

## COMMENTARY

**The Impact of the Financial Crisis on Emerging Asia**

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Morris Goldstein and Daniel Xie provide a very comprehensive presentation and discussion on the impact of the financial crisis on emerging Asia. In order to try to add some value to this discussion, I will focus on what is primarily a single issue, though there are a number of aspects to it. Figure 1C in the Goldstein and Xie paper summarizes the main message of what I want to focus on. The figure plots annualized growth rates for exports of emerging Asian economies. Since the prices of exports, which are predominantly manufactured rather than primary products, did not have a great deal of movement during this period, the figure effectively describes real export growth. What is clear for Asia is that exports wiggled around, but essentially were flat from 2003 until late 2008, when exports collapsed.

In terms of this metric, the crisis and its impact on emerging Asia occurred mainly in late 2008 and early 2009. This was well after the financial difficulties in the subprime market in the United States that began to emerge in early 2007 deepened further in the summer of 2007 and intensified with the Bear Stearns episode in 2008. It was only beginning around the middle of September of 2008 with the demise of Lehman Brothers that the global financial crisis really stepped up in magnitude. Indeed if we look at measures like the *Vix index*, a measure of volatility in the stock market, it fluctuated between roughly 8 and 30 for a number of years and then suddenly shot up to almost 90. This unprecedented movement and changes in many other indicators of financial market stress at the end of 2008 occurred in a way that we had never seen before in the postwar era. So in discussing the effects of the global financial crisis, it makes a great deal of difference if one is talking about the effects of the crisis beginning in September 2008 or about the longer period of financial stress that began in mid-2007.

Now, we might also note that some of the other emerging market areas show a slightly different pattern in terms of exports. For Africa and the Middle East, nominal export growth rose in late 2007 and the first part of 2008 as the result of an acceleration of global inflation in commodity prices that occurred

just before the global economic collapse and intensification of the financial crisis that occurred in the latter part of 2008.

Let me discuss further the timing of the financial crisis and the timing of the impact on emerging Asia. The first key point is that, while a great deal of attention has focused on the global financial crisis, I think that to a greater extent than is widely appreciated we have seen a classic boom-and-bust cycle in the world economy, to which has been added some elements of typical financial stress, augmented by the extraordinary financial market turbulence experienced in the fall of 2008. So we need to understand the global crisis as part of a broader cyclical phenomenon.

World economic growth slowed very substantially in 2001 and 2002 and accelerated beginning in early 2003 into the 4 to 5 percent range through 2007. This first phase of the general global expansion ended around mid-2006. Note that U.S. gross domestic product (GDP) also accelerated in this period, as did GDP growth in emerging Asia and most regions of the world economy. It was a very broad-based global economic expansion, with inflation remaining generally very well subdued at least through 2006 and 2007, despite some upward movement in commodity prices. In Asia, growing exports were a very important part of the economic boom. In the United States the housing sector was booming with residential investment (having suffered no downturn in the recession of 2001) and continuing to expand rapidly through the end of 2005. Home prices escalated rapidly, reaching a peak in the middle of 2006. With U.S. domestic demand growing somewhat more rapidly than real GDP, there was a corresponding further deterioration in the U.S. current account deficit. So in phase one there was a general boom without inflation.

In phase two, the U.S. economy slowed significantly, especially in terms of domestic demand growth. Domestic demand growth from the middle of 2006 to the end of 2007 was barely more than 1 percent at an annual rate. GDP growth also slowed to a little bit more than 2 percent. Improvement in U.S. real net exports, aided by the continuing boom in the rest of the world economy, was the key reason why the U.S. did not slow more or fall into recession during this stage of the business cycle. So we see a differential movement between the U.S. and most of the rest of the world economy in this six-quarter period from mid-2006 through 2007. Emerging Asia on the whole continued to do quite well, as did Western Europe and Japan to an extent. However, global inflation began to accelerate towards the end of this period, with 12-month inflation rates picking up in most of the world economy. The U.S. was a bit of an exception because core inflation in the U.S. showed very little response to the general rise of prices elsewhere in the world economy. This difference is important in terms of the

conduct of economic policy. The Federal Reserve, concerned about both developments in the financial sector and the weakening of economic activity, started easing monetary policy in the fall of 2007. In contrast, almost all other countries around the world were either maintaining relatively firm monetary policies or tightening policies further at this stage.

Moving to phase three, during the first eight or nine months of 2008 the U.S. economy was in recession according to the National Bureau of Economic Research. Other countries generally continued to expand through the first quarter of 2008, and inflation worldwide continued to surge with the oil prices moving to new highs. However, in the second quarter of 2008, global GDP growth began to slow substantially. Most other industrial countries experienced negative growth, as did a number of emerging market countries such as Korea and Singapore. Though growth in most of emerging Asia including China remained positive, the overall global economy entered into recession by the third quarter of 2008. The United States contributed to this global recession through spillovers from its financial crisis and its domestic recession. But the global recession was also partly a result of the global tightening of monetary policy implemented to combat rapidly rising commodity price inflation earlier in 2007. In addition, the remarkable upsurge in world oil prices dramatically cut the real value of consumer income and spending power in the U.S. and many other economies.

So the deepening global economic slowdown in the first eight or nine months of 2008 was certainly not exclusively due to the financial crisis up to that point. It was also the result of cyclical events, including the upsurge in oil prices and tightening of monetary policy abroad. Then on top of it all, we added this remarkable, unprecedented collapse in the functioning of key global credit markets and economic activity around the world. This showed up in everybody's GDP growth rates in the fourth quarter of 2008, as growth rates around the world all dropped very substantially from where they had been in previous years. The global decline in real GDP by more than 6 percent at an annual rate is unprecedented in the postwar history of the world economy. So it is there where we see the impact of the global financial crisis.

This has several implications. First, what we are ultimately going to think about this crisis is probably going to have to wait until another conference to consider further because a great deal depends upon whether, as I expect, we will get a V-shaped recovery or we have a long period of very sluggish economic recovery including in the United States and most industrial countries. We just do not know the answer to that yet but it will surely influence how we think about this episode. Just as if, had we held this conference a year ago, it would have been very different from the conference we're having now because

we wouldn't have seen the economic impact of the collapse of global financial markets.

A second point is, I do not fully understand what caused the great global financial crisis of the fall of 2008. Many people say it was the failure of Lehman Brothers. But that is like saying that the assassination of the Archduke Franz Ferdinand caused the First World War. I think the current situation is more complex than that. The demise of Lehman Brothers may have been a triggering event, but it is unclear why it triggered such a remarkable collapse of market function. How and why that happened is something that requires greater explanation.

Finally, there is the question of, what should we do about all of this? I feel a little uneasy in that there are many proposals for reform and reconstruction of our financial system. Almost all of those proposals were out on the table before the Lehman Brothers collapse. So they could not have been formulated with that experience in mind. Thus the question is, how do these proposals need to be adapted in light of what we should have learned from that remarkable event. If we're talking about the economic impact on the crisis of emerging Asia, we are primarily talking about the impact of the crisis from that point onward, not the crisis before that time.