Asia and the Global Financial Crisis: Conference Summary

Reuven Glick and Mark M. Spiegel

The global financial crisis of 2007–09 has starkly demonstrated the extent to which the economic fortunes of the United States, Asia, and the rest of the world are intertwined. The crisis was transmitted to industrial and emerging market economies through both financial and trade channels. Investors were affected by exposure to failing assets in the United States and increased uncertainty in global financial markets. Emerging market economies experienced abrupt halts in capital inflows and downward pressure on their exchange rates. Exporters throughout the world saw demand for their products decline. While Asian economies were initially perceived to be insulated from developments elsewhere, the notion of Asia "decoupling" from the problems in the United States and Europe evaporated as the crisis intensified. Policymakers around the world faced the tasks of stabilizing financial conditions and managing economic growth in the short run as well as adopting long-run reforms aimed at preventing future crises.

To explore these issues, the Federal Reserve Bank of San Francisco inaugurated its Asia Economic Policy Conference series with a conference on "Asia and the Global Financial Crisis" held October 19-20, 2009, in Santa Barbara, California. The conference brought together experts from around the world to discuss the transmission of the crisis to Asia and the responses of economic policymakers and regulators. The conference program consisted of five commissioned papers and other presentations by distinguished speakers.

In opening remarks, Federal Reserve Chairman Ben Bernanke noted that, in the aftermath of the financial crisis of the late 1990s, many emerging market economies in Asia and elsewhere took advantage of improved global conditions to strengthen their economic and financial fundamentals. They bolstered fiscal and foreign debt positions, accumulated foreign exchange reserves, and reformed their banking sectors. When financial turmoil erupted in the summer of 2007, Asian economies were well-positioned to avoid its worst effects. In particular, most financial institutions in the region were not heavily exposed to distressed markets for structured credit products and other asset-backed securities.

Still, Asian nations were affected in late 2007 and 2008 when economies weakened in the United States and other industrial countries. The global financial crisis intensified dramatically when Lehman Brothers failed in September 2008. As investor appetite for risk declined, capital flows shifted away from countries that were viewed as more vulnerable. Moreover, financial institutions withdrew money from risky assets in both advanced and emerging markets. The Federal Reserve established liquidity swap lines with central banks in Asia and other regions to help alleviate dollar funding pressures.

In Bernanke's view, emerging Asia's sound macroeconomic and financial fundamentals provided room for maneuver in carrying out countercyclical monetary and fiscal policy, in contrast with earlier crises or compared with options available to other emerging market countries. In particular, China implemented a sizable fiscal program, supplemented by accommodative monetary and bank lending policies. Bernanke attributed Asia's relatively rapid recovery in large part to such domestic demand-boosting policies, which provided a substitute for exports to trading partners outside the region.

First-day presentations reviewed national experiences of the crisis. Morris Goldstein and Daniel Xie of the Peterson Institute for International Economics identified several characteristics that affected the depth of the downturn among Asian countries. China and India experienced relatively small growth slowdowns, but the economies of Hong Kong, Korea, Singapore, and Taiwan contracted sharply, on par with the recessions they experienced during the financial crisis of 1997–98.

Declining demand for imports among advanced economies transmitted the crisis to export-reliant Asian countries. And, compared with most other emerging market regions, emerging Asia was more sensitive to declines in U.S. asset prices. On the other hand, emerging Asia benefited because it had not increased its exposure to banks in the advanced countries in the decade preceding the crisis. Developing Asian countries also relied more than other emerging market regions on foreign direct investment inflows. And Asian economies were not heavily exposed to U.S. subprime loans. Goldstein and Xie also argued that Asian countries largely avoided the combustible mix of large currency depreciations and adverse mismatches in the currency denominations of assets and liabilities. Recent experience in emerging Europe underscores the exposure to risk when currency and maturity mismatches are not controlled.

Anne Krueger of Johns Hopkins University drew out several lessons from the experiences of Japan and Korea during the 1997–98 financial crisis. First, policymakers must choose an exchange rate regime compatible with monetary and fiscal policy. Unless policymakers are willing to subordinate monetary and fiscal policy to the demands of a fixed exchange rate regime, a flexible exchange rate is preferable. Second, mismatches between banking assets and liabilities must be avoided. When their currency denominations differ, unhedged positions are vulnerable to exchange rate movements. Third, short-term debt should not exceed foreign exchange reserves.

Krueger noted that delays in addressing financial problems are costly. The extent to which authorities implement policies forcefully and quickly is an important determinant of the speed of recovery. Krueger emphasized that authorities must recapitalize financial institutions and see to it that nonperforming loans are addressed. Fiscal stimulus can boost growth in the short term, as it did in Japan in 1996. However, this response is likely to be temporary and full recovery unsustainable as long as the financial system remains impaired. In addition, official credibility and transparency are crucial. Uncertainty about the health of financial institutions can prolong and deepen crises.

Maurice Obstfeld, University of California, Berkeley, and Kenneth Rogoff, Harvard University, argued that, although global imbalances in trade and capital flows didn't cause the crisis, they were generated by some of the same underlying factors and they amplified its magnitude. Excessively stimulatory U.S. monetary policy combined with low global interest rates, credit market distortions, and problematic financial innovations led to a housing bubble. At the same time, exchange rate and other economic policies of emerging market countries such as China helped the United States borrow cheaply abroad to finance its bubble. To limit future global imbalances, Obstfeld and Rogoff suggested policies to improve domestic financial market efficiency in less-developed economies, where structural shortcomings tend to boost corporate and household saving rates. They also proposed stronger global financial market regulation, including more extensive international cooperation.

In a keynote address, Andrew Crockett, president of JPMorgan Chase International, argued that the crisis showed that market failures are more widespread and problematic than previously believed. In the future, the global financial system is likely to continue to be market driven, but regulation will play a more substantial role. Crockett foresaw a fragmented institutional structure, with various international regulatory bodies playing roles alongside established international financial institutions, such as the International Monetary Fund. Asian countries are likely to have a larger voice, consistent with their growing economic clout.

In day two of the conference, presentations concentrated on policy responses to the global financial crisis. Takatoshi Ito of the University of Tokyo reviewed the challenges faced by policymakers in advanced countries during the crisis and evaluated their policy responses, including the U.S. Treasury's liquidity provision program and the Federal Reserve's monetary easing policies. He drew comparisons with the actions of the Japanese Ministry of Finance and the Bank of Japan during that country's 1997 financial crisis, which also started with the failure of a major financial institution, Hokkaido Takushoku Bank. It was also marked by the Bank of Japan's "quantitative easing" monetary policy after interest rates reached the zero bound, similar to the Federal Reserve's balance sheet expansion in 2008 and 2009.

Ito argued that the March 2008 forced sale of Bear Stearns indicated that the crisis had become sufficiently severe that the stability of the entire financial system was at risk. Moreover, the rescue of Bear Stearns, combined with the lack of an explicit framework for the resolution of failed nonbank financial institutions, led investors to believe that other troubled financial institutions, such as Lehman Brothers, were also privy to similar assistance, magnifying the shock when Lehman Brothers was allowed to go under. Ito also argued that, in the immediate aftermath of the Lehman failure, U.S. authorities squandered an opportunity to impose a tough financial recovery program, which would have reduced taxpayer losses. He concluded that actions taken by policymakers during the crisis appeared to have prevented the worst outcomes, but financial conditions would have improved more rapidly if U.S. regulators had moved quickly to shut down troubled institutions early in the crisis.

A panel of Asian policymakers delivered remarks concerning their countries' crisis experiences. Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, noted that the impact of the global financial crisis showed Asia's "deep integration" with the rest of the world, putting to rest the theory that nations in the region had decoupled from the global economy. Asian nations experienced a severe and highly synchronized collapse in trade, with exports within Asia plummeting almost 50 percent. This decline was substantially steeper than the nearly 30 percent decline in exports to the United States and Western Europe. This led to difficulties in Asian financial markets as well. Average sovereign credit default swap spreads increased more than threefold in several economies, and stock prices fell by more than 60 percent. However, Heng noted that Asian monetary and financial systems proved resilient, thanks partly to reforms enacted following the 1997–98 Asian financial crisis, including regulations encouraging Asian investors to avoid currency mismatch exposure. He argued that the relative good fortune of China, India, and Indonesia in avoiding recession was partly attributable to their greater reliance on domestic demand, while the more open economies of Asia were harder hit. Indeed, increases in domestic demand from the region, particularly China, played an important role in the region's relatively rapid recovery.

Heng acknowledged that countries in Asia probably will have to accept lower economic growth rates in the future, as it has been demonstrated that the rapid growth in external demand enjoyed by the region over the previous decade is unsustainable. He concluded that adjustment to this reality will require greater reliance on domestic demand within the region. To achieve this goal the region needs to continue its structural reform efforts, including enhancing investor protection, promoting infrastructure investment, and enhancing regional trade and financial integration. He also acknowledged that currency flexibility was an important vehicle for facilitating structural adjustments and correcting global imbalances, but he noted that exchange rate adjustments were unlikely to eliminate global imbalances on their own.

Kyungsoo Kim, Deputy Governor of the Bank of Korea, discussed his country's experiences during the crisis. On the surface, Korea appeared to be equipped to weather these shocks because it had accumulated a substantial cushion of official reserves and had implemented extensive liberalization measures in response to the disruptions suffered during the 1997–98 Asian financial crisis. These measures improved regulatory conditions in Korea's financial system and limited the exposure of Korean banks to U.S. subprime assets at the onset of the recent global financial crisis. However, Korea experienced substantial capital outflows at the beginning of the crisis that resulted in downward exchange rate pressure. After the Lehman Brothers failure, Korean authorities responded by taking steps to ensure the liquidity of domestic financial markets, including the establishment of a $30 billion swap arrangement with the Federal Reserve. It used these funds, along with its own stock of foreign hard currency reserves, to inject liquidity into its financial system.

Kim's discussion highlighted the difficulties associated with procyclical capital inflows in small open economies and the need to manage capital account openness so as to avoid excessive swings in credit conditions. After the onset of the crisis, Korea's private financial system faced severe currency and maturity mismatch difficulties and experienced capital outflows despite the government's guarantee of bank debt and its willingness to draw down some of its stock of foreign currency reserves. He concluded that the crisis reveals that, while capital account openness can bring benefits, it needs to be managed to avoid excessive procyclical swings in credit conditions. He noted that using foreign reserves to manage procyclical short-term borrowing may raise moral hazard issues if government-financed hedging of risk encourages too much private short-term borrowing. In the end, he argued that regulation must align the incentives of private borrowers with the public interest.

Takafumi Sato, former Commissioner of Japan's Financial Services Agency, discussed Japan's experience and policy responses. Comparing the effects of the recent crisis with the impact of that country's financial troubles of the 1990s, he noted that the recent crisis was less damaging to Japanese financial markets because the problems originated outside Japan. In contrast, the Japanese financial system had played a major role in the buildup of vulnerabilities going into the 1997 crisis. By and large, Japanese banks were generally less exposed to securitized assets than their U.S. and European counterparts. In addition, the reforms undertaken by Japan in response to the previous crisis allowed for a quicker response. Nevertheless, the Japanese financial system was not immune to this crisis, as risks were transmitted internationally through a variety of financial instruments, and some individual Japanese banks did have notable exposure. Moreover, the crisis hit Japan particularly hard as its exports plummeted.

Japanese regulators took steps to maintain the functioning and liquidity of financial markets, preserve financial sector soundness, and sustain bank lending by, for example, authorizing government and central bank purchases of commercial paper and implementing other liquidity provisions. Still, Sato noted that the magnitude of the Japanese response has fallen short of that undertaken by Western governments, mainly because Japan's difficulties in this crisis were the results of external shocks and did not necessarily warrant extensive domestic reforms in response. Consequently, Japan's policy response has been primarily focused on mitigating the short-term cyclical downturn of the economy.

Following the panel, Barry Eichengreen of the University of California, Berkeley, outlined global policy reforms that should be implemented in light of the crisis. He cited two primary causes of the crisis: excessive deregulation and global imbalances that fueled an unsustainable U.S. credit boom.

On the issue of excessive deregulation, Eichengreen argued that financial institutions had incentives that prompted them to take on ever greater levels of risk, particularly as managers within these institutions were motivated to maximize short-term compensation. Moreover, regulators lacked the resources to assess the severity of financial system vulnerability accurately. In addition, lenders made inadequate efforts to evaluate asset risk because they followed an originate-to-distribute business model that left them with little exposure, while rating agencies lacked the capacity to value complex instruments and faced conflicts of interest in doing so. Eichengreen's policy prescriptions included regulations requiring reduced leverage, incorporation of off-balance-sheet items into financial assessments, creation of resolution mechanisms for nondepository institutions, enhancement of regulatory agency resources, as well as addressing problems in derivatives markets by requiring originators of debt to maintain more "skin in the game" to better align their incentives with investors and creating an agency responsible for macroprudential oversight.

Concerning the role of global imbalances, Eichengreen concluded that monetary policy makers should pay attention to these imbalances, even in cases when inflation is absent and countries can borrow in their own currency. In borrowing countries, policymakers should address fiscal policy procyclicality, which seems to have exacerbated the severity of global imbalances. In lending countries, reserve accumulation should be less aggressive because building up these reserves could lead to imbalances of the magnitude that preceded the crisis. Finally, Eichengreen argued that relative prices need to be adjusted to deal with changes in the pattern of demand. This can happen through either nominal exchange rate adjustment or inflation, although exchange rate adjustment is likely to be less disruptive.

In a closing address, International Monetary Fund Deputy Managing Director John Lipsky noted that while the beginnings of an economic recovery were apparent, the global economy remained in an exceptionally difficult and challenging period. Ensuring economic recovery would require continued international collaboration. He criticized the notion that Asian nations had decoupled from the global economy, as the pace of recovery from the crisis appeared to be most robust in the countries that were most integrated with the rest of the world. He also argued that recovery in the region reflected quick and forceful policy responses, which were aided by the strong economic fundamentals enjoyed by Asian nations going into the global crisis. Lipsky stressed that recovery was still in its early stages in Asia, and policy support should be maintained until the recoveries of the Asian economies were secure.