What Does the Asian Crisis Mean for the U.S. Economy?

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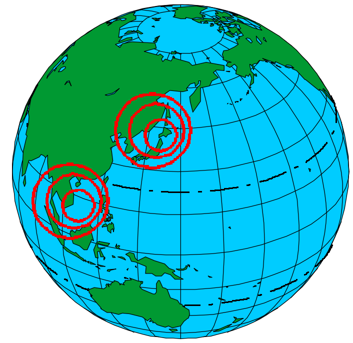


It has been nearly eight months since the Asian crisis began with the dramatic devaluation of the thai baht, but it has been only a little over three months since that turbulence began to shake U.S. financial markets. What was first seen as an isolated correction in an exotic East Asian currency is now being viewed as a potential catalyst to global financial meltdown. Is it now time to batten down the hatches and hope we don't get smashed in the Asian turbulence, or is the recent tumultuous period just a mild swell on otherwise calm waters?

The simple answer is that the direct impact on the U.S. economy will be modest but not trivial. Some industries will feel it more than others. The indirect impact from increased financial market uncertainty and spillovers into Japan and other emerging markets, however, has the potential to be much larger than the direct impact. Unfortunately, these indirect effects are particularly difficult to quantify.

Characteristics of the Asian Crisis

Asia has suffered a rather large economic and financial crisis, which has been characterized by the following three elements. First, there have been large devaluations. Currencies that were once pegged to the dollar have dramatically devalued. For example, the Indonesian rupiah is trading at one-fifth the value it had before the devaluation. Second, asset deflation has also been a problem. Asian stock markets have lost one-third of their value, and property prices have plummeted. Finally, because many banks are having liquidity problems, export firms that are set to benefit from the devaluation of the local currency can't even get letters of credit to fund purchases of raw materials. For example, the *Wall Street Journal* reported that a Korean company was unable to buy aluminum ingots because a Singapore bank was not willing to accept its letter of credit from a Korean bank.

If some of these problems seem reminiscent of the Texas Banking crisis of the 1980s, they should. Many of Asia's problems can be traced back to similar issues, such as risky ventures, government guarantees, and a lack of adequate supervision and regulation.

Overall, the current situation is quite serious, and the outlook for the next six months remains uncertain. However, recent signals indicate Asian markets may be regaining some calm.

As Figure 1 illustrates, since the thai baht devalued on July 2, 1997, most of the frontline Asian currencies have lost nearly half their value. Since mid-January, however, several of the currencies have begun to show some signs of stability as agreements have been negotiated with the IMF and international banks over debt payments and austerity measures. Indonesia, however, remains the exception. Its currency has devalued nearly 80% and has shown no signs of diminished volatility. A 10,000 rupiah note was worth about $4 last June; now it is just pocket change. Even though President Suharto of Indonesia has agreed to tough adjustment measures by the IMF, it is still not clear that he has the political power or the will to implement them. Furthermore, although some currencies have shown less volatility lately, we do not expect completely smooth sailing in 1998. There is likely to be further periods of turbulence interspersed with periods of stability as some banks are declared insolvent and some firms fail.

Asian equity markets, which had lost about one-third of their value *(figure 2)*, have also shown signs of improvement since the beginning of the year. Again, the improvement reflects positive policy pronouncements and less uncertainty about the nature of these countries' problems. However, like currency markets, expect periods of turbulence in asset markets in 1998.

Figure 1

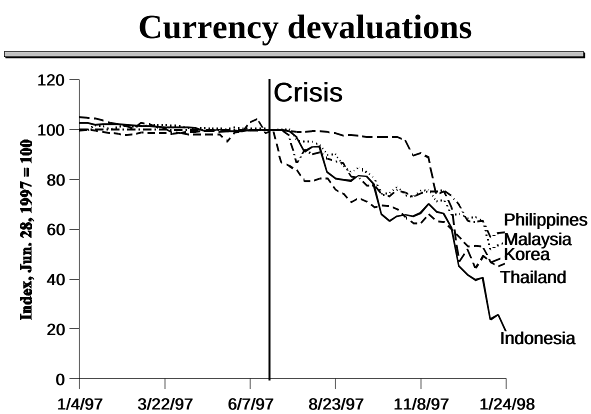
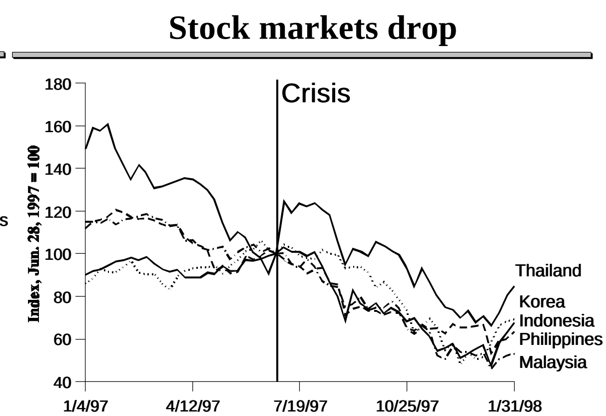


Figure 2



Most estimates for the region predict flat to slightly negative growth in real gross domestic product (GDP) for 1998. In contrast, real GDP in the region grew almost 8 percent per year between 1990 and 1997.

U.S. Markets Tied to Asia

If the United States were completely isolated from the rest of the world and did not trade with other countries, Asia's crisis would not have any effect on the United States. However, this is not the case. The United States trades heavily with Asia and benefits greatly from being able to export to and import from the region. We also benefit from lending money to the region at higher rates than we receive at home. Of course, these ties also mean that, at least to some degree, we're all in the same boat and turbulence on one side of the Pacific will affect us here on the other side.

Figure 3 shows our top five manufacturing exports and imports to the region as a share of our total trade with the Asian crisis countries. These are the U.S. industries that are most likely to be affected by the recent Asian turmoil. As the figure shows, electrical goods and machinery dominate both exports and imports with these Asian countries. In addition, imports from Asia are dominated by apparel, rubber products, and vehicles while our exports to Asia are weighted heavily toward the aerospace industry, optical equipment, and chemicals.

As Figure 4 shows, our trade with the Asian crisis countries has grown steadily since the mid-1980s, rising from around 5 percent of U.S. trade in 1986 to nearly 8 percent of total U.S. trade in 1997. It is interesting to note that our share of trade with these countries has declined slightly since 1995.

Figure 3

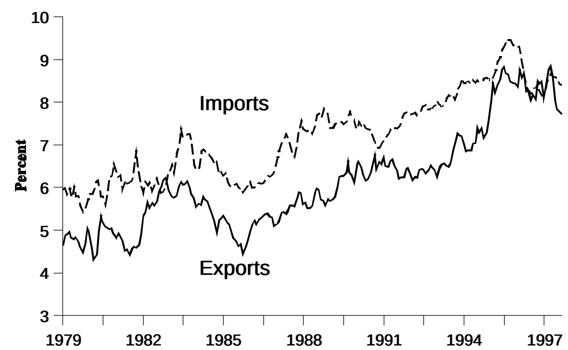
What we trade

IMPORTS	Percent
Electrical Goods	37
Machinery	20
Apparel and Clothing	9
Rubber Articles	3
Vehicles	3

EXPORTS	Percent
Electrical Goods	31
Machinery	18
Aerospace	10
Optical Equipment	4
Organic Chemicals	3

Figure 4

U.S. trade share with Asian crisis countries



One explanation for this decline is increased trade with Latin America, particularly Mexico, since 1995. As shown in Figure 5, Latin America's share of our imports grew substantially beginning in 1995, while trade with the Asian crisis countries declined. Greater openness in Latin America and Mexico's peso devaluation are probably responsible for this shift in trade shares and may have contributed to Asia's recent troubles.

U.S. direct investment in this region has also increased dramatically since the mid-1980s *(figure 6)*. Direct investment in the region was less than 500 million dollars in 1986; in 1996 it had grown to 4.5 billion dollars—an eight-fold increase.

Figure 5

U.S. import shares with Latin America and Asia

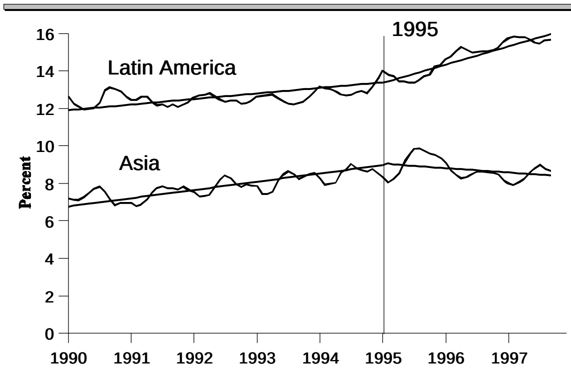
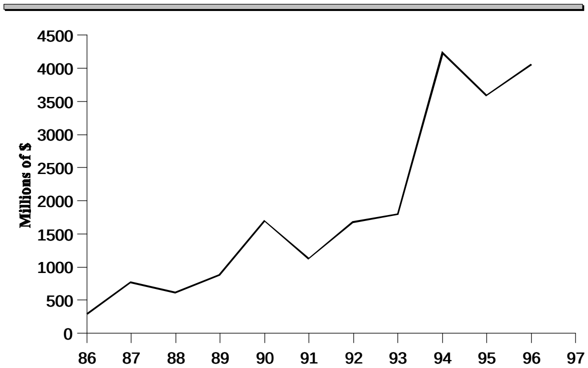


Figure 6

U.S. direct investment in Asian crisis countries



Because trade and capital flows are the economic points of contact between the United States and Asia, they will also be the channels through which the Asian crisis influences the United States. However, there are both positive and negative aspects to this influence, and the short-run effects may be very different from the medium-run effects.

The Positives and Negatives of the Asian Crisis

On the positive side, the lower value of Asian currencies causes import prices to fall, benefitting consumers and manufacturers that use imported Asian inputs in their production process. Lower import prices also can reduce inflation in the near-term.

Another positive from the Asian crisis is that we may be the beneficiary of capital inflows as the U.S. is considered a safe haven. The capital inflows lower U.S. interest rates which benefit borrowers in general and the construction industry in particular.

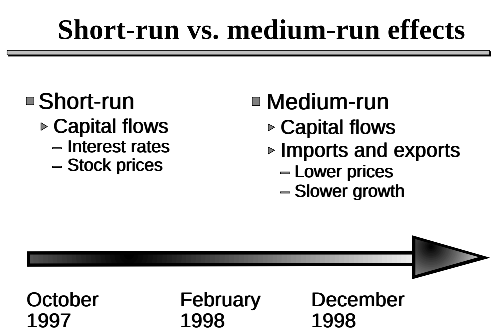
Finally, corporate profits can rise in those sectors that benefit from cheaper imported products and lower interest rates, like the retail and construction sectors. Higher corporate profits can have positive wealth effects for those who hold stocks in these sectors. Employment in these sectors can rise as well.

There are also a number of negatives to the Asian crisis. Cheaper imports can make it difficult for sectors that compete with imported Asian goods, for example apparel manufactures. However, this effect may be muted right now because of financing problems in Asia and the difficulty some exporters are having in purchasing raw materials. A large drop-off in Asian demand for our products could lead to a fall in U.S. exports. Korea reported that its demand for foreign goods fell 40% in January from year-earlier levels. Lower interest rates also have adverse effects on some sectors, particularly savers. Finally, corporate profits will fall in those sectors that suffer from reduced export demand, greater import competition and market uncertainty. This can depress stock prices, reduce wealth, and lead to employment losses.

Short-run and Medium-run Effects of the Asian Crisis

The effects of the Asian crisis are also not likely to be the same across time *(figure 7)*. In the short-run, financial markets dominate goods markets. The impact we have experienced since October of last year has mainly come from financial markets. Capital inflows reduced interest rates, and stock prices (in general) took a hit from expectations of reduced profits and greater market uncertainty.

Figure 7



Over the next three to six months, capital flows are likely to stabilize as market uncertainty falls, but the impact on the goods market will begin to be felt through lower import prices and reduced exports and a slowing in some sectors of the economy.

The Effects of the Asian Crisis on the U.S. Economy

The Asian crisis will likely put downward pressure on U.S. inflation and economic growth in 1998. Most private sector economists estimate that, assuming that it does not mushroom into a worldwide financial crisis, the Asian crisis will lower U.S. GDP growth by between one-half and one percentage point in 1998.

Initial Effects

Before examining more detail on these overall estimates for 1998, consider some evidence on how the U.S. economy is already responding to the Asian crisis. First, stock prices have generally traded in a flat range since early-October, after rising on a strong upward trend in the three prior years. This flattening suggests that the Asian crisis is removing a source of economic stimulus rather than imparting an outright negative wealth effect. Nevertheless, the less rosy outlook for profit growth is apparently inducing some U.S. firms to announce a new series of restructurings designed to bolster their bottom lines. Indeed, according to the employment firm Challenger, Gray and Christmas, announced layoffs in December 1997 were 56 percent higher than they were in December 1996, even though announcements through the first eleven months of 1997 were nearly 15 percent *below* those posted through the first eleven months of 1996.

On a brighter note, for reasons mentioned earlier, the Asian crisis has already induced a decline in interest rates, such as the 30-year Treasury rate shown in Figure 8. These interest rate declines have boosted some sectors, especially mortgage markets, where mortgage refinancing activity *(figure 9)* and applications to buy homes *(figure 10)* are setting records. Because rising mortgage applications indicate a further rise in overall home sales, the Asian crisis has already stimulated construction and benefitted homebuilders like Dallas-based Centex whose stock price has recently outperformed the S&P 500 by rising roughly 15 percent since early October.

On the other hand, the negative effects of the Asian crisis on traded goods industries may be showing through to durable goods orders, which are a leading indicator of investment spending *(figure 11)*. After surging in November, durable goods orders plunged in December, led by a big decline in aircraft orders. Cutting through the November spike, durable goods orders appear to have flattened out since September.

More timely data from the purchasing managers survey from January imply that an even bigger Asian crisis effect is forthcoming. As shown in Figure 12, an index of import orders has firmed slightly since October, whereas export orders have plunged in the last two months. Together, these indexes imply that the U.S. trade deficit will widen substantially in early 1998. In addition, the Asian crisis is apparently reducing the backlog of U.S. orders. For example, Boeing has seen cancellations of some prior plane orders.

Uncertainty Surrounds Estimates of the Output Effects

Most analysts are expecting a negative overall effect of the Asian crisis on U.S. GDP growth. Nevertheless, the magnitude of the negative effect is uncertain. For example, there are sizable differences between two scenarios in which the Asian crisis has conventional trade and wealth effects *(figure 13)*.

Figure 8

The Asian crisis pushes down interest rates

Figure 9

...spurring households to refinance their mortgages...

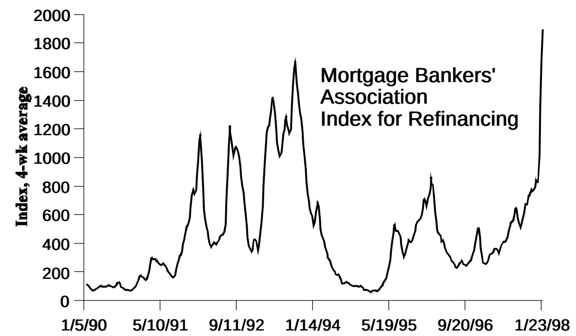


Figure 10

...and purchase homes

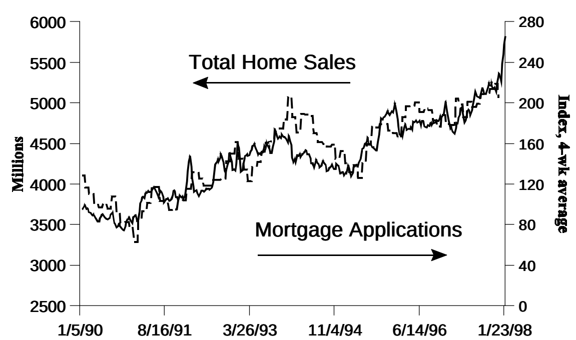


Figure 11

Durable goods orders surge in November but plunge in December

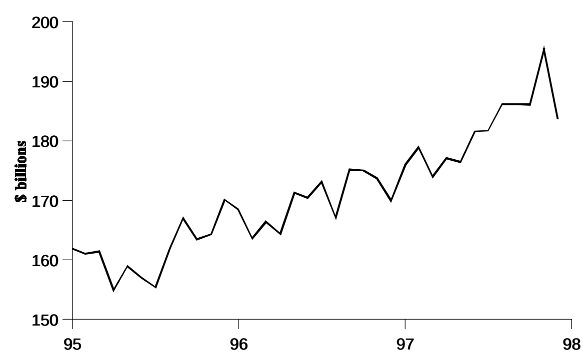


Figure 12

Purchasing managers' survey shows real signs of the Asian crisis

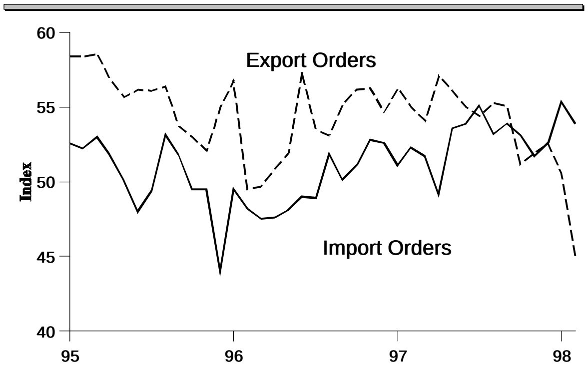
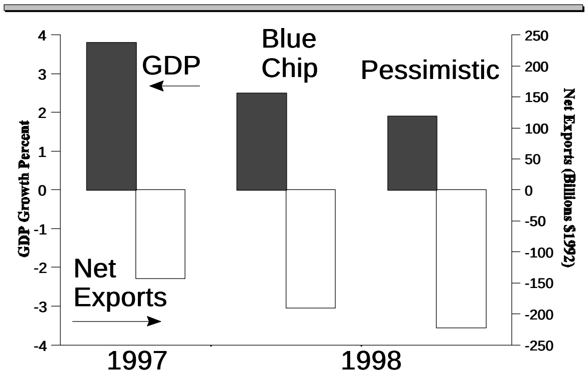


Figure 13

GDP and trade scenarios



The first scenario is based on the average forecasts from the January Blue Chip Survey of economists. According to this scenario, U.S. net exports will deteriorate from a deficit of $141 billion to nearly $190 billion (1992 dollars), while GDP growth decelerates to an annual average of 2.5 percent.

The second scenario, that of Chase Securities, is the most pessimistic of the Blue Chip Survey respondents. According to this scenario, real net exports fall to an annual average deficit of $221 billion. The larger estimated deficit reflects, among other things, both larger assumed impacts of the Asian crisis on Japanese and Asian economic growth, and larger assumed impacts of higher interest rates on Latin American economies. This scenario predicts that the drag from net exports will pull GDP growth down to below a one-percent annual rate in the second and third quarters. According to Chase, this mid-year slump will spur the Federal Reserve to cut the federal funds rate by one-half of a percentage point.

Thus, there is a substantially wide range of conventional Asian crisis scenarios. The uncertainty surrounding the impact of the Asian crisis is compounded by several other factors. First, neither of the scenarios assumes that the Asian crisis will cause a financial crisis in Japan, Latin America or Eastern Europe, something which would magnify the effects already in train. Second, the restructuring of the Asian economies away from a model of export-led growth to a more market-driven system may be more drawn out and pronounced.

Third and finally, the experience of the Mexican peso crisis of 1994 provides only some limited guidance. It took about two quarters before U.S. net exports with Mexico hit bottom following the late-1994 plunge in the peso. Arguably, it may take longer for U.S. net exports to roughly hit bottom following the Asian currency meltdown because the peso crisis differs in some respects. For example, the rescue plan was drawn up more promptly in the case of Mexico, and Mexico more readily adopted reforms—especially compared to Indonesia.

Uncertainty Also Surrounds Estimates of the Inflation Effects

There is also some uncertainty surrounding how much downward pressure the Asian crisis will put on U.S. inflation. In general, the strengthening of the dollar against East Asian currencies is expected to cut CPI inflation by one quarter to one-half of a percentage point this year. In addition, the Asian crisis has, along with other factors, also put downward pressure on oil prices. Together, these effects will work to lower inflation, particularly in early 1998, which will help counteract price pressures arising from tight labor and real estate markets.

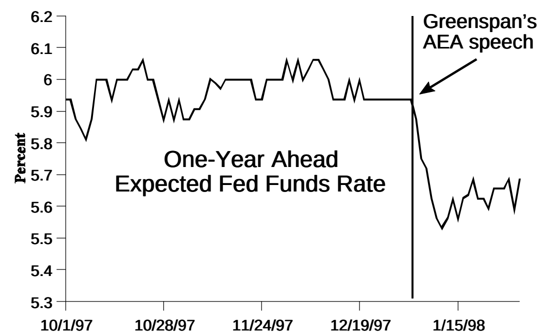
Note, however, that energy and import price declines prior to the Asian crisis had already cut U.S. inflation last year. Thus, to some extent, much of Asia's effect on inflation will merely maintain prior downward price pressure from foreign and energy sources. For this reason, the Asian crisis will cause less of a further deceleration in CPI inflation this year than some analysts believe.

Implications for Monetary Policy

The Asian crisis has several implications for monetary policy. Prior to the crisis, it appeared that domestic price pressures were building in an environment of unsustainably fast economic growth that led markets to expect the Fed to tighten policy. Indeed, prior to this year, the financial markets had expected the Fed to hike the federal funds rate from 5.5 to 6 percent by year-end 1998. However, following Chairman Greenspan's remarks to the American Economic Association in early January, markets have upwardly revised their estimates of how much the Asian crisis will dampen GDP growth and inflation. So much, in fact, that market participants now assume, on average, that the Fed will be on hold this year *(figure 14)*. Indeed, some Fed watchers have argued that the Asian crisis has done the tightening for the Fed, with the added bonuses of keeping interest rates down, pushing inflation lower right away, and putting less downward pressure on stock prices.

Figure 14

Markets no longer expect the Fed to tighten



Recent data show the conflicting effects of the Asian crisis. In general, domestic demand has been stronger than markets have anticipated, but at the same time, market analysts now generally forecast larger effects of the Asian crisis on net exports. In addition, Asian crisis effects on inflation imply that the inflation-adjusted or real federal funds rate will rise in early-1998 if the Federal Reserve maintains the current funds rate target.

In 1998, we will face a highly fluid and changing economic environment in which the first and second halves of this year could differ greatly. For example, declines in import and energy prices will likely cause inflation to slow in the first half. These effects, however, may be offset in the second half if rising cost pressures from tight labor markets dominate. In addition, net exports will likely fall hard in the first half, as slower Asian growth and the stronger dollar hit exports and boost imports. How much will the stimulus of lower long-term interest rates cushion this effect? As the year unfolds, it will eventually become clearer whether the economy will slow too little, just enough, or too much from the Asian crisis. If the outlook for growth slows too little, we'll need to tighten. If too much, we'll need to cut the funds rate. As shown by the newly released minutes, this uncertainty led the FOMC to keep the funds rate unchanged and adopt a symmetric policy directive in December.

In addition to dealing with a tale of two halves, we will face a tale of two economies, reflecting the positive and negative effects of the Asian crisis mentioned earlier. On the one hand, traded goods sectors, like manufacturing and oil, will slow. On the other hand, nontraded sectors will gain from the lower interest rate environment, especially construction. Falling rates will induce mortgage refinancings, thereby cutting mortgage payments, increasing household discretionary income, and boosting consumer spending. Falling rates will also allow corporations to refinance their debt, thereby cushioning cash flow and investment from Asian effects.

The Effects of the Asian Crisis on the Texas Economy

Because the Asian crisis will affect industries differently, it will likely have an uneven effect across the regions of the United States. Fortunately, Texas is in a good position to avoid the brunt of the storm. From a Texas perspective, if we have to have an Asian crisis, now is a good time for it.

The Texas economy has been expanding briskly *(figure 15)*. For the ninth consecutive year, employment growth exceeded the national average in 1997. Total nonfarm employment increased 4.2 percent, with strong growth in all major industry groups.

For a variety of reasons, the outlook calls for continued healthy growth in Texas. While the Asian crisis has increased uncertainty about the economic outlook for 1998, the U.S. and Mexican economies are expected to slow only moderately. Oil price futures indicate that the price of West Texas Intermediate Crude should return to the $18–19 range, which is a price range that supports continued strong drilling activity. The construction industry should get a boost from low vacancy rates and recent tax law changes that favor investments in housing. The recent move to expand home equity lending in Texas should generate a one-time boost in economic activity in 1998, as homeowners gain better access to their largest asset. One UT study estimated that the temporary stimulus could be equivalent to a 9-percent increase in Texas retail sales. The Texas leading index continues to signal expansion.

However, because certain industries are more exposed to the Asian crisis than others, the crisis is likely to have a meaningful effect on the composition of the Texas economy. As was the case for the U.S. economy, the Asian crisis will affect Texas industries through its effects on interest rates and international trade flows.

Figure 16 presents some of the interest-sensitive industries in Texas that are particularly likely to benefit from lower interest rates in the wake of the Asian crisis. If historical patterns are any guide, the construction industry is likely to gain employment almost immediately, while employment gains in other highly sensitive industries are unlikely to appear until late 1998 or even 1999.

Figure 15

1997 Texas growth surpassed U.S.

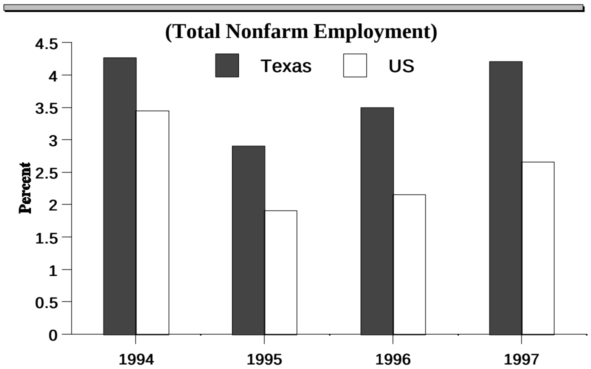


Figure 16

Effects of the Asian crisis on selected Texas industries

	Interest Rate Effects	Trade Effects
Agriculture		–
Chemicals		–
Construction	+	
Energy		–
Fabricated metals	+	
Primary metals	+	
Retail		+
High-tech		
Computers	+	+
Semiconductors		–

The terms of trade effects will be more mixed. Not surprisingly, retailers and other importers should gain, while import-competing industries and exporters should lose. Because they represent a large share of our exports to Asia, agriculture and chemicals manufacturing are particularly likely to lose sales in the wake of the Asian crisis.

One interesting terms of trade effect is the sharply falling price of semiconductors. While it would be inappropriate to attribute all of the recent price declines to the Asian crisis, it has undoubtedly contributed to the decline. The net effect of the Asian crisis on the Texas high-tech industry is difficult to determine, however, because lower chip prices benefit Texas computer manufacturers like Compaq and Dell, while they hurt Texas manufacturers of semiconductors and semiconductor equipment like Texas Instruments, Motorola, and Applied Materials. Our best guess is that the net effect will be negligible.

An important factor in determining the net trade effects of the Asian crisis will be its impact on Texas trade with Mexico. Although Texas exports considerably more to Mexico than it does to Asia, Mexico and Asia (broadly defined) have historically acted like substitute markets for Texas products. For example, a temporary surge in exports to Asia nearly offset the drop in exports to Mexico following the peso crisis *(figure 17)*. Such a pattern is not surprising since, to a large extent, the industries that dominate Texas exports to Asia— electronics, nonelectrical machinery, and chemicals—also dominate Texas exports to Mexico. If history repeats itself, then an increase in exports to Mexico could dampen the impact of the Asian crisis for Texas exporters.

On net, the Texas impact of the Asian crisis will probably depend on its effect on oil prices, not only because Texas continues to lose from lower oil prices but also because Mexico loses from lower oil prices. Assistant Vice President Stephen Brown estimates that the Asian crisis can explain between one-quarter and one-third of the recent decline in the price of oil *(figure 18)*. As such, the crisis only slightly dampens the forecast for Texas. We still expect Texas employment to grow nearly 3 percent in 1998.

Figure 17

Asia & Mexico can be substitute markets for Texas goods

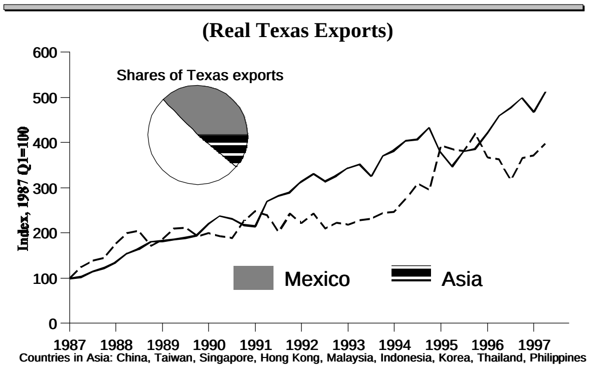
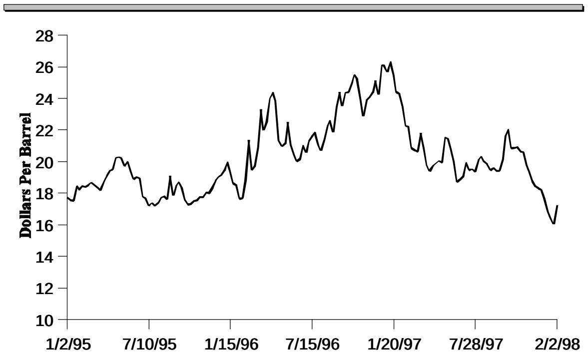


Figure 18

West Texas Intermediate Crude



Conclusion

Asia has suffered a significant economic crisis, but its financial markets are beginning to stabilize. Unless the recent calm is merely the eye of the storm, the Asian crisis should have only a modest impact on the U.S. economy. The crisis should moderately slow U.S. output growth and temporarily reduce U.S. inflation. In Texas, the net effects of the crisis will arise primarily from its modest impact on oil prices.