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RESPONDING TO THE GLOBAL ECONOMIC CRISIS

Toyoo Gyohten

Thanks to the development of extraordinary fiscal and monetary instruments, the worst phase of the crisis is said to be behind us now. People are talking about "green shoots" and exit strategies. All that is very fine. However, there is one concern on my part. The process of recovery is alarmingly disconnected between the financial world and the real world. The massive injection of liquidity by governments and central banks has inundated the financial world, relieving banks and investors from the plight of drought. What we see today is the revival of active risk taking, particularly by those players who survived the drought while their competitors perished. The winners are reaping record profits and paying out a record remuneration. The question here is, what really was the crisis?

In the real economy, the situation is still gloomy. The global collapse of demand is yet in the process of fragile recovery. Households are still sparing, corporate profits are not buoyant, cost cutting is pervasive, and unemployment is rising, making the household less optimistic about the future. In other words, the real economy will continue to need the support of monetary and fiscal policies. So, as a result, easy money will continue, and redundant liquidity will find no other place to flow but into risky asset markets. Aside from the near-term prospects as such, I would like to touch on somewhat more fundamental problems.

There are three fault lines running through the real world economy today—first, the unsustainability of the growth model; second, the blow to the financial sector; and third, the instability of the international monetary system. These fault lines existed even before the current crisis, but the current crisis has exposed them in a glaring fashion. Let me very briefly discuss each one of them.

First, the growth model. Obviously, this is directly linked to the issue of the global imbalance. During the last decade, the world economy was running on a virtuous cycle. Insatiable US household consumption induced large imports and large current accounts deficits. This created a big demand for exporting countries, particularly in Asia, and left them with huge surpluses and robust growth. The accumulated dollar reserves were invested in the United States and fueled US household consumption. Even those with a poor memory should remember that in 2005, just four years ago, all the economies in the world—for the first time since World War II—registered a positive growth rate. We all hailed the arrival of the so-called "Goldilocks economy."

Well, alas, now the cycle is broken. The collapse of asset markets and the credit crunch dealt a severe blow to the US household. We are faced with several intriguing questions. Can and will the US household reduce consumption on a lasting basis? The US current account deficit will shrink—to what extent will a depreciation of the dollar help reduce the US deficit? To put it another way, is the US household price elastic or inelastic? Can US consumer goods industries, such as the auto industry, restore global competitiveness? On the other hand, countries in surplus will also be faced with serious challenges. Can they shift from exports to domestic demand as the main engine of growth? After the current stimulus measures, will they run out of steam? Such a shift certainly will require a change of industrial policy and scrapping of export supports, which will hit vested interest groups. Domestic households need to be assured of higher income and improved future confidence. For that purpose, significant improvement of the social security system is surely sine qua non. I certainly cannot answer these questions easily. However, it is realistic to assume that neither deficit nor surplus countries can change their growth model quickly. That means we need to accept a considerable period of slower growth, or we will create another bubble, which will result in a more severe burst.

The second fault line is the bloated financial sector. One of the striking changes that took place during the last decade was the explosive expansion of the role of finance in the world economy. There are several factors that prompted the change. They include the global imbalance, continuous easy money, financial engineering, globalization, financial liberalization, and last but not least, a global addiction to greed. Indeed, compared to the global GDP of US$60 trillion and world trade of US$15 trillion, total financial assets today amount to some US$200 trillion, and daily turnover of foreign exchange reaches almost US$2 trillion.

There are few who disagree that the excessive expansion of the financial sector, which was supported by unsustainably high leverage, was the main cause of the current crisis. The situation was also exacerbated by the total unpreparedness and incompetence of the regulatory apparatus. Thus, it was inevitable and quite natural to see a strong trait toward tightening financial regulation in order to reduce leverage. It sounds quite reasonable to argue for a decrease in the role of finance in the economy. However, it may not be easy for many people to accept a more stable but humble role for finance, because it implies less employment and less profit.

The third fault line is the instability of the international monetary system. Since 1971, when the Bretton Woods regime collapsed, the world economy has lived with a de facto dollar standard. The value of the dollar was no longer guaranteed, but everybody held it and used it, because the issuer of the dollar was the hegemonic power in the world. In recent years, US economic and diplomatic supremacy has been dented. The influence of the group of countries who do not accept the unipolar leadership role of the United States has also been growing. The current crisis, with the weakening of US economic and financial prowess and the prospect of its ever-growing fiscal deficit and international indebtedness, has further eroded confidence in the dollar. Yet, nobody thinks that the dollar will be replaced by another currency any time soon—no currency, national or synthetic, is capable yet. Thus, the current situation is such that we have a leader who is getting weaker, but there is no successor in sight. We have two options. One is to urge the leader to wake up and rejuvenate itself. The other is to accept a prolonged period of instability.

It is obvious that we have a set of long-term challenges. If the current crisis is a once-in-a-century crisis as some people argue, then it should be legitimate to ask if the world is prepared to undertake a fundamental restructuring of the global economy. I am sorry to say, but I do not think we are prepared for that daunting task yet. So, we will have several years of slower growth with accompanying uneasiness. Incremental reforms will be made, but, on the whole, things will carry on until another bubble emerges.

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Zhang Yunling

I remember last year we discussed the global financial crisis and its impact. But this year, it seems the situation is better than we expected because the growth rate and the economy recovered faster and the crisis ended earlier than we expected. The consensus now among the economists seems to be that the worst is over, the global economy has started to recover, and that next year will be much better than this year. The developed economies went back to positive growth rates, and developing economies will achieve higher growth rates. In the financial sector as well, it seems the most difficult time has also passed. Financial markets seem stabilized and confidence seems back. Many of the measures agreed upon by the G20 have started to be implemented, and the financial sector itself has started to implement some rigid measures to control their assets and debt. With the cooperation among countries, large-scale cross-border capital flows are also being monitored. So, there are some good aspects of the present situation.

We said last year that this was a serious crisis and we will need more time to recover. But now it seems that recovery is coming more quickly than expected. But there are still a lot of problems, especially in terms of future sustained growth. In their statement at the 2009 Singapore conference, the APEC leaders said that we cannot go back to growth as usual or trade as usual. We need a new paradigm. They called for structural reform and called for the financial markets to better serve the real economy rather than the virtual economy. The question is how.

The first issue is the US economy. US unemployment is at 10 percent. The Obama administration has to create new jobs, but how? Of course, a higher growth rate is needed. But if you have a higher growth rate, you have to have a lot of changes. There has to be a big reduction in the budget deficit, but if you want to maintain higher growth, you need a bigger budget deficit and to export more or consume more. The US current account deficit is still very big, and in order to export more, you have to devalue the US dollar. But continuous devaluation will create an unstable situation. We have not seen a major restructuring of the US economy yet, although there have been some signs like the savings rate climbing up a little bit, so we will not see a big restructuring in the next one or two years.

The second issue is the Chinese economy. Based on the government's stimulus package, the Chinese economy has achieved a higher growth rate. The government committed to an 8 percent growth rate. During the National People's Congress some people asked why the growth target

was so high, but now it seems to have gone even higher than 8 percent. The problem is that in the first three quarters of 2009, 90 percent of this growth was led by investment. Investment-led growth increases demand for raw materials and equipment, so domestic demand replaced exports to become the leading factor to stimulate economic growth. The question is, how long can this investment-led growth last? Where will future dynamism come from? This is all very controversial and there is a lot of debate about it in China, but what China really needs is structural reform of the economy.

The Chinese government has already adopted some social policies that will intensify reform by increasing income and expanding the social welfare network, especially in the rural areas. But in the future, they need to do even more to reduce savings and encourage consumption. For instance, in the year 2000, the percentage share of consumption in GDP was 45 percent, but in 2008, it went down to 35 percent. By contrast, investment was at 35 percent in 2000, and in 2008 it rose to 45 percent. So it has flipped. The question is whether it is possible to return to a more normal situation.

People are also worried about this new "clean economy" strategy, under which the Chinese government just announced an ambitious goal before the Copenhagen conference to reduce carbon emissions.

So, on one hand restructuring the economy is a strategic necessity. But on the other hand, such reforms can hurt the growth rate itself. It is not clear whether such restructuring is positive or negative for the economy in the short term.

Another debate in China is about whether we are in a credit bubble and whether the credit increase in the first half of this year was too large, so sustaining economic growth next year might be difficult. You cannot keep government stimulus at such a high level. We will watch and see. If you looked at economists' earlier comments on the Chinese economy, most of them were wrong—they pointed out many problems, but the Chinese economy continues to grow.

Lastly, the regional economy's production network—in the past decade, this production network expanded very fast based on the credit bubble and demand from the US market. But how much of this export capacity in the region was reflective of internal demand? That is a big question.

Recently, I have been thinking about an issue that we are all discussing—the East Asia Free Trade Agreement (FTA). The original aim of the FTA was to improve the economic environment and to help the expansion of the production network, but now, continuing with such a model is no

longer sustainable. We have to think about some other way for this integrated open market to help the restructuring of the region. Since achieving a regional FTA has become difficult, we should think about shifting to other priorities for the moment, for instance, region-wide infrastructure projects, support for the development of local economies, and creation of internal demand. The governments in the region have to change their policies from export incentives to support for local development. So, we have a lot of things to do.

Foreign direct investment (FDI) in the region is coming from the big Japanese and Korean companies as well as, increasingly, from China into Southeast Asia. But we have to rethink the strategy for it—restructuring the regional economy in East Asia is crucial, but the method for it is not clear yet. We have a lot of things to do in East Asia. In the past several years, we have had major discussions about how to promote market liberalization through support for the production network, and, in the future, we have to discuss how to create real internal dynamism in the region. Otherwise, the regional economy will face a lot of problems. We will see some progress in the future in East Asia, but the conventional strategies will seem to work slower than we expected.

We cannot expect a quick, integrated East Asian FTA, and we will probably meet with more difficulties. Every country welcomes FDI inflows, while at the same time remaining cautious of FDI's role in their economies. For instance, in China, our main priority in terms of past financial cooperation has been to make the regional financial system safe. But when we called for capital markets to play some role in supporting the regional economy, the big banks in the region did not listen to us. The APEC leaders have called on the financial markets to support the real economy, but how will regional financial monetary cooperation help us move in this direction? How should we develop capital markets further to help the real economy? How should we use the local currencies to encourage the less-developed countries to increase their trading capacity and support their development?

China is also greatly concerned about trade protectionism. Because of China's large production capacity due to FDI, Chinese manufacturers are still waiting for the next export boom. They can export any time if the outside environment allows—that is what happened in the past decade. The Chinese government cannot simply allow these manufacturers to just shut down. But, if the export machine turns on at any time and if this economic environment continues, this will lead to more trade protectionism. Now, China seems to be the only country in the world that still holds aloft the anti-protectionism flag, but a lot of questions are now raised about how to

carry this out. If we follow the leaders' call that we cannot pursue the trade as usual, we will not be able to grow as usual, and we will need reform.

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Jesus P. Estanislao

In the current global economic crisis, we are all the same. We have all been affected, one way or another, by the global economic crisis in many different ways, and there has been no economy that has really been able to escape from the global economic crisis. So unlike the paradigms that we usually use in which India speaks very much "as India" and China speaks very much "as China," when you start discussing the global financial crisis, you cannot make too much of a reference to nation-states. You really have to look at a much bigger region—the entire global economy. The global economy has perhaps reached bottom, but it may take us a long while before we might get ourselves out of the woods. So I wanted to highlight just a few points regarding lessons to consider given the global financial crisis.

The first lesson that comes to my mind is the role of ideology. There have been many reasons that have been given for the global financial crisis, but there is one thing that I would like to highlight. The United States, and perhaps the United Kingdom, has been caught by an extreme market fundamentalist ideology. There seems to be a tendency by those governments not to do too much and to think that the less government there is, the better. Well, we do not have that disease in East Asia. As a matter of fact, we probably come from the other side, where we have too much government. Take a look at China—the moment they mixed strong markets with strong government, their economy really took off. So, I submit the basic proposition that one of the things we have to really think about in the future is taking care of both market fundamentalism and state fundamentalism. That is the real challenge for us, whether in East Asia or as a global economy: to strike the proper balance between strong state institutions and strong market mechanisms and strong market discipline. It is something that we really have to find answers for if we are very serious about creating an East Asia community.

The second lesson is the usual disconnect between the real economy and the financial system. I submit that the financial system is the virtual economy and its significant disconnect from having to provide support to the real economy is a problem that will remain to be resolved. In the case of the United States and in a few other more developed financial markets as well, the disconnect became a little bit too much. The financial system failed to recognize that it exists mainly and precisely to have a real economy function. It was growing very much on its own, up and up and up, while the real economy was growing normally.

Here, I tend to disagree with many of the comments that have been made about the US dollar. My sense is that we are faced with the Triffin paradox, which is that for as long as the world economy continues to rely on the dollar and the world economy continues to grow and is therefore necessarily in need of additional liquidity, the US dollar will weaken because more and more dollars will have to be printed in order to serve the needs of the global economy. In addition, the tendency on the part of Asian economies to accumulate all of these currency reserves, most of which are kept in dollars, means even more dollars have to be printed. And the more dollar supply there is, naturally the long-term tendency of the dollar is to weaken.

This is a paradox that has already been noted, but the only thing that we would like to see is that there is some rational connection between the real economy and the financial economy. I warn that, while the financial system tends to run very much on its own, it cannot disregard its connection with the real economy. And that relates to the checklists that we have been using, especially the credit rating agencies used to evaluate assets—we have been placing too much importance on these. I asked investment bankers at Citibank, what exactly happened to you? "Well," they said, "all of the assets that we are holding were rated 'A.'" Rated by whom? By ratings agencies that were selling their services for the rating. We place too much importance on these financial metrics. We should place some importance on them, but the reality is that there is a whole wide world out there waiting for us beyond the financial metrics game of the credit ratings agencies.

This leads us to the new model for growth. What is the new model that we are going to move toward? There are only four drivers for economic growth: (1) the old one, which is net exports; (2) consumption, which the United States relied on; (3) investments; and (4) governments. How is the world economy growing now? It is growing mainly because of government stimulus packages. In the case of China, they pushed their consumption upwards, although the figures of Zhang Yunling indicate that consumption as a percentage of GDP has gone down. So it is essentially due to

government stimulus packages. Will this be sustainable? Obviously not. But we cannot go back to the old model, so therefore we are looking for big drivers for change.

Here in Asia, and perhaps less so in the United States, we cannot rely on exports, so we will have to go on the basis of investments. There is a limit to this, insofar as public investment is concerned, because of the question of the deficits. Therefore, one big question mark would be the level of private investment flows. The other, of course, would be consumption. For the East Asian community, we have a headwind acting in our favor in that we have a big population base that is still hungry for consumer goods. That is why the Chinese car manufacturers are aiming at the bottom of the pyramid, and I think that is appropriate. The reality is that if we are serious about an East Asia community, we have to look at the production base and the consumer market in the region. Our strong population base in East Asia can be the basis for consumer-led growth over a long period of time, as long as we continue to make private investments and we make sure our financial system really addresses all the financial flows that we need.

Let me move onto the challenge of the G20. I am very happy with the G20. We probably have the beginnings of a globally oriented instrument that can think in terms of global problems. I am not so worried about representation there: the economies there are the biggest, accounting for three-fourths of total world GDP. And it is not so Europe-focused: China is there, India is there, Brazil is there, and Indonesia is there—Indonesia is beginning to forget about ASEAN because now Indonesia is part of the G20. That is fantastic, as long as the G20 really begins to think in terms of "global organic development," a phrase from George Yeo of Singapore, rather than in terms of a global financial architecture. Let us grow in many different, myriad, organic ways—not in one fixed way—moving forward. The absolute necessity is that we cannot have a group of 20 economies thinking only of themselves. They really have to think in terms of the rest of the world.

That leads me to my last point about the whole concept of solidarity and the social investment that we make in people. This is another huge issue we have in this part of the world. When we begin talking about East Asia, the Japanese do not have to worry too much about making investments in its people. But China has to do this, Indonesia has to do this, and the whole of ASEAN has to do this, with the possible exception of Singapore. This becomes a huge area for investment, which will have substantial returns for investment funds. So from a financial standpoint, we hope that the G20 gets strengthened, but—from the perspective that the world economy has

become one—that it strengthens as an institution that thinks globally rather than according to the parameters of nation-states. Lastly, of course, we have a great opportunity for East Asia to step forward and really use our region as a base for long-term, sustained, higher-end global development.

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