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Post Financial Crisis - New Global Paradigm and Asia's Role

1. I would first like to thank the organisers of this conference, the Commonwealth magazine, for inviting me to speak at this year's Economic Forum. I am honoured to be participating in a conference that seeks to explore how we in Asia should adapt to the post-crisis world.

2. Over the past two years, the world has experienced what is likely to have been the most severe economic and financial crisis of the modern era. What I will do in my speech this morning is first to share a few thoughts on how the Great Financial Crisis of 2008/9 will change the economic and financial environment. I will then consider the opportunities and risks this environment poses for Asia.

3. To give you a preview: My belief is that the next decade could be a "Golden Age" for Asia. But seeing this become reality will require us to adapt and innovate so we can overcome some difficult challenges. These include finding the right balance between the private sector and public management in the development and running of the financial sector, dealing with short-term economic and financial risks particularly avoiding destabilizing asset bubbles, rebalancing domestic vs external demand in growth models and developing broader, deeper and more efficient financial systems. Given Asia's strengths, I see no reason why Asian countries cannot do so and become a new source of global stability and prosperity.

The Global and Asian Outlook

4. First, an update on the global financial crisis.

5. The global economy has rebounded. After hitting a trough in first half of 2009, the global economy has seen consistent growth. Massive policy support provided by governments and central banks has worked. The recovery is stronger in economies that are not over-leveraged and have room for huge fiscal stimulus such as those in Asia, led by China and India, Brazil, and now followed by the US and Europe.

6. The recovery should be sustained over this year after which growth should settle to its long-term trend in 2011. Global growth could hit 3 to 4% in 2010, up from a contraction of close to 2% last year. The global recovery has generally been stronger than most analysts' expectations and could further surprise on the upside, at least for the next few quarters.

7. Growth, however, will be uneven with the strongest performance coming from the emerging market economies, especially Asia. Asia will benefit from an expected pick-up in global trade and manufacturing; additionally, strong balance sheet fundamentals remain supportive of domestic demand.

8. Economies at the centre of this crisis – the US and Europe – should continue to grow over the coming year. In the US, growth could be moderately strong in the first half of 2010 before slowing down to a below-average pace. Although prospects for the US economy have improved, it does not look like the US will enjoy the growth spurt that typically follows from a deep contraction. Europe too, should benefit from the pickup in global trade although a muted response in consumption tempers the likelihood of a strong bounce. Growth in Europe is likely to be weak.

9. Nevertheless, despite differences in growth and other risks which I will discuss further on, the good news is that we appear to have avoided a global depression. The global economy has stabilised and is now recovering.

Post-Crisis Environment

10. Beyond this recovery, the post-crisis environment will be very different from the world we have been used to, a world that has been dominated by the OECD. My sense is that the global economic and financial environment will change in three important ways.

11. First, the global economy will be, to a greater extent than before, extremely reliant on policymakers for the next couple of years. Extensive government support for the financial sector—liquidity support, asset purchase and guarantee schemes, and public recapitalisation programs—remain in place and have facilitated the healing of money and credit markets. Monetary and fiscal policies are extremely loose, and have mitigated the collapse in domestic demand. The current recovery is being sustained by such unprecedented policies. Changes in policies or mistakes will thus have a significant impact on the global economic and financial environment.

12. A key challenge for policymakers is how to properly time the withdrawal of unprecedented monetary and fiscal policies. The recovery could be derailed if withdrawal is too early or too sharp. However, policymakers run the risk of creating excessive inflation over the medium-term, if emergency-levels of policy stimulus are left unchanged for too long.

13. In some countries, policymakers will come under pressure to repair public finances which have deteriorated because of the financial crisis. Over the past couple of months, for example, government bond yields have risen, in part because investors are growing concerned about the risk of holding such bonds. The challenge for policymakers will be to convince markets that they have credible plans to ensure sustainable public finances over the medium to long-term, while maintaining fiscal stimulus in the short-term. This is particularly true for countries that already faced difficult medium to longer-term fiscal challenges before the crisis. The US remains a risk and other countries such as Greece, Ireland, Italy, Japan, Spain, and the UK are vulnerable.

14. In the emerging economies, policymakers will have to deal with rising inflation and likely asset price bubbles. In contrast to the developed countries, the strong recovery in emerging markets means that CPI inflation will be driven by narrowing and then positive output gaps and rising commodity prices. Asset prices, particularly

real estate for Asia, have been supported by accommodative credit policies, a positive structural story, and in some countries, capital inflows.

15. Given likely protracted extremely easy monetary policy settings in the developed world and managed currency regimes of some emerging markets, combined with their vulnerable underlying demand, it will be a challenging balancing act for policymakers to keep prices under control while not snuffing out growth or precipitating another economic downturn.

16. Finally, high unemployment and unhappiness over “bail-outs” could lead to populist policies, including excessive regulation and protectionism. There is, especially in the developed world, a feeling that the financial sector has “rigged” the system so that it cannot lose—it is simply too big to fail. The upcoming bonus season, when investment professionals are expected to receive record compensation so soon after last year’s turmoil, will only serve to accentuate such feelings. There is little doubt that some rebalancing towards better regulation and supervision is needed but in this environment, there is a risk that such reforms are excessive and ends up stifling innovation and growth. Protectionism also remains a risk despite the recovery. Indeed, despite promises by the major economies in the world as represented by the G-20, in November 2008 to eschew trade restrictions, both developed and emerging countries have actually put in place a significant number of trade restrictions since then.

17. The second major change in the post-crisis environment is the increasing importance of the emerging economies, anchored by Brazil, Russia, India, and China or the BRICs as they are sometimes called. As noted by Antoine van Agtmael who first coined the term emerging markets, the next decade is likely to demonstrate that we are truly living in an “emerging markets century”.

18. The rise of emerging markets is not a new trend but over the next decade we are going to hit a tipping point where the influence of emerging markets in economic, financial, and geopolitical issues will be important, if not dominant.

19. Of course, emerging markets have been growing for years now. Asian economies are well-recognized as world-class producers and exporters. The Middle East and Latin America are important sources of commodities. This is expected to continue. Emerging economies are expected to account for more than half of the world’s GDP growth over the next decade. As estimated by Goldman Sachs, the combined GDP of the BRICs will exceed that of the US by then. China will be three times larger than today and two-thirds the size of the US. Emerging economies are going to displace the G-7 as the world’s largest economies, even if their per capita incomes will still be lower.

20. The shift in economic power to the emerging world will 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 will still be heavily dependent on foreign countries, including key emerging geopolitical rivals, to finance its large public debt.

21. Conflicts could also arise over natural resources. Severe demand supply imbalances could lead to greater and more intense competition among nations for

vital resources such as energy, arable land, and key commodities. This could lead to higher commodity prices, or conflict, or both.

22. The rise of emerging markets also puts pressure on unrestrained carbon-based growth. Aside from rising commodity prices discussed earlier, countries are going to face increasing environmental constraints which will require adaption and innovation if growth is not to be stifled. Our current carbon-based growth model will need to become more carbon efficient and environmentally sustainable. This is especially true as an increasingly sophisticated population adds to pressures for more environmentally friendly policies.

23. Finally, for investors, the rise of emerging markets will mean that a larger proportion of their investments will be in these markets. Far from being a risky and perhaps alternative part of their portfolio, emerging markets will become a core and unavoidable asset class. At the same time, emerging markets will become a leading source of investment and credit, and become large players in new and old financial markets.

24. The third and final aspect of the post-crisis environment which I would like to emphasize is the longer than expected time it might take for the developed world to fully heal from this crisis. The current recovery could be strong, at least in the very short-term, but even the most optimistic economist expects the bounce to be much weaker than what has occurred in the past. Beyond the recovery, work done by the OECD, IMF, and other economists point to weaker growth prospects for a number of years. We should therefore not expect growth in the developed world to power a strong sustained recovery.

25. Several reasons might explain the modest recovery in the developed world. Notwithstanding substantial improvements, the bulk of the globalised banking system consisting of major banks in the US and key parts of Europe are likely to remain 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. However, it may not be strong enough to support credit needed for sustained growth much above potential growth. This is likely also true for UK and parts of Europe with banking and real estate sector problems.

26. US household consumption is unlikely to be robust as spending is being undermined by weaker income prospects, high unemployment, weak house prices and the need for higher savings to maintain long run consumption and repay debt. Household de-leveraging is likely to take a number of years, keeping overall recovery muted.

27. 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. Aging populations will also increasingly be a drag on growth in these economies.

28. The future economic environment is thus different from the past in at least three respects:

- 1) Over the next couple of years, government policies will have an inordinately large impact on the global economy and financial markets,
- 2) A tipping point will be reached where emerging markets will be a significant then dominant global actor, and
- 3) Developed economies could face years of low to modest growth.

Implications for Asia

29. What does this imply for Asia? I group Asia's challenges into four areas.

Balancing private sector development and public regulation

30. First, at the very broad level are the fundamental uncertainties raised by the apparent failure of Anglo-Saxon models of financial sector regulation and development, as well as financial stability management. At the extreme, these paradigms seem to have put blind faith in markets and a lightly regulated private sector, including a belief that markets, especially financial and capital markets, can regulate themselves. In the last decade we have seen a sequence of crises starting with the dot.com crash, Enron scandal, LTCM's near failure, and the Great Crisis of 2008/9.

31. Notwithstanding these crises, the longer term evidence points to the great benefits that sound and mature financial sector development and liberalisation can bestow, especially in enabling a successful transition from an emerging economy to a developed economy.

32. So what should Asia learn and do to keep the potential of well-functioning markets while minimising the risks of instability or crises? It will take time before we will know the answers to these questions but Asian countries have never had a blind belief that markets work best or that the public sector is always inferior to the private sector. As noted by two Chicago economists, Raghuram Rajan and Luigi Zingales in their book *Saving Capitalism from the Capitalists*, Asian countries have long recognized that markets are human institutions and can be imperfect. Government intervention and guidance might therefore be needed to ensure they function well.

33. The challenge for Asian policy makers is to chart an appropriate path between private sector leadership and appropriate public intervention and regulation in the development and management of Asian countries' financial sectors almost from first principles, learning from the mistakes of the West.

Flexible Responses to Short-Term Risks

34. The second area of challenge for Asia is for policymakers to respond flexibly to risks as the global economy recovers. One medium term challenge is managing asset prices. Across the region, we have seen significant rises in equity and real estate prices on the back of domestic reflationary policies and capital inflows supported by low global interest rates. These have not in general hit their previous peak, and can be justified by positive fundamentals, but continued low interest rates could push prices higher, and eventually lead to bubbles. Like in the early 1990s, managing large capital inflows and prospective bubbles will be a major task for policymakers. Asian countries have to be vigilant so that they do not repeat the same mistakes which led to the Asian Financial Crisis in 1997.

35. While not my central expectation, Asian policymakers might also have to respond forcefully if on the other hand recovery in the US and OECD turns out to be weaker than expected and the world finds itself again threatened by recession.

Sustainable Growth

36. The third area of challenge for Asia is the need to rebalance to a more sustainable growth model. This is particularly true for countries with large populations like China and India. Asia's economic growth model will need to be re-oriented from depending largely on exports to a more balanced model that is also dependent on services and domestic consumption. Such rebalancing would be helpful in three ways.

37. 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.

38. 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.

39. Third, a more balanced growth could reduce pressure on the environment. As noted earlier, a growth model that is heavily dependent on resources will soon hit constraints given the amount of supply available, so innovation and adaptation will be necessary.

40. Indeed, 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 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.

41. 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.

Opportunities for Asian Finance

42. This brings me to the fourth important challenge for Asia arising from the economic crisis. Asian financial institutions and markets have been given a golden opportunity. 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 few years.

43. Fortunately, Asian banks generally came into this crisis much healthier than their global counterparts given the experience of the Asian Financial 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.

44. In this context, regulatory and development authorities in the financial sector in Asia need to cooperate as never before with each other and financial institutions to develop regional financial and capital markets.

Conclusion

45. To sum up, given its strong fundamentals Asia is recovering well from the Great Financial Crisis of 2008/9. The post-crisis environment will be different in at least three aspects: greater reliance on policymakers, the dominance of emerging markets, and the relative underperformance of the developed world.

46. This poses four challenges for Asia. First, Asian financial development has to find the right balance between private and public sectors. Second, Asia has to respond in a flexible manner to a volatile environment. Third, Asia has to develop a more balanced and sustainable growth model. Fourth, Asian financial institutions have to gear themselves to take advantage of an unparalleled opportunity to develop and mature.

47. These are difficult challenges but I am optimistic we can overcome them. The next decade could thus be a “Golden Age” for Asia. Asia’s fundamentals are generally sound, policy makers have lots of flexibility, and the population is hardworking and educated. There will likely be bumps along the way, perhaps a few crises, but if we learn the right lessons from history, especially those of the recent Great Financial Crisis, we can re-tool and re-orientate ourselves to propel Asia into its next stage of development.

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