

# **Asia-Europe Economic Relationships: Prospects and Challenges**

**Luncheon Speech by  
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Distinguished guests, ladies and gentlemen:

I am honored to be here today to speak about prospects and challenges of Asia-Europe economic relationships. I would like to start with a discussion on the implications of the global financial crisis as it affects the prospects of Asia-Europe economic relationships.

We are currently experiencing the worst global financial crisis since the Great Depression. Over the last two months, we have witnessed failures and collapses of major financial institutions in the United States (US) and several European countries, as well as massive coordinated actions by their authorities to inject liquidity into money markets, to reduce policy interest rates, and to restore confidence in their financial systems. While the effectiveness of these measures still remains to be judged, the policies of industrialized countries affected by acute financial crises are now heading in the right direction.

Most recently, strong calls are being made for significant reform of the global financial system. The Group of Eight (G-8), joined by major emerging economies such as the People's Republic of China (PRC), India, and Brazil will hold a series of global summits beginning in November to forge a new system aimed at preventing future financial crises and maintaining global financial stability.

With the spread of the US subprime mortgage crisis to the rest of the US financial system and other industrialized countries' financial markets, a significant slowdown in economic growth has taken place in the US, Europe, and Japan. The crisis has moved from the financial sector to the real economy. In my speech today, I will focus on the impact of the ongoing global financial crisis on Asia.

## **I. Global Financial Crisis and Impact on Asia**

The unfolding global financial crisis is beginning to exert negative impact on Asian economies. Some economies are trying to respond in a serious way, especially as the crisis that struck East Asia eleven years ago and brought economic pain to a large proportion of the Asian population is still fresh in our minds. Many economists, including myself, have argued that the spillover effects of the US subprime mortgage crisis on the Asian financial and real economic activity have been and will be relatively limited, and

that the growth prospects of Asian economies will remain robust. Asian financial institutions' exposure to subprime-related products has been limited due to three factors: (i) they have lagged behind global financial institutions in incorporating highly complex financial innovations into their business models; (ii) many of them have been cautious in investing in high-risk, high-return instruments—such as mortgage-backed securities and collateralized debt obligations—after experiencing their own financial crisis eleven years ago; and (iii) their authorities have strengthened prudential supervision and regulation and risk management practices in their respective financial sectors. For example, Japanese banks fully implemented Basel II in March 2007, ahead of the European Union and the US. In addition, Asian banks and non-bank financial institutions are fundamentally sound, with well-capitalized balance sheets, low non-performing loan ratios (less than 5%), small exposure to real estate, and limited off-balance activities.

Recent developments, however, are raising concerns about the resilience of Asian financial and economic conditions. The global financial crisis is more acute and the real sector impact is likely more severe than had been hoped. According to the recent updated forecast by the International Monetary Fund released in early October, economic growth in advanced countries will be close to zero until at least the middle of 2009, while the relatively high economic growth in emerging and developing countries will slow to substantially lower rates than in the recent past. In the PRC, figures for the third quarter showed an annual growth rate of 9%, well below the 2007 record of 11.9%, suggesting that the global financial crisis has begun to affect the country's real economy. India's growth is also expected to decelerate from 9.3% in 2007 to 6.9% in 2009. Similarly, Association of Southeast Asian Nations (ASEAN) countries will slow down from 6.5% in 2007 to below 5.0% in 2009. Indeed, the global financial crisis could send the world economy into a recession.

The acute global financial crisis and looming slowdown in the industrialized economies have had first round effects on Asia's financial markets through capital flow channels and are beginning to exert second round effects on the real economy through trade channels. Before the outbreak of the US subprime crisis, most Asian economies had faced the problem of receiving too much private capital inflow, which potentially could have undermined macroeconomic and financial sector stability. Today, private capital inflows are dwindling and in some countries these inflows have stopped or even reversed. The global financial crisis has already induced capital outflows from many emerging Asian economies, thereby causing currency depreciation and sharp falls in stock market prices. One of the reasons for this is that many US financial institutions have been trying to secure needed cash and capital by deleveraging their overextended balance sheets—that is, by selling both domestic and foreign assets. As a result, many Asian countries are now facing steeply rising risk premiums and their access to the international capital markets is severely curtailed. Particularly vulnerable to this new development are countries that had enjoyed large capital inflows with large current account deficits, large external debt, and high inflation rates.

The slowdown of the industrialized countries is beginning to have negative effects on Asia's real economic activity through trade channels. The rapid expansion of Asia's intraregional trade observed over the past decades—driven largely by trade in parts and components within regional production networks—has been supported by the region's exports of finished manufactured products to world markets. Expansion of exports to the US and European markets has been essential for Asia's sustained growth. The prospect of weak demand for emerging Asia's products—due to the downturn of US, European,

and Japanese economic growth—could slow its exports and foreign direct investment inflows, further reducing Asia’s economic growth.

In addition, countries with traditionally large remittance inflows from overseas workers—such as India, Philippines, Viet Nam, and Indonesia—may face declining remittances from abroad. Economic slowdown in industrialized economies could reduce demand for foreign workers in these economies, causing a large drop in remittances. And workers may return home to find that home markets may have difficulty reabsorbing them.

## **II. Asian Responses**

Asian policymakers have taken several responses to the global financial crisis and looming global economic downturn. To protect banking systems, some economies in the region (like Hong Kong, Malaysia, and Singapore) have emulated what the US and some European countries recently did, i.e., they have guaranteed the repayment of customer deposits held with authorized institutions. Korea has unveiled a US\$130 billion package to guarantee short-term foreign bank loans. The Philippines and Singapore are considering easing the mark-to-market accounting rules so that declines in asset values—such as prices of equity—held by banks will not cause a severe credit crunch.

With the sharp decline in prices of oil and other commodities and the slower growth prospect, some countries have seen room for easing monetary policy to increase liquidity in the system without exacerbating inflation. The PRC, India, and Korea have cut the benchmark interest rates, while Bangladesh, PRC, India, Indonesia, and Pakistan have reduced reserve requirements on deposits. The PRC and Korea have decided to boost fiscal spending to offset the declining growth. Other countries with fewer resources—such as Indonesia, Philippines, and Pakistan—have started informal discussions with international financial institutions for precautionary financial packages to stabilize their economies, avoid balance of payments crises, or rescue financial institutions facing liquidity problems.

Although these measures have been uncoordinated, there is now a strong sense in Asia of the urgent need to minimize the negative impact of the global financial crisis and economic downturn on Asia’s financial sectors and real economy. A key strategy so far has been to maintain the confidence in the financial market, prevent the emergence of financial crises, and maintain growth. In this way, Asia is trying to maintain an engine of growth amid the global financial crisis and slowdown. This sets a stage for my next topic: Asia-Europe trade and investment cooperation.

## **III. Asia-Europe Trade and Investment Cooperation**

Asia has been diversifying its export markets. Total trade between developing/emerging Asia and Europe rose by more than 150% between 2000 and 2007—to around US\$830 billion, with Asian exports to Europe growing faster than European exports to Asia. In 2000, developing/emerging Asia’s total trade with the US accounted for 20% of its global total, but this share declined to 16% in 2007. In contrast, the share of developing/emerging Asia’s trade with Europe rose from 9% to 10% during the same period.

Foreign direct investment has also surged between the two regions. The stock of outward foreign direct investment (FDI) by EU-15 in emerging Asia—particularly ASEAN, PRC, Korea, and India—rose by 23% between 2000 and 2007, to US\$70 billion. Some Asian companies have invested in Europe. For the same period above, the Asian stock of outward FDI in Europe almost doubled to US\$14 billion.

Two-way trade and investment flows between Asia and Europe can indeed intensify economic links between them and can stimulate economic cooperation. One important way to strengthen economic cooperation is through forming free trade agreements between the two regions. Over the last several years, many Asian economies have pursued a strategy of forging free trade agreements (FTAs) with economies in the region and the rest of the world. ASEAN has been most aggressive in such moves. It has established, or is establishing, a series of ASEAN+1 FTAs with PRC, Japan, Korea, India, Australia, and New Zealand. Some of these “plus” countries are also negotiating bilateral FTAs among themselves. While producing the infamous “noodle bowl” of uncoordinated rules, regulations, and procedures under different, multiple FTAs, ASEAN’s initiatives can provide a basis for consolidating these overlapping FTAs into a single, East Asia-wide FTA among ASEAN+3 countries (ASEAN, PRC, Japan, and Korea) or among ASEAN+6 countries (further including India, Australia, and New Zealand).

The next agenda is to connect East Asia with the global markets, such as North America and Europe. The US has already proposed to form an FTA among Asia-Pacific Economic Cooperation (APEC) members, particularly between East Asia and North America. We also need to explore the possibility of forming an FTA among Asia-Europe Meeting (ASEM) members, particularly between East Asia and Europe. The European Union’s (EU) ongoing FTA negotiations with ASEAN, Korea, and India can offer a solid basis for an East Asia-EU FTA. It is crucial to make efforts at including not only liberalization of trade in goods and services but also wider issues, such as investment, intellectual property rights, competition policy, procurement, labor mobility/standards, and dispute settlement, in FTA negotiations so that the two regions can pursue deeper economic cooperation. Through such a commitment, both East Asia and Europe can strengthen trade, investment, and other relationships for mutual benefits.

So Asia’s approach to trade and investment can be a stepping stone towards global integration, by first forming an East Asia-wide FTA and then linking itself with North America and Europe. I believe this is a practical way of preserving multilateralism and supporting the WTO process, which we all value highly.

This broad picture of Asia-Europe economic cooperation can embrace some specific areas where Asia and Europe can further strengthen their partnership. Let me now elaborate on some of these.

#### **IV. Asia as a Partner with Europe**

Small- and medium-sized enterprises (SMEs) typically comprise a significantly large proportion of the total number of business entities in Asia. Contrary to the common perception that SMEs are not very active in technology transfer, surveys conducted by European chambers of commerce in Asia and also by some of the agencies in FDI receiving Asian economies show that a considerable amount of technology has been transferred from European SMEs located in Asia, especially in areas such as electrical

products, electronics, and machinery. SMEs are indeed modernizing themselves to improve productivity and competitiveness in the globalizing world economy. Thus, supporting the continuing growth of European SMEs in Asia is important for encouraging technology transfer and building a strong economic relationship between Asia and Europe.

Another area is human resource development. This is of utmost importance for both regions' businesses to remain competitive and innovative. Increasing student exchanges between Asian and European countries, enhancing reciprocal understanding, and developing a new international culture of people beyond the borders are all vital steps. Today many European universities and vocational schools—mostly from UK, France, Germany, but some also from Italy, Spain, and the Netherlands—have opened campuses in Asia or have started joint degree programs. European countries with strong technical vocational education and training programs could work with Asia's existing technical and professional schools to produce high quality graduates equipped to take advantage of changing demand for skills of businesses. These graduates can be a bridge between Asia and Europe.

Finally, elimination of the European perception that Asia is a threat for labor employment is a subject for cooperation between Asia and Europe. European business can learn a lot from Asia, as for several decades Asia has relied on outward-oriented, market-driven economic growth and focused on productivity and competitiveness enhancement. Pragmatism, flexibility, and adaptability to the changing global and regional economic environment have been Asia's main approach to maintain its global competitiveness. Strengthening relationships between Asian and European firms is an important way to bring the two regions together.

## **V. Lessons from European Economic Integration**

Finally, let me return once again to the responses of Europe and Asia to the current financial crisis. Difficulties hit Europe first, and Asia is considering possible collective policy responses. We hope to learn from Europe's success, and with luck avoid failure.

We recognize there are major differences in the policy environments. Most of Europe is under the overarching legal framework of the European Union, while Asia has legally independent systems. Although we Asians talk with each other, through such forums as the ASEAN+3 process and the East Asia Summit (for ASEAN+6 countries), we have far fewer cooperation forums than in Europe to address common policy issues and challenges, and we cannot impose actions on Asian countries. Much of Europe shares a single currency and can execute a common monetary and exchange rate policy, while Asia has multiple currencies that permit individual countries to adopt different policies and move in different directions.

The European response to the current financial crisis until very recently was not a coordinated one, but was looking at national interests first. One reason for this is that although the European Central Bank can pursue a single monetary policy, it has no direct authority over banking and financial sector supervision or deposit insurance, and there is no single fiscal authority that supports common, euro zone-wide fiscal affairs. But we now see much more concerted action in liquidity provision, deposit insurance, interbank claim guarantee, and bank recapitalization. It is interesting to observe that Europeans are now

beginning to discuss the possibility of setting up a unified financial sector supervisory framework. This would enhance financial stability in Europe, just as the single currency arrangement in Europe ensured not only intraregional exchange rate stability, but it must also have saved several peripheral countries from potential currency crises, unlike Iceland, Hungary, or Ukraine.

The rising degree of economic interdependence among Asian economies requires much more coordinated policy action. We need to support increasing institutionalization of Asian economic and financial cooperation by for example: (i) enhancing the ASEAN+3 Economic Review and Policy Dialogue (ERPD) process; (ii) strengthening the Chiang Mai Initiative (CMI)—which is currently a network of bilateral currency swap arrangements—through its multilateralization, size increase and further delinking to IMF programs; (iii) advancing the Asian Bond Markets Initiative; and (iv) creating an Asian Currency Unit (ACU) to initiate informal exchange rate policy coordination. We need to establish new institutions, such as an Asian Financial Stability Dialogue—an Asian version of the Financial Stability Forum—to ensure regional financial market stability and development, and a secretariat for Asian monetary and financial cooperation to support the ERPD, CMI, and ACU.

Asia has the potential to help bolster the global economy because its banking systems are relatively less exposed to the troubled assets and its economic fundamentals are stronger than anywhere else in the world. Sustaining domestic demand in Asia is vital to reduce the negative impact of the global financial crisis and economic downturn. With large amounts of financial resources available, Asia can embark on comprehensive programs for infrastructure development to sustain growth and social safety nets to mitigate the negative impact on the poor and socially vulnerable.

The world is entering a very important period in global financial history. In response to the strong impetus of European leaders, the international community will begin a series of global summits in order to reform the global financial architecture to prevent future crises like the one we face now and to put into place a new system that more closely reflects the current distribution of economic and financial power. Emerging Asian economies—such as the PRC, India, and ASEAN countries—will have to work closely with the G8 countries. Their views need to be fully reflected in any discussion of the reform agenda.

The time has never been more important for mutual dialogue and cooperation between Asia and Europe. Financial crises can provide opportunities to strengthen cooperation and this side of the coin gives us some “hope” for a better future, despite the “threat” posed by the crisis. This is a great opportunity for Asia and Europe to work together for ensuring a more stable and dynamic global economy.