



Portfolio Strategy Service

#37 New Era Recession?

#38 Fed's Stock Market Model Finds Overvaluation

#39 The Baby Boom Chart Book 1997

#40 Is Asia Minor?

Topical Study #41

ASIA'S GREAT LEAP: FORWARD OR BACKWARD?



Dr. Edward Yardeni
Chief Economist

February 10, 1998

E-Mail: yardeni@ix.netcom.com

Web Site: <http://www.yardeni.com/>

I. From Crony Corruption To Arms-Length Capitalism

Capitalism defeated Soviet communism at the end of the 1980s. I argued that this was wildly bullish for stocks.¹ Now, it appears that capitalism is defeating corruption in Asia. Isn't this also bullish? Yes, it is. However, corruption has been on the planet Earth much longer than either capitalism or communism. Asia's great transformation from corruption to capitalism will take some time and is bound to be turbulent.

It is possible, I suppose, that the US stock market can look past Asia's current turmoil and discount future opportunities. However, the many long-term benefits of Asia's transformation are likely to be offset by several short-term bearish influences on the United States, including a widening trade deficit, deflationary pressures on prices and profits, and probably a wave of corporate restructuring and layoffs.

Nevertheless, I must admit that I am very impressed by the pace of change in Asia. Up until now, I have put mostly a negative spin on the Asian Crisis. See, for example, my previous *Topical Study #40*, "Is Asia Minor?" dated November 17, 1997. Now, I believe, is a good time to adopt a more neutral, open-minded, stance on developments in Asia. In this spirit, let me list some encouraging recent events:

1) Huge Bailout In Japan. In Japan, the government-sponsored Resolution and Collection Bank will be authorized to spend a whopping ¥30 trillion (\$250 billion) to assist the troubled banking sector. ¥10 trillion (\$83.3 billion) will be raised by issuing government bonds. The rest will be borrowed by the RCB from the Bank of Japan and guaranteed with public funds. Of the total, ¥17 trillion will go to assist banks that acquire failed institutions. The rest will be used to buy preferred stock in selected banks.

Some of Japan's bigger and better-quality banks are starting to raise capital by issuing preferred stock to bolster their Tier One capital so that they will meet the requirements of international regulators. A recent Sumitomo Bank deal was oversubscribed. Industrial Bank of Japan and Fuji Bank intend to come to market soon with preferred stock.

There is much that I don't like about the Japanese government's bail-out approach. It minimizes disclosure and continues to give secretive bureaucrats enormous power. It also will prop up some banks that are probably insolvent and should be closed. However, it is a huge pile of money and demonstrates that the government is very serious about finally fixing the banking system in Japan.

¹ *Topical Study #17*: "The Triumph Of Capitalism," (Aug. 1, 1989). *Topical Study #20*: "The Collapse Of Communism Is Bullish," (Sep. 4, 1991). *Topical Study #23*: "The End Of The Cold War Is Bullish," (Sep. 10, 1993). *Topical Study #34*: "Populist Capitalism And Other Wildly Bullish Themes," (Feb. 25, 1997) *Topical Study #35*: "The Economic Consequences Of The Peace," (May 7, 1997). You can find most of these at <http://www.yardeni.com/topical.html>.

2) Arrests In Japan. The recent arrest of two Ministry of Finance officials is perhaps the most important sign that Japan's transformation away from corruption is for real. Furthermore, the Bank of Japan (BOJ) is investigating about 600 current and former officials in their dealings with private-sector bankers in the last five years. A BOJ official said the central bank decided to carry out the internal probe in response to a Japanese media report that said two incumbent BOJ officials allegedly received "excessive favors" from Japan's banks.

3) Asians Restructure Financial System. At the end of January, Korea's Ministry of Finance and Economy announced that it was closing one-third of the country's 30 merchant banks that were forced to suspend their operations in early December. The remaining 20 have until March to devise restructuring plans. A bridge bank assumed the assets and liabilities of the ill-fated 10 banks. The government also successfully negotiated with international creditors to turn \$24 billion in short-term loans into long-term debt.

In Kuala Lumpur, the Finance Ministry is prodding Malaysia's 39 relatively weak finance companies to merge into six stronger groups by March 31. The government can't force the mergers, but officials indicated they won't bail out institutions that don't cooperate with the merger plan.

Indonesia has a de facto debt moratorium on \$65 billion owed by the country's businesses to more than 200 foreign banks. The IMF recently established a steering committee of the creditors and borrowers to establish a framework for restructuring this debt. In addition, Indonesia plans to hire the world's six biggest accounting firms to audit 120 privately owned banks as part of a program to repair the country's battered banking system. The plan is to audit half by March and the rest by July.

II. Economic Pain & Resistance Will Follow Reform Gains

These latest reforms are very significant. However, these gains are setting the stage for massive restructuring of Asian economies. Reforms will initially exacerbate Asian economic recessions in 1998. This will be painful as unemployment soars. The risk is that there might be a backlash against reforms and the IMF. Indeed, the first major setback may be unfolding in Korea.

In a major concession, Korea's labor union leadership agreed in early February to the legalization of layoffs. This is vitally important to attract foreign investment to South Korea and to give Korean business managers the flexibility to restructure their companies. Without this reform, the \$57 billion IMF bail-out plan signed in December would have failed.

The agreement was struck by a three-party committee of government officials, business leaders, and unionists formed by President-elect Kim Dae Jung. He has long been a supporter of the union movement, but now champions a more flexible labor market. In return, the government will increase unemployment insurance. The plan is likely to be endorsed by the National Assembly sometime this month.

Unfortunately, 300 heads of individual unions rejected the deal by a 3-to-1 margin and threatened to strike. The leadership of the Confederation of Korea Trade Unions resigned after the vote.

Unemployment is likely to rise significantly in South Korea later this year assuming the new law allowing massive layoffs is passed. A severe credit crunch is causing numerous business failures. In December alone, 3,197 companies sought protection from creditors, triple the year ago pace. Car sales are down 50% from a year ago.

Last year in Japan, 16,365 businesses failed, the highest number of bankruptcies in over a decade. Another big wave of failures is likely this year because Japanese banks are lending less as they struggle to clean up their own books.

A drought caused by El Niño and dramatic devaluation of the rupiah are causing food prices to soar in Indonesia, the fourth most populous nation on earth with 201 million people. In January, food riots erupted in several towns in Indonesia's East Java Province. More recently, unrest was reported on Sumbawa island and in Jakarta, the capital. In Malaysia, troubled finance companies employ about 88,000 workers, and 30% could lose their jobs.

III. Asian Flu Contained?

Since late last year, economists and investors have strived to assess whether Asia matters to the rest of the world. The optimists, who believe that Asia doesn't matter, expect economic growth in the United States, Europe, and Latin America to more than offset Asian recessions in 1998. Lazlo Birinyi noted recently that the entire capitalization of South Korean stock market at \$60 billion is smaller than that of American Home Products. Malaysia's market is no bigger than the value of Philip Morris.

I think Asia matters a great deal. I believe that recessions in Asia will depress economic and profits growth around the world:

1) Commodity Prices Plunging. I've been monitoring the CRB raw industrials spot price index as one way to assess whether Asia matters. The yearly percent change in this index is highly correlated with the growth of both G7 industrial production and S&P 500 profits. This sensitive price index plunged during November through early February, reversing roughly 50% of the previous big rise during 1994 (Exhibits 1, 2, and 3).

The special focus of the December 3, 1997 issue of the *Weekly Economic Briefing* was "Oil demand: Is Asia minor?"² Debbie Johnson and I estimated that Asian oil demand could fall by one million barrels a day. The recent drop in oil prices confirms this forecast (Exhibit 4).

² <http://www.yardeni.com/webin.html>

2) Asian Imports Plunging. In the three months through January, South Korea's trade balance swung into surplus largely because of a big drop in imports of capital goods and luxury items. Qualcomm Inc., a maker of wireless-communications equipment, recently announced that two South Korean manufacturers canceled orders of its circuits and \$60 million for digital phones. The company plans to lay off 700 temporary employees because of the downturn.

3) US And German Exports Plunging. In my previous *Topical Study*, I predicted that the cancellation of numerous projects in Asia would depress capital goods exports, especially from the United States and Germany. Sure enough: In the United States, the New Export Orders index compiled by the National Association of Purchasing Management declined 5.6 percentage points, to 45%, in January. This is the first time that it has been below 50% in the past 24 months (Exhibit 5).

German factory orders fell 0.9% in December, the fourth consecutive monthly decline. Capital goods orders are especially weak, led by a big plunge in export orders (Exhibits 6 and 7). Both German and French government leaders were counting on booming exports to fuel a more broad-based recovery in their economies this year. Now, any export-led slowdown could drive already high unemployment even higher (Exhibit 8).

4) Latin America On The Verge Of Plunging? Brazil pushed interest rates above 40% last October to defend its currency against a speculative attack during the Asian Crisis. Policymakers there still don't feel confident enough to lower interest rates. Tight credit conditions are starting to depress consumer and business spending. To avoid paying such high interest rates, the government issued \$34 billion in dollar-linked debts by the end of 1997, or about two-thirds of the country's total hard-currency reserves. Brazil's currency has been weak recently. The Mexican peso is also starting to look weak again.

Chile, the third largest economy in Latin America, may be suffering the most in the region from the turmoil in Asia. The country is a major exporter of copper. Since June 1997, the price of scrap copper has plunged from 98 cents to 62 cents per pound.

IV. The Taiwan Model

With so much turmoil in Asia, the stability of Taiwan is truly impressive. Why is Taiwan different? The government has meddled less in the economy and has not embraced the "industrial policy" approach that failed so badly in Southeast Asia. Taiwan's economy isn't dominated by a few large highly leveraged corporations as in South Korea. Rather more than one million small and medium-sized companies are financed largely by equity investments of individual shareholders, not bank loans. The government does not bail out bankrupt companies. They are allowed to fail. The country has very little foreign debt and a large pile of foreign reserves.

V. China's Promise

Chinese President Jiang Zemin and his associates see the Asian economic crisis as an opportunity to enhance China's influence in Asia and gradually to build political pressures that would force the United States to withdraw its military forces. These political considerations have led Chinese leaders to promise that they will not devalue their currency. Behind the currency pledge are \$140 billion in foreign-exchange reserves. China's holdings are second only to Japan's \$228 billion. Chinese officials say China will give more than \$1 billion to Indonesia and has given \$1 billion to Thailand.

In many ways, China's economic and financial situation is at least as bad as its neighbors', if not worse. According to the November 4, 1997 issue of *The Wall Street Journal*, nonperforming loans are around \$200 billion, or five times the equity capital of all Chinese banks: "China's banking system is essentially insolvent." At least 50% of China's state-owned companies are in the red. Deflation may already be setting in for the first time since free market policies were first promoted 20 years ago. Much of the recent slowing of the economy is attributable to Beijing's decision to stop supporting the 47% of state-owned companies that are losing money. The crisis in the rest of Asia can only worsen China's economic outlook. It is conceivable that economic considerations might dominate political goals and force the Chinese to devalue their currency. Maybe they won't do so this year. But they might in 1999.

VI. Opening Jurassic Park In Asia

The Asian Crisis is both a short-term setback and a long-term opportunity for most multinational companies. This is especially true for US companies that were blocked from expanding in the region by protectionist policies. Now Asian governments are rushing to open their economies to attract badly needed foreign investment. Of course, given the dramatic devaluations in the region, there are lots of great bargains available to American multinationals.

- 1) **General Motors** bought out President Suharto's half-brother's 40% stake in GM Buana Indonesia, which builds vehicles there. The company is in talks with Daewoo Motor Corp. of South Korea. Both Ford and Chrysler are also shopping in the region.
- 2) **Coke** paid \$500 million for the company's South Korean bottler and \$50 million to increase Coke's share of its Thai bottler to 49% from 45%. **Proctor & Gamble** bought South Korea's Ssangyong Paper, which makes diapers and other paper products.
- 3) **Citibank** is examining the books of First Bangkok City Bank, a major bank in Thailand, for possible acquisition. **Prudential Securities Inc.** has agreed to buy parts of Nava SC Securities (Singapore) Pte., including seven of its seats on the Hong Kong Stock Exchange. **Merrill Lynch** may buy part of the branch network of Yamaichi Securities. **Fidelity Investments** is opening counters in Japanese banks.

VII. Greenspan's Advice To Asia: More Transparency

In his January 30, 1998 Congressional testimony, Federal Reserve Chairman Alan Greenspan supported the IMF approach to dealing with the Asian Crisis³. He acknowledged the logic of opponents who prefer a hands-off, free market approach. However, he argued that while the odds were low that a do-nothing approach would lead to a global economic and financial meltdown, such an outcome would be so catastrophic that it is better to let the IMF meddle.

Basically, Mr. Greenspan believes the IMF approach can buy the time needed by Asian nations to improve the efficiency of their domestic market system: "Here a major improvement in transparency, including both accounting and public disclosure, is essential." Markets can work to avert extreme disequilibrium, e.g., the Asian financial turmoil, only if market participants have all the information they need to make rational decisions that give appropriate weights to both risks and rewards. I believe, as does Mr. Greenspan, that the government has an important role in a free-market system, specifically, regulating and supervising the market so that it remains free.

VIII. Building The Foundation Of Capitalism

Most Asian nations do have relatively free markets for goods and services. And they have some of the world's finest manufacturing plants and best workers. They are as productive as any you'll find in the industrialized capitalist economies of North America and Europe. Driven by the profit motive, Asians have prospered greatly over the past three decades.

However, under the thin veneer of capitalism there has been too much corruption. In the world's free markets for manufactured goods, Asians have been world-class competitors. But, at home, they've stifled competition. They've developed the industrial and technological infrastructure necessary to sustain export growth. But, at home, they've made little progress in establishing the legal, accounting, and regulatory infrastructure of capitalism necessary to sustain economic growth. Asia's prosperity has benefited mostly Asia's producing classes rather than the consumers. Asians have embraced free-market capitalism globally, while maintaining an antiquated culture of mercantilism and crony corruption at home.

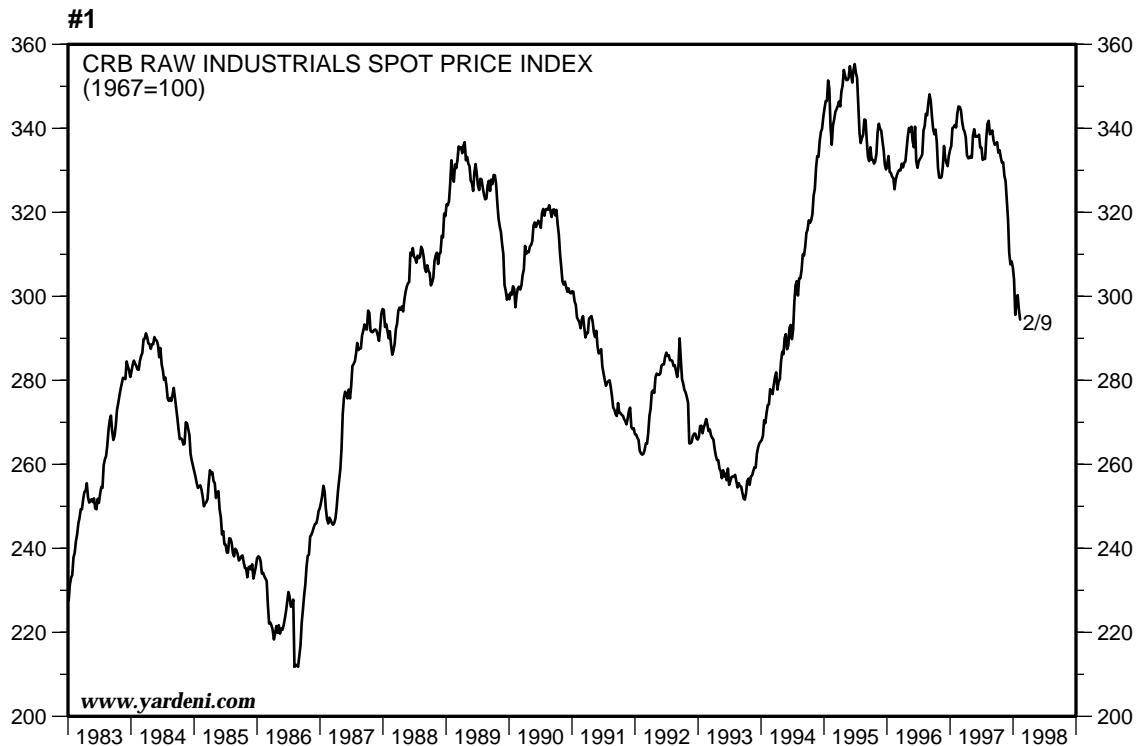
This could all change as a result of the Asian Crisis. It could change for the better or for the worse. Asians could turn xenophobic and protectionist, blaming "Westerners" for their recent woes. I'm optimistic they'll go the other way: They'll turn more capitalistic by rooting out corruption. They will build the legal, accounting, and regulatory foundations of capitalism that they need to revive their economies and prosper in the coming millennium. Hopefully, Asians are about to take a great leap forward, rather than backward.

* * *

³ <http://www.bog.frb.fed.us/BOARDDOCS/TESTIMONY/19980130.htm>

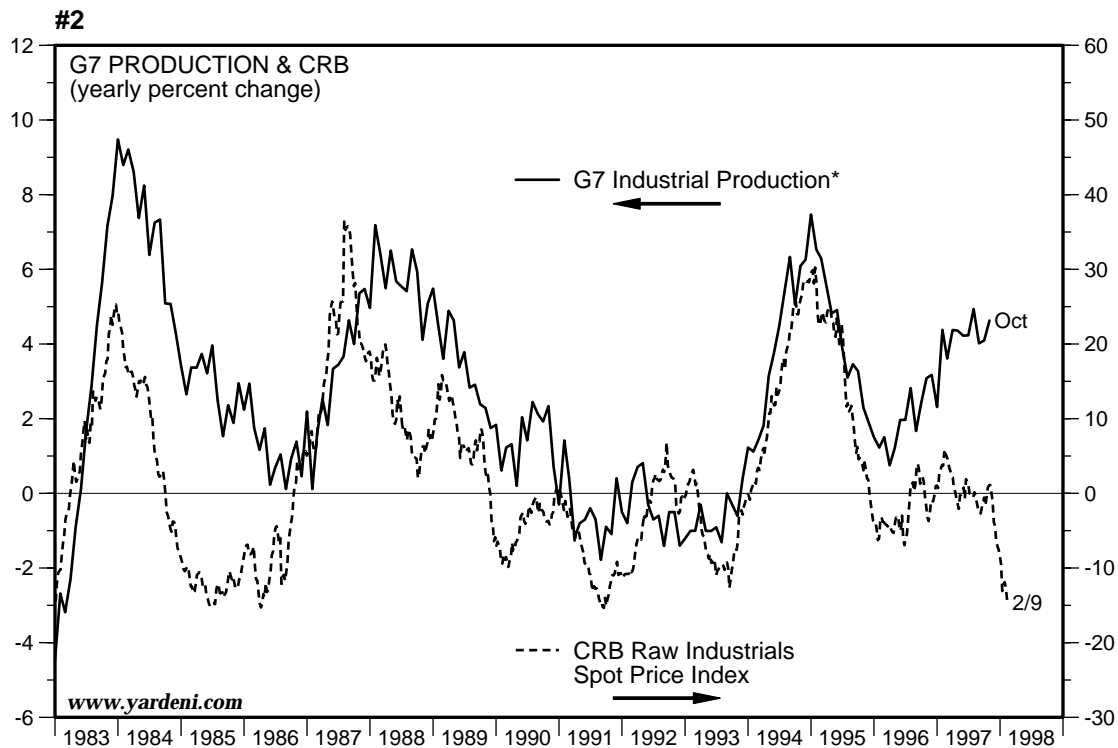
- Commodity Prices -

Asian Crisis likely to push commodity prices lower.



* Weekly Tuesday data. Includes copper scrap, lead scrap, steel, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, tallow.

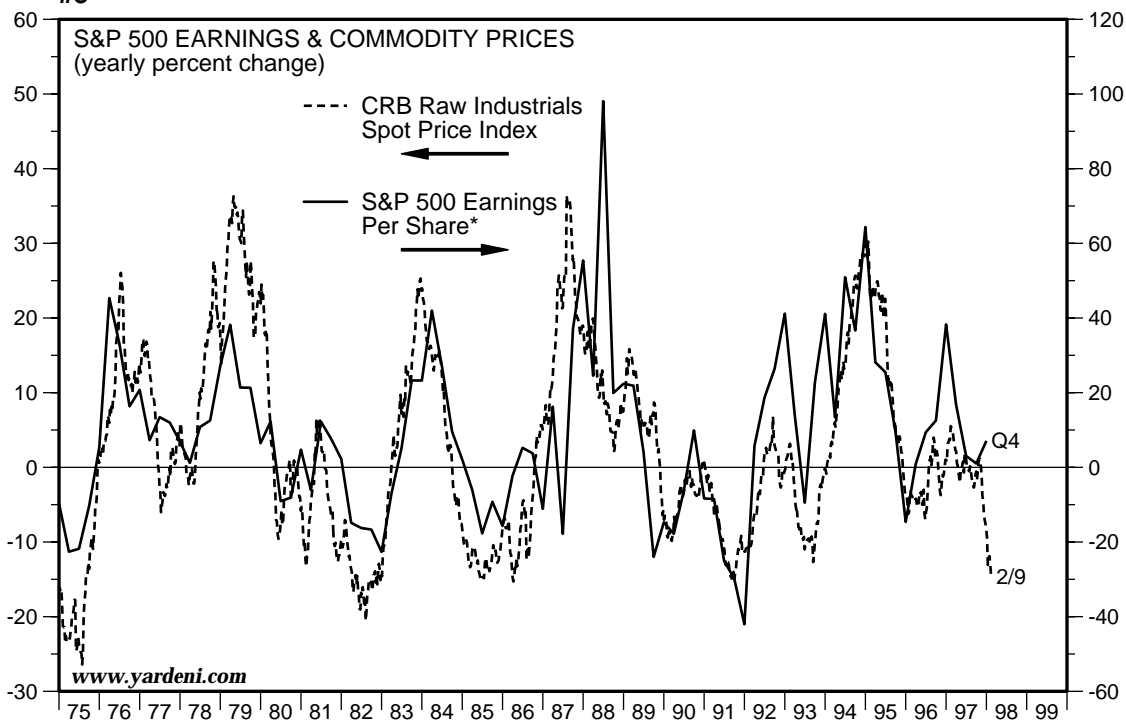
Industrial commodity prices suggest slower economic growth even in G7 economies.



* Includes United States, Japan, Germany, United Kingdom, Canada, France and Italy.

- Commodity Prices -

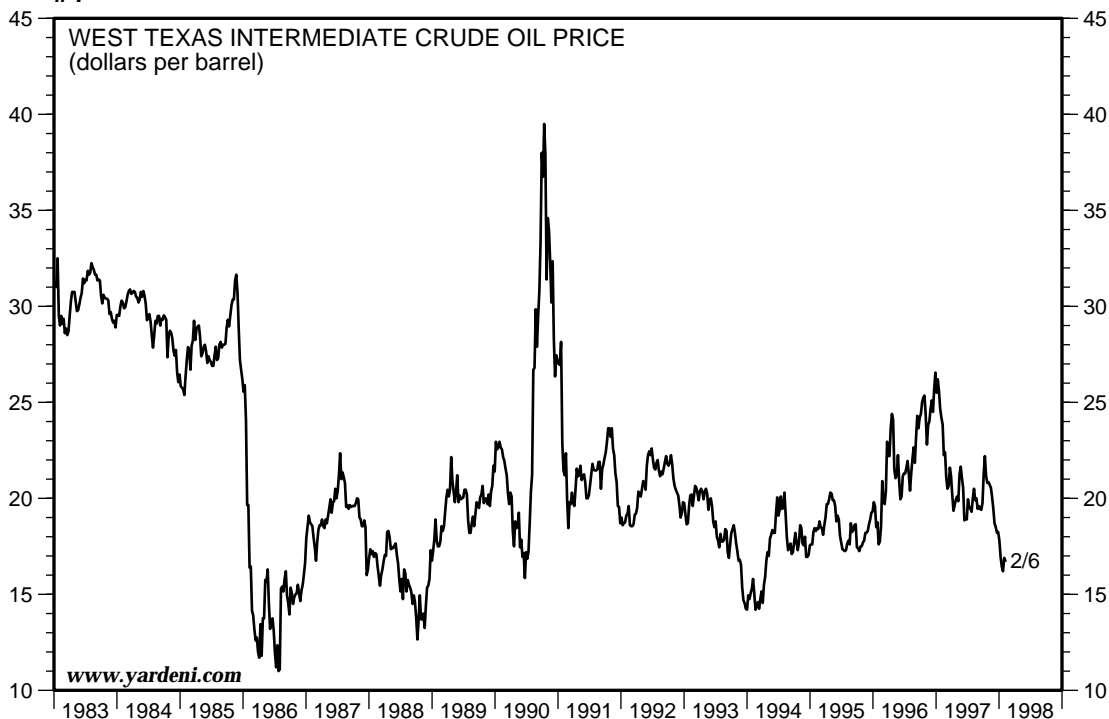
#3



Asian Crisis suggests pricing will be very tough in 1998, which is likely to depress profits growth.

* Reported earnings.

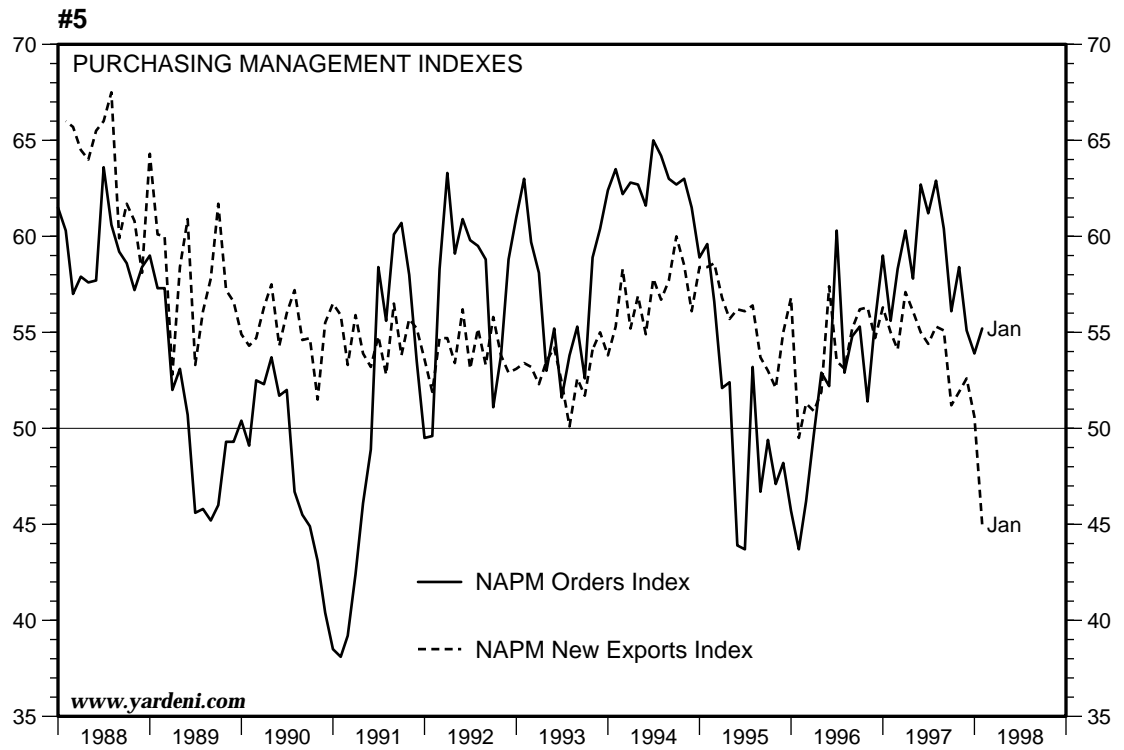
#4



Asian crude oil demand likely to fall by 1 million barrels per day in 1998. This is already discounted in the oil market.

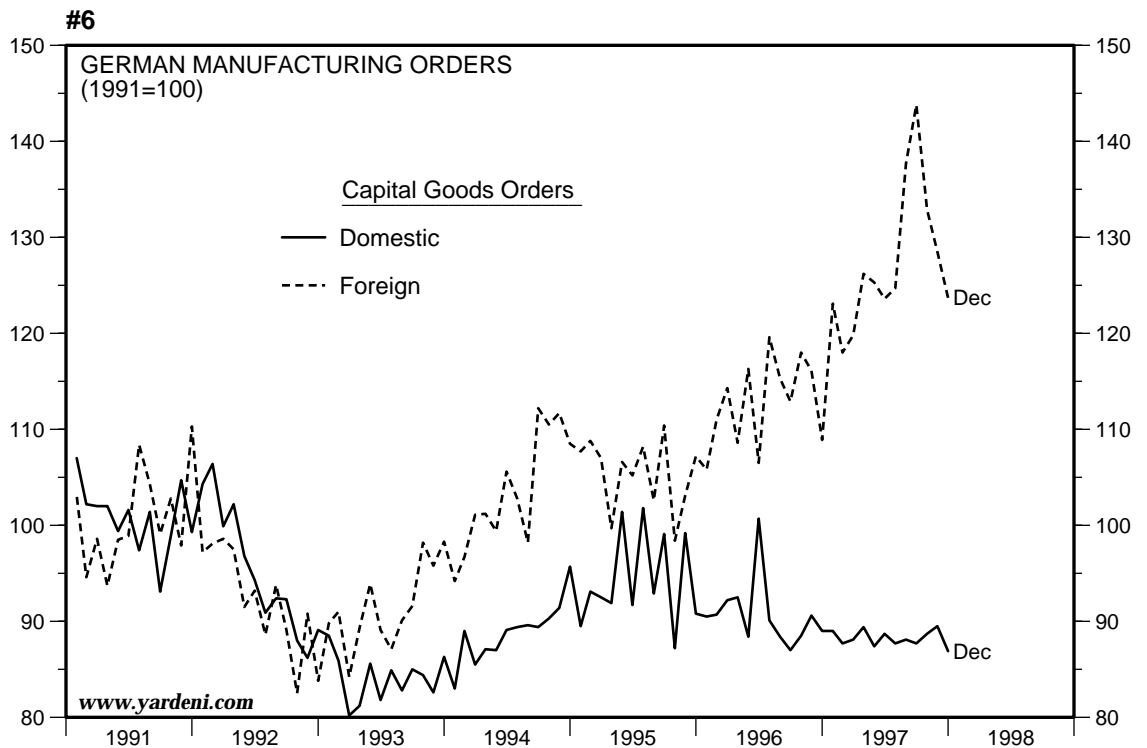
- Factory Orders -

Purchasing managers report big drop in export orders.



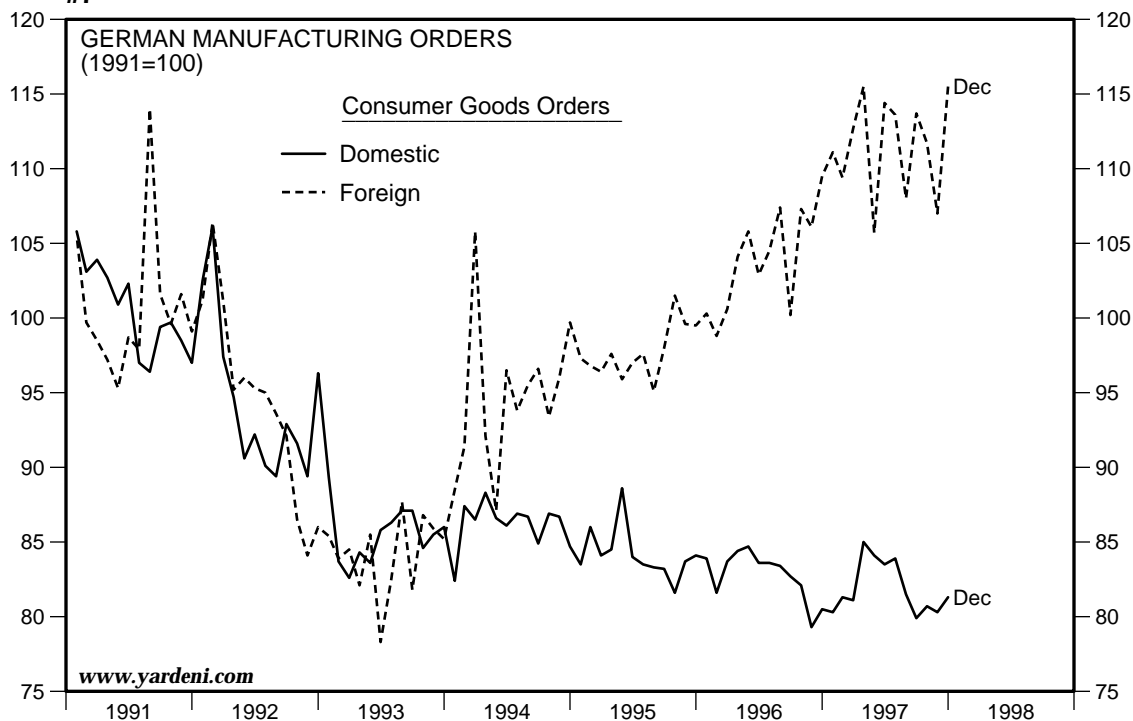
Source: National Association of Purchasing Management.

German capital goods orders, especially placed by foreign customers, are falling.



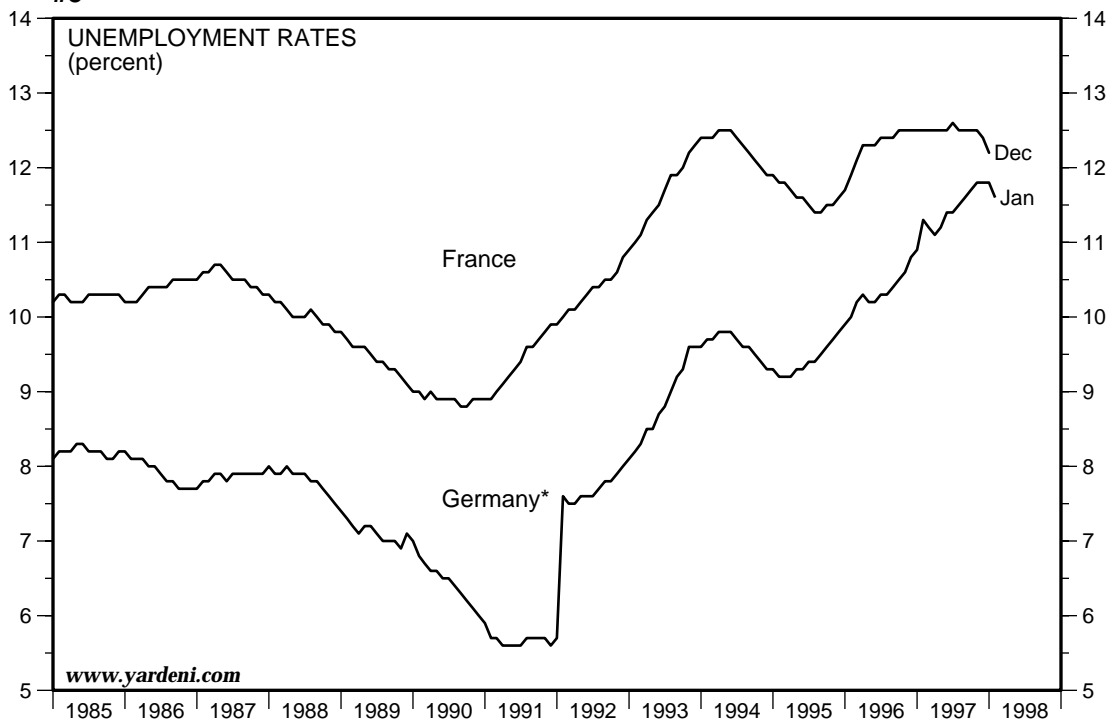
- Factory Orders -

#7



Foreign orders of German consumer goods are likely to turn down soon as a result of Asian Crisis.

#8



European jobless rates may soon move even higher if weaker exports depress economic growth.

* Unified Germany data begins in 1992.

Dr. Edward Yardeni
TOPICAL STUDIES

Topical Studies #19 and higher are available on <http://www.yardeni.com/yardeni/topical.html>

- #40 *Is Asia Minor?*, November 17, 1997
- #39 *The Baby Boom Chart Book 1997*, November 11, 1997
- #38 *Fed's Stock Market Model Finds Overvaluation*, August 25, 1997
- #37 *New Era Recession? Deflation, Irrational Exuberance, & Y2K*, July 14, 1997
- #36 *Conference Call With Alan Blinder*, June 2, 1997
- #35 *The Economic Consequences Of The Peace*, May 7, 1997
- #34 *Populist Capitalism And Other Wildly Bullish Themes*, February 25, 1997
- #33 *Productivity Must Be Booming*, January 20, 1997
- #32 *The Undefeated Forces Of Deflation*, October 28, 1996
- #31 *Economic Consequences Of The Internet*, October 22, 1996
- #30 *Backlash: Workers Vs. Bonds*, May 8, 1996
- #29 *The Baby Boom Chart Book 1996*, March 28, 1996, with Amalia Quintana
- #28 *Liquidity Story Is Wildly Bullish*, February 12, 1996
- #27 *10,000 In 2000*, November 6, 1995
- #26 *The US Economy's Mega-Trends*, July 10, 1995
- #25 *The High-Tech Revolution In The US of @*, March 20, 1995
- #24 *Hard Or Soft Landing?*, February 6, 1995
- #23 *The End Of The Cold War Is Bullish*, September 10, 1993
- #22 *Apocalypse Now! (NOT!)*, May 8, 1992
- #21 *The Baby Boom Chart Book 1991*, October 9, 1991, with Amalia Quintana
- #20 *The Collapse Of Communism Is Bullish*, September 4, 1991
- #19 *The Triumph Of Adam Smith*, July 17, 1990, with David Moss
- #18 *Dow 5000*, May 9, 1990, with Deborah Johnson
- #17 *The Triumph Of Capitalism*, August 1, 1989
- #16 *The Baby Boom Chart Book*, January 25, 1989, with Amalia Quintana
- #15 *The New Wave Manifesto*, October 5, 1988, with David Moss
- #14 *Could Real Estate Prices Fall? And What If They Do?*, August 24, 1988
- #13 *The Coming Shortage Of Bonds*, June 20, 1988
- #12 *How The Baby Boomers Are Changing The Economy*, April 6, 1988
- #11 *The Restructuring Of Corporate America Is Bullish*, December 9, 1987, with Deborah Johnson

Copyright (C) Deutsche Morgan Grenfell Inc. 1998. All rights reserved. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. Deutsche Morgan Grenfell Inc. and its affiliated companies and/or individuals may, from time to time, own, have positions in, or options on the securities discussed herein and may also perform financial advisory services, and/or have lending or other credit relationships with those companies. This material has been approved for distribution in the United Kingdom, to professional investors who fall within the exemptions contained within the UK Financial Services Act 1986 - Investment Advertisement Exemptions Order 1988, by Deutsche Bank AG London, 6 Bishopsgate, London EC2P 2AT. Member of the LSE and regulated by SFA, Tel: (171) 545-4900, Fax: (171) 545-4988. Orders placed by UK persons directly with Deutsche Morgan Grenfell Inc. will not be governed by all investor protection provisions of the UK Financial Services Act 1986. **Additional Information Available on Request.**