The International Connection: The Asian Crisis and U.S. Economic Activity

Noonday Club Meeting
St. Louis, Missouri
December 2, 1999

The East Asian crisis, which broke open in the summer of 1997, focused attention on the international economic relationships of the U.S. economy, especially those with the crisis countries. The Asian shock to the world economy set in motion numerous changes—some favorable, some unfavorable to U.S. economic activity. Correspondingly, the recovery in East Asia, which began in earnest earlier this year and will almost certainly continue next year, should reverse many of the earlier changes. However, some changes will be permanent—mostly healthy changes, I am pleased to say.

In my remarks this morning I plan to stress three themes. First, to understand the Asian crisis and its aftermath, the analyst must look at much more than exports and imports of goods and services. Clearly, the trade channel is important, but a review of recent history reveals that the Asian crisis set in motion numerous changes, some of which offset the negative impacts of reduced exports to East Asia. My second theme is that the decline in U.S. exports caused by the crisis was a *relative* demand shock rather than an *aggregate* demand shock. That is, the shock had mixed effects on U.S. employment and economic activity, depressing some sectors and stimulating other sectors. As a first approximation, the sum of these sector-specific effects—the aggregate or total economy effect—was a wash. By the same token, recovery in Asia will also appear primarily as a relative demand shock, stimulating output in some sectors and depressing it in other sectors. Third, with respect to inflation, the Asian crisis likely reduced U.S. inflation in 1998; the recovery has probably contributed to the higher U.S. inflation this year compared to last year.

Before proceeding to elaborate on my major themes, I want to emphasize that my remarks reflect my own views and do not necessarily reflect official positions of the Federal Reserve System. I particularly want to thank Cletus Coughlin, vice president at the St. Louis Fed, who is a co-author of these remarks. However, I retain full responsibility for errors.

EAST ASIA AND ITS EFFECTS ON U.S. TRADE

To set the stage for my discussion, let me highlight a few facts about the Asian crisis. Economic performance throughout most of Asia was quite strong during the 1990s until the latter half of 1997. Propelled by favorable economic conditions such as policy changes and technological developments, private capital flowed into Asia to take advantage of what appeared to be an increasingly attractive investment climate. However, in the latter half of 1997, investor sentiment for East Asia switched from being very positive to very negative. Consequently, investors reversed the flow of capital from into to out of these countries. The five economies most affected by the Asian crisis—Indonesia, Philippines, Malaysia, Korea, and Thailand—had private capital inflows of $93 billion in 1996 and outflows of $12 billion in 1997. Moreover, the foreign exchange values of these countries' currencies and their stock markets suffered sharp declines. Not surprisingly, economic activity in most East Asian countries declined between 1997 and 1998.

Many forecasters initially predicted that the Asian crisis would have a chilling effect on U.S. growth. Their thinking was that the recessions in East Asia would reduce the demand for U.S. exports and that this export shock would propagate itself into a substantial reduction in demand for U.S. production.

Part of their thinking was based on the increasing importance of international trade, especially exports to East Asia, for the U.S. economy. In 1997, total exports of goods and services were 11.9 percent of U.S. gross domestic product (GDP). By comparison, in 1960, this share was only 4.8 percent. Between 1991 and 1998, rising exports were a key factor propelling the expansion of the U.S. economy. Moreover, in light of the rapid growth in East Asia during the 1990s, an increasing share of U.S. exports was being sent to East Asia. Prior to the crisis, roughly 30 percent of U.S. exports were destined for East Asia.

As national forecasters began, after mid-1997, to assess the potential consequences of the Asian crisis for the U.S. economy, regional forecasters began to do the same for their own areas. As our regional economists at the St. Louis Fed studied the situation, it became apparent that the markets of East Asia are less important for manufacturing firms in Missouri than they are for manufacturing exporters in the United States generally. In real, or inflation-adjusted, terms, during 1997, Missouri sent 14 percent of its manufactured exports to East Asia, roughly half the U.S. average. As a general rule, states in the western United States have stronger trade links with Asia than do other states.

Japan is the most important export destination for Missouri's manufactured exports. About 30 percent of Missouri's manufactured exports are destined for Japan; Korea is the next important destination with 16 percent. In terms of product categories, Missouri's exports are concentrated in transportation equipment, primarily aircraft. During 1996 and 1997, over 42 percent of Missouri's exports to East Asia were transportation equipment. Exports of chemical products and industrial machinery were the next most important product categories. Exports accounted for 12 percent of Missouri's chemical products production and 10 percent of its industrial machinery production.

Despite Japan's importance as an Asian export destination, other foreign destinations—Canada and Mexico, for example—are far more important for Missouri's exporters. During 1996 and 1997, Japan received roughly 5 percent of exports from Missouri. Meanwhile, Mexico was the destination for 8 percent and Canada for a much larger 42 percent. Clearly, the direct trade effect of the Asian crisis on Missouri manufacturing firms as a whole was fairly small although, obviously, the effects might be well above average for certain firms.

Between 1997 and 1998, U.S. manufacturing exports to East Asia declined by 12 percent. The export decline experienced by Missouri's manufacturers mirrored the national decline, falling by 13 percent. These declines explain to a large degree the weakness in U.S. export growth during 1998. In fact, from December 1997 to December 1998, U.S. exports of goods and services fell by 1.8 percent; meanwhile, imports were continuing to increase. Consequently, the U.S. trade deficit ballooned, increasing from $105 billion for the 12 months ending December 1997 to $164 billion for the 12 months ending December 1998. The percentage decline in exports and the size of the trade deficit are even larger if one restricts the focus to trade in goods.

Despite many forecasts that the Asian crisis would have a chilling effect on U.S. growth, it appears that the crisis had little effect on the growth of U.S. GDP or employment in either the United States or Missouri. How can it be that the U.S. economy was able to shrug off such a large loss of business?

Let's review a few macroeconomic facts. First, the U.S. economy has been growing rapidly in recent years. U.S. GDP expanded by 4.3 percent between the fourth quarter of 1996 and the fourth quarter of 1997, and by 4.6 percent between the fourth quarters of 1997 and 1998. Growth actually rose a bit in 1998 over 1997; a slowing associated with the Asian crisis is certainly not obvious. A similar conclusion is supported by looking at employment growth, unemployment rates, and many other indicators of the aggregate economy.

Consider the employment numbers for Missouri. Comparing December 1997 with December 1996, payroll employment increased by 2.6 percent, while from December 1997 to December 1998 employment grew 1.9 percent. This slowing of employment growth, however, likely reflected a scarcity of workers rather than an Asian effect; Missouri's unemployment rate declined from 4.5 percent in December 1997 to 3.2 percent in December 1998.

A GENERAL EQUILIBRIUM PERSPECTIVE

So, back to the main question: why didn't the Asian crisis cause a recession or, at least, a major slowdown in the United States?

First, the size of the export demand shock was relatively small. Recall that the demand decline involved a portion of a relatively small sector of the U.S. economy. That is, despite the sharp increase in the importance of trade to the U.S. economy in the past 40 years, most of what we produce is still bought domestically. To understand this point better, let's take a look at some numbers. As noted previously, U.S. real merchandise exports to East Asia fell by 12 percent during 1998. East Asian economies accounted for about 30 percent of U.S. exports. Given this market share, the Asian impact was to reduce U.S. merchandise exports by 4 percent, absent any changes in export sales elsewhere. Because merchandise exports account for roughly 10 percent of U.S. output, the 4 percent decline in exports would have resulted in a 0.4 percent decline in total U.S. output, absent any changes in domestic demand. While such a decline is not trivial, it is much smaller than the decline that would have resulted from a similar percentage drop in domestic demand. U.S. export business to East Asia is a small tail on a large dog, and it doesn't make sense to believe that this little tail could wag the dog.

Moreover, domestic demand was not stagnant. Indeed, it grew so strongly that the export drag on the economy was noticed primarily only by economists and the firms directly affected.

Why did domestic demand grow so strongly? One reason is that the Asian crisis actually helped boost domestic demand. One effect arose from the reallocation of international capital flows from East Asia to elsewhere, with the United States being the primary elsewhere. The reallocation of capital put downward pressure on interest rates in the United States as well as upward pressure on U.S. equity prices.

Lower interest rates tend to stimulate spending on interest-rate sensitive goods, such as automobiles and new homes. The United States did indeed enjoy booms in both these sectors. Also, rising equity prices tend to stimulate spending as households become wealthier. Thus, while U.S. export demand was declining due to reduced demand in Asia, this reduction in demand was being offset by increased spending by households and businesses in the United States.

Another part of the explanation is that reduced demand in Asia tended to reduce commodity prices. Of course, reduced demand in Asia was only one of a number of factors putting downward pressure on commodity prices. Generally speaking—and I want to stress "*generally speaking*"—this reduced demand generated beneficial effects for the U.S. economy. In particular, the Asian crisis contributed to a decline in oil prices. Clearly, declining oil prices adversely affected U.S. oil producers and those supplying inputs to the oil production industry. However, on net, since the United States imports a large percentage of its oil, the United States as a whole tended to benefit. Obviously, you and I benefited from lower gasoline prices, which enabled us to spend on other goods what we saved on gas. Moreover, U.S. firms, such as those in the airline industry, paid lower prices for energy and some of these savings were passed on to U.S. consumers, who in turn spent the savings on other goods.

To summarize the analysis of the effects of the Asian crisis on U.S. output and employment, the crisis simultaneously depressed some export industries and stimulated industries responsive to lower commodity prices and lower interest rates. Thus, Asia created a relative demand disturbance, depressing some industries and stimulating others, with a small aggregate effect.

I've discussed the demand effects of lower commodity prices, but the effects on overall inflation are also of interest. Most analysts believe—and I share the belief—that lower commodity prices were not offset by higher prices elsewhere in the economy. Thus, lower commodity prices contributed to keeping overall inflation lower than it might otherwise have been in 1998. I would be remiss, however, if I did not stress that ultimately inflation is tied to monetary policy rather than to temporary shocks to supply or demand.

Suggestive evidence on my assertion concerning the short-run effects of commodity prices on overall inflation is provided by examining recent changes in consumer prices. Over the 12 months ending December 1998, the consumer price index rose 1.6 percent. Over the same period, the so-called "core" consumer price index, which excludes food and energy prices, rose 2.5 percent. Thus, to the extent the Asian crisis tended to depress food and energy prices, measured inflation in 1998 was lower than it would have been otherwise.

In addition to the declines in energy and other commodity prices, there was one other factor associated with the Asian crisis that tended to hold down inflation. As I mentioned earlier, the foreign exchange value of many Asian currencies declined in value relative to the dollar. The appreciation of the dollar tended to hold down and, in some cases, led to actual declines in the prices of goods imported into the United States. Consequently, the prices of imported goods, as well as the prices of competitive goods produced in the United States, were temporarily lower than they might have been otherwise.

Before leaving this section of my remarks, I would like to reiterate that the reduction in commodity prices, while likely beneficial on net, was not beneficial to everyone. The Asian crisis has hurt many—perhaps most—producers of agricultural commodities because their prices have been so weak.

CONSEQUENCES OF THE RECOVERY IN ASIA

The downdraft stage of the Asian crisis is past, and today we are witnessing the recovery stage. My comments concerning the consequences for the U.S. economy of the recovery in Asia follow directly from my previous comments about the consequences of the Asian crisis. Simply reverse the direction of the change—"increase" becomes "decrease" and "decrease" becomes "increase."

Recovery is indeed underway in Asia. I do not want to deluge you with numbers, but I would like to recite a few figures from the International Monetary Fund. Here are the growth rates for GDP for a few countries:

	Forecast (percent)		
	1997	1998	1999
Thailand	–1.3	–9.4	9; 4.0
Indonesia	4.8	–13.7	–0.8
Korea	5.0	–5.9	6.5
Malaysia	7.7	–6.7	2.4
Philippines	5.2	–0.5	2.2

In addition, with the exception of Korea, which is expected to grow at a slightly slower rate, these countries are expected to grow at least as fast during 2000 as in 1999.

As Asia recovers, we should see the reversal of capital flows—financial capital should begin to flow into this part of the world rather than out of it. This reversal may have something to do with the upward pressure on interest rates in the United States this year. The higher rates have clearly taken housing construction down a bit from its peak, and may well be slowing automobile demand a bit. If long-term interest rates remain at current levels, we may see somewhat broader effects in coming months.

An obvious consequence of expanded economic activity in Asia for the United States should be increased demand for U.S. exports and, thus, increased export shipments from the United States. Based on the most recent data, U.S. exports to East Asia have not yet returned to 1997 levels.

However, exports to East Asia did increase during the second and third quarters of this year, an obviously positive development for the U.S. export sector.

A similar comment applies to exports by Missouri manufacturers. Exports, even though still below 1997 levels, are beginning to increase. In a comment echoed by a number of Missouri manufacturers, a local manufacturer reported to us that his firm's sales to East Asia dried up for 18 to 20 months. Only in the past six months has his company begun to receive orders.

We are also seeing rising oil prices, with the price of a barrel of oil doubling over the last year. I would like to stress, however, that many factors are contributing to rising oil prices—the recovery in Asia is simply one. In contrast to the earlier period, we are now seeing the consumer price index (CPI) rise at a faster rate than the core CPI. Over the 12 months ending October 1999, the CPI rose 2.6 percent, while the core CPI rose 2.1 percent.

The bottom line is that in coming quarters demand for U.S. production should shift somewhat from consumption and investment to exports. This shift should have minimal effects on the level of macroeconomic activity in the United States.

CONCLUSION

I've not attempted to identify the cause of the Asian crisis; that's a subject for another day. I've concentrated on the effects of the crisis on the United States, and have emphasized that those effects go well beyond the surface effects on U.S. exports. Despite substantial trade effects for the United States generally as well as for many Missouri exporters, the crisis had minimal aggregate effects on U.S. economic output and employment.

The inflation story is a bit different. Arguably, the largest macroeconomic effect of the crisis was to lower U.S. inflation in 1998. The decline was temporary; recovery in Asia temporarily raised U.S. inflation, accounting for some and perhaps most of the increase in the U.S. CPI in 1999. Based on current forecasts, I'm guessing that the Asian recovery will continue and that Asia's role in the U.S. economy will revert, more or less, to the role it played in the years before the crisis.

My remarks this morning have focused on the short-term effects of the Asian crisis and its aftermath. The fact that the U.S. macroeconomy has not been adversely affected by the Asian crisis does not mean we are unaffected in the long run by the health of East Asia. A strong and rapidly growing East Asia will contribute to a healthy U.S. economy. We should welcome prosperity abroad, and never fear it. And we should pursue every opportunity to strengthen trade relations. Doing so will strengthen our prosperity, and that of our trading partners.