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Short-term Policy Responses to the International Financial Crisis and Risks to Sustainable Medium-term Policy Frameworks in Asia: Complications Arising from Enduring Global Imbalances

by

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The views expressed in this paper are those of the author and do not necessarily represent those of the Bank for International Settlements.

Introduction

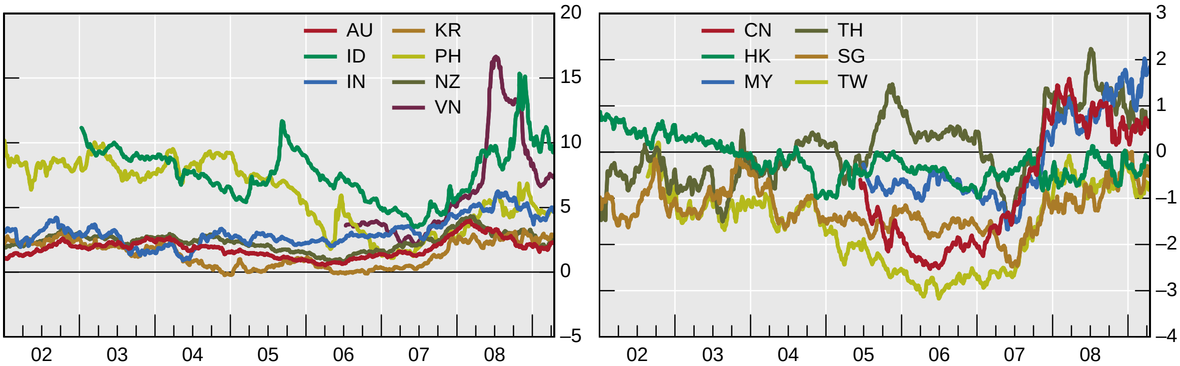
The policy measures taken to date in the Asia-Pacific region are helping to cushion the blow of the global recession. Monetary and fiscal policy stimulus has been strong and there has been considerable attention given to strengthening the financial system. Questions, however, remain about how well the short-term responses fit into a broader medium-term framework for sound monetary policy, fiscal policy and institutional reforms. I will argue that actions to date have been very important for short-term stabilisation but may exacerbate key medium-term risks associated with enduring global imbalances. The analysis also raises some questions about the benefits of emphasising export-led growth strategies in the region in the future.

Recovering from the body blow

From an Asian perspective, if there was a silver lining to the international financial crisis, it is that the economies in the region began it in a healthy state. This was not just an accident or good luck. The greater resilience of the economies in Asia reflects a decade of efforts to strengthen the fundamentals of these economies and lay the foundation for sustained economic growth through economic globalisation and prudent financial liberalisation. The favourable outcomes from these strengthening measures were reflected in the low and declining trend of sovereign spreads in the region prior to the crisis (Graph 1). It might be said that the Asian crisis had served as a stark reminder to the public and the policymakers of the downside risks to alternative approaches.

Graph 1

Five–year sovereign bond spreads[1]



AU = Australia; CN = China; HK = Hong Kong; ID = Indonesia; IN = India; KR = Korea; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand; TW = Chinese Taipei; VN = Vietnam.

[1] Over the US bond yield; five-day moving averages.

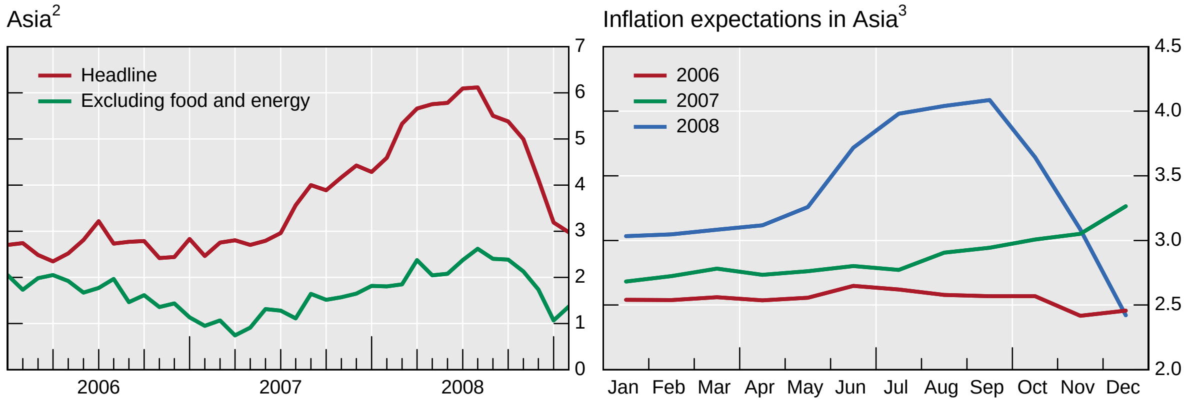
Source: Bloomberg.

The decline in the sovereign spreads prior to the start of the international financial crisis underscored the overall improvement in policies in the region, not least being inflation control, fiscal rectitude, the soundness of FX reserve positions and the strengthening of financial systems. Of course, the region is very diverse and the approaches employed were equally diverse. A brief description of each one of these features sets the stage for the later discussion:

Inflation control. Despite the pick up in regional inflation due largely to global commodity price developments in 2007-8, the record of inflation in the region has been quite favourable. Underlying inflation trends were relatively low and stable; this can be more easily seen by excluding food and energy inflation (Graph 2). This outcome largely reflects the renewed focus by central banks on inflation in the region. Indeed, over the past decade, several central banks adopted formal inflation targeting regimes and those which did not chose inflation control as a priority in their policy frameworks (Genberg and He, 2007). Central bank success in controlling inflation can also be seen in relatively stable inflation expectations (compared to past periods of crisis) and a general narrowing of the dispersion of private sector inflation forecasts for economies in the region.

Graph 2

Inflation (Twelve-month changes)[1]

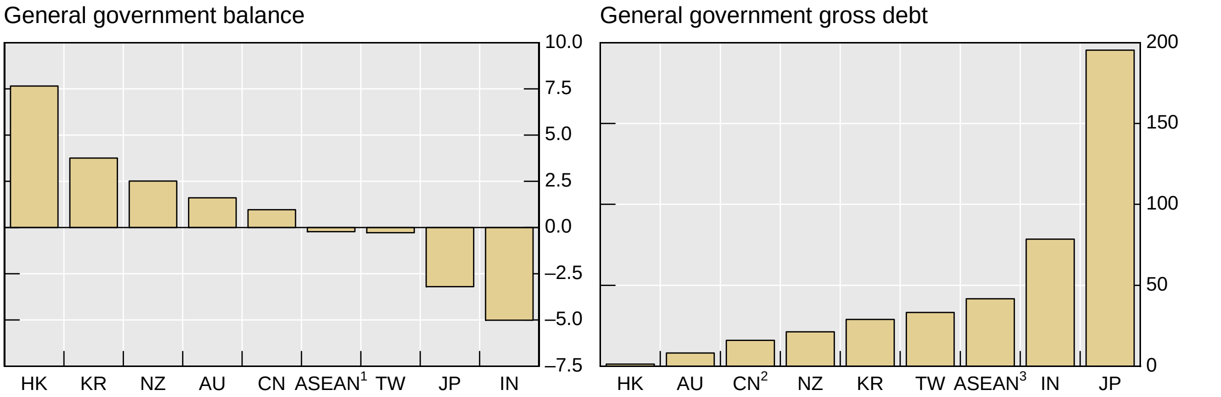


[1] In consumer prices; in per cent. [2] China, Hong Kong SAR, India, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Thailand and Chinese Taipei; weighted average based on 2005 GDP and PP exchange rates. [3] Expectations for the next year in consecutive months; Asia refers to the aggregate shown in the first panel plus Australia and New Zealand.

Sources: OECD; ©Consensus Economics; CEIC; Datastream; national data; BIS calculations

Fiscal rectitude. Fiscal positions entering this international financial crisis were generally quite strong. Fiscal surpluses have been the result of sound medium-term fiscal frameworks which benefited from the years of robust regional growth. This is illustrated by the modest fiscal deficits prior to the international financial crisis and relatively low levels of sovereign debt (Graph 3). These favourable fiscal positions generally have given governments in the region the ability to respond aggressively to the current economic slowdown without raising significant concerns about fiscal dominance and sustainability.

Graph 3
Public finance in 2007 (as a percentage of GDP)



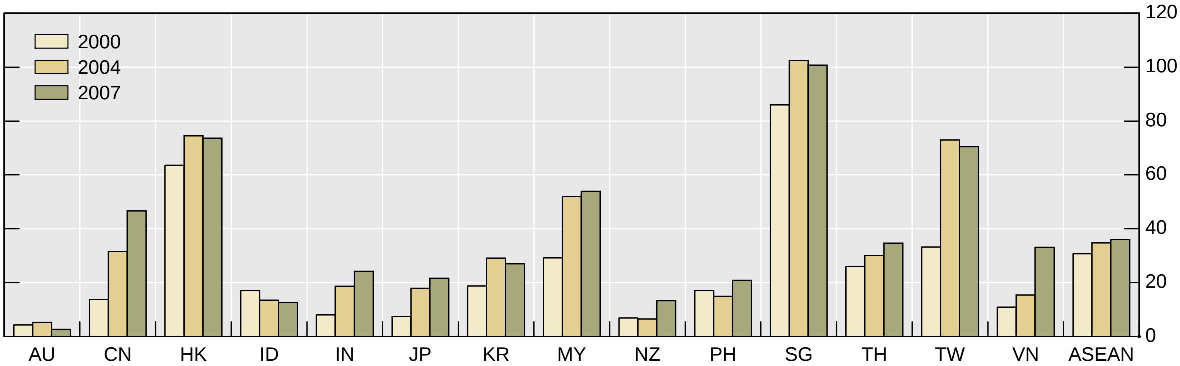
AU = Australia; CN = China; HK = Hong Kong; IN = India; JP = Japan; KR = Korea; NZ = New Zealand; TW = Chinese Taipei.
[1] Brunei not included. 2 Refers to net debt. [3] Brunei, Myanmar and Vietnam not included.
Source: IMF.

Ample reserves and current account surpluses. Economies in this region entered the period with a sizeable stock of foreign currency reserves, providing the means not only to offset disorderly market developments but also to condition the mindsets of the private sector about the likelihood of adverse unexpected swings in the exchange rate (Graph 4). In addition, various countries in Asia and the Pacific have made use of foreign reserve derivative contracts as an integral part of their reserve management techniques. The availability of reserves, especially those denominated in US dollars, proved to be very important as dollar liquidity in global markets dried up at times. However, the policies promoting reserve accumulation were not without their critics. Questions still remain about the desirability of continuing to build up such reserves in the future.

Graph 4a

Foreign exchange reserves

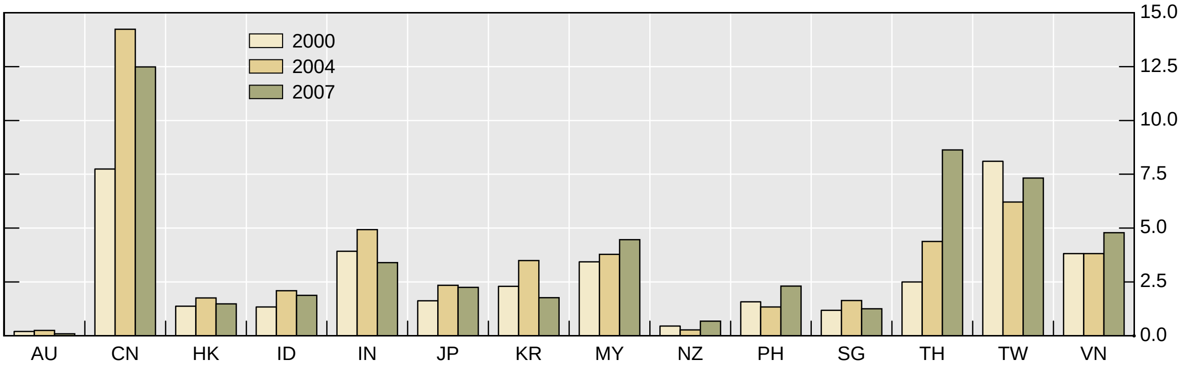
As a percentage of GDP



Graph 4b

Foreign exchange reserves

As a ratio to short-term external debt[1]



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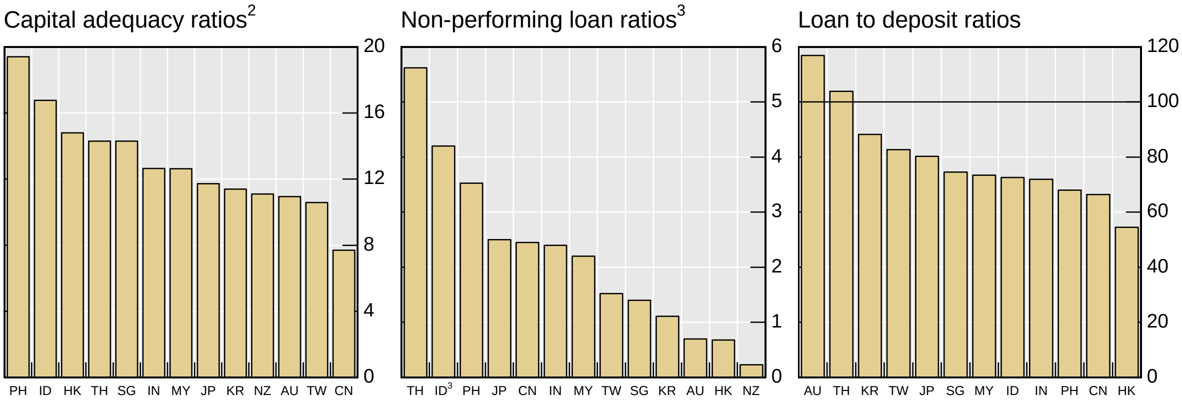
[1] Short-term external debt comprises consolidated international claims of BIS reporting banks with a maturity up to and including one year, plus international debt securities outstanding with a maturity up to one year.

Sources: IMF, Datastream, BIS.

Healthy financial systems. Possibly most important in the light of the international financial crisis, the region's financial systems entered the period healthy (Graph 5). Balance sheets were generally free of the infamous toxic assets at the heart of the crisis. Years of efforts to strengthen banking systems to meet Basel II standards and, possibly more important, relatively conservative bank regulators provided a foundation for financial resilience, though not complete immunity. In addition, there has been a general improvement in the financial plumbing during these years, as efforts to enhance the quality of payment systems, legal arrangements and market microstructure boosted the attractiveness of financial markets in the region.

Graph 5

Asian banks[1]



AU = Australia; CN = China; HK = Hong Kong SAR; IN = India; ID = Indonesia; JP = Japan; KR = Korea; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand; TW = Chinese Taipei;

[1] In per cent; numbers refer to the most recent available data. [2] Capital as a percentage of total risk-weighted assets. [3] Definitions may vary across countries.

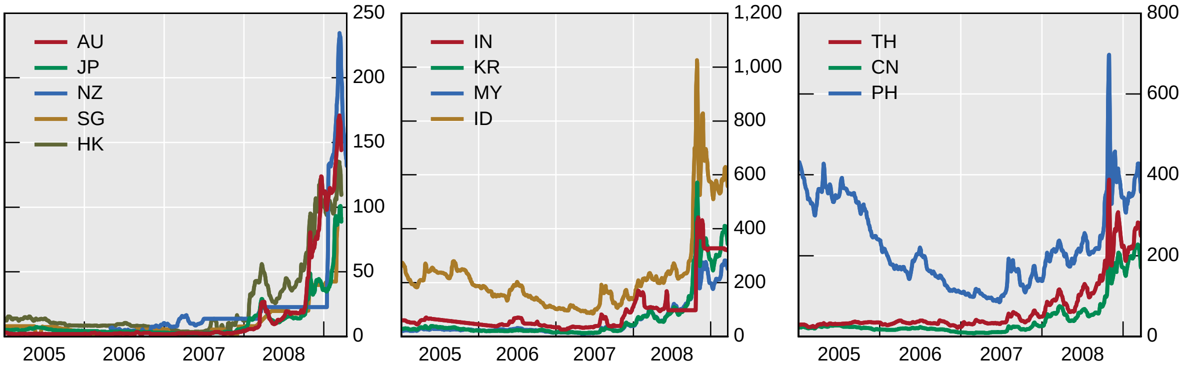
Sources: IMF; Bloomberg; CEIC; national data.

Four phases of the impact of the international financial crisis on Asia

To understand the rationale of regional policy responses to the international financial crisis, we have to understand the nature and timing of the spillovers from the international financial crisis to the region. The CDS sovereign spreads provide a useful metric for dating the evolution of the impact of the crisis in the region. The timeline can be summarized in four distinct phases:

Graph 6

Five-year CDS sovereign spreads[1]



AU = Australia; CN = China; HK = Hong Kong; ID = Indonesia; IN = India; JP = Japan; KR = Korea; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand.

[1] In basis points.

Source: MarkIt.

Phase one – the initial financial turmoil. Spillovers from the international financial turmoil in 2007 and early 2008 to the region were fairly limited. To be sure, regional financial markets felt the rumblings in markets elsewhere. But this immunity largely reflected modest direct exposure of banks and other financial institutions to distressed asset classes. And, with relatively weak financial headwinds at the time, elevated inflation pressures tended to dominate the Asian economic landscape during this phase, though, by mid-year, prospects for growth began to deteriorate.

Phase two – the sharp intensification of financial conditions in the region. Phase two could be dated from the time of the bankruptcy of Lehman Brothers, as financial strains, a sharp decline in risk appetite and a crisis in confidence spread around the world with unprecedented speed and severity. Financial markets in the region suffered substantial losses, trade activity and its financing contracted sharply and prospects about the future went through a series of abrupt downward revisions. This led to a range of immediate policy actions, summarised in Table 1.

Table 1

Summary of policy actions taken in North America, Europe, Asia and the Pacific[1]

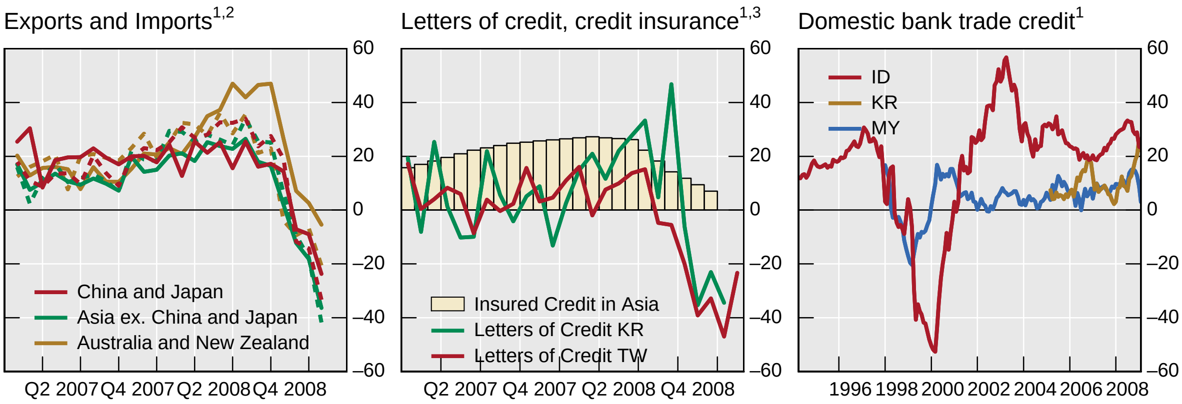
	CA	US	Euro area	CH	UK	AU	CN	HK	IN	ID	JP	KR	MY	NZ	PH	SG	TH
Ease monetary policy	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√
Introduce fiscal stimulus		√	√		√	√	√	√	√		√	√	√				√
Liquidity assistance in local currency	√	√	√	√	√	√	√	√	√	√	√	√		√	√		
Lend foreign exchange	√		√	√	√	√	√		√	√	√	√		√	√	√	
Expand deposit insurance		√	√		√	√		√		√		√	√	√	√	√	√
Guarantee non-deposit liabilities	√	√	√		√	√						√		√			
Prepare bank capital injection		√	√	√	√		√	√			√	√					
Create demand for assets	√	√		√		√	√		√	√			√				
Impose short-sale restrictions	√	√	√	√	√	√		√			√	√				√	
Relax mark-to-market rules		√	√[2]	√	√		√			√	√	√	√		√		

[1] As of 9 December 2008. This table summarises policy actions proposed but not necessarily implemented, and may be incomplete. [2] Applies to countries whose companies report under IFRS.

Phase three – the macroeconomic fallout. Phase three began before the end of 2008 as the rapid deterioration of financial conditions began to subside and initial signs of financial stabilization emerged. The role of the massive government intervention abroad and in the region in contributing to this improved state of affairs should not be underestimated. Nonetheless, while the response to the deteriorating conditions was swift and substantial, the financial turmoil was sufficiently extreme to upset private sector confidence in global economic activity and financial headwinds blew briskly enough to jolt the Asian macroeconomy, particularly through the trade channel (Graph 7).

Graph 7

Trade and Trade Finance



[1]Year-on-year change, in per cent. [2] Solid line represents export, dashed line imports. [3]Data by residence of the borrower. The aggregate number for insurance is from Berne Union and incorporates China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Philippines, Thailand and Taiwan. Letters of credit received by resident banks.

Sources: Bloomberg, CEIC, Joint External Debt Hub of BIS, IMF, OECD and the World Bank

Phase four – stabilisation and recovery. Phase four – though very tentatively labelled at this point in time – represents the initial consolidation and foundation for a sustained economic recovery. This is the phase where both reactions to the symptoms of the crisis and policy responses to the underlying causes are addressed from a perspective of a sound medium-term policy framework, an issue developed more fully later in the paper.

Short-run policy actions to stimulate economies have been important in size and scope – have they been sufficient?

Even though the international financial crisis has subsided, we need to treat the lessons being learnt about the effectiveness of the government responses as tentative, especially because many of them are still in the pipeline. Bearing this in mind, it is nonetheless useful to lay out potential working hypotheses. This section highlights four key types of responses: monetary policy, fiscal policy, new swap lines and financial system strengthening.

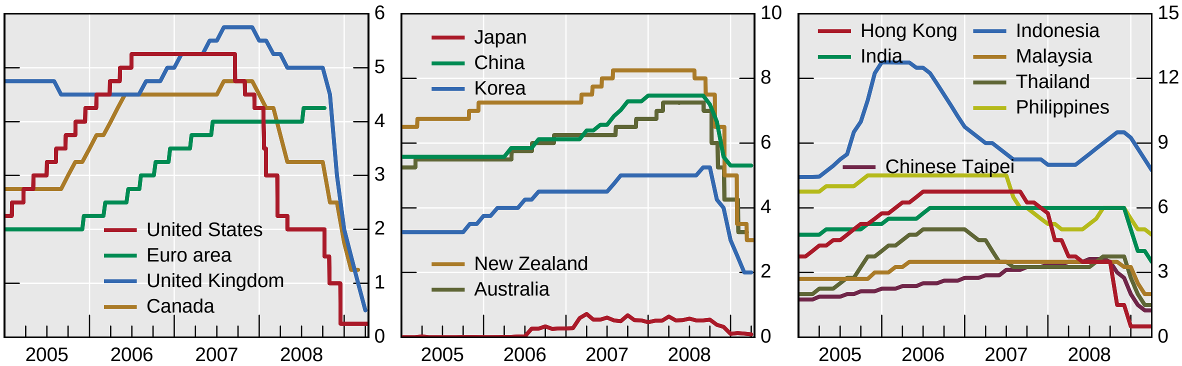
Monetary policy actions

One hallmark of the regional monetary policy response to the rapid deceleration in economic and financial conditions last fall was an aggressive easing. A range of policy measures were adopted, including reductions in policy rates and required reserve ratios, increased provision of local currency liquidity, liquidity assistance in foreign currency, injections of capital and guarantees of the liabilities of financial institutions, and direct support of asset prices.

Policy interest rates were cut sharply as concerns about inflation pressures waned and worries about global recession waxed (Graph 8). This was not enough to offset the drag from the external sector, given the high level of trade dependence for the region and especially for some of the small, open economies. And, of course, monetary policy lags are long and variable.

Graph 8

Policy rates, per cent per annum



Sources: Datastream; national data.

Many countries started to cut policy rates last August and September, with large reductions of 100 or even 150 basis points becoming common. Indonesia, Malaysia, the Philippines and Thailand started cutting policy rates slightly later. In addition, in a number of economies including China, India, Indonesia, Malaysia, the Philippines and Chinese Taipei, monetary easing was accompanied by a reduction in reserve requirements, by as much as four percentage points in the case of banks in India and small banks in China. Despite the policy rate actions to date, there is still room for further policy easing in most Asian economies (except Japan, Hong Kong and Singapore, the latter two due to constraints implied by their exchange rate arrangements and the trinity).

Beyond these conventional monetary policy measures, central banks took additional actions in an effort to restore market confidence and to improve the effectiveness of the monetary transmission mechanism. Local currency liquidity support also provided considerable relief to domestic financial institutions in many economies. In domestic money markets, measures focused on increased frequency of operations to address liquidity needs (eg Australia), extended maturity of financing (eg Hong Kong, Indonesia, New Zealand and Chinese Taipei), and broadened eligibility of collateral (eg Australia, Hong Kong, Japan, Korea and New Zealand).

The efforts to ease monetary policy in Asia have been countered somewhat by the financial headwinds. In terms of sovereign interest rates, the policy rate cuts have corresponded to a lowering of borrowing costs for governments. The rate reductions have been less effective for the cost of corporate borrowing, as risk appetites in the financial markets have declined and the underlying riskiness of the corporations has naturally risen during this global slowdown. In addition, the flow of credit to domestic borrowers has been fairly favourable despite the drying up of some particular segments of the capital markets, especially towards the end of 2008.

On the whole, however, the monetary transmission mechanism in the region seems to have weathered the international financial crisis relatively well, though notably less so in Northeast Asia. With the prospects for financial and economic conditions having recently taken a tentative turn for the better and the monetary transmission mechanisms not being seriously impaired, the role of monetary policy during the recovery will be particularly important, unless central banks find themselves at the zero lower bound for short-term interest rates (as is the case in Japan).

Fiscal policy actions

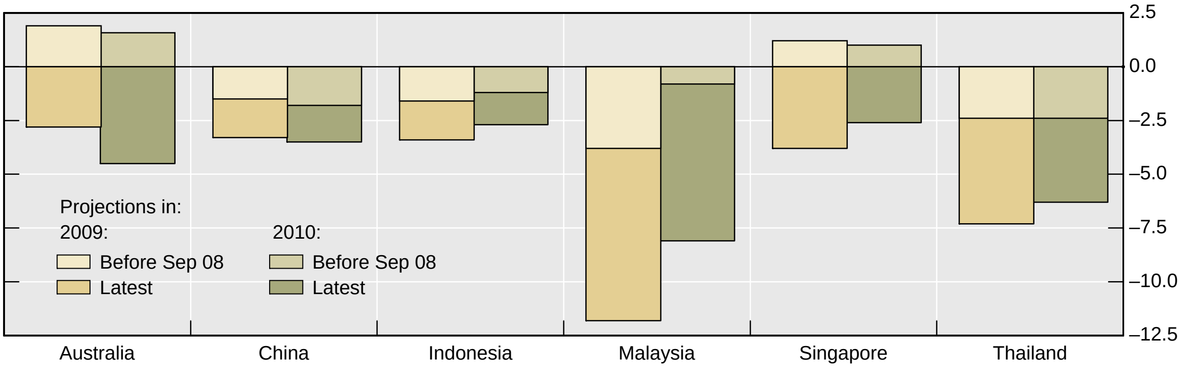
The fiscal policy responses have been diverse across the region. As the region's economies decelerated sharply in late 2008, the speed of adoption and size of the fiscal packages have been helpful in stabilizing economic activity. Most economies in the region enacted significant fiscal packages in the wake of the intensification of the spillovers of the international financial crisis to the region, the two largest packages being implemented by China and Malaysia.

China's package was notable for its size, timing and scope. The four trillion yuan package, roughly 13% of GDP, to be spent over two years was the largest package in the region and was announced in the middle of the fourth quarter 2008. The package emphasised infrastructure investment and also expanded social programmes and the transfer system. In the short run, this should help boost growth. He, Zhang and Zhang (2009) estimate that the spending in 2009 alone would boost output by 1.7 trillion yuan and result in nearly 20 million new jobs in the non-farming sectors. In the longer run, these types of spending will help to spur consumption, longer-term growth and a rise in standards of living. Malaysia's fiscal packages of MYR7 billion last October and MYR 60 billion in March amounted to roughly 8% of GDP; it emphasized a mix of spending, tax incentives and other measures over the next two years. The main aim was to insulate Malaysia's economy as the export sector has been battered by falling commodity prices and the collapse of external demand.

Most others in the region implemented special fiscal packages on the order of a one to several percentage points of GDP for 2009 and 2010 (Graph 9). Some packages include income supports, as in Singapore, to insulate export-oriented employment from the collapse in external demand. Others provide for tax breaks and greater social spending. While it is difficult to get a firm grip on the exact impact of these special fiscal packages, there is little doubt that they entail a significant boost to aggregate demand. Indeed, the increase in the size of expected fiscal deficits indicates a sea change in thinking since September of last year.

Graph 9

Fiscal balance, budget as a percentage of GDP



Source: Bloomberg.

Many questions remain about the effectiveness of the fiscal stimulus. How much of the stimulus was new spending? How quickly will the output and employment effects be realised? Possibly more daunting are concerns about fiscal sustainability. In Japan, the latest expansion of fiscal spending announced in April, though welcomed, has raised concerns about the burgeoning government debt and its sustainability. In China, there has been some concern that unfunded mandates to the provinces could lead to future impairment of bank balance sheets if the loans were used to support unproductive projects. These concerns highlight the importance of further efforts to be taken to ensure a sound medium-term fiscal framework.

Enhancement of swap lines

Shortages in foreign currency, especially US dollar funding, have been addressed by a range of policy measures and institutional reforms. In some economies, financial institutions may now borrow against official reserves. For example, US dollar-denominated government bonds may now be used in repo transactions in the Philippines, and restrictions on bank borrowing from overseas branches have been eased in India. Additionally, a number of economies have benefited from bilateral swap facilities with the US Federal Reserve, and amongst themselves (Graph 10).

From a regional perspective, the bilateral swap arrangements announced in recent months represent an important signal of the deepening of the commitment amongst the nations in the region to one another. In an effort to internationalise the use of its currency, China has arranged 650 billion yuan in swap lines with South Korea, Malaysia, Indonesia and Hong Kong (as well as with Belarus and Argentina). These efforts might become quite useful as China has just expanded yuan settlement as a means of promoting bilateral trade with Hong Kong and neighbouring countries.

Possibly more important from a political economy point of view has been the progress toward a fully operational, multilateral US dollar swap arrangement amongst ASEAN+3. Even though the details have yet to be worked out, the progress to date and the sharp increase in the likelihood of bringing a framework to completion this year represents a breakthrough in regional cooperation.

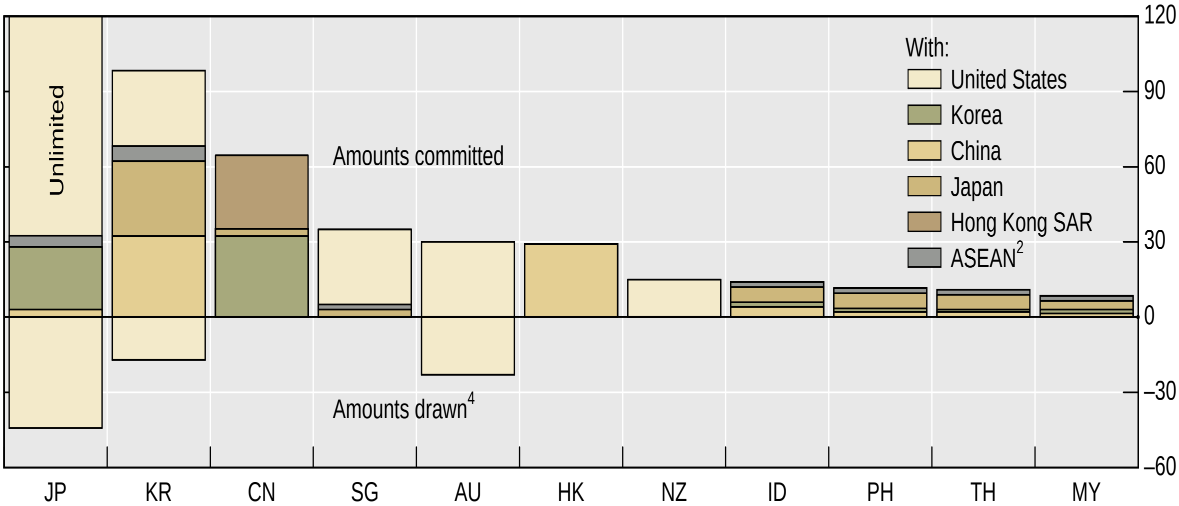
The benefits of the new enhanced swap lines appear to be both direct and indirect. The direct benefits have accrued to those needing foreign currency to meet financial obligations. In this case, the swap lines have helped to smooth the operation of the global financial system; for

Korea and Indonesia, they proved to be handy. Yet, on the whole, drawdowns of the swap lines have been smaller than the levels implied by short-maturity foreign obligations of most countries.

Nonetheless, the existence of the swap facilities appeared to play a big indirect role in boosting confidence in the effective functioning of FX-related financial transactions and reduced the likelihood of a systemic incident arising from an isolated dislocation. Government provisions of dollar liquidity (as in the case of India), and government guarantees more generally, were seen as effective means to calm the worst fears of market participants during the periods of great uncertainty.

Graph 10

Official bilateral swap arrangements[1]



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[1] In billions of US dollars; includes swaps under the Chiang Mai Initiative and swaps of Asian currencies against Asian currencies, eg CNY for KRW or HKD. [2] Refers to swaps with members of the Association of Southeast Asian Nations (ASEAN) as well as swaps under the ASEAN Swap Arrangement. [3] As of 20 January 2009.

Sources: IMF; national data; BIS.

Strengthening of financial systems

Various measures have been adopted in recent months to fortify financial institutions in the region. For example, financial institutions' balance sheets have benefitted directly from the expansion of deposit guarantees in most ASEAN+3 countries (except China where an explicit deposit insurance scheme is yet to be introduced and Japan). In some countries, such as India, Japan and Korea, governments have directly injected capital into troubled banks, although the scale and scope of such actions has been much less than in the United States and Western Europe.

In some markets, financial institutions have also benefited from both direct and indirect support of asset prices. For example, governments have purchased mortgage backed securities in Australia and both commercial paper and corporate bonds in Japan, while Hong Kong and Malaysia have introduced credit guarantee schemes for SME loans, and Singapore has launched a special programme to support trade finance. Additionally in Australia, Indonesia, Japan and Chinese Taipei, restrictions on short sales were introduced to protect financial institutions from speculative attacks.

In addition to these short-term responses, the region has become more committed to the development and implementation of international standards with the extension of the umbrella of the Basel committee and the Financial Stability Board (FSB, formerly the Financial Stability Forum). The Basel committee has extended membership to China, India and Korea, and the FSB to China, India, Indonesia and Korea. The greater reach of the international standards and the bigger input from the region to the international standard setting bodies are bound to strengthen the financial systems in all of Asia, both for those participating actively in these international bodies and for those who look to these international bodies for guidance on how to improve their financial systems.

In response to the international financial crisis, the Basel Committee has taken on a number of initiatives that should strengthen the resilience of financial systems. The initiatives include a long list of improvements: better coverage of banks' risk exposures, including those for trading book, securitisation and derivative activities; more and higher quality capital to back these exposures; countercyclical capital buffers and provisions that can be built up in good times and drawn down in stress; the introduction of a non-risk based measure to supplement Basel II and help contain leverage in the banking system; higher liquidity buffers; stronger risk management and governance standards; more regulatory focus on system-wide or "macroprudential" supervision; and greater transparency about the risk in banks' portfolios.

The FSB's principal task is the elaboration of international financial sector supervisory and regulatory policies and standards, and coordination across the various standard setting bodies. Its current workstreams have emphasised a number of key issues, including recommendations on reducing the procyclicality of the financial system, on principles for sound compensation practices and on principles for cross-border cooperation on crisis management. Efforts of the FSB continue to address (i) strengthening capital, liquidity and risk management in financial systems; (ii) enhancing transparency and valuation; (iii) changing the role and uses of credit ratings; (iv) strengthening authorities' responsiveness to risks; and (v) putting in place robust arrangements for dealing with stress in the financial system.

At the recent G-20 in early April, the mandate of the FSB was expanded from that of the FSF. In addition to its current responsibilities, the FSB will intensify its collaboration with the IMF in conducting early warning exercises and making joint presentations on financial risks and how to address them. It will also monitor and advise on the implications of market developments for regulatory policy and best practice in meeting regulatory standards, and conduct joint strategic reviews of international standard-setting bodies' policy development work. Furthermore, it will set guidelines for and support the establishment of supervisory colleges, and manage contingency planning for cross-border crisis management, especially regarding systemically important firms.

Squaring the circle – challenges facing policymakers with rebalancing

Most of the discussion above has highlighted the range of policy responses taken in the region of late. Quite naturally, the main focus of the actions was to stop the most immediate recessionary/depressionary concerns arising from the rapid deceleration of economic and financial activity. To use a medical analogy, it was to stop the bleeding. In addition to the stimulus, the government guarantees, the improvements in the financial plumbing and the greater regional and international cooperation have generally lent credence to the view that a similar financial meltdown happening in the future is unlikely.

As initial signs of stabilization are emerging and some hope for a recovery is warranted, policymakers naturally have been looking forward and addressing the farther ranging implications for the actions taken, and the need for additional actions. In other words, issues associated with the timing and pace of exit strategies have gained importance. In this section, I comment on one particular set of issues, which has been a subject of debate in the past, namely the desirability of economies in Asia relying heavily on export-led strategies in the future.

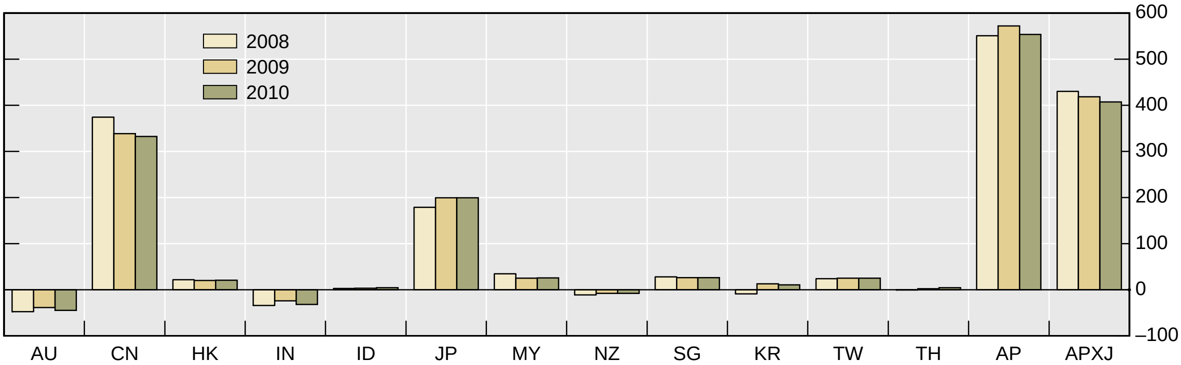
What have we learnt from the crisis for global rebalancing?

If there is one key lesson to be learned it is that the global imbalances, which have been building for years, are very resilient. Indeed, many prophets of doom and gloom in the past were pointing to the global imbalances as the lynchpin of future crises. One often-heard story emphasised that the weight of the accumulated US current account deficits would inevitably lead to a collapse of the dollar. This would, in turn, wreak havoc on global financial systems and expose vulnerable segments of the financial intermediation process. The global macroeconomy would suffer as a result. This assumed sequencing of events in the crisis scenario has proved to be far from the mark. For one thing, the US dollar appreciated sharply against a range of currencies as safe haven flows underpinned the demand for dollars. Possibly even more surprising, the international financial crisis and subsequent global recession has had little impact on the size and trajectory of the global imbalances.

The persistence of global imbalances despite the global economic recession points to another possible set of determinants. Namely, we may be learning that durable consumption and savings trends are the real key drivers of the global imbalances. If this proves to be true, there are some immediate implications that follow - some good and some not so good.

Graph 11

Current account balance (in billions of US dollars)



AU = Australia; CN = China; HK = Hong Kong; ID = Indonesia; IN = India; JP = Japan; KR = Korea; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand; TW = Chinese Taipei; AP = Asia Pacific (includes all the countries listed before plus the Philippines, Sri Lanka and Vietnam); APXJ = Asia Pacific excluding Japan.

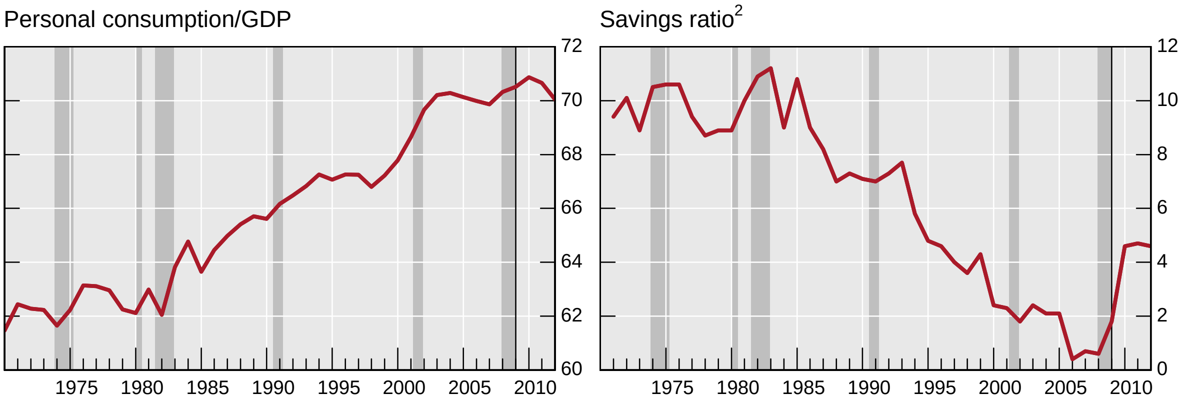
Source: © Consensus Economics.

On the positive side, if consumption trends are the key drivers of the imbalances, the dynamics of the financial crisis are not likely to directly affect the likelihood of a collapse of the dollar or a disorderly unwinding of the current account balances. In fact, forecasters presently see very little change in current account balances in the foreseeable future (Graph 11). This could be relatively good news for Asia in the short run because a further rotation of demand away from Asian exports, at a time when Asian exports are already sharply contracting, would be even more disruptive than the current situation.

On the negative side, the policy responses to the fallout of international financial crisis on the macroeconomy are likely feeding the global imbalances. For example, with the very easy US monetary policy, the expansionary US fiscal policy that promises to deliver 1+ trillion US dollar deficits year after year, and the financial system reforms aimed at reinvigorating demand for durables such as housing and autos, American consumers will continue to demand a lion's share of the global economic pie. Even though forecasters are expecting a sustained increase in US savings rates, they also expect the US consumption-to-GDP ratio to remain elevated (Graph 12). This, of course, raises the spectre of a more disorderly unwinding sometime in the future.

Graph 12

US Personal consumption and savings ratio[1] (in per cent)



[1] The shaded areas refer to business cycle contractions as defined by the Business Cycle Dating Committee, NBER. [2] Personall saving as percentage of disposable personal income.

Sources: BEA; Macroeconomic Advisers.

There is a silver lining, however. As noted above, fiscal stimulus programmes and social spending plans in Asia have helped to boost regional consumption spending. What is harder to assess is the extent to which the policies are providing new incentives for further growth of export-led industries (ie exports outside the region) versus programmes geared to promote output destined for domestic and regional markets. The analysis here suggests that policies should provide incentives to reorient output toward domestic and regional consumers.

We have also learnt that global problems may require global solutions. Such a lesson might suggest that greater emphasis needs to be put on taking actions, individually *and* jointly, to address the global imbalances. There are two issues that immediately arise. Have the international financial crisis and its aftermath changed views on what needs to be done to resolve the global imbalances? Have they changed views on the types of responses necessary to achieve an orderly resolution?

On the first question, the basic answer to the question seems unchanged: the chronic trade deficit economies need to save more and the surplus countries need to consume more. Of course, as Table 2 shows, this would apply particularly to China and the United States.

Table 2

Private consumption, exports and savings, as a percentage of GDP

	Private consumption					Exports[2]				Savings[3]
	1985	1995	2000	2007	Level[1]	1985	1995	2000	2007	2007
ASEAN[4]:	54.4	55.2	56.4	57.1	724.3	33.2	60.0	84.7	79.6	31.6
Cambodia	99.5	94.8	88.8	85.9	7.5	1.6	31.2	49.8	68.2	14.0
Indonesia	54.0	54.9	61.7	63.5	274.7	18.3	24.5	41.0	29.4	27.2
Laos	50.7	78.6	85.5	66.7	2.7	2.9	22.9	30.0	36.8	22.0
Malaysia	51.8	47.9	43.8	45.6	85.2	54.7	94.1	119.8	110.2	37.6
Myanmar	81.8	84.8	78.0	80.6	10.9	5.1	1.2	0.7	0.1	19.0
Philippines	73.6	74.1	69.6	69.4	99.9	24.0	36.4	55.4	42.6	19.7
Singapore	45.0	42.3	42.2	39.6	63.9	157.2	187.0	195.6	230.9	46.8
Thailand	62.2	53.2	56.1	53.6	131.5	23.2	41.8	66.8	73.3	33.3
Vietnam		73.6	66.5	67.6	47.9	5.0	36.7	55.0	77.0	32.4
Australia	55.9	59.6	58.8	55.9	508.3	15.8	18.8	21.6	20.1	22.2
China	52.0	46.7	46.2	37.1	1215.4	9.2	20.2	23.3	40.9	55.5
Hong Kong SAR	61.2	62.0	59.0	59.8	123.8	107.5	143.2	143.3	207.3	34.8
India	74.7	63.3	63.5	55.7	612.6	5.6	10.8	12.8	21.6	35.8
Japan	53.9	55.0	56.2	56.9	2494.9	14.4	9.2	11.0	17.6	28.6
Korea	56.6	52.3	54.0	54.1	524.6	32.0	28.8	40.8	45.6	30.0
New Zealand	59.8	58.2	59.5	58.8	75.7	32.1	29.7	34.4	28.4	15.6
Chinese Taipei	51.1	58.2	60.7	59.2	226.8	53.3	47.2	53.8	73.7	30.5
Memo:										
United States	*64.5*	*67.3*	*68.7*	*70.3*	*9710.2*	*7.2*	*11.0*	*11.2*	*12.0*	*14.2*
Germany	*56.6*	*57.7*	*58.9*	*56.7*	*1882.9*	*33.3*	*24.0*	*33.4*	*46.9*	*25.9*
France	*58.6*	*56.6*	*55.7*	*56.7*	*1470.7*	*23.3*	*22.8*	*28.6*	*26.6*	*20.9*

[1] In 2007; billions of US dollars. [2] Of goods and services. [3] Gross national savings. [4] Brunei not included.
Source: IMF.

On the second question, the answer is far less clear. There does not seem to be a fundamental difference in views about which countries should bear the burden of leading the way. Most policy prescriptions fall into two categories: those suggesting the West should lead the way by consuming less and saving more, and those suggesting the East should lead by consuming more and saving less. The differences tend to stem from differences in beliefs about the roots of the imbalances, ie whether it is a savings glut (Bernanke (2007), Wolf (2009)) or an investment drought in the East (Chinn and Ito (2005)). Others talk about the efficiency of the global financial intermediation system (Caballero et al (2006)). While the focus on the savings and investment considerations still seems reasonable, it strikes me that the resilience of the global imbalances in the face of a huge shock to gross and net flows during the international financial crisis suggests another, possibly more important, factor driving the imbalances. I call this the consumption-crowding-out factor.

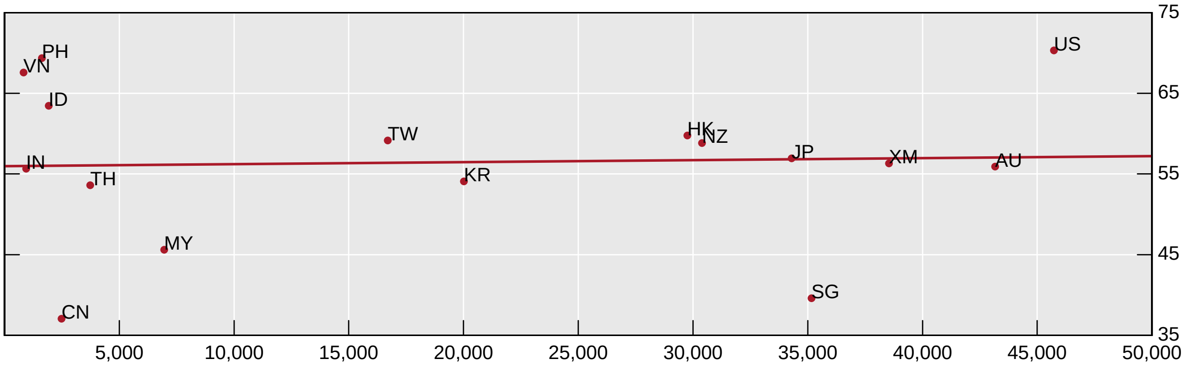
The consumption-crowding-out factor can be best seen from the global output perspective. At any point in time, the amount of consumption available is fixed - a fixed size of the pie if you will. From this perspective, it is clear that the East and the West are vying for the same pie. But the contest is, of course, lopsided. The rich will always have an advantage to outbid the less well-off for consumption goods.

Standard economic theory would suggest that such considerations should be inconsequential; what really matters is the consistency of preferences with a lifetime budget constraint. However, recent behaviour in US housing markets suggests that relying too heavily on such neoclassical arguments could be very seriously misleading. Instead, another way of looking at the problem is through the lens of consumption norms, habit persistence and keeping-up-with-the-Jones' motivations (Akerlof and Shiller (2009)). This newer perspective may provide a more compelling explanation for persistent consumption and savings trends.

To assess the extent of adjustment that might be called for under the consumption-crowding-out view, Graph 13 illustrates the empirical relationship between private consumption relative to per capita GDP. In general, most economies consume roughly 55-60% of GDP at various levels of development (as measured by per capita GDP). There are some notable deviations, with the United States roughly 10 percentage points above the average and China 20 percentage points below the line. (It should be noted that this graph does not account for government consumption which would significantly raise the total consumption share in countries such as Singapore; the general impression of the graph using total consumption is not fundamentally different from this one using private consumption).

Graph 13

Private consumption[1] and nominal GDP per capita[2], 2007



AU = Australia; CN = China; HK = Hong Kong; ID = Indonesia; IN = India; JP = Japan; KR = Korea; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand; TW = Chinese Taipei; US = United States; VN = Vietnam; XM = euro area.

[1] As a percentage of GDP. [2] In US dollars.

Source: IMF

The flip side to this consumption story is a production story, especially one associated with globalization. Global production centres have boosted efficiencies by reducing costs. This has led to a sharp drop in import prices in many economies around the world. But, these firms comprising the global production centres also had to make key decisions about how best to allocate their scarce capacity – ie which markets should they target? Given the economic limits to the pace of expansion, there was a natural tendency to cater to the highest profit margins, and those tended to be in the rich countries with consumers demanding somewhat uniquely tailored product lines. There is also a tendency to stick with production strategies that have worked in the past, especially if change would include sizeable adjustment costs. These production factors suggest that there would be a tendency to focus in the short run on export-led (to the West) solutions in Asia rather than push for more sustainable medium-term production trends.

One additional lesson learnt from the international financial crisis of the past couple of years is that the sense of urgency with which to address the global imbalances may be higher. The crisis has illustrated that a "relatively" small shock (US subprime problems in the hundreds of billions of dollars) can expose very large, systemic vulnerabilities (many trillions). Given this, one has to wonder whether a disorderly unwinding of global imbalances could reveal deep macroeconomic vulnerabilities that may seem difficult to imagine at this time. For example, could the adjustment include not only a sharp adjustment in the configuration of foreign exchange rates but also extreme consumption aversion analogous to the extreme risk aversion that arose during the crisis? It is instructive to note that the movements in FX rates in the past year in Australia, New Zealand and the United Kingdom have had only a limited impact on current account levels in these countries.

Turning now to some practical considerations of the consumption-crowding-out view, we first address the timing issue: who should lead the policy effort? In the East-should-consume-more-first view, discussions recently have suggested that Asian economies should do much more to stimulate the economy by boosting purchasing power in the hands of the public. Part of the argument is that the severe recession in the United States and Europe makes these countries too fragile to pursue a policy of boosting saving. But, is it really feasible for the East to ramp up consumption in this environment? It is important to note that the West is also racing to stimulate its economies, especially in the United States, with very low interest rates, unprecedented fiscal deficits and the flooding of financial markets with credit.

Consider the following possibility. If massive stimulus in the West were to ensure a V-shaped business cycle at the same time that the East expands, with a fixed global pie, it is a distinct possibility that consumption crowding out in the surplus countries would remain. A likely outcome would be a simultaneous over-stimulation in the East and the West, followed by a spike of commodity prices and a burst of global inflation. Alternatively, if inflation expectations were so anchored that goods and services inflation did not sizeably increase, the accompanying excessive credit growth would flow once again into asset prices, leading to boom-bust dynamics with deflation as a possible outcome.

For the surplus countries, there might be a natural temptation to stick to a formula that has shown success, ie such as an aggressive export-led strategy with a corresponding growth in reserves. However, a case can be made that surplus countries in Asia are in a much stronger position than after the Asian Crisis in the late 1990s and do not need to build up a substantially larger pool of reserves. At least four reasons suggest there is little need to pursue another aggressive plan to build up foreign reserves. First, recent levels of reserves in the region appear to have been ample to address one of the largest global shocks in decades. Second, the availability and use of FX derivative positions to manage currency mismatches appears to have worked quite well in New Zealand and Australia. Lessons from their experiences may suggest more modest reserve positions are sufficient as long as the currency mismatches are managed well. Third, the availability of enhanced swap lines in US dollars and other currencies have reduced the need to individually insure against adverse shocks in the future. The availability of such swap lines looks permanent at this time, but of course until the swap lines are tested, questions about their availability and conditionality during periods of stress in the future cannot be ruled out. Fourth, the substantial increase in lending capacity of the IMF, despite the stigma traditionally associated with participation in its funding programmes, may reduce the need to stockpile as many reserves in Asia as in the past.

At the same time, surplus countries in Asia can do much to improve their own economies by adopting sound medium-term policies that naturally lead to greater consumption possibilities. For countries with relatively low consumption-GDP ratios, policies geared toward reducing borrowing constraints could yield tangible benefits. Those policies would include financial liberalisation policies aimed at boosting consumption by allowing consumers to tap their human and non-human capital as a means to optimise their consumption patterns over their lifetimes. Reducing the desired savings rates would also be prudent if savings rates were deemed to be too high from a long-run growth vantage point. Policies that bolster social safety nets would be a natural choice for increasing standards of living and reducing incentives for excessive precautionary savings. In addition, actions that raise the attractiveness of domestic saving through improved financial technologies with a favourable risk-return tradeoff would provide less incentive to export capital, thereby fostering conditions that could eventually lead to a net importation of capital as economic theory would broadly suggest. Finally, promoting efficient wholesale and retail distribution channels would likely go a long way to increasing competition and value-added to the consumer.

More difficult policy choices do arise on the production side of the equation. Further subsidies to capital and infrastructure in situations where there is evidence of past over-investment (see eg Prasad (2009)) would tend to boost economic activity in the short run but aggravate the adjustment over the longer run. Such tradeoffs would suggest caution, on the margin, when considering such policy choices.

While most of these policy recommendations are hardly new, the international financial crisis has opened up a window of opportunity to reconsider them. As countries in Asia look for ways to stimulate their economies, they may find it useful to consider medium-term criteria in their decisions so as not only to cushion the impact of the international financial crisis on the region but also to lay a stronger foundation for medium-term balanced growth opportunities

Some tentative conclusions

The size and scope of measures across the region have been impressive, along with the tighter cohesiveness of regional and international bodies in adopting new policies and pushing for new sound longer-term agendas. The immediate responses to the rapid deceleration in economic and financial conditions have been diverse in the region but, on the whole, have been constructive.

This alone, of course, will not guarantee medium-term success. It may be fair to say that the region has had to react to conditions that have been largely out of its control. Indeed, the initial shock was external to the region and the failures of those same countries caught in the eye of the international financial maelstrom to fully appreciate and offset the consequences of the actions in a timely manner have meant the shocks have spilled over to the region. The recent downgrading of the 2010 prospects for the US economy illustrates how the external sector is continuing to challenge the region.

And, empirical and analytical questions for medium-term frameworks remain. Are the fiscal packages and their debt implications sustainable? If not, what are the exit strategies? Is there a risk that monetary policy may wind up being too easy for too long? How much weight should be put on financial stability issues when setting monetary policy, during periods of stress and during quiescent periods? Will this feed global inflation trends and/or initiate another asset price boom in the future? Have enhanced swap lines reduced the incentives for each country to keep an ample buffer in the future, or will the region continue to build up reserves through export-led strategies? Will they continue to emphasise financial liberalization and currency internationalization, or will populist pressures for financial protectionism arise?

While all countries in the region face these important questions, one overarching medium-term issue which may be of even greater importance is whether the individual actions of the countries, and to some extent through the reinvigorated regional groups such as ASEAN+3 and EMEAP, are sufficient to aid and abet an orderly rotation of demand from the West to Asia. Important collective action issues arise. It is clear that avoiding beggar-thy-neighbour economic and financial policies is a necessary condition for the future. But, is greater regional and international cooperation necessary too? The success on the inflation front in the past decade suggests that each country following its own sensible policies can deliver favourable outcomes.

International efforts to address the global imbalances may be reinvigorated by momentum from the current crisis. Some signs are positive. On the one hand, recent efforts of the G-20 along with the IMF and the FSB suggest that strong international cooperation has been both possible and desirable to address the complexities of global financial stability issues. In addition, the recent ASEAN+3 progress with Chaing Mai-inspired multilateral swap lines and progress on the credit guarantee and investment mechanism hold much hope too. These are examples where issues that transcend national boundaries can benefit greatly from regional and global efforts, or so it seems. On the other hand, the IMF multilateral talks on global imbalances yielded very little in terms of tangible results, which many felt were mere promises rather than substantive actions toward resolution.

In the end, the pace of progress will not be determined by good intentions and joint statements but beneficial outcomes. While we are still in the early days of the stabilization and recovery phase, the legacy of this international financial crisis is likely to be the global efforts to build a sound foundation for financial globalization going forward.

As emphasized above, fixing the financial plumbing is essential to sustainable growth ahead, but the crisis has revealed that more is needed. Without a fundamental reorientation of such consumption and saving patterns across countries, the build-up of global imbalances will continue and an orderly unwinding may become increasingly unlikely. A sound financial system and sustainable, balanced global growth is a strong recipe for economic development and rising standards of living.

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