

The Global Financial Crisis and Asia-Pacific¹

Anwar Nasution²

1. Introduction

It is impossible to predict the nature and extent of the damage that the current global economic crisis will inflict and how long the world and the Asia-Pacific economies will suffer from the ensuing low economic growth. The recession will hit the economies of this region hard through falls in commodity prices, declining trade, capital outflows and lower remittances from citizens working overseas. As this region has neither sufficiently robust domestic demand, nor large intra-regional trade to offset the impact of falling exports to the United States and Europe, countries in Asia-Pacific should adopt a two-prong approach to the crisis. Internally, they should foster closer policy cooperation to make better use of the region's financial resources and relatively large domestic markets in order to speed up economic recovery. In the long term, the expansion of potentially large domestic markets can gradually replace the current export-oriented development strategy of many countries in this region. Globally, this region should work hand in hand with other regions, particularly with the relevant authorities in their main export markets in the US and Europe, to promote world economic growth in line with the APEC ethos of open economies, and resist the temptation of protectionism. All of these require closer cooperation on monetary and fiscal policies and exchange rate policy, both regionally and globally. Otherwise, Asia-Pacific may well experience a "lost decade" like that suffered by Indonesia following the Asian financial crisis in 1997-98, or by Japan in the 1990s.

The crisis has been strengthening the position of the U.S. as the global financial superpower. US financial institutions are now consolidating to become giant financial conglomerates. The U.S. Treasury and the Federal Reserve Bank are able to issue billions of dollars in debt at close to zero nominal interest rates -- lower than the inflation rates. Negative real interest rates mean that rather than paying interest rate, the U.S. Government actually gets paid for borrowing money. People around the world are now so risk averse, and the scramble for both safety and liquidity so strong, that they are hoarding the safer U.S. dollar, U.S. Treasury bills and U.S. long-term government bonds. Massive capital inflow has allowed the U.S. to finance its budget and balance of payment deficits, and provide funds for rebuilding its financial system, stimulating its economy, recycling funds to provide dollar liquidity to foreign central banks through the Federal Reserve Bank's bilateral currency-swap facilities, and for financing the expensive wars in the Middle East.

The world economic downturn is being exacerbated as all sectors in the economy stop spending. Deterioration in borrowers' balance sheets due to faltering mortgages and

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² Professor of Economics at the University of Indonesia and Chairman of the Supreme Audit Board of Indonesia (*Badan Pemeriksa Keuangan Republik Indonesia*). e-mail address: anwar_n42@yahoo.com

stock markets, foreclosures and bankruptcies have worsened credit risks and made the problems of adverse selection and moral hazard more prominent. Both banks as well as companies need to deleverage to improve their liquidity positions, reduce dependency on wholesale funding and rebuild profit margins. As a result, the banks have stopped lending, businesses have stopped investing and lending to each other and households are refusing to spend. All of this has reduced the velocity or turnover of money-to-service transactions in the economy. At a given money supply, the fall in the velocity of money will reduce gross domestic product, which is the multiplication of the two monetary variables.

The rest of this note is organized as follows. Section 2 analyzes the evolution of the global financial crisis and contrasts it with the Asian financial crisis of 1997-98. Section three examines the current economic situation in Asia Pacific. Section four describes global and regional responses, and the final section sets out my recommendations for policy coordination in the region to promote global economic recovery.

2. The Global Financial Crisis

Similar to the Asian financial crisis of 1997-98, the current sub-prime mortgage debacle, which erupted in the United States in the summer of 2007, was precipitated by a crisis of confidence among short-term creditors that caused them to withdraw funds from the shadow banking system. Over the years, the shadow banks relied on short-term collateralized lending in the form of repurchase agreements³. The shadow banking system includes finance companies, hedge funds and investment banks that buy mortgages and loans from banks, as well as corporate bonds and other assets, like credit card receivables, automobile and student loans, and repackage and sell them in sophisticated but arcane ways to financial investors around the world.

The increase in the delinquency rates of sub-prime mortgages eroded the collateral value of the assets of the highly leveraged shadow banks and, at the same time, caused maturity mismatches on their balance sheets as they borrowed short and lent long. The drop in market prices and liquidity adversely affected the capital and solvency of shadow banks, raised the funding needs of all financial institutions and reduced their access to the lending markets. The supply of funds further diminished as creditors and uninsured depositors pulled their funds from risky institutions and transferred them to safer bets. This made the financial institutions vulnerable to runs and resulted in them hoarding their liquidity, and to interest rate surges in the short-term money markets. Gridlock in the markets for certain asset-backed securities occurred as institutions were unable to pay their obligations because others were not paying theirs. On the other hand, the demand for credit by companies and household decreased due to the economic recession and reduced values of their assets.

³ See Brunnermeier, Markus K. 2008. "Deciphering the 2007-08 Liquidity and Credit Crunch". *Journal of Economic Perspectives* (forthcoming). Draft. May 19, and David Greenlaw, Jan Hatzius, Anil Kashyap and Hyun Song Shin. 2008. "Leveraged Losses: Lessons from the Mortgage Market Meltdown". *US Monetary Policy Forum Conference* Draft. www.chicagogs.edu/usmp/docs/usmp/2008confdraft.pdf.

A number of policies were adopted to deleverage the balance sheets of the shadow banks, such as by tightening lending standards, improving credit quality, reducing the volume of loans, and selling assets. However, the simultaneous attempts by so many institutions to deleverage depressed asset prices and produced additional losses. As it is nearly impossible to determine market prices for certain asset-backed securities, they cannot be used as collateral for new funding to borrowers.

The credit crunch in the U.S. financial markets spread quickly around the globe. By mid September 2008, after 13 months of market stress, short-term credit markets froze and the interbank markets of many countries were disrupted as the banks stopped lending to each other. The process of flight to safety began with the hoarding of cash by investors, the pulling of capital from perceived weak institutions and the shifting of portfolios to government bonds, mainly U.S. Treasury bills. Short-term interest rates surged, far above central banks targets, on fears that many leveraged financial institutions might collapse due to lack of short-term credit. Some banks in the U.S. (Wachovia) and Europe (the Northern Rock, IKB, Bradford & Bingley and Fortis) were either taken over by stronger institutions or nationalized. Bank of Asia of Hong Kong experienced a small bank run. Bank Century, a small bank in Indonesia, was taken over by *Lembaga Penjamin Simpanan* (Indonesian Deposit Insurance Corporation) on 21 November 2008, and PT Bank IFI went bankrupt. Four banks in the Philippines were taken over by the Philippine Deposit Insurance Corporation (PDIC), in addition to 9 small banks placed in PDIC receivership by order of the Central Bank of the Philippines.

The credit crunch has reduced the flow of financing for the economic activities of both companies and households, which has exacerbated the economic downturn, and in turn weakened financial institutions and intensified the credit crunch. Uncertain about demand for their products, both in domestic and export markets, and unsure about how to finance their activities, nonfinancial firms reduced production and cut demand for inputs, including raw materials, oil and labor. The credit crunch and high interest rates have encouraged them to repay debt, reduce spending and put investment plans on hold. At the same time, the credit crunch has also left households with fewer resources to finance spending.

3. Current Situation

At the end of their meeting in Lecce, Italy, on 13 June 2009, Finance Minister of the Group of Eight issued a cautiously optimistic statement on progress of policies to address the present economic turmoil. They have seen positive signs of stabilizations in major economies include a recovery of economic growth and stock markets, a decline in interest rate spreads and improvement in both business as well as consumer confidence. As the monetary policy has been more aggressive in the US and the size of fiscal stimulus has been greater, the American economy is expected to recover faster than that of Europe. The progress allows the authorities to begin discussing framework for unwinding the lax monetary policy and massive fiscal stimulus to maintain fiscal sustainability, combat inflation, prevent currency realignments, avoid high long-term interest rates once a recovery is certain. The statement warns, however, that the positive signs remain very weak, uncertain and significant risks remain to economic and financial stability. Even

after economic growth has been picking up unemployment is, however, expected continue to rise, partly due to progress of restructuring of major industry such as General Motor including its expensive health and pension costs.

The negative effects of the crisis filtered into the export-oriented Asia Pacific economies through the current and capital accounts of the balance of payments. Foreign demand for this region's exports fell sharply as the deeply interconnected world economy began to show signs of having entered a dangerously downward spiral: recession or low economic growth, falling commodity prices, rising unemployment, faltering stock markets, exchange rate realignments, collapsing property values, the implosion of hedge funds, foreclosures, bankruptcies and write-offs, as well as a credit crunch. The fall in demand has resulted in unsold stock piling up, higher excess capacity and signs of deflation.

Until recently, international and regional banks and institutions have been revising their economic forecasts downward with depressing frequency. The IMF forecast for world economic growth for 2009 was revised downward to 0.5 percent in January 2009 from 2.2 percent in November 2008. The group of advanced economies is forecast to contract by -2% over the whole of 2009. Japanese economy is predicted to shrink by -2.6 percent. Because of the fading in demand for mining resources and global economic crisis, the Australian economy is projected to contract by 0.2 percent in 2009. The highly export dependent economy of Singapore is expected to shrink between 2% to 5% in 2009. This is mainly due to the falling demand for its export products, such as petrochemicals and electronics. China is projected by the IMF to grow by 6.7 percent in this year, lower than the average annual rate of 9 percent over the past few decades. This is lower than the minimum rate of growth at 8 percent to absorb new entrants to the labor market. Newly Industrialized Asian Economies are predicted to contract by -3.9 percent and ASEAN-5 is to grow by 2.7 percent.

Euler Hermes⁴, a subsidiary of Allianz Insurance of Germany, is predicting that corporate bankruptcies in the advanced economies of Europe, the U.S. and Japan will hit a record this year. The highest annual increase in company failures in 2009 will be in the U.S. at 50.4 percent, followed by Western Europe at 16.7 percent and Japan at 7.9 percent. A number of airlines and automobile companies around the world, including General Motors, have received equity injections from governments to keep them in operation. At the end, General Motor declared bankrupt on 1 June 2009 and applied for Chapter 11 protection from its creditors.. Toyota Motor, the best run and most profitable car producer, suffered its first loss in 2008 since it began its financial reporting 68 years ago⁵ and some of its assembly plants have been temporarily closed. Labor disputes and riots are increasing in China as a result of the closure of labor intensive export-oriented manufacturing firms, and the ensuing redundancies.

The economies of the emerging countries in this region are very much driven by foreign capital inflows. This is because of the high dependency of companies and the banking system, and to some extent the public sector, on foreign financing. The emerging

⁴ "Company crashes set to hit record next year". *Financial Times*. Monday, December 8, 2008. Companies and Markets. p. 19.

⁵ "Toyota to suffer first loss in 68 years", *Financial Times*, Asia, Tuesday, December 23, 2008. page 1.

economies in this region are also prone to capital outflows. Benefiting from the economic and commodities boom, they had regained the confidence of international investors after the Asian financial crisis of 1997-98. In the beginning of the crisis, private investors, however, pulled their funds out of South Korea, Taiwan, Thailand, Indonesia, and the Philippines.

Falling commodity prices and export revenues, and rising unemployment in labor importing economies have dealt a triple blow to commodity dependent and labor surplus emerging economies, such as Indonesia and the Philippines. Political instability has hit the tourism industry in Thailand. Sharply reduced revenues from both exports and labor remittances, together with capital outflows, mean that these countries will need to cut spending and let their currencies depreciate. The rise in unemployment in labor importing economies, and the ensuing deportation of foreign workers from these countries, has increased the pressure on the labor markets of the labor surplus countries. Unemployment, healthcare and job-retraining assistance are practically non-existent in these countries, which are mainly emerging economies. Prolonged economic hardship could cause political instability and social unrest in densely populated countries that could end up being exported globally.

The crisis has also seriously affected banking systems in this region and eroded the value of foreign assets and external reserves. The stronger capital bases, better supervision of the banking system, and larger external reserves that have been built up since the Asian financial crisis of 1997-98 have proved inadequate to overcome foreign exchange illiquidity, particularly as regards the U.S. dollar, with the result that the settlement of international transactions has been affected. Fortunately, the exposure of financial institutions in this region to U.S. collateralized debt obligations (CDOs) arising from sub-prime mortgages is relatively small. This has saved the region from the sort of bank failures that have occurred in Europe. In addition, the homegrown subprime market is relatively small in this region, as household debt is insignificant and the shadow banking system is underdeveloped.

4. Responses

The first policy response of all countries to overcome the crisis is to restore the flow of credit to avoid a deeper recession and to stabilize the financial system. As financial sector is closely interlocking with the real sector of the economy, the financial resources is not only made available to help the financial sector but also extended to their major clients such as AIG insurance and General Motors as well as local governments in the United States. The second policy response is to prevent further deterioration in economic activities by expanding aggregate demand. As traditional monetary policy has proved ineffective in promoting the expansion of consumption and investment, central banks are now switching to monetary easing and greater reliance on fiscal policy as an instrument for restoring economic growth.

It is interesting to note the contrast between the US policy to address the crisis and those adopted by the EU member countries. The US adopts larger stimulus spending and more vigorous policies to restructure its financial system and manufacturing industries. In contrast, the European adopt more cautious stance as the use of fiscal policy

that will cause unprecedented budget deficit can only be used temporarily while fixing the dysfunctional credit markets caused by the uncertain value of asset-backed securities. This is because not all of the government spending are desirable and necessary and many of them are wasteful. Prolonged large deficit spending can reignite inflation, raise long-term interest rates and cause a detrimental effect on the solvency of the economy..

The third policy response is to dampen liquidity pressures. To dampen international liquidity pressures that have seriously affected international trade and investment, the central banks move together to provide currency swap facilities between them. Policy cooperation and coordination to enhance effectiveness of policies to address the crisis not only step up between central banks. Fiscal programs across major economies are also better coordinated. The fourth policy response is to increase financial resources available and reforming the IMF. Major countries agreed to increase their contributions to the augmented New Arrangements to Borrow (NAB) at the IMF. A portion of agreed gold sales of the IMF is to be used to support low-income countries. Capital resources of multilateral development banks are to be strengthened to enable them to play countercyclical role in responding to the global financial crisis by providing financial resources to member countries for mitigating capital outflows and declined exports. The fifth policy response is to make market work better by strengthening market fundamental to protect individual property rights. This includes promotion of transparency and strengthening regulatory and supervisory systems as well as business ethics.

4.1 Restoring credit markets

With the non-functioning of short-term credits and inter-bank money markets, commercial banks around the world have turned to central banks as lenders of last resort for liquidity. A central bank is a powerful monetary authority, which controls the supply and demand for high-powered money, or the monetary base. The source of monetary base consists of gold and foreign exchange reserves administered by central banks and their loans outstanding to government, commercial banks, and, during crises, directly to businesses. There are two principal uses of monetary base, namely, currency and bank deposits with central banks. The central bank has a monopoly right over the issuing of bank notes, coins, and sets the minimum reserve requirements for the commercial banks. The reserve requirement ratio requires commercial banks to keep a certain fraction of their deposits as reserves, and hence, just like a tax on bank deposits, reduces their capacity to lend and invest. Normally, central banks expand money supply by buying short-term government papers, such as Treasury bills, and paying for them by printing money. To contract the money supply, central banks sell government papers and withdraw money from circulation. Central bank activities designed to affect the money supply through the buying and selling of government papers are referred to as open market operations (OMO). In the absence of short-term government securities, as in the case of Indonesia, the central bank creates its own short-term debt instruments. As the bankers' bank and lender of last resort, a central bank also offers short-term credit facilities to the commercial banks.

At the beginning of the crisis, the U.S. Fed encouraged banks to borrow using the discount window facility by lowering the penalties on such borrowing. The discount window is used as an instrument to influence the reserves of the commercial banks and hence money supply. The facility is backed up by government securities and has a very short-term maturity, usually overnight. Through the discount window, central banks can set their policy rates, discount rates, fees for loans and the quantity of loans. Banks are reluctant to borrow from the discount window as very often market participants will perceive them as being in trouble and may begin to pull their funds. In December 2007, four months after the crisis erupted, the U.S. Fed introduced three new lending facilities with wider collateral requirements and longer maturities.

On the international front, the U.S. Fed has coordinated its monetary policy with other leading central banks so as to provide liquidity to the globalized interbank and money markets, and has cut its nominal discount rates to close to zero at the present time. The U.S. Fed has also established temporary bilateral currency swap facilities with 14 central banks to allow participating institutions to draw down balances denominated in the U.S. dollar to meet their needs in that currency⁶. Governments, banks, companies and investors outside the U.S. have borrowed huge amounts in dollars. However, renewing these loans and rollover corporate and sovereign debts has become more expensive, especially for emerging economies. The combination of rising interest rate and tightening lending standard has made it more difficult for these economies to repay the debts. This problem is likely to continue after the crisis. Similar swap facilities have also been established by the ECB and, in line with the Chiang Mai spirit, by central banks in this region. South Korea received currency swap facility from Japan and China. China increased the amount of currency swap facility made available to Indonesia.

Similar to credit lines from international and regional financial institutions, bilateral currency-swap facilities add to the foreign exchange reserves of the recipient countries. The currency-swap facility is designed to expand lending facilities and cut policy rates, to revive the frozen credit markets and stagnant bank lending both to businesses as well as consumers, and lower interest rates spread. During the early stage of the crisis, Taylor and Williams reported that central bank target interest rates had become disconnected from the overnight rates. This was partly because the markets were uncertain about U.S. policy regarding the losses on sub-prime mortgages, with the result that interbank interest rates and the cost of borrowing have been pushed up⁷.

As normal procedures have proved ineffective in restoring the proper functioning of interbank and money markets, the U.S. Fed has revised its procedures by switching to monetary easing. Pumping liquidity into the economy has not worked, however, because of the liquidity trap as nominal interest rates are now close to zero and already negative in real terms. As interest rates have nearly hit the zero boundary, the Fed cannot push them much lower. With interest rates close to zero, Treasury bills are transformed into the equivalent of cash as both of them become perpetual government bonds that carry no interest. In the liquidity trap, the demand for money is infinitely elastic. Because of this,

⁶ The central banks are those in Australia, Brazil, Canada, Denmark, ECB (the European Central Bank), Korea, Japan, Mexico, New Zealand, Norway, Singapore, Sweden, Switzerland, and the United Kingdom.

⁷ Taylor, John B. and John C. Williams, 2009. "A Black Swan in the Money Market". *American Economic Journal Macroeconomics*. 1(1). January. Pgs. 58-83.

people prefer cash to bonds as the future rise in interest rate would consequently cause a fall in bond prices. Therefore, like the Bank of Japan in the 1990s, the U.S. Fed is now purchasing financial assets outright, starting with the longer term Treasury bonds and securities issued by government-sponsored enterprises, such as Fannie Mae and Freddie Mac. The types of securities that can be purchased by central banks can be expanded to include corporate bonds, state and local government bonds or even the sovereign bonds of foreign countries.

4.2 Stabilizing the Financial System

To stabilize the U.S. financial system, on October 14, 2008, the U.S. Congress authorized the Treasury to establish TARP (Trouble Assets Relief Program Funds) amounting to \$700 billion. The TARP facility is being used to address solvency problems in the banking system and in other financial institutions by injecting capital into them, and by removing toxic assets from their balance sheets. To avoid further erosion in the financial condition of banks, including their Tier 1 or core capital, Securities and Exchange Commissions around the world have banned short selling of shares of financial institutions and their clients.

Panic withdrawals of deposits from banking system have been stopped by restoring trust and confidence through broadening the coverage and increasing the size of the guaranteed liabilities of insured institutions by deposit insurance companies. Similar blanket guarantees on bank deposits have been introduced all around the world, including this region. To avoid disruption of foreign trade and investment, some emerging economies, such as South Korea, have provided guarantees for foreign-currency borrowings by their private sectors.

The process of bank consolidation in the U.S., backed by government, started with the provision of emergency financing by the New York Fed to JP Morgan on March 14, 2007, to enable it to take over the financially distressed Bear Stearns, a large and well-regarded investment bank. The availability of TARP funds has accelerated the process of consolidation through mergers and the conversion of many non-bank financial institutions (NBFI) into regular commercial banks. In return, for a closer scrutiny by the central bank, the commercial banks are entitled to receive liquidity support from the bankers' bank.

Through capital injections, loans and guarantees on commercial debts, the U.S. government has effectively nationalized the financial sector and automobile industry in the United States. The Treasury allocated \$250 billion of the TARP funds for recapitalizing large banks (\$125 billion each for 9 large banks), smaller local banks, savings associations, and certain bank and savings and loan holding companies. The large banks that have received TARP funds include JP Morgan, Citigroup and Wells Fargo. A number of small and financially weaker institutions have been taken over by financially stronger ones. The NBFIs in the U.S. that have been approved to become regular commercial banks include industrial loan companies, such as GMAC, IB Finance Holding Companies, CIT Group, the American Express Company and the American Express Travel Related Service Company (AMEX). Owned by General Motors, GMAC

has been a primary source of financing to customers and dealerships seeking to purchase and lease GM vehicles. AMEX provides charge and credit payment-card products and travel related services all over the world.

One hundred billion of the TARP funds has been used to purchase direct obligations of three housing related government sponsored enterprises, namely, Fannie Mae, Freddie Mac and the Federal Home Loan Bank, while \$500 billion has been allocated for the purchase of mortgages guaranteed by these quasi governmental companies. The American International Group (AIG), a large insurance company, received a capital injection of \$40 billion in TARP funds. The financially distressed car makers, General Motors, Ford, and Chrysler, are seeking \$25 billion in financial support from the TARP funds.

After rigorous stress testing, 10 of the financially sound US banks in early June 2009 repaid \$68 billion of the TARP funds back to the Treasury. The banks include JP Morgan-Chase, Goldman Sachs, Morgan Stanley, US Bankcorp and Amex. Other giants such as Citicorp, Bank of America and Wells Fargo remain in the program. Compensations of the executives of financial institutions under TARP Program is subject to scrutiny of the Treasury to protect the interest of shareholders and tax payers and reinforcing the stability of firms and the financial system.

The Eurozone, with one currency for 15 sovereign member countries, possesses neither a single supervisory authority nor integrated supervision of Euro area banks with lender of last resort facilities to help prevent a recurrence of the present financial turmoil. Eurozone does not have a concerted plan to deal with the failure of systematically important cross-border European banks, either. Each member country supervises the financial institutions within its own jurisdiction, and acts individually to resolve the liquidity and solvency problems of its own home banks. After the collapse of the Icelandic banks, it became clear that both supervision and support on the part of the Icelandic central bank were insubstantial.

To protect their financial systems, the authorities around the world have developed programs similar to the U.S. recapitalization bailout program. There are three ways in which government has injected capital and removed toxic assets from bank balance sheets. First, the public sector directly purchases the toxic assets from the financially distressed banks. This is the original plan of the U.S. Treasury. Second, the government provides asset guarantees in return for warrants, the way the U.S. Treasury rescued Citigroup. The third way is to establish bad banks to purchase toxic banks from the financially troubled financial institutions. This plan has been abandoned as it turns out that it is not easy to buy toxic assets due to the difficulty in assessing their price in a time of crisis in order to insulate taxpayers from losses.

4.3 Fiscal Policy

Fiscal policy, both tax cuts and expansion of government spending, has been the most powerful policy instrument to expand aggregate demand after the credit crunch made monetary policy ineffective in expanding consumption and investment expenditure, and hence increasing economic growth. Fiscal stimulus is expected to cause an

incremental increase in aggregate demand. This only happens, however, if the recipients, both households and businesses, are willing to spend more money than they would otherwise have spent. Because of this requirement, the structure of a fiscal stimulus is very important as it does not only impact the aggregate demand, but also income distribution. Another important element of fiscal policy is the timing of both tax cuts and expenditure expansions.

Fiscal policy that will cause unprecedented budget deficit is only, however, a temporary initiative and cannot be continuously relied upon as it can negatively affect a country's solvency. Government borrowing from both domestic and international financial market to finance budget deficit raises interest rates and crowds out private investment. The slowdown in private sector investment reduces productivity and the standard of living. At present, gross public debt of the G-20 economies will reach 106 percent of GDP in 2009 as compared 78 percent in 2007. Servicing domestic and foreign debt requires higher future taxes to pay both the principal as well as the interest on that debt. The resulting higher tax rates distort economic incentives. Servicing external debt requires an increase in export revenues and causes transfer problem that weaken economic performance.

The large number of issuers of sovereign bonds for financing fiscal stimulus increases competition for a limited pool of international savings that will increase interest rates in international markets. This in turn will reduce access of both the corporate sector and the governments of many countries to the international credit markets. In January 2009, Standard&Poor downgraded sovereign credit rating and long-term sovereign debt of many countries, including Greece, Spain and Portugal because of their deteriorating public finances and exports. During the time of crisis, government tax revenue is declining and government social spending is increasing. A combination of the shrinking supply of funds, rising credit risk, the increase in interest rate, and the downgrading of sovereign credit rating as well as bonds of the emerging economies has ended the easy credit and has given the way to a withdrawal of funds from less advanced economies. Political pressures, government regulation and 'moral suasions' are increasingly putting pressures on financial institutions to give priority to home markets. The state support of financial institutions in many countries, for example, is increasingly accompanied by explicit obligations to lend to support businesses and jobs at home, not abroad. Banks themselves are retreating from overseas markets to minimize credit risks. Credit risk in home markets is perceived much easier to manage than in overseas markets. In his remark recently at the World Economic Forum in Davos, Lord Adair Turner, the Chairman of Britain's Financial Services Authority, calls the reflux of capital from foreign markets to home ones as "the risk of new mercantilism" centered on credit availability.

At the November 2008 summit in Washington D.C., the G-20 recognized the need to coordinate sporadic fiscal policy initiatives to overcome the present global crisis. In reality, however, there has been no effective global fiscal policy response to magnify the combined impacts of coordinated national stimuli. The Eurozone also lacks a central fiscal authority. Fiscal policy coordination in the EU is dependent on the government budget deficit rule (not higher than 3 percent of the GDP) and debt rule (no more than 60 percent of the GDP), as set out in the Maastricht stability pact of 1991. The EU

(European Union) proposed a Euro 200 billion economic stimulus program on November 27, 2008, which amounted to 1.5 percent of the EU's GDP. The funding (Euro 170 billion) is expected to mainly come from contributions by the EU's 27 member states in the form of tax cuts and expansion of infrastructure expenditures. Some member states, however, are unwilling to make large commitments.

Table 1 shows fiscal stimulus packages in leading economies as of the first week of December 2008. Again, the Table indicates the contrast between the size of the US fiscal policy with those of members of the European Union. Fiscal stimulus in Germany, the leading economy in the Eurozone, for example, only amounted to below 4 percent of its annual GDP for the Fiscal Year 2008-10. Most of the fiscal stimulus in Germany is to be spent on infrastructure investment. In contrast, the stimulus packages in the United States and Taiwan was around 5 percent of GDP, while the figure in Japan is 2 percent. On January 22, 2009, Singapore announced a larger fiscal stimulus totaling S\$20.5 billion equivalent to 8 percent of GDP, partly financed by withdrawing \$4.9 billion from its fast external reserves. The objectives of the Singaporean stimulus program are to save jobs, to help viable companies to stay afloat, to provide support to low income groups and to finance long-term sustainable projects such as health, education, green transport and energy. On January 28, 2009, the U.S. House of Representatives passed a \$787.2 billion economic stimulus plan containing emergency spending and tax cuts as proposed by the new administration of President Barack H. Obama came to power on January 20, 2009.

China is one of the countries in this region that has had both huge budget and large current account surpluses for many years. The country has also accumulated nearly \$2 trillion in foreign exchange reserves. All this allows China to step up domestic spending to fill the gap left by a major drop in exports due to recession in its main export markets, namely the U.S., Europe and Japan. Cash rebates for low income groups will likely be more effective in promoting expansion of aggregate demand in China than tax cuts. Tax rebates for middle and high income groups in thrifty China are unlikely to work as people will simply save the money. This is because household tax is either non-existent or very light in China.

The recently announced fiscal stimulus package in China, amounting to four trillion Renminbi (\$586 billion), or 16 percent of the GDP, is unlikely to be enough to maintain the minimum economic growth of 8 percent in order to absorb new entrants to the labor force. The structure of the stimulus package will not encourage domestic spending as it focuses on modernizing railways, building roads and airports, rebuilding the rural areas devastated by the Sichuan earthquake in May last year, and other infrastructure projects that may be useful to support short-term economic growth, but not long-term productivity. Only about 1 percent of the fiscal stimulus will be spent on expanding social services to cope with the economic downturn by easing the burden on families as regards education, healthcare, old age and unemployment.

Australia, Japan, South Korea and Taiwan can also afford to expand domestic aggregate demand to ease the global crisis. Benefiting from the commodities boom, Australia has enjoyed budget surpluses and ballooning external reserves since the mid-1990s. Japan, while it has large external reserves, also has large government debt. South Korea and Taiwan also have financial resources. Like China's exports, the exports of

sophisticated manufacturing products from Japan, South Korea and Taiwan are also suffering from falling demand in their traditional markets in the U.S. and Europe. South Korea has announced a 33 trillion won fiscal stimulus in its 2009 budget. Australia unveiled a large stimulus plan on February 3, 2009 totaling 41.5 billion Australian dollars or US\$26.19 billion over the next four years in combination of cash handouts, infrastructure spending and tax breaks. Fiscal stimulus in Taiwan includes shopping vouchers worth NT\$3,600 (\$107) per person. Low income workers, farmers and students in Australia are given cash hand outs A\$1,000 each to spend.

Weak fiscal balance and small amount of fiscal surplus and external reserves limit the capability of developing and emerging economies to introduce fiscal stimulus. Raising funds through selling sovereign bonds is difficult while raising tax revenue is likely impossible due to the economic recession and weak tax administration. As evident in Indonesia's experience in the early sixties, printing money for financing expanding government spending will cause a high inflation rate with disastrous consequences. At the same time, widespread tax evasion makes tax break a useless policy to stimulate economic growth. Most of the fiscal stimulus in Indonesia is in form of tax relief. Expansion of expenditures are mainly financed by unused expenditures of the past budget and from government borrowings.

5. Recommendations for regional policy coordination and cooperation

The economies of Asia-Pacific are sitting on huge foreign exchange reserves, which are mainly invested in U.S. dollar denominated assets, particularly U.S. Treasury papers. As of November 2008, six of the top ten countries in terms of foreign exchange reserves in this region were-- China (\$1,885 billion), Japan (\$977 billion), Taiwan (\$292 billion), South Korea (\$212 billion), Singapore (\$162 billion) and Hong Kong (\$155 billion). These exclude Russia (\$441 billion), which is a member of APEC, and India (\$239 billion) in South Asia. Learning from the experience of the Asian financial crisis of 1997-98, the countries of the region have long been accumulating foreign currency as a shield to ward off speculators. This region has generated savings both from exports and the boom in commodity prices. The money, however, is unevenly distributed.

Well endowed with the huge amounts of foreign exchange reserves, the Asia-Pacific economies can forge five forms of economic cooperation and coordination to achieve common goals. First, to stimulate national economies through the expansion of both public sector spending and private consumption expenditures. As pointed out earlier, in the long-term, the export-led development strategy of many Asia-Pacific economies can gradually be replaced by domestic oriented growth strategy particularly in the countries with potentially large domestic demand. The usefulness of tax rebates is limited in the emerging economies of this region due to the people's thriftiness, the low number of effective taxpayers, and rampant tax evasion and avoidance. Coordinated and well-structured efforts in Asia Pacific are capable of amplifying sporadic national programs for mutual benefit. Part of the economic stimulus should be to build modern infrastructure that is so badly needed for further growth in this region.

The program to stimulate national economies with large external reserves includes expansion and the strengthening of domestic demand by correcting the government

policies that suppressed both the share of wage income relative to GDP as well as domestic household consumption. To lift up the share of wage income relative to the GDP, there is a need to correct government policies that are biased towards manufacturing industries and, particularly favor capital-intensive industries. The program to ease the burden of families in social service expenditures such as health, education, old age and unemployment benefits, also requires the modernization of the financial system such as social security, health insurance and pension funds. Policies that favor capital intensive manufacturing and export oriented development program include subsidies and tax breaks, interest rates and exchange rate policies.

Second, to use the huge external reserves of this region for expanding the bilateral currency swap arrangements under the Chiang Mai Initiatives (CMI) so as to facilitate intra regional private sector investment and trade in the Asia-Pacific. The CMI can be expanded by increasing the number of country participants, increasing the amount of the swaps, and by making the use of swap facilities more flexible. Ideally, the funds should be multilaterally pooled as a kind of collective action to help neighbors in meeting their liquidity needs. These pooled financial resources could be used to directly lend to member countries in need. The facility could also be used as credit enhancements or guarantees to facilitate member countries in borrowing in the regional and international financial markets to overcome the growing financial mercantilism. The recent trilateral summit between Japan, China and Korea that provided a currency swap for Korea represents a good starting point for reforming the CMI. This currency swap facility, and a currency swap facility provided by the U.S. Fed, will allow Korea to address the urgent issue of capital flight because of the high dependency of both its private sector and banking system on foreign funding.

To operate a multilateral pooling of exchange reserves, the Asia-Pacific region needs to establish macroeconomic surveillance. At present, this region relies on inputs from the Asian Development Bank, the only regional financial institution in the Asia-Pacific.

Third, to provide financial resources to emerging countries in this region, in order to limit the adverse effects of global crisis on their economic growth and employment, particularly due to adverse capital outflows and decline in exports. This can be done through bilateral mechanism and/or through multilateral financial institutions such as the ADB, IMF and the World Bank. The recent pledge by Prime Minister Taro Aso of Japan at the World Economic Forum in Davos to provide aid amounted to 1.5 trillion yen (\$17 billion) to emerging economies in Asia is a welcome initiative. The financial assistance would be used for building infrastructure projects in the recipient countries.

The London Summit of G-20 in April 2009 pledged to raise fiscal stimulus to \$5,000 billion. Of this, \$500 billion for IMF funding and \$250 billion allocation of Special Drawing Rights, another \$250 billion for trade finance and \$100 for increasing capital of all development banks to provide aid for poorest. Japan and the United States have committed to contribute \$100 billion each to the augmented New Arrangement to Borrow at the IMF.

Aside from increasing the capacity of regional and international financial institution to lend, the principles to borrow from these institutions need to be changed by relaxing conditionality for those countries that are facing difficulties mainly because

external adverse effects and not because of their fault. Stringent conditionality should be applied to those countries with policy inadequacies.

Fourth, to strengthen regional cooperation to avert the threat of financial mercantilism. Closer regional economic cooperation on financial issues can be started by forging closer cooperation of bank and financial market regulators in sharing information on the management of liquidity by banks, total leverage and assessment of risk-weighted assets. Because of the oversensitivity of sovereignty, diversity in the levels of economic development and social system in this region, creation of a single supervisor of cross border banks and financial markets is not feasible at the present time.

Fifth, policy coordination should also be strengthened to ward off the return of trade mercantilism that would only serve to deepen the recession. This requires close policy coordination on exchange rate management, the environment, state aid, agriculture, trade and investment.

Jakarta, June 9, 2009.

Table 1. Fiscal Stimuli for FY 2009 in Leading Countries

Country	Size of Stimulus		The Use of Stimulus
	In Nominal Terms	As % GDP	
1. The United States	US\$500 billion to US\$700 billion	3% to 5%	<ul style="list-style-type: none"> ▪ Income tax cuts for consumers and temporary increases in food stamp payments for lower income groups. ▪ US\$136 billion in infrastructure projects that are “ready to go”. ▪ Investments in renewable energy projects and other “green jobs” initiatives.
2. Germany	31 billion euros	1.25%	<ul style="list-style-type: none"> ▪ 15 billion euros for new lending to companies through state-owned bank KfW. ▪ New government investments and contracts in infrastructure and transport.
3. Britain	£20 billion	1.2%	<ul style="list-style-type: none"> ▪ Tax cuts and £3 billion of capital spending. ▪ Cut in VAT (sales tax) to 15% from 17.5%. ▪ Tax repayments where business can offset current losses against past profits, and tax exemptions for companies’ foreign dividends.
4. France	26 billion euros	1.3%	<ul style="list-style-type: none"> ▪ 10.5 billion euros on infrastructure, research and development, and financing for local authorities. ▪ Aid for the auto industry with a 1,000-euro subsidy for car buyers to scrap their old vehicles and buy new, more environmentally-friendly models. ▪ 11.4 billion euros to help companies by early reimbursement of state debt due them, spending to create or safeguard jobs. ▪ 1.8 billion euros for more zero-interest housing loans and public housing schemes
5. Russia	US\$20 billion	1.5%	<ul style="list-style-type: none"> ▪ Cut in tax on profits to 20% from 24% and a new depreciation mechanism that will allow firms to reduce the profit tax further. ▪ Billions of dollars of soft funding from state-run banks to support industry.
6. Japan	5 trillion yen	2%	<ul style="list-style-type: none"> ▪ 2 trillion yen in direct cash payouts to families, tax breaks on mortgages, bank rescue scheme involving 2 trillion yen in public fund injections, and tax relief for small firms.
7. China	4 trillion yuan	16%	<ul style="list-style-type: none"> ▪ 1.8 trillion yuan on large-scale infrastructure projects such as railways, roads, and airports. ▪ 1 trillion yuan to rebuild areas ravaged by May’s Sichuan earthquake. ▪ Lower-income housing, large-scale environmental cleanup, rural infrastructure, and industrial restructuring.
8. Australia	A\$15.4 billion	1.2%	<ul style="list-style-type: none"> ▪ Spending on hospitals and schools to generate 133,000 jobs
9. South Korea	14 trillion won	1.5%	<ul style="list-style-type: none"> ▪ Wide range of tax cuts including corporate tax and income tax over five years. ▪ 8 trillion won to help the construction industry including buying firms’ unused land and unsold new homes.
10. Taiwan	NT\$483 billion	3.5%	<ul style="list-style-type: none"> ▪ A NT\$82 billion shopping voucher handout-or NT\$3,600 for every one of its 23 million citizens. ▪ NT\$58.3 billion in infrastructure spending to create 100,000 jobs by mid-2009. ▪ Subsidies to low-income households and tax cuts for private investment.
11. Singapore	S\$2.9 billion	1.2%	<ul style="list-style-type: none"> ▪ Enhancing existing business financing schemes by giving bigger loans, raising government risk sharing of loan defaults and extending schemes to all local enterprises. ▪ S\$600 million packages over two years to enhance job training programmes and increase training subsidies for workers.
12. Hong Kong	HK\$19.3 billion	1.2%	<ul style="list-style-type: none"> ▪ 66 small-scale projects to create over 12,000 jobs. ▪ Construction brought forward to 2009 from 2010 on a mega bridge to link Hong Kong, Zhuhai, and Macau.
13. Malaysia	RM7 billion	1.1%	<ul style="list-style-type: none"> ▪ RM5 billion for construction and upgrading of infrastructure such as schools, high speed broadband, hospitals, roads, low-cost housing, and government buildings. ▪ Fuel subsidies and a cut in employees’ pension fund contribution to 8% from 11%. ▪ RM600 million for worker training programmes.

Source: The Straits Times, Saturday, December 6, 2008, pages A12-A18.