

Global Financial Crisis and Japan–ASEAN Economic Cooperation

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Introduction

The world economy has been experiencing the worst global financial and economic crisis since the Great Depression. Over the past twelve months, we have witnessed the eruption of systemic financial crises in the United States and Europe, simultaneous contractions of output, a dramatic shrinkage of international trade and investment, and rises in unemployment in these and many other affected economies.

The US subprime mortgage crisis that had emerged by the summer of 2007 spread to the entire US financial system and financial markets of other industrialized countries. Many European countries also had their own financial vulnerabilities. While investing in “toxic” assets created by US institutions, they were also exposed to inflated real estate and Eastern European economies. With the failure of Lehman Brothers in September 2008, the crisis in the US and Europe moved quickly from the financial sector to the real economy. Real GDP contracted sharply in the US, Europe, Japan, and other economies affected by sudden stops—or even reversals—of capital flows and sharp declines in exports.

Most industrialized countries and many emerging economies that were affected by the crisis responded to it by easing monetary policy, resorting to fiscal stimulus, and providing financial sector support. The G20 summit, first held in Washington (November 2008) and then in London (April 2009), has become the leading forum for international policy coordination to enable the global economy to recover from the crisis and put the economy back on track to sustainable growth.

The central banks in the US and Europe embarked on “credit easing” by setting their policy rates at levels close to zero and purchasing various types of market instruments. Fiscal stimulus of 2% of GDP was called for. Programs for blanket deposit protection, interbank loan guarantees, bank recapitalization, and bad asset purchases were implemented or designed. In addition, International Monetary Fund (IMF) resources were raised to enhance its capacity to support crisis-affected economies—like Iceland, Hungary, Ukraine, Latvia, and Belarus.

As a result of these efforts, by early summer of 2009, we witnessed signs of incipient economic stabilization and recovery. It seems so far that the world has been able to avoid the repeat of the Great Depression of the 1930s. But this does not mean that the global economy will strongly recover; there are good reasons to believe that it will not, and that developed

country growth will be anemic for many years to come.

This paper focuses on the implications of the global financial and economic crisis for Asia—including Japan and the Association of Southeast Asian Nations (ASEAN) countries—and for Japan–ASEAN economic and financial cooperation.

Impacts on Asia and Asian Responses

Even though the crisis did not originate in Asia, Asian economies were hit hard by the downturn in export demand, and, in some cases, by turbulence in foreign exchange and capital markets as a result of a sudden stop in the inward flow, and/or the withdrawal, of capital. Exports have virtually collapsed, industrial production has declined sharply, and GDP contracted steeply in Japan; in the newly industrialized economies of Hong Kong, China; Korea; Singapore; and Taipei, China; and in export-dependent middle-income ASEAN countries like Malaysia and Thailand. GDP did not contract in the People's Republic of China (PRC), India, or Indonesia but their growth rates slowed. Many economies are now showing signs of recovery.

Similar to the US and Europe, many Asian economies responded with aggressive measures to ease monetary and fiscal policy and to support national financial systems. Although it is difficult to estimate the actual impact of these packages, the recent recovery seen in quarterly GDP growth in the second quarter of this year in Japan, PRC, Korea, Viet Nam, and others suggests that these policy steps are working.

The fact that Asian economies were able to take aggressive policy measures underscored the dramatic improvement that had taken place in macroeconomic and financial sector fundamentals in these economies since the Asian financial crisis of 1997–1998. A number of regional central banks had achieved low inflation, as a result of commitments to non-inflationary policy, while many governments substantially reduced fiscal deficits and contained levels of public debt.

The rise in foreign exchange reserves in the region, which many had criticized as being excessive, played a key role in minimizing currency turmoil in the region, while greater exchange rate flexibility also provided a cushion in the face of turmoil. Notably, the global financial crisis did not force any country in the region to go to the IMF for financial rescue, nor even raise interest rates to defend the currency value. Korea, which faced unusually large downward pressure on its exchange rate, was able to stabilize the situation by using the \$30 billion currency swap line established with the US Federal Reserve. Indonesia, another country whose exchange rate depreciated sharply, was able to secure \$5.5 billion for fiscal support in standby loan facility—referred to as “deferred drawdown options”—from Japan, Australia, the Asian Development Bank and the World Bank.

Asian Challenge of Growth Rebalancing

Nonetheless, Asian policymakers cannot afford to rest on their laurels. The reason is that although Asian growth is expected to recover in 2010, it will remain weak because of likely low growth globally.

Asian economies had benefited tremendously from export-led growth centered on US and European markets during the years leading up to the global financial and economic crisis. This growth model, however, can no longer be relied upon to sustain the region's economic growth beyond the crisis.

The reason is that US consumer spending will likely remain sluggish over many years to come, and this will be a structural long-term phenomenon, not a temporary one. US personal

consumption was excessively large until mid-2008 because households spent too much as a result of their inflated ability to borrow against the bloated housing equity created by the housing price bubble. This over-consumption in the US is now under retrenchment, forcing households to repay debt and rebuild wealth, a process which will last for some time. US (and European) consumers are unlikely to be the major source of growth for export-dependent Asian economies. In addition, the size of US and European potential GDP may have shrunk and their potential growth rate will likely be lower over the medium-term.

Asian economies need to adapt to this difficult environment and to take up the challenge of rebalancing growth toward greater reliance on domestic and regional demand. This presents a new development paradigm for Asia so that the region will not only remain the world's factory of manufactured products but also become a new source of global demand.

Policymakers in Asia should focus on three priorities:

- First, the demand side of the economy needs to be strengthened, particularly household consumption, which requires both household income and the propensity to consume to be higher. The propensity to consume can be raised by establishing or reinforcing social sector protection systems—including those for health, education, unemployment, and pensions—to provide households with “security” and predictability about their future and reduce needs for precautionary savings.
- Second, the supply side should be stimulated by focusing on investment in areas of future potential for long-term growth. This includes investment in human resources (for education, health, and training), infrastructure development, information and communication technologies, and green growth such as renewable energy development, energy conservation, and environmental improvements. Small and medium-sized enterprises (SMEs) often play a significant role in these areas.
- Third, regional market integration is essential to encourage regional trade in goods and services and foreign direct investment, thereby enhancing the potential for long-term growth in Asia. Integration of financial markets is also crucial to mobilize the high level of regional savings for productive investment within the region. In this sense efforts toward the creation of an East Asian Community will go a long way to supporting growth rebalancing.

While the challenges are substantial, the crisis could be an opportunity for Asia to fundamentally restructure its approach to development and bring about a more sustainable, balanced growth. Without intensive economic and financial cooperation among Asian economies, this growth rebalancing cannot be achieved.

Japan-ASEAN Economic and Financial Cooperation

How can Japan and ASEAN cooperate to help transform Asia into a more regional demand-oriented economy? I have identified five areas of possible cooperation.

Japan's growth strategy and ASEAN's structural reforms

The greatest contribution that Japan can make for ASEAN (and other Asian economies) would be to restore a healthy growth of 2% or more on a sustainable basis and open its economy to ASEAN (and other Asian) goods, services, investment, and skilled labor. To do so, Japan needs to establish a comprehensive growth strategy to address the challenges of declining fertility and aging population, the social security system reform, and massive public sector debt.

ASEAN countries need to continue to pursue structural reforms in key areas. Improving governance—the ability of governments to implement needed policies and deliver public services effectively—and creating conducive business climates are essential in maintaining economic resilience and rebalancing growth. Various sectoral reforms are needed to

implement judiciously its plan to build an ASEAN Economic Community (AEC) by 2015. ASEAN may set an even more ambitious objective of creating a customs union. These efforts would enable ASEAN members to present themselves as a unified market for global firms and investors and as East Asia's hub for regional integration and cooperation.

If Japan and ASEAN can jointly embark on these initiatives, the actions can set the stage for future sustainable growth. Complementarity between Japan and ASEAN can create opportunities for further cooperation. Essentially, Japan can assist ASEAN countries through the provision of technical assistance and long-term development financing in a way consistent with the countries' development strategies. Promotion of green growth (such as promotion of renewable resources and improvement of energy efficiency), human resource development, and building credible social sector protection systems would be areas of such cooperation.

Asia-wide economic partnership agreement

Second, the creation of an Asia-wide free trade and investment area going beyond the ASEAN Free Trade Area and Investment Area would contribute to the goal of rebalancing growth. This initiative would expand markets for Asian firms and consumers and create greater trade and investment opportunities within the region. Consolidating the existing Asian "noodle bowl"—an array of overlapping bilateral and plurilateral free trade agreements in the region—into a single agreement is a high priority as it would enable Asian business firms to enjoy the benefits of having access to larger integrated markets.

In addition to liberalization of goods and services trade, liberalization and harmonization of cross-border investment are also critical to further expanding regional markets and demand. In this way, Asian producers can target the expanding middle class in emerging Asia—totaling 880 million people in 2008 in the PRC, India, ASEAN and others. Asian governments should take concrete steps toward establishing an Asia-wide Economic Partnership Agreement.

To realize such market integration, it is essential that Japan open up its markets for all products—including agricultural and fishery products—and to temporary skilled workers from ASEAN and other Asian countries, and that Japan and the PRC work together. ASEAN could play a vital role in encouraging both the PRC and Japan to embark on negotiations for region-wide market integration. Japan could provide technical and financial assistance to help ASEAN implement both the AEC Blueprint and the ASEAN-Japan Comprehensive Economic Partnership, including narrowing the gap between the developed and less developed members of ASEAN.

Infrastructure development

Development of national and cross-border infrastructure remains one of the biggest challenges for ASEAN. Infrastructure development requires the "soft" component—policies, regulations, rules and procedures—that makes the "hard" component work. In many cases, public-private partnerships are essential to attract private sector funding and management know-how while mitigating risks involved. Cross-border infrastructure investment—including the Greater Mekong Sub region program—is the most challenging area because of the involvement of multiple stakeholders.

A recent study by ADB and ADBI, entitled *Infrastructure for a Seamless Asia*, recommends the creation of an Asian investment infrastructure fund as a mechanism by which infrastructure projects in the region can be prioritized and funded. A starting point could be for ASEAN to set up an ASEAN infrastructure investment fund. Investment-short ASEAN countries need to improve investment climates, while Japan can make financial and technical contributions.

Financial market development and integration

Third, further deepening and integration of financial markets can also help support the region's long-term growth. A financial sector that can finance SME businesses and consumer purchases of durables goods and residential housing is quite important to strengthen both the supply and demand sides of the economy. The recycling of Asia's high savings for regional investment requires a high degree of integration of financial markets in Asia. Further development of Asian bond markets—through the establishment of a credit guarantee and investment mechanism to provide credit guarantees for local-currency bond issuance—is the key to the acceleration of domestic currency financing of investment.

In April 2009, the ASEAN finance ministers endorsed the “Implementation Plan to Promote the Development of Integrated Capital Market in ASEAN.” Its core strategies include a mutual recognition and harmonization framework—supported by efforts to establish trading and settlement alliances and infrastructure—and stronger coordination and monitoring processes at both national and regional levels. Japan can help ASEAN in its efforts to integrate their capital markets through technical assistance.

Japan and ASEAN may take the initiative in setting up an Asian Financial Stability Dialogue—an Asian version of the Financial Stability Board—by inviting the PRC, Korea, and others to strengthen cross-border financial supervision and regulation at the regional level and help ensure Asia's financial stability by developing effective early warning systems. This forum—to be created among finance ministries, central banks, and financial sector regulators and supervisors—could also serve to promote longer-term financial market development and integration, establish standards for governance and transparency, and improve investor confidence.

Creation of an Asian Monetary Fund

Fourth, regional economic surveillance and regional reserve pooling—under the Chiang Mai Initiative (CMI)—is a potentially powerful mechanism to complement the global role of the IMF. The recent agreement by ASEAN+3 finance ministers to multilateralize the CMI with US\$120 billion and set up a surveillance unit is a positive step for regional currency and financial stability. Once the CMI is fully multilateralized, an effective regional surveillance mechanism is fully in place, and the surveillance unit exhibits its ability to formulate independent conditionality associated with crisis lending, the multilateral CMI can be delinked from IMF programs, paving the way toward the creation of an Asian Monetary Fund (AMF).

An AMF is essential to support Asia's rebalancing process, as economies in the region would accept smaller current account surpluses—and less accumulation of foreign exchange reserves—if an AMF would mitigate financial turbulence and act as a regional lender of last resort. Japan's strong support for timely establishment of an independent surveillance secretariat under the multilateral CMI would be crucial and ASEAN members would be the largest beneficiaries. Japan could also help support ASEAN by arranging additional, bilateral yen-based currency swaps with ASEAN members who cannot easily obtain currency swaps with the US Federal Reserve.

Exchange rate policy coordination

Finally, considering the rising degree of economic interdependence among Asian economies, exchange rate policy coordination is increasingly important. Once global financial stability is restored and growing Asian economies begin to tighten monetary policy, one can expect the resumption of large capital inflows into Asia. To manage such capital inflows and maintain macroeconomic and financial sector stability, it will be important to allow sufficient exchange rate flexibility while preserving relatively stable intraregional exchange rates.

As growth rebalancing will probably be accompanied by a weaker US dollar, a challenge is to avoid intraregional currency misalignments. This requires coordinated exchange rate

management to allow greater rate flexibility vis-à-vis outside currencies—particularly the US dollar and the euro—and exchange rate stability vis-à-vis regional currencies. To facilitate such exchange rate policy coordination, it would be useful to introduce an Asian Currency Unit index as a monitoring indicator. Japan and ASEAN could work together toward such currency cooperation.

Conclusion

Given that it is unlikely that the US and Europe will be engines of global growth, Asian economies should create their own growth engines. This is the only way for Asia to be able to maintain sustainable growth in the postcrisis era, and will also contribute to growth of the global economy. In order to achieve this, Asia needs to transform itself into a large consumer area while maintaining its competitiveness as the world's factory, by rebalancing sources of growth away from extraregional—particularly the US and EU—demand toward domestic and regional demand. Asian firms can target the rising middle-class in emerging Asia—the PRC, India, and ASEAN members—who will become a big source of consumption demand. This requires closer policy coordination in Asia to pursue structural adjustment, integration of regional markets, and stronger social sector protection through regional economic and financial cooperation. Such cooperation will go a long way in creating foundations for an East Asian Community.

The greatest contribution that Japan can make for ASEAN and the larger Asian community would be to restore a healthy economy that grows at the rate of 2% or more. But this will require a comprehensive growth strategy that addresses the low-fertility and aging issues, the social security system, and the high public debt. A crucial part of this strategy is for Japan to strengthen its links with emerging Asia, including ASEAN, so that it can benefit from the region's growth dynamism while supporting this growth through economic and financial cooperation. ASEAN can play a vital role in this context as the hub of integration and cooperation in wider Asia, while Japan can assist such ASEAN efforts. In this sense, Japan-ASEAN cooperation is a lynchpin of Asia's sustainable growth.