

The Subprime Mortgage Crisis, Capital Flows, and the Asian Economy

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**Opening Remarks
by
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Introduction

As you know very well by now, financial markets in the United States (US) and in a number of other industrialized countries have been under considerable strain since August 2007. Financial market conditions have in turn negatively impacted economic prospects across the globe, most notably by affecting the liquidity situation. It is likely that the upcoming chain of events might lead to sudden shifts of global capital flows, which would subsequently affect financial conditions and growth perspectives in Asia.

Thus, it is only proper to think about possible ramifications of the subprime fallout in the Asian context as Asia is largely responsible for generating excess liquidity that ended up in the US subprime lending. Given that subprime-related losses require sizable capital injection for securing financial stability in the US, some drastic changes in liquidity situations are unavoidable for Asian emerging economies. This would lead to further corrections in asset markets, especially in real estate, which will eventually impair collateral values and bank balance sheets. Given that the real estate market is tightly regulated in most Asian economies, and the overriding importance of asset market stability in securing credit channels, heightened volatility in the financial markets is likely to hurt growth potentials and aggravate inflationary concerns.

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inflation outlook remains highly uncertain, especially in Asia. The weakening dollar and demand inertia, and policy efforts to sustain growth momentum via extended credit contribute to this prospect.

In a global context, especially given that the US has been experiencing unprecedented financial instability and economic contraction, the rest of the world is braced for a similar chain of events, if not a moderated one. Now that the Beijing Olympics have become memories of the past, some changes in Chinese policy stance toward growth are expected to put more pressure toward stagflation in other countries. Specifically, the upcoming turn of events will jeopardize asset price stability to pull the trigger on the housing collapse. When this happens, even robust economies in Asia would face serious challenges of avoiding a sharp economic downturn. In short, Asian economies are behind the curve of subprime-related shocks and when things get serious, markets are likely to experience “a sudden stop” and the economic toll would be far greater than that experienced by the US. With weaker financial systems that occasionally freeze and export-oriented economies that cannot escape from the US downturn, it would propagate and amplify the external global shock to take a bigger toll on the Asian economy.

Sources of the Current Financial Turmoil

Although the severity of financial stresses became apparent only in August 2008, several factors served as a prologue for the recent turmoil and helped bring us to this current situation.

The first of these factors was the asset bubble driven by a global liquidity glut. From 2000 to 2005 alone, house prices in the US increased by roughly 60 percent, which “turned to bust” in 2006. Further, global excess liquidity made us assume greater risks in the form of complex derivatives and massive securitization that were poorly regulated. In fact, we have been “planting the seeds” for the current crisis for many years.

A second factor contributing to recent financial and economic developments is the unprecedented growth in China and India. The rapid growth in the emerging markets has been the most dominant factor in increased demand for raw materials and the current inflationary pressure. And the overall picture of global capital shows drastic

increases in oil revenues and foreign reserves, which reflects “poor allocation” in a globalized environment. In short, the pressure of increased Asian and Middle Eastern savings led to lower long-term real interest rates around the world, stimulated asset bubbles, and pushed current accounts toward deficit in the US. By extension, the current economic and financial situation reflects the global unwinding of the housing boom and the credit boom amid stronger performance of Chinese and other Asian economies.

Wrapping-up: Call for the Asian Economic Summit

National authorities will continue to face serious challenges ahead as the need for strong growth and financial stability often comes into conflict with the goal of price stability. An initial easing of monetary policy has been emphasized to proactively address the sharp deterioration in financial conditions and to forestall some of the potential adverse effects on the broader economy. However, this creates moral hazard of “too big to fail” in the newly-broadened financial system and also jeopardizes the anchor position of the US dollar in the global financial system. For instance, the new liquidity facility at the US Federal Reserve led to reductions in funding pressures and helped to promote an orderly resolution of current market dislocations. However, inflationary pressures and a weakening US dollar direct us to approach global economic issues more carefully. In recognition of the global nature of financial markets, this direction of efforts needs to be better consulted and discussed for better coordination among sovereign countries.

Further, regulatory efforts need to put in place changes that will help make the financial system less vulnerable in the future. Among the changes we expect to see are the strengthening of capital and liquidity rules, greater disclosure requirements, an increased emphasis on the measurement and management of systemic risks, and further steps to increase the transparency and resilience of the financial infrastructure.

In the region, even with lingering effects of financial instability, no consensus has emerged yet. It seems national authorities try to protect national interests first and often delay necessary policy coordination. For instance, Asian banks were somewhat passive in interest rate policy as their growth momentum remained intact despite initial subprime shocks, adding more pressure on US dollar.

I emphasize the serious need to cooperate regionally in future policy coordination for the dual mandate for price stability and job-creating growth. We have to derive regional solutions within which individual countries pursue their own set of policy efforts without violating regional concerns of creating jobs and maintaining price stability. In this vein, I propose an economic summit in the region to talk about exchange rate adjustments, industrial and environmental policy coordination, and better ways to strengthen the financial sector. This would serve as a wake-up call against the impending sub-prime fallout in Asia.

Even though this sounds unrealistic, reality wakes us to face the hard truth that a lack of global and regional governance has continued to fail to address the real issues facing us. Ignoring the need to resolve these issues would only increase our stabilization costs, and debilitate our growth momentum significantly. To preserve the core set of financial indicators, we need stronger joint efforts to compensate for the inherent lack of market infrastructures, and serious vulnerabilities most emerging economies have in common. Specifically, given that our financial system expanded beyond national boundaries, a new set of regulatory efforts to preserve financial stability seem necessary. And future policy efforts need to take these changes into account to come up with better regional solutions. Once again, capital flows would seriously challenge financial stability and growth potential in the region. It is only proper to mull over the current subprime fallout in the Asian context as we enter the full-blown stage of global financial deleveraging and real economic adjustments.

Today, I am delighted to see this timely conference on subprime losses and implications for the region. The heated discussions in this seminar would surely help us motivate better-coordinated policy responses in the region. I extend my sincere thanks to Dr. Kawai, our distinguished experts from Asia and the support staff for quickly responding to our call for organizing this important meeting in such a short period of time. This will serve as a catalyst for future collaboration between Asian experts on many important topics. Thank you very much.