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The Global Financial Crisis – Implications for Asia

1. I would first like to thank the organisers for inviting me to speak at this year's Economic Society of Singapore Dinner which is being held in conjunction with the Singapore Economic Review Conference. Well over 200 papers will be presented at the Conference, attesting to the breadth and richness of the discussions that took place today and will take place over the coming two days.

2. In 2008, the world went through an economic and financial crisis which was the most severe that we have faced in the last fifty years. What I will do in my speech this evening is first to provide an update on the crisis. I will then proceed to talk about the economic and financial outlook going forward and end with some thoughts on the implications and challenges the crisis poses for Asia.

Update on Crisis

3. First : An update on the crisis. There are signs that the global economy is stabilising after the shock late last year. The massive policy support provided by governments and central banks is beginning to work through the world's economies. Confidence is returning and fears of a meltdown in global financial markets and banks have receded. The reaction to the stress tests of major US banks indicate that the markets believe that these banks, with the support of the US government, will be able to weather the economic storm and earn their way out of future prospective losses. This prognosis is far from certain but the markets have chosen to give the banks the benefit of the doubt. Reflecting this, one closely watched measure of confidence, the Treasury Euro Dollar (TED) spread, has recently declined to pre-Lehman levels. The normalisation in credit flows in turn is supporting the recovery in global industrial production.

4. The global growth recovery is being led by economies that are not leveraged and have room for large policy stimulus like China, Japan, India, and other Asian countries. So despite historic falls in real GDP growth in some countries over late last year and early this year – and therefore dismal growth rates for 2009 – the worst seems to be behind us in Asia. Asian Economies are now expected to see continued improvement through 2010.

5. The US and other major developed economies are also expected to register positive growth later this year. This may be augmented near term by inventory adjustment and pent up demand from extremely depressed spending and output levels. However, sustained OECD growth in 2010 and beyond has less visibility and is likely to be weak given de-leveraging headwinds in the key consumer, financial, and housing sectors that were at the center of this Great Crisis.

Global Economic Outlook

6. So, the good news is that we appear to have avoided a global depression. The global economy seems to be stabilising and is expected to recover, although slowly. Beyond this cyclical recovery, however, my sense is that the global economic and financial environment has changed in three important ways.

7. First, the developed world is likely to experience lower growth in the coming years. De-leveraging, de-risking, re-regulation and, on the margin, even some de-globalization are disrupting markets and dampening economies and could reverse some of the progress due to past liberalization, globalization, and reforms. At the same time, aging populations will increasingly be a drag on growth in the developed economies.

8. The bulk of the globalised banking system consisting of major banks in the US and key parts of Europe are likely to remain capital impaired and subject to greater regulation. In the US, the banking sector is being supported by massive policy intervention and will likely be stable enough to support sub-par growth of 1-2%. However, it may not be strong enough to support credit needed for a sustained robust growth significantly above 2%. This is likely also true for UK and parts of Europe with banking and real estate sector problems.

9. US household consumption is unlikely to be robust as spending is being undermined by weaker income prospects, high unemployment, falling house prices and the need for higher savings rate to maintain long run consumption and repay debt. Household de-leveraging is likely to take a number of years, keeping overall recovery muted. As if these headwinds were not enough, re-regulation, higher taxation, government intervention and the pressing need for medium term fiscal consolidation will also constrain growth in the developed world.

10. In particular, the unprecedentedly large peace-time increase in public debt for many OECD countries from around 50% to over 100% of GDP could eventually put significant upward pressure on real interest rate over the next 3-5 years, potentially crowding out private investment and dampening growth and risk asset valuations.

11. The severe impact of this crisis on employment, household wealth, and public finances also raises difficult political and policy challenges in the West, especially in the US and UK. In the short-term, how governments deal with the continuing crisis will be of the utmost importance. As the troubled US and Japanese recoveries in the 1930s and 1990s demonstrated, policy errors could dramatically change the global economic and financial outlook for the worse.

12. Longer-term, the already difficult trade-offs between populist measures and economic efficiency will become more acute. It will require considerable skill by policy makers to assuage widespread concerns over job security, income inequality, healthcare, retirement, and environmental issues while maintaining a dynamic and open economy.

13. The second major change in the global economic environment is increased risk of both deflation and inflation, reversing a three decade decline in inflation and growth volatility and hence macroeconomic uncertainty. The golden age for asset markets that some have called “the great moderation” looks to have ended.

14. Given the weak economic recovery, excess capacity and high unemployment are expected to keep inflation under control over the next few years. Indeed, deflation remains a significant near term risk given extremely weak labour markets

and downward wage pressure. With prolonged stagnation in employment and income growth, a vicious self re-enforcing downward spiral could easily develop.

15. However, once the recovery is in train, risks are ironically tilted towards higher inflation. Reversing unprecedented quantitative easing will be challenging. Given high unemployment and the risk of stalling a nascent recovery, central banks may be tempted to accommodate higher inflation. Governments may also be tempted to deal with higher fiscal deficits and debt accumulated during the crisis via higher inflation.

16. The global supply of commodities and labour could turn less friendly towards low inflation. Continued growth and urbanization in huge emerging economies will put pressure on food and energy prices, natural resources, and the environment. In addition, the slowing pace of global labour supply expansion will increase inflationary headwinds. This is because towards the end of the next decade, the pace of industrialisation will eventually slowdown in China, while the capacity for other large emerging markets, such as India, to replace China's contribution to global labour supply remains uncertain. At the same time, developed countries will start to see significant declines in their working-age populations.

17. The third major change in the global economic environment is the increasing importance of the emerging economies, anchored by China and India. Emerging economies should continue to grow relatively robustly notwithstanding OECD weakness. Emerging economies are expected to account for more than half of the world's GDP growth over the next decade. In 2000, for instance, emerging markets accounted for 20% of global growth, but over the coming decade this is expected to rise to about 60%.

18. Emerging economies are likely to displace the G-7 as the world's largest economies over the next 10-15 years, even if per capita incomes will still lag behind the developed economies. This relative outperformance will be driven by

(i) larger savings and domestic demand potential,
(ii) relatively healthy public and private sector balance sheets,
(iii) policy flexibility, and
(iv) room for significant productivity catch-up.

The current Great Crisis has markedly accelerated such trends.

19. Medium-term prospects for China and India are positive, even as they face difficult structural challenges going forward. For China, this would include successfully rebalancing its growth drivers, dealing with resource constraints, meeting the aspirations of an increasingly richer population, and reforming a tightly controlled monetary, financial, and exchange rate system.

20. With its fiscal and ideological constraints, India is somewhat behind China in terms of urbanization and economic liberalization but faster progress may be possible with the recently elected government. In addition, at the regional level, some states have been markedly more progressive while the rise of a larger middle class may reduce pressures for more populist politics and increase pressure for economic reforms.

21. Beyond China and India, prospects vary across Asia. Countries that are more dependent on exports and capital inflows, have less healthy balance sheets, and have significant structural impediments such as political uncertainty will fare less well. By contrast, economies with large potential internal markets and which are also more complementary to China and India will benefit. These would include the Greater China and Indochina regions, and Indonesia.

22. But the shift in economic power to the emerging world will also likely increase geopolitical risks. For one, the emerging economies, especially the BRICs will

become key global powers and increasingly demand more say on world affairs. An awkward transition is likely to occur: In terms of military power the US is likely to be dominant for decades to come, and will be called upon to carry out most of the heavy lifting in global trouble spots. However, the US would still be heavily dependent on foreign countries including key emerging geopolitical rivals, to finance its large public debt.

23. Conflicts could also arise over natural resources. Severe demand supply imbalances could lead to greater and more intense competition among nations for resources such as energy, arable land, and useful commodities. This could lead to higher commodity prices, or conflict, or both.

24. The future economic environment is thus fraught with higher macroeconomic, policy, and geopolitical risks. Growth is likely to be lower for a number of years given significant de-leveraging. Deflation risks are high in the near term with inflation risks rising in the longer term. The unprecedented peace-time increase in public debt in the developed countries especially the US and the UK will likely lead to significantly higher real interest rates which could dampen long-term growth. Global growth will recover, but will be skewed towards the emerging countries. The continued rise of emerging markets is positive but will bring increased geopolitical and inflationary risks.

Implications for Asia

25. What does this imply for Asia?

26. The first important implication is that, particularly for countries with large populations like China and India, Asia's economic growth model will be re-oriented from depending largely on exports to a more balanced model that is dependent as much on domestic consumption as on export growth. Such rebalancing would be helpful in two ways. First, as growth in the developed world - hitherto underpinned by the US consumer - is expected to remain weak over the next few years, stronger domestic demand may help mitigate some of that weakness. Second, in so far as some of this rebalancing would be done through increased domestic investment, it could help improve productivity and an economy's productive capacity. A more balanced growth could also help reduce income inequality by improving wage prospects for labour.

27. A strategy that mainly relies on cheap factors of production – labour and other inputs – is not likely to work as well going forward, especially outside excess labour economies like China, India, Indochina and Indonesia. Instead, the rest of Asia will need to look at its own institutions and markets to drive a more sustainable and higher quality growth via strong productivity improvements. In this economic environment, the winners will be those countries that can evolve to be among the world's leading innovators and designers, rather than countries whose factory floors are buffeted by the volatility of structural change and intensifying competition from large labour surplus economies. Innovation driven economies require supply side nimbleness and strengths: investment in human capital (ie education, healthcare, and research) hard and soft infrastructure including competitive domestic markets; and an environment that will attract and retain talent, as well as foster creativity and entrepreneurship. Such an environment will not be compatible with low cost, production oriented strategies.

28. Rebalancing growth drivers will not be an easy process. China illustrates, on a large scale, the positive aspects of this adjustment as well as some of the difficulties. At one level, China is now drawing on its vast savings to help mitigate the impact of the decline in external demand. Some aspects of its fiscal stimulus such as public infrastructure investment will encourage and strengthen domestic growth. At

the same time, short-term concerns over unemployment mean some measures - export rebates, for example - are slowing down adjustments that need to take place for rebalancing to occur. The Chinese authorities are walking a fine line between restructuring the economy for longer-term sustainability and attempts to mitigate short-term pain. It may be that some slowdown in growth is unavoidable in the short-term.

29. China also needs to, over time, bring about a better balance between consumption and investment in GDP. The decline in consumption as a share of GDP makes China vulnerable to external shocks. At the same time, growth has become reliant on investment and on markets to absorb excess supply. This cannot be sustained over the long term. Developing consumption will require more difficult and substantive medium to long term reforms that increase household wage income as a share of GDP and at the same time reduce corporate and household savings. This could include allowing more competition in service industries, recalibrating performance measurement for local officials to include employment and not just GDP growth, and improvements in social safety nets.

30. Understandably much of the focus has been on the negative aspects of this adjustment but I am optimistic that Asia will come out of this crisis in a stronger position. Asia's fundamentals are generally sound, policy-makers have lots of flexibility, and the population is hard-working and educated. There will be bumps along the way, perhaps a few crises, but if we learn the right lessons from history, especially those of the recent Great Crisis, we can re-tool and re-orientate ourselves so Asia's development is more balanced and therefore more sustainable.

31. This brings me to the second important implication for Asia arising from the economic crisis. Asian financial institutions and markets have been given tremendous opportunities over the next decade. The globalised Western banking system, hampered by capital constraints and re-regulation, will likely not be able to intermediate the massive capital demand needed to finance Asian growth. This leaves the playing field unusually open for Asian financial institutions and markets, particularly for the next 3-5 years.

32. Fortunately, Asian banks generally came into this crisis much healthier than their global counterparts given the experience of the Asian Crisis in the 1990s. Capital, liquidity, and nonperforming assets were at healthy levels while exposures to toxic assets were limited. Asian household, business and government sectors are relatively un-leveraged with excess debt. In order to take advantage of this opportunity, however, Asian banks and capital markets will need to develop quickly to step into the breach.

33. In this context, the coming redesign of the global financial regulatory architecture will be a major and difficult exercise with its share of opportunities and risks. First, a lack of coordination in regulatory architecture and practice, together with the rising global unemployment in coming years, may lead to regional trading and financial blocs or at worst, a retreat to protectionism and nationalism. Second, the swing of the political and policy pendulum towards greater regulation may end up with overregulation which stifles financial sector efficiency, productive financial innovation and helpful market discipline. Regulatory and development authorities in the financial sector in Asia need to cooperate as never before with each other and with financial institutions to develop regional capital markets.

34. The third important implication for Asia arising from the global financial crisis relates to the issues policy-makers will face as low global interest rates combined with ample liquidity could give rise to volatile capital flows and asset bubbles across Asia. Across the region, we are already beginning to see significant rises in equity and some real estate prices on the back of domestic reflationary policies and some

capital inflows. Low global interest rates combined with easy domestic monetary policies could lead to higher speculative asset prices. Like in the early 1990s, managing large capital inflows and prospective bubbles given managed exchange rates will be a major task for policy-makers.

Risks and Challenges

35. The greatest risk to the outlook for Asia is a global economic and financial environment that does not stabilize and recover by 2010. Downside risks remain high, despite signs of stabilization. If the US economy turns out to be worse than expected, requirements for banks' capital will be higher and the US administration might need to go back to Congress to ask for additional funding.

36. A second risk is that US consumption fundamentals have deteriorated. Nominal incomes are contracting and the savings rate is rising. Income and spending are being supported now by tax rebates, benefits and transfer payments but it is not clear how sustainable these would be. Hence, weak demand and deflation risk are still significant problems. Sustained deflation could cause private consumption and investment to contract further due to higher real interest rates and real debt burdens. The US could relapse into recession and losses and capital needs escalate again.

37. A third risk is protectionism. In developed countries, chronically higher unemployment and a more receptive political leadership will increase pressures to protect domestic industries from Asian exporters. Policies such as subsidies to protect ailing industries could contravene world trade rules, potentially heightening trade tensions. But protectionism is not just a developed country phenomenon: several developing countries are using import restrictions to mitigate the impact of slowing global demand and weaker current account balances. Clearly there is a danger - probably highest if there is no recovery next year - that protectionism could rise dramatically.

38. A major challenge going forward is the uncertainty raised by the apparent failure of Western or American models which, at the extreme, put financial markets above other sectors of the economy. Will there be a structural change in how savings are mobilized and allocated in the West? Will the state guided models of the East do better? It will take time before we will know the answers to these questions but the balance between private and public sector as the prime economic driver is shifting towards the latter, likely in significant and long-lasting ways.

Conclusion

39. To sum up, Asia has experienced a dramatic slowdown but Asia's fundamentals are strong. As the global economy stabilises, Asian economic growth will recover. China and India will do relatively better but cannot be the drivers for the world economy in the short-term. But over time, China's and India's growth will anchor both the region and a global economy that is likely to see more balanced and sustainable growth. The greatest risk to the region is a failure of policies in the developed world and a return to isolationism or protectionism. More generally, however, there are serious unanswered questions on the role of markets and the state, including the appropriate level of regulation and state intervention. In this environment, Asian banks and capital markets will face both a tremendous challenge and opportunity to intermediate huge regional savings to meet massive capital demand from Asian growth and the integration of major Asian emerging economies into the modern global economy.

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