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The Global Economic Crisis and Asian Developing Countries: Impact, Policy Response and Medium-Term Prospects

YILMAZ AKYÜZ

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Third World Network

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Chapter 1

INTRODUCTION

AFTER several years of impressive growth, the world economy encountered an equally impressive downturn starting in the third quarter of 2008, triggered by financial fragility and imbalances generated by speculative lending and investment and debt-driven spending in major advanced economies (AEs), notably the United States. Initially, there was widespread optimism that growth in developing and emerging economies (DEEs) of East Asia[1] would be decoupled from the difficulties that pervaded AEs and the region would continue to surge ahead as an autonomous growth pole. Sound balance-of-payments positions and self-insurance provided by large international reserves accumulated from current account surpluses and/or private capital inflows were expected to protect them against the kind of financial shocks that had devastated the region during 1997-98. In the event, however, the region could not avoid a significant drop in growth, in large part because of a sharp contraction in exports. Growth fell even in countries such as China which responded to fallouts from the crisis with massive counter-cyclical fiscal packages and aggressive monetary easing, while in many others growth fell to negative territory for the first time since the 1997 crisis.

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1 For the purpose of this study East Asian DEEs are defined to include the newly industrialized economies (NIEs; Korea, Taiwan, Singapore and Hong Kong), China and members of the Association of Southeast Asian Nations (ASEAN). Asian DEEs include, in addition, South and West Asian countries.

Like the earlier episodes of instability, this crisis too has revealed certain structural weaknesses and vulnerabilities among various DEEs in Asia. As a result of the growth strategies pursued, economic activity has come to depend heavily on exports to major AEs or international capital flows or remittances from workers abroad and hence become highly vulnerable to their interruption. Furthermore, despite the measures taken in response to the lessons drawn from recurrent crises, almost all Asian DEEs now manifest increased susceptibility to financial boom-bust cycles and gyrations in equity, property and currency markets because of their closer integration with major financial centres through liberalization of the capital account and significantly increased presence of foreign financial institutions and investors in their markets.

There is now increased agreement that the dependence of countries in the region on foreign markets and/or external financing needs to be reduced, particularly since the world economy is unlikely to go back to the conditions prevailing before the outbreak of the crisis, characterized by rapid expansion of exports to AEs and plenty of footloose capital and cheap money. Moreover, the original enthusiasm about bringing international financial markets and institutions under tighter global regulation and control has so far yielded little result and in all likelihood instability in international financial markets and capital flows will continue unabated. Thus, a key lesson from this crisis is that DEEs ought to look for a strategic rather than full and close integration with markets in AEs, in both trade and finance, and need to rebalance domestic and external sources of growth.

This paper is produced as part of a research project sponsored by the Third World Network (TWN) and coordinated by this author on the impact of the global crisis on Asian DEEs and the policy issues that need to be addressed for securing sustained growth and stability over the medium term. The countries studied in the TWN project include China (Yu 2010), India (Chandrasekhar 2009), Korea (Lee 2010), Malaysia (Goh and Lim 2010), Pakistan (Haque 2010), the Philippines (Lim 2010), Singapore (Lim and Jaya 2010) and Turkey (Uygur 2010). While drawing on the findings of these studies, discussions in this paper are organized around issues rather

than countries, also using data and information provided by other studies and for other countries in the region.

The following chapter explores the link between the current crisis and the forces driving the preceding economic expansion. It is argued that the property and consumption surges in the US and elsewhere after the turn of the millennium produced not only a strong economic expansion, but also financial fragility and global trade imbalances that culminated in the subsequent crisis. Chapter 3 examines the transmission of the impact of the crisis through three main channels: finance, remittances and trade. This is followed by a discussion of the policy response to fallouts from the crisis and its role in recovery. Medium-term growth prospects and policy challenges are examined in Chapter 5. It is argued that a return to "business as usual" is not a viable option and coming years are likely to see tightened global economic and financial conditions in comparison to pre-crisis expansion, including an external adjustment in the US based on export expansion and instability and sluggish growth in the European Union. This means that medium-term growth prospects of the Asian DEEs hinge crucially on their success in reducing their dependence on foreign markets and/or capital flows. Assessed on the basis of possible evolution of the global economic environment and domestic policy spaces and options, the Asian DEEs are not expected to go back, over the medium term, to the kind of rapid and sustained growth they enjoyed in the years before the crisis. Slowdown in growth is expected to be greater in countries suffering chronic current account and budget deficits. The concluding chapter summarizes the systemic and structural strengths and weaknesses of the countries in the region and the policy approaches needed in order to reduce vulnerability to external shocks.

Chapter 2

THE GREAT FINANCIAL BUBBLE, GLOBAL EXPANSION AND IMBALANCES

AFTER the turbulent years of the 1990s and early 2000s characterized by recurrent financial crises in emerging economies, financial instability and sluggish and erratic growth in Japan and the dot-com boom-bust cycle in the US, the world economy enjoyed a period of exceptional growth and stability until the outbreak of the global crisis in 2008. Average growth of the world economy during 2002-07 exceeded that of the 1990s by almost one-half (Table 1). This was entirely due to acceleration in DEEs where growth was twice as fast as in the 1990s, exceeding even the rates attained during the golden age. Almost all developing regions and countries enjoyed faster growth than in the 1990s and many Asian DEEs with already high growth rates also saw a significant acceleration. All this took place in conditions of a high degree of price stability, with average consumer inflation hovering around 2 per cent in AEs, 6 per cent in DEEs and less than 4 per cent in Asian DEEs.

This period also witnessed a rapid expansion of international trade and capital flows. World exports of goods and services in dollars increased by 2.5 times during 2002-07, with most Asian DEEs experiencing double-digit export growth rates. From the beginning of the decade the DEEs as a whole started to run growing current account surpluses with the AEs, notably the US where current account deficits exceeded 6 per cent of GDP on the eve of the crisis. The current account surplus of DEEs was as high as $660 billion in 2007 and almost two-thirds of this was due to East Asian DEEs and the rest to fuel exporters (FEs).

Table 1: Real GDP Growth (annual percent change)

	1991-2000	2002-2007	2008	2009	2010*
WORLD	3.1	4.4	3.0	-0.6	4.2
AEs	2.8	2.5	0.5	-3.2	2.3
DEEs	3.6	7.0	6.1	2.4	6.3
ASIAN DEEs	7.4	8.9	7.9	6.6	8.7
CHINA	10.4	10.7	9.6	8.7	10.0
INDIA	5.6	8.0	7.3	5.7	8.8
INDONESIA	4.0	5.3	6.0	4.5	6.0
PHILIPPINES	3.0	5.7	3.8	0.9	3.6
KOREA	6.1	4.8	2.3	0.2	4.5
MALAYSIA	7.1	5.9	4.6	-1.7	4.7
THAILAND	4.4	5.6	2.5	-2.3	5.5
SINGAPORE	7.6	6.8	1.4	-2.0	5.7
PAKISTAN	3.9	5.9	2.0	2.0	3.0
TURKEY	3.7	6.8	0.7	-4.7	5.2

Source: IMF WEO (various issues)
* Projections

After falling to some $50 billion in 2002, net private capital flows to DEEs (that is, net non-resident inflows minus net resident outflows) rose to $620 billion in 2007, and the Asian DEEs were one of the main recipients. The twin surpluses on current and capital accounts allowed the DEEs to accumulate large amounts of international reserves which increased fivefold during 2002-08 and reached $5 trillion; more than half of these belonged to Asian DEEs. The period also saw a rapid increase in workers' remittances, from less than $100 billion at the beginning of the decade to some $330 billion on the eve of the crisis, ranking only behind foreign direct investment (FDI) as a source of external financing for DEEs (Ratha *et al.* 2009).

This above-trend performance of the world economy and widening global trade imbalances were greatly helped by the factors that subsequently led to the most severe post-war global financial crisis and recession. At the centre of the crisis were the financial bubbles that were allowed to drive the

US economy from the mid-1990s onwards. The combination of advances in information technology and sharp reduction in policy rates in response to the 1990-91 recession created the dot-com bubble in the second half of the 1990s when equity prices rose to unsustainable levels. This was also accompanied by a housing bubble. Exceptional capital gains on stocks gave a major boost to spending on consumption and property, and this made a major contribution to the decline in household savings, bringing it down from 7.7 per cent of disposable income in the early 1990s to 2 per cent at the end of the decade.[2]

The US housing bubble continued with even greater force with the bursting of the dot-com bubble in the early years of the present decade for several reasons. First, the US Federal Reserve responded to the bursting of the dot-com bubble and the collapse in equity markets by bringing policy rates to historical lows for fear of asset deflation and recession. Second, the collapse of the stock market made investment in property even more attractive. Finally, a new piece of legislation introduced in the late 1990s allowed greater room for banks to engage in and expand speculative lending through securitization. All these combined to produce a massive expansion in lending for property investment as well as for household consumption. Capital gains from the property boom helped bring down personal savings even further, as homeowners increasingly extracted equity to finance consumption, making it disappear altogether in the middle of the decade and raising the household debt to some 140 per cent of disposable income.[3]

The policy of easy money and low interest rates in the US were also mirrored in several other AEs. Interest rates in Japan were brought down to almost zero as a result of efforts to break out of deflation. Even the otherwise conservative European Central Bank joined in and brought interest rates to unusually low levels.

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[2] On the contribution of the dot-com bubble to the decline in the personal savings rate in the United States, see Maki and Palumbo (2001).

[3] On the housing boom, see Baker (2008), and on expansion and crisis, see Akyüz (2008).

Low interest rates, stagnant equity prices and ample liquidity played a major role in redirecting private capital flows to DEEs in search of quick windfall gains and arbitrage profits. Oil surpluses also added considerably to the surge in capital flows. Unlike China which has run twin surpluses on current and capital accounts and used them entirely for investment in international reserves, FEs have had deficits on their capital account. They used about one-third of oil surpluses generated after 2002 for investment abroad, mainly through sovereign wealth funds, and two-thirds for reserve accumulation. Unlike in the 1970s, the oil surpluses were not recycled through commercial banks, but were used for direct equity and portfolio acquisitions, including in DEEs. These investments supported widening current account deficits and appreciating exchange rates in some DEEs in Europe and elsewhere, including Turkey.

The global financial bubble and widening trade imbalances in the run-up to the 2008-09 crisis are occasionally explained in terms of a global savings glut rather than monetary and regulatory slippages in the US, including by former and present governors of the Fed (Bernanke 2009; Greenspan 2009). According to this view, high savings in several Asian emerging economies, notably in China, brought down long-term interest rates globally, thereby reducing incentives for private savings in the US and some other economies. At the same time, investment of these savings in the US markets resulted in significant increases in funds available for domestic lending, creating aggressive competition for borrowers and lowering lending standards. Briefly, on this view, the global savings glut resulting from export-led growth strategies of Asian DEEs was responsible for the build-up of financial fragility, excessive debt-driven spending and collapse of household savings and for rising current account deficits in the US in the run-up to the crisis.

It is true that low interest rates and the surge in consumer spending in the US were supported by exchange rate, balance of payments and reserve policies of surplus East Asian countries, notably China. These policies were motivated by the lesson drawn from the 1997 crisis that at times of turbulence DEEs cannot rely on support from the International Monetary Fund (IMF) and they would need to secure self-insurance by sustaining sound current

account positions and accumulating large amounts of international reserves. They thus managed their currencies in close pegs to the dollar, avoiding appreciations, achieving growing trade surpluses and investing them – and their net private capital inflows – in US Treasuries and the debt of government-sponsored agencies such as the mortgage firms Fannie Mae and Freddie Mac. On the eve of the crisis around 90 per cent of China's and 65 per cent of FEs' holdings of US Treasuries were long-term. Consequently, when the Fed started to tighten monetary policy after 2004, long-term rates moved only a little and the yield curve flattened, giving rise to what is known as Greenspan's conundrum. Thus, monetary policy lost its effectiveness in checking private borrowing and spending, notably for investment in property.[4]

There can be little doubt that without large inflows from China and FEs, the financial bubble in the US could not have been sustained for long. Both the dollar and long-term interest rates would have eventually come under strain. This would have made it difficult for the US to pursue lax monetary and regulatory policies and ignore the spending boom and mounting current account deficits.

However, the link between savings and current account imbalances on the one hand, and the financial bubble in the US, on the other hand, is much more complex than is typically portrayed by the proponents of the "savings glut" argument. First, as noted, the housing and consumption boom in the US started long before China began running large trade surpluses. Second, low interest rates do not always give rise to surges in consumer spending. For over a decade the Japanese economy suffered from under-consumption despite historically low interest rates, which often became negative in real terms. Furthermore, personal savings have been strong in some other surplus countries, notably Germany, where interest rates were also low. US households were willing to incur a growing amount of debt not so much because of low interest rates as because of widespread and firmly held

[4] This lending behaviour by China and FEs also created problems for the so-called special investment vehicles (SIVs) which operated on the assumption that the yield curve would remain steep, borrowing short and lending long.

expectations that property prices would keep on rising. Expansionary monetary policy and regulatory shortcomings allowed the banks to expand lending while spreading the risks widely to investors both inside and outside the country through exotic and opaque instruments. Capital inflows helped to keep a lid on long-term rates, but it was excessive household debt and overinvestment in property, not a cutback in the supply of Chinese savings, that brought an end to speculative lending, the housing bubble and the consumption spree in the US.

Indeed, without profligate American consumers and reckless lending by American banks, China would not have been able to run large and growing trade and savings surpluses. As discussed subsequently, in the event of the US starting to live within its means, it would be very difficult for China to maintain simultaneously strong growth, large and growing trade surpluses and exceptionally high savings. In such an event a return to growth of some 10 per cent would depend very much on a considerably faster growth of consumption in China than has been the case so far and sizeable declines in the shares of national savings and current account surpluses in GDP.

Chapter 3

ASIAN VULNERABILITIES AND SPILLOVERS FROM THE CRISIS

CONTRARY to the initial hype about decoupling, Asian DEEs have been severely affected by shocks and contagion from the financial turmoil in AEs, to a much greater extent than during the 1997 crisis. Growth slowed down sharply everywhere at the end of 2008 and about half of the countries examined here are estimated to have registered negative growth in 2009, with the swing from the average growth attained during 2002-07 ranging between 5 and 12 percentage points in Korea, Malaysia, Thailand, Singapore and Turkey (Table 1).

With few exceptions, the exposure of Asian DEEs to shocks and contagion from the crisis has its origin in their growing financial and economic linkages with the AEs, rather than their domestic macroeconomic imbalances and financial fragilities. Closer and deeper integration with major financial centres and rapidly growing gross asset and liabilities positions of DEEs with the AEs have intensified the transmission of financial stress to asset, banking and currency markets in the region. Large stocks of assets invested in AEs have exposed the Asian DEEs to losses resulting from declines in asset prices and increased defaults. Similarly the surge in private capital inflows exposed them to withdrawal of funds from equity and debt markets, putting pressure not only on international reserves and exchange rates, but also on domestic asset prices. The crisis led to a contraction of credit in DEEs due to cutbacks in international bank lending and local lending by foreign banks' affiliates in DEEs as well as declines in interbank cross-border lending for funding by domestic banks (Cetorelli and Goldberg 2010). Strong fiscal, balance-of-payments and reserve positions did not insulate the East

Asian DEEs against adverse spillovers and shocks, but helped to contain their impact on the real economy, by allowing, *inter alia*, considerable space for counter-cyclical policy response.[5]

Trade has been the principal channel of transmission of deflationary impulses from the crisis, particularly in countries where exports have been growing faster than domestic components of aggregate demand. In others, declines in exports impinged on economic activity not so much by reducing aggregate demand, but by tightening the payments constraint and thereby narrowing the space for counter-cyclical policy response.

Losses on foreign asset holdings

The period since the early 2000s has seen an unprecedented accumulation of foreign assets by Asian DEEs invested in AEs, due to a surge in private capital inflows and the emergence of large and growing current account surpluses. Countries such as China have enjoyed twin surpluses on their current and capital accounts while in many others with current account deficits such as India, capital inflows have exceeded by a very large margin the needs for current account financing.

Most Asian countries followed a policy of stable and competitive exchange rates, not only as part of an export-led growth strategy, but also to avoid the kind of difficulties that were laid bare during the 1997 crisis resulting from currency appreciations, large and growing current account deficits and lack of self-insurance.[6] As a result, they intervened heavily in currency markets in order to absorb the excess supply of foreign exchange, thereby

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5 Balakrishnan *et al.* (2009) measure the pass through by means of a financial stress index that combines correlation between banking stocks and overall market stocks, stock market returns and volatility, sovereign debt spreads and an exchange market pressure index comprising currency depreciations and declines in reserves, and find that transmission of shocks to emerging economies has been very rapid and financial stress experienced has been more severe than that during the 1997-98 Asian crisis, particularly in countries with larger stocks of foreign liabilities to AEs.

6 For a detailed discussion of the issues taken up in the next two paragraphs, see Akyüz (2008).

preventing large appreciations and accumulating large amounts of international reserves. A few others, notably Turkey, chose to float independently and accumulated reserves only to the extent deemed necessary to meet external payments rather than to prevent appreciations. Most of the reserves – at least some 60 per cent of the total – are held in dollar-denominated public sector liabilities, including those issued by government-sponsored agencies in the US.

As capital inflows and/or current account surpluses continued to grow, many countries found it extremely difficult and costly to fully sterilize the impact of interventions on domestic liquidity. Rather than checking capital inflows through tighter direct and indirect controls, they chose to liberalize resident outflows for both direct and portfolio investment abroad. Private portfolio investment abroad by Asian DEEs in AEs, excluding reserves, rose from less than 5 per cent of GDP in the late 1990s to over 10 per cent in 2007, while international reserves held by central banks increased even more rapidly, exceeding on average 40 per cent of GDP.

The increased holding of foreign assets has no doubt resulted in greater exposure of Asian DEEs to instability in their market valuations as well as exchange rate swings. There is no readily available information on the exposure of commercial banks and institutional investors in Asia to toxic derivatives and on counterparty risks with respect to their asset holdings in AEs. However, the amounts involved appear to be small compared to the global scale of the problem. On the eve of the outbreak of the crisis, Chinese commercial banks' holding of bonds issued or guaranteed by the US mortgage firms Fannie Mae and Freddie Mac is estimated to have been in the order of some $25 billion. The Bank of China is reported to have lost some $2 billion on its holdings of collateralized securities, including those backed by US mortgages (Pearlstein 2008; Yu 2010). The investment portfolio of Temasek, Singapore's state-owned investment company, fell by over 30 per cent in 2008 due to losses on Western banks, and further losses were reported on assets sold during 2008-09 (Bowring 2008; RGE Monitor 2009c).

More importantly, Asian central banks appear to have invested large amounts of their international reserves in debt issued or guaranteed by Fannie

Mae and Freddie Mac which had combined liabilities of around $5.5 trillion. Holdings by central banks outside the US of such debt are estimated to be in the order of $1 trillion, and large amounts are also known to be held in private portfolios. China's holding of US agency debt is estimated to be at least 10 per cent of its GDP, mostly in Fannie and Freddie assets (Pesek 2008). Had the US government not taken over these institutions, losses could have been severe. Central banks are also known to have invested in equities in AEs as well as bonds. For instance, the loss of $6.3 billion incurred by the Monetary Authority of Singapore in the fiscal year ending in March 2009 on assets invested in the US, Europe and Japan was partly due to equity price declines.

Capital flows and financial and currency instability

During 2002-07 cumulative net private capital flows to Asian DEEs added up to only $500 billion, but this was associated with a massive gross cumulative inflow of $2.5 trillion (IMF WEO May 2009). A large proportion of these inflows were in direct and portfolio investment and only a small proportion in bank loans. At the end of 2007, the stock of portfolios held by the residents of AEs in Asian DEEs was about 25 per cent of the GDP of these economies (Balakrishnan *et al.* 2009). This represents a significant increase in foreign presence in the securities markets of Asian DEEs, making them highly susceptible to changes in market sentiments in AEs. In Korea, for instance, non-resident holding of equities reached almost one-half of market capitalization (McCauley 2008). In China foreign share as a percentage of market capitalization increased from 2.5 per cent in 2001 to 23.2 per cent in 2006 and in India from 6.6 per cent to 10 per cent in the same period (BIS 2009). The share of foreigner transactions in 2005 in average daily turnover was around 20 per cent in Korea, 30 per cent in Thailand and 70 per cent in Taiwan (Chai-Anant and Ho 2008). The share of non-residents in long-term local-currency-denominated bonds rose in Indonesia and Malaysia to reach 15-20 per cent in 2007 (World Bank 2009: 29).

The surge in non-resident capital inflows was associated with rapid credit expansion in several Asian countries. On the one hand, low interest rates in AEs and large and continued inflows of capital encouraged governments in several DEEs to lower interest rates and expand domestic credit without facing the risk of external liquidity problems and exchange rate pressures. On the other hand, the impact of interventions in foreign exchange markets on domestic liquidity could not always be fully sterilized, particularly in countries where the banking sector was not closely controlled. Thus, in several Asian emerging economies too monetary conditions became extremely expansionary, leading to a rapid credit expansion.

The increased foreign presence associated with the surge in non-resident capital inflows and domestic liquidity expansion played a major role in generating stock, property and investment bubbles and currency appreciations in several Asian DEEs. Stock market bubbles were most marked in China, India, Turkey and Korea where equity prices in dollar terms rose between 135 and 500 per cent during 2003-07 (Table 2). These countries also experienced property bubbles, driven partly by foreign acquisition and partly by domestic credit expansion. From the early 2000s investment in India and China started growing much faster than income, with its share in GDP rising by 10 and 7 percentage points, respectively. Exchange rates saw significant nominal and real appreciations not only in countries pursuing independent floating (Korea, the Philippines and Turkey) but also managed floating (India, Singapore and Thailand) (Table 3).[7]

These bubbles came to an end with spillovers from the global crisis. Capital inflows to emerging markets, including bank-related flows, initially kept up, but after the collapse of Lehman Brothers and the deepening of the credit crunch, there was a sharp decline starting in September 2008. Redemption by highly-leveraged hedge funds in the US and the UK which had been very active in Asian equity markets in earlier years was a main driver of withdrawal of non-resident investment. In a way emerging

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[7] This distinction between independent and managed floating is based on the classification by the IMF (2008) based on actual, de facto arrangements, not officially announced arrangements.

Table 2: Equity Prices in US Dollars (period-to-period percentage change)

	2003-2007	2007-2008	2008-2009
China	502.1	-51.9	58.8
India	349.5	-65.1	100.5
Indonesia	30.4	-57.6	120.8
Korea	136.9	-55.9	69.4
Malaysia	67.5	-43.4	47.8
Pakistan	28.2	-75.7	78.1
Philippines	25.4	-53.8	60.2
Taiwan	55.2	-48.7	75.1
Thailand	78.0	-50.3	70.0
Turkey	332.1	-63.4	92.0

Source: MSCI and IMF GFSR (various issues)

Table 3: Exchange Rate Swings (percentage change in nominal bilateral rates)

	Dollar rates			Yuan rates		
	Boom	Bust	Recovery	Boom	Bust	Recovery
Chinese Yuan	9.4	10.8	0.1	–	–	–
Indian Rupee	18.6	-17.1	10.7	8.4	-25.1	10.7
Indonesian Rupiah	-1.8	-20.5	24.6	-10.1	-28.3	24.4
Malaysian Ringgit	11.8	-3.6	7.6	1.3	-13.2	7.6
Pakistan Rupee	-5.3	-24.0	-4.5	-13.2	-31.3	-4.6
Philippine Peso	17.4	-2.9	4.4	7.5	-12.3	4.3
Singapore Dollar	13.8	0.4	9.3	5.0	-9.1	9.5
S. Korean Won	28.5	-34.8	25.3	17.6	-41.2	25.1
Taiwan Dollar	5.6	-3.6	6.2	-3.2	-13.0	6.6
Thai Baht	40.5	-10.4	7.6	28.8	-19.0	7.5
Turkish Lira	28.3	-21.1	13.2	17.2	-28.7	13.6

Source: OANDA (FXhistory)
Boom: January 2003–July 2007
Bust: August 2007–February 2009
Recovery: March 2009–December 2009

economies in Asia and elsewhere were providing liquidity to portfolio managers and institutional investors in mature markets in order to cover their mounting losses and margin calls and to reduce debt.

As the crisis deepened, resident outflows increased while non-resident inflows declined, and for 2008 as a whole both gross and net private capital flows to Asian DEEs were significantly lower than in 2007 (IMF WEO April 2010). These fluctuations were closely followed by sovereign spreads on foreign and local-currency bonds. Premium on credit default swaps (CDS) was between 100 and 200 basis points for most of the Asian DEEs before the outbreak of the crisis and withdrawal of funds from the region. From late 2008 they started shooting up, reaching 500 basis points for Malaysia and Thailand, 700-800 for Korea and the Philippines and 1200 for Indonesia. The increase in spreads on domestic bonds was even steeper, particularly in countries with sizeable financing needs. In Indonesia, spreads on 10-year government local currency bonds surged to 1260 points over US Treasuries (World Bank 2009: 30). However, they stabilized gradually after the first quarter of 2009, with spreads on CDS falling to a range of 250-500 basis points.

With the rapid exit of foreign and resident investors and global retrenchment of risk appetite, equity and currency markets came under pressure in Asia. Equity markets lost more than half of their values in 2008 in most countries examined here (Table 2). Booms in property markets also came to an abrupt end, with house prices declining in China in December 2008 for the first time since the government started releasing the data in 2005 and urban fixed asset investment falling after September 2008, forcing the government to take measures to revive the property market.[8] In Korea the slump that started in 2008 threatened to set off a process of debt deflation, reminiscent of the 1997 crisis when housing prices fell by some 13 per cent (Citigroup 2009).

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[8] See Xinhuanet (2009) and Forbes (2008). In earlier years, concerned about the growing speculative spree, China had adopted measures to stem increases in property prices; see ESCAP (2007: 10).

Because of the sharp slowdown in net capital flows, several currencies that had faced strong upward pressure against the dollar after 2003, particularly the Indian rupee, Indonesian rupiah, Korean won, Thai baht and Turkish lira, started falling sharply during summer 2008 (Table 3). Given strong deflationary trade impulses from the crisis, this was often seen as a welcome development. Indeed, unlike in 1997, governments were unwilling to use their reserves for stabilizing their currencies. However, in some of these countries, notably India and Korea, reserves declined sharply as a result of rapid exit of capital and widening current account deficits.[9]

After the first quarter of 2009, however, these trends have been reversed. With aggressive monetary easing in the US and sharp cuts in interest rates across the AEs generally, capital flows to DEEs soon recovered, driven to an important extent by dollar carry-trade (Roubini 2009). This, together with significant easing of monetary policy in several DEEs, gave rise to new bubbles in asset markets and put upward pressures on currencies and commodities. In all Asian economies, equity prices stood at much higher levels at the end of the year than at the beginning (Table 2). In some cases – India and Indonesia – they fully recovered the losses incurred earlier. However, as doubts mounted about the strength of the recovery in major AEs towards mid-2010, stock markets again came under severe pressure in many Asian countries, notably in China.

Similarly, from March 2009 almost all currencies in the region started to go up against the dollar, with appreciations being generally stronger for countries which had faced stronger declines previously, notably Korea, Indonesia and Turkey (Table 3). This reflected in part the general weakening of the dollar after the first quarter of 2009 vis-à-vis other major reserve currencies, notably the euro, after considerable strengthening in the second half of 2008 and the early months of 2009. Nevertheless, in most cases the decline of the dollar vis-à-vis Asian currencies has been steeper.

An important consequence of these large swings in Asian currencies against the dollar is increased instability of intra-regional exchange rates of

[9] On the behaviour of reserves in India and Korea during 2008, see Obstfeld *et al.* (2009) and RGE Monitor (2009a and b).

East Asian countries closely connected through trade and investment, notably China, Korea and the major member countries of the Association of Southeast Asian Nations (ASEAN), as indicated by the swings in regional currencies vis-à-vis the yuan (Table 3). Before the outbreak of the financial crisis, most currencies in East Asia appreciated against the yuan, and the Thai baht appreciated against other ASEAN currencies along with their growing strength against the dollar. This was sharply reversed after mid-2007 when almost all currencies fell against the yuan. More recently, after early 2009, this was reversed once again with all currencies – except the Pakistan rupee – rising against both the dollar and the yuan.

These sharp swings in intra-regional exchange rates have no doubt been greatly influenced by differences in capital flows, current account positions and overall macroeconomic conditions in different countries. Nevertheless, their origin also lies in differences in currency regimes pursued by the countries in the region, which now span the entire spectrum between the two corners. At one corner there are economies with independent floating – Korea, the Philippines and Turkey. At the other there is Hong Kong with a currency board. While India, Thailand and Singapore have been using relatively flexible regimes, China and Malaysia followed very tightly managed pegs (IMF 2008). Whether or not the change introduced in June 2010 in the yuan peg policy in China would result in more flexible exchange rates remains to be seen.

Remittances

Both East and South Asia are among the main recipients of remittances from workers abroad, together accounting for more than 40 per cent of total inflows to DEEs. According to World Bank estimates, among the top five recipients of remittances in 2008, there were three Asian countries – India ($52 billion), China ($49 billion) and the Philippines ($19 billion) (Table 4). These countries retained their positions as top recipients of remittances in 2009 (Ratha *et al.* 2010). In the Philippines remittances made it possible to generate current account surpluses despite large and persistent trade deficits (Lim 2010). In Pakistan during 2002-07 remittances amounted to $25 billion,

Table 4: Remittances (billions of US dollars)

	2003	2007	2008	2009	As % of GDP 2007
China	15.1	38.8	48.5	47.0	1.0
India	21.0	37.2	51.6	47.0	3.3
Indonesia	1.5	6.2	6.8	6.6	1.4
Korea	0.8	1.1	3.1	2.9	0.1
Malaysia	1.0	1.8	1.9	1.9	1.0
Pakistan	4.0	6.0	7.0	8.6	4.2
Philippines	10.2	16.3	18.6	19.4	11.3
Thailand	1.6	1.6	1.9	1.8	0.7
Turkey	0.7	1.2	1.4	1.3	0.2

Source: World Bank, *Migration and Remittances Factbook* (Nov. 2009)

exceeding net capital inflows by more than 50 per cent and accounting for about 20 per cent of total foreign exchange receipts (Haque 2010).

Remittances add to growth in two ways. First, they help ease the balance-of-payments constraint, thereby allowing domestic spending to rise without facing foreign exchange shortage. This is particularly important in countries which run structural trade deficits such as India, Pakistan and the Philippines. Second, income from workers abroad is often translated into domestic consumption, thereby adding to effective demand, output and employment. This is identified to be a main source of growth in the Philippines in recent years where remittances boosted incomes by some 10 per cent (Lim 2010).

The crisis tends to reduce remittances because of falling employment and wage incomes and declines in the flow of migration. Where migrant workers are employed in cyclically sensitive sectors such as construction, the impact can be felt disproportionately by foreign workers.[10] However, despite the rapid increase in unemployment in the major host countries,

[10] This was observed during the Asian crisis in Malaysia where rising unemployment mostly affected migrant workers; see Akyüz (2006).

notably in construction, remittances to DEEs have been more resilient than both private capital flows and export receipts. They grew strongly during 2008, but slowed down in the last quarter of the year. According to recent estimates by the World Bank, in 2009 they fell by 6 per cent to $316 billion. The decline is mostly concentrated in Latin America because of close linkages with the US, notably in construction, while for South and East Asia they continue to register modest increases (Ratha *et al.* 2010).

In Pakistan remittances rose by $1 billion in 2008 while portfolio investment disappeared and FDI remained unchanged (Haque 2010), and there was a further increase in 2009 despite the slowdown in transfers from the US, thanks to continued growth from the Gulf. The Philippines also saw increases in 2008 and 2009, with higher remittances making up for declines in other sources of foreign exchange (Lim 2010). In India there was a large increase in 2008, by some $12 billion, despite the contraction in the US and Europe which together account for close to 60 per cent of total remittances to that country, particularly from workers in IT-related sectors, linked closely to the export of software services (Chandrasekhar 2009). Part of these transfers to India seems to have been used for investment in local markets, attracted by currency depreciations and declines in asset prices, including property.

Despite the continued relative strength of remittance flows to South and East Asia, over the medium term they are unlikely to return to the rapid growth experienced in pre-crisis years, particularly if recovery in the US and Europe turns out to be sluggish and jobless, creating not only unemployment but also xenophobia and discrimination against foreign workers, and construction activities in the Gulf continue shrinking with persistent weakness of oil prices.[11] Indeed, the most recent World Bank projections for remittances in 2010-11 suggest faster growth than earlier projections, but weaker than in pre-crisis years (Ratha *et al.* 2010).

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[11] According to Ratha and Mohapatra (2009), almost all major destination countries have tightened controls against migrant workers.

Export shocks

Trade has been by far the most important channel of transmission of deflationary impulses from the global crisis.[12] After growing by close to 10 per cent per annum during the years before the crisis, world trade volume started to fall sharply in the last quarter of 2008 and throughout the first half of 2009. Despite the subsequent recovery, it registered a decline of close to 13 per cent for the year as a whole (WTO 2010).

In most Asian DEEs in the years preceding the crisis exports were the most dynamic component of aggregate demand, growing faster than domestic investment and consumption and at double-digit rates in China, India, Indonesia, Korea, Singapore and Turkey. With the downturn of the global economy, this rapid growth was followed by a sharp downturn in the last

Table 5: Real Export of Goods and Services

	2004-2007 Average		2008		2009[a]
	Growth (Y-o-Y)	As % of GDP	Growth (Y-o-Y)	As % of GDP	
China	24.1	37.8	8.6	36.5	-15.9
India	17.0	20.4	12.8	22.7	-26.4[b]
Indonesia	12.0	31.7	9.5	29.8	-19.4
Korea	12.9	40.5	5.7	52.9	-14.3
Malaysia	8.9	115.0	1.3	103.6	-24.9
Pakistan	9.1	15.2	17.9	12.8	-22.1[b]
Philippines	9.7	47.1	-1.9	36.9	-29.2[b]
Singapore	13.0	233.6	1.3	234.3	-20.2
Thailand	7.5	72.8	5.5	76.4	-12.0
Turkey	16.1	22.6	20.7	23.9	-22.6

Source: WB CQU (various issues), ADB (Key indicators 2009) and IMF IFS (various issues)
[a] Merchandise exports
[b] Average for the first three quarters of 2009

[12] This section draws on Akyüz (2010b), using more up-to-date data on exports for more recent years.

quarter of 2008, with exports falling at double-digit rates in most countries until the last quarter of 2009 (Table 5).

The impact of export contraction on economic activity has varied according to the importance of exports in the income generation process in comparison with the components of domestic demand. To account for the contribution of different components of demand to income and growth, one needs to go beyond the conventional growth accounting based on *ex post* national income identity. The trade balance or net exports (that is, exports minus imports) describe the *ex post* contribution of trade to income, but do not provide a correct measure of dependence of income on exports because all imports are deducted from exports and imports used for domestic consumption and investment are not accounted for. They thus underestimate the contribution of exports and overestimate the contribution of domestic demand to GDP.

On the other hand, the standard exports X/GDP ratio overestimates the income (value-added) generated by exports because it ignores the foreign (import) content of exports. Since exports use, directly or indirectly, imported intermediate goods, parts and components, any contraction in exports would bring, *pari passu*, a contraction in imports used for the production of exportables, thereby tempering the impact of export declines on income and growth. Thus, in order to correctly assess the impact of export shocks on income and growth, it is necessary to identify direct and indirect import content of exports, using input-output linkages.

Furthermore, a contraction in exports reduces income not only directly but also indirectly, through its effects on domestic consumption and investment. The Keynesian multiplier establishes an indirect link between exports and income through consumption. There are also strong knock-on effects of exports on investment, particularly where an important part of manufacturing is export-oriented.

Estimates for import content of different components of aggregate demand and spillovers from exports to domestic demand are not always readily available for DEEs. However, it is known that a common feature of East Asian DEEs closely linked to international production networks is that

not only their X/GDP ratios but also the import content of their exports are high.[13]

Evidence suggests that the import content of Chinese exports is between 40 and 50 per cent; that is, domestic value-added generated by exports is less than 60 per cent of their gross value. In value-added terms the share of exports in GDP is no more than 20 per cent. A very large proportion of the foreign content of exports consists of imported parts and components directly used in sectors producing exportables. Almost two-thirds of domestic value-added contained in exports are generated in industries supplying inputs to sectors producing exportables. Around 60 per cent of imports are used, directly and indirectly, for exports; less than 15 per cent for consumption; and some 20-25 per cent for investment.

Despite high import content, one-third of growth of income in China in the years before the outbreak of the global crisis is estimated to have been due to exports because of their phenomenal growth of some 25 per cent per annum. This figure goes up to 40 per cent if spillovers to domestic consumption are accounted for and further to 50 per cent if knock-on effects on domestic investment are added. The sharp contraction of exports in 2009 is estimated to have dragged down GDP by more than 3 per cent, without allowing for spillovers to domestic demand.[14] This meant a sharp swing of more than 6 percentage points in the contribution of exports to GDP compared to pre-crisis years. Despite massive government intervention, this is only partly offset by faster growth of domestic demand so that GDP growth in 2009 is estimated to have remained some 3 percentage points below the 2002-07 average.

Available evidence suggests that the import content of exports is lower in Indonesia, Korea, the Philippines and Thailand than in China. With the exception of Indonesia, these countries also have higher X/GDP ratios (Table

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[13] These include China, the newly industrialized economies (NIEs; Korea, Taiwan, Singapore and Hong Kong) and the members of ASEAN.

[14] The impact of export contraction on GDP is estimated using $g_x (1 - \delta) (X/Y)$, where g_x is the growth rate of exports, δ is the import content of exports and X/Y is the share of exports in GDP as conventionally measured; see Akyüz (2010b).

5). Consequently, in value-added terms the share of exports in GDP is higher in these countries than that in China, reaching 30-40 per cent. This means that they are more susceptible to export shocks. Thus, it is estimated that the impact of export contraction in these countries during 2008 on GDP varied between 4 and 6 per cent. Malaysian and Singaporean exports have higher import content than Chinese exports, but these countries also have much higher X/GDP ratios than China. Consequently, in value-added terms their exports account for a higher share of GDP than not only China but also the first group of countries. Accordingly, export shocks in 2009 had a stronger impact on GDP growth in these countries, possibly reaching double-digit figures.

All in all, it can be estimated that, on average, contraction of exports during 2008-09 reduced GDP in East Asian DEEs by 5-6 per cent. When spillovers to domestic demand are accounted for, this figure is likely to be much higher. Indeed, according to an estimate by the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP 2010: Box 1) for East Asian DEEs and Japan, the impact of the 2009 shortfall in exports on GDP reaches 7.8 per cent, accounting for both direct and indirect effects.

India, Pakistan and Turkey also suffered significant drops in exports from the last quarter of 2008. However, in the run-up to the crisis, growth in these countries was not as dependent on exports as in East Asia. They are less integrated into international production networks and their X/GDP ratios are much lower – in India and Turkey less than half the average X/GDP ratio in East Asia, and in Pakistan less than one-third. While data and information on import content of exports are not readily available for these countries, in value-added terms the share of exports in GDP is likely to be around 15 per cent in India and Turkey and 10 per cent in Pakistan.[15] This would mean that the contraction in exports during 2008-09 pulled down GDP by some 4-5 per cent in India, 3-4 per cent in Turkey but less than 2 per cent in Pakistan.

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[15] Agarwala (2009) assumes that in India the import content of exports is no more than that of domestic demand. This gives a figure of 20 per cent for 2007-08. On this assumption, in value-added terms the share of exports in GDP would be around 17 per cent.

These considerations suggest that the more successful exporters of manufactures with very high X/GDP ratios have been hit particularly hard by trade shocks emanating from the global crisis even when the import content of their exports is relatively high. These include not only countries which enjoyed large current account surpluses such as China, Malaysia, Singapore and Thailand, but also Korea where the current account was broadly in balance in the run-up to the crisis, but an important part of the manufacturing industry was export-oriented.

By contrast, countries which are not so closely integrated into the global trading system and international production networks in manufacturing suffered relatively less from contraction in exports. These include India, Indonesia and, to a lesser extent, the Philippines where domestic demand played as important a role in pre-crisis economic expansion as exports. In India, both domestic consumption and investment grew rigorously. Consumption, particularly of upper-income groups, was stimulated by a credit boom resulting from financial deregulation and rapid inflow of capital, while investment in property rather than industry was the most dynamic component of domestic demand (Chandrasekhar 2009). In the Philippines rapid expansion of private consumption supported by growing remittances resulted in an above-trend growth during 2002-07 despite the falling share of investment in GDP (Lim 2010). All three countries maintained broadly sustainable external positions, running small current account surpluses or deficits. Turkey, which also enjoyed above-trend growth based on domestic demand, was externally more vulnerable to export shocks because of a large current account deficit and heavy dependence on capital inflows. Consequently it has been hit hard by the combination of sharp declines in capital flows and export earnings.

Chapter 4

POLICY RESPONSE AND RECOVERY

THE growth outcome during 2008-09 naturally depended not only on the incidence of shocks but also on the policy response. The space for counter-cyclical policy varied considerably among countries. The East Asian economies have generally been able to respond by expansionary monetary and fiscal measures, but growth losses could not be prevented even where strong stimulus packages have been put in place. Thus, despite the original hype that growth in East Asia would decouple from advanced economies and could even help prevent the world economy plunging into recession, many countries in the region could not avoid negative GDP growth in 2009. For the sample of DEEs in Table 1, growth for 2009 was around 5 percentage points below the average growth over 2002-07.

The reaction to the reversal of capital flows and the hike in risk premia after the collapse of Lehman Brothers was quite different from the response to the exodus of capital in previous emerging-market crises, including the East Asian crisis of 1997. Although Indonesia initially succumbed to the Washington Consensus instinct and resorted to interest rate hikes in an effort to stabilize the currency, this was soon reversed. The large stock of reserves accumulated from current account surpluses and capital inflows in pre-crisis years was not used to any significant degree for exchange rate stabilization. Rather, as already noted, currencies were allowed to fall, as this was seen to provide some buffer against the severe drop in exports.

Unlike in the 1997 crisis, no country resorted to control over capital outflows, neither for residents nor for foreigners. Instead, several measures were announced to boost confidence and increase the resilience of the financial system to shocks. Indonesia, Korea, Malaysia, the Philippines and Thailand expanded deposit insurance. Korea also provided guarantees on interbank transactions and external debt of domestic banks up to $100 billion. Singapore introduced a Deposit Insurance Scheme in October 2008 to avoid erosion of bank deposits, guaranteeing all Singapore dollar and foreign currency deposits of individual and non-bank customers in banks, finance companies and merchant banks licensed by the Monetary Authority of Singapore until 31 December 2010 (Lim and Jaya 2010). China, Korea, India and Thailand injected capital into financial institutions.

With the stabilization of capital flows, monetary authorities in almost all countries started to cut policy rates from the last quarter of 2008, including those with relatively high inflation such as Turkey, in order to stimulate domestic demand. In addition, quantitative easing has been sought in several ways. Reserve requirements have been reduced in several countries in order to increase liquidity in the banking system. In India, Indonesia and Korea central banks not only provided liquidity support to financial institutions in local currency, but also used international reserves to lend in foreign currency in order to offset the reduction in external financing, notably to exporters. Moreover, as capital flows recovered, currency interventions were no longer sterilized, unlike in the period before the outbreak of the crisis (Akyüz 2008). In the third quarter of 2008 China stopped issuing central bank bills to sterilize the impact of dual surpluses on its current and capital accounts, adding significantly to credit expansion (Yu 2010).

East Asian countries with favourable combinations of current account and reserves positions faced no balance-of-payments constraint in pursuing expansionary macroeconomic policies to offset the impact of drastic declines in exports by increasing domestic consumption and investment, particularly since capital flows quickly stabilized after the initial reversal. Nor did they face fiscal constraints since their central government budgets were either in surplus or moderate deficits and debt and debt burden were quite moderate

compared to most other DEEs. India too had significant policy space despite a higher sovereign debt ratio than East Asian countries.[16] Its current account deficit was relatively small compared to reserves despite some large initial losses due to capital outflows. At some 4 per cent of GDP, its central government budget deficit was moderate and its debt burden was not onerous.

The main exceptions among the countries examined here were Turkey and Pakistan, with current account deficits in the order of 5-6 per cent and declining reserves (Uygur 2010 and Haque 2010, respectively). In the face of sharp declines in export earnings and reduced and unstable capital flows, both countries saw the payments constraint tighten considerably. Use of tariffs and other trade measures to alleviate the payments constraints was not part of the accepted thinking of policy makers in these countries, as in most other DEEs, even though doing so would have been quite legitimate under current multilateral rules (Akyüz 2009b).

Both Pakistan and Turkey had little scope for fiscal expansion. Pakistan had already a large budget deficit of some 6 per cent of GDP and resorted to pro-cyclical fiscal tightening. In the event, it managed to grow moderately in 2009 under an IMF programme, by one-third of its average growth after 2002, while its current account deficit doubled. In Turkey the main concern was to secure sovereign debt sustainability by generating a primary surplus of some 5 per cent of GDP. Besides, the government was quite confident that the crisis would bypass Turkey. In any case, given the dependence of the economy on foreign capital and a high level of indebtedness, a strong counter-cyclical fiscal expansion could have undermined market confidence, thereby curtailing access. In the event the fiscal incentives came too late and too little. Growth collapsed in 2009, with a swing of about 12-13 percentage points from the 2002-07 average. As expected, the current account deficit fell as imports contracted faster than exports while the central budget deficit rose sharply to exceed 5 per cent of GDP.

[16] The average sovereign (central government) debt in East Asia is less than 40 per cent of GDP. The only major economy with a high debt ratio is the Philippines where it is close to 60 per cent. The average ratio in South Asia is much higher, with Indian central government debt exceeding 60 per cent of GDP and general government debt 80 per cent.

In East Asia the counter-cyclical fiscal response was unprecedented, not only for the region alone but also the developing world as a whole.[17] On some estimates, the fiscal package in 15 DEEs in East, South and Central Asia amounted to 7.5 per cent of 2008 GDP, almost three times the average level in the G7 major industrial countries. China introduced the largest fiscal package, close to $600 billion, but in terms of share of GDP some smaller countries implemented even bigger packages; e.g., the Thai fiscal stimulus package amounted to some 17 per cent of GDP compared to 13 per cent in China. Fiscal packages were also relatively large, in excess of 5 per cent of GDP, in Malaysia, Singapore and Korea, but somewhat smaller in the Philippines, India and particularly Indonesia.[18]

Unlike in advanced economies, counter-cyclical fiscal packages in Asia placed much less emphasis on tax cuts and focused on increases in spending, particularly in infrastructure investment. Since public works are politically easier to control than current spending and tax cuts, this approach is consistent with the Keynesian approach to counter-cyclical fiscal intervention which calls for fiscal consolidation at times of expansion (Akyüz 2006). The main exception was Indonesia where over 80 per cent of the fiscal stimulus package consisted of tax breaks and subsidies to consumers and business. India also used taxes and subsidies while China, Malaysia, Korea and Singapore focused on infrastructure spending. Although some attention has been paid to rural infrastructure and building schools and hospitals and public housing projects, in general spending targeting the poor, including social transfers, has been a relatively small part of stimulus packages.

In China less than 20 per cent of the fiscal package has been allocated to social spending, with the rest going mainly into infrastructure investment in roads, railways, ports and airports. It has pushed the investment rate to 50

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17 On fiscal stimulus packages, see United Nations (2010), Khatiwada (2009), ESCAP (2009 and 2010), ADB ADO (2010), IMF WEO (October 2009) and IMF REOAP (October 2009).

18 Difficulties in identifying fiscal stimulus measures are revealed by widely different figures given by different international organizations for some East Asian countries; cf. United Nations (2010: Table I.4), ADB ADO (2010: Figure 2.4.1) and ESCAP (2009: Table 1).

per cent of GDP, and aggravated the problem of excess capacity that had pervaded several sectors and increased the dependence of growth on exports. Policies designed to revive real estate demand and an unprecedented growth of mortgage lending to households created a bubble in the property market, with real estate investment growing by close to 40 per cent. While private consumption held up thanks to several incentives, particularly for car purchases, it did not provide much impetus to offset the sharp decline in exports. The increase in investment is estimated to have contributed between 80 and 90 per cent of growth in 2009 (Wolfe and Ziemba 2009a and 2009b; Hung 2009).

Large as they may have been, stimulus packages have not always been adequate to deal with the consequences of export shocks for economic activity.[19] According to estimates by ESCAP (2010), only in less than half of East Asian DEEs (i.e., China, India, Korea and Thailand) were the announced fiscal packages sufficiently large to offset the overall impact of the decline in exports on GDP. However, this did not prevent loss of growth compared to pre-crisis years even though these countries also pursued highly expansionary monetary policy.

There are several reasons for the absence of a very strong correlation between the size of fiscal stimulus packages and growth performance across countries, even allowing for diversity in the incidence of export shocks. First, there appear to have been considerable variations in the impact of trade and financial shocks on private domestic demand, notably investment. The impact has been particularly strong in Korea, Taiwan, Malaysia, Thailand and the Philippines where private investment, notably in durable equipment, slowed down or contracted significantly. This, together with a slowdown in FDI, is the main reason for sharp drops in the share of domestic investment in GDP during 2008-09 in these countries even though in most cases government investment spending rose as part of the counter-cyclical policy response to

[19] Khatiwada (2009) reaches the same conclusion on the adequacy of fiscal measures for a sample of 32 countries including the G20 major economies where stimulus spending in 2009 was 1.7 per cent of GDP as compared to the 2 per cent recommended by the IMF.

the crisis (ADB ADO 2010). Second, there are slippages in the implementation of announced measures. Third, infrastructure investment projects take a long time to implement fully. Finally, in most cases fiscal packages were introduced from late 2008 onwards to be implemented in several steps, extending into 2010 and even beyond. In Thailand, for instance, the second package introduced in 2009 was for implementation in 2010-12. Nevertheless, it is beyond doubt that counter-cyclical fiscal policy in Asia has been highly effective in stabilizing output and promoting recovery in the face of severe external shocks, both directly through its impact on aggregate demand and indirectly by helping maintain confidence among consumers and investors.

While recovery is stronger than expected at the outset of the global crisis, current projections for 2010 put growth well below the average rates attained in pre-crisis years (ADB ADO 2010: Table 1). Without doubt much of that growth is coming from monetary and fiscal stimulus packages introduced from the last quarter of 2008. With exit from stimulus packages, growth will depend on private spending. A main concern is that a premature exit, in both major industrial and developing economies, could short-circuit recovery, leading to sluggish growth or even another dip in economic activity.

In this context, exit can refer to two different things: ending or reversing reflationary measures. In the former sense, exit would mean ending cuts in interest rates or quantitative easing on the monetary front, and phasing out tax cuts and additional discretionary spending on the fiscal front. In the case of reversal, there would be monetary tightening and interest rate hikes and fiscal consolidation designed to reduce structural budget deficits.

Central banks have ended interest cuts and liquidity expansion in almost all major developing and developed economies. In AEs there are signs of the beginning of monetary tightening, with the US Fed raising the interest rate it charges on short-term loans to banks and Canada raising policy rates. In several DEEs in Asia, including China, monetary tightening has started as interest rates and/or banks' reserve requirements are raised gradually with the upturn in growth and inflation. On the fiscal side, there appear to be no plans for new packages even though some spending programmes introduced

earlier extend to the current year and the next. While fiscal consolidation is not yet in sight anywhere in the developing world, in view of large deficits that emerged, Asian DEEs are urged to go back to fiscal prudence, rather than maintaining fiscal activism in response to continued growth slowdown (ADB ADO 2010). While the US administration appears to be reluctant to undertake fiscal retrenchment before recovery is strongly in place and growth is restored, sovereign debt problems and pressures from currency and bond markets are forcing premature fiscal adjustment in Europe.

Even without a monetary and fiscal policy reversal, the current pace of recovery may not be maintained if stimulus programmes so far put in place do not lead to sustained increases in private spending. Indeed, the 1990s witnessed several failed fiscal pump-priming attempts in Japan in conditions of financial fragility whereby recovery stalled when fiscal injection came to an end. Such an outcome cannot be entirely ruled out in the current recovery. Since pre-crisis growth in East Asia was driven mainly by exports, a central issue over the medium term is whether they can go back to export-led growth and the kind of policy challenges they face in the likely case that there may be no return to business as usual. This clearly depends not only on policies in China and Asian DEEs, but also on the evolution of the global economy and policy and performance of major AEs.

Chapter 5

MEDIUM-TERM PROSPECTS AND POLICY CHALLENGES

Adjustment and growth in major advanced economies

A RETURN of the global economy to the kind of rapid and broad-based expansion enjoyed from the early years of the decade until 2008 is no doubt desired by all, but the main question is how to achieve this without the accompanying financial fragilities and trade imbalances that led to the most severe post-war global economic crisis.[20] There is wide agreement that a return to "business as usual", with the US continuing to consume beyond its means and absorbing Chinese exports by issuing growing amounts of dollar liabilities, is not a sustainable option – it is a recipe for heightened international monetary and financial instability and disorderly and deflationary adjustment to global economic imbalances.

The prospects for global stability and growth are thus believed to depend crucially on rebalancing the US and China – the largest deficit and surplus countries, respectively. In view of the central place occupied by the dollar in the international reserves system, it is recognized that international monetary and financial stability crucially depends on spending discipline by the US, in line with its income, allowing for a fundamental and sustained balance-of-payments adjustment. However, in order to maintain growth, the US should not simply cut domestic absorption but also shift to export-led growth. An orderly US adjustment would also require, *inter alia*, a shift

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[20] For a further discussion of the issues taken up in this section, see Akyüz (2010a).

by China from export-led to consumption-led growth and the realignment of the exchange rate of the yuan against the dollar. In this way, prospects for global stability are expected to improve without sacrificing growth.[21]

A significant adjustment by US consumers is already under way, brought about by massive losses of personal wealth caused by the subprime crisis. Personal savings have moved into positive territory and, on recent trends, may reach 10 per cent of disposable income in coming years.[22] By contrast, stimulus and bailout packages have resulted in a significant increase in fiscal deficits, which now exceed 10 per cent of GDP, pushing the public debt ratio towards 100 per cent. Clearly, with consumer spending staying behind income growth, attempts to reduce public deficits and debt through tax increases and spending cuts would be highly deflationary.

Given consumer retrenchment, a growth-driven US fiscal adjustment would require strong export growth. Indeed, a shift from consumption-led to export-led growth is the main objective of the National Export Initiative (NEI) launched by President Obama in his State of the Union Address, which targets a doubling of exports in five years.[23] However, even with rapid export expansion, US growth is likely to be sluggish due to the decline in potential growth brought about by the crisis.[24] Actual growth may fall even further if bond markets force a swift fiscal adjustment. In other words, the US may have to pay the cost of decades-long bubble-bust cycles and aggressive monetary and fiscal policy easing in response to consequent crises by going through slow and unstable growth for some years to come. But, whether or

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[21] This was broadly the plan promoted by the IMF in its multilateral consultations to reduce global imbalances on the eve of the crisis. Although the crisis has resulted in sizeable changes in external positions and savings patterns, the Fund recognizes that imbalances are not a problem of the past and there is still a need to remove global imbalances; see Blanchard and Milesi-Ferretti (2009).

[22] On US consumer adjustment in the coming years, see Glick and Lansing (2009).

[23] Achieving this target would require, *inter alia*, an active industrial policy to redirect investment in export sectors. For a discussion of the main ingredients of the NEI, see Akyüz (2010a).

[24] According to the IMF (WEO October 2009), after a sharp decline during 2008-09, potential output growth will pick up only slowly to about 2 per cent over the medium term; see also IMF (2010).

not growth slows down over the medium term, net demand stimulus from the US to East Asian DEEs is likely to be significantly lower than in the years preceding the financial crisis. This means that domestic demand in surplus countries, including China, needs to expand much faster than in the past in order to maintain a relatively rapid global growth.

Germany and Japan are also among the major surplus countries that need to adjust and add to global demand. Although these countries often escape attention because their bilateral trade surpluses with the US are much smaller than that of China, they have also been running large amounts of current account surpluses – $250 billion in Germany and $210 billion in Japan before the onset of the crisis, compared to $370 billion in China. They have both been siphoning off global demand without adding much to global growth. During 2002-07, exports grew 25 times faster than domestic demand in Germany and 8.5 times in Japan while this figure was less than 3 for China. In both countries, the contribution of exports to growth was much higher than that in China during the years preceding the crisis. This lack of dynamism in domestic demand has been due to the falling share of consumption in GDP along with stagnant or falling real wages, slow employment growth and the downward trend in the share of wages in GDP.

In Germany reliance on exports for growth through wage restraints (or the so-called "competitive disinflation") at the expense of consumer demand has been compromising growth and stability in other eurozone countries which are unable to restrain wages to the same extent, but locked into a common currency. It has played a major role in growing external imbalances and debt accumulation in several eurozone countries including Greece, Portugal and Spain where current account deficits as a percentage of GDP have been hovering around double-digit figures and debt ratios have been rising rapidly. The region is highly vulnerable to financial turmoil due to the combination of large and what looks like unsustainable sovereign debt in these countries and a high degree of exposure of European banks to sovereign default.

Avoiding such an outcome would call for strong growth, but this has been severely constrained by continued beggar-my-neighbour policies of

Germany. The deflationary policy bias would be aggravated by premature fiscal consolidation which the countries in the region seem to be determined to pursue under the pressure of bond and currency markets, posing the risk of a double-dip. According to the IMF (2010 and WEO April 2010), potential growth in the euro area, currently at zero, will only reach 1.5 per cent over the medium term and actual growth would remain below the rates attained during pre-crisis years. With increased concerns over sovereign insolvency and premature fiscal retrenchment, the figure may even be lower, if positive at all. Under these conditions, even if the spectre of a double-dip recession could be averted, Europe is unlikely to provide a rapidly expanding market for East Asian exporters for several years to come.

Japanese growth prospects look as bleak as Europe's, expected to be the worst among the G7 by the Organization for Economic Cooperation and Development (OECD) (Fujioka 2010). Sluggish markets in the US and the EU would cut down Japan's growth not only directly but also indirectly since Japan provides over 15 per cent of China's total intermediate imports used in the production for exports. Indeed, a very large proportion of negative export shocks to China during 2008-09 were passed on to Japan alongside Taiwan and Korea, as the main suppliers of parts and components to China. Therefore, Japan is unlikely to provide much independent growth stimulus to lesser developed countries in the region.

Sustaining rapid growth in Asia

With consumer retrenchment and external adjustment in the US and sluggish growth or stagnation in the EU and Japan, it will be very difficult for the world economy to return to the kind of rapid growth enjoyed in the years preceding the global economic crisis. This means considerably dampened export prospects for Asian DEEs. Fiscal and balance-of-payments adjustment and monetary tightening in the US could also lead to considerably tightened global financial conditions over the medium term. They could result in significant increases in interest rates, strengthening the dollar and leading to a rapid unwinding of dollar carry-trade. By triggering rapid and

sustained capital outflows, these could wreak havoc in DEEs heavily dependent on foreign capital flows.[25]

The impact of these possible changes in the global economic environment on the countries under study would vary considerably depending on their underlying macroeconomic and structural conditions. The growth outcome will also depend on the policy response, the space for which also varies significantly across countries. In these respects, a distinction can be made between, on the one hand, the South and West Asian countries, India, Turkey and Pakistan, where domestic demand has been a more dynamic component of growth than exports and external accounts are in structural deficits, and, on the other hand, China and the East Asian DEEs linked to the Sinocentric production network where growth is export-led and much less dependent on foreign capital inflows.

South and West Asia

Turkey and Pakistan need to overcome a number of structural weaknesses in order to be able to return to the kind of rapid and sustained growth they enjoyed in the years before the global crisis. This may be difficult to achieve rapidly even under drastic policy changes. Turkey suffers from a fundamental disequilibrium in its current account balance. Even though its current account deficit has narrowed since the last quarter of 2008, it will certainly start climbing with any acceleration of growth based on domestic demand. Thus, it could need, *inter alia*, a major currency alignment to help achieve external adjustment without facing deflation. It is important that this takes place in an orderly way, rather than through a rapid exit of capital and an attack on its currency that may be triggered by postponing adjustment, which would lead to defaults in the private sector with extensive liability dollarization as well as severe difficulties in servicing domestic public debt.

[25] On the possible impact of dollar carry-trade on assets and currencies, see Pineda *et al.* (2010).

Turkey also needs to raise national savings in order to reduce its dependence on foreign capital. Currency adjustment can play a role in this since there appears to be an inverse correlation between real appreciations and private savings (Uygur 2010). However, the country also needs to raise its fixed investment rate significantly – from some 20 per cent of GDP before the crisis and 17 per cent now – in order to accelerate structural change though upgrading and moving out of labour-intensive manufactures. This is absolutely essential because its markets are wide open to cheaper Asian exporters of manufactures and it has very little room for trade policy measures in view of its customs union agreement with the EU. With its national savings rate hovering around 16 per cent of GDP since 2003, closing the external gap while raising investment is a daunting task. Thus, Turkey can face severe problems regarding stability and growth if the global economic environment in coming years does not turn out to be as favourable as in pre-crisis years.

Much of this is also true for Pakistan. From 2002 onwards Pakistan enjoyed above-historical growth, driven primarily by inflows of capital and remittances: during 2002-07 net capital flows and current transfers accounted for as much as 45 per cent of total foreign exchange receipts, with exports covering less than three-quarters of imports (Haque 2010). However, the country had been facing serious difficulties in maintaining growth and keeping deficits under control long before the onset of the global crisis – a process which culminated in an IMF programme. Medium-term prospects regarding capital inflows and remittances do not look very bright. In all likelihood, recovery in advanced economies will continue to be jobless for some time to come and activity in the Gulf cannot pick up without a sustained upturn in oil prices. Therefore, following the modest recovery in sight over 2010-11, the Pakistan economy may well return to the more moderate growth rates of the 1990s.

Although India has been running current account deficits constantly since the middle of the decade, the contribution of its exports to growth is much greater than is commonly appreciated. As noted, the share of value-added exports in GDP is in the range of 15-17 per cent. With Indian real exports growing, on average, by 17 per cent per annum during 2004-07, it

can be estimated that around one-third of GDP growth in that period was due to exports, even without accounting for spillovers to domestic demand.[26] It would be difficult to replicate this export performance over the medium term. With unchanged pace and pattern of domestic demand, Indian growth over the medium term is thus likely to be about some 2 percentage points below the average enjoyed in the years before the crisis, coming down to around 7 per cent. This is still respectable – more than twice the so-called Hindu growth of the 1960s and 1970s. It could be possible to push this up by faster expansion of domestic demand, but this would widen the current account deficit, possibly to 5 per cent of GDP. Coming at a time when global financial conditions can become quite tight, this could make the economy highly vulnerable to sudden stops and reversal of capital flows. Thus, it might be wiser to settle at a somewhat lower growth rate than try to replicate the 9-10 per cent growth of the earlier period and expose the economy to such risks.

China[27]

For countries closely linked to the East Asian production network, the policies and performance of China, as well as major AEs, hold the key for medium-term growth prospects, given the sheer size of China and their close trade linkages. For the reasons already discussed, China cannot go back to pre-crisis export growth rates in excess of 25 per cent per annum, more than three times the projected medium-term growth in world trade volume (IMF WEO April 2010: Table A17). An aggressive export push in the markets of AEs or DEEs is likely to meet strong resistance, creating conflicts in the trading system. If, on the other hand, the rate of expansion of Chinese exports comes down to a more acceptable level, say to 10 per cent, then, without a fundamental change in the pace and pattern of domestic demand, its growth

[26] Agarwala (2009) estimates that the contribution of exports to GDP growth during 2003-08 in India was *at least* 26 per cent. With spillovers to domestic consumption, this figure is raised to 31 per cent.

[27] This and the following sections draw on Akyüz (2010b) which contains further analysis and evidence on the issues discussed here.

may barely reach 7 per cent. Growth may drop a lot more if the credit-driven investment bubble bursts, exposing bad loans and giving rise to difficulties in overstretched banks and, eventually, to a financial crisis.

One option is to expand rapidly in the markets of poorer economies where imports are constrained by foreign exchange availability, by simultaneously providing them the necessary financing through lending and/or direct investment. However, there are limits to what these economies could absorb while securing sustainable external debt and asset positions. For instance, total merchandise imports of least developed countries (LDCs) are less than 10 per cent of Chinese exports and for sub-Saharan Africa the ratio is less than one-to-five. Besides, Chinese expansion in these markets could threaten the domestic industry in certain sectors such as clothing, a main manufactured export item of several low-income countries, including the larger ones such as Bangladesh and Vietnam. While such an option would certainly help both the poorer countries and China in expanding trade, it should be seen as a step in the transition from export-led to domestic-demand-led growth, rather than as a way of postponing the necessary adjustment.

Another option would be to lower the foreign content of exports by upgrading and import substitution of high-tech parts and components so as to enhance their contribution to growth. Such a transformation has been under way, but even if accelerated considerably, it will take a long time to have its effects felt on domestic content of exports. Besides, it would imply continued growth of the Chinese trade surplus, thereby aggravating global imbalances.

The solution should be sought primarily in raising domestic consumption much faster than has been the case so far. Since the beginning of the decade until the global financial crisis, investment in China went ahead of consumption and the demand gap was filled by rapidly growing exports. The share of private consumption in GDP fell from over 50 per cent in the 1990s to around 36 per cent on the eve of the crisis while that of investment rose to 45 per cent. Consumption as a share of GDP remained stable during the 2008-09 downturn while the investment rate has been pushed up to 50

per cent by the stimulus package. With a sustained slowdown in the pace of exports, a return to a path of some 9-10 per cent growth will require reversing the downward trend in the share of private consumption and the upward trend in the share of investment in GDP.

The main reason for under-consumption in China is not excessive household savings. They are no doubt high, but not always higher than those in other DEEs. In the past few years they have remained around 20 per cent of GDP, broadly the same as household savings in Malaysia in the 1980s and in India in recent years. As a proportion of household disposable income, they are in the order of 28 per cent compared to 32 per cent in India. However, at more than 50 per cent of GDP, the Chinese national savings rate exceeds that of India by a large margin because of significantly higher corporate savings or profit retentions – over 20 per cent of GDP compared to 10 per cent in India. Chinese corporate profits and savings are also much higher than those in late industrializers in Asia. While household savings as a proportion of disposable income have been rising in recent years, their share in national savings has been declining because of sharply rising corporate savings.[28]

The disparity between consumption and investment and the consequent dependence of China on foreign markets is largely the outcome of the imbalance between wages and profits. Wages in China constitute a very large proportion of household income because government transfers and investment income, including dividends, are very small. Despite registering impressive increases, wages have lagged behind productivity growth and their share in value-added has been declining. The downward trend in the share of wages in GDP is almost perfectly mirrored by the share of private consumption in GDP.[29] This has no doubt been a factor in the recent labour unrest in China.

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28 On household and corporate savings in early industrializers, see Akyüz and Gore (1996) and UNCTAD TDR (1997: Table 44). On savings in China and India, see Prasad (2009). See also Anderson (2007) for a discussion of household and corporate savings in China.

29 On the behaviour of labour productivity, profits and wages and consumption, see Kim and Kuijs (2007); WB CQU (August 2005, August 2006 and February 2007); Kuijs (2005); Yu (2007); and Aziz and Dunaway (2007).

A return to trend growth in China thus crucially depends on a sizeable increase in the share of household income in GDP and a corresponding decline in corporate profits and investment, which are boosted by tax incentives and the practice of non-payment of dividends to the government by state-owned enterprises. This calls for a higher share of wages in value-added and significantly greater government transfers to households, particularly in rural areas where incomes remain depressed. Greater public spending on social infrastructure in health, housing and education would not only improve social welfare but also serve to reduce relatively high precautionary household savings. These expenditures and income transfers can be financed with dividend payments by state-owned enterprises.

As noted, with its emphasis on investment, the recent policy response in China to fallouts from the crisis has done little to address the problem of under-consumption. It will be in a weaker position to give a similar positive response to fallouts from a possible second dip in global economic activity that may result from debt difficulties and premature fiscal tightening in Europe. Indeed, the longer the adjustment to under-consumption is delayed, the greater the vulnerability of China to instability of economic activity in its main markets in AEs. Instability in the latter economies is likely to persist since the crisis response has not eliminated its root causes – namely, excessive indebtedness and rapid liquidity expansion.

China's East Asian suppliers

As noted, the dependence of growth on exports is greater in East Asian DEEs closely participating in the Sinocentric production network than in China. These economies have direct exposure to a sustained slowdown in exports to the US and the EU, which together account for more than a quarter of total exports of some of these countries. They also have a significant indirect exposure through China. Although China has become the largest export market for an increasing number of East Asian DEEs, an important part of Chinese imports from them is used for inputs into exports of final consumer goods to the US and the EU. For every $100 worth of processing

exports of China to the US and the EU, about $35-$40 accrue to East Asian DEEs.

As an export hub to the US and the EU, China is a major importer from East Asian DEEs, but it is not a major market for them since an important part of Chinese imports is destined to exports rather than used internally. Domestic consumption in China generates proportionately much less demand for imports from East Asian DEEs than its exports to the US and the EU. Consequently, a shift by China from export-led to consumption-led growth could result in a significant slowdown of its manufactured imports from East Asian DEEs. Thus, at its current pattern of domestic spending, the Chinese market is not a good substitute for US and EU markets for East Asian DEEs. It cannot replace the US even if it maintained GDP growth of some 10 per cent based on domestic consumption rather than exports; its GDP is about one-third of the US, the share of households in GDP is much smaller, they save a much higher proportion of disposable income and the import content of household consumption is much lower than in the US. Briefly, a China-US rebalancing can make it quite difficult for East Asian DEEs to sustain rapid export-led growth.

To become a regional locomotive, China would need to raise not only its domestic consumption as a proportion of GDP, but also its import content and, in particular, its imports of final goods from the region. While the share of such goods in Chinese imports from the region has been increasing in recent years (Athukorala 2008; Kim *et al.* 2009), production sharing continues to dominate the intra-regional trade. Moreover, even if there is a rapid increase in domestic consumption and its import content in China, many East Asian DEEs may not be able to expand their exports rapidly because intra-regional network trade is crucially different from trade in final goods. A shift from the former to the latter would call for industrial restructuring and a significant change in the mix of exports. For the same reason a shift to alternative markets may prove to be difficult even for smaller countries supplying parts and components to China. The same problem would also be encountered in reducing dependence on exports by shifting to domestic markets.

Outside China a main reason for excessive reliance on exports is under-investment. In several economies including Malaysia, Singapore, the Philippines, Taiwan and Indonesia, investment rates have been hovering around 20 per cent of GDP in recent years, less than half the rate in China. In none of these economies have investment rates recovered the levels attained before the 1997 crisis (Table 6).[30] Even recognizing that the pre-crisis investment boom was an unsustainable bubble driven by massive capital inflows, recent investment rates are too low to generate rapid growth of either productive capacity or effective demand.

Exceptionally high investment in China and low rates of investment in the rest of East Asia are related. Generous incentives provided by China to export-oriented FDI play an important part in attracting large amounts of investment from the region. There is a need to redistribute aggregate investment within East Asia, from China towards the rest. This would be greatly helped if China were to start focusing on domestic markets and dismantling incentives to export-oriented FDI.

Private consumption has also been weak in most East Asian countries. In Korea, Malaysia, Taiwan and Thailand its share in GDP barely reaches 55 per cent – much below the rates in more affluent countries such as the US (over 70 per cent) and the EU (some 60 per cent). Singapore is another

Table 6: Investment in Asia (per cent of GDP)

	1994-1997	**2003-2007**
Indonesia	31.4	24.4
Korea	36.5	30.0
Malaysia	42.3	21.7
Thailand	39.1	27.7
Philippines	23.2	15.4
Singapore	35.9	20.0

Source: ADB ADO (various issues)

[30] See Akyüz (2009a). Singapore experienced a property boom in 2007 which took investment to some 30 per cent of GDP; see Lim and Jaya (2010).

under-consumption economy in the region where the share of private consumption in GDP has been declining since the beginning of the decade – it is now below 40 per cent while national savings are as high as 53 per cent of GDP, very much as in China. In some of these cases too under-consumption has its origin, in part, in low and/or declining shares of wages in income.[31] They thus face the dual task of raising both consumption and investment while allowing wages to grow faster.

[31] This is most clearly the case in Singapore – see Lim and Jaya (2010) which reiterates that Singapore has a First World per capita income level but a Third World income distribution profile.

Chapter 6

CONCLUSIONS: POLICY ISSUES AND LESSONS

THE global crisis has uncovered systemic and structural weaknesses and vulnerabilities in certain areas in the Asian economies examined here and strengths in others. Given that global economic conditions are likely to be less favourable than those prevailing before the outbreak of the crisis, it is important to address these weaknesses and vulnerabilities in order to be able to return to the rapid and sustained growth enjoyed in the earlier part of the decade.

First, start with strengths. In almost all countries the financial sector has shown a significant degree of resilience to shocks from the subprime crisis. This is in part due to various measures taken in the aftermath of financial crises of the late 1990s and early 2000s. Exposure of the banking system to toxic assets has been limited. This has been so also for indigenous institutional investors which were allowed greater freedom to invest in foreign securities from the early years of the decade in order to, *inter alia*, ease the pressure of the surge in capital inflows and growing current account surpluses on currencies. Losses on reserves invested in mortgage-based securities of government-sponsored institutions in the US have also been limited.

Self-insurance provided by large stocks of international reserves and strong payments positions have certainly been a key element in the resilience of the financial system to shocks. These not only prevented any threat to financial stability during the rapid exit of capital in the early months of the crisis, but also allowed implementation of strong counter-cyclical policies without facing a payments constraint.

Korea could not demonstrate the same degree of resilience to financial shocks as other East Asian countries in large part because it had chosen to liberalize the capital account almost fully in the aftermath of the 1997 crisis and allowed considerable build-up of external financial fragility in much the same way as it had done in the run-up to the 1997 crisis. However, large reserves and a sustainable payments position helped avoid financial meltdown. Turkey and Pakistan found themselves with large and growing current account deficits on the eve of the crisis, in large part because they had allowed their economies to be driven by easy money from abroad. Both countries had already faced difficulties in sustaining growth before the outbreak of the global crisis. With these two exceptions, all countries have had adequate fiscal and balance-of-payments space to respond to shocks through counter-cyclical policies.

A common feature of the countries examined here is their high degree of susceptibility to financial boom-bust cycles and gyrations in equity, property and currency markets. This is in large part due to excessive and widespread capital account liberalization for both residents and non-residents. Indeed, in all East Asian countries the capital account is much more open and integration into the global financial markets is much closer today than was the case on the eve of the 1997 crisis (Akyüz 2008). This crisis has shown the risks of full integration with markets in global financial centres and the need to adopt a strategic approach to financial opening and integration. Both the capital account regimes and policies regarding rights of establishment of foreign financial institutions thus need to be reassessed, particularly since the initial enthusiasm for tightening the control over major players in global financial centres has died away.

The subprime boom-bust cycle has also entailed gyrations in intra-regional exchange rates in East Asia. A main reason is the co-existence of inconsistent exchange rate regimes in the region, ranging from hard pegs to various brands of soft pegs and independent floating. This is a potential source of conflict and not a sound basis for deepening regional economic integration. Quite apart from reorienting their integration into the international financial system, the region also needs relatively close cooperation over exchange rate policies (Akyüz 2009a).

Finally, the crisis has uncovered a high degree of vulnerability of East Asian DEEs to trade shocks, raising the question of whether the end of export-led growth has been reached. This echoes the dilemma that Arthur Lewis pointed out in his Nobel Lecture three decades ago (Lewis 1980), that dependence of growth in DEEs on AEs through trade would make it difficult to catch up and close the income gap. The solution proposed by Lewis was to develop an internal market in DEEs and South-South trade. East Asia has ample space in these respects. Traditionally the balance-of-payments constraint is seen as the main reason for the dependence of DEEs on exports. But East Asian DEEs export not simply to earn foreign exchange for imports needed for capital accumulation and utilization of productive capacity, but to find markets for goods for which there is little or no domestic demand because of imbalances between investment and consumption and profits and wages. The solution is not to turn inward, away from world markets, but to stop relying on cheap labour and cheap currency and start allowing wages and private consumption to grow in tandem with productivity and underpin the expansion of productive capacity by providing growing internal and regional markets in final goods, very much as in the first-tier newly industrialized economies.

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The global crisis has uncovered systemic and structural weaknesses and vulnerabilities in certain areas in the economies examined here and strengths in others. In almost all countries the financial sector has shown a significant degree of resilience to shocks from the global crisis. However, a common feature of the countries examined is their high degree of susceptibility to financial boom-bust cycles and gyrations in equity, property and currency markets. This crisis has shown the risks of full integration with markets in global financial centres and the need to adopt a strategic approach to financial opening and integration.

The crisis has also uncovered a high degree of vulnerability of the developing economies of East Asia to trade shocks, raising the question of whether the end of export-led growth has been reached. With unfavourable global economic conditions likely to persist, the paper underscores the need to reduce the dependence of the region on markets in advanced economies and to rebalance domestic and external sources of growth.

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