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December 2009



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ISSN: 1882-6717

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The Global Financial Crisis and Macroeconomic Policy Issues in Asia

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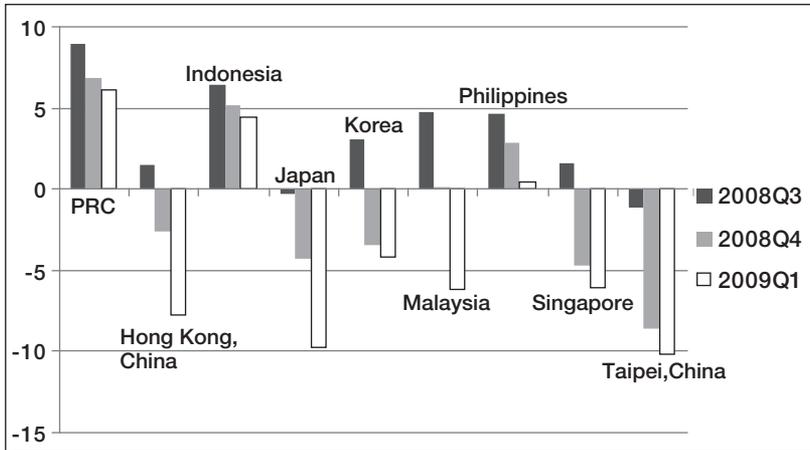
1 ■ Introduction

The global financial crisis severely impacted Asia from late 2008 to early 2009 (Figure 1). Although the initial impact appeared limited, the region was directly hit when the crisis spread to the real sector and caused the volume of world trade to collapse. According to the latest projection by the International Monetary Fund (2009), real gross domestic product (GDP) growth is forecast to decline in industrial Asia (Japan, Australia, and New Zealand) from 3.2% in 2007 to -2.3% in 2009¹; from 5.7% to -2.4% in Asian newly industrialized economies (Hong Kong, China; Republic of Korea [hereafter Korea]; Singapore; and Taipei, China); and from 6.3% to 0.7% in ASEAN-5 (Indonesia, Malaysia, Philippines, Thailand, and Viet Nam). Even the People's Republic of China (PRC) and India were severely affected, with growth in those countries expected to fall from 13% to 8.5% and from 9.4% to 5.4%, respectively. Particularly hit hard among these economies were Singapore and Taipei, China, as their openness made them vulnerable to the sudden collapse of global trade.

¹ These are simple averages for the three countries.



Figure 1: Quarterly GDP Growth in Selected Asian Economies



GDP = gross domestic product, PRC = People's Republic of China, Q = quarter.
Source: International Monetary Fund, World Economic Outlook database.
Available at: www.imf.org/external/pubs/ft/weo/2009/02/weodata/index.aspx.

Almost all countries in Asia responded to the sudden collapse of real activity by easing both monetary and fiscal policies. With the financial sector in reasonable health, the expansionary macroeconomic policies for the most part appear to have succeeded in preventing the economies from falling further. On the brighter side, there are budding signs of nascent recovery, though their durability remains uncertain. The IMF forecasts the volume of global trade to grow only by 2.5% in 2010 after contracting by 12% in 2009. It is also unclear how much longer the current extraordinary stance of monetary and fiscal policies could be maintained. Given the fragility of the situation, a premature withdrawal of stimulus could cause recovery to halt; at the same time, the continuation of expansionary macroeconomic policies could also raise inflationary and debt sustainability concerns.



The purpose of this policy brief is to draw lessons from the recent and ongoing macroeconomic policy experience of Asia's economies. To do so, in each of three policy areas (monetary, fiscal, and exchange rate/reserve management policies), I review the principal measures taken by Asian economies during recent months in response to the global financial crisis, and discuss issues that have emerged out of the experience. I then conclude with a forward-looking discussion of medium- to longer-term measures to improve the effectiveness of macroeconomic policies and to make the world and the region a safer place.

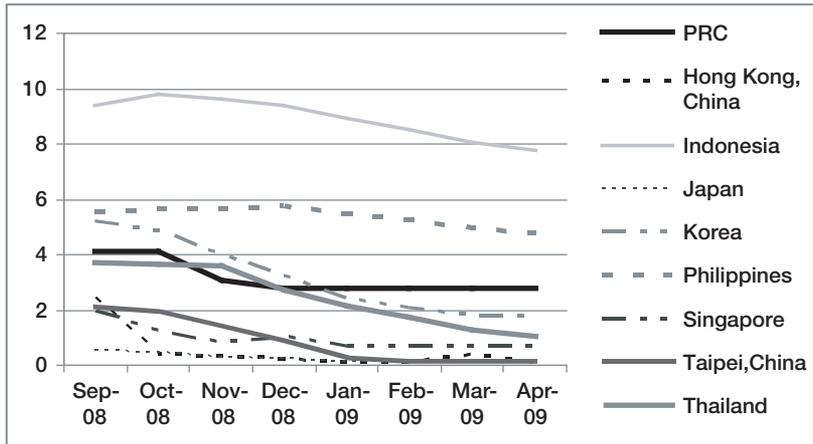
2. Monetary Policy Issues

Some countries in Asia came into the onset of the global financial crisis in the fall of 2009 with substantially tight monetary policies. The United States' (US) subprime crisis had little impact on these economies, whose pressing concerns instead were about the inflationary consequence of overheating and rising commodity prices. In contrast, other countries, notably Japan, were already pursuing easy monetary policies, with extremely low policy interest rates. From about September 2008, however, almost all economies in the region began to ease substantially monetary policies. Those economies with considerable space for easing aggressively reduced their policy interest rates in several steps over the subsequent months. Those with little space did what they could to further ease monetary conditions, including pushing the level of interest



rates to virtually zero. As a result, market interest rates in Asia converged to extremely low levels in the early months of 2009, except in a few economies (Figure 2).

Figure 2: Market Interest Rates in Selected Asian Economies



PRC = People's Republic of China.

Source: International Monetary Fund, *International Financial Statistics*, on-line database.

Available at www.imfstatistics.org/imf/.

Some economies not only cut interest rates but also expanded the flow of credit to the private sector. For example, the PRC, after reducing interest rates and reserve requirements in the latter part of 2008, removed limits on credit growth, which led to an extraordinary expansion of bank lending in the first quarter of 2009. Exchange rate policy was another tool of monetary easing in some economies. In the second half of 2008, the PRC abruptly halted the policy of allowing the yuan to appreciate gradually against the US dollar. In October 2008, the Monetary Authority of Singapore shifted to a 0% appreciation of the nominal exchange rate in a reversal of a policy of gradual



appreciation it had followed since April 2004. Furthermore, in April 2009, Singapore, while keeping its zero appreciation policy, re-centered its policy band to the prevailing level of the nominal exchange rate (which represented an effective depreciation of the currency).

For the most part, monetary policy appears to have worked reasonably well for countries with sufficient policy space. With the level of interest rates sufficiently high at the onset of the crisis, the conventional monetary policy transmission channel was largely intact, allowing a substantial reduction in market interest rates. This may explain the relatively quick economic recovery in such countries as Australia, Korea, and New Zealand. On the other hand, in the countries where the level of interest rates was already low (or virtually zero in some cases) to begin with, the interest rate transmission mechanism was impaired by the zero lower bound (i.e., the constraint that a nominal interest rate cannot fall below zero), requiring the use of “unconventional” monetary policies that involved, instead of interest rate easing, an expansion of central bank liabilities or a change in the composition of their assets. Even in countries where the level of interest rates was sufficiently high, some use was also made of unconventional policies when, in an extraordinary environment of global de-leveraging, rising risk premiums loosened the relationship between policy rates and long-term lending rates. In fact, some type of unconventional policy was used to one extent or another by many central banks in the region, including Australia; India; Japan; Korea; Singapore; and Taipei, China.



From the earlier experience of Japan with zero interest rate policy and quantitative easing, as well as the US' recent experience since the onset of the subprime crisis, evidence on the effectiveness of unconventional policies has been mixed (Morgan 2009). More recent experience, however, seems to suggest that central bank purchases of financial assets in certain market segments appear to have some effectiveness. For example, the announcements by the US Federal Reserve Board and the Bank of England to purchase government bonds outright led to a sharp drop in long-term government bond yields and exchange rates; the Federal Reserve's term securities lending facility also reduced the repo financing spreads between Treasury and non-Treasury collateral (Bank for International Settlements 2009). Within the region, Korea's currency swap arrangement with the US Federal Reserve appeared to stabilize the market for short-term dollar liquidity.

Even though the type of unconventional policies used in Asia was modest compared to those used in the US or the United Kingdom, they nonetheless represent a more active participation of the public sector in the allocation of credit, which during normal times is best left to the market. Sooner or later, therefore, an exit policy must be considered. The need to exit is also important from the point of view of securing sufficient policy space during good times, and to preempt the recurrence of inflationary pressure. The current experience has shown that those economies that came into the crisis with a sufficiently high level of interest rates were able to use monetary policy more effectively. The economies with extremely low interest rates



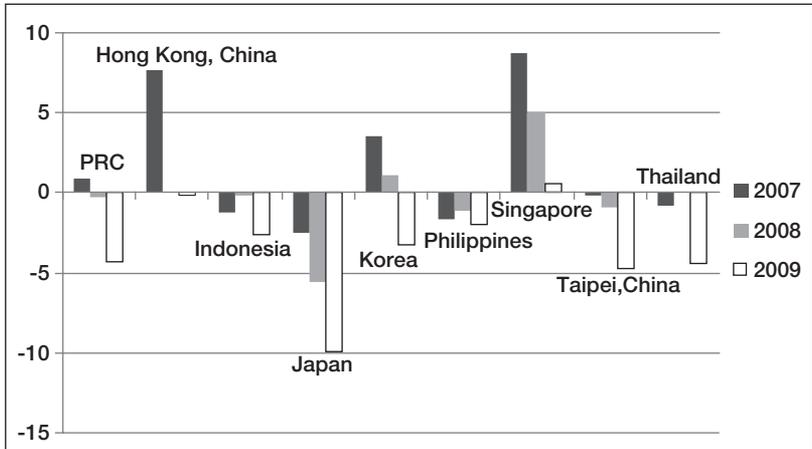
must therefore resist the natural tendency toward the asymmetric use of monetary policy (i.e., interest rate action tends to be more decisive during downturns than during upturns) by raising interest rates decisively when recovery takes hold.

3. Fiscal Policy Issues

Given the unprecedented collapse of real economic activity, and the awareness that further monetary easing was either infeasible or constrained, many governments in the region resorted to aggressive easing of fiscal policy. The fiscal positions deteriorated sharply in these countries from 2007 to 2008, and further in 2009 (Figure 3). Of course, not all of the fiscal deterioration was due to the introduction of a fiscal stimulus package, as automatic stabilizers also kicked in. It is not easy to estimate the size of the fiscal packages, net of the automatic stabilizers, and the spending or tax reduction measures that had already been planned. To complicate matters further, the announced spending increase in some cases also included prospective contributions from the private sector and may even include an amount which will never be implemented in the end. With this caveat, the announced fiscal stimulus packages ranged widely across the region, from less than 1% to over 10% of GDP.



Figure 3: Fiscal Balances in Selected Asian Countries
(in percent of GDP)



GDP = gross domestic product, PRC = People's Republic of China.

Sources: International Monetary Fund, World Economic Outlook WEO database.

Available at: www.imf.org/external/pubs/ft/weo/2009/02/weodata/index.aspx.

Public Information Notices (PINs) for Article IV consultations.

Available at: www.imf.org/external/country/index.htm. The figures for 2009 are projections.

The PRC had a particularly large fiscal package, mainly concentrated in public investment. Given the comfortable fiscal space it enjoyed, the PRC government quickly expanded public investment in key infrastructure while cutting taxes. More than 85% of the CNY4 trillion stimulus package announced in early November 2008 (amounting to some 16% of GDP) was accounted for by investment spending. Coupled with the impact of monetary easing, the PRC's fiscal expansion appears to have helped support the country's economic recovery in early 2009. Japan also had a large fiscal package, although the country's fiscal space was limited by the chronic fiscal deficits that had raised the level of debt to over 200% of GDP. India was another



country that eased fiscal policy when the fiscal space was rather limited (with the balance of public debt exceeding 80% of GDP). With the state budgets included, India's general government deficit is expected to reach 10% of GDP in 2009, though some of the increase in government spending reflects the increase already implemented before the onset of the crisis.

Estimates of fiscal multipliers vary widely (Horton, Kumar, and Mauro 2009), but it is certain that, regardless of the size of the multiplier, expansionary fiscal policy added to aggregate demand (even though the multiplier may well have been one or less than one). The resurgence of fiscal activism, long disowned by the economic profession, has presented an occasion to reflect upon the countercyclical use of fiscal policy. In the context of Asia, a large share of fiscal expansion fell on infrastructure, which entailed implementation problems, given lags and capacity limitations. Not all investment projects can be profitable, and some may well lead to corruption. This led some in participants at ADBI's macroeconomic policy conference to argue that more should have been done on the revenue side, both because the impact of a tax cut is more immediate and because tax reform can be a way of removing distortions in the economy. Empirically, however, it is well understood that the multiplier of a tax cut is typically much smaller than that of an increase in spending.

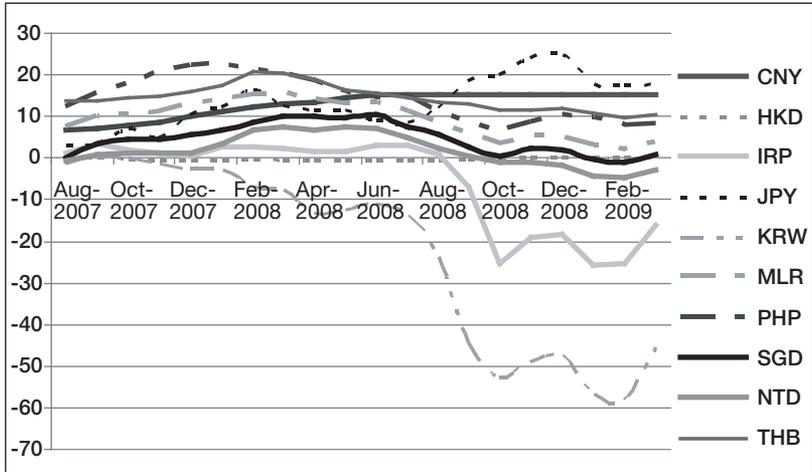


4. Exchange Rate and Reserve Management Policy Issue

Asian economies entered the onset of the crisis with considerable diversity in exchange rate arrangements. Some currencies (such as the Korean won and the Indonesian rupiah) were floating with considerable flexibility, while others remained tightly managed. With the crisis, those two flexible currencies depreciated sharply, while the PRC and Singapore terminated the policy of allowing their currencies to appreciate gradually against the US dollar (Figure 4). Viet Nam, in late 2008, devalued the dong and widened the trading band against the US dollar. As most other currencies also softened against the US dollar, these developments meant that the Japanese yen, which remained flexible, became the only currency that appreciated against the US dollar, in part reflecting the unwinding of the yen carry-trade and greatly reduced interest rate differentials favoring other major currencies. In an environment where most Asian economies, especially Korea, benefited from currency depreciation in weathering the negative impact of the global crisis, Japan had to assume more than its share of the adjustment burden.



Figure 4: Movements of Selected Asian Currencies vis-à-vis the United States Dollar



Source: International Monetary Fund, *International Financial Statistics* on-line database. Available at: www.imfstatistics.org/imf/.

The propensity of most Asian economies to manage exchange rates, especially when their currencies were under appreciation pressure, meant that they accumulated large balances of foreign exchange reserves. The accumulation of foreign exchange reserves not only was an insurance against a sudden reversal of capital inflows but may also have allowed these countries to achieve some degree of monetary independence and exchange rate stability while they moved toward greater capital account openness (Aizenman, Chinn, and Ito 2009; Kim and Yang 2009). Reserve accumulation may have thus served useful purposes from the point of view of individual countries. From a more global standpoint, however, the outcome was costly. It allowed large US current account deficits to be financed at low cost and contributed to the global imbalance, the unwinding of which was



in part a triggering cause of the global financial crisis. These considerations suggest that the choice of exchange rate policy by one economy could have regional and global implications, making it a subject for useful cooperative discussion.

5. Medium- to Longer- Term Issues

A. Turning Crisis Into Opportunity

Crisis is a time to think ahead about what to do when good times return. While macroeconomic policies must remain supportive until recovery is firm, it is also important to develop exit strategies for unwinding central bank balance sheets and raising interest rates as well as for withdrawing unprecedented fiscal stimulus. Over the medium- to longer-term, it is important not only to take measures to help prevent the occurrence of another crisis by strengthening the system of prudential supervision, but also to build institutions that will help make policies more effective when responding to a negative shock. The overwhelming lesson of the recent crisis experience is that countries must secure adequate monetary and fiscal policy space during good times by maintaining sufficiently high interest rates and by keeping public debt to GDP ratios sufficiently low.

B. Monetary Policy

Going forward, what type of monetary policy regime should be pursued by Asia's central banks? Experience in Asia suggests that inflation targeting is not the only way to achieve price



stability (Filardo and Genberg 2009). Much less consensus exists on the extent to which central banks should take account of asset prices in the conduct of monetary policy. It would probably be a mistake to target a particular level of asset prices. In the context of inflation targeting, central banks simply cannot stabilize two prices (the consumer and asset prices) with a single instrument; even if it were possible, it would not be prudent to adjust policy interest rates in response to frequent changes in asset prices. It should be possible, however, to pursue medium-term price stability while taking some account of a sustained one-way movement in asset prices.

C. Fiscal Policy

As to fiscal policy, debt-financed spending could increase the cost of borrowing for an emerging market economy and hence reduce investment and growth over the medium-term. Although the long-term impact is theoretically ambiguous, standard models suggest that higher debt has negative effect on investment and growth. Fiscal policy therefore is not a permanent solution. Increasing government purchases may raise GDP in the short run; but a short-term fiscal stimulus could not jump start an economy adversely affected by other factors, nor could it cause a sustained recovery (Taylor 2009). To stimulate domestic demand, rebalancing toward private demand is eventually necessary, but the political economy of fiscal policy may make exit difficult by turning what is intended as a short-term measure into a permanent one. Institution building is the key. Countries should consider putting into place good automatic stabilizers, fiscal rules to minimize the procyclicality of fiscal



policy, and ensure long-term fiscal sustainability procurement procedures for public works that minimize the scope for corruption among other things.

D. Regional Cooperation

Regional cooperation must be part of the longer-term solution. Agreeing on a region-wide free trade agreement would help reduce Asia's vulnerability to adverse demand shocks from outside the region by creating a larger Asian market for final goods. A closer framework of macroeconomic coordination would make the use of countercyclical fiscal policy more effective when an extraordinary event calls for fiscal activism again (Kawai and Zhai 2009). In view of the helpfulness of the US Federal Reserve Board swap arrangements in stabilizing the markets for short-term dollar liquidity, there is no reason why the region cannot pool part of its enormous foreign exchange reserves to provide liquidity to each other; this would also allow the region's economies to terminate the unproductive policy of reserve accumulation. Such a framework would also allow the region's economies to cooperate more on exchange rate policy. The type of beggar-thy-neighbor response seen in some countries during the recent crisis would then be a thing of the past, with greater exchange rate cooperation spreading the burden of adjustment more evenly across the region.



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About this Policy Research Brief

Responding to the severe negative impact of the recent global financial crisis, many Asian economies resorted to substantial easing of macroeconomic policies. This policy brief reviews the principal policy measures implemented, examines the issues that have emerged from this extraordinary experience, and concludes with a forward-looking discussion of medium- to longer-term measures to improve the effectiveness of macroeconomic policies and to make the world and the region a safer place.

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ISSN: 1882-6717

