

# Prospects for Asia and the Global Economy: Conference Summary

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The Federal Reserve Bank of San Francisco's Center for Pacific Basin Studies held the third in its biennial Asia Economic Policy Conference (AEPC) series with a program on "Prospects for Asia and the Global Economy" on November 3–5, 2013. The program focused on the challenges faced by policymakers in both advanced and emerging economies as their countries continue to recover from the global financial crisis of 2008–09. Participants considered many ongoing questions, such as what are the channels through which monetary policy easing in advanced economies has affected other countries, particularly emerging markets? How can monetary policy and macroprudential policy be managed to achieve the objectives of price, output, and financial sector stability? What is the global growth outlook, particularly in Asia? How vulnerable is the global financial system to another crisis? Finally, what reforms in financial sector regulation would help mitigate the likelihood of future crises? To explore these issues and others, the conference brought together experts from around the world and commissioned papers and other presentations by distinguished speakers. This chapter highlights the principal issues raised at the conference and summarizes the papers presented.

In opening remarks on "Advanced Economy Monetary Policy and Emerging Market Economies," Governor Jerome Powell of the Federal Reserve Board of Governors spoke on the challenges posed by volatile cross-border capital flows for emerging market economies (EMEs). He acknowledged that accommodative monetary policy in advanced economies, particularly in the United States, has drawn capital into EMEs and put upward pressure on their currency values and asset prices. However, he argued, even if those policies caused EME currencies to appreciate, the consequent drag on their exports has been offset by the positive effects of stronger demand from advanced economies. In addition, Powell said that capital flows depend on other factors as well, such as relative growth prospects and global attitudes towards risk: Capital has been attracted to EMEs by their stronger growth outlook and greater risk tolerance by global investors. Moreover, in his view credit growth and rising house prices in many

EMEs seem to reflect domestic developments more than spillovers from global financial conditions.

Although monetary policy in the United States is likely to remain highly accommodative for some time, Powell acknowledged that financial markets in EMEs may be affected as the U.S. economic recovery continues and the Federal Reserve tapers its pace of asset purchases and moves closer to raising the federal funds rate. However, just as was the case in the most recent financial crisis, EMEs generally should exhibit greater resilience than they did in prior decades, reflecting their more flexible exchange rates, greater international reserve holdings, stronger fiscal positions, and better regulated and managed banking systems. Powell concluded by stating that the Federal Reserve's mandate, like those of other central banks, is focused on the pursuit of domestic policy objectives. Nonetheless, the Federal Reserve takes into account the linkages between the U.S. economy and the rest of the world when conducting monetary policy.

The Asian giants, China and India, have experienced historically unprecedented episodes of growth over the past 30 years. Consensus forecasts for the global economy over the medium and long term call for Asia including China and India to continue to grow strongly. In "Asiaphoria Meets Regression to the Mean," Lant Pritchett and Lawrence Summers of Harvard University coin the term "Asiaphoria" to describe this optimistic forecast, but argue for a more pessimistic outcome. More specifically, they argue that past growth performance is of very little value for forecasting future growth and that there are good reasons to expect that future growth in China and India may be much less rapid than is currently anticipated. In their view, abnormally rapid growth is rarely persistent and "regression to the mean" is an empirically robust feature of economic growth.

Pritchett and Summers also show that the growth process in developing countries is typically characterized by sharp changes or "discontinuities," with very large accelerations or decelerations of growth. Rapidly growing countries are substantially more likely to suffer a sharp downward change in growth than an upward movement; that is, growth declines are more likely to be sudden and large than gradual and small. Moreover, the risks of sharp declines in growth are much higher in countries with weak institutions and policymaking frameworks.

For these reasons their forecasts for Chinese and Indian growth are much more pessimistic than consensus projections. In their view, high levels of state control and limited respect for the rule of law add to the likelihood of a sharp decline in growth in these countries. They refer to prior bouts of Asiaphoria—the

growth projections of Japan from the 1960s and 1970s and the growth booms of the East Asian Tigers of Korea, Taiwan, Singapore, and Hong Kong in the 1980s. Economic growth ultimately declined sharply in all of these economies. Pritchett and Summers predict a similar outcome for China and India.

In “Surprising Similarities: Recent Monetary Regimes of Small Economies,” Andrew Rose of the University of California at Berkeley provides evidence on how monetary regimes in small open economies fared during the recent global financial crisis. He classifies monetary regimes into three categories: those that target the inflation rate; those maintaining a “hard” exchange rate peg to some stable foreign currency either by accepting it as separate legal tender or by adopting a currency board arrangement or a conventional peg; and those regimes in the “sloppy center” with crawling bands, adjustable pegs, or monetary aggregate targets.

Rose presents two main results. First, he shows that hard fixers and inflation targeters generally were able to sustain their regimes during the shocks from the global financial crisis. Of the countries that targeted inflation in 2006, almost all were still doing so in 2012; almost three-quarters of the hard fixers also survived over the period. By way of contrast, less than a quarter of the sloppy center maintained the same monetary regime during the crisis and its aftermath. This stability is historically unusual because, as Rose also shows, during prior recessions and crises it was very common for countries to abandon their monetary policy regimes.

Second, Rose finds that macroeconomic performance—whether measured by growth, inflation, fiscal policy, current account, reserve growth, or asset prices—over the period 2007–12 were similar for countries with hard fixed and inflation targeting regimes. In contrast, outcomes for the sloppy center were quite different, particularly on the inflation front, where inflation performance was substantially worse. This result is somewhat surprising, since a hard commitment to a fixed exchange rate seems quite different from the constrained discretion of an inflation target. Hard fixers have severely limited monetary autonomy, while inflation targeters are not directly constrained by exchange rate targets. Thus, hard fixers with open capital markets would seem to have substantially less ability than inflation targeters to insulate themselves from the spillover effects of foreign capital flows.

A possible explanation for Rose’s finding is that because the financial crisis was a common shock, creating a deep recession and strong deflationary pressure virtually everywhere, independent inflation targeting central banks as well as the central banks to which hard fixers pegged all aggressively eased monetary policy. Thus, any countries that had pegged to the dollar or the euro

also experienced policy ease because of the actions of the Federal Reserve and the European Central Bank. For most countries very accommodative monetary policy was appropriate during the global financial crisis, and this is what their monetary regimes delivered. This might not be the case for other shocks, such as terms of trade or inflation shocks, where the outcomes may well be very different for hard fix versus inflation targeting regimes.

In a keynote address entitled “The Shifts and the Shocks: Emerging Economies in an Age of Financial Crises,” Martin Wolf of the *Financial Times* discussed the origins of the 2007–08 financial crisis and its implications for emerging markets. He views the crisis as the result of the interaction of a vulnerable financial system with a global savings glut after the Asian crisis of the late 1990s, as many emerging economies, including China, pursued economic policies that generated large current account surpluses. This led to large capital flows to the rest of the world, particularly to the advanced economies, including the United States.

In this environment, the Federal Reserve pursued aggressive monetary policies to offset the external drag of growing U.S. current account deficits and concerns about deflation after the stock market bubble burst in 2000. The capital inflows and accommodative monetary policy led to increasing asset prices, particularly in housing, and borrowing in the United States. These effects were amplified by investors “reaching for yield,” the proliferation of mortgage-backed assets, and a dramatic increase in leverage within the financial sector. With house prices and credit rising, greater household indebtedness stimulated additional spending by households on consumption and residential investment. When the crisis hit in 2008, the pumped-up demand collapsed. In Wolf’s view, the exceptionally aggressive monetary policies in advanced countries since 2008 have been largely ineffective in boosting economic growth and reducing unemployment. He attributes the ineffectiveness of monetary policy to a breakdown in the functioning of the credit mechanism and the effects of the zero lower bound on policy rates.

In discussing the implications for emerging economies, Wolf notes that after the crises of the 1980s and 1990s, emerging economies sought to minimize the risks of crises by adopting more conservative fiscal policies, placing greater reliance on borrowing in domestic currencies, focusing central banks on inflation targeting, allowing their exchange rates more flexibility, and using capital controls when appropriate. These policies generally worked, with emerging economies proving far more resilient to shocks recently than in the past.

Looking forward, Wolf maintained that macroprudential policy through permanently higher capital ratios or by automatic countercyclical adjustments

of leverage ratios could help lower the probability of crisis further. However, he argues that financial crises are inescapable features of greater risk-taking behavior fostered by economic and financial liberalization in a global economy. He suggests that the way to encourage a less crisis-prone world economy involved some reserve accumulation by emerging economies as well as by making more resources available through international financial institutions, such as the IMF.

Reserve accumulation by emerging market economies rose significantly in the aftermath of the 1997–98 Asian financial crisis. This buildup was motivated by efforts to limit currency appreciation in order to maintain competitiveness, as well as by the desire of policymakers in these countries to provide self-insurance against the effects of capital flow reversals. The need for such insurance increases with capital account liberalization, where potential currency mismatches, bank runs, and capital flight can rapidly drain a central bank’s foreign exchange reserves.

Reserve accumulation has costs as well. These include the income loss associated with earning interest on reserves that is typically lower than the interest paid on instruments issued by the central bank—typically government bonds or its own liabilities—to finance or sterilize its reserve accumulation. Other costs may arise if sustained reserve accumulation fuels domestic credit booms and asset price bubbles or creates distortions when the banking sector is induced to hold more of these instruments than it would choose to do so voluntarily.

In “Crowding Out Redefined: The Role of Reserve Accumulation,” Carmen Reinhart and Takeshi Tashiro of Harvard University emphasize another cost of reserve accumulation in the form of the crowding out of domestic investment in the aftermath of the 1997–98 Asian financial crisis. They show that, for the nine Asian economies in their study, average investment as a share of GDP fell by about 6 percentage points during the period from 1998 to 2012 compared to its average level in the decade before the sustained reserve accumulation. They interpret this dampening of investment in Asia as a form of crowding out, with Asian governments absorbing domestic saving in order to acquire the securities of the advanced economies as reserves.

More specifically, Reinhart and Tashiro show that in the wake of the Asia crisis, many governments in the region redirected their borrowing toward the domestic market because external borrowing was either prohibitively expensive or altogether unavailable. Even in cases where capital market access was not lost, many governments sought to borrow more from “captive” domestic savers, such as pension funds, insurance companies, and domestic banks, to lessen rollover risk. This fostered greater competition for domestic borrowers

in the home market for loanable funds. The resulting higher cost of borrowing curtailed domestic investment through what Reinhart and Tashiro refer to as “conventional” crowding out. To the extent that central banks also funneled domestic saving abroad to accumulate foreign reserves, a broader form of crowding out occurred.

Their analysis suggests that countries with relatively more pervasive capital flow barriers may have a better chance of limiting the crowding out effects of reserve accumulation on investment. This may be because capital controls limit private outflows or capital flight and/or because the magnitude of desired reserve accumulation is smaller, as the controls also insulate the domestic economy from external shocks.

In his address “The Second Phase of Global Liquidity and Its Impact on Emerging Economies,” Hyun Song Shin of Princeton University discussed how recent trends in global liquidity have affected the vulnerability of the international financial system. Shin distinguishes two phases of global liquidity during the past decade. The first phase, starting roughly in 2003 and lasting until the 2008–09 crisis, primarily involved the transmission of looser financial conditions across borders through the acceleration of banking sector capital flows. The second phase of global liquidity, which started around 2010, involved the cross-border transmission of financial conditions through the growth of offshore bond markets, particularly involving the debt securities of emerging market corporations.

Shin argues that the second phase of global liquidity has increased the vulnerability of emerging economies for several reasons. First, to the extent that the offshore debt issued by emerging market corporations is denominated in foreign currency, mismatches arise on their consolidated balance sheets, exposing them to exchange rate risk. Second, the increased offshore issuance of bonds has been accompanied by growth in corporate deposits in the domestic banking system, making them more vulnerable to withdrawal in the event of corporate distress. Third, the growing stock of emerging market debt securities has been absorbed increasingly by asset managers, such as hedge funds, that may be more prone to engage in risk-taking behavior in comparison to other investors, such as pension and life insurance companies.

As Shin discusses, most analyses of past financial crises have focused on the banking sector and emphasize leverage or maturity mismatches of banks or other financial intermediaries. In contrast, he argues that future crises are more likely to depend on the activities of the corporate sector and asset managers. Consequently, he argues that the usual indicators of vulnerability, such as bank leverage, may be of limited use in signaling the next crisis. He suggests

several alternative measures of financial system vulnerability that better measure the exposure of emerging market nonfinancial firms to capital flow reversals. These include tracking offshore borrowing as well as corporate bank deposits and other short-term claims of the nonfinancial corporate sector on the domestic financial system.

The second day of the conference began with a paper by Olivier Jeanne of Johns Hopkins University, entitled “Macroprudential Policies in a Global Perspective.” Jeanne examines the case for global coordination of macroprudential policies aimed at managing international capital flows. As capital inflows sometimes can be disruptive, countries may unilaterally improve their welfare through macroprudential intervention. However, Jeanne’s analysis demonstrates that such policies may involve spillovers to other economies, raising the scope for mutually beneficial policy coordination. In particular, Jeanne presents a theoretical model in which private foreign borrowing can influence the probability of a financial crisis, but this effect is not fully internalized by domestic private agents.

Jeanne finds that there is little scope for mutually beneficial international policy coordination in his frictionless benchmark model, because any international spillovers that may exist manifest themselves through compensating global interest rate movements. The best attainable outcome under such conditions can be reached by each country pursuing its unilaterally preferred domestic macroprudential policy affecting domestic borrowing, rather than implementing controls on capital inflows. In contrast, when nominal frictions—such as wage rigidity—are present, or when countries are large, there is a scope for beneficial policy coordination. For example, policy coordination may be required to avoid pushing one or more countries into a liquidity trap in which the zero-bound constraint on the nominal interest rate makes it impossible to achieve full employment with monetary policy.

Jeanne presents the example of a two-country model of the United States and China, considering macroprudential policy when the United States finds itself in a liquidity trap. He demonstrates that a Pareto-improving outcome that could be achieved through policy coordination would be for the United States to be less aggressive in its pursuit of monetary expansion to escape the liquidity trap, while China lessens its efforts to dampen the impact of U.S. monetary policy on its domestic credit growth by accumulating less foreign reserves.

In “Financial Regulation after the Crisis: How Did We Get Here, and How Do We Get Out?,” Gerard Caprio of Williams College reviews the recent regulatory reform initiatives undertaken by the Basel Committee on Bank Supervision and argues that regulatory responses undertaken to date in response

to the global financial crisis need to be reconsidered. In particular, he argues that the main framework underlying the Basel reforms needs to be restarted because of its neglect of the endogeneity of risk to the regulatory structure and the dynamic nature of finance and its regulation. In his view, applying similar risk weights for all banks in all countries has resulted in increased correlation of bank asset returns. This is because similar risk weights induce banks to move into similar asset exposures, which can become more correlated as conditions deteriorate. In addition, Caprio believes that a restart of regulatory oversight is necessary because the response to difficulties in the regulatory framework in the past has been an increase in the complexity of the regulatory system, with regulatory intervention at “an ever more granular level,” to forestall undesired behavior by regulated firms.

In order to reverse this pattern of ever-increasing regulatory complexity, Caprio recommends that the risk weights codified under the Basel regulations should be abandoned in favor of a simple leverage rule supplemented by heightened shares of equity finance and conditional convertible debt, commonly referred to as “CoCos.” CoCos automatically convert from debt to equity when equity falls below a specified level. His view is that CoCos could induce banks to follow more prudent lending and funding practices, thereby lowering their risk of failure. He also argues for a regulatory approach that focuses on regulator accountability and greater transparency, claiming that regulatory intervention during the crisis was late. He gives the example of Northern Rock in the United Kingdom being allowed to issue dividends shortly before its failure. He therefore argues for the need of a “sentinel” that would monitor regulators against both corrupt and obsolete practices. Such a sentinel would provide public commentary on regulatory practices, forcing the regulator to be more accountable to the public, but have no regulatory power itself. Caprio acknowledges that the creation of such a regulatory sentinel provides no guarantee that regulators will respond to vulnerabilities more vigorously, but he argues that it would increase the odds of a more prompt regulatory response.

In the policymaker panel, Bank of Korea Deputy Governor Woon Gyu Choi discussed “Current Policy Challenges Faced by Emerging Market Economies and Korea.” Choi considered policy problems raised for emerging market economies by the anticipated removal of accommodative monetary policies by Western central banks as the recovery from the global financial crisis progresses. In particular, he examined the challenges raised by the Federal Reserve’s tapering of its quantitative easing policies.

Choi argues that the anticipated removal of accommodative monetary policy by foreign central banks is analogous to a negative external shock exerting

deflationary pressure on emerging market economies. However, this impact would likely be mitigated by a negative impact on their exchange rates boosting their export competitiveness. Moreover, the appropriate monetary policy response to such a shock is unclear due to possible adverse implications of monetary tightening on domestic economic conditions. Empirically, vulnerable countries, most notably the well-known “fragile five” (India, Indonesia, Brazil, South Africa, and Turkey) experienced capital outflows resulting in exchange rate depreciation and reduced domestic equity values. He echoed the remarks at the conference by Federal Reserve Governor Jerome Powell, arguing that advanced economy monetary policies should account for such international linkages.

Choi claims that the signaling of tapering by the Federal Reserve in May and June 2013 served as a test run of the implications the removal of accommodative Western monetary policies could have on emerging market fortunes. The primary lesson he draws from this experience is that fundamentals, in terms of fiscal space and domestic economic conditions, play a significant role in determining these implications. Moreover, in the event of such policy changes, the scope for adjustment to these external shocks among the most vulnerable emerging market economies is likely to be severely limited.

The Deputy Governor finished his remarks by focusing on the Korean case. Korean fundamentals had improved markedly since the global financial crisis, and this improvement was rewarded by a relatively benign experience during the initial signaling period of Federal Reserve tapering. Still, Korea faces a number of unique challenges, including its extraordinary openness, which results in increased vulnerability to foreign shocks, which could lead to sluggish domestic investment and increasing household debt that could weigh on domestic Korean demand going forward.

The next speaker in the policy panel was David Dollar from the Brookings Institution, who spoke on “Financial and Fiscal Reforms in Support of China’s Rebalancing.” Dollar began his analysis by noting that, while China weathered the global financial crisis relatively well, it did so through government stimulus that increased already high investment levels. Consequently, China emerged from the crisis in need of structural rebalancing.

Dollar notes that structural reforms are likely to play an important role in this rebalancing. These will include opening up the service sector to competition, easing labor mobility, and most importantly greater liberalization of the financial sector. Financial reforms could allow for gradual Chinese adjustment to a more sustainable growth pattern. Chinese deposit interest rates are exceptionally low, leaving households almost no return on savings. Investment

options outside of the banking sector, such as through equities or securities, are very limited. Under these conditions, a large amount of capital has flowed into the real estate sector, inflating prices.

Some reform has already taken place. Commercial banks are permitted to offer deposit rates up to 1.1 times benchmark rates, and the band may be further widened. Moreover, the shadow banking system, in which higher interest rates prevail, has grown considerably. However, Dollar notes that light regulation in that sector raises vulnerabilities for the Chinese financial system. Further interest rate liberalization in the formal banking sector would therefore be welcomed. On the fiscal side, Dollar argues that a key problem is that revenues are primarily raised by the central government while expenditures typically take place at the local level. Allowing local governments to issue bonds or to raise local revenues through property taxes would address this mismatch.

The final panel speaker was Bank of Canada Deputy Governor John Murray. Murray began his remarks by comparing Canada's current situation with those of the Asian economies. While Canada shares many similarities with Asian economies, most notably its openness and its vulnerability to external shocks from neighboring large economies, there are also notable differences. In particular, while many Asian economies, particularly China, are discussing a rebalancing away from excessive reliance on external demand, Canada is looking forward to greater stimulus from external sources, primarily driven by the U.S. economic recovery. Unlike most Asian nations, Murray argues that the level of reliance on external demand displayed by Canada just before the crisis in 2007 was both sustainable and appropriate. In addition, he notes that, while Canada's maintenance of nominal exchange rate flexibility—which also stands in contrast to many Asian nations—has led to episodes of instability, over the long run it has permitted market signals to feed through to the Canadian economy and allowed for smoother and more timely adjustment.

Murray also reviewed the performance of emerging Asian economies leading up to the crisis, acknowledging that growth rates posted in the region were extraordinary, but also cautioning that the imbalances that accompanied these achievements likely rendered them unsustainable. Thus, in his view, it is not surprising that the export sectors of emerging Asian economies were particularly hard hit during the crisis. Still he argues that the framework crafted by the Group of 20 leaders early in the crisis laid the framework for sustainable recovery.

Nevertheless, Murray acknowledged that the global recovery to date has been disappointing. Moreover, he argues that the pace of recovery achieved was largely due to exceptionally aggressive monetary policies. Further progress

will only be achieved through true structural reform. Along these lines, he points to reform efforts in Asia's two largest economies, China and Japan, as hopeful signs of future meaningful adjustment.

The conference was closed by a broad overview of current issues faced by the Asian region by Barry Eichengreen of the University of California at Berkeley. In his overview, Eichengreen argues that the outlook for the region is first and foremost a question about its two major economies, China and Japan. He was cautiously optimistic about the prospects for what he terms the "great reflation" in Japan. He noted that positive, albeit modest, inflation numbers have begun to show up in Japanese data, a marked change for that economy. He also praised the efforts Japan's government has made to balance its need for short-term fiscal stimulus with that of medium-term fiscal consolidation. However, like many commentators, Eichengreen remains pessimistic about the commitment to the so-called "third arrow" of Japanese adjustment, namely structural reform. He notes the strong opposition that the government has already encountered in its efforts to lower labor adjustment costs.

Turning to China, he characterized its efforts to rebalance its economy as "monumental," noting that household consumption currently only accounts for about a third of the Chinese economy, well below the two-thirds share in many other economies. Since such a rebalancing presumably would be accomplished through greater consumption of services, Eichengreen argues that it would be accompanied by slower output growth since productivity growth in services is lower than that in manufacturing. He therefore wondered whether government authorities would be willing to accept such a growth slowdown in the name of reform.

Eichengreen then turned to the question of the likelihood of another Asian crisis. He highlighted a number of contrasts of the current situation with that of the 1997–98 Asian crisis: Asian countries have more flexible exchange rates, they have a greater share of their debt denominated in local currency, and they are running current account surpluses and have built up substantial war chests of foreign reserves. Still, Eichengreen points to China as a risk, noting that credit broadly defined has boomed in China from 125 percent to 200 percent of GDP. Eichengreen notes that many such credit booms have ended badly.