The Global Economic Crisis and the Issues Facing Asian Developing Countries

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1. Recent Developments in Major Developed Economies

The United States and Europe are both mired in growing economic crises, and caught up as well in policy conflicts on how to get out of the mess. This does not bode well for the global economy. Meanwhile Asian developing countries should review the evolving situation and prepare better to deal with the effects.

In the first week of September, there were new signs of weakening of the major industrial economies, raising the prospects of global slowdown or recession. Another problem is that there is also a kind of policy paralysis in these major countries that hinder them from taking the kind of policy measures that helped them and the world recover from recession in 2009.

Warnings have already been given by major establishment organizations. The world economy is entering a "new danger zone" this autumn, said the World Bank president.

The United States announced there was no growth in jobs in August. It was the first time in 11 months that there was a standstill in jobs. Unemployment remained at 9.1% and the White House said this high level is likely to remain in 2012.

Can the US do something to counter this trend? President Obama will address Congress on the jobs situation. He is expected to announce some measures such as government spending on infrastructure, tax incentives for job creation and an extension of unemployment benefits and payroll tax cuts. But these are unlikely to be adequate to the task of reviving an economy on the verge of a new recession. Even then, it is uncertain the Republicans will allow him to take the inadequate measures.

The situation has changed drastically since the Obama administration introduced a US$800 billion fiscal stimulus package, implemented over two years, that Congress approved in February 2009. This fiscal stimulus is credited by Keynesian economists with a having major role in getting the economy out of recession, and its ending a few months ago is thought to have contributed to the economy's weakening.

But this line of thinking is now challenged by many Republicans which saw the fiscal expansion as getting the US further into debt. Since the Republicans won a majority in the House of Representatives last November, they have made cutting government spending and the budget

deficit the top priority. By linking the needed increase in the government debt limit to spending cuts, they forced Obama to shift from battling recession to deficit reduction.

Many economists believe job creation and economic revival is now the top priority and that the US needs to take short-term job creation policies immediately, even if that means an increase in spending. The spending cuts and deficit reduction would have to wait till the economy recovers, and even then there must be an increase on taxes on the rich to help reduce the deficit. However this argument will be resisted by a core of Republican Congress members. Thus, there will be severe limits to the President's strategy of recession-busting in the short term and deficit-busting in the medium term.

In the United States, the problem is more with policy paralysis due to the conflict in ideologies. In Europe, the situation is even more complicated and probably deeper, as the region has moved into the zone of sovereign debt crisis, with contagion spreading to more countries in the Euro-zone.

The chosen policy model of getting the worst-affected country out of the mess is not working. Greece was given two bail-out loan packages, in exchange for taking drastic austerity measures. A report of the Greek state budget office has concluded that the debt problem is out of control, and that there has been no primary budget surplus despite the stern austerity and privatization policies. The deficit is in fact increasing, due to the shrinking economy.

Keynesian economists will point out the failure of the bail-out model is to be expected, since big budget cut-backs are bound to squeeze the economy, which in turn will reduce government revenue and increase the deficit. While the economy spirals down, the debt crisis worsens rather than reduces.

Many analysts have concluded that Greece and probably some of the other affected countries need a partial debt write-off. The sooner this is done the better, as part of a permanent solution to the crisis. However debt default brings its own problems, and so this measure is being resisted. It will take place only when nothing else works, and by then the damage will be extensive.

The US and European economies are thus going to be caught in a deteriorating condition as well as in fierce policy conflicts for some time. As the situation evolves, Asian developing countries will be affected one way or the other, since most of them are still tightly linked to the developed countries. It is important for them to continuously review the situation and devise their own policies to respond better to this crisis. This presentation will rely on the recent research of the South Centre and the Third World Network.

2. Asian countries and the crisis

The transmission routes of the global crisis in 2009 to Asian developing countries have been through the finance sector, remittances and the trade in goods and services.

There was limited adverse effects on the domestic financial sector, mainly because Asian developing countries' banking sector generally had not been significantly exposed to the speculative financial products and mechanisms in the advanced developed countries. There were however serious losses made by some Asian banks and sovereign wealth funds in their investments in banks and financial institutions that failed or whose value diminished.[1] A lesson of the crisis is that there should continue to be caution against exposure to so-called toxic assets, especially since it has become evident that speculation-based financial instruments and activities have had damaging if not devastating effects on both the financial and real sectors in developed countries.

What is also notable is that generally Asian countries were able to avoid the kind of external debt crises that affected several countries in the region in 1997-99. Most Asian countries have built up considerable foreign reserves for self-insurance as a result of not wanting a repeat of the 1997-99 Asian financial crisis when countries with current account deficits fell into external debt crises. The countries were able to weather the 2009 economic recession without danger of descending into external debt distress, despite large falls in export earnings.

However, three points should be noted. First, there are significant differences among the Asian developing countries, in that some have accumulated "earned reserves" (in that the reserves come from current account surpluses, and added to these are also net inflows of capital) while some other countries have mainly accumulated "borrowed reserves" (in that they have current account deficits, which are covered by capital inflows which often exceed the current account deficits). The second category of countries are thus more vulnerable to a potential run-down in reserves if there is a reversal of capital flows or if future capital inflows are insufficient to cover the current account deficits. According to an estimate, excluding China, two-thirds of Asian countries' reserves in recent years were from capital flows (rather than current account surpluses) (Akyuz 2009: p18). Second, there is a high carrying cost in holding large quantities of foreign reserves, since there is a significant differential between the low returns on the foreign reserves held (which are usually in low-yielding US treasury bills and bonds) and the higher interest or return being paid for the foreign capital that has entered the country. According to South Centre estimates, the annual carry cost of borrowed reserves alone to developing countries is in the order of some $130 billion (Akyuz 2009:p14)[2]. Akyuz estimates that as at 2008, about

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[1] Akyuz(2010) notes that the Bank of China is reported to have lost $2 billion on its holdings of collateralized securities including those backed by US mortgages, and the investment portfolio of Temasek (the Singapore state investment company) fell by 30% in 2008 due to losses on Western banks.

[2] Akyuz, Y. (2009), Policy response to the global financial crisis: key issues for developing countries. South Centre research paper 24.

half the total stock of reserves in Asia would be "borrowed reserves". This is approximately equal to the external debt stock in the region. Assuming a modest 500 basis point margin between the interest cost on debt and the return on reserves, the annual carry cost of the region would be $50 billion (Akyuz 2009a: p20)[3]. This is what the region could save per year by paying up its external debt by drawing on reserves. Third, Asian countries have been incurring significant losses on their dollar holdings because of depreciation of the currency. The second point on high carry cost of reserves raises the question of alternative investments in higher yielding foreign securities or in alternative uses of the reserves generally, while the third point raises the question of alternative arrangements with regard to the global reserve currency.

It was in the trade sector that the crisis was transmitted with great force to Asian developing countries, with large percentage declines in exports within a short period. In 2009, real exports of goods fell by 20-30% in India, Indonesia, Malaysia, Singapore, Philippines; and 12-14% in Korea and Thailand, and 16% in China, in 2009. Due to the rapid recovery in developed countries as a result of fiscal and monetary stimulus, exports recovered. However, with a return to global economic slowdown and a possible new recession, the export sector can be expected to be affected again, and possibly for a longer period since the possibility of developed countries making use of similar stimulus policies has diminished. This raises the issue of a need to rethink East Asian countries' growth policies.

3. Rethinking of East Asian growth policies

As the global economic crisis evolves, China and other East Asian developing countries will be profoundly affected as their old growth strategies will no longer be able to serve them as before. Changes in economic policies and strategies that rely less on exports to the West will thus be required in China and even more so in the other Asian countries, according to a Research Paper by the South Centre.[4]. The global crisis exposed the high dependence of China and other East Asian developing countries on exports for their growth. This makes these countries economically vulnerable as prospects for global economy deteriorate.

The Centre estimates that exports contribute about 50% of China's recent pre-crisis growth. This high export dependence makes China more vulnerable than normally perceived to the slowdown in the US and Europe. In the medium term, China will not be able to return to reliance on exports to maintain its pre-crisis growth of 10% or more. If its exports expand at the moderate rate of 10% a year (instead of the 24-30% in 2002-2006) its growth may barely reach 7%. Returning to a path of 10% growth requires raising domestic consumption much faster.

[3] Akyuz, Y. (2009), The management of capital flows and financial vulnerability in Asia, TWN Penang.
[4] Akyuz, Y. (2010), Export Dependence and Sustainability of Growth in China and the east Asian Production Network", South Centre Research Paper 27.

In recent years the share of consumption in GDP has gone down from 55% in late 1990s to 36% in 2008. A major cause of under-consumption in China is the low share of household income in GDP, as wage increases lagged behind productivity increases. As a result the share of wages in GDP fell to about 40% at present from 50-55% in the 1990s.

The following suggestions are made in the way forward for China:

- In view of bleak export prospects, a return to trend growth in China crucially depends on a sizeable increase in the share of household income in GDP and a corresponding decline in corporate profits, savings and investment.
- 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.
- There should be greater public spending on social infrastructure in health, housing and education. These can be financed by dividend payments by state-owned enterprises.
- A shift from export-led to consumption-led growth would also require significant industrial restructuring.

The slowdown in global growth may impact other East Asian developing countries more seriously than China. This is because they are even more export dependent, and their exports not only to the West but also to China will be affected, even if China continues its high growth. In Indonesia, Korea, Taiwan and Thailand exports contributed over 60% to growth, compared to 40-50% in China. The export dependence of Malaysia, Singapore and Vietnam is even higher.

The indirect exposure of these countries through China to a slowdown in exports to the US and the EU can be as important as and even more important than their direct exposure.

China's assembly-manufactured exports depend a lot on inputs from other Asian countries. For every $100 worth of processing exports of China to the US and EU, about $35-$40 go to East Asian developing countries and $20-$25 to China. Thus a slowdown of Chinese exports to the US and EU can have a strong impact on these countries. This means that the other Asian countries are more vulnerable to a sustained slowdown of Asian exports to the US and the EU than China.

Further, while China is a major importer from these countries, it is not a major market for them since an important part of Chinese imports are destined to exports to advanced economies rather than used internally.

Domestic consumption and investment in China generate 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 a consumption-led growth and a shift by the US in the opposite direction would result in a significant slowdown of their combined imports from East Asian developing countries. A $100 increase in Chinese consumption increases imports by less than $10 while a $100 decline in US consumption reduces imports by some $25. In other words, at its

current pattern of domestic spending, the Chinese market is not a good substitute for the US and the EU markets for the other East Asian countries..

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. Moreover, the other Asian countries will need industrial restructuring even if there is a rapid increase in domestic consumption and its import content in China. The same problem would also be encountered in reducing dependence on exports by shifting to domestic markets.

The paper also notes that for several Asian countries, a main reason for excessive reliance on exports is under-investment. In several economies including Malaysia, Singapore, 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. Recent investment rates are too low to generate a rapid growth of either productive capacity or effective demand.

4. Vulnerabilities of Asian countries in the current unstable period

A key lesson learnt by many Asian countries from the 1997-99 Asian crisis is that they should not be exposed to and caught in a vulnerable situation having their foreign reserves drawn down to the point of facing a debt default. Thus the high current account surpluses and significant accumulation of reserves have cushioned many countries during the 2008-2009 global crisis. However, besides that vulnerability caused by dependence on exports, the region also faces a number of vulnerabilities that may become more evident in the current period od global financial and economic instability.

First, some countries in the region have significant current account deficits and rely on inflows of foreign capital to meet the deficits. These countries are more vulnerable to balance of payments and liquidity problems, should export performance and the trade balance deteriorate, or there is inadequate new capital inflows, or a surge of capital outflows.

Second, many Asian countries have undertaken a process of progressively liberalizing their capital account since the phasing out of the 1998-99 financial crisis. This liberalization has involved the opening up to various types of foreign capital inflows (including direct investment, equity, portfolio investment and loans) as well as capital outflows by residents (individuals, banks and companies). This has made the countries more susceptible not only to surges of foreign capital inflows, but also to outflows of private funds by local companies and individuals. In periods where capital inflows are large, they balance out or exceed resident outflows. However, when a country faces a reversal of foreign capital flows from net inflow to net outflow, it would be difficult to bring about a matching reversal of local flow from outflow to inflow. As

a result, the country would be exposed to the risks of significant net outflows on the capital account. If this is not adequately matched by a current account surplus, or worse if the current account is in deficit, then the country is exposed to deterioration in the balance of payments and in the longer term to a potential debt problem.

Third is the when the liberalization of capital flows in developing countries is coupled with the "push factor" of international funds searching for higher yield. This has happened recently when the expansionary monetary policy of low interest rates and massive injection of liquidity especially in the United States led to a recovery of the surge in capital from developed countries to emerging markets. The renewed wave of capital inflows into developing countries in Asia has caused concern because of a range of adverse effects, including currency appreciation (resulting in exports being less competitive), excess liquidity, inflationary pressures, and bubbles in equity and housing prices. The affected countries are also vulnerable to a sudden reversal of capital flows, which can have devastating effects on asset prices, currency rates and the balance of payments. Like developing countries in other regions, some Asian developing countries have made selective use of capital controls to reduce the pressure of inflows. However, the risks of adverse effects from a surge of inflows have continued to be felt.

Fourth is the vulnerability of many Asian countries to their diminution in value of their foreign reserves, much of which is held in US treasuries and bonds, as a result of the volatility of exchange rates and the downward pressure on the value of the US dollar. The vulnerability is worsened by the present lack of alternative to the dollar as a global reserve currency.

While Asian developing countries can take national policy measures to control or reduce the vulnerabilities above, these may not be effective unless there is collective action at the global level. Thus, Asian countries have an important stake in the reform of the global financial system.

5. Reforming the international financial and monetary system[5]

The inadequacies of the international financial system are at the root of many of the problems and vulnerabilities facing Asian countries in the current unstable situation and thus the region should be active in the global pursuit of reforms.

Recent papers by the South Centre have advocated reforms in the area of prevention of crises, and the appropriate management of crises when they occur. Below is a summary of the analyses and proposals.

[5] This section is a summary of the South Centre Research Paper 24 by Y. Akyuz on Policy response to the global financial crisis: key issues for developing countries

On the first aspect of crisis prevention, the Centre's paper[6] defines this as how best to reduce the vulnerability of developing countries to international financial instability and crises while retaining adequate policy autonomy in determining the pattern and degree of their integration into world financial markets and managing capital flows and exchange rates. Prevention of crises with global repercussions requires addressing three major sources of instability: policies, markets and the current international reserves system centred on the dollar. It calls for:

- Effective multilateral discipline over financial, macroeconomic and exchange rate policies in systemically important countries;
- Establishment of an international reserves system not based on a national currency or currencies and;
- Effective regulation and supervision of financial markets and capital flows.

The global initiatives proposed are however not substitutes for national policies and institutions for crisis prevention. Thus it is vital for developing countries to be able to retain adequate national policy space while setting up a new multilateral framework for international finance.

On the second aspect of crisis management, this is in recognition that regardless of prevention measures, crises with global ramifications will continue to occur. Thus appropriate international and national responses to crises are important. Multilateral cooperation and tighter discipline are needed to ensure that national policy responses take into account their impact on other countries and to avoid negative international spillovers and beggar-my-neighbour policies. Even more importantly, there is a need to improve international interventions in the balance-of-payments, currency and debt crises in developing countries. This also calls for a fundamental reform of the mandate, operations and funding of the IMF.

Crisis prevention measures

Multilateral policy discipline in money and finance

National policies especially in systemically important countries play a central role in financial instability and crises. Misguided deregulation of domestic financial markets, premature liberalization of the capital account, and unsustainable macroeconomic and exchange rate policies are often the proximate causes of currency and balance-of-payments instability and financial crises. Boom-bust cycles in capital flows to developing countries and major international financial crises are typically connected to large shifts in macroeconomic and financial conditions in the major industrial countries. The sharp rise in the United States interest rates and the appreciation of the dollar was a main factor in the debt crisis of the 1980s. Likewise, the boom-bust cycle of capital flows in the 1990s which devastated many countries in Latin America and East Asia were strongly influenced by shifts in monetary conditions in the United States and the exchange rates among the major reserve currencies. In current conditions the boom-bust cycle in the United States financial markets has produced the most serious post-war global financial and economic crisis.

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[6] Akyuz, A (2009), Policy response to the global financial crisis: key issues for developing countries (South Centre Research Paper 24).

Unlike in trade, there is no effective multilateral discipline in money and finance. The IMF is unable to impose meaningful disciplines over the policies of its major shareholders who have a large influence on global financial stability. A key question is, therefore, how to overcome the problems regarding quality, effectiveness and evenhandedness of IMF surveillance.
This cannot be resolved without addressing its governance-related shortcomings. Given that the existing mechanisms within the Fund have so far failed, such a process should best be conducted outside the Fund.

Stable international reserves system

A reserves system based on a national currency as a means of international settlement and a reserve asset suffers from a major dilemma as pointed out by Triffin (1960). In a dollar-based system net holding of dollar assets by the rest of the world depends on the United States running current account deficits. If the United States stopped running deficits, the shortage of international liquidity would stifle global trade, investment and growth. If, on the other hand, the United States runs growing deficits and supplies adequate liquidity to the world economy, the accumulation of liabilities could undermine the confidence in the dollar, depressing its value. Restoring confidence and overcoming inflationary pressures would then call for United States interest rates to rise and deficits to fall, depressing economic activity and employment.

A practical alternative would be to build on existing mechanisms and institutions and make a gradual move away from the dollar towards the SDR (or expanded SDR). An important advantage of SDRs is that unlike dollar reserves, holding SDRs does not entail costs; cost is incurred only when they are used. Under present arrangements the IMF may allocate SDRs to members in proportion to their quotas. The cost advantage of SDRs has given rise to calls for regular distribution to alleviate the burden of holding reserves on low-income countries. Regular allocations of SDRs on the basis of existing rules cannot promote the SDR to be a major reserve asset and address the inequities and instability resulting from the current system based on national currencies, even if such allocations are done more often. A way forward is to make the IMF an SDR-based organization, and to allow SDRs to replace quotas as the single source of funding for the IMF. The Fund could be permitted to issue SDRs to itself up to a certain limit which should increase over time with growth in world trade. Under such a scheme the present practice of allocations to countries according to their quotas would be discontinued.

Making the Fund an SDR-based institution result in a considerable increase in the supply of SDRs compared to the existing stock or the growth that could be expected under current practices. It would allow major surplus countries to invest their reserves in SDRs instead of reserve currencies. It is also possible to supplement this with a mechanism to remove the dollar overhang by allowing countries to rapidly replace their existing stocks of dollar reserves with SDRs without causing disruption in currency markets. Such a proposal was made by the Governor of the People’s Bank of China. According to this proposal the IMF would “set up an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired” (Zhou 2009).

Regulation of international financial markets and capital flows

Unregulated financial markets can generating instability and crises with serious consequences for the real economy, as the current global financial turmoil has shown. There is wide agreement on the need for tighter regulation but not on how and the degree to regulate. It has been argued that financial regulation should be international; since financial instability often has adverse global spill overs, national regulatory practices should be subject to multilateral disciplines. But there are both political and technical difficulties in establishing multilateral discipline in financial regulation and supervision. It is still quite unrealistic to expect systemically important countries to give up national policy autonomy to the extent required. More importantly, such an arrangement would carry risks and drawbacks for developing countries. It is unlikely a global institution with genuine clout over major advanced economies could be established unless it is based on a governance basis similar to that in existing multilateral financial institutions. Thus, it may not be wise to create another multilateral body before solving satisfactorily the governance-related problems that pervade the existing institutions such as the IMF, WB and WTO.
Also, it is likely that regulations to be agreed in such a setting would be shaped by the exigencies of financial markets and institutions of more advanced economies. These would not always be suitable to developing countries. The danger is that a process designed to broaden the scope of global governance over finance may end up extending the global reach of financial markets.

A possible guiding principle in the reform of financial regulation and supervision could be to allow and retain considerable autonomy in setting standards for financial institutions without significant border-crossing activities. A multilateral framework for national regulatory systems or global regulators should be introduced only for transnational financial institutions. The nature and extent of regulations of different transnational financial activities and institutions needed is a highly complex issue that would require considerable deliberations. Developing countries should have voice in setting global rules and standards.

There should be a serious rethinking of the approach to international capital flows. The international community should firmly establish that controls over capital flows are legitimate tools in the arsenal of policy measures needed for macroeconomic and financial stability and they should be effectively used as such.

Crisis intervention and management

In crisis intervention and management, the following points should be noted:

- Crisis intervention should not undermine market discipline and distort the balance between debtors and creditors. Private creditors and investors should be involved in the resolution of payments crises through both voluntary and mandatory mechanisms. With mounting sovereign debt with international dimensions in several emerging and mature economies, it is no longer possible to deny or ignore the need for impartial sovereign insolvency procedures.

- In providing international liquidity the Fund should not impose structural conditions; nor should it insist on macroeconomic policy adjustments when payments imbalances are due to temporary external shocks beyond the control of the borrowing country.

- IMF bailouts of international lenders and investors in countries facing rapid exit of capital undermine market discipline, encourage imprudent lending, shift the burden onto debtors and threaten the Fund's financial integrity. The IMF should not finance large and sustained capital outflows, but encourage involving private creditors and investors in the resolution of balance-of-payments and debt crises in emerging economies.

- The rights of countries experiencing large and sustained capital outflows to exercise temporary debt standstills and exchange controls should be recognized; and they should be granted statutory protection in the form of stay on litigation.

- To the extent possible restructuring of sovereign debt should be based on negotiations with private creditors and facilitated by inclusion of rollover and collective action clauses in debt contracts. But an international system of impartial arbitration is needed to settle sovereign debt disputes.

- Sustainability analyses in official debt restructuring exercises should be taken from the IMF and given to an independent body of experts. Consideration should be given to introducing arbitration for the restructuring of official debt of DEEs.

Further areas of reform of the IMF

Several of the above measures needed for reducing the likelihood of financial crises with global repercussions and ensuring better crisis intervention call for fundamental changes in the IMF. There are also additional reforms that need to be undertaken, particularly in its governance and mandate, in order to enhance its effectiveness and relevance.

- There should be reforms in the Fund's governance in several areas including the selection of its head, the distribution of voting rights, transparency and accountability.
- Ending the dependence of the IMF on its shareholders for funding through quotas and bilateral lending (GAB and NAB) by translating it into an SDRbased institution.
- The separation of surveillance from program lending and giving the task to authorities who are independent of their governments and who are not involved in lending decisions.

The Fund needs to focus on its main responsibility of safeguarding international monetary and financial stability. Consequently:

- It should stay out of development finance and policy and poverty alleviation. This is an unjustified diversion and an area that belongs to UN agencies and multilateral development banks.
- It should also stay away from trade policies. Its attempts to promote unilateral trade liberalization in developing countries drawing on its resources undermine the bargaining power

of these countries in multilateral trade negotiations. In this area its main task is to ensure a predictable global trading environment by helping secure stable payments positions and exchange rates.