pre-crisis growth trend.[2] Under this measure, the Asian economies performed distinctively worse than Mexico.

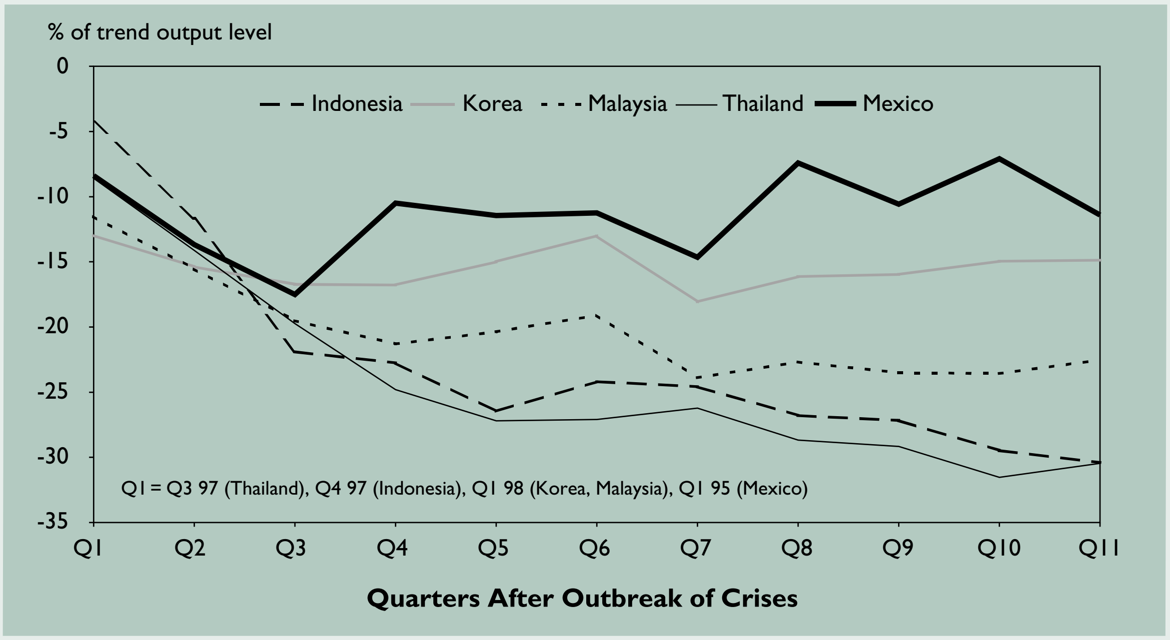
As indicated in Chart 2, both Mexico and South Korea recorded a deviation of about 15% from their trend output in the depth of their recession, while Malaysia, Thailand and Indonesia experienced a gap in the range of 25-30%. However, Mexico managed to reduce its gap to about 5% within 10 quarters after the outbreak of the crisis, while the Asian crisis countries suffered from more protracted deviation from their pre-crisis growth trend. Obviously, Asia's growth of 7-9.5% in the pre-crisis period set a much higher standard to catch up compared with Mexico's pre-crisis growth of 3.5%. However, it will still be useful to examine the recovery pattern with a view to assessing Asia's potential in returning to its previous growth path.

Another conventional comparison of the severity of recessions in different economies is to examine nominal GDP expressed in a common currency (US dollar), assuming that the exchange

1 Real GDP growth is measured on seasonally adjusted quarter-on-quarter basis. Recession here is defined as a period when an economy registers at least two consecutive quarters of negative real GDP growth.

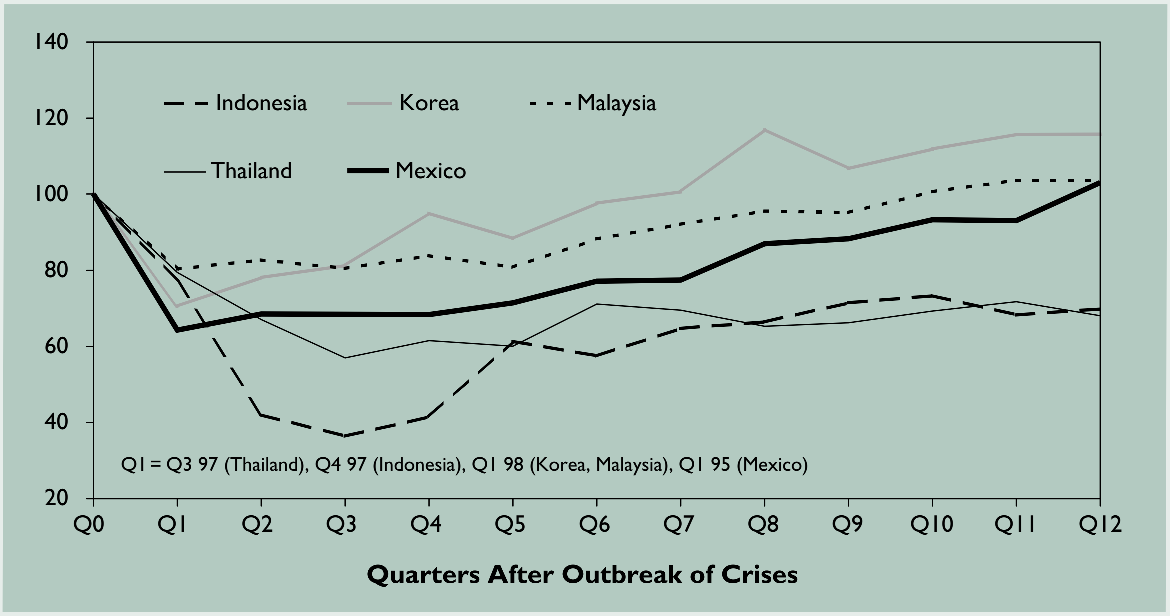
2 This method assumes that output growth can be sustained at a pre-crisis trend rate, taken here as the average real GDP growth rates of the seven years before the outbreak of crises, i.e. 1990-96 for Asia and 1988-94 for Mexico. The choice of seven years is somewhat arbitrary. Nevertheless, this time frame should include the latest growth momentum while being long enough to smooth out short-term cyclical fluctuations. In any case, results obtained from growth trends covering 5-10 years show marginal difference. Another way to estimate potential output is to use the HP filter smoothing method to obtain the long-term output trend component from the actual output series. This method differs from the previous one in that the long-term growth trend will not be confined to the pre-crisis period, but include long-term changes introduced by the crises themselves. Under the latter method, differences in output performance among the five countries are marginal.

Chart 2
Deviation of Actual Output from Pre-crisis Trend



rate reflects the purchasing power parity. In **nominal US dollar terms**, the four Asian countries lost between 20-60% of their pre-crisis GDP during their recessions. The average loss of the four Asian countries, about 40% of their pre-crisis US dollar GDP at the trough of the crisis, is comparable to Mexico's loss of about 35% (Chart 3). The Asian economies managed to recover all (in the case of South Korea and Malaysia) or close to half of their losses within about one year after their

Chart 3
Nominal GDP Indices in US Dollar Terms



Source: CEIC and Datastream

recessions, while Mexico took about the same time to fully recover.

It is, however, debatable whether nominal GDP in US dollar terms offers a good basis for cross-country comparison. Exchange rate movements may be influenced by a host of factors, some of which may not bear any direct relationship with economic fundamentals. Moreover, the size of the external sector varies considerably among the economies under study, ranging between Mexico's 30% (of GDP) and Malaysia's 90%. For relatively less externally oriented economies, US dollar nominal GDP may not be a good measure in assessing their economic performance.

An alternative measure is the seasonally adjusted **real GDP indices** of individual economies. As indicated by Chart 4, there is no clear difference between the depth of the recession in Mexico and that in the Asian economies under this measure. The maximum output loss suffered by Mexico during the Tequila crisis, of about 15% in terms of real GDP level, is about the mid-point of the 8-20% losses suffered by the four Asian economies. The recovery pattern was also similar. Mexico fully recovered to its pre-crisis output level in about 1-1½ years, comparable to the 90-110% recovery achieved by the Asian economies during the same time frame.

III. Driving Forces behind the Recovery

To understand the factors that could have contributed to Asia's sub-potential recovery performance when measured in terms of pre-crisis growth trends, we studied the different driving forces behind the recovery in Mexico and Asia. Among the different demand components, we found that there were little difference between Asia and Mexico in the contributions of consumption and net export demand to GDP growth during and after the crises. However, the contributions of investment to GDP growth in Southeast Asia were significantly less than that in Mexico and South Korea.

a. Net Exports

During the crises, all five countries experienced sharp improvements in their external payment positions. Yet, while Mexico maintained a

Chart 4
Real GDP Index

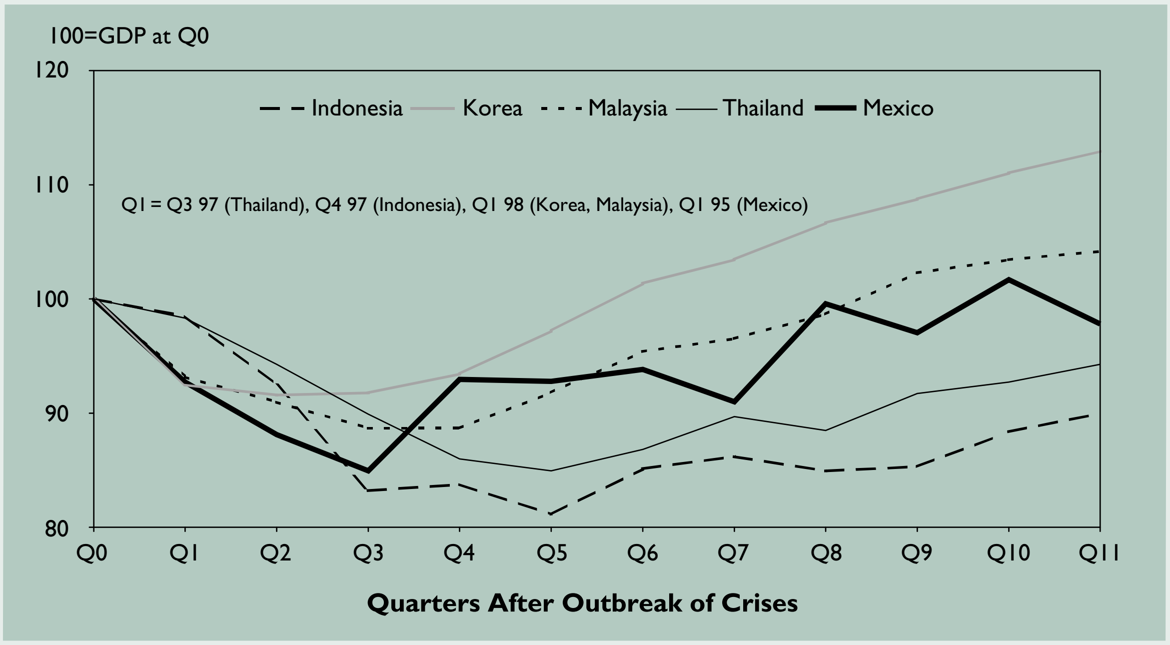
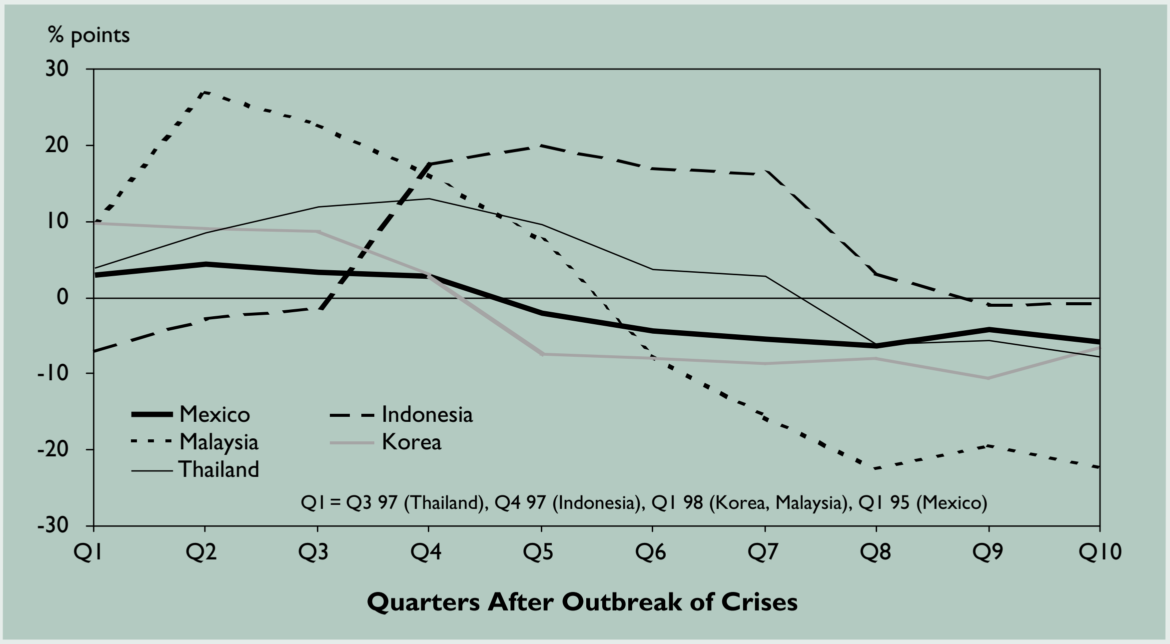


Chart 5

Contribution of Import Reduction to GDP Growth



steady export recovery, Asia's export rebound was highly unstable. Most of the Asian crisis countries had their initial export recovery short-circuited within 2-5 quarters of their depreciation, partly due to severe disruptions in export finance and social unrests that followed after the currency crisis. It was only eight quarters after the outbreak of the crisis that exports re-emerged as a steady driving force for Asia's recovery.

Import contraction contributed more significantly to the improvement in external payment positions in Asia than in Mexico. This is especially apparent in the case of Malaysia in the early stage of the crisis, followed by Indonesia in a later phase, as reflected in Chart 5. Either export expansion or import contraction would lead to improvements in net exports and current account balance. However, export expansion would be more preferable as external demand could cushion the economy from falling into deeper recession. Import compression, on the other hand, usually implies severe domestic demand contraction that would lead to large unemployment and under-utilisation of resources.

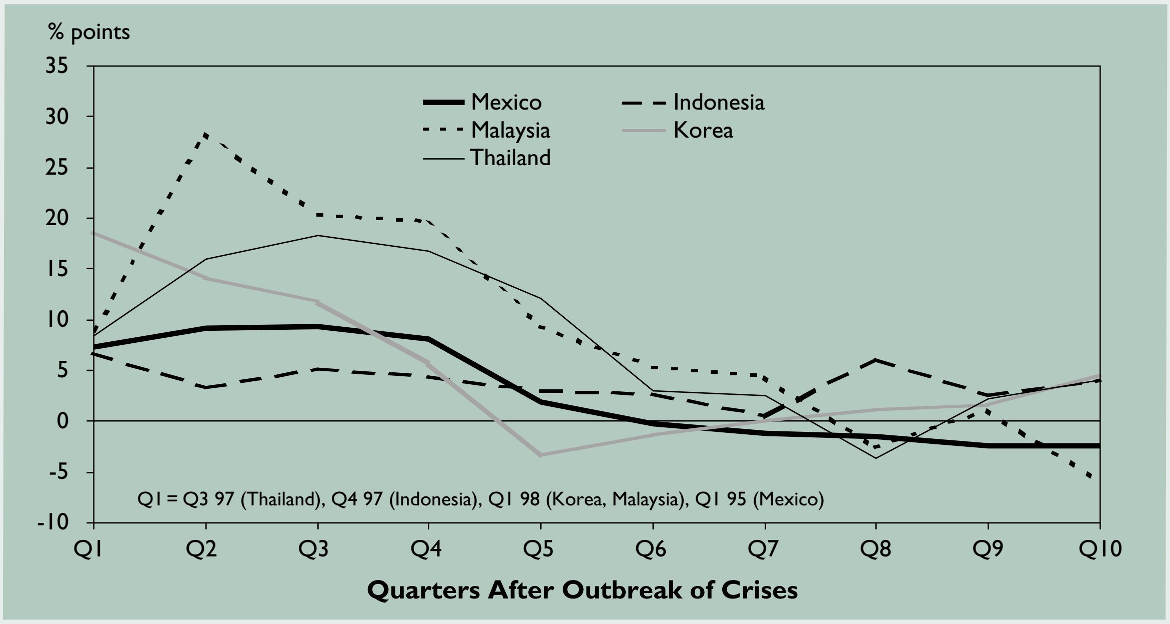
In terms of contribution to real GDP growth, net exports contributed between 5 to 30 percentage points during the first four quarters following the outbreak of the crises, cushioning the sharp contraction (Chart 6). Given that foreign trade generally accounts for a larger GDP share among the Asian economies than in Mexico, contributions from net exports were generally larger in Asia than Mexico during the crisis periods.[3]

However, net exports became a much less significant factor once these economies entered their respective recovery phases. In fact, net exports had a negative contribution to Mexico's GDP growth as soon as it entered its recovery in early 1996. For the Asian economies, contributions of net exports to real GDP growth also shrank sharply after the fourth and fifth post-crisis quarters, but remained generally positive until recently. This is largely driven by strong export demand in electronic products, especially in the case of South Korea. In sum, the external sector has contributed to Asia's recovery, and is unlikely a factor behind Asia's sub-potential performance in the recovery period.

3 At the time of the outbreak of their respective crises, the ratios of total trade in goods and services to GDP of the five economies were: 40% (Mexico), 73% (South Korea), 78% (Indonesia), 92% (Thailand), and 194% (Malaysia).

Chart 6

Contribution of Net Exports to GDP Growth



b. Consumption

Since consumption normally accounts for about two-third of the aggregate demand, its fluctuation will contribute significantly to GDP growth. During the crises, all the crisis countries experienced sharp contraction in consumption demand, reducing GDP growth by 5-10 percentage points. It took about 4-6 quarters for consumption to recover and contribute positively to GDP growth. In this respect, there was no obvious difference between the Tequila crisis and the Asian crisis (Chart 7).

Chart 7

Contribution of Consumption to GDP Growth

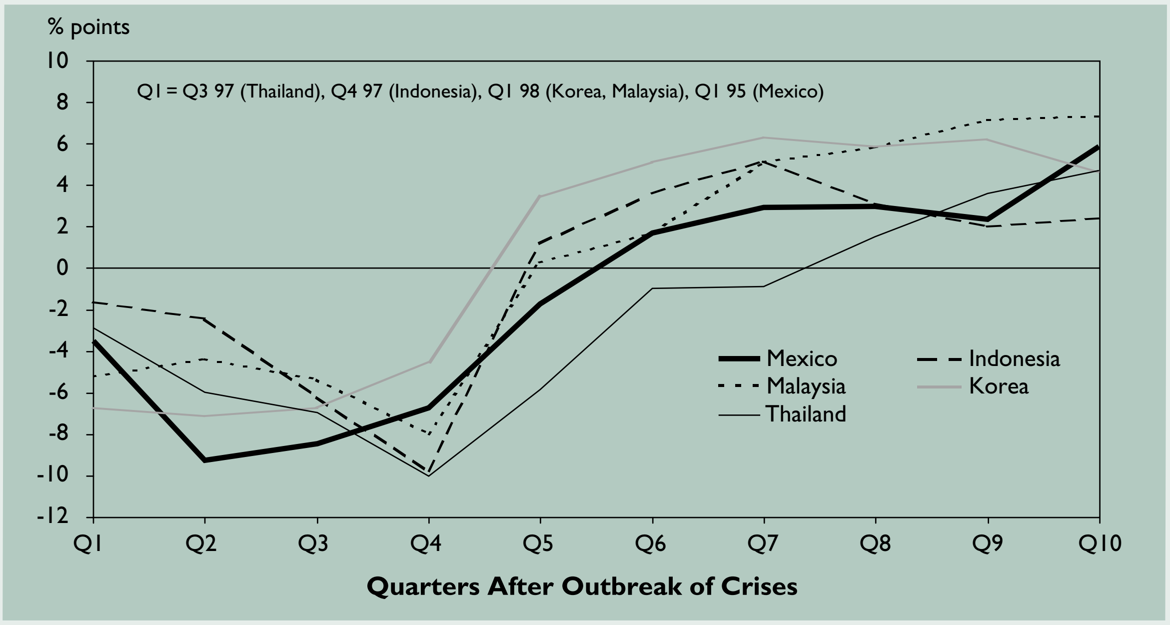
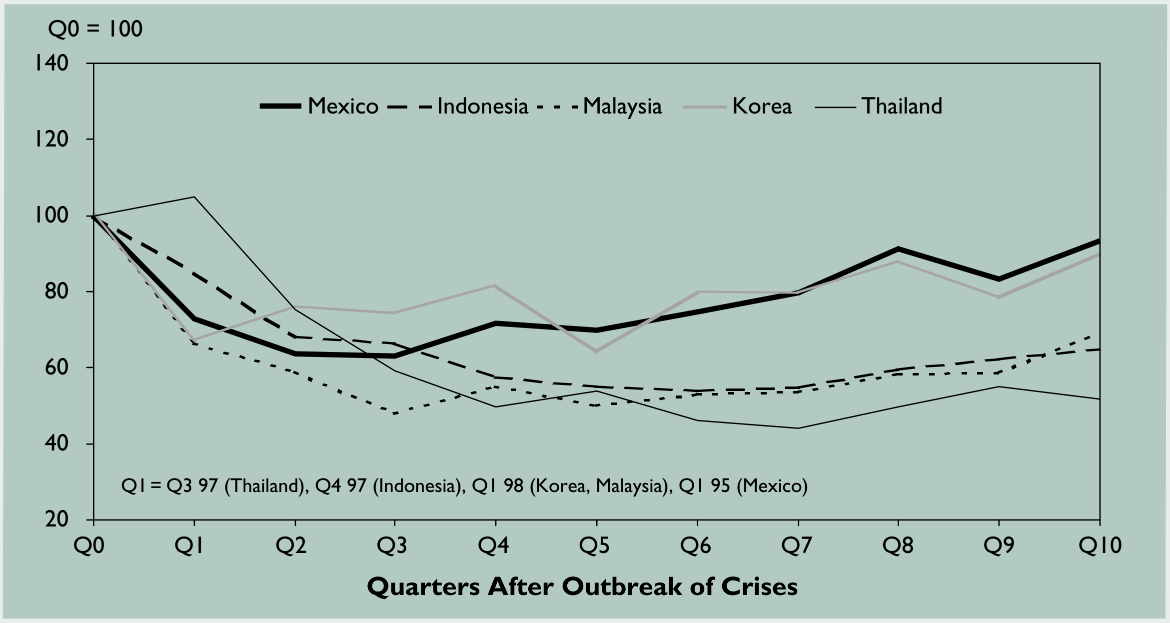


Chart 8
Fixed Capital Formation



c. *Investment*

The collapse in investment was a key element behind the contraction in post-crisis Asia, given that investment used to account for a relatively high share of 30-50% of GDP in the region, compared with less than 20% in Mexico. While investment recovered along with a pick-up of economic activity in Mexico and Korea, they remained well below their pre-crisis levels three years after the outbreak of the crises in Indonesia, Malaysia and Thailand (Chart 8).

Chart 9
Stock Market Performance

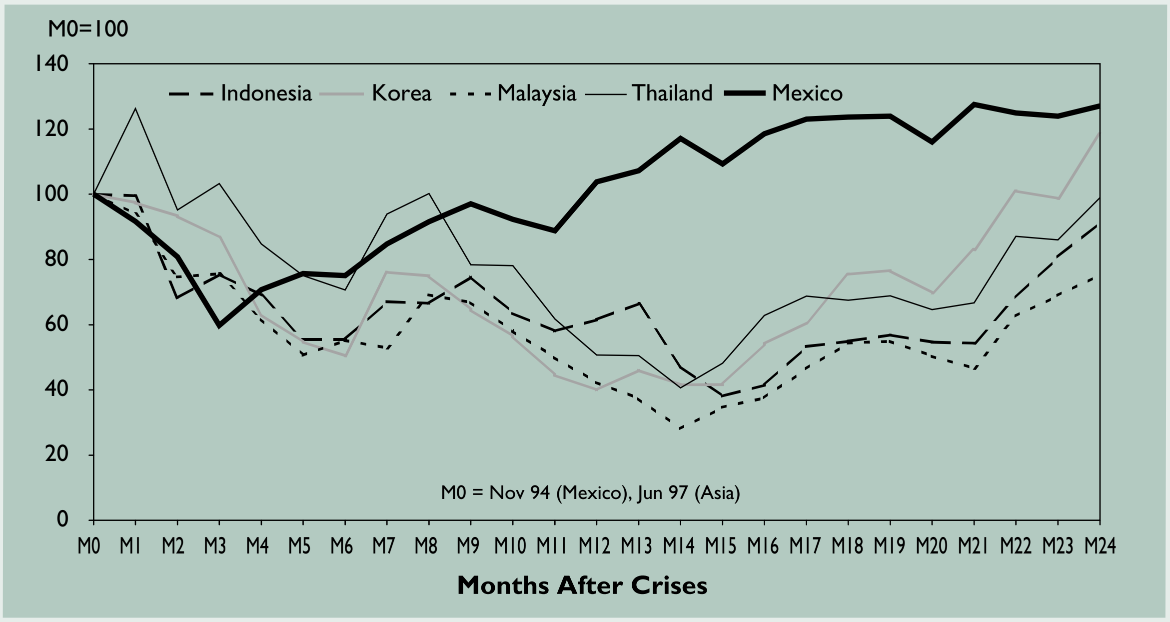
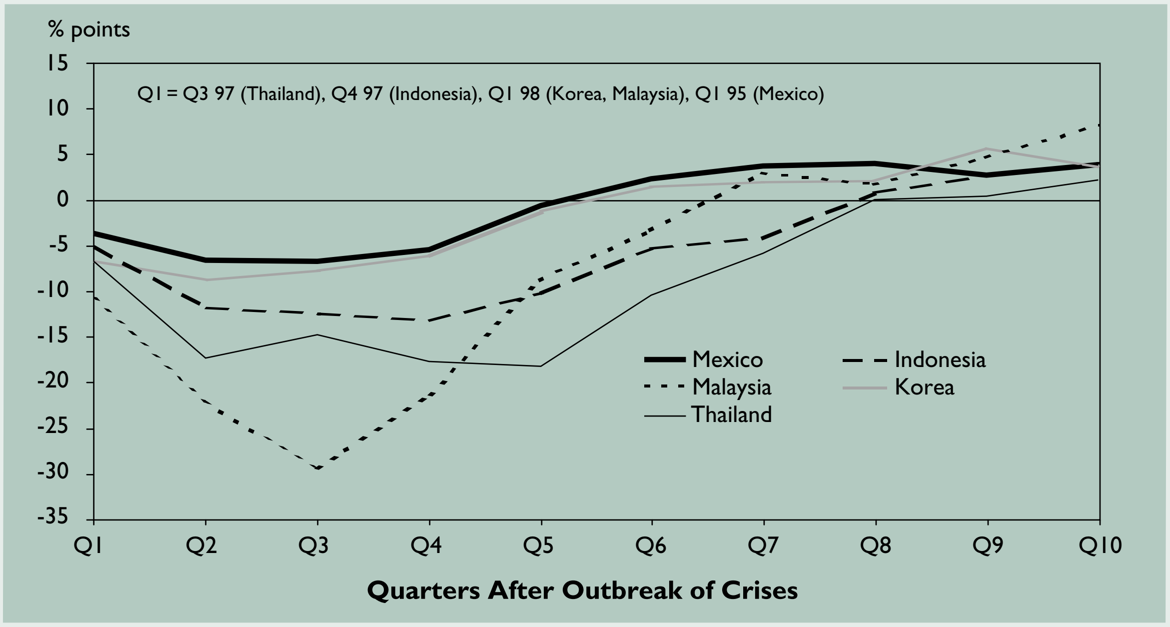


Chart 10

Contribution of Investment of GDP Growth



The more positive investment sentiment in Mexico was also evident in their stock market performance. The Bolsa Mexicana de Valores Index bottomed out two months after the flotation of the Mexican peso. On the contrary, a clear upward trend did not emerge in the Asian economies until about 14 months after their respective depreciations (Chart 9).

In terms of the contribution to GDP growth, investment in the Southeast Asian economies suffered a deeper contraction than that of Mexico and South Korea during the initial crisis period (Chart 10).

IV. Reasons for the Differences

Among the various demand components, investment appears to be a more obvious factor accounting for the protracted sub-potential performance of the Asian economies in the recovery period. Intuitively, this may be related to a few factors, which are discussed below.

a. Banking Sector Vulnerability

The health of the banking system is likely to be a major factor contributing to the difference in the recovery paths. Companies in Asia rely more heavily on banks as a source of finance, while Mexico depends more on direct capital market financing. At end-1996, bank claims on the domestic sector were about 140% of GDP in Thailand, 54% in Indonesia and about 60% in Korea. These compared with roughly 45% in Mexico. In a financial crisis, a large but ineffective banking system would present serious systemic risks and resulted in severe macroeconomic disruptions, inhibiting the recovery in activity that require long-term funding and commitment like capital investment. The financial sector restructuring costs would likely be high and the contractionary effect on aggregate demand, especially investment demand which depends heavily on bank financing, would also be large. With the benefit of hindsight, banking sector reforms in Mexico before the Tequila crisis has strengthened the sector's ability to withstand financial shocks. Conversely, rapid bank deregulation and expansion in pre-crisis Asia have undermined banking sector health and exposed Asian banks to new risks.

b. Japan's Economic Downturn

As the leading economy in the region and a major market for Asian exports, Japan's own economic malaise prohibited it from playing a more constructive role in checking the crisis. Worse still, Japan's own financial problems aggravated the region's crisis when Japanese banks – by far the region's biggest creditors – were forced to retreat from the region because of insolvency and capital inadequacy problems at home. Between mid-1997 and end-September 2000, lending to Asia by Japanese banks shrank by 60% to a total of US$160 billion (Chart 11). In contrast, the Tequila crisis was checked by a buoyant US economy, which absorbed 80% of Mexico's exports, and provided for 34% of Mexico's foreign bank funding. During 1995-97, US imports from Mexico increased by 73%, though its bank lending to Mexico dropped by 27%. Economic malaise in Japan also restrained Japan's direct investment in Asia, which used to account for 20-30% of the total foreign direct investment inflows to the respective crisis countries. According to Japanese statistics, Japan's direct investment in the four Asian economies dropped by 40% in fiscal year 1998 (ending March 1999) and fell by another 15% in fiscal year 1999. In comparison, the stock of US direct investment in Mexico rose by 14% between end-1994 and end-1996.

c. Over-investment in Asia

While all five crisis countries suffered from large current account deficits before the crises, Asia's problem originated more from its heavy capital spending, while Mexico's shortfall was mainly due to excess consumption growth. In the two years before their respective crises, gross domestic investment of Mexico averaged about 20% of GDP, while that of the four Asian countries ranged between 30-50% (Chart 12). In comparison, consumption in Mexico consistently accounted for a larger share of GDP, averaging about 75%, than that of the Asian economies, which averaged about 60-65% in the $2^1/_2$ years before crises. Although spending in investment enhances productive capacity provided that resources are efficiently allocated, Asia's experience seems to suggest that adjustments for excesses in investment could be more difficult than in consumption. This may be partly due to the fact that it usually takes longer to remove excess production capacity, either by downsizing or raising utilisation, than to rebalance consumption demand, especially non-essential ones. This is especially true for the correction of excesses in real estate investment, given long time lags in adjusting supply, and the rather inelastic demand.

Chart 11
Japan's Bank Lending to Asia

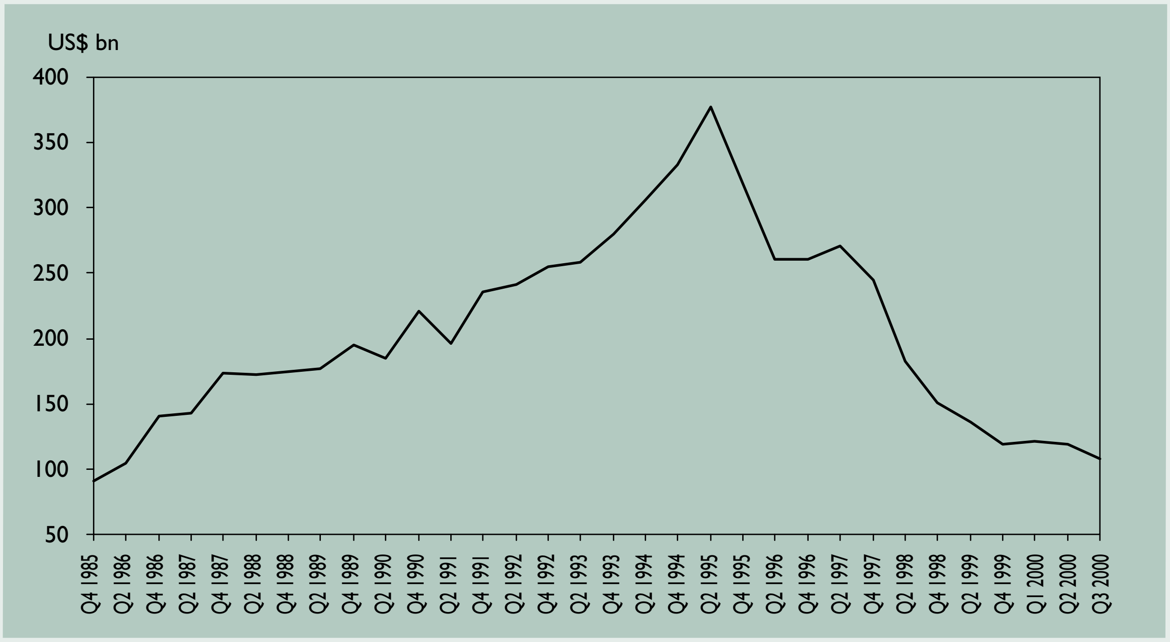
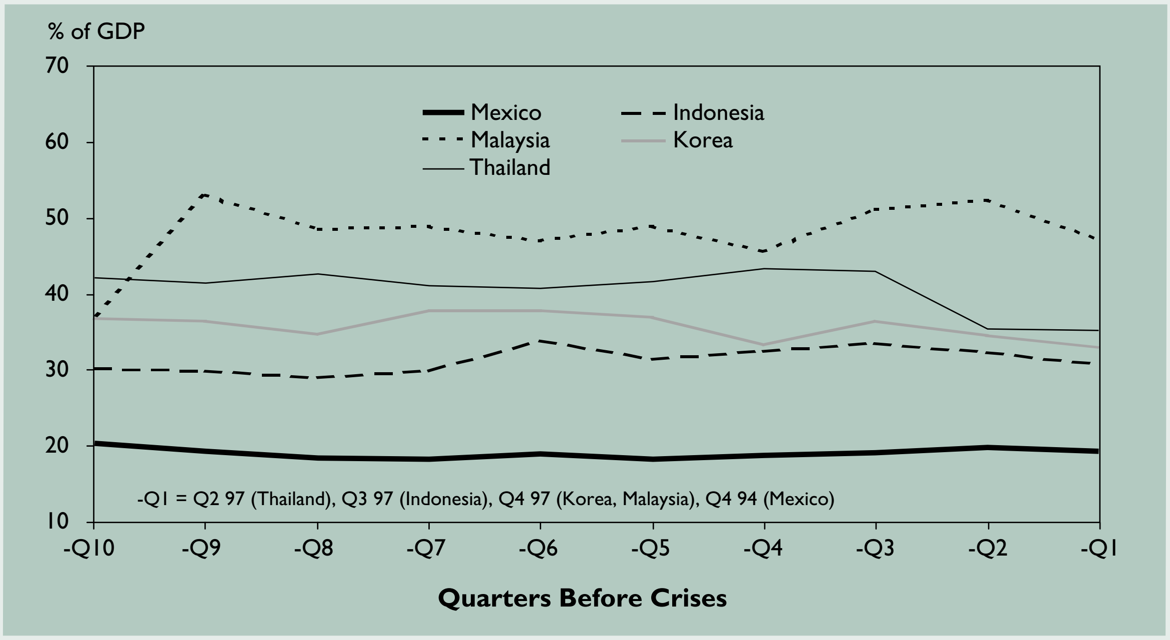


Chart 12

Gross Investment Ratio



d. Political Instability

A stable political environment is critical in restoring investor confidence and preventing a flight of capital. While most of the crisis countries suffered from serious political uncertainties and changes in government during the crises, their success or otherwise in restoring political stability produced a marked difference in their recovery process. In Mexico, despite the uncertainties created by the assassinations of a presidential candidate and the secretary general of the ruling PRI party just months before the devaluation, the newly elected President Zedillo managed to restore political stability with two cabinet reshuffles during his first year in office. In South Korea, the election of President Kim Dae-jung to office within one month of the crisis helped to calm public dissent on the previous government and revived investor confidence. In contrast, Thailand and Indonesia were less fortunate. Although public revolt forced the Chavalit government in Bangkok to give way to a more popular Chuan administration, protracted party politics continued to paralyse the new government and hamstrung the progress of economic restructuring. The situation was worse in Indonesia as the obsolete political system disintegrated under the pressure of mounting ethnical and religious conflicts, giving way to widespread civil unrest and prolonged political instability, leaving many of the economic adjustment programs unattended. The recent election of Megawati Sukarnoputri as President of Indonesia has helped to restore some calm to Indonesia and may pave the way for more economic reforms.

V. Outlook for Asia's Recovery

To the extent that the above factors contributed to Asia's sub-potential performance in its recent recovery, one has to be cautious in assessing the outlook of Asia's recovery and its chance to return to the pre-crisis growth path. To fully regain the potential output is almost impossible, because it requires Asia to grow even faster than during the pre-crisis period to make up for the loss. Japan's economic situation remains disappointing, and there is little sign of any early rebound in its investment and bank lending overseas. Within the crisis economies, the unwinding of excess capacity built before the crisis, especially in domestic-oriented sectors like real estate and infrastructure, remains a protracted process. Earlier rebound in export-related investment is also being clouded by a weakening of export demand. In the financial sector, restructuring and recapitalisation efforts are generally disappointing, as evidenced from the slow reduction in non-performing loans and the need for additional injection of public funds in Korea and Thailand. On the political front, emerging nationalist and protectionist sentiment led by vested interest groups like labour unions in Korea, Thailand, and ethnic unrest in Indonesia have added to the uncertainties in the socio-political environment, and further inhibited the full recovery in investor confidence. All these factors are unlikely to be resolved quickly, and hence may lead to an extended period of sub-potential growth performance.

VI. Conclusion

Notwithstanding their V-shaped recovery and double-digit rebound in GDP growth in the early stage of their recovery, Asia thus far has not yet returned to its pre-crisis growth parth. In this aspect, Mexico seems to have fared better. Among the various demand components, relatively sluggish investment appears to be a major factor contributing to Asia's sub-potential recovery. This may be attributed to the impact of over-investment in Asia during the pre-crisis period, political instability in selected Asian countries, relatively large but weak banking sectors in the region, and Japan's economic malaise that aggravated the drain on foreign finance and investment. To the extent that these factors are responsible for Asia's sluggish investment and recovery performance, Asia's chance to regain its full pre-crisis growth potential in the near future may be discounted, given the discouraging outlook of, and the long-term nature in, resolving the above factors.

- Prepared by Nicholas Kwan and Miranda Cheng
of the Research Department