Shamshad Akhtar: Asia – impact of recent global developments and central bankers' response

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Asia Lecture, Emerging Markets, Madrid, 4 May 2008.

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A. Introduction

1. Deepening financial globalization, driven mainly by far-reaching financial market liberalization and openness and benign global economic environment, has helped nations accumulate capital surpluses and augment cross border flows. Exploiting excess liquidity, financial institutions over-leveraged themselves through esoteric and innovative structured products and loan markets (both on- and off-balance sheets). In an environment of enhanced risk appetite and high returns, households, corporates and other industry participants invested in these products. Growing defaults and lack of liquidity to back these securities, however, generated an unprecedented credit crunch. In the process of unwinding and settling their obligations, several global banks, investment houses and other entities faced substantial financial losses. Resultant loss of confidence of investors created additional risks to financial stability.

2. The risk appetite for these products consequently turned into risk aversion. Facing losses in asset backed securities and persistent dollar depreciation, investors opted to hedge themselves by investing in global commodities. While advanced countries were dealing with the losses emanating from securitized products, growing investor demand for global commodities resulted in an exceptional hike in international prices of strategic food, oil, metals and other products.

3. The world is not unaccustomed to episodes of crisis and has developed experience and expertise to deal with these events. What is unusual in this round is that the global economy is faced with multidimensional crises: (i) liquidity crunch in interbank and money markets, of an unprecedented nature, in the otherwise most lubricated and well nurtured markets; (ii) downturn and distress in housing markets; and (iii) bizarre trends in global commodities' markets. Added to this is the unfolding food crisis. The vibrations and gyrations of a crisis that emerged in one small segment of the financial sector in the US were deeply felt across other segments around the glob*e. These events are a fresh reminder of the costs associated with financial globalization, particularly when there are gaps in the oversight of markets and risk management guidelines are compromised and violated.*

4. Given that the epicenter of this wave of global financial crisis are the developed financial markets, the firefighting by the US and European central bankers is helping contain the contagion. Fed and ECB's vigilance on markets, reliance on conventional tools, such as lowering of policy rates, and use of unconventional tools – ranging from special liquidity facilities offered on the basis of low grade assets as collateral – to rescue operations for housing and investment banks (traditionally not in the purview of central banks) are some examples of how these institutions dealt with the crisis. These central bankers are striking a balance between monetary stability and financial stability, while walking a tight rope of weighing the tradeoffs between economic growth and inflation risks. Steepest reduction in the Fed funds rate reflects that the US weighs economic growth risks more serious to its fundamentals and to the global economy while ECB and BOE weigh inflation risks more seriously. Irrespective of this positioning, all three have acted forcefully to stabilize financial markets by easing liquidity in the interbank and money markets. If the global economy accelerates by early 2009 as anticipated, all monetary authorities will generally shift their focus back to containing inflation.

5. In my remarks, I will confine myself to the impact of the recent global developments on Asia and the implications for central banks and their policy responses. In offering these perspectives, few qualifiers are in order:

- The spillover impact of disruptions in developed markets historically has had a limited impact on Asia. As the region grew faster than the rest of the world, the economies expanded and inter-linkages deepened, with the channels of transmission maturing rapidly.
- Asia's resilience was proven after the 1997 Asian financial crisis as the region was quick to rebound and regain macroeconomic stability. Despite its growing exposures and linkages with world economy, Asia's strong export base and oil revenues have helped the region to build external current account surpluses; consequently Asia's foreign exchange reserves, which rose to $3.9 trillion (and constitute 62% of the world reserves) now act as a strong buffer. Smaller economies of Asia, however, have limited ability to withstand shocks and their macroeconomic stability has been disrupted and their reserves' level has declined in the face of exogenous shocks.
- Unlike past episodes of crisis, the global economy today faces multidimensional challenges. Interdependence among economies introduces its own complications.
- Finally, what is worrisome is that neither the financial markets' turmoil is over nor the US economic slowdown has bottomed out. Equally uncertain is the outlook for the oil and food prices. Unfolding events in these areas could deepen the impact of developments on Asia.

6. **Economic growth outlook.** In the wake of growing economic diversity and divergence of Asia, it is no surprise that the impact of global developments varies considerably across the region. Interestingly, Asia performed fairly well in the last two quarters of 2007 when, in the first round, the US slowdown was confined primarily to the housing sector. As the liquidity crunch deepened, defaults grew and financial losses magnified, resulting in a fall in US consumer spending and confidence. These and associated developments started to filter down across Asia and are now visibly impacting key economic indicators of the region. While the growth outlook for Asia has softened, the growth prospects remain sound and the overall base line of Asia is strong.

7. Despite multiple forecasts, there is a broad consensus that Asia's economic growth is likely to slow down:

- **IMF –** Regional Economic Outlook (REO) forecasts that Asia's growth in 2008 will be 6.2% – or about 1¼ percentage points lower than 2007. Growth of China, with its growing global linkages, is anticipated to be 2.2% lower than the 2007 outcome, India about 1% and the rest of Asia 0.5%.
- **World Bank –** East Asia Pacific Updates, 2008 forecasts that developing East Asia growth will falter by 1.5% to 8.5% relative to 2007 but that expected growth is in line with the trends prevailing in the past. Large deceleration in the growth of China in 2008 impacts the average for East Asia.
- **Asian Development Bank –** Asian Development Outlook, 2008 forecasts that its member developing countries will grow by 7.6% or almost one percentage point lower than last year.
- **Fund managers and other private entities** revised their forecast for different countries by 0.5% to 1.5%.

8. The 2008 outlook for Asia would depend on how uncertainty regarding the US and European economic scenarios resolves itself. While growth outlook has already been moderated, economic activity in Asia will be strong as domestic demand remains robust and is being backed by investment growth particularly in China, India, and ASEAN 5.

9. **Trade prospects.** After faltering somewhat, Asia's exports have regained momentum; in the recent quarter they grew by double digits. Decline in the US and European markets' demand hit Asia hardest in few sectors including IT, electronic, electrical and office machinery industry. Asia's exports performance was nonetheless better than the experience of the 2001 recession, as commodity and non-traditional exports, and exports to newer markets continued to grow.

10. Growing trade integration within the region has also served Asia well. While Asia's exports to countries outside the region have swelled to $1.7 trillion by 2006, (relative to $0.4 billion in the 1990s) intra regional trade grew faster from under $0.2 billion to $1.6 trillion. Consequently, intra regional trade constitutes almost half of the total trade in Asia, and is set to grow further as Asia is gearing itself for greater market diversification. Impetus to this will come as Japan continues to recover, China deepens its trade with Latin America and other regions, and India opens up further on the back of growing middle class incomes and demand. The regional integration is also evident from the growing momentum and scale of regional free trade agreements.

11. Larger economies of Asia and the ASEAN 5 have a dual cushion of continued large, if not growing, external current account surpluses and exceptionally high foreign exchange reserves. However, few economies face growing macroeconomic vulnerabilities. Largely reliant on import of oil and, now, food, external current account deficits in these countries have reached unsustainable levels. Macroeconomic instability and developments in the international environment have also impacted foreign inflows to these countries. In this scenario financing external current account deficits is a challenge complicated further by the exceptional rise in sovereign spreads in international markets as the liquidity constraints deepened.

12. **Implications for financial markets.** Benefiting from the recapitalization, restructuring and stronger regulatory and supervisory systems in the post financial-crisis period, Asian financial markets have been performing well. Emerging Asia's financial assets, as percent of their GDP, rose to 306.3, higher than the ratios for Latin American, African or European countries (155.1, 168.7 and 139.0, respectively), but lower than the world ratio of 401.5.

13. Relative to trade, Asia's financial markets are less integrated particularly within the region. Emerging Asia (excluding Japan) holds only 10 percent of the world's total value of bonds, equities and bank assets. Growth and diversification of capital flows to Asia is impressive. Foreign direct and portfolio flows to Asia have reached almost $989 billion or 2% of the world flows and 9.3% of Asian GDP. Three-fourths of the portfolio flows to Asia were directed to equity markets.

14. In contrast, Asian investors have less than 20% of their equity portfolios (in most cases less than 10%) in markets outside the region and are less dependent on overseas bank lending. Notwithstanding, stock market correlations, co-movements of interest rates and bond yields, and foreign participation in selected markets, do reflect that Asia's financial markets are gradually, but not completely, undergoing global integration.

15. In general, Asia's (excluding Japan's) exposure to the sub-prime mortgage market was limited and confined to few banks in relatively more developed financial markets. The related losses were estimated to be in the range of $20-30 billion and in most cases these losses have been accounted for. Asian central banks' exposure to US mortgage-based securities was also limited, except for China, where these holdings were backed by Government mortgage entities.

16. Financial stress resulted in delays in certain financial deals with Asia but had otherwise little impact on the region's banks and financial institutions. Steeper impact has been observed on securities markets, and to a lesser extent on bond markets, driven by revaluation of risks in financial markets and worries about the global economic outlook. In some cases this resulted mainly in correction of valuation/returns on securities. While the equity markets recovered towards the end of 2007 – with several indices hitting new highs in

October – they came under pressure in the beginning of 2008 as myths regarding Asia's decoupling from the US and Europe faded. By mid-March 2008, most Asian equity indices were down 15-25 percent for the year. Despite the dampening effects on the Asian equity markets, they largely outperformed the mature markets and the world average indices.

17. International debt markets did not go unscathed. Reflecting the liquidity constraints and higher risk premiums, spreads for offshore borrowing widened significantly for both sovereign and other borrowers. Spreads rose for Asia in line with the trends in emerging markets and virtually doubled and tripled (but were below US high yield debt markets). Risk premiums magnified further for countries facing complex economic and political environments. The iTraxx Asia ex-Japan Credit Default Swap (CDS) Index (including sovereign, corporate and financial issuers) surged by almost 300 bps over the last nine months.

18. **Inflationary pressures.** Most worrisome have been the inflationary pressures facing Asia. Rise in oil prices towards the end of 2007 and its subsequent surge in 2008 reaching $120 per barrel, and the food supply shortages in economies that had approached self sufficiency, are two major problems. Oil importing economies are now facing high external current accounts deficits whose stress has resulted in currency depreciation. In other economies, rise in US dollar price of oil has been offset by an appreciation of exchange rates.

19. Inflationary pressures and expectation are on the rise as: (i) Governments allow full or partial pass-through to food and oil prices, (ii) core inflation rises due to fiscal pressures magnified by subsidies on food, agriculture inputs and oil products, and budgetary recourse to central bank borrowings, and (iii) investors seek safe havens in the commodities exchange markets. The depreciating dollar can also be given its share of blame for the record high price of oil, almost double its price just one year ago (from $63/barrel to $119/barrel). Given the fast pace of economic activity, it has not taken long for price changes in metals, commodities, and oil to manifest themselves in higher labor costs and increased prices of many finished goods and services.

20. Financial turmoil, its fallout and contagion, is by no means the only reason for the global commodity price pressures. It has to be recognized that the current trend in global commodity prices is not a one-off distortion or a cyclical spike. The global commodity prices uptrend reflects growing population stress and is likely to now stabilize at a new and higher level. Food prices hike is driven by multiple factors, key among which are: (i) rising population and consumption demand including the China and India factor, (ii) low and stagnating yields, and (iii) farmers switching to crop production for bio-fuels. Larger debate and financing support to resolve the food crisis is likely to rejuvenate food production, albeit with a lag.

21. **Policy responses of central banks**. As highlighted above, the first round effects of the financial market turmoil were largely contained in Asia, given their limited direct exposure to the sub-prime mortgage and other asset based securities. With grimmer economic outlook and concerns regarding financial stability, both at the home front and globally, Fed, BoE and ECB are taking steps to ease monetary policy through liquidity support and lowering interest rates to avert recessionary tendencies from permeating deeper. Asian countries face a different set of challenges, though, like developed countries, they have the difficult task of striking an adequate balance between growth and inflation risks.

22. Since economic growth was steadier in 2007, more immediate preoccupation of Asia's central bankers since July 2007 has been to deal with growing inflationary pressures. Inflation rates in Asia rose beyond projections and in case of inflation targeting regimes resulted in clear breaches. China and India, the two large economies, have resorted to monetary tightening, but primarily through raising cash reserve requirements by 700 bps and 350 bps since July 2007, respectively. These attempts to curb liquidity in the system and excessive demand pressures have not arrested the structural rise in prices. Pakistan has been in a monetary tightening mode since April 2005 and has cumulatively raised the policy

rate by 350 bps with the last two rounds of increase of 100 bps taking place after July 2007. Meanwhile, other countries have held the policy rates steady. In only few cases, such as Thailand and the Philippines, growth risks outweighed inflation risk. Consequently, policy rates were moderately lowered to ease monetary policy but with inflation creeping high, scope for loose monetary policy may no longer exist.

23. The complexity for central bankers in Asia is that food inflation, with 40-50% weightage in price indices, is a major driver of inflationary pressures. An excessive monetary tightening in this situation would end up creating complications for the economy without the desired impact on food inflation that is principally propelled by supply side constraints. At the same time, if monetary policy ignores stubbornly high food inflation, second round impacts would eventually strengthen the inflationary expectations. To resolve this dilemma, governments are resorting to fiscal subsidies to avoid full pass-through. High fiscal deficit countries cannot afford these subsidies and as such have resorted to a gradual and phased pass-through of rise in prices to consumers.

24. Exchange rate appreciation emerging in a number of Asian economies may offset some of the inflationary pressures. However this option is not available to some countries either because currencies are pegged or external current account deficits are high. Given these limitations, it is best for countries to focus on fiscal consolidation to allow fiscal space for subsidies. However, this should be perceived as a short term policy response, while encouraging appropriate investments in the agriculture sector to raise productivity and improve functioning of the wholesale and retail markets under vigilance of local authorities, being more non-inflationary ways of dealing with the current chaos in commodity markets.

25. The financial market turmoil and its consequences offer Asian central bankers a number of lessons. Financial globalization with all its benefits does carry significant risks which hit the weak and under-regulated financial systems more adversely than others. Liquidity crunch and an economic downturn may lead to losses on a wider range of securities, including some of the more highly-rated securities that Asian financial institutions hold in much larger amounts. Moreover, global banks might withdraw financing to Asian economies because of liquidity problems faced in their home markets, which might adversely affect credit conditions.

26. The present events are a reminder that the effects of contagion from small segments of financial markets (i.e. the sub-prime paper and its structured products which are a small proportion of financial assets) or small financial institutions cannot be underestimated as they can threaten and destabilize financial systems and – given the cross border exposures – can create unexpected turbulence for global financial markets and economy.

27. This dispels any notions of a decoupling from the US economy. The size and scale of interaction between Asia and the US brings immeasurable benefits when the going is good, but it will also bring a measure of misery when the economy is in trouble. Asian central banks and governments need to better integrate with each other to mitigate and hedge such risks in future, take advantage of higher returns, and participate in developments in their own region.

28. Increased appetite for, and under-pricing of risk, needs to be checked so that Asia does not repeat the US mistakes. Asian financial markets and regulators have to be wary of speculators and traders that will invariably be promoting a range of high risk financial products. Supervisory bodies must fully understand and meticulously examine the extremely technical financial products that they regulate.

29. Liquidity operations and excessive lowering of policy rates, while easing short term constraints, inducing financial stability, and reviving US and other economies, do however pose the attendant risk of inducing global inflationary pressures. The associated bail out of investors presents a "moral hazard". Besides promoting once again the issuance of alternative investment vehicles without proper due diligence, floatation of these products and injection of liquidity carries the potential risk of recreating economic bubbles in stock and real estate markets.

30. Asian central banks must realign the institutional framework to face these repercussions while addressing the challenges of the highly intertwined, multidimensional crisis on economic growth.

31. **In conclusion,** let me reiterate that there is now a broad consensus that slowdown of the US and Europe is likely to have a more distinct impact on Asia. Impact has been slow to filter down to Asia in 2007, but is predicted to impact economic growth in 2008. The initial set-back to exports in the categories of IT, electrical and electronic products has been offset by growth in nontraditional exports and diversification of trade to newer markets, so much so that Asian exports grew by double digits in a number of countries.

32. Losses on account of sub-prime mortgage markets were limited on the balance sheets of banks and financial institutions and have been written off. In the financial sector, the steepest decline was registered in the securities markets that were fast to recover with the Fed and ECB policy stance, however, the markets remained volatile with corrections in valuations already factored in.

33. Intertwined with financial market turmoil is risk aversion to financially innovative products, and investors' move to global commodities whose demand pressures broke all historical price behavior patterns and reached new levels. This price spiral of strategic commodities such as oil, wheat and other products has created dilemmas as pass-through mechanisms are augmenting inflationary pressures, while not passing through this is complicating macroeconomic management.

34. Asia's inherent strength and resilience remains intact, supported by all time high reserves being fed by surpluses in external current account and boosted regularly by robust export growth, which in the case of net oil exporting countries has received additional impetus from oil export revenues. This has allowed the region to withstand economic shocks but appropriate policy responses are critical to contain the impact of these shocks.

35. Asia's central banks faced additional but different challenges than their counterparts in the West: headline inflation in China has increased to over 8% and in few other countries it has hit double digits. To the extent this is driven by uptrend in international oil and food prices with the latter being more a supply side phenomena, central banks in Asia have held on to their monetary policy stance. Asia in any case has been undergoing monetary tightening since 2007 (or a little earlier) and in some cases demand pressures have led monetary tightening via adjustments in reserve ratios while holding policy rates. Greater vigilance remains essential in order to ensure that hike in commodity prices does not set off second round inflationary expectations leading to rising core inflation which in some cases is already rising because of domestic overheating or over-borrowings by the Government. To the extent inflation rate is being contained through fiscal measures, this in turn will also impact monetary trends and require further tightening.