Achieving Global Cooperation on Economic Recovery and Long-Term Sustainable Development

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The global financial crisis results from three factors: overly expansionary US monetary policy; inappropriate financial deregulation; and a financial panic following the bankruptcy of Lehman Brothers. Asia is now experiencing a serious downturn as the result of falling consumption and exports, and an intensifying credit squeeze due to global deleveraging. Through appropriate monetary, financial, and public-investment policies, Asia can lead the world to recovery, in essence by replacing the declining consumption spending with increased public spending on critical goods and services (such as health and education) and public investments in sustainable infrastructure, including pollution control, sustainable energy systems, efficient water use, broadband connectivity, and other priority areas.

I. INTRODUCTION

Thank you for the warm introduction. I imagine that this wonderful turnout has very little to do with me, and everything to do with the topic of how we are going to get out of this global financial crisis. This is a crucial and challenging topic, especially since nobody yet knows the answers!

While I did not believe we would find ourselves in a crisis this deep, I did believe that the United States (US) was quite miserably managed for many years. As a general principle, one can assume that chronic mismanagement will lead to a crisis. Even so, I was of the view—which is now disproved—that America's crisis could be to a substantial extent decoupled from the rest of the world. I believed, for example, that Asia would escape any significant downturn, protected by its US$4 trillion of foreign exchange reserves, its current account surplus, relatively healthy fiscal policies, and relatively healthy banking policies across the region, along with many important targets of opportunity for productive investments.

In fact, there is no deep reason for Asia to experience a significant downturn. When I thought about that during the past year, I said, "Well, since

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there is no reason for a deep downturn, Asia therefore *won't* experience a significant downturn." Yet Asia is experiencing a significant downturn right now, and one that is probably worse than in the official forecasts. Still, stubborn as I am, I continue to believe that there is no reason for such adverse outcomes to occur. There are policies, still largely untapped, which can buffer the Asian economies. I'll summarize it this way: Asia can, and should, lead the rest of the world out of the crisis, starting in the second half of 2009.

My real concern today, therefore, is to try to understand what more can be done in policy terms within Asia. The US and Europe will follow their own policies. There will certainly be some scope for cooperation, but the US is currently preoccupied internally with its own politics and debates. Without much international cooperation right now, it is going to have to be an Asian-led effort within Asia.

My continuing position is that with the current account surplus and cash-rich economies in this region, Asia should escape a significant downturn. In what follows, I will explain this point of view and identify what I think are the missing pieces that could be put in place to stop what otherwise is a continuing downward spiral on the world scene right now.

II. ROOTS OF THE UNITED STATES ECONOMIC CRISIS

This global financial crisis clearly has, as its epicenter, the US. As a Manhattanite I know the epicenter is actually about two miles from where I live: Wall Street. When the Asian crisis hit almost twelve years ago, the Americans came and preached about all the things wrong with Asia. At the time some of you may recall that I said that does not sound right. First of all Asia is not as bad as Americans say, so the Asian crisis is exaggerated—it is really a panic, not a deep-rooted crisis. Moreover, much of what the US was complaining about—of crony capitalism and so forth—turned out to be very much an American phenomenon.

So I guess the preachers knew it when they saw it, but at the time the theory was the US is great and others should just follow what America does, and that Asia's all bad and that if Asia would just behave a little bit more like the US, everything would be fine. We now see that this was not a very accurate description at the time and not a very accurate description about the nature of institutions.

Looking back I think we can say that the US—especially the Federal Reserve (Fed)—played the central role in all the major bubbles in recent years. Policies from the Fed have been destabilizing, i.e., swinging from one bubble to the next. I also think we have a case of "instrument instability," which is turning the dials so hard on policy to avoid one crisis that you set up the next crisis, and then turning the dials even more the other way, which then sets up yet another crisis. So we have actually had three bubbles in a decade.

The Asian bubble was partly the result of very expansionary US monetary policy combined with unregulated international capital flows. When the Asian crisis hit, the Fed eased policy, and that helped to create the dot-com bubble. When that burst the Fed eased policy again, and especially after September 11, ratcheted up monetary expansion that created the third bubble in a decade, this time the subprime and mortgage-backed-security bubble.

The underlying condition of this present crisis is essentially a very expansionary monetary policy combined with an expansionary fiscal policy in the US for most of the past 25 years. The US has refused to tax itself adequately, but has liked to spend; and has therefore veered between modest and large budget deficits almost continuously except for a few years at the end of the 1990s, when tax revenues were bulging with capital gains taxes built on the dot-com bubble.

The US has been spending well beyond its means at the national level, by about 5–6 percent of gross national product (GNP) per year, reflecting chronic budget deficits and low or negative household saving rates. Household saving fell to historically low levels as of the late 1990s, backed up by soaring asset prices stoked by easy Fed policies. Households borrowed against rising housing prices and assumed that easy credit (whether for credit-card purchases, home-equity loans, home mortgages, or auto loans) would always be available. These are the roots of the US-made bubble. This easy-credit period led to a sense of well-being for a number of years, which started to peak around 2006 when housing prices reached a peak value before they started to decline.

All of this was aided and abetted by financial market deregulation, lax oversight, and no small amount of corruption and fraud. Leverage ratios of the investment banks, which formed a veritable unregulated “shadow banking industry,” were up to 30-to-1 or even 50-to-1. The most famous case is nearly laughable if it weren’t so tragic for so many. Bernie Madoff, the infamous Ponzi-scheme investment manager, mishandled tens of billions of dollars without being detected by the Federal authorities. Even more astounding, if news reports are to be believed, he did so without engaging in a single actual trade for many years, perhaps more than a decade. (The facts, however, are yet to emerge in court.)

I think all of this is now pretty much conventionally understood. What was the big surprise and puzzle to me is how this percolated to the rest of the world, given that much of this description vis-à-vis the US was pretty clear

2 or 3 years ago. I remember distinctly conversations where I said that yes, the US would have a recession because we have been living beyond our means; and yes, there will have to be a correction, but no, it won't bring down the world economy. To my mind, thinking back a couple of years, these did not add up to the worst financial crisis since the Great Depression.

One part of this story that I only fully appreciated after the fact is that the very easy credit policy of the Federal Reserve—which was at the root of the crisis—was mimicked by enough of the rest of the world that bubbles developed in a lot of places. I also had not fully appreciated that the bubbles were even more in the equity markets than in the housing markets. The worldwide total rise and then collapse of equity wealth is astounding. Stock-market capitalizations around the world increased by perhaps US$30 trillion during the period 2003 to 2007, before collapsing by around US$30 trillion by early 2009. Housing bubbles probably added an up-and-down of another US$10–US$15 trillion. These asset bubbles were mainly the product of US monetary ease being replicated abroad, through one of three mechanisms: pegged exchange rates, leading to a massive flow of capital from the US to the rest of the world (heavily through inter-bank transmission lines) stoking foreign exchange reserve accumulation and soaring high-powered money outside of the US; dirty floating matched by forex interventions to slow currency appreciations vis-à-vis the US dollar; or capital inflows from the US that produced stock market increases but without significant increases in the domestic money supplies.

The collapse of wealth worldwide, of perhaps US$40 trillion (adding stock markets and housing), and in the US alone of US$15 trillion or so, is the main cause of the dramatic collapse of consumer spending, or at least is the main cause of the first-round effects. The typical rule of thumb is that each dollar of decline of wealth leads to a cut of consumption of between 5 cents and 8 cents. A worldwide decline of US$40 trillion, therefore, would cause a worldwide consumption decline of US$2–US$3.2 trillion dollars. With a gross world product of around US$55 trillion, this amounts to roughly 4 to 6 percent of global gross domestic product. And that's the direct effect. It gets multiplied in feedback loops, both through the collapse of income that comes with the decline in spending and through the impact on bank balance sheets and the availability of loans.

It is probably the case that the collapse in equity and housing prices was driven not only by an inevitable reversal of the preceding bubble, but also by the frightening run-up of oil and food prices last year. This run-up of essential resource prices also underscored for the world the long-term challenges to global economic growth. For a long time it had seemed relatively straightforward for the world to achieve four or even five percent per annum global growth, and no doubt the exuberant equity markets were pricing in such optimistic expectations. Then we were reminded that conventional energy supplies and even food supplies are more precarious than we had assumed. Conventional oil production is probably reaching peak conditions within the next 10–20 years, and some believe that the peak has already been reached. Food production is also struggling to keep up with rising populations and rising staples intake per person as the demand for meat rises with incomes (raising the demands for feed grains). The implications of marking down the estimated long-term global growth rate from say 4.5 percent to 3.0 percent per annum can be enough to cut worldwide equity market capitalization very sharply. If dividends are discounted at say 6.0 percent, then stock prices vary inversely with 6 minus growth. A drop from 4.5 percent to 3.0 percent would then entail a halving of stock market capitalization.

III. THE GLOBAL FINANCIAL FALLOUT: THE FINAL STRAW

All of the foregoing explains the world is experiencing a significant slowdown. It still, however, does not yet add up to calamity. There are more things that have happened that we need to take note of.

The most important thing to add to this is that the end of the bubble produced not only a decline of wealth, and not only an end to the exaggerated investments in the housing sector and consumer purchases, but also a very deep financial crisis, starting in the US but then spreading to the rest of the world. The crisis resembles in many basic ways the financial crisis and deleveraging that took place in Asia during the 1997–1998 Asian crisis.

We know that the banking sector is prone to runs and panics, but we have tended to believe that “modern scientific management” of risk and banking has brought such runs and panics to an end. Yet we now find ourselves in a rip-roaring financial panic and massive global deleveraging. What went wrong? Bank runs and panics are prevented by a trilogy of policy tools: capital adequacy standards, lender-of-last-resort facilities of the central bank, and deposit insurance. Yet in the US, all three of these apply only to commercial banks, not to investment banks or other kinds of financial intermediaries. And outside of the US, the coverage of even mainstream banks by these three policy tools is uneven and sometimes non-existent. The Wall Street firms created a “shadow banking system” outside of the regulatory framework of the commercial banks, and therefore subject to runs and panics. Even the poor regulation of the commercial banks left them exposed to crisis, though it is true that the crisis began outside of the regulated commercial banks.

Hence, Merrill Lynch, Bear Stearns, Lehman Brothers, Goldman Sachs, and others, were allowed by the regulators to grow a full shadow banking sector that was dependent on very short-term loans from money market funds and other investors seeking high liquidity and higher returns than in commercial banks. The Wall Street firms bought up mortgages (and consumer loans), packaged them into mortgage-backed securities (MBSs), and then chopped them up in collateralized debt obligations (CDOs). They also held a portion of the MBSs and CDOs on their own account, funded by borrowing short term from the money markets. The Wall Street shadow banking system did not have any of the protections of the commercial banks. They were over-leveraged, lacked direct support from the Fed, and were not protected by deposit insurance. The huge regulatory mistake, therefore, was to ignore all of the controls that had been put in place on the commercial banks over the course of the past century to forestall panics. Bear Stearns maintained funds that had leverage of 35-to-1 for example. The Wall Street firms were exposed, and ended up in collapse when the credit bubble burst.

The Fed had actually taken the shocking view that it was fine to have an unregulated financial system, forcing Alan Greenspan to acknowledge last fall that he had detected a “flaw” in his support for a self-regulated financial system. Some flaw, US$30 trillion dollars in loss after the fact! The whole shadow banking system began to unravel after the middle of 2006, when Fed monetary policies tightened and defaults began on the subprime mortgages that had featured prominently in the shadow banking system. The MBSs and CDOs built on them started to lose value quickly, and several Wall Street firms quickly ran into deep crisis, reflecting the loss of asset values coupled with the enormous leveraging of the banks’ balance sheets. Bear Stearns had to close down some funds early on, and then one after another of the major investment firms revealed their own off-balance-sheet “structured investment vehicles” (SIVs), which were designed to borrow short in order to buy MBSs and other risky assets.

These SIVs quickly faced redemptions and difficulty in borrowing new funds. The mortgage-backed-securities market thereby started to collapse, and this by itself led to a significant decline in new housing starts, and thereby to a fall in housing prices as well as a rise in unemployment. Credit to the housing sector first slowed and then eventually stopped. Housing prices fell even faster as credit flows dried up, and the fall of housing prices accelerated the retreat from new home financing. Since the SIVs were so leveraged, they were threatened imminently by insolvency.

As the system unraveled completely between the middle of 2006 and the middle of 2008, the SIVs went bankrupt, were closed, or were taken on to the balance sheet of the main financial houses. None existed beyond 2008. That meant that several percent of GNP and of credit flow that had been supporting housing construction disappeared. Of course, the commercial banks could not make up the difference in mortgage lending and also did not want to make up the difference because of the rising foreclosure rates and declining house prices. This downward spiral was a big part of the deepening of the US crisis.

By the middle of 2008, one could already figure out that the US recession would be more than just a mild recession. One could see that other parts of the world were going to be caught up in this because their own housing bubble had burst and because their stock prices had declined. My sense is that even retrospectively it did not have to be a calamity, nor does it have to be a calamity now. Unfortunately, in that famous weekend of 12–15 September, panic hit the world's financial system with the bankruptcy of Lehman Brothers, the collapse and emergency government rescue of AIG, and the desperate sale of Merrill Lynch to Bank of America, backed by taxpayer dollars.

Looking back, it is clear that the bankruptcy of Lehman Brothers was really the coup de grace that set us off to a very deep global downturn, complete with plunging stock markets and an ongoing financial panic still not resolved till today. After Lehman Brothers filed for bankruptcy on 15 September, one of America's money market funds, Reserve Primary Fund, declared the next day that it would have to "break the buck" on its deposits. It could not meet the dollar par value of its money market deposits, but would redeem accounts at 97 cents per dollar. This in turn triggered one of the greatest panics in financial history, and surely the greatest in terms of the absolute decline in worldwide wealth.

There was a sudden and nearly complete withdrawal of money-market lending to the commercial banking system in the US, a cessation of nearly all interbank loans, a massive withdrawal of loans by American and European banks on all lines of credit from abroad, and a drying up of the industrial commercial paper market. Even the most blue chip and established commercial and industrial firms could no longer roll over short-term paper. What resulted was a liquidity crisis that was the most severe ever seen in the world since the Great Depression. Very much like the 1997–1998 Asian financial crisis when it was impossible to get short-term financing, the deleveraging was immediate and fierce, but this time not restricted to a region but enveloping the global financial system.

Lehman Brothers should not have been allowed to go into bankruptcy the way it did. This was meant to be a demonstration of "toughness" by the Fed, to show that moral hazard would be avoided by taking the tough decision not to bail out every bank. It was similar in motivation to the policy of the International Monetary Fund in Indonesia in November 1997 when it insisted that Indonesia shutter several weak banks, thereby triggering a nationwide banking panic, and exacerbating Asia's regional crisis. The International Monetary Fund's action destroyed the Indonesian economy overnight. The Fed's action led to a collapse of short-term financial markets and stock markets around the world.

In the end, the moral hazard lessons are the opposite of what was intended, since after Lehman, the US and other governments have devoted trillions of dollars to bank bailouts. As short-term lending ceased, and deleveraging became nearly worldwide, governments responded with bank bailouts. Within a month, around US$2 trillion of guarantees were suddenly thrown in place in Europe, US, parts of Asia, and parts of Latin America. By then, the combination of the wealth effect, the panic, the decline of equity prices, the decline of housing prices, and the complete drying up of consumer credit had led to a worldwide utter collapse of consumer spending and investment spending. We do not yet know the depths, but my guess is that consumer spending in the US will fall by around 10 percent, perhaps more, and therefore by around 7 percent of 2008 gross domestic product. Worldwide, the decline in consumption spending might amount to 5 percent of 2008 GNP. Moreover, industrial investment is also clearly plummeting, both because demand for products has collapsed and because credit is not available.

This is being transmitted worldwide partly through the financial sector, partly through trade, and partly through the drying up of direct investment projects which have been eliminated in the downturn. Up to this point, it seems to me that Asia has felt the crisis in essentially the three ways that I identified. First, there has been some decline of the housing values in parts of Asia, but probably not enough to really lead to a region-wide recession. Second, there have been very sharp declines of stock market prices, which have a wealth effect and investment effect, and probably *are* big enough to result in a significant decline of economic growth—although again, probably not enough to throw the whole region into a serious and prolonged crisis. Third, there has been an abrupt withdrawal of credit lines from abroad, as in 1997, which has particularly affected a few economies, the Republic of Korea (henceforth Korea) perhaps being the most notable. Korea had something like US$150 billion of interbank short-term liabilities, a lot of which is being abruptly withdrawn.

The sum total of these effects—exports, consumption decline, and deleveraging by international banks—has added up to a significant economic downturn, much greater than I would have imagined. Now is the time that Asia must deploy its vast resources—in human skills, technology, manufacturing prowess, current account surplus, and financial reserves—to fight off the recessionary forces. I turn to this policy challenge next.

IV. FILLING THE MISSING PIECES IN ASIA

Let me bring you back to where my thinking was a half a year ago, that is, to an Asia with roughly US$4 trillion in reserves, current account surpluses, and booming economies, especially the People's Republic of China's. Based on these strengths, it ought to be possible to fend off recession coming from abroad, although we now know better that much of the recession is coming from home base as well in the decline of stock market and housing prices. Still, I think there is a lot of room to maintain growth in Asia. However that is not going to be fulfilled under the current policy mix. So, what should the new policies be?

First, countries that are seeing a withdrawal of international credits should accommodate those withdrawals through the deployment of their own reserves. Mechanically, this means extending domestic credit lines from the central bank to companies (especially banks) that are seeing their international credits withdrawn. If the central bank expands credit to replace the loss of international credits, and does so while pegging the exchange rate, the loss of international bank lines will be substituted by a decline of foreign exchange reserves at the central bank. The commercial banks will still have forex liabilities, but now to their own central bank rather than to foreign commercial banks.

It seems, however, that countries are hoarding their reserves in this "dangerous" period, rather than spending down the reserves that would allow them to make up for the loss of international bank loans. Korea's own reserves, which are about US$250 billion, should be enough to protect against the withdrawals of international credits, but Korea must accept the need to run them down partially. Korea's willingness to do so can be bolstered, I will emphasize in a moment, with "backstopping" support of the neighboring central banks.

The second thing that is happening that I find troubling is Japan's monetary response to this crisis. The repatriation of yen loans—the unwinding of the so-called carry trade, has appreciated the yen significantly. We know from Japan's modern experience that when the yen reaches levels of 90–95 yen per dollar, Japan has a significant crisis in its real economy, of course especially the export-oriented manufacturing companies. I would have expected that the Bank of Japan would have intervened in the foreign exchange market to prevent the yen from appreciating so strongly. Putting a brake on the appreciation of one's currency is an easy thing to do, since it simply involves buying the foreign currency with the domestic currency, which after all is in unlimited supply to the central bank. The reluctance of the Bank of Japan to do this is a huge puzzle to me because the government is saying how worried it is about the yen appreciation. Further, I do not think it is in America's interest to see the yen as strong as 90 or so, if this leads to a collapse of the Japanese economy. So it seems to me that even though interest rates are very low in Japan, Japanese monetary policy is not expansionary enough right now. By buying dollars and selling yen it would be possible to keep the yen at around 100 yen to the dollar. This would prevent the collapse of the Japanese economy, which is already under way right now.

When you see a country that has a current account surplus, a trillion dollars of reserves, an appreciation of its currency, and a collapsing economy, the situation does not "add up." I can understand why Japan does not want to expand fiscal policy because it has not had a great experience with domestic fiscal expansion. The public debt is at quite a high level of GNP. The public infrastructure does not need massive upgrading. Yet monetary policy is not similarly constrained. Japan could weaken the exchange rate, or it could use its financial power to support other countries, and thereby to strengthen its own economy.

Specifically, Japan could expand monetary policy very significantly, and thereby backstop other countries of Asia. One of the things I would consider highly advisable would be massive currency swaps among the central banks of Asia. The Bank of Japan could provide, in effect, massive low-interest yen loans to its neighbors, especially the ones in financial distress. Most importantly it seems to me that Japan should be making yen reserves readily available to Korea and the Association of Southeast Asian Nations countries in huge amounts. That would give those countries the means to replace the loss of credits from European and US banks (especially European banks, quantitatively), and it would have the second advantage of inducing a modest depreciation of the yen. Japan probably will not get out of this global financial crisis through domestic expansion, but it could get out through exporting more goods and services to the rest of Asia, especially to the People's Republic of China. This would be greatly facilitated if yen loans were easily available in these other countries to support their currencies, banks, and specific investment projects.

That brings me to my final observation, which is that most fundamentally, the world is experiencing a steep drop of consumption right now and needs to compensate with a sharp increase in public investments. The drop of consumption occurred because consumers and their banks got ahead of reality in housing prices and equity prices, in mortgage loans, etc., and now there is a brutal reversal which will last for years in the form of reduced wealth. So what does macroeconomics tell us? If aggregate demand is falling because of a decline of consumption, we have to find alternatives to maintain full employment and efficient use of resources. One way could be to bolster consumer demand some other way or to try to recreate these bubbles. This is not a good idea because households (at least in the US) are heavily indebted, and should actually save for a while. In any event, it's probably not even possible to induce households to consume much more. They are rightly shocked and in the mood to rebuild their savings balances.

Two other ways to expand demand are through government consumption and through investment spending (both public and private). Private investment, however, is unlikely to make up for the loss of consumption spending. As private consumption goes down, we will see much less corporate investment as well in the consumer goods industries and in the basic industries that feed them. I do not, therefore, believe that corporate investment is likely to lead the way out of this crisis. It seems to me, therefore, that the most likely way out will be to rely heavily on public-sector spending, specifically on the government provision of services in health, education, and housing; and on public investments, especially infrastructure investment in pollution control, roads, power, ports, conservation areas, broadband connectivity, water and sanitation, and other infrastructure areas.

Asia needs all of that infrastructure investment desperately. This is still the region of the world with the fastest urbanization and the most dramatic needs for air pollution control, for cleaning up the energy sector and making it sustainable, for cleaning up the lakes and rivers, and for sustainable urban development. Hence, public spending has a very high social return and also has a very high macroeconomic purpose right now, if it can be financed in a responsible way. Therefore, finding ways to bolster aggregate demand largely through government investments in priority areas is the most appropriate policy response (in addition to ending the financial panic).

With the strengthening yen, there is no limit to Japan's ability to fund such investments throughout Asia, and thereby to bolster demand for Japanese construction firms, machinery, design, and indirectly, upstream industrial production. Since Japan is very reluctant to expand its own domestic public investments (after a decade of high infrastructure spending), it can expand other countries' government investments by providing long-term, yen-backed financing, either bilaterally or through the Asian Development Bank. In this way, the world's second largest economy would help the region to increase the levels of government spending on critical, long-term sustainable development programs, including sustainable energy, pollution control, public housing, roads, ports, urbanization, and other big-ticket investment items. In macroeconomic terms, such investments could offset the declines of export earnings from the US and Europe and the homegrown declines in consumption spending.

There are huge investments needed that are hugely worthwhile in societal terms to bolster Asia's long-term sustainability. The region does not face an overall balance of payments constraint, inflation constraint, or even credit constraint (given the massive holdings of foreign exchange reserves). I would therefore like to view this global financial crisis as an opportunity to invest in public goods around the world. The public sector is chronically under-invested compared to private consumption. The US is the worst case of this, since public investment has been lagging for decades. There is also a huge backlog of public goods that are needed in Asia. The health sector and the education sector have too-low investment. The energy sector needs to be fundamentally overhauled, and pollution control needs to be put in place in the world's most densely populated and polluted regions.

I would like to add one more very important thing to the recommended policy mix: Asia could finance a lot of investment goods for Africa as well. This is an interest of mine because Africa is the poorest and least capitalized part of the whole world, with disastrously poor infrastructure. As a region, Africa needs power plants, roads, ports, and agricultural renovation. These are all things that Asia knows how to do very well. Rather than letting the factories sit empty, these goods should be sold to Africa as well, on favorable financial terms for the poor countries of Africa (meaning on the basis of low-interest, long-term loans, such as 2-percent, 40-year yen loans). Such investments would have a triple win: stimulus for the exporting countries; development for the African countries; and sustainability as long as we take care to put special emphasis on renewable energy, efficient water use, and information technology broadband investments which help to economize on natural resource demands.

In conclusion, we now have the historic opportunity to rebalance the public and the private sectors, and an opportunity to link the short-term macro stimulus with the long-term sustainability agenda. This is the kind of counter-recessionary, counter-cyclical stimulus that would allow Asia as a whole to maintain high growth, improve the environment, confront the challenge of climate change, and continue to export to other parts of the world by providing low-interest and long-term credit. A region that has a large trade surplus, massive foreign exchange holdings, low inflation, wonderful technologies, and an almost unlimited need for public-sector investments should see the ongoing global financial crisis as an opportunity to invest in the future for long-term well-being and sustainability.