Chapter 6
Conclusion and Recommendations

This chapter begins with a summary of this study's findings; first, from the analysis of the economic performance of the ASEAN countries based mainly on a consideration of six macroeconomic variables, and then from a regression analysis that relates the forecasts of macroeconomic variables to external borrowing costs. Then, corresponding to the results, policy implications are provided for both policymakers and global investors. Finally, in the last section, the limitations of the study as well as some recommendations for further study are provided.

6.1 Country risk of the ASEAN economies

In most developing countries including the ASEAN, during periods of high economic growth, their economic stability generally deteriorates. This is because, during these periods of high economic expansion, there are strong domestic spendings both in consumption and investment; but with limited availability of domestic resources, inflationary pressures build up, eroding the countries' internal stability. Moreover, the strong growth in domestic spending also stimulates large increase in the demand for imports which can not be matched by the increase in the countries' exports, thus resulting in trade and current account deficits. With inadequate domestic savings, the deficits in the countries' current accounts must be financed by foreign sources of capital. However, relatively high domestic interest rates are required to attract large foreign capital inflows. These inflows of foreign capital together with high interest rates then gives rise to an increase in the countries' external indebtedness and increased debt service burdens, thereby putting even more pressure on the countries' external payments positions.

Likewise, accompanying the rapid growth of the ASEAN economies during the 1990s, there have been some problems of economic overheating as indicated by their relatively high inflation rates, increased current account deficits and increased level of external indebtedness. In this regard, it can then be concluded that the country risk of the ASEAN economies has increased to a relatively high level during the 1990s.

6.2 Impact of macroeconomic forecasts on the country's borrowing costs

In order to determine the extent to which the forecasts of macroeconomic variables affect the country's borrowing costs in international financial markets, a pooled cross-sectional, time series regression relating one-year forecasts of four macroeconomic variables (real GDP growth, inflation, current account deficit and percentage change in exchange rate) as well as total capitalization of the stock market to the one-year cross-currency swap rate is performed for three developing ASEAN countries, namely, Indonesia, Malaysia and Thailand, using monthly data from February 1996 to May 1997.

The regression results show that the forecasts of real GDP growth, inflation, current account deficit and percentage change in exchange rate, as well as the market capitalization of the stock market are important factors determining the costs of external borrowings for Indonesia, Malaysia and Thailand. Specifically, an expectation of an increase in inflation rate is a negative factor that increases the country's costs of external borrowings; whereas, expectations of an increase in real GDP growth, a decline in current account deficit and an increase in domestic currency value as well as the increase in the market capitalization of the stock market are the positive factors that reduce the country's borrowins costs.

6.3 Policy Implications

Considering the results from the previous chapters that show the importance of macroeconomic forecasts in determining the country's borrowing costs, this section provides policy implications first for policymakers and then for global investors in response to these results.

Policymakers

As the forecasts of real GDP growth, inflation, current account deficit and change in exchange rates, as well as the market capitalization of the stock markets have powerful influences on the costs of external borrowings for Indonesia, Malaysia and Thailand; so, in order for policymakers to reduce country risk and hence the costs of their external borrowings, they need to pursue more prudent economic policies in order to achieve increased real economic growth, reduced inflationary pressures, narrower current account deficits*, higher domestic currency value, and increased market capitalization of the stock markets. However, as an increase in real economic activity generally gives rise to stronger domestic currency value and higher stock market capitalization which reduce the country risk and borrowing costs; while contributes to the increase in inflationary pressures and current account deficits which increase the country risk and borrowing costs, a prudent application of the various policy instruments should be pursued to stimulate economic growth while limiting domestic inflationary pressure and current account deficits simultaneously.

However, the country should not adhere to increasing economic growth since high growth in the developing country with limited capital generally results in a sharp increase in current account deficit which further increases more reliance on foreign capital in financing such deficit. Therefore, the country may allow its growth to decline in some periods in order to avoid over-external borrowing which may well lead the economy in an unmanageable direction and ultimately trigger an economic crisis. Furthermore, apart from maintaining growth with stability, the country should also be careful not to become over reliant on large foreign capital inflows, especially the speculative short-term capital or hot money. This is because, as suggested in Demirguc-Kunt and Detragiache (1997), the greater the vulnerability of the country to sudden capital outflows, the more likely it is that the banking crisis will emerge. Thus, in these circumstances, there should be careful break from the government from

* Although the regression results show the negative association between swap rates and expected current account deficits, the graphical analysis reveals that the swap rates in Indonesia, Malaysia and Thailand are positively related to the expected current account deficits, specifically

importing excessive foreign capital inflows. In addition, as traditional approaches to country risk analysis, although necessary, are no longer sufficient in assessing the country risk, some additional indicators should be developed to help provide the country an effective economic early warning system.

Investors

As the coefficients of regression can be interpreted as a system of penalties and rewards, a positive coefficient of expected inflation implies that a country with an increase in expected inflation will tend to be penalized by an increase in yields. Conversely, the country will tend to be rewarded with yield decrement when the forecasts of its real GDP growth, current account deficit, domestic currency value, or the market capitalization of its stock market increase. Therefore, it may probably be the time for investors to go long the countries with high expected economic growth, high current account deficits, high domestic currency's value, or high market capitalization in the stock market on the expectations that the yields will decline.

6.4 Limitations and Recommendations for Further Study

Although the explanatory power of the regression analysis in this study seems satisfactory, the addition of some other macroeconomic forecasts, such as the level of countries foreign reserves and the level of their external debt as a percentage of GDP, as explanatory variables in the regression might improve the regression results. Furthermore, data availability also limits the study to focus the analysis of the influences of macroeconomic forecasts on the costs of external borrowings for a group of only three countries—Indonesia, Malaysia and Thailand. However, as the forecasts of macroeconomic variables may affect the costs of borrowings for each country differently, the determination of each country's yield structure could be expected to lead to a better understanding of the exact influence of macroeconomic forecasts on the country's external borrowing costs.

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during the 1996, meaning that an increase in expected current deficits will lead to an increase in the swap rates.