

Crisis Contained

Archana Kumar

AS Asia tentatively makes its way out of the global economic crisis, the region—and the world—watches and learns from its resilient, though far from invulnerable, journey. Five leading Asian voices share their views on Asia's economic pain and recovery, and how there are no easy answers for coping with the region's future challenges.

Ajith Cabraal is the Governor of the Central Bank of Sri Lanka; *Shuli Hu* is a leading Chinese journalist; *Yung Chul Park* is Research Professor and Director of the Center of International Commerce and Finance at the Graduate School of International Studies, Seoul National University; *Raghuram Rajan* is Eric J. Gleacher Distinguished Service Professor of Finance at the University of Chicago and an Economic Advisor to the Prime Minister of India; and *Tharman Shanmugaratnam* is Singapore's Minister of Finance.

F&D: How has the crisis affected your region and how has the region responded to it?

PARK: For about six months, beginning in October of last year, emerging Asia suffered a great deal of economic pain and losses as the entire region fell into a deep economic crisis as a result of the vanishing export market, which was, in turn, caused by the spread of the global economic crisis.

Adding to the pain of the recession, some of the East Asian countries, such as Korea, also suffered a liquidity crisis. Fortunately, the liquidity crisis was over by the beginning of the second quarter of this year. Since then, these emerging economies have staged a rather impressive recovery.

What are the developments and factors responsible for this remarkable economic recovery? First, the epicenter of the crisis was located elsewhere, unlike in the Asian crisis of 1997, so that these economies suffered basically collateral damage from the crisis. Second, these economies made many strides in restructuring their corporate and banking sectors to improve their financial soundness and competitiveness to help them withstand external shocks much better than before. Asia's financial institutions also held very small amounts of U.S. toxic assets in their asset portfolios. Third, to my great surprise, most of these East Asian economies were very quick to respond to the crisis by introducing and implementing large fiscal stimulus packages, which, in

fact, have started kicking in. Fourth, some of these economies, like Korea, have been able to absorb domestically the impact of this crisis by making market adjustments—for instance, by cutting real wages and lowering the cost of capital to the greatest extent. Finally, most [Asian] currencies, except the Chinese renminbi and Japanese yen, have depreciated a great deal vis-à-vis the dollar, restraining the decline in exports. This has cushioned the impact of the crisis to a large extent.

SHANMUGARATNAM: If you look at the Asian region, or East Asia in particular, this was not a case of a balance sheet recession. This was an economic crisis for us, but it was caused by balance sheet problems elsewhere. Our banks were sound, and government finances by and large were in good condition. Several governments which 10 years ago had serious fiscal problems had since been running down their deficits, and in some instances have been running surpluses so as to reduce debts.

We took a big knock because global trade fell, and so did foreign investments. But it would have been much worse if our financial systems themselves had problems on their balance sheets.

It also meant that the region, from China down to Southeast Asia, was able to respond aggressively to the crisis, and could play a significant role in the global effort to

counter the recession through public sector stimulus. In Singapore, for example, we had a fiscal stimulus of 6 percent of GDP, delivered in one year, which helped reduce job losses and helped prepare firms for the recovery.

HU: The crisis has affected the region mainly through the trade channel. Since last year, the region witnessed a sharp decline of demand from its export sector, and the region heavily depends upon exports. As a result, it has suffered a very, very painful experience from the economic slow-down.

In China, for example, in the coastal area, a lot of factories—especially private factories—closed down, with layoffs among workers, including migrant workers who are originally from the inland of China.

Like the rest of the region, China adopted a fiscal stimulus policy to help the economy foster economic growth as part of the export sector and, at the same time, to help the transformation for the economy: from being heavily dependent upon the export sector toward encouraging greater domestic consumption. The latter is actually very hard to do.

CABRAAL: The most fundamental manner in which the region was affected was by the flight of capital. It was sudden, it was large, and it was something that the region did not expect.

At the same time, the vulnerability caused by certain banking institutions also had its aftershocks and led to some instability in the Asian region. Third, in many of the countries, the reserves that were reasonably adequate suffered a sharp downturn, particularly because of the monies moving out, plus the added disadvantage of the values at which they were recorded in their own balance sheets coming down sharply.

I think the region coped reasonably well. The challenge was to give the stability feature out to the market, and the way the central banks as well as the governments responded was pretty adequate. The stimulus packages that were put in place to address the reductions in the shorter term were also adequate. So the downturn, as far as the growth was concerned, was not as sharp.

RAJAN: The crisis has been a global crisis, of course, and in Asia, many of the countries (not all) have been export led, and clearly with industrial countries slowing down, that had an immediate effect because of the trade compression. There's been a rebound since, because we first thought this is the Great Depression all over again and, since then, realized it's not the Great Depression—it's a deep crisis, but not as bad as people thought.

So there's been some inventory rebuilding. In the short run, this strongly affected rates of growth—leading to double-digit rates of growth. In the medium term, there will be effects that will vary across countries. Countries that

are more export oriented are going to have to readjust their growth model, which is not easy. This is something that they have grown into over 10, 15, 20 years. It's a very producer-led model that has to move toward a more consumption-led one. This is very hard to do in practice because the channels through which you do it are not easy and not laid out. The temptation for governments is just do more of the same, and that's the tendency they will have to fight.

For countries that are not so export led—India is one example—the issue really is to strengthen the financial sector because they are still running large deficits. This is a time that financial market participants are very concerned about any sense of financial fragility.

China is also finding new ways to grow. It has much more fiscal room than India has, but it also has a greater transformation need away from export-oriented growth toward more domestic demand-led growth.

All in all, the good news is that there are possibilities for continued strong growth in Asia, and the balance of economic power continues to flow toward Asia. The bad news is Asia is not immune. It has to make serious changes, sometimes radical changes, to its growth process.

F&D: What do you think will be the longer-term changes and challenges in Asia as a result of the global economic crisis?

HU: I think in Asian countries like China, people are starting to think about the transition to a different economic model, following the crisis. We need to move from a more export-led economy, export-led growth to a more domestic model to achieve balanced growth. We need to correct this imbalance ourselves. However, it is very difficult to do because export-led growth has been taken for granted for several decades as a successful economic model.

PARK: In the short run, the most significant challenge these policymakers will face is dealing with fiscal policy management. Sooner or later, the effects of fiscal stimulus packages will wear off, and at that point what will these countries have to do to sustain reasonable rates of growth? My concern is that they may turn to export promotion again, which is really something that they should try to avoid, if they are serious about resolving global imbalances.

Second—and related to this dependence on exports—they should try to rebalance growth by reforming their policies and adjusting development strategies to rely less on exports and to depend more on internal demand. And, at this stage, they don't seem to have any idea about how they should go about restructuring the economy to boost domestic demand as a major source of economic growth.

Third, in the short run they'll have to think about exit strategies that will help prevent a reemergence of asset market bubbles and building up of inflationary pressures. And, on this

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question again, the region is in a dilemma. For example, they need to raise the interest rate to prevent asset market speculation, but then monetary tightening may be premature and may derail the recovery process.

Finally, East Asia is responsible, to some extent, for the growing global imbalances, because all of these East Asian countries are going to run huge current account surpluses this year, and the question is whether they can continue to do so, and whether the surplus accumulation is in the interest of East Asia. It is not, but then, they are reluctant to take necessary measures such as currency appreciation to slow down the growth of the surplus. They know that they should actively participate in policy discussions on reducing global imbalances with the United States and Europe, but they seem to avoid the policy coordination largely because they are not prepared to make the policy adjustments required to deal with the imbalance problem.

There has to be some sort of policy coordination among East Asian countries to deal with the exit strategy and the resolution of the global economic imbalances problems.

CABRAAL: We need to look at longer-term maturities as far as our debt capital is concerned. And we need to ensure that the capitalization of the banks is at an even higher level than what it has been. The banking sector came up quite resilient, but it is necessary for us to strengthen ourselves a little more, so that the absorption of shocks becomes easier.

And we must think of diversifying our markets a little more than we have. Also, our reserves management has to look at better positioning of reserves vis-à-vis where they are invested as well as their accumulation. The banking sector stability, as well as the financial system stability, has to be strengthened further, which means that regulation has to be strengthened.

These are good lessons for us. One of the problems is that when problems ease, everything is forgotten, and people think there has been a strong recovery—faster-than-normal recovery—and they are back to business. That can lead to a false sense of complacency. We need to guard against that.

SHANMUGARATNAM: We have to shift our sights to the long term, even now. We have to manage problems in the short term—particularly unemployment—as well as we can. But how we manage the short term, and how we exit from fis-

cal stimulus packages, must depend on what we want to see over the long term. If we focus only on the short term, we risk undermining our chances for self-sustaining growth beyond the current recovery.

Our key objective should be to see private investment grow, as the basis for long-term growth. What this means is that we shouldn't want to raise income taxes in order to raise more fiscal revenues, and certainly not corporate income taxes. Fiscal exit strategies must reflect that objective. The aim is not just to reduce fiscal deficits and to prevent public debt from going out of control, but to do so in ways that give incentive for private investment to grow.

There is the question of where future demand will come from, since the U.S. consumer can no longer drive this. East Asia's growth will depend increasingly on how much demand it generates within the region itself. (See "Rebalancing Growth in Asia" in this issue.) But it would be a mistake to move away from global markets. The real source of East Asian growth over the last three decades has been the remarkable gain in knowledge and techniques, obtained by plugging into global markets—whether through exports or imports. Global markets spur the spread of knowledge. If we give that up, and focus production on home markets, we are going for lower long-term growth in East Asia—and globally. The real challenge therefore must be to grow East Asian demand and allow for increased imports. Abandon export subsidies, but don't abandon exports.

RAJAN: Over the longer term, Asia will look a little more inward rather than outward for growth, which means not just domestic but also to each other. Despite the changes that have been taking place over the years, Asian exports to one another are still relatively limited compared to what they could be. I think economies will try and sell to each other more, which will be an interesting change. But I also think the shift in demand toward the emerging markets, toward Asia, is going to produce a whole set of new, interesting opportunities—which companies in the region, but also companies from outside, can exploit. And this could be a new source of growth—this is growth targeted at the bottom of the pyramid. ■

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