

Global Credit and Inflation Shocks: Asia's Policy Challenges

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1. Introduction: Key Issues

The US subprime loan crisis that erupted in August 2007 has been severely affecting the US financial system, its real economic activity, and global financial and economic conditions. Economic prospects in Europe and Japan are now highly uncertain. The financial ripples—which originated in the housing sector, securitized mortgage loans, the capital market in the US, and the associated balance sheet losses of large financial institutions in the industrialized world—continue to darken the global economic outlook. Partly due to the loss of confidence in the US economy and the consequent flight away from US dollar assets amid ongoing financial turmoil, oil prices broke new records at US\$147 per barrel, and prices of major non-oil commodities—food in particular—have also surged to record high levels.

Despite the better than expected performance in the first half of this year, the US economy may contract in the second half. The International Monetary Fund's (IMF) initial growth forecast, published in the *World Economic Outlook* (April 2008), indicated that US economic growth would slow to 0.5% this year from 2.2% registered last year and continue to be weak at 0.6% in 2009. But the IMF has revised upward the growth projection for the US over the last several months. The Organization for Economic Co-operation and Development's (OECD) most recent forecast for the US economy is even rosier, indicating 1.8% this year and 1.1% next year (Table 1). Despite the ongoing financial crisis, the US Federal Reserve policy options are increasingly constrained due to rising inflation. The eurozone economies will slow to 1.3% in 2008, well below the 2.6% rate last year.

Table 1. Economic Growth Forecast (%)

| Country/Region | 2005 | 2006 | 2007 | 2008 | 2009 |
|----------------------------------|------|------|------|------------|------------|
| US (OECD, [IMF]) | 3.1 | 2.9 | 2.2 | 1.8 [1.3] | 1.1 [0.8] |
| Euro Area (OECD, [IMF]) | 1.5 | 2.8 | 2.6 | 1.3 [1.7] | 1.4 [1.2] |
| Japan (OECD, [IMF]) | 1.9 | 2.4 | 2.1 | 1.2 [1.5] | 1.5 [1.5] |
| Advanced Economies (OECD, [IMF]) | 2.7 | 3.0 | 2.7 | 1.4 [1.7] | 1.7 [1.4] |
| China (ADB, [IMF]) | 10.4 | 11.7 | 11.9 | 10.0 [9.7] | 9.8 [9.8] |
| Korea (ADB, [IMF]) | 4.2 | 5.1 | 5.0 | 4.6 [4.2] | 4.5 [4.4] |
| ASEAN (ADB, [IMF]) | 5.7 | 6.0 | 6.5 | 5.4 [--] | 5.4 [--] |
| India (ADB, [IMF]) | 9.4 | 9.6 | 9.0 | 7.4 [8.0] | 7.0 [8.0] |
| Developing Asia (ADB) | 8.1 | 8.9 | 9.0 | 7.5 [--] | 7.2 [--] |

Note: (1) Data for 2005-2007 are actual. (2) OECD data for advanced economies are proxied by data for G-7 economies.

Source: OECD, Interim Economic Assessment (September 2008) for USA, Euro Area, Japan and G-7 in 2008; OECD Economic Outlook No. 83 (June 2008) for OECD data for 2009; IMF, *World Economic Outlook Update* (July 2008); ADB, *Asian Development Outlook 2008 Update* (September 2008).

In Japan softening external demand and sluggish domestic consumption will push down its GDP growth to 1.2% this year, from 2.1% in 2007. After last year's incredible 11.9% growth, the Asian Development Bank (ADB) projects the Chinese economy to cool down to 10% this year and to 9.5% in 2009 as it continues to tighten. I believe slower growth is not bad for China as it will help contain overheating and inflation, and will lead the economy to soft-land to more sustainable, robust growth. India's economic growth is also expected to moderate from 9% in 2007 to 7.4% in 2008 and 7% in 2009.

High prices of energy, food, and other agricultural commodities have led to higher domestic prices in most economies, developed and developing. Although oil and commodity prices have eased somewhat since the peaks in July, many observers believe that the tight demand and supply balance will likely keep crude oil, food, and other commodity prices high, unless the US slowdown evolves into a severe, prolonged recession in the second half of this year and into next year. At that point, global energy and commodity demand could soften. In the absence of such a scenario, I believe we will continue to observe stagflationary pressure globally—the slowdown of US and global economic growth accompanied by a rise in inflation due to high energy and commodity prices.

The current uncertain global economic conditions pose significant challenges for Asia in terms of macroeconomic and financial sector management. Rising inflation of oil and food can create serious social tensions in many emerging market economies in Asia. In this paper, I would like to explore some of these challenges and identify desired policy responses.

2. Impacts of the Subprime and Credit Crisis on Asia

In general, financial market turbulence in a country can spill over into the real economy through three channels: (i) the direct impact of affected financial institutions on their loans and investments; (ii) a credit re-pricing that limits the overall supply and channeling of credit; and (iii) a loss in confidence that leads to a weakening of consumer and business sentiments. The resulting tightening of credit conditions can have a significant negative impact on real economic activity by curtailing consumption and investment due to increased cost of credits, the credit crunch, and the negative wealth effect.

Given Asia's growing participation in international financial markets, it is no surprise to see the ongoing US subprime crisis and global financial turbulence affecting the Asian financial markets and its real economy. There are two channels—financial and real. The US subprime

crisis and global financial turmoil can make Asian financial conditions volatile, thereby adversely affecting the region's real economic performance through financial channels; and they can lower US and global economic activity, thereby negatively affecting Asian economic growth through real—largely trade—channels.

Impact on Asia's financial institutions. Asia's financial institutions had relatively small exposure to US subprime-related, securitized products such as mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). Japan had the largest exposure among Asian economies and the impact of the subprime crisis on its financial institutions has not been insignificant: The losses at Japanese banks caused by the subprime crisis reached 754 billion yen (US\$7.1 billion) in June 2008—while holding 958 billion yen (US\$9 billion) of subprime-related products, down from 1.52 trillion yen (US\$14.5 billion) in December 2007. But so far the turmoil has not had a serious impact on Japan's financial system.

Other Asian banks have reported even smaller exposures to, and losses from, subprime-related products (Table 2). Even though the loss figure has kept rising with the deepening credit crisis in the US, the general exposure to subprime-related securities in Asia is minimal relative to the size of bank capital and assets. As of August 2008, the world total write-down and credit losses are reported to be US\$650 billion among more than 100 of the world's biggest banks and securities firms.¹ Most of them belong to US financial institutions (68%) and European institutions (15%). Asia's losses are \$40 billion, which is only 6% of world losses.

Table 2. Subprime Losses in Asia (Billion US Dollars, %)

| | US | Europe | Japan | Korea | China | Malaysia | Asia Total |
|---------------------------------|-----------|-----------|-----------|----------|----------|----------|------------|
| Subprime Losses | 442.00 | 99.30 | 20.80 | 0.45 | 2.76 | 0.09 | 40.00 |
| Bank Capital | 1,547.49 | 2,761.60 | 468.49 | 82.93 | 264.62 | 31.16 | 901.20 |
| Total Bank Assets | 15,491.80 | 35,886.40 | 11,506.44 | 1,172.49 | 6,449.99 | 287.64 | 20,567.54 |
| Subprime Losses as % of Capital | 28.56 | 3.60 | 4.44 | 0.54 | 1.04 | 0.30 | 4.44 |
| Subprime Losses as % of Assets | 2.85 | 0.28 | 0.18 | 0.04 | 0.04 | 0.03 | 0.19 |

Note: (1) US—14 banks; Japan—Mizuho Financial Group, Mitsubishi UFJ Financial Group, Sumitomo Financial Group, and Nomura Holdings; Korea—Woori Bank; China—Bank of China, Industrial and Commercial Bank of China, and China Construction Bank; Malaysia—0.3% of capital base of banks; Asia Total—including data for other Asian commercial banks.

(2) Bank capital as of May 2008; Total bank assets as of March 2008 for US and Malaysia, and as of May 2008 for Japan, Korea and China.

Source: Bloomberg; various news media; IMF, International Financial Statistics.

¹ The IMF's initial projection of total potential losses from all sectors in the world was US\$945 billion. The projected loss figure, however, has expanded as the US credit crisis continued deepening: it went up to US\$1.1 trillion in early September 2008 and then to US\$1.3 trillion in late September.

Asian financial institutions' exposure to subprime-related products was limited due to three factors: (i) they were lagging behind global financial institutions in the securitization business; (ii) many of them were cautious in investing in risky instruments after overcoming the 1997-98 financial crisis in respective countries; and (iii) they were subject to tight regulatory and supervisory oversight for more prudent risk management—for example, Japanese banks had to fully implement Basel II beginning in March 2007, before banks in the European Union and the US.

Impacts through equity markets. Asia's equity markets have been increasingly integrated with US and global markets due to capital market liberalization and opening of equity markets to foreign investors. As a result, the sharp decline in US equity prices caused by the outbreak of the subprime crisis has severely dampened Asia's equity markets.

Figure 1a plots dynamic correlations between stock returns (measured by log first differences in stock prices) in the US and in major equity markets in the world, using monthly data from January 2000 to May 2008.² Europe has the highest correlation with the US. Europe's contemporaneous correlation with the US reaches 0.76, followed by those of Brazil, Canada, and Japan, respectively, with the US. Interesting is the fact that most non-contemporaneous correlations—based on lags and leads—are almost close to zero in Europe, implying strong integration between US and European equity markets.

In contrast, the dynamic correlations between US and Asian stock returns exhibit a different pattern (Figure 1b). First, the correlations are generally lower. Singapore has the highest contemporaneous correlation with the US (0.61) in Asia, while China's correlation is significantly lower (0.15). Second, non-contemporaneous correlations are often high. Lagged US stock returns have high correlations with Asian stock returns, which implies that the Asian markets are not fully integrated with the US market but utilize US market information for pricing with a long memory. So the US stock market turbulence has likely dampened affect Asia's stock prices since late 2007—which can have negative wealth effects on Asia's economic activity, such as consumption and housing purchases.

Impacts through bond markets. Dynamic correlations between daily changes in US treasury yields and government bond yields in other countries suggest that the US bond market has impacts on European and Asian markets. Correlations between the US and Europe (Figure

² Dynamic correlations are obtained between the lags and leads of US stock returns with the current stock returns in other equity markets.

2a) are high contemporaneously, but almost zero with lags and leads, implying that bond markets are highly and efficiently integrated between the US and Europe. On the other hand, correlations between the US treasury yields and the Asian government bond yields (Figure 2b) suggest weaker contemporaneous co-movements but stronger co-movements with lags and leads. Although this is a sign of less-than-full integration between US and several Asian bond markets, the US impact is eventually felt in Asia.

One of the outcomes of the subprime crisis is an increased risk aversion among investors. To capture this change, credit risk spreads are constructed for selected countries by taking the difference between BBB-rating and AAA-rating corporate bond yields in each country. These figures can represent local market's credit condition in term of local currency. Dynamic correlations between credit spreads in the US and in other countries exhibit that, except Canada, many countries in the sample indicate low correlations with US credit spreads. This result suggests that, with rising US credit risks, Asian borrowers tend to face higher interest rates, which can have a negative impact on Asian real economic activity.

Thus, we can observe some links between US and Asian financial markets, although Asian financial institutions' exposure to subprime products is limited. Indeed, Asian financial markets—particularly stock markets—have been affected by the US market turbulence. Asian financial institutions—which have restored health measured by nonperforming loan (NPL) ratios and capital adequacy ratios (CARs) since the 1997-98 financial crisis—have entered the current global financial turmoil from a position of considerable soundness. The question remains as to how the US and global financial crisis may affect Asia's real economic activity.

3. Is Asia “Decoupled” from the US Subprime Fallout?

With the US and global economy slowing, global financial crisis deepening, and oil, food, and other commodity prices elevated to high levels, the external economic environment facing Asia remains uncertain. Growth is likely to ease and some moderation is expected. But I believe the Asian economy will remain generally robust as the region's dynamism will partly offset the sluggish external conditions. Of course this optimistic view needs to be supported by the expectation that many Asian economies will manage the current turbulence through a mix of appropriate macroeconomic and structural policies.

“Coupling” and “decoupling” debate. There has been a great deal of discussion about whether Asia—particularly East Asia—will be able to “decouple” itself from the US financial

crisis and its economic downturn. There are two views: the “coupling” and “decoupling” views. The “coupling” view argues that the health of the US market is critical for Asia’s exports of final products, that the expansion of intra-Asian trade—which is largely that of parts and components—cannot be a substitute for the US market during the economic downturn as the US is the most important destination for Asia’s finished product exports, and that Asia is financially connected with the US and, hence, bound to be affected by the US financial market turmoil. Essentially, the “coupling” view states that Asia cannot escape from the consequences of the US financial crisis—particularly the associated economic downturn in the US.

The “decoupling” view argues that Asia’s robust growth can be sustained even if the US economy slows down sharply or slips into a recession. The claimed reasons are that: Asian financial institutions have not been severely damaged by the subprime crisis; Asian economies have created a strong growth momentum backed by improved economic fundamentals and expanding regional domestic demand; and Asia has found growing export markets in countries that benefit from price hikes of resources such as oil, food, and other commodities.

Being integrated with the global economy through trade, investment, and finance, it is impossible for Asia to be completely “decoupled” from the developments in the global economy. Asia’s financial markets are strongly linked with US and global finance and have in fact been affected by the US financial turbulence as evidenced by sharp declines in stock prices throughout the region. A global credit crunch has reduced capital inflows to the region, and credit spreads have widened. If the US undergoes a severe, prolonged recession, then many other industrialized countries will be affected, and Asia will not be immune to such developments. In this sense, the complete “decoupling” view may be premature.

But I believe the reality lies somewhere in between, and increasingly more on the “decoupling” side. Asian financial institutions are generally healthy, the region’s economies have retained resilience, and Asia has been diversifying sources of demand.

A diversifying Asia. Asia’s major trading partners—other than the US and Europe—continue to perform well. Importance of new trading partners—like the Middle East, Africa, Eastern Europe and Latin America—has risen because they are expanding imports by earning revenues from oil, food and other resource exports. This is supported by the fact that despite the decline in growth rates of exports to the US, Asia’s overall exports have been strong. Table 3 shows that Asian countries’ exports over time have largely shifted away from the US and the EU towards the East Asian region and other new markets, with the exception of China and

Vietnam. Intra-regional trade within Asia has been expanding steadily, and the growth momentum in the region's internal demand can help provide a significant buffer against external shocks.

Table 3. Export Destinations of East Asian Economies and India (%)

| Exporters | 1990 | | | | 2007 | | | |
|-----------------|------|-------|-------|-------|------|-------|-------|-------|
| | EA | US+EU | Other | World | EA | US+EU | Other | World |
| Japan | 29.7 | 52.1 | 18.2 | 100.0 | 47.3 | 33.5 | 19.1 | 100.0 |
| China | 65.8 | 18.5 | 15.8 | 100.0 | 37.7 | 37.7 | 24.6 | 100.0 |
| Hong Kong | 44.3 | 42.6 | 13.1 | 100.0 | 63.7 | 24.7 | 11.6 | 100.0 |
| Korea | 33.6 | 43.4 | 23.0 | 100.0 | 51.7 | 23.4 | 24.9 | 100.0 |
| Singapore | 44.9 | 36.3 | 18.8 | 100.0 | 63.3 | 19.0 | 17.7 | 100.0 |
| Taipei,China | 38.4 | 51.0 | 10.7 | 100.0 | 65.3 | 22.5 | 12.2 | 100.0 |
| Indonesia | 66.8 | 25.2 | 8.1 | 100.0 | 59.1 | 22.8 | 18.1 | 100.0 |
| Malaysia | 56.8 | 32.3 | 10.8 | 100.0 | 54.7 | 27.7 | 17.6 | 100.0 |
| Philippines | 37.2 | 56.4 | 6.4 | 100.0 | 71.5 | 23.0 | 5.6 | 100.0 |
| Thailand | 37.9 | 45.4 | 16.7 | 100.0 | 52.8 | 25.4 | 21.8 | 100.0 |
| Viet Nam | 39.2 | 6.8 | 53.8 | 100.0 | 37.5 | 43.0 | 19.5 | 100.0 |
| East Asia Total | 40.0 | 43.6 | 16.5 | 100.0 | 49.9 | 30.2 | 20.0 | 100.0 |
| India | 18.3 | 42.3 | 38.9 | 100.0 | 26.5 | 35.8 | 37.7 | 100.0 |

Note: EA – East Asia, including Japan, China, Asian NIEs, and ASEAN countries.

Source: IMF, *Direction of Trade*.

Some interesting insights can be drawn from historical data showing the US economy's declining impact over time on Asia. Using annual GDP data, one can compute 10-year moving correlations among real GDP growth rates of East Asia, the US and Europe over the last 30 years or so. We find that ASEAN+3 economies—i.e., Japan, China, Korea, and the ASEAN countries—demonstrate high and rising growth correlations among themselves, while exhibiting low and falling growth correlations with the US and the EU (Figure 3a). One may argue that this trend is due to the simultaneous contraction of economic activity across many East Asian economies during the 1997-98 financial crisis. While this economic synchronization can be considered a manifestation of close interdependence of the region's economies, the exclusion of 1998 data from the sample altogether would not alter the basic qualitative trend (Figure 3b). Though surprising to some, these results suggest that East Asia's real activity has been highly correlated with itself and not with the US or the EU over the last ten years. This simple correlation analysis supports the view that East Asia has been "decoupled" from the US and Europe over the last decade and, therefore, will not be severely affected by the slowdown in the US and European economies. Although Japan's weak economic conditions are a negative factor, emerging Asia is likely to be capable of sustaining robust, albeit slower, growth as long as the global

economy does not fall into a severe depression and Japan's contraction is temporary and mild.

In short, East Asia is naturally affected by the slowdown of the US and global economy. But the magnitude of this impact is likely smaller than in the past. It used to be said that "if the US sneezes Asia gets a cold, and if the US catches a cold Asia gets pneumonia." Now the US is getting pneumonia, but Asia is hardly close to it. In this sense, East Asia is no longer a vulnerable hostage of the US economy.

4. Emerging Risks in Asia

While my view is that Asia is better prepared to adjust to global financial turbulence and economic downturns in the US and other industrialized countries, the region faces four key risks. Asia's success hinges on how the region's policymakers can respond to the global shocks and minimize the risks.

Severe US recession. The first is a sharper and more protracted global slowdown, driven by a deeper and more prolonged US recession than currently expected. The US housing prices continue to decline, depressing the construction sector and housing investment. Restoration of financial system stability would be difficult with the declining housing prices. Tightening credit markets and deteriorating employment prospects could stall household consumption—the domestic demand component that has been resilient for many years—and weaken overall economic activity. The stagflationary mix of slowing growth and rising inflation is thus a major risk to the US economy.

The collapse of Bear Sterns, the two government sponsored enterprises (Fannie Mae and Freddie Mac), Lehman Brothers, American International Group, and Washington Mutual have sent shivers to the market. Further US financial turbulence would not only undermine its economic prospects, but also dampen growth prospects in other industrialized countries—in Europe and Japan in particular—with cascading impacts on emerging Asian economies. This could lead to another round of sell-offs in Asia's stock markets and expose the region's vulnerability to a sharp re-pricing of financial risk.

Asia's trade link with the US—though gradually declining—makes the US still an important export market for many Asian economies, particularly China and Vietnam. Including Japan and Europe, the industrialized world still accounts for close to 40% of the region's total trade. In

addition, banks and investors in the US—those exposed to subprime-related losses—have become cautious in their business by hoarding cash and reducing loans and investments in order to protect their capital bases. This could indirectly undermine growth prospects in East Asia amid global re-pricing of financial risks.

High oil and food prices. The second risk is an elevated level of—or worse, ever-rising—oil, food, and other commodity prices (Figures 4a and 4b). With precarious supply conditions and inventory rundowns, both crude oil and food prices may remain high. Crude oil prices kept rising from around US\$40 per barrel in 2004 and set a new record at US\$147 per barrel in July 2008, although they have eased somewhat with the expectation of a stabilizing US financial system. These price hikes have heightened social anxiety across Asia, highlighting the urgent need to address medium- to long-term energy and food security.

There are several factors—both structural and cyclical—that led to global hikes in oil, food, and other commodity prices: (i) the creation of global liquidity since the bursting of the IT bubble in 2001 and the steep decline of the US dollar against all major currencies in recent years; (ii) persistent and rising demand for oil, food, and other commodities by the rapidly growing, large emerging market economies, such as China and India; (iii) inadequate supply of crude oil, food, and other commodities; and (iv) various cyclical factors such as bad weather and speculative activities.

The most important factor is structural, that is, production has not kept up with soaring demand as evidenced by declining stocks. The oil market has seen a long-term imbalance between rising incremental oil demand (estimated at 1.7 million barrels of oil more per day in 2008 over 2007) and stagnating production and supply—with non-OPEC production having peaked and OPEC unwilling for political reasons to expand output. In the food market, growing populations, together with rising incomes in emerging economies—notably in Asia—has contributed to a change in diets toward grain-intensive meat and dairy products and increased food consumption. At the same time, food production has been curbed by the rising cost of energy-intensive inputs such as fertilizers, increasing water scarcity, underinvestment in new high-yield and pest-resistant crops, and diversion toward biofuels. Governments have exacerbated the problem, not only through long-standing protectionism that limits global agricultural trade, but also through their ill-conceived responses to the food crisis, such as export bans, increased taxes, and price controls.

The steep decline of the US dollar against all major currencies in recent years likely contributed to a rise in commodity prices, which are quoted in US dollars. Declining stocks of oil and food likely triggered the initial spur of speculative activity in recent years along with the turmoil in global financial markets that has reduced expected returns on bonds, equities, and other financial assets relative to commodities.³ The flow of funds into commodities has also been exacerbated by the weakness in property and housing markets in several industrialized economies.

Further hikes of crude oil, food, and other commodity prices can impose costs on many Asian economies. First, price hikes can imply a supply shock and a terms-of-trade deterioration for net importing economies. Price hikes hurt investment, production, and employment, and cause a drain of income to net exporting countries. According to the World Bank (2008), terms-of-trade deterioration over the period 2004-07 may have cost emerging East Asian economies on average about 0.9% of regional GDP per year. With the exception of Indonesia, Malaysia and Vietnam—which are net exporters of commodities—most economies suffered terms-of-trade losses, leading to worsening trade balances and depreciation pressure on the real exchange rate. As a result previously upward pressure on currency values has been reversed for several currencies.

Second, high oil and food prices can undermine social stability throughout the world, particularly across emerging Asia. Food expenditure comprises a large share of the poor's total expenditures (more than 60%), and the combined expenditures on food and energy comprise over 75% of total consumption expenditures in Asia. Millions of people in Asia—perhaps as many as 1.2 billion—are thus vulnerable to soaring food and oil prices.

Rising inflation. High and rising oil and food prices can push inflation higher. This impact has been added to the domestic inflationary pressure due to robust economic growth and rapid liquidity growth in the region over the past few years. Elevated inflation can dampen consumer spending and threatening macroeconomic stability. As food and energy prices carry considerable weights in constructing the consumer price index (CPI) in developing Asia (see Table 4), there is a strong correlation between food and energy price inflation and general CPI inflation. That is, hikes of food and energy prices are easily translated into high general price inflation.

³ A report by Japan's Ministry of Economy, Trade and Industry argues that the "fundamental price" of oil was \$60 per barrel in the second half of 2007—based on the analysis of crude oil prices for the 1992 Q1-2007Q4 period. See METI FY 2007 Annual Report.

Indeed, many Asian economies have seen sharp rises in producer prices and headline CPI inflation, although the rise in core CPI inflation has been less pronounced (Figures 5a and 5b). The reason is that monetary authorities have accommodated the first-round effects of higher global food and oil prices on domestic price inflation. The pass through of global prices to domestic prices—particularly producer prices and then headline CPI—is a natural process in the absence of subsidies and price controls. With subsidies that cap domestic prices, global price hikes are not—at least immediately—passed through to domestic prices but can raise the fiscal cost of subsidies. Core CPI inflation—which excludes volatile oil and food prices—has been lower than headline CPI inflation because second-round price effects from high energy and food prices to core CPI take longer time to work out. For example, the average headline CPI inflation rate for emerging East Asian economies during the first eight months of 2008 was 6.7%, while the core CPI inflation rate was 2.7% (Figure 12). High producer price inflation can be relatively easily translated into high headline CPI inflation, which in turn leads to high core CPI inflation with some time lag.

Table 4. Food and Energy Weights in CPI Baskets in East Asia and India (%)

| Economies | Food | Energy | Total (Food & Energy) |
|-----------------------|-------------|---------------|----------------------------------|
| Japan | 25.9 | 7.4 | 33.3 |
| China | 33.6 | 13.0 | 46.6 |
| Hong Kong | 26.9 | 3.6 | 30.5 |
| Korea | 14.0 | 17.0 | 31.0 |
| Taipei, China | 26.1 | 7.0 | 33.1 |
| Singapore | 23.0 | 22.0 | 45.0 |
| Brunei Darussalam | 28.8 | 22.5 | 51.3 |
| Indonesia | 43.4 | 25.6 | 69.0 |
| Laos | 55.0 | 12.0 | 67.0 |
| Malaysia | 33.8 | 22.4 | 56.2 |
| Myanmar | 64.9 | 8.8 | 73.7 |
| Philippines | 46.6 | 2.4 | 49.0 |
| Thailand | 36.1 | 9.1 | 45.2 |
| Viet Nam | 42.7 | 10.1 | 52.8 |
| India | 46.2 | 6.4 | 52.6 |
| Emerging East Asia | 37.0 | 13.2 | 50.1 |
| <i>Memorandum:</i> US | 14.9 | 5.1 | 20.0 |
| EU | 15.5 | 4.7 | 20.2 |

Note: (1) Data for energy for Japan and India include fuel only.

(2) Emerging East Asia—including China, Asian NIEs, and ASEAN countries.

Source: ADB, *Asia Economic Monitor*, July 2008; National central bank data.

Thus, the explosion in food and oil prices across the region threatens macroeconomic stability by generating overall inflation, raising the fiscal cost of food and oil subsidies, dampening consumer spending, and possibly inducing exchange rate depreciation. Any further increases in costs could trigger persistent price inflation that can generate a wage-price-

exchange rate spiral. Essentially, the risk of full-blown inflation threatens hard-won macroeconomic stability. Limiting second-round price effects and thereby containing inflation is a major challenge for macroeconomic and social stability throughout emerging Asia.

Renewed surges in capital inflows. The fourth risk is the possibility of renewed surges in short-term capital inflows into Asia and the consequent upward pressure on the value of regional currencies. Several countries like Thailand and Vietnam had been experiencing excessive capital inflows until the US subprime crisis broke out (IMF 2007). Once the crisis deepened, many US financial institutions began to secure liquidity, reduce lending and investment abroad, shrink the over-extended balance sheet, and rebuild the capital bases—which curtailed financial capital flows to many parts of Asia. Together with the terms-of-trade shock due to high oil and food prices, this has led to mixed trends in currency markets: Some currencies—such as the Philippine peso and the Korean won—faced downward pressure against the US dollar, while others continue to appreciate, supported by strong balance of payments positions.

When the US financial system restores its stability and the credit crunch eases, there is a real possibility that emerging Asian assets will be re-priced and capital inflows to growing Asia will resume in a massive way. A correction in risk valuation will inevitably accompany high volatility in financial markets and could turn out to be disorderly. Furthermore, with the background of the still large—though declining—US current account deficit and with the erosion of overall confidence in the US dollar, renewed capital inflows can generate once again significant appreciation pressure on Asian currencies. If not managed properly, they can be another source of macroeconomic and financial sector instability, which could potentially lead to overinvestment, over-extension of loans and asset price bubbles in recipient countries. This risk is particularly so if the authorities resist currency appreciation. Allowing currency appreciation is advisable to stem domestic inflationary pressure and asset price bubbles, but policymakers' hesitance may come from the concern about the potential damage to a country's international price competitiveness and its economic growth prospect. This concern can be minimized if Asian authorities allowed their currencies to appreciate collectively.

5. Macroeconomic and Structural Policies

Given the global credit and inflation shocks—credit market turmoil, economic slowdown (or recession), high oil and food prices, and a possible dollar crash—Asia faces a new set of

challenges to achieve the region's sustained economic growth. To be successful, Asian economies need to adopt a mix of appropriate macroeconomic and structural policies.

Improving financial-sector resilience. The Asian financial system has achieved a greater level of resilience since the time of the financial crisis in 1997-98. Asian market conditions have improved markedly: short-term external debt as a ratio of reserves is much reduced; NPL ratios have continued to fall; risk-weighted CARs have improved; stronger regulatory and supervisory oversight has been in place to improve financial institutions' risk management practices and balance sheets; and new standards and codes have provided more reliable and timely information on the financial system.

However, vulnerabilities remain in Asia. Despite improvements in financial conditions, the banking sector's ability to respond to volatile financial conditions may still be limited. Although NPLs have fallen, problems with restructured loans (Thailand), new NPLs (China), compromised assets (Indonesia), and distressed assets (Philippines) leave commercial banks vulnerable to the emergence of new instability. In many economies, banks have allocated a significant portion of assets to zero-risk-weighted sovereign securities, but detailed information is not fully available on bank exposure to market risk through holdings of securities—official and private—and derivatives. As a result, Moody's Investor Services rates large parts of banking systems in emerging Asia in the low D and E range with the exceptions of Hong Kong and Singapore (Turner 2007). The reasons for these low ratings include relatively strong market views on the need to strengthen risk management and questions about the effectiveness of supervision and regulation.

While Asia's banking sectors are much less exposed to foreign currency liquidity risks than in the pre-crisis period, they have also assumed new risks by moving into lending to the property sector and households and new business activities—such as securities holdings. As financial products and services become ever more complex—with risk distributed widely throughout the global financial system—the vulnerabilities of being exposed to a financial crisis spread. Asia cannot be immune. Also, economic overheating in several economies can make their financial institutions vulnerable to the bursting of the economic boom. Financial markets in many countries still need deeper reforms in upgrading prudential oversight and market transparency.

Adjusting to hikes in oil and food prices. To the extent that the high prices of oil, food, and other commodities are driven by fundamental factors of supply and demand, Asian economies need to respond by adopting several structural policies. With regard to oil and energy prices, they include: (i) accepting high prices of oil and energy as the right price signal so as to encourage efficient use of crude oil and energy; (ii) promoting wide-spread, energy-saving initiatives through technology development and transfer; and (iii) developing alternative sources of energy such as renewable energy and nuclear power.

These require aligning the domestic prices of oil and energy with the permanent part of the high global prices, which means elimination of fuel subsidies and price controls in many countries. Most Asian emerging economies subsidize domestic fuel prices, hoping to artificially cap the fuel price and protect the domestic residents from high external prices. This policy may be justified when the high price is temporary and reversible, but cannot be sustained if the price increase is permanent because of the ballooning fiscal cost of subsidy to an unsustainable level. With permanently high prices, a better policy would be to raise the general price of fuel by reducing or eliminating subsidies and deregulating price controls, thereby encouraging fuel consumers to economize on its use. This market-oriented policy measure should be accompanied by a cash transfer program to directly help targeted low-income people so that they can cope with higher prices. If emerging Asian economies—like China and India—can cut their universal subsidies, they should be able to spend their public resources for protecting the poor directly, improving energy efficiency, and developing alternative sources of energy.

Similarly, to the extent that the recent surge in global food prices is due fundamentally to structural factors—that is, rising demand for food grains for all purposes with limited supply—governments have to address the food shortage problem through structural policies. These policies should include: (i) accepting the high food prices to encourage consumers and farmers to respond; (ii) investment in the agricultural sector to help farmers expand food supply capacity; and (iii) liberalization of agricultural trade.

As in the case of energy prices, governments need to pass the permanent component of the high global price of food to domestic prices so that consumers can economize on food use—particularly for feeding purposes—and farmers can increase supply. Substantial investment should be made throughout Asia to improve agricultural infrastructure and technology, increase productivity, enhance institutional capacities and governance, and provide educational facilities. Liberalization of agricultural trade—particularly elimination of export bans

and taxes—could help moderate food prices, reduce uncertainty, and increase food security. And by facilitating information exchange, increasing policy dialogue, adopting best practices, regional cooperation can also help find a long-lasting solution to the food crisis. Similarly to the case of fuel prices, a targeted social sector protection program needs to be put in place to help reduce the negative impact on the poor and socially vulnerable sectors of the economy.

Managing inflation. The inflationary pressures driven by high oil, food and other commodity prices pose a significant threat to macroeconomic, financial and social stability throughout emerging Asia. These rising prices are nothing but negative supply shocks for net importing countries, which exert stagflationary impact on any economy by raising overall price inflation while adversely affecting economic activities. In the face of imported, negative supply shocks with stagflationary impacts, governments may be tempted to keep monetary stance unchanged or even accommodative, hoping to moderate the negative impact of rising prices on domestic economic activity—but at the risk of fueling general inflation. Unchanged monetary policy may be warranted, if the external supply shocks are cyclical and temporary but not when they are structural and permanent.

To the extent that increases in global oil and food prices are driven by fundamental, structural factors, tight monetary policy is needed to contain second-round price effects—i.e., pass through to core CPI inflation. Otherwise, the risk of inflation is ingrained in the economy. Once a vicious circle of inflationary expectations, wage increases and price hikes sets in and a wage-price spiral is embedded in the economy, macroeconomic stability can be lost, causing the interest rate to shoot up and the exchange rate to depreciate. This can undermine the economy's long-term sustainable growth as it must eventually face a crisis and/or a severe stabilization program sooner or later. A combination of monetary policy tightening and exchange rate flexibility is a desirable policy option to avert such a disastrous outcome.

Tight monetary policy can aggravate economic slowdown by raising real interest rates and dampening stock prices. But it is the price the economy must pay in order to achieve low-inflationary, sustainable growth. In the interim, governments should pass the fundamental, permanent part of the high global prices of oil and food on to the economy—through price deregulation and price subsidy cuts—to provide the right signals for consumers (of oil and food) as well as for producers (particularly farmers) to generate larger demand and supply responses. This would help reduce distortionary subsidies or pricing and strengthen fiscal positions in many

countries. Governments may also undertake targeted subsidy programs to alleviate the negative impact of rising oil (fuel) and food prices on the poor and the socially disadvantaged.

So far many Asian economies have been relatively soft on the inflation challenges. They have chosen to protect economic growth rather than promote price stability. Several countries—like Indonesia, the Philippines and India—have raised benchmark interest rates recently to address the inflation problem. China has also been pursuing tight monetary policy, although the country appears to be shifting its policy priority toward maintaining growth. After experiencing high inflation, current account deficits and a weakening currency, Vietnam has been curtailing credit supply and investment. Nonetheless, Asian central banks can go several steps further to combat inflation in the current conditions. This will imply raising the policy interest rate, making the real interest rate positive, and in most cases allowing faster currency appreciation. However, excessive monetary policy tightening—in response to the very high headline CPI inflation which is much higher than core CPI inflation—should be avoided as doing so may send the economy into recession. Central banks are advised to respond to the rise in core CPI inflation—by raising the policy rate above the core CPI inflation rate—and prevent the creeping up of inflationary expectations by paying due attention to headline CPI inflation. In essence, sacrificing some economic growth is a worthy attempt to contain disastrous inflation outcomes. Monetary policy tightening needs to be pursued and the right balance between low inflation and sustainable long-term economic growth should be achieved.⁴ Prudent macroeconomic policy—both monetary and fiscal—has to be combined with conducive structural policies.

6. Regional Financial Cooperation

Given the rising degree of economic and financial interdependence in Asia, regional financial cooperation is also vital for Asian economies to strengthen their financial systems and manage macroeconomic conditions—for policy dialogue, economic and financial surveillance, financial market supervision and regulation and, particularly, effective exchange rate policy management.

Enhancing regional reserve pooling and economic surveillance. Today in emerging Asia, the risk of a currency crisis is substantially lower than it was ten years ago. Nonetheless, a crisis is always a possibility for any emerging market economy—like the mini rupiah crisis in

⁴ When economic activity deteriorates significantly, expansionary fiscal policy may be mobilized in countries with sufficient fiscal space.

Indonesia in the summer of 2005 and in Viet Nam in the spring of 2008—particularly given the ongoing global financial turmoil. Asian economies have made efforts to strengthen regional crisis prevention mechanisms within the framework of ASEAN+3 (10 ASEAN members plus China, Japan and Korea) by creating the Chiang Mai Initiative (CMI) and the economic review and policy dialogue (ERPD) process. Over the past few years, ASEAN+3 economies have been working to multilateralize the CMI and enhance the effectiveness of ERPD, which are inter-related issues. If the CMI—even after full multilateralization—is expected to remain linked with IMF programs, the ERPD process may not need to go beyond achieving an economic review and peer pressure. However, if the CMI is to become a centrally administered reserve pooling arrangement that is independent of the IMF, the ERPD process must substantially increase its effectiveness and role (Kawai and Houser, 2008). The reason is that the ASEAN+3 group must address the generally held concern that a financing arrangement that could lend too generously with too little conditionality might create a moral hazard for the government at the receiving end as well as for private investors with stakes in the affected economy.⁵

From this perspective, the following recommendations may be made:

- provide large resources for a multilateral CMI, and reduce the link between CMI activation and IMF programs with a view to improve the effectiveness of ERPD and clarify rules for CMI activation;
- move beyond the simple “information sharing” stage of ERPD to a more rigorous “peer review and peer pressure” stage, and eventually to a “due diligence” stage, to improve the quality of economic surveillance;
- establish a joint forum for ASEAN+3 finance ministers and central bank governors to strengthen surveillance and policy dialogue on macroeconomic and financial issues; and
- set up a professional secretariat on Asian Monetary Cooperation to support CMI/ERPD, and independent conditionality formulation.

Development of resilient, integrated financial systems. Establishing sound, resilient financial systems at the national level is essential to ensure financial stability. This requires

⁵ To minimize moral hazard, it is essential to put in place an effective ERPD, improve the capacity to formulate an appropriate policy package in the event of a liquidity crisis, and enforce needed policy adjustment.

deeper reforms in upgrading prudential oversight and market transparency. Also Asian financial markets need to be more integrated regionally in order to channel the region's massive savings for investment—particularly for infrastructure and small- and medium-sized enterprises—which requires common standards or mutual recognition, and coordinated regulation in the region. External financial surveillance mechanisms need to be further improved through the region's cooperative efforts to ensure financial stability at the regional level. For these purposes it is crucial to:⁶

- strengthen financial markets and their infrastructure by expanding catalytic official initiatives such as the Asian Bond Markets Initiative (ABMI) and the Asian Bond Fund (ABF) and creating a regional credit guarantee agency and a regional settlement and clearance system;
- promote consistent standards and mutual recognition with regard to prudential norms, regulation and supervision, business practices, governance and transparency;
- improve the surveillance of financial markets by establishing a new, high-level “Asian Financial Stability Forum” with finance ministries, central banks, and other financial regulators and supervisors participating; and
- liberalize capital accounts, cross-border financial flows and financial services in a well-sequenced, prudent way.

Exchange rate policy coordination. Currently no consensus exists—even within ASEAN or ASEAN+3—on an appropriate regional exchange rate arrangement or a desired mode of exchange rate coordination, as countries wish to maintain sovereignty over macroeconomic policymaking. At times exchange rates among some regional currencies have diverged too much and too fast, like the Japanese yen vs. the Korean won due to carry trades, and the Chinese yuan vs. some ASEAN currencies. This has not led to coordination to reduce divergent exchange rate movements. But given the high and rising degree of economic interdependence within East Asia, maintaining a certain degree of intraregional exchange rate stability is increasingly desirable.

When a sustained, sharp downward pressure on the US dollar emerges, many authorities have resisted market forces through currency market intervention in order to maintain price

⁶ Some of these recommendations have also been proposed by ADB (2008b).

competitiveness. Such a temptation has been especially great as neighboring countries continue to stabilize exchange rates against the dollar. But resisting currency appreciation in the face of downward pressure on the US dollar can result in a continuous build-up of foreign exchange reserves, the consequent injection of liquidity into the economy, and a rapid growth of money and credit, thereby generating the risk of price inflation, asset price bubbles and banking sector vulnerabilities. Faster currency appreciation together with tighter monetary policy can contain these risks. If loss of competitiveness is the reason for not allowing a currency to sufficiently appreciate, a country can work with its competitor neighbors in similar circumstances to take the needed action simultaneously.

Collective appreciation could be a solution to this dilemma because it can achieve the objectives of price stability, financial-sector soundness and sustainable growth without affecting much of the price competitiveness of individual countries (see Kawai 2008a). In the context of East Asia, such collective currency appreciation would spread the adjustment costs across the region, thus minimizing and balancing the costs from the perspective of individual economies while at the same time reducing macroeconomic and financial-sector risks.⁷ Hence collective appreciation should be in everyone's interest as it can help achieve sound macroeconomic and financial performance and stable, sustainable economic growth.

East Asian economies may consider beginning this type of policy coordination with *ad hoc* coordinated actions. For example, countries could coordinate informally on a particular wave of exchange rate adjustments against the US dollar by keeping their relative competitive positions stable. Specific recommendations are the following:

- introduce an Asian Currency Unit (ACU) and its index for purposes of currency market monitoring and guiding *ad hoc* policy coordination;⁸

⁷ Simple calculation would indicate that a 20% collective appreciation of East Asian currencies vis-à-vis the US dollar would entail an effective (trade-weighted) appreciation of only 9%—given the intra-regional trade share of 55%, even if all other non-East Asian currencies were to remain stable against the dollar. If the other currencies also appreciated against the dollar, the effective appreciation of the East Asian currencies would be even more limited. For example, if the other currencies appreciated against the dollar by 10% (20%), the East Asian currencies would appreciate only by 7 percent (4 percent) in effective terms—on the assumption that the share of the United States is 20% in East Asian trade. Even a collective appreciation of 30% against the US dollar would not amount to a significant appreciation of the East Asian currencies when measured in effective terms.

⁸ Developing an Asian Currency Unit (ACU)—a composite index of regional currencies—is potentially useful for exchange rate management in the region. An ACU index can measure the degree of joint movement of East Asian currencies and the divergence of individual component currencies from the regional average given by the ACU rate. See Kawai (2008b) for the concept of ACU and its possible roles.

- provide practical steps toward exchange rate coordination, including possible actions in the event of rapid US dollar depreciation against East Asian currencies; and
- launch a comprehensive study on an Asian exchange rate system from long-term perspectives, and outline a broad roadmap to achieve it.

7. Conclusion

The current global economic conditions—coincident slowdown in industrialized countries, rising inflation due to high oil and food prices, and the risk of disorderly dollar depreciation—pose major challenges for Asia. I believe Asia is well positioned to face such challenges. To be successful, however, each economy must pursue prudent macroeconomic policy, accompanied by market-oriented structural policies, with a view to maintain long-term sustainable growth. This means: putting in place better financial-sector regulation and supervision; tackling the inflation challenge through tighter monetary policy; addressing energy and food security; protecting the poor and socially vulnerable from hikes in energy and food prices; and establishing clear accountability and governance for economic management and social protection. I also believe regional financial cooperation is essential. Asian economies need to strengthen the Chiang Mai Initiative, regional economic and financial surveillance, and financial market development and integration—especially through the Asian Bond Markets Initiative. They must also embark on exchange rate coordination.

The impetus toward exchange rate policy coordination may come sooner rather than later—as the US dollar depreciates sharply against Asian (and other major) currencies in view of the weak economic and financial prospects in the US and the still large current account deficit. This process of dollar depreciation may have already started—as has been observed in the global oil and commodity markets. If Asian economies must accept currency appreciation vis-à-vis the dollar and the euro, they had better do so collectively, while maintaining intraregional exchange rate stability. This will facilitate rebalancing the sources of growth away from external demand towards the region's internal demand, thus contributing to the resolution of global payments imbalances. Such policy coordination will help Asia achieve non-inflationary sustainable growth.

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