The US Subprime Fallout and East Asia's Economic Challenges

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1. Introduction: Key Issues

President Wu Jianmin of China Foreign Affairs University; President Feng Guoqin of CPPCC Shanghai Committee; Deputy Governor Liu Shiyu of the People's Bank of China; Vice Mayor Tu Guangshao of Shanghai; President Wang Ronghua of Shanghai Academy of Social Sciences; Executive Vice President Zuo Xuejin of Shanghai Academy of Social Sciences; distinguished participants, experts, friends, ladies and gentlemen.

It is a great honor to be invited to deliver a keynote speech at the 4th NEAT Conference on East Asian Financial Cooperation, organized by the China Foreign Affairs University and the Shanghai Academy of Social Sciences.

The US subprime loan problem that erupted in August 2007 has begun to affect the US financial system, its real economic activity and global financial and economic conditions. Economic prospects in Japan and Europe are worsening. The financial ripples which originated in the housing sector, securitized mortgage loans and the capital market in the US and the associated balance sheet losses of banks in the industrialized world, continue to darken the global economic outlook. Partly reflecting the renewed weakness of the US dollar and a flight to safety

* This keynote speech reflects the speaker's personal view, and not necessarily those of the Asian Development Bank, its Institute, their executive directors, or the countries they represent.

amid ongoing financial turmoil, oil prices broke new records at over $110 per barrel, and prices of major non-oil commodities—food in particular—have also surged to record high levels.

Despite the recent monetary and fiscal policy support, the US economy may already be contracting. The IMF's most recent growth forecast indicates that the US economy will slow to 0.5% this year from 2.2% registered last year and continue to be weak at 0.6% in 2009. With inflation rising, the US Federal Reserve policy options appear increasingly constrained. The eurozone economies will slow to 1.4%, well below the 2.6% rate last year. In Japan softening external demand and sluggish domestic consumption will keep its GDP growth at 1.4% this year, down from 2.1% in 2007. After last year's incredible 11.9% growth, the Chinese economy is expected to cool to 9.3% this year as it continues tightening. I believe slower growth is not bad news for China as it will help the economy contain overheating and soft-land to more sustainable, robust growth. India's economic growth is also expected to moderate from 9.2% in 2007 to 7.9% in 2008.

Many observers believe that the tight demand and supply balance will likely keep crude oil and other commodity prices high at least in the first half of the year, unless the US slowdown evolves into a severe, prolonged recession. At that point, global energy and commodity demand could soften. In the absence of such a scenario, I believe the slowdown of US and global economic growth will likely be accompanied by a rise in inflation due to high energy and commodity prices.

The current uncertain global economic conditions pose significant challenges for East Asia in terms of macroeconomic and financial-sector management. Today, I would like to explore some of these challenges.

2. Is East Asia De-coupled from the US Subprime Fallout?

With the US and global economy slowing, global financial market turmoil lingering, and high oil and other commodity prices being sustained, the external economic environment facing East Asia will remain weak. Growth is likely to ease and some moderation is expected. But I believe the East Asian economy will remain generally robust as the region's dynamism will partly offset the sluggish external conditions.

There has been a great deal of discussion about whether East Asia will be de-coupled from the US economic downturn. There are two views. The "coupling" view argues that the health of the US market for East Asia's exports of final products is critical, that the expansion of intra-East Asian trade—which is largely that of parts and components—cannot substitute for the US economic slowdown, and that East Asia is financially connected with the US and hence will be affected by the US financial market turmoil. Essentially, the "coupling" view asserts that East Asia cannot escape from the US subprime fallout.

The "de-coupling" view can be derived from historical data that show the US economy's declining impact over time on East Asia. Using annual GDP data, for example, one can compute simple 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 East Asian economies—like Japan, China and ASEAN—exhibit high and rising business-cycle correlations among themselves. However, East Asia exhibits low and falling business-cycle correlations with the US and the EU. Though surprising to some, these results suggest that East Asia's real activity tends to be highly correlated with itself but not with the US or the EU. Essentially, this view says East Asia has been de-coupled from the US and Europe and will remain so.

I believe the future lies somewhere in-between. East Asia's financial markets are strongly linked with US financial markets 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 can certainly reduce capital inflows to the region. If the US undergoes a severe and deep recession, then many other industrialized countries will be affected, and East Asia will not be immune to such developments. In this sense, the view that East Asia will be de-coupled from the US subprime fallout is premature. Nonetheless, East Asia's limited exposure to US subprime-related products, the availability of huge regional savings, and the region's dynamic growth are providing some cushion. In this sense, East Asia is neither independent, nor is it a hostage, of the US economy.

3. Risks for East Asia

While my view is that East Asia is better prepared to adjust to economic downturns in the US and other industrialized countries, the region faces three key risks.

The first is a sharper and more protracted global slowdown, driven by a deeper and more prolonged US recession than expected. The US housing market collapse will continue to spillover into the construction sector, housing investment and overall economic activity. Tightening credit markets and deteriorating employment prospects could stall household consumption that has been resilient for many years. The stagflationary mix of slowing growth and rising inflation is thus a major risk to the US economy. Its negative international spillovers could dampen growth prospects in many industrialized countries—in Europe and Japan—with cascading impacts on emerging East Asian economies. This risk could be exacerbated by worsening US financial conditions. Banks in the US—and in Europe to a lesser extent—have become cautious in managing their portfolios by hoarding cash and reducing loans and investment in order to protect their capital bases. This could indirectly undermine growth prospects in East Asia amid global re-pricing of financial risks.

The second risk is a continued rise in oil and food prices. With precarious supply conditions and inventory rundowns, further oil price hikes remain a possibility. The recent spike in the price of rice, the main staple of the region, also heightened anxiety across East Asia, highlighting the urgent need to address long-term food security. With oil, food and other commodity prices at record highs, any further increases in costs could trigger persistent price inflation that can generate a wage-price spiral. Inflation has already reached alarming levels in Viet Nam, China, and many other economies. Clearly, the inflationary pressures driven by rising energy and commodity prices pose a significant threat to macroeconomic stability throughout East Asia.

The third risk is a possible surge in short-term capital inflows and the consequent upward pressure on the value of regional currencies. Several countries like Thailand and Viet Nam had been experiencing excessive capital inflows until the US subprime crisis broke out. Once the subprime problem became serious, many US financial institutions began to secure liquidity and reduce lending and investment abroad. As the US financial system restores its stability and the credit crunch eases, there is a real possibility that capital inflows to East Asia will resume and in a massive way. With the overall confidence in the US dollar eroded, these inflows may generate significant further upward appreciation of East Asian currencies. If not managed properly, they can be another source of macroeconomic and financial-sector instability, by creating overinvestment, over-extension of loans and asset price bubbles in recipient countries. Allowing currency appreciation is advisable in order to stem domestic inflationary pressure and asset price bubbles, but it can also damage a country's international price competitiveness.

4. Enhancing Regional Financial Cooperation

Given the US subprime fallout—global credit market turmoil, US economic slowdown (or recession), and a possible dollar crash—East Asia faces a new set of risks that can threaten the region's macroeconomic and financial stability. To prepare for these events, East Asian economies need to strengthen regional financial cooperation—including for policy dialogue, economic and financial surveillance and, particularly, exchange rate policy.

Currently no consensus exists—even within ASEAN or ASEAN+3 (10 ASEAN members plus China, Japan and Korea)—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 the 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 degree of economic interdependence within East Asia, maintaining a certain degree of intraregional exchange rate stability is increasingly urgent.

When a sustained, sharp downward pressure on the US dollar emerges, some authorities may be tempted to resist market forces in order to maintain price competitiveness. Such a temptation will be especially great if neighboring countries continue to intervene in the markets to stabilize exchange rates against the dollar. But resisting currency appreciation in the face of persistent capital inflows 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.

This entails collective currency appreciation which can ensure macroeconomic and financial stability without much affecting the competitiveness of individual countries. Collective appreciation would spread the adjustment costs across countries in the region, thus minimizing the costs from the perspective of individual economies while at the same time reducing macroeconomic and financial-sector risks. Hence collective appreciation should be in everyone's interest as it can help achieve sound macroeconomic and financial performance and stable, sustainable economic growth.

5. 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 East Asia. I believe East Asia is well positioned to face such challenges. To be successful, however, regional financial cooperation is essential. East Asian economies need to strengthen the Chiang Mai Initiative, regional economic 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 policy coordination may come sooner rather than later—as the US dollar depreciates sharply against East Asian (and other major) currencies in the light of the weak economic and financial prospects in the US. If East Asian economies must accept currency appreciation vis-à-vis the dollar, 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 East Asia achieve non-inflationary sustainable growth.