

**GENERAL DISCUSSION****The Impact of the Financial Crisis on Emerging Asia****Chair: Rakesh Mohan**

**Mr. Mohan:** While people think of their questions, let me start off with one question for Morris. Given your documentation of the very large fall in GDP growth and exports from Asian countries, do we have an understanding about why banks in the region were not more affected? Given that kind of fall, one would expect greater corporate stress and therefore greater financial stress in Asian countries.

**Mr. Goldstein:** Well, I think you are seeing some corporate distress in Asia. The IMF, among others, has done an analysis of the current crisis and how it compares with earlier crises. I think the conclusion of this analysis is that the current crisis will be serious but not anywhere near as serious for the region as it was a decade ago.

As for the banks themselves, over the past decade you've seen big increases in capital and provisioning rates, so they are in better shape. This crisis is a lot about wholesale funding. When you're looking at differences in how different financial institutions were affected, I think one of the most helpful questions to ask is, how did they fund themselves, whether you're talking about institutions within the United States or you're talking about the impact on a cross-country basis? When you're getting very large deposit growth, you don't have to depend as much on wholesale financing. The institutions that did depend a lot on wholesale financing and that were, in particular, very dependent on bank lending seem to have suffered the most. In contrast, Asia, at least the larger economies in the region, had more robust bank deposit growth and suffered relatively less.

**Mr. Hooper:** I'd like to address the issue that Mike Mussa was wrestling with in his discussant comments. What was it that caused the massive drop in trade affecting Asia in the fourth quarter of 2008, and to what extent do we attribute the trade drop to the Lehman Brothers collapse in September 2008? I think the huge drop that came has to have been related importantly to what happened to global inventories. There was a huge buildup of inventories in the second and third quarters as U.S. consumer spending on durables fell ahead of Lehman.

I think the bottom in durable spending came not long after the Lehman collapse. This inventory buildup led to a massive liquidation affecting trade globally. So, yes, the financial crisis and the availability of credit obviously is a key factor, but I think we may be overstating the case. The rapidity with which this downturn came is something that, as Mike suggests, may have been pretty much baked in the cake because of the massive inventory correction that took place.

**Mr. Mohan:** Do you want to take a couple of questions?

**Mr. Bery:** Two questions for Mike Mussa, just to pursue the interesting points you've made. The first is, do you think we're declaring victory too quickly for Asia? As Rakesh just mentioned if, indeed, the downturn is post-Lehman then the impact on financial systems may still lie ahead. Or do you have reasons for thinking that the financial systems are sufficiently robust that there won't be a second round? And secondly, I wasn't sure where you were on the tightening of monetary policy in response to the commodity price shock. Rakesh [as Deputy Governor of the Reserve Bank of India] was, of course, in the hot seat at that time. I was on the Indian Monetary Committee and there was a lot of advice coming from the Asian Development Bank, and to my knowledge even from the IMF, that the right response in order to anchor inflationary expectations was to tighten. So in hindsight, was that bad advice?

**Mr. Kashyap:** Morris, I want to pick up on your point about bank lending. It seems to me that the numbers for the condition of banks in China don't add up. If you just look at loan growth, who it's going to, and the relative performance of the SOEs (state-owned enterprises) in China during all of this, it seems to me that they've got a huge raft of bad loans that are just kind of like the check is in the mail and it hasn't been cashed yet. I wonder if you have any reason to believe otherwise. I'm not saying that this is necessarily a bad thing. Maybe it's a reasonable way to run your unemployment policy if you don't have a full social safety net. But I'd like to know whether you think there's any evidence against that view?

**Mr. Mohan:** We'll take responses after this and then take a next round of questions.

**Mr. Eichengreen:** Peter Hooper anticipated my point, but I'll restate it anyway. I think we can all agree that it was primarily the collapse of exports that was the driver in the crisis in Asia, but we still don't agree about what caused the collapse of trade. So, are we simply in a world where inventory management has changed, and when there are serious downturns there will be more serious

inventory corrections? Or is it something distinct from inventories about the articulation of global supply chains? Or was it the interruption of trade credit for which there is relatively little systematic evidence, or was it something else? I think we still don't know.

**Mr. Xie:** Thanks for the questions. I want to answer the last question. I think there's emerging evidence that shows that global vertical integration and the global supply chain is contributing to global business cycle synchronization, especially in the case of Asia. So, even though Asian countries have very high levels of intraregional trade, they were not shielded from the trade drop with countries outside the region.

**Mr. Goldstein:** I'll respond first to Anil's question about Chinese banks. We have seen extraordinary loan growth. There's a good side and a bad side to that. The good side is that in China you can tell the banks to step up lending and they do it quickly. So, it's not like in the U.S., where loan growth has been flat or going down. In China, you tell them and bang, you get loan growth up to 35 percent in the first six or eight months, and that helps. It's like a stimulus.

As to whether that's going to come back to haunt them, I think it's not clear. I put quite a bit of weight in the views of my colleague, Nick Lardy, who watches those numbers from month to month. Quite a lot of the new loans have been directed to infrastructure, which is essentially backed by the government; not as much has gone to property lending and the like. And they have shown in the past that when you think lending growth is really going off the rails they are able to bring it back. So if loan growth keeps up at anything like the current pace, I worry a lot about the future cost of that in terms of nonperforming loans. But I think it depends on what happens in the next four or five months. If they get it back down to what is a reasonable rate for them, it may not be too bad.

On the export side, what we do know about is the product mix. If you're exporting cars and people cannot get car loans, it affects your exports, whether you're Germany or whoever you are. I bow to Peter Hooper's much more detailed knowledge about the U.S. economy and what was happening with inventories and the like. So, it's likely to be a bunch of things. I've seen differing reports on trade credit, as I think Barry has, with some people saying it's been a big factor and other people saying not. I'd also direct your attention to a chart on net exports in our paper that shows you the contribution of net exports to GDP growth in emerging Asia over the 2000 to 2008 period. For the nine economies we have, the median contribution is only about 11 percent; most of the growth has been coming from domestic sources. So although there have been periods, for example, in China where net exports accounted for 20, 25, 30 percent

of growth, for most of the period as a whole the contribution is 10 percent, 11 percent. Indeed, of the economies that we compare, the one that's most export-led, by far, is Germany.

This feeds back on the rebalancing issue. If you're going to rebalance growth in China, a lot of it is going to come from a shuffling in the components of domestic spending; that is, by bringing investment down or bringing consumption up. You can get net exports down, but that is not really what's driving growth most of the time in those countries. It's investment.

Let me just say on Mike's comments, I find them very useful and I think they are a very helpful complement to our paper. We looked at what was different in emerging Asia, particularly compared to other emerging market groups. I think what Mike's comments bring out is that the timing is very important in understanding the cross-country spread of the crisis. You can see a lot if you break it up quarter by quarter. Some of the studies that attempt to measure the independent effect of spillover take some of that into account by putting on the right-hand side global commodity prices and other things, but they don't really capture it in the way that Mike was describing it.

**Mr. Mohan:** Mike, I think he wanted you to respond.

**Mr. Mussa:** I have a couple of things to say about the role of trade and inventories as well as the role of the financial crisis. It may be that the move to recession already in the second and third quarters of 2008, before the intensification of the financial crisis after Lehman Brothers, was not fully reflected yet in a slowdown in output as inventories built up. I think the recession would have continued in the fourth quarter and perhaps even deepened somewhat, even if we had not had the remarkable financial crisis. But the financial crisis undoubtedly mattered a great deal.

Whenever I consider modeling this, I think of Adam Smith, who described the economy as functioning through the great wheel of circulation whereby credit and money flow through the economic system. Normally, we don't pay very much attention to that since, as Irving Fischer put it, "money matters only when it's out of order." But when even the prime borrowers in an economic system, such as the General Electrics, that regularly rolled over their commercial paper, can no longer do that and cannot get the credit necessary to meet their payrolls and pay their dividends, or they feel threatened that such circumstances will soon befall them, the great wheel of circulation begins to grind to a halt and with it much of economic activity. I think there's no doubt that is the type of process we were getting into a little bit more than a year ago. And if the

monetary authorities and fiscal authorities had not imposed the effective equivalent of defibrillation on the credit system, we would have been in much deeper trouble.

So, I take the point that probably the recession would have continued and deepened even without the Lehman Brother collapse. But there is no doubt, given the magnitude and the speed of the response of the real economy, that the disruption of the function of the fundamental mechanisms of credit circulation played an important part. Was the response of monetary policy to rising inflation appropriate? Well, monetary policy, like all policy, is made in real time, and you need to respond to the information that is available.

Now some will say that they anticipated the great financial crisis of the fall of 2008. I think that's complete nonsense. That's not an event which is possible to anticipate. It suddenly arises. There is a panic. You can know perhaps that vulnerability to such a panic has escalated as the economy has weakened and as the financial sector has weakened, but being able to predict that you're actually going to get an event of that magnitude, I think, is beyond our capacity. Just as we know at some point that there's going to be a big earthquake in this area of California, but we don't know when it will occur. I think it's a similar problem in the financial sector: you can know vulnerability is high, but it's very difficult to forecast a crisis in advance. If the monetary authorities had ignored the upsurge of inflation, the consequence might well have been not only more inflation, but we would have gotten the same crisis a little later.

**Mr. Mohan:** Thank you, Michael, for defending the actions of monetary authorities in early 2008 and the increasing of interest rates in response to inflation. We have time for two or three more questions depending on their length.

**Mr. Kohns:** Could you elaborate a bit on your estimate of the impact of the crisis on potential output in Asia? You said a lot about the origin of the crisis and that overcapacities will build up, so we might see long-term declines in output levels. But what will be the impact on growth rates? You said that it might be necessary for countries in Asia to promote domestic demand in order to maintain growth rates? Some remarks on that would be very helpful.

**Mr. Mohan:** David Hale.

**Mr. Hale:** Question. The consumption shares of GDP in Asia are very diverse compared to the rest of the world. The highest in the world was the Philippines at 74 percent, higher than the United States. China was at 36 percent. Most countries are clustered in the range of 50 to 60 percent. The policy response

to the crisis over the last year has involved a lot of fiscal stimulus in Malaysia, Thailand, Singapore, and so on. Do you see any hope, looking out two to three years, that the consumption share of GDP in these countries will rise, thereby contributing to the reduction of global imbalances?

**Mr. Mohan:** I think we'll have to keep that as the last question.

**Mr. Xie:** I will try to answer the last question. Most of the rebound in Asia since the crisis has been due to direct fiscal stimulus. I think that greater domestic demand in Asian countries could be helpful both to boosting growth and also decreasing global trade imbalances. But probably any such rebalancing will take some time to achieve.

**Mr. Goldstein:** Just briefly, maybe I can combine the two questions a bit. The fact that the consumption share is so low in parts of Asia has the upside that it can go up a lot. If you look at what's happened over the past couple of years, for example in China, there have been very big increases in fiscal spending on the social safety net. Also if China allows more exchange rate flexibility and appreciation of the renminbi then it could do more with interest rate policy to stimulate domestic demand. So, there is quite a bit of potential to rebalance the sources of growth without a huge decline in China's overall growth rate. But China would have to be convinced that was in its interest to allow significantly more appreciation than in the past, and I'm not so persuaded that this crisis is going to do it. Particularly as China comes out of the recovery, people will say that it was a terrible shock, but it's over, so let's go back to where things were. We've seen the renminbi has been pretty flat now for 14 months in real effective terms—I think it's going to be an uphill battle to have more than small future upward movements in the currency.

**Mr. Mohan:** Michael, last word.

**Mr. Mussa:** I believe Asians can and will consume more. We saw five or six years ago when the Koreans liberalized credit card availability there was a big explosion of consumer demand in Korea. In fact, it was too big. In China, I think an important part of the problem is that Chinese government policy has really repressed household income, forced people, in effect, to accumulate money balances through the accumulation of foreign exchange reserves rather than the central bank printing money domestically. That has had an important depressive effect on household income and held down the growth of consumer spending. So, I'm not pessimistic that we will see a substantial increase in consumption in China in the future.

Also keep in mind, the U.S. saving rate will probably go up. Recently it's been running 4 or 5 percent. I think it's probably going to go up to 6 or 7 percent. The U.S. is 20, 25 percent of the world economy. So, to get an offsetting reduction in saving in the rest of the world requires their saving rate to come down 1 percentage point or less. I think that that's within the range of what's achievable.

**Mr. Mohan:** Thank you very much to Morris, Daniel Xie, and Michael Mussa.