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Asia's Role in the Post-Crisis Global Economy

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In the wake of the global financial crisis of 2007–08, Asia has emerged as a pillar of financial stability and economic growth. A recent San Francisco Federal Reserve Bank conference focused on Asia's changing role in the global economy. Asia's relative strength is allowing it to play an expanded part in multilateral responses to the European sovereign debt crisis. And the reforms put in place following the 1997 Asian financial crisis offer models for countries currently trying to stabilize their economies.

This Economic Letter *summarizes presentations made at the Federal Reserve Bank of San Francisco Center for Pacific Basin Studies' second biennial Asia Economic Policy Conference, "Asia's Role in the Post-Crisis Global Economy," held November 29–30, 2011, in San Francisco. Conference presentations are listed at the end of this* Letter *and are available at* *http://www.frbsf.org/economics/conferences/aepc/2011/agenda.php*.

In the aftermath of the financial crisis of 2007–08, how can monetary and supervisory policy be coordinated to stabilize prices, economic output, and financial markets? What are the relative merits of regional coordination in Asia in light of the lessons of the crisis? What are the prospects for global rebalancing of trade and capital flows, and what role might China play in these developments? To explore these and other issues, the Federal Reserve Bank of San Francisco's Asia Economic Policy Conference brought together experts from around the world and commissioned papers and other presentations by distinguished speakers.

Asia's post-crisis role in the global economy

The rate of recovery from the global financial crisis of 2008–09 has varied between advanced and emerging market economies. Many emerging market economies, particularly in Asia, recovered quite quickly. In remarks opening the 2011 Asia Economic Policy Conference, Federal Reserve Board of Governors Vice Chair Janet Yellen noted that emerging Asia's growth bolstered the global economy in the wake of the financial crisis. However, the global economy still faces an ongoing aggregate demand shortfall in the advanced economies. For that reason, Yellen argued, it is crucial that emerging market economies, particularly in Asia, take further steps to boost domestic demand. Greater internal demand in those economies would support stronger, more balanced, and sustainable global economic growth. It would also improve social welfare at home.

Yellen cited several specific policy measures that emerging Asian nations could adopt. Increased public spending on social services would spur consumption by reducing the need for precautionary household saving. Government support could shift toward encouraging development of the service sector, which tends to have a higher nontraded component than goods production. Faster service-sector expansion would help rebalance growth toward domestic demand. Finally, exchange rate adjustments could boost Asian demand for imported goods and services.

Two conference presentations examined the monetary policy lessons of the financial crisis. Lars Svensson from Sweden's Riksbank argued that monetary policy is distinct from financial stability policy. During the crisis, it was financial stability policy that failed, not monetary policy. Flexible inflation targeting remains the best approach to monetary policy. Monetary policy should take financial stability policy into account, and vice versa. But, under normal conditions, financial stability should be achieved through regulation, not monetary policy.

Some emerging economies have experienced increased inflows of foreign capital over the past few years. Svensson maintained that these inflows stem from policies of stabilizing dollar exchange rates or pegging to the dollar. These countries could adopt more flexible exchange rate policies, which would allow them to conduct independent monetary policy more appropriate for their specific circumstances.

Joon-Ho Hahm, Frederic Mishkin, Hyun Song Shin, and Kwanho Shin provided an overview of policy options that can complement traditional tools of bank regulation and monetary policy to rein in financial system excesses. The authors argued that macroprudential regulatory policies should be the first line of defense against credit booms. In particular, macroprudential policies should constrain excessive growth and imprudent practices in bank lending during booms. Macroprudential tools could include administrative rules that limit bank lending, such as caps on loan-to-value and debt-service-to-income ratios. Countercyclical capital requirements and forward-looking provisioning can also protect individual financial institutions and reduce systemic risk.

Eswar Prasad and Lei Ye analyzed the growing internationalization of the renminbi through its use in cross-border trade and financial transactions. Renminbi trade settlement in Hong Kong has expanded rapidly, and some central banks are considering holding renminbi-denominated assets in their foreign exchange reserve portfolios. Nonetheless, the renminbi is a long way from attaining full convertibility or meeting other prerequisites for reserve currency status. Achieving such status would require China to make its exchange rate more flexible and open its capital account by allowing domestic citizens to hold foreign assets and foreign investors to hold renminbi-denominated assets. Prasad and Ye argue that these steps would create for China only modest risks of vulnerability to external shocks. By contrast, a fixed or tightly managed nominal exchange rate makes it harder to cope with capital flow volatility because currency revaluation cannot be used as a shock absorber.

China's achievements since the beginning of economic reforms in 1979 are one of the most striking developments of our era and its growth prospects in the years ahead are a vital matter for the global economy. In a review of China's progress, Justin Lin of the World Bank noted that the country posted an annual 9% growth rate from 1979 to 1990, which remarkably rose to 10.4% from 1990 to 2010. Such an extended period of high growth in a populous country is unprecedented. Moreover, China has the potential to maintain an 8% annual expansion rate for another two decades, which would make it a leading engine of global growth. Lin attributed China's remarkable performance over the past 30 years to its ability to implement structural economic reforms in an environment of relative stability.

Many scholars and policymakers have noted that China's growth path has been unbalanced, favoring development of its export sector as opposed to promoting domestic demand. Nicholas Lardy of the Peterson Institute for International Economics examined how Chinese authorities are trying to address this imbalance and sustain growth. In his view, China's unbalanced pattern of aggregate demand is primarily attributable to distortion of the domestic financial sector. Since 2004, the inflation-adjusted return on one-year deposits in Chinese banks has averaged –0.4%, far below the average 3% rate between the late 1990s and the early 2000s. The negative real return on savings has decreased consumer spending in two ways. First, it has depressed household interest income, dampening household spending. Second, it has contributed to a sharp increase in the household saving rate. This is not surprising in an economy in which the pension and health-care systems are relatively underdeveloped and many households don't have retirement or health insurance plans. Negative real deposit rates have also contributed to a sustained rise in residential property investment.

Two conference papers addressed economic relationships within Asia and between Asia and the rest of the world. Edwin Truman, also of the Peterson Institute, considered the prospects for greater regional cooperation and integration in Asia. He noted that the continent would benefit from greater regional policy coordination. But he added that a focus solely on intra-Asian policy coordination is unlikely to be successful for at least two reasons. First, Asian economies are sufficiently heterogeneous so that they are unlikely to find mutually advantageous grounds for much deeper regional coordination. Second, the recent financial crisis demonstrated that no region of the world is so isolated that it can ignore global economic spillovers. Thus, Asian policy coordination cannot ignore the global economy.

Pierre-Olivier Gourinchas of the University of California, Berkeley, argued that the global financial crisis revealed a need to reassess the way global imbalances are interpreted. In particular, proper assessment of financial stability should be based on measures of liquidity mismatches over time and across countries. This focuses on national funding risk, providing a better indicator of financial vulnerability than such standard indicators as the current account. Gourinchas noted that, during the boom period prior to the crisis, the U.S. current account position improved modestly, even as unsustainable financial excesses were building up. That history supports the view that current account balances provide an inadequate picture of a country's financial vulnerability.

In a panel discussion entitled "Policy Reforms after the Crisis," Jun Il Kim, Deputy Governor and Chief Economist of the Bank of Korea, credited aggressive U.S. and European monetary and fiscal policy responses to the financial crisis with preventing another Great Depression. However, the global economy is still hampered by excessive leverage. The need for continued expansionary fiscal policy in the short term requires a commitment to long-term budgetary tightening to persuade the public that fiscal policy is sustainable over the long run. Kim also recommended regulatory reforms that focus on systemic risk, but are not so stringent that they hinder investment and economic growth.

In addition, the international swap arrangements set up by the Federal Reserve with several emerging market economies played an important role in calming markets during the crisis. Kim advocated creating a global financial safety net to address future international liquidity needs.

Ryuzo Miyao, Policy Board Member of the Bank of Japan, noted that the central cause of the financial crisis lay in an asset price bubble fueled by new financial instruments, particularly derivative products. These instruments led to a rapid increase in leverage, raising global vulnerabilities on a scale that was not fully appreciated during the boom. Miyao said monetary policy tools should be used to limit asset price bubbles before a crisis erupts because the power of such tools is limited once problems spin out of control. He acknowledged that this view is controversial. Nonetheless, he said, asset price bubbles can increase the instability of economic growth and inflation, which means that containing them falls squarely under the purview of monetary policy. He also called for the use of macroprudential tools to contain bubbles, such as limiting loan-to-value ratios of loans made by systemically important financial institutions, as well as countercyclical capital buffers.

In the final panel presentation, Norman Chan, Chief Executive of the Hong Kong Monetary Authority, said recent financial crises in industrialized countries stemmed from market failures. For example, extremely low yields on debt prior to the European sovereign debt crisis reflected market participant misperceptions that the large debt levels built up by Greece and other countries were sustainable. The only way to fully recover from the crises was through deleveraging. While Hong Kong suffered its own painful housing bubble collapse, it has since restructured and emerged as a more resilient economy. Chan contended that similar reforms are needed in the United States and other overleveraged countries.

In a closing address, Barry Eichengreen of the University of California, Berkeley, noted that the title of the conference, “Asia’s Role in the Post-Crisis Economy,” was prescient in light of the possibility that Asian countries might help European countries stabilize their finances. Eichengreen argued for strong monetary and fiscal responses to the sovereign debt crisis, but noted that the best policy is not always clear. For example, last-resort lending is an obvious monetary policy response after a crisis has hit. But, he asked, what is the role for monetary policy prior to a crisis?

Eichengreen said he was disappointed that the Basel negotiations had failed to agree on an international standard for countercyclical capital requirements. He also said that it was unfortunate that some Asian countries have not “been able to get over their [International Monetary Fund] phobia.” He pointed to the limited effectiveness of regional responses to the 1997–98 crisis, arguing that national differences in political systems and levels of economic development have limited the achievements of regional Asian institutions.

Conclusion

A key conference theme was that the global financial crisis demonstrated that Asian nations cannot “go it alone.” A sufficiently large global shock would have devastating implications for the region. Thus, Asian nations should participate in multilateral efforts in financial regulation and the provision of liquidity in emergencies. Moreover, while Asia suffered heavily in the global financial crisis, the policy reforms put in place after the 1997 Asian financial crisis left the region relatively well-equipped to weather the severe shocks of the 2007–08 period.

This has two implications. First, many of the policy reforms that Asian countries adopted, such as improved accounting standards and regulatory practices, provide examples to western nations of positive responses to crisis. Second, some Asian countries emerged from the recent crisis in sound financial condition. For that reason, they might be able to play a prominent role in assisting countries still suffering financial disruptions.

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Conference Presentations

Chan, Norman T.L. "Policy Reforms after the Crisis."

Eichengreen, Barry. "Closing Remarks."

Gourinchas, Pierre-Olivier. "Global Imbalances and Global Liquidity."

Hahm, Joon-Ho, Frederic Mishkin, Hyun Song Shin, and Kwanho Shin. "Macroprudential Policies in Open Emerging Economies."

Kim, Jun Il. "Global Policy Challenges in the Post-Crisis Period."

Miyao, Ryuzo. "A Macroprudential Perspective in the Conduct of Monetary Policy."

Prasad, Eswar S., and Lei Ye. "The Renminbi's Role in the Global Monetary System."

Svensson, Lars E.O. "Monetary Policy after the Crisis."

Truman, Edwin M. "Asian Regional Policy Coordination."

Yellen, Janet L. "Aggregate Demand and the Global Economic Recovery."

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