GENERAL DISCUSSION
Lessons from Asian Financial Experience

Chair: Rakesh Mohan

Mr. Mohan: Questions?

Ms. Hughes Hale: Concerning current weaknesses, I'd like to ask Andrew Sheng a question about China. You've described why savings is so high. So, where is the increase in bank lending going? Is it going to the state-owned enterprises, and is that going to cause a potential asset bubble? Or is it going to SMEs (small and medium enterprises), which will increase employment and then increase consumption? The second question I had is, there is an assumption that the social safety net is expanding, but the number of doctors and hospitals in China, according to my statistics, has actually decreased over the past 10 years of prosperity in China. If that is true, households are going to continue to be really incentivized to save. So, I'm wondering if you think that consumer spending in China will rise or not.

Mr. Mohan: I think we'll collect three or four questions.

Ms. Amador: You mentioned that the opacity in the data on the financial systems and on the market economy is one of the reasons for the herd behavior of market participants during the Asian financial crisis. Do you think that there has been an appreciable shift in the information and disclosure practices of the Asian economies in general?

Mr. Mohan: Taka.

Mr. Ito: Andrew had an interesting table comparing the Asian currency crisis with the current crisis. In the current crisis, you were referring to both the U.S. and European emerging marketing economies, I suppose. My question to Andrew and Anne is, what went wrong in Latvia, Iceland, Hungary, and other European emerging market economies in this global crisis? Could they have learned lessons from Asia in 1997 and 1998? And if they did, what went wrong with the IMF, which was supposed to have watched over all those things and helped prevent new crises?

Mr. Hooper: Question for Anne. I wonder if you would comment on whether the current consensus forecast for the global economy might be a little bit pessimistic. I think conventional wisdom has been influenced strongly by the seminal work of Reinhart and Rogoff, that financial crisis begets sluggish recoveries. But your findings suggest that maybe it's a little more nuanced, that perhaps one doesn't need to be quite so pessimistic in light of how aggressive the policy response has been this time. I was wondering if you might comment on that.

Mr. Mohan: If I can add to the first point on Chinese consumption and the relationship with social security. If anything, the condition of Indian social security is even worse than the Chinese social security situation. So why do Indian households consume more than the Chinese? Is improving social security a real solution for underconsumption by Chinese households?

Mr. Mohan: Anne, you want to go first?

Ms. Krueger: I think what happened—in Korea, at least—was that the authorities lowered domestic interest rates before macroeconomic conditions really called for it. In a sense, of course, they didn't know what was happening and it was a policy mistake that led to this decision because private sector spending was not that weak, though the private sector subsequently responded to lower interest rates by increasing domestic borrowing. I don't disagree with the outcome, but I do think that the carry trade was there because of what happened on the domestic front.

The question on the Chinese social safety net I will leave to Andrew. Where does the bank credit go? It seems to me that the Chinese banks are simply the government's fiscal agent, and when they are told to put the money out there, that's what they do. And it goes into infrastructure or whatever else happens to be on the drawing board when the money goes. I don't think there's any mystery about it; it doesn't necessarily go directly to consumers. The saving, however, is coming predominantly from the corporate sector. It is not coming so much from the private sector as from retained earnings on the part of the enterprises. I think the Chinese government could affect policy there, as well as work on the social safety net.

The third question was about information provision in Asia. Clearly in Korea and Japan it is much, much better than it was. Of course, we never know what isn't there. My impression is that in Korea the authorities, if anything, bent over backward to the point that once or twice I have wondered whether telling all is always a good move. I would leave it to someone like Taka [Ito] to tell me whether the Japanese authorities are going that far or not.

For Latvia, Hungary, and other Eastern European countries, the numbers on the extent to which households were taking up mortgages in Swiss francs and Swedish krona and others are truly astonishing. And in Latvia, something like 80 percent of GDP was held by households as mortgage debt in foreign currency, which means that for Latvia a big change in the exchange rate wipes out the household sector, but failing to change it wipes out the business sector, so they are really caught. So far they have tried to manage it by cutting wages 20 percent almost across the board and otherwise trying to get the price level down. Obviously they've now said that isn't enough so they're going for a second round. I think the political scientists need to tell us if that's doable or not. The big problem is that they're caught on both sides. The same in Hungary, the same in some other Eastern European countries. This buildup of foreign debt was definitely a variant of the carry trade because there was higher inflation in the Eastern European countries, their domestic interest rates were high, their exchange rate was fixed, and so households figured they should borrow in foreign exchange, which is a perfectly sensible response. Something like 60 percent of Austrian mortgages are in Swiss francs; the numbers are really huge but that's what was allowed to happen.

Are the consensus forecasts too pessimistic? I've been wanting to see what the forecasts were before the end of 1996 for the East Asian economies and then again at the beginning of the current crisis. Certainly in the previous crisis in Korea all forecasts were incredibly pessimistic relative to what actually happened. In Thailand, the forecasts were somewhat more favorable. The one country where the forecasts were not so pessimistic was Indonesia, which had a large political element to it. I haven't seen systematic documentation on this, but I believe the forecasts at that time were on the pessimistic side in all cases but Indonesia.

Mr. Mohan: Andrew Sheng.

Mr. Sheng: Thank you for the questions on China. I first want to give a caveat. Even though I've studied it, I don't consider myself an expert on the Chinese economy. I have some understanding of the banking system, so the views expressed here are all my own. On Lyric's question about the spending, and the apparent anomaly that Rakesh mentioned between Indian and Chinese household saving rates, my impression is that Chinese household expenditures actually are not low. I don't understand why it doesn't get picked up in the data. My sense is that the data reported on the investment side have a consumption element to them, but I can't say for sure. But there are several important trends to understand about the Chinese economy.

The first one is demographics. The Chinese demographic pattern is actually very similar to Japan in the late 1960s and early 1970s, when Japan was growing nearly 8 to 10 percent, and then there was a sharp falloff. China's one-child policy implies a roughly 10- to 15-year window in which there is a demographic endowment because the population is young and household saving levels are very, very high. When China opened up and Chinese enterprises engaged in exporting like the rest of Asia, there was a surge in productivity gains and the corporate saving rate went up as well. This is clearly an issue.

The second major trend is the massive urbanization going on in China. There's a massive shift from rural areas towards urban areas, which means that the pressure on the infrastructure in the cities is huge, and that's why massive public investment is needed. Even considering what appeared to be excessive building, for example in Pudong and Shanghai in the mid-1990s, we see today that there's just not enough supply relative to the demand. So what appears to be overinvestment in infrastructure, in fact because of urbanization has actually created its own demand. So the predictions of large nonperforming loans may not come true.

The social safety net is an area that must be addressed, and the Chinese government is addressing this very seriously. It will take time, there's no doubt. You're actually talking of a massive change in the social security system as well as the equivalent of Medicare health-care reform. Over the last 10 to 15 years, rural health care has not gotten as much attention as I think it deserves, so the Chinese government is pouring a lot of money, particularly through the $4 trillion stimulus package, into the rural areas. After the Golden Week holidays in October (2008), spending has gone up a lot. So I think this shift towards domestic consumption is increasing.

On the question about data in Asia, the overall transparency of Asian statistics has improved quite a lot, but what I still consider to be a major failing is the lack of implementation of UN SNA standards on flow of funds and balance sheet data, particularly balance sheet data on corporate leverage and local government leverage, as well as real estate data—they are just not available. And if we look at what we mean by macroprudential problems, it really means that the balance sheet numbers don't add up. They don't make sense. And if they don't make sense, it's very likely you've got a huge problem sitting in your hands. Thus, it's very important for statistics departments within Asia to improve the quality of data they collect. I agree with Taka in that I'm surprised that certain parts of Europe repeated the Asian double mismatch before the 1997–98 crisis when currency and maturity mismatches were widespread. Anybody who saw that Asian crisis should know that foreign currency borrowing to speculate in domestic markets is asking for trouble.

Mr. Heng: I would just like to share a comment and then a question for both Professor Krueger and Andrew. My comment is that, when you look at the transmission of the current financial crisis, the most significant channel of transmission to Asia was not through the financial sector, but rather the real sector. This very significant fact needs further study, which I think Morris Goldstein and Daniel Xie's paper helps provide.

Let me just share two other bits which I think may be useful. One concerns the psychology of policymakers as well as bankers after the Asian crisis. Bear in mind there were two very significant events in Asia over this period. One was the 2001 IT (information technology) downturn, which affected quite a number of Asian economies. The other one was the 2003 SARs outbreak, which had a very big impact on the more open economies in the region. As a result of that, both regulators and bankers acted quite conservatively. The other point is that the structure of finance in Asia has been very conservative and very plain vanilla. There was none of the complex stuff and most of it was oriented towards real economy development, growth, exports, and so on. However, this has the implication that you are more likely to get funding if you are an exporter with a known strategy than if you're a domestic SME or an entrepreneur thinking of doing something new. In that context, I agree with Professor Krueger's comment that in Asia the discussion ought not to be about regulations per se, but about development and innovation in the financial system to support growth.

And my question is, in the context of our earlier discussion about rebalancing growth and a new growth strategy, what sort of changes do Professor Krueger and Andrew think are needed in the financial sector in Asia to support a new growth strategy?

Mr. Mohan: Jacob Frenkel.

Mr. Frenkel: My comment is stimulated by Andrew's remarks. You spoke about the role of demography. You spoke about increasing urbanization in China, and indeed, the way I see it, there was a political decision to engage in massive urbanization. To sustain it, the Chinese authorities had to provide employment to the migrants. To provide employment, they had to be engaged in the production process. Hence, output grew. Without domestic demand to sustain it, you have to rely on exports. Therefore, as long as there is no domestic demand, and as long as the decision to pursue greater urbanization continues, you will need to continue to rely on exports, which explains the reluctance of the Chinese authorities to appreciate the currency. To get out of this loop requires a strategy of increasing domestic demand, but that likely involves a very long process, as you just said. One way to shorten the process and reduce domestic savings and increase domestic demand is to focus more on the corporate sector. Much of the savings in China, as well as elsewhere in Asia, comes from corporations that do not distribute dividends. Taxing these savings could encourage greater distribution of dividends.

Let me make one more point about the demographics. Indeed, China has an aging society, and in fact I saw a demographic projection that between now and the year 2030 there will be about 150 million more Chinese, but all of them will be concentrated in the age 55 cohort. If you want to have more friends around you, you'd better be 55 and above. The other cohorts literally shrink. This situation differs greatly from that in India. In India, you will have probably 300 million additional people but with attractive growth in younger age cohorts.

Mr. Mohan: Thank you. I'm afraid time is up for questions. Anne, would you like to go first?

Ms. Krueger: I think much of it was directed towards Andrew. What changes are needed to support Asian growth going forward? I think we've already talked about shifting more toward domestic demand, avoiding more protection and lowering barriers for domestic economic activities. At least there, I think, it really is a bit country-specific. In Japan, quite clearly, there are a lot of things one could do by way of changing land regulation. In India as well land use regulations are important, where regulations on retail and protecting the "ma and pa" stores have clearly held up any productivity growth in those sectors. In other countries, it is important for politicians to interfere less than they otherwise would by getting in and throwing a lot of sand into the system. For sectors where there isn't much foreign competition, it's easier to maintain archaic regulations that thwart productivity growth and change. I think that for each Asian country it will be incumbent to begin looking more closely at some of the things that have been holding up growth within their domestic markets.

Let me just make one comment on the one-child policy and what it's done. I agree its main purpose is demographic, but I wonder: If people know that they've got one child and only one child to support them in their old age, the motive to save is likely a lot stronger than it was in traditional society. It seems to me that we have underestimated this effect on saving. Quite clearly the motive for health-care saving is incredibly strong at the current time as well.

Mr. Mohan: Let me just add to the observation you made when you were giving your discussion comments about the deleveraging of the corporate sector that took place in Asia after the Asian crisis. Is there an analogy between that development and the deleveraging of the financial sector that is happening now in Europe and the United States? Does this shed any light on current proposals for increasing bank capital ratios and so on?

Mr. Sheng: Well, I think that Asian capital adequacy ratios currently are actually fairly okay because most of it is core capital, whereas, if I understand it correctly, the problem with the Western banking system is that the core capital—tier one— is actually relatively small, while tier two capital is fairly large. Although I'm entering into a very controversial area, there is not just an issue about appropriate capital ratios. There's also the issue of the quality of the provisions against nonperforming loans. Of course, if you don't have enough provisions you're wiped out. But I think the lesson of the Asian crisis was that a lot of banks looked as if they had enough capital, but the provisions were clearly inadequate. This time round, I think everybody has gotten a little bit smarter, so Asia didn't suffer so much through the financial channel. And I agree with Heng Swee Keat, this time around the transmission channel was primarily on the real sector side. The crisis that Asia is facing at the moment was amplified by the Asian global supply chain; that supply chain was designed to supply goods to both Europe and America, but suddenly exports fell somewhere between 25 to 50 percent. So it's very clear that there was no decoupling, though the degree of linkage varied. The countries that had very large domestic markets did not suffer as much as those countries that were relatively small, such as Hong Kong, Singapore, and others who could only export, whereas Indonesia and China could switch to domestic production. The simplest example I found was a suit manufacturer; he said he was not suffering because he could switch very rapidly to domestic production, since all Chinese in the rural areas need to buy a suit when they get married. The manufacturer sold a cheaper version and could compensate somewhat, though not completely, against his export losses.

On the regulation point by Heng Swee Keat, I think, there is a major question facing Asian financial institutions of what business model to follow. At one time they all wanted to be another Citibank, but now they realize that the universal banking models have some complications. So they are beginning to rethink the relative merits of the investment banking model. Very clearly Asian regulators are now thinking about financial innovation, not in the context of increasing leverage, but rather in terms of how better to serve the real sector.

That's the area we're all struggling with, whether we use technology or service quality, et cetera.

On Jacob Frenkel's point, I would agree that the big problem with Asian corporate governance is that the corporate sector is not paying out enough dividends. And that's why the retired populations in high savings economies in Asia actually don't have much cash flow for expenditures. So I would actually encourage Asian corporations to save less, increase their capital efficiency, and pay more dividends.

Mr. Mohan: Thank you very much, Anne and Andrew. Anne, I can't let you get away with that graph that you put up earlier comparing growth in India and Korea, because the higher growth of Korea had nothing to do with its financial sector. Given Korea's crisis experiences, presumably the Korean financial sector did not perform much better than the Indian financial sector over time.

Ms. Krueger: But the negative effects of the financial crises on Korea's growth were dominated by a higher overall long-term growth path.

Mr. Mohan: That is true, but the financial sector didn't have very much to do with the differences. I thought I would have the last word before you would answer.

Ms. Krueger: Not a chance.

Mr. Mohan: Thank you very much, everyone.