

**Conference on
Global Financial Crisis: Europe in Crisis?
Lessons for Asia and from Japan**

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Welcome Remarks

by

**Masahiro Kawai
Dean
Asian Development Bank Institute**

Mr. Shunichiro Higuchi, President of the Policy Research Institute of the Japanese Ministry of Finance, Dr. Pier Carlo Padoan of the Organisation for Economic Co-operation and Development, Dr. Eric Berglof of the European Bank for Reconstruction and Development, colleagues from the European Commission, the private sector, the public sector, universities, and think tanks, distinguished guests, ladies and gentlemen. Good morning.

Let me express my gratitude to all of you for taking time off from your busy schedule to participate in the conference on the ***Global Financial Crisis: Europe in Crisis?: Lessons for Asia and from Japan***, jointly organized by Japan's Finance Ministry's Policy Research Institute and the ADB Institute.

The subprime crisis has now evolved into a full-blown global financial and economic crisis, the worst since the Great Depression in the 1930s. This crisis is different from other financial crises we have observed over the last several decades not only in its breadth and magnitude, but in its origin. The crisis is global, affecting almost all countries in the world, not just a few, and its impact so devastating. The epicenter of this crisis is not a peripheral country but the United States (US), which is the largest and central economy in the world, and home to the most dominant global key currency—the dollar—and the world's most sophisticated and developed financial system.

Today we will look at the crisis from the standpoint of its challenges and implications for Europe, with focus on the European Union (EU), particularly the eurozone, and its prospective members. This is very relevant for Asian economies, which are beginning to move down the path of economic cooperation and integration that the EU has pioneered. To be sure, Asian economies are approaching issues of integration somewhat differently from European countries, reflecting differences in levels of economic development, historical and cultural background, and policy priorities. Nonetheless, the impact of the current crisis on Europe and its responses are likely to provide many useful lessons for the integration process for Asia. At the same time, we will look at the lessons for Europe from the experience of Japan's earlier financial crisis.

Impact of the global financial and economic crisis on Europe

The current global economic and financial crisis poses the biggest challenge so far to the eurozone and the single currency, the euro, in its ten-year history. The eurozone and the euro have had a very successful first decade, and have proven many doubters wrong. The original group of 11 countries has expanded to 16, and four more are at the final stage before entry, while others are still lining up. Some European countries outside the EU are now keen on joining the eurozone, so they are considering joining the EU as a step to becoming eurozone members. The eurozone has seen steady and sustainable growth of 2.1% over the past decade. Moreover, this growth was accompanied by a decline of the unemployment rate from 9.1% in 1999 to 7.4% last year, and by low and stable inflation, averaging 2.2%. As a result, the eurozone last year attained an economic size of €9.27 trillion, or US\$13.6 trillion, almost as large as the US economy.

Now, the influence of the euro area extends well beyond its official size. Four countries, including Denmark, belong to the Exchange Rate Mechanism II, which is the final stage before joining the eurozone. A number of other countries have linked their currencies to the euro, either on the basis of bilateral agreements or unilaterally, including monetary unions in West Africa and Central Africa, the Czech Republic, Romania, Croatia, the former Yugoslav Republic of Macedonia, Latvia, Serbia, and Tunisia. In some cases, especially Latvia, these links are now under severe pressure.

So far, the euro has firmly established itself as an international currency with wide acceptance outside the eurozone. It has gradually emerged as the second most important key currency after the US dollar. A recent European Central Bank (ECB)

study and data from the International Monetary Fund (IMF) suggest that the share of the euro in global foreign exchange reserves has reached over 25%. Based on the latest Bank for International Settlements survey (2007) the euro was the second most traded currency in the foreign exchange markets globally after the US dollar and well ahead of the Japanese yen. The euro was on one side in 37% of all foreign exchange transactions worldwide.

Challenges to Europe

However, the current global financial and economic crisis has provided a severe challenge to the eurozone economy and financial system. The latest estimates of the IMF regarding total expected write-downs emanating from the subprime crisis are US\$2.7 trillion for loans and securities originating in the US versus only US\$1.2 trillion for those originating in Europe. However, the key word is “originating”, as European financial institutions are believed to hold close to half of the toxic securities that originated in the US. Adjusting for this, the losses likely to be suffered by European financial institutions are of the same magnitude as those for US institutions. Moreover, some of the worst-hit economies are in the eurozone, including Ireland, Germany, and Finland. Some European countries outside the eurozone have been even more severely hit, including Iceland, the Baltic States, Hungary, and Ukraine.

Against this background, the ECB and national governments have mounted an impressive counterattack of expansionary fiscal and monetary policy and financial sector support. On the whole, however, these responses have been more restrained than what has been seen in the US and the United Kingdom, for example, not to mention some Asian countries. The ECB only began to ease policy in October of last year, and the cumulative rate reduction of 325 basis points has been less than what was seen in the US. The ECB has also been less aggressive in expanding the monetary base than the US Federal Reserve (Fed) or the Bank of England. The ECB has engaged in some “credit-easing” measures, but, again, much less than was done by the Fed. Fiscal stimulus measures have also been more restrained. The IMF estimates that the total fiscal stimulus relative to the 2007 baseline in Europe will be 1.0% of GDP in 2009 and 0.8% in 2010 (with some variations across countries), while that of the US is 2.0% of GDP in 2009 and 1.8% in 2010.

Moreover, fiscal and financial support measures have been implemented mainly at the national level, and without much coordination. This is of concern, given that some countries have limited capacity for expanding fiscal policy. The absence of a body for

coordinating fiscal policy may well have hindered Europe's ability to jointly respond to the ongoing crisis. The absence of a single financial supervisory and/or regulatory authority in Europe may have also reduced the effectiveness of policy response. The need to coordinate the response of large numbers of independent financial regulatory bodies has been daunting, perhaps even more so than in the case of the US.

On the other hand, monetary policy has been fully coordinated, as an inherent characteristic of the eurozone is a single currency, a single central bank, and a single monetary policy. This was nonetheless reflected in divergences among eurozone members in real interest rates and real effective exchange rates due to differential inflation rates and nominal interest rate spreads. As a result, countries with higher inflation faced lower real interest rates and stronger real exchange rates, thereby experiencing more active housing markets, greater construction investment, and larger foreign borrowing. This contributed to macroeconomic and financial vulnerabilities in a number of countries in the run-up to the global financial crisis, especially Ireland, Spain, and Greece. Vulnerabilities were even more apparent, with larger current account deficits in some of the non-eurozone countries including Iceland, Hungary, and the Baltic countries. The large exposure of European financial institutions has further complicated the matter. On the positive side, the euro has been an anchor of stability for eurozone members as they were able to avoid any speculative attack on the currency, something that could have happened to the legacy currencies if they still existed.

Given the single monetary policy for the eurozone, it will be important to address these issues of integration of fiscal policy and financial supervision and regulation if the euro is to achieve full status as an international key currency. This includes the development of a macro-prudential supervisory framework.

Lessons for and from Asia

Turning to Asia, there are still many challenges ahead for Asia's ability to absorb some of these lessons. The path to achieving macroeconomic and structural convergence will still be a long one. Asian economies are still very diverse in terms of per-capita income levels, human and social conditions, economic and financial systems, institutional and governance quality, and political systems. Trade is gradually being liberalized, but rules regarding capital flows, taxation, and financial services have yet to be harmonized. A region-wide free trade agreement (FTA) has yet to be created by consolidating the Asian noodle bowl of various types of

overlapping FTAs. Greater coordination also needs to be developed in the areas of fiscal policy, monetary policy, and exchange rate policy, including establishment of regional institutions that support such coordination.

What are the lessons that Japan can offer Europe? If one looks at Japan's financial crisis in the 1990s, there clearly was a long period of forbearance, and effective policy reactions were delayed until 1998, when the development of a systemic financial crisis forced a needed response. Once it came, however, the response was decisive and large-scale. One key lesson is the importance of stress tests of the financial system. The Japanese Financial Services Agency carried out quite rigorous tests to ensure consistency of loan classification across different banks, to identify non-performing loans (NPLs), to have banks remove NPLs from their balance sheets, and to inject capital into banks if needed. An important lesson is that new NPLs are likely to arise until the next economic recovery gets on a firm basis. Therefore, it is critical to halt any negative feedback loops between tightening of credit and weakness in the real economy.

The challenge is actually greater for Europe this time, because Japan benefited greatly from a strong global economy, which underpinned an export recovery that improved firms' profitability and therefore the quality of banks' assets. This time around, consumer spending in the US and Europe is likely to remain sluggish for an extended period. Europe, together with Asia and the US, will have to make greater efforts to find sources of sustainable growth of domestic and regional demand. It will also have to move toward a strengthened and more coordinated framework for financial supervision and regulation, and take steps to develop a deeper and more integrated financial market.

I believe that all of these important issues will be discussed and debated here in the conference. Hopefully, these discussions and debates can point toward key policy measures to be taken by Asian governments to achieve stable, sustainable economic growth for all.