

The current global financial turmoil and Asian developing countries

by Yilmaz Akyüz

After about six years of exceptional growth, the world economy has now entered a period of instability and uncertainty due to a global financial turmoil triggered by the subprime crisis in the United States. Current difficulties, however, are not unrelated to forces driving the preceding expansion. From the early years of the decade the world economy went through a period of easy money as interest rates in major industrial countries were brought down to historically low levels and international liquidity expanded rapidly. In the United States ample liquidity and low interest rates, together with regulatory shortcomings, resulted in a rapid growth of speculative lending, sowing the seeds of current problems. Global liquidity and an increase in the risk appetite, rather than improvements in fundamentals, have also been the main reason for a generalized and sustained surge in capital flows to emerging markets. They have given a boost to growth in the recipient countries, but also generated fragility and imbalances, including unsustainable currency appreciations and current account deficits, and credit, asset and investment bubbles, which now render them vulnerable, in different ways and degrees, to shocks from the subprime crisis.

The crisis is comprehensive and global, encompassing the banking sector, securities and currency markets, and institutional and individual investors in most parts of the world. The bursting of the bubble has left the United States with excessive housing investment which cannot be put into full use without significant declines in prices. The household sector has ended up with debt in excess of equity represented by such investment. An important part of portfolios of banks and their affiliates is not performing. Bond insurers face massive obligations they cannot meet. And many investors across the world have found themselves holding worthless mortgage-based securities and commercial paper.

The evolution of the world economy now depends crucially on the impact of the crisis on growth in the United States and its global spillovers through trade and finance. Whether growth in Asia would be decoupled depends not only on the nature and extent of contagion and shocks from the crisis, but also on the strengths and vulnerabilities of the economies in the region and their policy response. Adverse spillovers from this crisis will certainly surpass those from the crises in emerging markets in

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the 1990s. However, for the first time in modern history hopes seem to be pinned on developing countries for sustaining stability and growth in the world economy. On the one hand, the sovereign wealth funds (SWFs) from emerging markets are increasingly looked at as stabilizing forces in financial markets by providing capital to support troubled banks in the United States and Europe while taking large risks. On the other hand, economic prospects in the world economy seem to hinge on the ability of developing countries to continue surging ahead despite adverse spillovers from the crisis.

Crisis, growth and external adjustment in the United States

There is great uncertainty as to whether the United States economy will succumb to this crisis brought on by years of profligate lending and spending or be able to restore growth after a brief interruption. Policy makers have responded to mitigate the difficulties in the financial system by cuts in interest rates and liquidity expansion, and to support spending by a fiscal package. But it is agreed that monetary easing cannot fully resolve the difficulties since this is, in essence, a solvency crisis. Again, the fiscal package may not be enough to make up for cuts in private spending. It now appears that the United States is unlikely to avoid an economic contraction and, on some accounts, may even face the worst recession since the Great Depression.

The crisis could well produce a sizeable retrenchment in private consumption, reduction in the savings gap and correction of external deficits in the United States. Not only could consumption be cut sharply with declines in employment, income and wealth, but any subsequent recovery is unlikely to be associated with the kind of consumption spree that has produced mounting external deficits. This adjustment could be a protracted process, resulting in erratic and slow growth, as in Japan during the 1990s. In any case, the rest of the world would need to rely less on the United States' market

for growth. Briefly, the crisis is likely to bring a fundamental adjustment to global imbalances, but the main question is how orderly and rapid that would be.

Recent capital flows and vulnerability in Asia

A key question in Asia is in what way and to what extent the crisis will affect the economies in the region. This depends, *inter alia*, on present vulnerabilities which are greatly shaped by the manner in which the recent surge in capital flows has been managed. In this respect it is possible to draw on the lessons from the Asian crisis, focussing on four areas of vulnerability associated with surges in capital inflows: (i) currency and maturity mismatches in private balance sheets; (ii) credit and asset bubbles and excessive investment in property and other sectors; (iii) unsustainable currency appreciations and external deficits; and (iv) lack of self-insurance against a sudden reversal of capital flows, and excessive reliance on outside help and policy advice.

The recent record in Asia in these respects is mixed. Most Asian countries have avoided unsustainable currency appreciations and payments positions, and accumulated more than adequate international reserves to counter any potential current and capital account shocks without recourse to external support. But they have not always been able to prevent capital inflows from generating credit, asset and investment bubbles or maturity and currency mismatches in private balance sheets.

Interventions designed to absorb excess foreign currency due to the surge in capital inflows and/or current account surpluses have been broadly successful in stabilizing exchange rates in the region. But their effect on domestic liquidity could not always be fully sterilized, and this has resulted in rapid domestic credit expansion. Outside China, reserves are largely "borrowed", coming from capital inflows rather than earned from current account surpluses. In the region

as a whole the cost of borrowed reserves is estimated to be around \$50 billion per annum. The option to invest excess reserves in more lucrative, less risky assets abroad through SWFs seems to be constrained because of resistance towards such investment in certain advanced countries. An alternative would be to recycle them in the region for infrastructure projects in low-income countries in need of development finance.

Asian countries have received, in different degrees, relatively large inflows of speculative capital. Foreign presence in equity markets and the banking sector has increased rapidly, raising volatility and the risk of contagion. Capital inflows, together with expansionary monetary policy, have created bubbles in stock and property markets in several countries, notably in China and India, where prices have gone beyond levels that could be justified by fundamentals. Low interest rates and equity costs have also given rise to a boom in investment which may cease to be viable with the return of normal financial conditions.

Many Asian countries have been facing macro-economic policy dilemmas mainly because they have chosen to keep their economies open to financial inflows, rather than imposing tighter countercyclical measures of control. Capital accounts in the region are more open today than they were during the Asian crisis. The main response to large capital inflows has been to liberalize outward investment by residents. This is partly motivated by a desire to allow national firms to become important players in world markets through investment abroad, but there has also been considerable liberalization of portfolio outflows. The rationale of such a policy as a strategy for closer integration with global financial markets is highly contentious. As a short-term measure, it could be even more problematic since, once introduced for cyclical reasons, it may not be easily rolled back when conditions change.

Financial contagion and shocks

Growth projections have been constantly revised downward since summer 2007 as financial difficulties became more visible. Still, none of the most recent baseline projections by the International Monetary Fund (IMF), World Bank, United Nations, the Asian Development Bank and the Institute of International Finance envisage a sharp drop in income in the United States in 2008. They also seem to assume that for emerging markets these difficulties are just a hiccup, not expected to cause a large deviation from the recent trend of rapid and broad-based growth. However, the downside risks they all mention may become a reality in the coming months with growth falling much more than predicted.

Asian economies do not appear to have large direct exposure to securitized assets linked to high-risk lending, and the financial impact of the crisis is likely to be transmitted through changes in the risk appetite and capital flows. These would be coming on top of domestic fragilities associated with credit and asset bubbles in some of the key countries in the region. The question of sustainability of these bubbles had been raised even before the subprime turmoil, and they have now become even more fragile, susceptible to a sharp correction. By itself this may not lower growth by more than a couple of percentage points in China and India. However, if combined with a sudden reversal of capital flows and/or contraction of export markets, the impact on growth can be much more serious.

According to the most recent projections, the crisis would not have much impact on private capital flows to emerging markets in the current year; there would be some decline in bank lending, largely compensated by increases in equity flows. It is also argued that capital flows may even accelerate if Europe joins the United States in easy monetary policy. This would imply persistence of asset bubbles in China and India, necessitating an even sharper correction in the future.

It is quite likely that international investors will now start differentiating among countries to a much greater extent than has been the case in recent years. Those with large external deficits, high levels of debt and inadequate reserves may face a sudden stop and even reversal of capital flows and sharp increases in spreads. Given massive amounts of reserves, even a generalized exit of capital from emerging markets would not create serious payments difficulties for most Asian countries, and the impact would be felt primarily in domestic financial markets. Such an exit could be triggered by a widespread flight toward quality, with investors taking refuge in the safety of government bonds in advanced countries, or a need to liquidate holdings in emerging markets in order to cover mounting losses and margin calls.

Trade linkages and growth in Asia

In general, trade shocks from the subprime crisis are not expected to result in a sharp decline of growth in Asia. Exports to the United States amount to some 8 per cent of GDP in China and 6 per cent in other Asian countries. In value-added terms these ratios are lower because of high import contents of exports. Consequently, even if exports to the United States stop growing or start declining in absolute terms, the Asian countries can still sustain rapid, albeit somewhat reduced, growth provided that other components of aggregate demand continue growing.

This line of thinking clearly focuses on the impact of exports on aggregate demand, rather than on the foreign exchange constraint. It is implicitly assumed that the countries affected can continue to maintain import growth despite reduced export earnings. This would pose no major problem for those running large current account surpluses. Others with deficits, however, would need to rely increasingly on capital inflows and/or draw on their reserves in order to finance the widening gap between imports and exports.

This simple arithmetic is further complicated by a number of factors. First, the trade impact of the crisis depends on how other Asian export markets are affected. A sharp slowdown in Europe can hurt growth in Asia since exports to that region account for 7 per cent of GDP in China and even more in other Asian emerging markets. Second, for some countries indirect exposure to a decline in growth of exports to the United States and Europe can be just as important because of relatively strong intra-industry trade linkages. Those supplying intermediate goods to China would be affected by cuts in not only their direct exports to the United States and Europe, but also their indirect exports through China. Finally, a slowdown in exports can trigger a sharp drop in investment designed to supply foreign markets and this can, in turn, contract aggregate demand further.

Policy challenges

Whatever the nature and extent of contagion and shocks from the crisis, it is important to avoid destabilizing feedbacks between real and financial sectors. A sharp drop in exports together with a rapid correction in asset prices could bring down growth considerably, which can, in turn, threaten the solvency of the banking system given the high degree of leverage of firms in some countries. The appropriate policy response would be to expand domestic demand through fiscal stimulus. If difficulties emerge in the financial sector, it would also be necessary to provide lender-of-last-resort financing. Nevertheless, policy interventions should smooth, rather than prevent, correction in asset prices and facilitate restructuring in over-expanded sectors.

China would need not just countercyclical macroeconomic expansion, but a durable shift in the composition of aggregate demand from exports towards domestic consumption because, *inter alia*, the crisis is likely to bring a sizeable external adjustment in the United States. Current conditions including the twin balance-of-payments surpluses, growing reserves, an undervalued

currency, and an unprecedented growth of production capacity heavily dependent on external markets cannot be defended on grounds of efficiency. As the experience of late industrializers in Asia shows, a development strategy emphasizing exports does not require generation of large and persistent current account surpluses with undervalued exchange rates. Cheap currency often leads to terms-of-trade losses and impedes technological upgrading.

If capital inflows continue at their recent pace or accelerate, a policy of controlled appreciation of the yuan combined with tighter control over inflows and a long-term strategy of expansion of Chinese direct investment abroad, including in developing countries, would appear to be a desirable response. But perhaps the greatest challenge would be to secure expansion of the internal market based on a more rapid growth of consumption than has hitherto been the case. Since the early years of the decade, consumption has constantly lagged behind income and investment, and its share fell below 40 per cent of GDP – almost half of the figure in the United States, and less than the share of investment in China. The imbalance between the two key components of domestic demand has meant increasing dependence of industry on foreign markets. This is largely a reflection of the imbalance between profits and wages. Despite registering impressive increases, wages have lagged behind productivity growth and their share in value-added has declined in recent years. There are also relatively large precautionary savings from wage incomes because of absence of adequate public health care, education and social security services.

All these imbalances are presumably among the problems that Premier Wen Jiabao was referring to when he pointed out at the National People's Congress in March 2007 that "the biggest problem with China's economy is that the growth is unstable, unbalanced, uncoordinated and unsustainable". They need to be addressed independent of the shocks from the subprime crisis if China is to avoid the kind of difficulties

that Japan faced during much of the 1990s. Expansion of public spending in areas such as health care, education and social security, as well as transfers to poorer households financed, at least partly, by dividend payments by state-owned enterprises, can play an important role in lifting consumption.

In other Asian economies closely linked through production networks, domestic stimulus would be needed to offset a reduction in exports to China as well as the United States and Europe. Given many burdens already placed on monetary policy, including control over inflation and management of capital flows and exchange rates, the task falls again on fiscal policy. Most countries in the region have considerable scope to respond by fiscal expansion, in very much the same way as they were able to do during the weakness of global demand at the turn of the millennium. The scope is somewhat limited in countries with fiscal deficits. In such cases it is particularly important to design fiscal stimuli in such a way that they do not add to structural deficits.

On the external side, Asian emerging markets appear to have sustainable current account positions as well as relatively large stocks of reserves to weather any potential worsening of their trade balances as a result of a slowdown in exports. Countries with current account deficits could see them rise further as exports slow down and growth of income and imports is sustained. Given their relatively high levels of reserves, this should cause no serious problem. However, if slowdown in markets abroad is accompanied by a sudden stop or reversal of capital flows, these countries could be restricted in their ability to respond positively to external shocks. In some of these cases twin structural deficits in fiscal and external accounts would thus need greater attention for reducing vulnerability to such shocks.

Low-income countries dependent on official flows are highly vulnerable to a sharp deterioration in global economic conditions and in many

of them, including small island economies, current account deficits could rise rapidly as a result of a slowdown in trade in goods and services. These countries should thus be able to have access to additional IMF financing through augmentation of resources made available under Poverty Reduction and Growth Facility arrangements and the Exogenous Shocks Facility.

Regional and international cooperation

A reasonable degree of consistency would be needed among policy responses of individual countries in Asia to shocks from the subprime crisis. A coordinated macroeconomic expansion would certainly be desirable, but it would be even more important to secure consistency in exchange rate policies. Despite a clear division of labour and complementarity of trade based on vertical integration, trade patterns in East and South East Asia are becoming increasingly competitive. Divergent movements in exchange rates in the region can thus be highly disruptive and conflictual. Experience shows that such movements can become particularly intensive at times of severe external shocks and instability of trade and capital flows. Some countries may even be tempted to respond by beggar-my-neighbour exchange rate policies.

It is, therefore, important to engage in intra-regional consultations in exchange rate policies and explore more durable regional currency arrangements. The experience of Europe in exchange rate cooperation culminating in the European Monetary Union holds valuable lessons, even though it may not be fully replicated since the region is not yet ready to float collectively vis-à-vis the G3 currencies (viz., the dollar, euro

and yen). There are other, more flexible options available. Complementary arrangements could also be considered, including a common set of measures to curb excessive capital inflows, formal arrangements for macroeconomic policy coordination, surveillance of regional financial markets and capital flows, and extended intra-regional short-term credit facilities based on the Chiang Mai initiative already under way.

Current conditions demonstrate once again that when policies falter in regulating financial institutions and markets, there is no limit to the damage that they can inflict on an economy and that in a world of closely integrated markets, every major financial crisis has global repercussions. This means that shortcomings in national systems of financial rules and regulations are of international concern – particularly those in major advanced economies because of their significant global repercussions. So far piecemeal initiatives in international fora such as the Bank for International Settlements, the IMF and the Financial Stability Forum have not been very effective in preventing recurrence of virulent global financial crises. A fundamental collective rethinking with full participation of developing countries is thus needed for harnessing financial markets and reducing systemic and global instability.

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