

## Asia and the Global Financial Crisis: Conference Summary

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This *Economic Letter* summarizes papers presented at “Asia and the Global Financial Crisis,” the first Asia Economic Policy Conference of the Federal Reserve Bank of San Francisco’s Center for Pacific Basin Studies, held October 19–20, 2009, in Santa Barbara, California.

“Asia and the Global Financial Crisis” brought together experts from around the world to discuss the transmission of the crisis to Asia and the responses of economic policymakers and regulators.

In opening remarks, Federal Reserve Chairman Ben Bernanke noted that, in the aftermath of the financial crisis of the late 1990s, many emerging market economies in Asia and elsewhere took advantage of improved global conditions to strengthen their economic and financial fundamentals. They bolstered fiscal and foreign debt positions, accumulated foreign exchange reserves, and reformed their banking sectors. When financial turmoil erupted in the summer of 2007, Asian economies were well positioned to avoid its worst effects. In particular, most financial institutions in the region were not heavily exposed to distressed markets for structured credit products and other asset-backed securities.

Still, Asian nations were affected in late 2007 and 2008 when economies weakened in the United States and other industrial countries. The global financial crisis intensified dramatically when Lehman Brothers failed in September 2008. As investor appetite for risk declined, capital flows shifted away from countries that were viewed as more vulnerable. Moreover, financial institutions withdrew money from risky assets in both advanced and emerging markets. The Federal Reserve established liquidity swap lines with central banks in Asia and other regions to help alleviate dollar funding pressures.

In Bernanke’s view, emerging Asia’s sound macroeconomic and financial fundamentals provided room for maneuver in carrying out countercyclical monetary and fiscal policy, in contrast with earlier crises or compared with options available to other emerging market countries. In particular, China implemented a sizable fiscal program, supplemented by accommodative monetary and bank lending policies. Bernanke attributed Asia’s relatively rapid recovery in large part to such domestic demand-boosting policies, which provided a substitute for exports to trading partners outside the region.

### Day 1: National experiences of the crisis

First-day presentations reviewed national experiences of the crisis. Morris Goldstein and Daniel Xie identified several characteristics that affected the depth of the downturn among Asian countries. China and India experienced relatively small growth slowdowns, but the economies of Hong Kong, Korea, Singapore, and Taiwan contracted sharply, on par with the recessions they experienced during the financial crisis of 1997–98.

Declining demand for imports among advanced economies transmitted the crisis to export-reliant Asian countries. And, compared with most other emerging market regions, emerging Asia was more sensitive to falling U.S. equity and bond prices. On the other hand, emerging Asia benefited because it had not increased its exposure to banks in the advanced countries in the decade preceding the crisis. Developing Asian countries also relied more than other emerging market regions on foreign direct investment inflows. And Asian economies were not heavily exposed to U.S. subprime loans. Goldstein and Xie also argued that Asian countries largely avoided the combustible mix of large currency depreciations and adverse mismatches in the currency denominations of assets and liabilities. Recent experience in emerging Europe underscores the risk when currency and maturity mismatches are not controlled.

Anne Krueger drew out several lessons from the experiences of Japan and Korea during the 1997–98 financial crisis. First, policymakers must choose an exchange rate regime compatible with monetary and fiscal policy. Unless policymakers are willing to subordinate monetary and fiscal policy to the demands of a fixed exchange rate regime, a flexible exchange rate is preferable. Secondly, mismatches between banking assets and liabilities must be avoided. When their currency denominations differ, unhedged positions are vulnerable to exchange rate movements. Thirdly, short-term debt should not exceed foreign exchange reserves.

Krueger noted that delays in addressing financial problems are costly. The extent to which authorities implement policies forcefully and quickly is an important determinant of the speed of recovery. Krueger emphasized that authorities must recapitalize financial institutions and see to it that nonperforming loans are addressed. Fiscal stimulus can boost growth in the short term, as it did in Japan in 1996.

But this is likely to be temporary and full recovery unsustainable as long as the financial system remains impaired. Secondly, official credibility and transparency are crucial. Uncertainty about the health of financial institutions can prolong and deepen crises.

Maurice Obstfeld and Kenneth Rogoff argued that, although global imbalances in trade and capital flows didn't cause the crisis, they were generated by some of the same underlying factors and they amplified its magnitude. Excessively stimulatory U.S. monetary policy combined with low global interest rates, credit market distortions, and problematic financial innovations led to a housing bubble. At the same time, exchange rate, and other economic policies of emerging market countries such as China helped the United States borrow cheaply abroad to finance its bubble. To limit future global imbalances, Obstfeld and Rogoff suggested policies to improve domestic financial market efficiency in less-developed economies, where structural shortcomings tend to boost corporate and household saving rates. They also proposed stronger global financial market regulation, including more extensive international cooperation.

In a keynote address, Andrew Crockett argued that the crisis showed that market failures are more widespread and problematic than previously believed. In the future, the global financial system is likely to continue to be market driven, but regulation will play a more substantial role. Crockett foresaw a fragmented institutional structure, with various international regulatory bodies playing roles alongside established international financial institutions, such as the International Monetary Fund. Asian countries are likely to have a larger voice, consistent with their growing economic clout.

## **Day 2: Policy responses to the crisis**

In day two of the conference, presentations concentrated on policy responses to the crisis. Takatoshi Ito focused on the U.S. Treasury Department's liquidity provision programs and the Federal Reserve's monetary easing campaign, drawing comparisons with the actions of the Japanese Ministry of Finance and the Bank of Japan during that country's 1997 financial crisis. Japan's crisis started with the Lehman Brothers-like failure of Hokkaido Takushoku Bank. It was also marked by the Bank of Japan's "quantitative easing" monetary policy after interest rates reached the zero bound, similar to the Federal Reserve's balance sheet expansion in 2008 and 2009.

Ito argued that the March 2008 forced sale of Bear Stearns led investors to believe that other troubled financial institutions would also get assistance, magnifying the shock when Lehman Brothers was allowed to go under. The near failure of Bear Stearns indicated that the crisis had become severe enough to threaten the global financial system. In the

immediate aftermath of the Lehman failure, U.S. authorities squandered an opportunity to impose a tough financial recovery program, which would have kept taxpayer losses smaller, according to Ito. He concluded that policy actions taken during the crisis appeared to have prevented the worst outcomes, but financial conditions would have improved more rapidly if U.S. regulators had shut down troubled institutions early in the crisis.

In a panel of Asian policymakers, Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, noted that the global financial crisis showed Asia's "deep integration" with the rest of the world, putting to rest the theory that nations in the region had decoupled from the global economy. Asian nations experienced a severe collapse in trade, with exports within Asia plummeting even more than the decline in regional exports to the United States and Western Europe. However, Asian monetary and financial systems proved resilient, thanks partly to reforms enacted following the 1997-98 financial crisis, including regulations encouraging Asian investors to avoid currency mismatch exposure.

Kyungsoo Kim, Deputy Governor of the Bank of Korea, said his country experienced substantial capital outflows at the beginning of the crisis that resulted in downward exchange rate pressure. Korean authorities took steps to ensure the liquidity of domestic financial markets, including the establishment of a \$30 billion swap arrangement with the Federal Reserve. Kim highlighted the difficulties associated with procyclical capital inflows in small, open economies, arguing that the crisis showed that capital flows need to be managed to avoid excessive swings in credit conditions.

Takafumi Sato, former Commissioner of Japan's Financial Services Agency, compared the effects of the recent crisis on Japan with the impact of that country's financial troubles of the 1990s. The recent crisis was less damaging to Japanese financial markets because the problems originated outside Japan. Japanese banks were generally less exposed to securitized assets than their U.S. and European counterparts. In addition, reforms undertaken by Japan in response to the previous crisis allowed for a quick response this time. Nevertheless, the Japanese financial system was not immune to this crisis, particularly after Japanese exports plummeted. Regulators took steps to maintain the functioning of financial markets by, for example, authorizing government and central bank purchases of commercial paper, and implementing other liquidity provisions.

Following the panel, Barry Eichengreen outlined global policy reforms that should be implemented in light of the crisis. Eichengreen cited two primary causes of the crisis: excessive deregulation and global imbalances that fueled an unsustainable U.S. credit boom. Financial institutions had incentives that prompted them to take on ever greater levels of risk. Moreover, lenders made inadequate efforts to evalu-

ate asset risk because they followed an originate-to-distribute business model that left them with little exposure. Meanwhile, rating agencies lacked the capacity to value complex instruments and faced conflicts of interest in doing so. Eichengreen's policy prescriptions included regulations requiring reduced leverage, incorporation of off-balance-sheet items into financial assessments, creation of resolution mechanisms for nondepository institutions, and enhancement of regulatory agency resources.

Eichengreen concluded that monetary policy makers should pay attention to global imbalances, even when inflation is absent. In countries that borrow in their own currency, policymakers should address fiscal policy procyclicality. Reserve accumulation should be less aggressive because building such surpluses requires global imbalances. Finally, Eichengreen argued that relative prices need to be adjusted to deal with changes in patterns of demand. This can happen either through exchange rate adjustment or inflation, although adjustment is likely to be less disruptive.

In a closing address, International Monetary Fund Deputy Managing Director John Lipsky noted that the global economy remained in an exceptionally vulnerable state, despite signs of recovery. Ensuring continued growth requires broad international collaboration. He criticized the notion that Asian nations had decoupled from the global economy, pointing out that growth appeared to be most robust in those countries that were most integrated with the rest of the world. Overall, recovery in Asian nations reflected quick and forceful policy responses, which were aided by strong economic fundamentals. Lipsky stressed that policy support should be maintained until incipient recoveries become more durable.

*Reuven Glick*  
*Group Vice President*

*Mark M. Spiegel*  
*Vice President*

## Conference papers

Links to conference papers are available at

<http://www.frbsf.org/economics/conferences/aepc/2009/agenda.php>

Eichengreen, Barry. "The Financial Crisis and Global Policy Reforms."

Goldstein, Morris, and Daniel Xie. "The Impact of the Financial Crisis on Emerging Asia."

Ito, Takatoshi. "Fire, Flood, and Lifeboats: Policy Responses to the Global Crisis of 2007–09."

Krueger, Anne. "Lessons from Asian Financial Experience."

Obstfeld, Maurice, and Kenneth Rogoff. "Global Imbalances and the Financial Crisis: Products of Common Causes."

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