



Crisis developments and long-term global responses Insights from Asia and Europe

Summary of the AEEF Conference held at the Institute for the World Economy

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More than nine months after the sudden aggravation of the financial crisis, it is now time to go beyond debates about 'green shoots' and 'yellow weeds' or about the alphabet-letter forms of the recovery. The fourth edition of the Asia Europe Economic Forum (AEEF), which took place on 7-8 July 2009 at the Institute for the World Economy in Kiel, helped to shed light on the way forward in a post-crisis world. The AEEF brings together experts, policymakers, academics and market economists from both continents for in-depth, research-based exchanges on global issues of mutual interest.

The previous AEEF conference, in December 2008 in Beijing, shortly after the fall of Lehman Brothers, mainly discussed the causes of the financial and economic crisis and the immediate policy responses of governments and international institutions. Six months later, the focus was on the responses to the crisis and their short-term implications, the appropriate timing of exit strategies, and the longer term reforms and their consequences at the global level. Participants indicated the importance of outlining longer term perspectives, if only because expectations of stable and growth-enhancing future policies are already important for agents in the short run. A key element of those discussions has been the reform of the international rules of the game, and the relationship of this reform to the strategies of national players. How to design government interventions to ensure more sustainable and stable growth? How to adapt the international arrangements to the new economic realities? Should global standards be set to tame destabilizing flows?

While Asia and Europe do not face the same challenges, their future economic fate to a great extent is shared. This includes not only the issues where a cooperative attitude is needed, or where conflicting interests exist, but also opportunities for learning across continents on questions raised by the reform of growth models and advances in regional integration.

1. Crisis developments and policy choices in Asia and Europe

The first session gave an overview of the inherent strengths and weaknesses of Asian and European growth models, and the reforms necessary for achieving a more stable economy. The presentations of **Masahiro Kawai** (ADB) and **Dennis Snower** (IfW) respectively highlighted the nature of the shock that the Asian and European economies went through. While the financial crisis originated in the United States, the integrated nature of the global economy prevented Asia and Europe from 'decoupling' from the global downturn: Europe suffered through its participation in financial markets for toxic assets and a general loss of confidence in financial markets, while contagion was transmitted through trade to Asian countries.

The scale of the trade shock (a decline of around 40 percent since the previous year at its highest), with its impact on industrial production and broader measures of real activity, is telling for the vulnerabilities of Asian model of the 2000s. The shock has revealed Asia's extreme dependence on US demand, and the power of the amplification effect through regional interlinkages. In fact, around 67 percent of Asian countries' exports in 2006 were estimated to depend directly or indirectly (exported to another Asian country and then reexported) on the final demand of developed countries in other regions. More importantly, a return of the behaviour of US consumers returns to its historical level, (as opposed to the overconsumption in the most recent years) will translate into the evaporation of global demand equivalent to five percent of US GDP. This would have massive impacts on the orientation of East Asian growth structures.

Building on a CGE analysis, Kawai showed that Asian countries would suffer a decrease in their current account surplus of three percent of their GDP, with terms of trade about 1.3 percent higher. Most affected sectors will be manufacturing sectors, such as textiles, apparel and vehicles. Policies should help countries to adapt to those changes and thus move towards an economic model that switches away from external demand to one based on domestic demand. This would involve major structural changes for the economy: less reliance on industry and manufacturing and more development of services (following the Indian example) and green sectors, more personal consumption through public and social spending and infrastructure investment. **Kyung-Tae Lee** (Korea Institute for International Trade) pointed out that the current export-based model was very much based on market mechanisms and thus hard to redirect, which gives a role to exchange rate flexibility: Asian countries should accept a deterioration of their competitiveness and an appreciation of terms of trade. In a nutshell, Asian countries need to develop the nontradable sector and support household consumption. As noted by **Huang Yiping** (Peking University), it will be impossible for Asian countries to export their way out of the recession, unlike the 1997 crisis – which planted the seeds of the current imbalances. Another recommendation is the strengthening of regional integration with the objective of avoiding too great a dependence on final demand from Europe and the US.

By contrast, European countries were affected through their financial exposure to US and European toxic assets. The downturn in activity has been much sharper, with major decreases expected in employment rates during 2009 and 2010. The consequences in the medium to long term could be very harmful: lower potential output growth, which might be less than one percent per year (the decline in

investment will reduce the capital stock in the economy, and the laid-off workers might lose their skills and thus their productivity). Uncertainty is pervasive, especially concerning the balance sheets of financial institutions. Fiscal conditions have quickly deteriorated, both because of the consequences of automatic stabilisers (lower revenues and the requirement to provide more gross social benefits) and because of the stimulus packages implemented by the European Commission and governments. Furthermore, beyond the wide heterogeneity of implementation across the European Union, actions have been taken to rescue financial institutions (recapitalisation, guarantees of liabilities and assets), and these might worsen the medium-term fiscal balance. Burden-sharing between taxpayers, share- and bond-holders seems to have played to the disadvantage of the latter. This triple stalemate (fragile financial system, doubts over fiscal solvency and low growth) leads to dire expectations over the medium and long term. Policymakers must address these.

Structural reforms could lead to higher rates of growth, while a credible fiscal framework and swift resolution of the financial mess are the keys to confidence in the economy, but the specifics are fuzzy and hard to agree on. **Marco Annunziata** (Unicredit) noted for example that the two main demands of the governments towards banks, ie that they should acknowledge the losses and increase lending, were to a certain extent contradictory. The timing of the exit (between monetary policy, intervention in financial institutions and fiscal policy) also remains unclear and under debate, with the consequences likely to be important. On the fiscal side, while **Moreno Bertoldi** (European Commission) called for a clear and rapid commitment to an exit strategy in the coming years, complemented by a return to the Stability and Growth Pact to be kept as a stringent rule for governments to return to fiscal balance after 2010, others cautioned against the recessionary effects of repelling stimulus packages too quickly, favouring instead alternative rules to return to fiscal balance.

On the financial sector, Snower argued in favour of bold action. Large systemic financial institutions (LSFIs) pose systemic risks and should thus be forced to self-insure against solvency risks. For example, they could be required to hold a certain amount of “convertible to equity”-debt, which would automatically increase the capitalisation of banks in times of crisis. On the markets, an agency could be set up on the model of drug regulation agencies, testing and validating (or rejecting) the use of possibly 'toxic' assets. To avoid regulatory arbitrage (which also exists in the pharmaceutical sector), such an agency should at least be set up at the European level. The main lessons from this session can be summarised as follows:

	Europe	Asia
What the crisis revealed	<ul style="list-style-type: none"> ▪ Mismatch between market and policy integration in the financial sector ▪ Pervasive moral hazard of financial institutions ▪ Inadequacy of macroeconomic surveillance ▪ Unsustainability of imbalances in Emerging Europe 	<ul style="list-style-type: none"> ▪ (Demand side) Overdependence to external markets ▪ (Supply side) Overdependence to manufacturing ▪ Lack of regional cohesion
Medium term challenge	<ul style="list-style-type: none"> ▪ Deal with long term exposure to fragility in the banking sector (costs of bail-outs and guarantees) ▪ Market fears about fiscal solvency ▪ Potential output losses (productivity and labour market participation) 	<ul style="list-style-type: none"> ▪ Permanent lower US (and Rest of the World) consumption ▪ Misallocation of factors and overcapacity in manufacturing
Policies	<ul style="list-style-type: none"> ▪ Reform and unify financial integration ▪ Strengthen growth potential ▪ Reform macroeconomic surveillance 	<ul style="list-style-type: none"> ▪ Accept Exchange Rate flexibility at the price of loss of competitiveness ▪ Reform social policies and public spending ▪ Redirect growth to non-tradable sector ▪ Strengthen regional integration

2. The future of global monetary arrangements

The second session focused on international monetary arrangements, which have clearly contributed to the crisis, alongside micro/regulatory failures. On one hand monetary policy has been criticised for having been too permissive, focusing on a narrow definition of inflation and leaving global developments outside of its scope. On the other hand the 'Bretton Woods 2' system was characterised by capital flows flowing the 'wrong way' (from emerging to developed countries), due to shortages of stores of value in emerging markets and lack of adjustment in exchange rates.

This system has raised a difficult challenge for China, outlined by **Yongding Yu** (CASS), which is to avoid being trapped in a 'Triffin dilemma', ie to be forced to accumulate only dollar reserves to sustain the dollar exchange rate, a self-feeding phenomenon. Four possible solutions have been presented, each demanding arduous political efforts if they are to be implemented. The reduction of current account surpluses would be a first step to reduce the demand for reserves. A second solution is to increase foreign direct investment from China to developing countries (mainly Asia and Africa). Third, switching from dollar reserves to other currencies, or to dollar-denominated assets indexed to inflation. Finally, in the longer run, the aim should be to pursue the internationalisation of the RMB (and thus, likely to allow for its convertibility), to deepen regional financial and monetary cooperation, and to increase the participation and the ownership of Asian countries in reforms of the international monetary system.

However, changing one player's strategy, even one of the most decisive, will not be enough because the very monetary system has been revealed as flawed. **Agnès Bénassy-Quéré** (CEPII) and **Jean Pisani-**

Ferry (Bruegel) took a systemic perspective to describe the main 'rules of the game' and the multiple disequilibria that arise from the disconnection between the real global economy and the monetary configuration: neither flows (trade and capital, important between the US, the euro area and East Asia) nor stocks (economic weights, roughly equal across regions) are well represented by monetary arrangements. Indeed, those are tilted towards an 'Asia-US' link, leaving aside the euro bloc. This has significant consequences, such as the puzzling fact that a shock in the US or in Asia has consequences on the euro/dollar exchange rate and not on the RMB. De facto pegs to the dollar are still prevalent, even for countries that trade more with the euro area. Those elements have allowed the US to follow a loose macro discipline (benefitting from positive wealth effects through devaluation and giving an incentive to run current account deficits) and trapped reserve-rich countries into a self-feeding dollar polarization.

Bénassy-Quéré and Pisani-Ferry outlined the desirable properties of a monetary system and used this approach to assess three reform proposals: a strengthening of surveillance, a SDR solution and a multicurrency system. They concluded that there was no overriding solution and that the evolution was likely to be gradual. **David Vines** (Oxford University) pointed out that without fiscal backing, a currency would have little credibility. Its convertibility remains disputed. A solution could thus be to use the SDR as a transitional device, to exit from the dollar trap, and allow several reserve currencies at a later stage.

3. Global regulatory reforms

The third session focused on the regulatory reforms that should be put in place to improve the functioning of the world's financial markets. **Yung Chul Park** (Korea University) focused on the weaknesses of the current system. By triggering very large and sudden currency depreciations (the Korean Won fell by 50 percent in October, a currency crisis by any other name), the crisis has underlined that contagion mechanisms were still a threat to emerging economies, even to those holding large stockpiles of reserve currencies. The 1997 crisis showed that emerging countries were affected by both maturity and currency mismatches, which could become deadly in unstable times. Markets seem to have overreacted, since it was clear after several months that the crisis had receded. But emerging markets lack a lender of last resort and do not dispose of enough reserves to ensure provision of liquidity when there is a run against the currency. It is thus not realistic to believe that emerging economies can solve these problems by themselves. They require the intervention of IFIs, with well-specified regulatory arrangements. Ex ante, one should avoid excessive lending and excessive leverage both from foreign and local banks. Such practices often fuel the mismatches. In her discussion, **Luo Jin** (People's Bank of China) pointed out that the 2000-2001 reforms in China led most banks to be funded with long term deposits, and were thus not concerned by any maturity mismatch. Foreign banks, whose funding came from the wholesale markets, could however be subject to more pressure. They tend to be procyclical by borrowing too much when low interest rates in developed countries favour borrowing in dollar or yen. In addition to financial sector regulation, emerging countries should be protected by an international lender of last resort (a discussant pointed out that while it was true for the maturity mismatch, national regulators could limit currency mismatches). But given the absence of concrete arrangements after the crises of the 1990s, one should be concerned about the lack of willingness or ability needed to set up

such mechanisms. From the East Asian point of view, the lack of coordination in regulatory reforms between the two main players, the EU and the US, is an additional reason for pessimism (although some pointed out the huge progress made since the onset of the crisis with the Financial Stability Forum and the G20). The regional level is thus privileged, on the model of the Chang Mai Initiative. But then again, it might not be the best forum for discussion between regulators. A modest, but more realistic proposal would emphasise the setting of permanent swap lines at the regional level, to be activated in times of crisis. Multiple and intertwined arrangements at the regional and global levels can be adapted to mitigate future crises.

Nicolas Véron (Bruegel) analysed the possibility of global coordination in setting the rules for financial sector regulation. Several hurdles are in the way: the objectives (stability, efficiency, fairness and integration) are not completely clear, and even sometimes contradictory, or at least involve trade offs. Additionally, some economists such as Dani Rodrik strongly expressed their skepticism relative to the possibility of going beyond what some countries consider as their sovereignty. There are, however, examples of global coordination success stories. Véron discussed the global harmonisation of accounting standards to show how a private sector initiative has been able to define and then expand a global standard. Despite controversies and problems of manipulation of standards, global accounting standards are still being adopted by new countries. Other financial arrangements, however, have seen limited internationalisation, and what internationalisation there was even receded slightly during the crisis. Supervision, for example, seems to be out of reach at the global level, and still faces many hurdles at the European level. Banks are 'international in life, national in death', which seems to preclude global supervision. However, there is a rationale for other sectors, such as audit networks or rating agencies, to be regulated internationally. But although regulatory arbitrage can deteriorate global welfare, the implementation of coordination still looks like a distant dream. The G20, however, might be an appropriate forum for identifying the main areas where regulatory reform can be coordinated. The importance of the G20 for the future of financial architecture seems undisputed, although there are controversies about the level at which it should intervene (some favoured a broad approach with general principles, the details being settled at the administrative level as in the April 2009 meetings, other preferred the November 2008 approach where the final communiqué described some measures in great details).

4. Panel session: taking stock

The closing panel discussion took stock of the presentations to draw out policy implications. **Ignazio Angeloni** (ECB and Bruegel) warned against the temptation of preventing exchange-rate flexibility from playing its role in adjusting current account imbalances: the interruption in 2008 of the gradual appreciation of the RMB that had started in 2005 is in his view worrying. He recalled the experience of the EMU in the early 1990s, which solved its large internal imbalances by letting the exchange rates adjust to absorb the disequilibrium of demand. In any case, adjusting only through

quantities can lead to more violent fluctuations both in surplus and deficit countries. **Jean Pisani-Ferry** (Bruegel) asked whether the global response would be sufficient to meet the hopes of some. On the Asian side, despite supposed self-insurance costs, there is still doubt about the ability of the IMF and the incumbents of global power, the EU and the US, to intervene in times of crisis. Meanwhile, Europeans tend to procrastinate before relinquishing their influence on international institutions. Despite its costs in terms of instability, however, financial globalisation is worth saving. Its direct benefits can be discussed, but it is an important counterpart of trade flows, which are undoubtedly beneficial for the welfare of all countries. Pisani-Ferry urged Asian partners to spell out the conditions they regard as necessary before they can invest in the reforming and strengthening of global governance.

Yinlin Jang (Chinese Ministry of Finance) agreed with the importance of trade for growth, despite its underlying role in building global imbalances. The internal disequilibria in China can in his view be solved, and policies aimed at strengthening services and social spending are now being put in place. At the international level, the crisis is also a window of opportunity for resolving the dollar trap, SDR being, from his point of view the best solution: switching to other reserve currencies can actually enhance welfare for every regions, even the US. **Ku-Hyun Jung** (Samsung Economic Research Institute) explained why, in his view, the cooperative behaviour of countries in the crisis were actually causes for optimism: unlike the Great Depression, protectionist moves have remained the exception, and the role of the 'global leader', which was sorely lacking in 1929, has been shouldered by the US. Ku-Hyun also warned against the increasing role of governments worldwide, and the risks of large inefficiencies this entailed: policies have unintended consequences and can sometimes backlash against their original purpose. This was also underlined by **Masahiro Kawai** (ADB): for example, if used wrongly, fiscal policy can be a burden, and can lead to bear negatively upon economic growth. He pushed for regional solutions: the transformation of the Chang-Mai Initiative into a full-fledged Asian Monetary Fund, which could become the leading institution on monetary arrangements and on regulatory macroprudential oversight. Responding to Pisani-Ferry, he indicated that a reduction of the EU quota share to 25 percent, the removal of veto rights and an open selection procedure for the heads of the Bretton Woods institutions (thus opening the way to the appointment of an Asian candidate) would in his view trigger a change of attitude vis-à-vis the IFIs. In conclusion, despite some remaining disagreements on the road that should be taken towards creating a more stable, growing world, there has been progress in clarifying and shedding some light on the possible solutions.

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