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IMPACT OF THE FINANCIAL AND ECONOMIC CRISIS ON ASIA-PACIFIC ECONOMIES, PATTERNS OF RECOVERY, POLICY RESPONSES AND THE RELEVANCE OF REGIONAL AND INTERNATIONAL COOPERATION

(Item 4 of the provisional agenda)

Note by the secretariat

SUMMARY

Countries in Asia and the Pacific, as in other regions, have been grappling with the economic crisis since it hit with full force in late 2008. The region experienced substantial impacts on its financial and real sectors, although the depth of the impacts varied according to each country's degree of exposure to global finance and trade and the ability to respond with expansionary fiscal policies.

While the incipient signs of a recovery of growth in the region are emerging, there are concerns about its depth and speed, and whether the nature of the recovery will resurrect old challenges.

The failure of the current international architecture to respond with sufficient speed or force to the distinctive problems faced by the region has created a pressing impetus for expanding the role of regional policymaking in crisis management and recovery. Some key policy gaps in this endeavour are: (a) the lack of a regional first line of defence for countries in balance of payments difficulties; (b) a regional mechanism to utilize local resources to meet local development needs; and (c) cooperation in exchange rate policies.

The Committee may wish to consider the issues analysed in the present document and provide guidance on the future regional policy agenda in crisis management and recovery.

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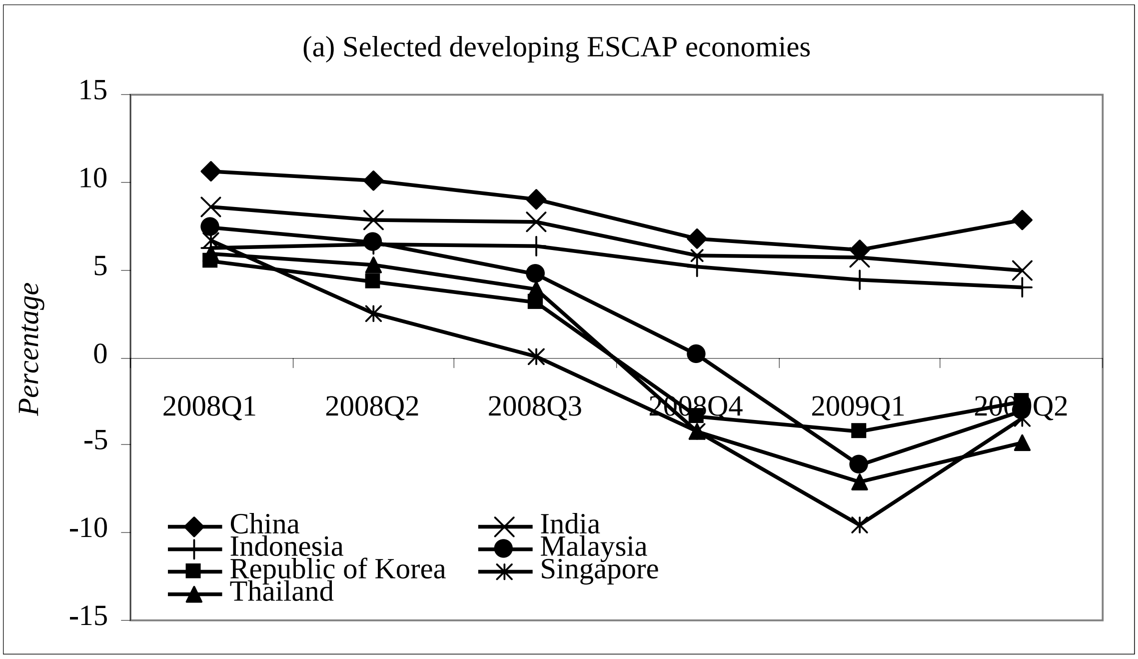
1. Countries in Asia and the Pacific, as in other regions, have been grappling with the economic crisis since it hit with full force in late 2008. At the time of writing, it would appear that the worst of the crisis is behind. The immediate challenge for the region's economies will be to devise policies that boost the speed and depth of economic recovery, while the medium-term challenge will be managing the quality of recovery for a more inclusive and sustainable development path.

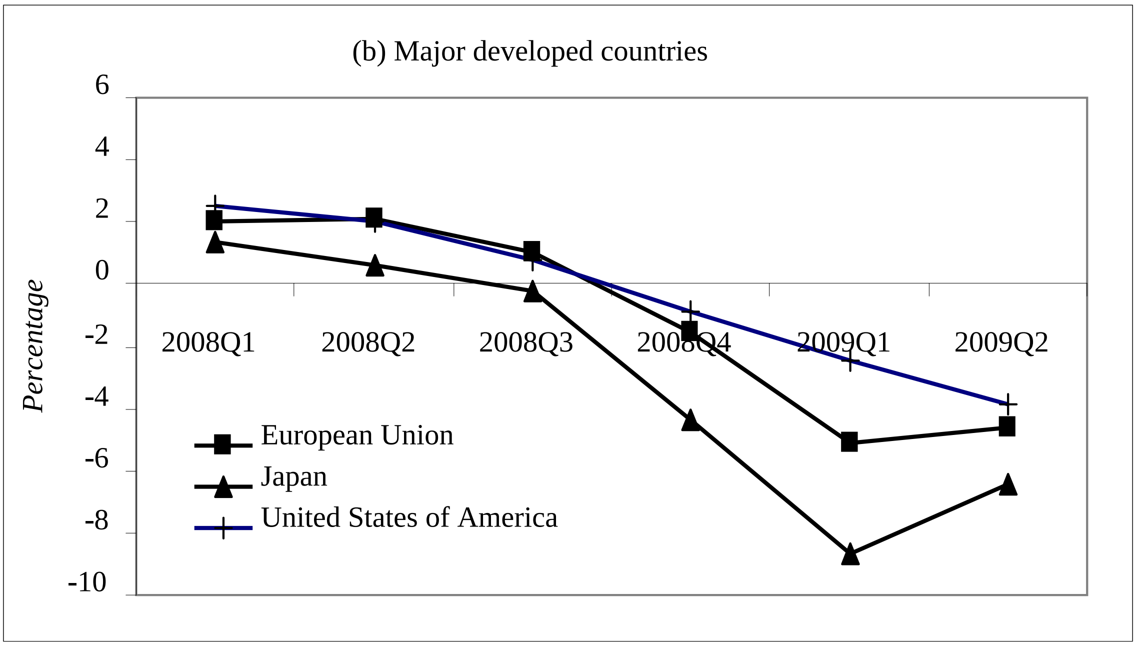
I. IMPACT OF THE CRISIS AND INCIPIENT RECOVERY IN ASIA AND THE PACIFIC

A. Growth and inflation

2. Growth in Asia and the Pacific was severely impacted from the fourth quarter of 2008 onwards as the full effect of the slowdown in exports to developed countries was felt (see figure 1). Deceleration deepened in the first quarter of 2009. It appears that the trough of the growth slowdown was close to being reached by the second quarter of 2009 in major economies of the region. This was in tandem with the bottoming out of the growth and consumption slowdown in the world's developed countries. Looking ahead, it is expected that economic performance will continue to pick up for the rest of 2009. Some economies may be able to return to the path of economic expansion very soon, although the exceptionally low base of comparison for the last quarter of 2009 should be borne in mind. Using currently available data, the gross domestic product (GDP) of developing economies in the Asia-Pacific region is expected to grow by 3.4 per cent in 2009. This forecast is predicated on the assumption that the world economy stays firmly on the current stabilization path and growth in developed countries bottoms out in the remaining months of 2009.

Figure 1. Real gross domestic product growth, year-on-year, in selected developing ESCAP economies and major developed countries, 2008-2009





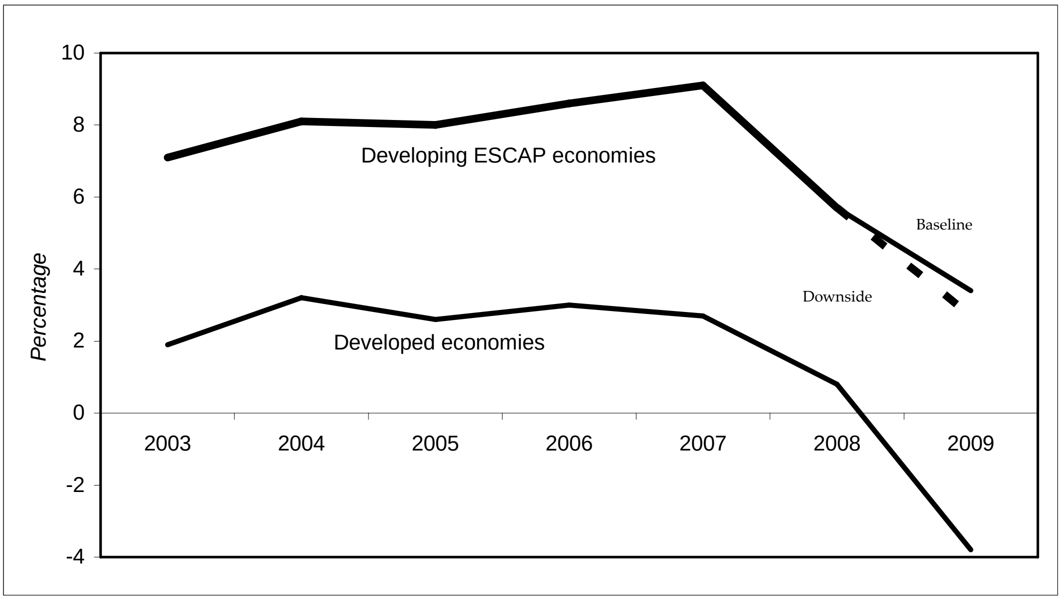
Source: ESCAP, based on data extracted from the online services of CEIC Data Company Limited.

3. While growth has started to recover in the region, the extent and durability of the recovery in the coming quarters is a matter of considerable uncertainty, dependent on developments outside the region—most importantly, the degree of recovery of consumption and industrial production in developed countries, a continued easing of the credit crunch and a return to normalcy in the global financial markets. Should the global economy, in particular the United States of America, post a stronger and faster recovery, the developing economies of Asia and the Pacific will be able to attain higher growth than the current forecast of 3.4 per cent. It nevertheless appears reasonably certain that it will take a number of years for demand from the developed world to return to its previous level as the debt overhang for consumers is cleared. On the positive side, it is also important to note that the continued growth resilience of developing ESCAP economies, in comparative global terms (figure 2), and the relatively large share of world GDP (16 per cent) accounted for by those economies, have made them the largest contributors to global growth in 2009.

4. Inflationary pressure came down significantly since the last quarter of 2008 in tandem with the downturn in domestic economic activity (see figure 3). This was also attributable to the lower imported inflation from declining global oil and food prices. The crude oil price averaged about $52 per barrel in the first half of 2009, as compared to an average of $97 in 2008. In the first half of 2009, food prices also fell, by around 30 per cent as compared to the same period the previous year.[1] Some economies, such as China, Singapore, Taiwan Province of China and Thailand, experienced various degrees of deflationary pressures, prompting some central banks to consider more aggressive monetary expansion measures. However, it is expected that this phenomenon will be short-lived and should not develop into a self-perpetuating downward spiral, as economic recovery picks up.

[1] Food and Agriculture Organization of the United Nations (FAO), FAO Food Price Index, September 2009, available at www.fao.org/worldfoodsituation/FoodPricesIndex/en/.

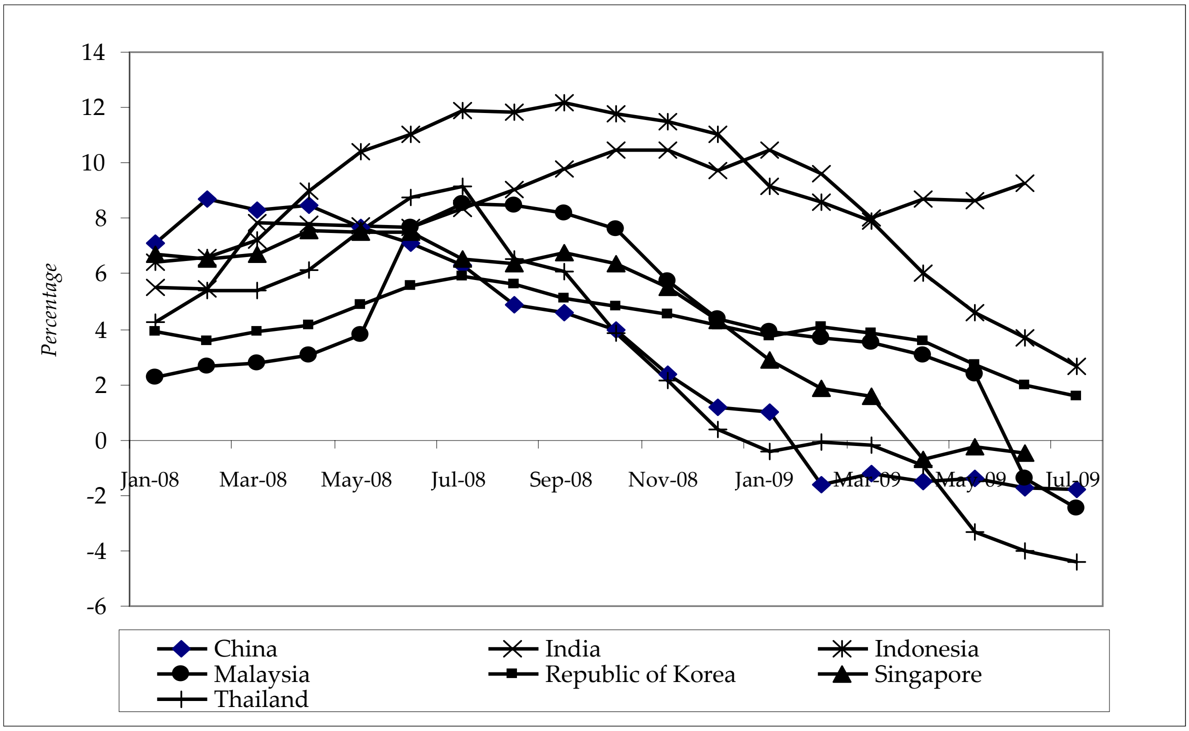
Figure 2. Real gross domestic product growth of selected developing ESCAP and developed economies, 2003-2009



Sources: ESCAP calculations based on national sources; International Monetary Fund (IMF), *International Financial Statistics CD-ROM* (Washington, D.C., November 2008); Asian Development Bank, *Key Indicators for Asia and the Pacific 2008* (Manila, 2008); website of the Interstate Statistical Committee of the Commonwealth of Independent States (www.cisstat.com), accessed on 5 August 2009; and ESCAP estimates and forecasts. Figures for developed economies are extracted from IMF, World Economic Outlook Database, April 2009 and *World Economic Outlook Update*, 8 July 2009.

Note: Gross domestic product growth for 2009 is based on estimates.

Figure 3. Consumer price inflation, year-on-year, in selected developing ESCAP economies, 2008-2009



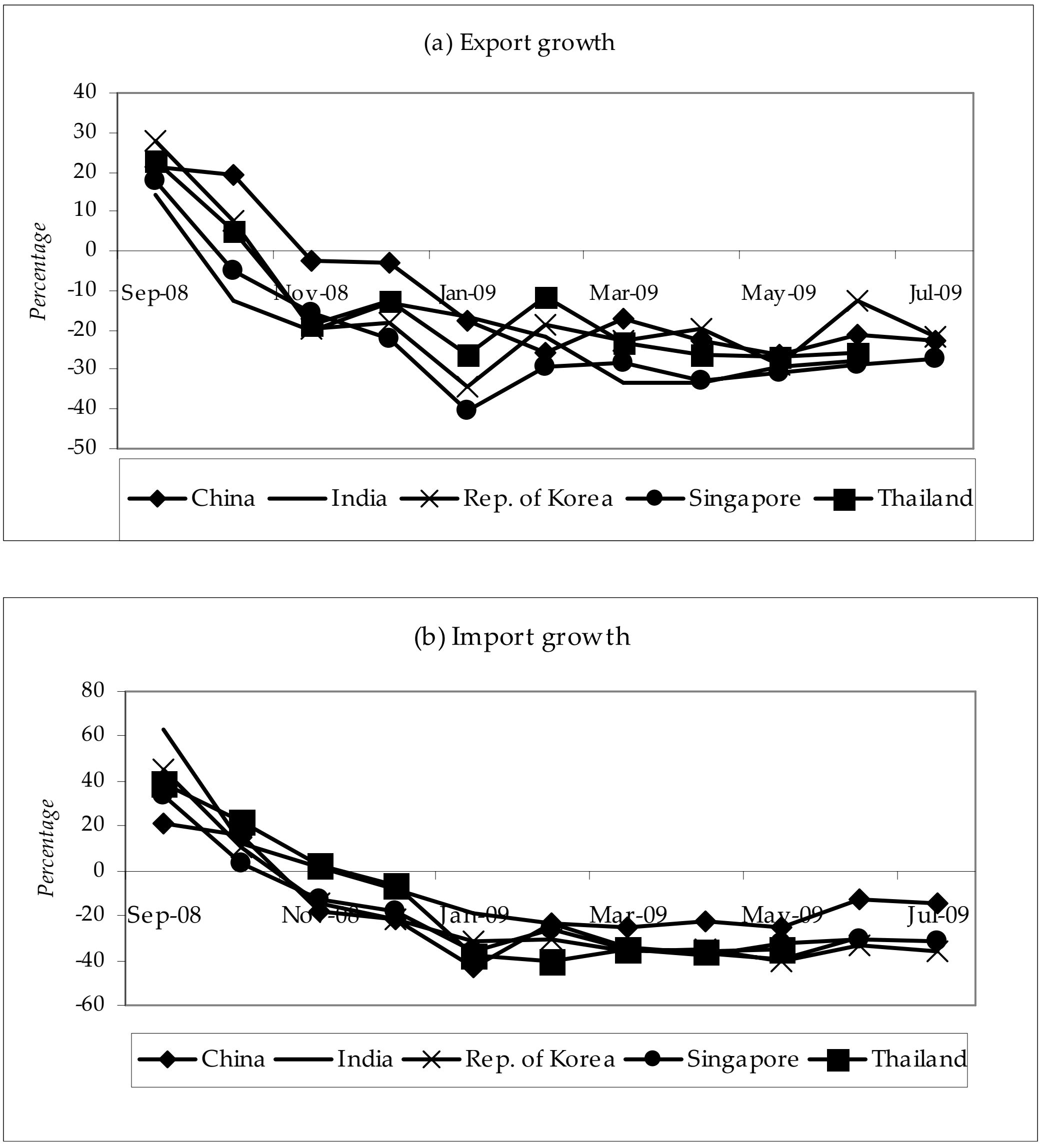
Source: ESCAP, based on data extracted from the online services of CEIC Data Company Limited.

B. Exports and domestic demand

5. The growth slowdown across the region was characterized by the relatively more severe impact on economies dependent largely on exports. Double-digit declines in export growth have been recorded for most economies since the latter part of 2008 (see, for example, figure 4(a)). Nevertheless, it appears that the depth of the export slowdown had stabilized across the region by around the first quarter of 2009 with some subsequent improvement.[2]

6. There is also some cause for relief from import growth data, which have revealed marked improvements (see figure 4(b)). Given the regionally integrated nature of the production base in South-East and East Asia, data on merchandise imports reflect the health of the regional vertically integrated production chain.

Figure 4. Growth in exports and imports, year-on-year, in selected developing ESCAP economies, 2008-2009



Source: ESCAP, based on data extracted from online services of CEIC Data Company Limited.

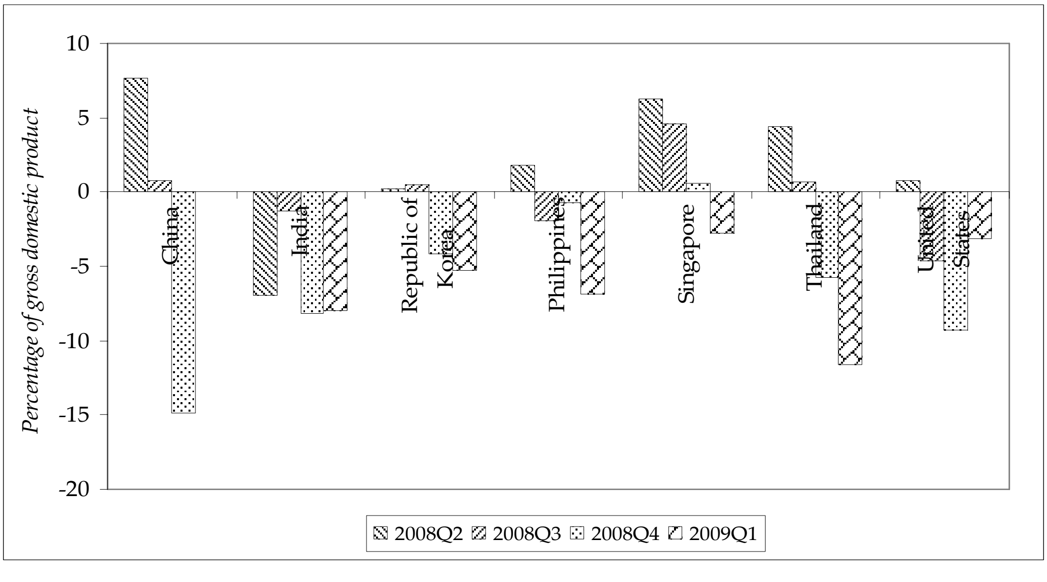
[2] Export data, like other macroeconomic data, may nevertheless exhibit historically high values for the next few quarters due to the exceptionally low base of comparison for the same period in the previous year, when the region was at the nadir of the crisis.

7. Some major economies more reliant on external borrowing to finance domestic credit creation, such as India and the Republic of Korea, were also impacted by the crisis through the channel of the global credit crunch. Despite the easing of monetary policy adopted by all countries, the reduced availability of international credit impacted growth by increasing the price of loans used to fund consumption and investment.

8. Economies in which domestic demand accounts for a large share of GDP, such as China and Indonesia, were notable in the region for continuing to display relatively robust and positive growth performance. India, other than its greater reliance on foreign financing, also benefited from the growth stability offered by its domestic demand. China, while being a major exporter, was cushioned by the relatively high proportion of GDP accounted for by domestic investment as well as by the second largest Government-spending programme in the world, permitted by the State’s sound fiscal position and accumulated reserves. Other Governments in the region also managed to contain the depth of their slowdowns through public spending programmes aimed at employment creation and support for domestic demand.

9. The unprecedented scale of Government spending, coupled with declining tax revenues, led to the major developing economies[3] in the region experiencing a decline in their fiscal balances as a percentage of GDP between the third quarter of 2008 and the first quarter of 2009 (see figure 5). Underlying these figures are some significant variations. Some major economies in East and South-East Asia had the ability to call on high fiscal reserves accrued through budget surpluses of the past. China, in particular, could afford to enact a fiscal stimulus package amounting to $586 billion, second only in size to the package of the United States, and the largest in the world in terms of share of GDP (see table). Economies in South Asia were less impacted by the export slowdown, but they had a lower capacity to moderate their growth declines through fiscal spending, due to their large fiscal deficits and the public debt accumulated prior to the crisis. Some economies, such as Japan, were impacted by both sharp declines in trade and large public debt levels, but were faced with little choice but to proceed with expansionary fiscal measures to moderate the depth of their GDP deceleration.

Figure 5. Budget balance as a percentage of gross domestic product in selected ESCAP economies and the United States of America, 2008-2009Q1



Sources: ESCAP, based on data extracted from the online services of CEIC Data Company Limited and the Economist Intelligence Unit online (accessed 19 August 2009).

[3] This refers to the 11 major developing economies in the region for which data on fiscal balances were available.

Size of stimulus packages and public debt as a share of the gross domestic product of selected Asia-Pacific economies and the United States of America

	Stimulus packages (Percentage of 2008 gross domestic product)	*Total public debt[a] (Percentage of gross domestic product)*
Australia	4.4	14.7
Bangladesh	0.6	39.4
China	18.1	15.6
India	4.1	62.1
Indonesia	2.7	29.3
Japan	4.3	178.8
Malaysia	9.0	48.6
Philippines	4.4	56.9
Republic of Korea	8.4	33.6
Russian Federation	7.2	6.7
Singapore	8.0	110.5
Thailand	17.0[b]	43.2
United States of America	5.5	75.0

Sources: ESCAP based on information on stimulus packages obtained from official Government websites; Economist Intelligence Unit (EIU) country reports; and various news sources. Data on total public debt obtained from EIU.com (accessed 7 September 2009) (Australia, Bangladesh, China, Indonesia, Philippines and Russian Federation); CEIC Data Company Limited (Japan, Malaysia, Singapore and Thailand); International Monetary Fund, "Staff Report for the 2009 Article IV Consultation (Washington D.C., IMF, 2009) (Republic of Korea); and national sources (India and the United States of America).

[a] Total public debt of Australia, Bangladesh, China, India, Indonesia, Philippines, Republic of Korea, Russian Federation and United States refers to 2008. Total public debt of Japan, Malaysia, Singapore and Thailand refers to 2009Q2.

[b] Including second stimulus packages, which will be implemented in 2010-2012.

10. While all stimulus packages in the region are designed to support aggregate demand, particularly domestic demand, the approaches differ according to each country's level of development and national circumstances.[4] Estimating the true scale of fiscal stimulus can, however, be difficult. Some announcements, for example, may refer to capital outlays that were already in the pipeline. Furthermore, many countries have found it difficult to ensure the swift disbursement of pledged stimulus funds, with some delays being experienced in maintaining anticipated schedules. Another issue has been the relatively longer time taken to execute capital projects, as opposed to tax cuts or cash-transfer-related stimulus measures. There also remain issues about the transparency of spending, although a few countries have put in place mechanisms for public monitoring. Thailand, for example, has announced a database, to be accessible through the Internet, that allows the monitoring of spending and budget disbursement on individual projects.[5]

C. Capital flows and exchange rates

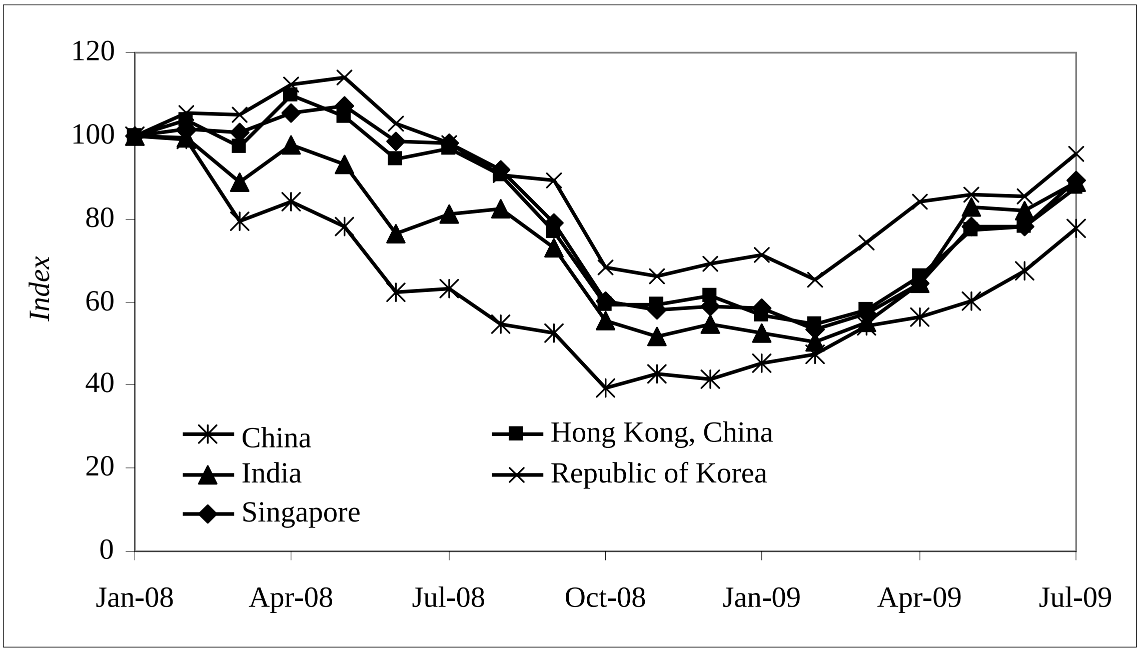
11. The initial impact of the crisis on the region was felt through the financial markets as investors withdrew capital from equity and debt markets in a flight to safety. For highly leveraged investors, declining equity values abroad also triggered margin calls. This outflow of capital led to particularly sharp falls in markets where,

[4] The secretariat provides a one-stop information and analytical service on the various packages. This information is updated regularly at www.unescap.org/pdd/publications/survey2009/stimulus/fiscal-stimulus.pdf.

[5] *Bangkok Post*, "Investment programme open to scrutiny online", 13 July 2009.

taking advantage of high global liquidity, foreign investors had acquired an increasing presence. In recent months, financial markets in the region have seen a sharp upturn (see figure 6), after reaching their troughs in early 2009, due to renewed inflows of foreign capital. In some cases, stock markets have returned close to levels seen immediately before the crisis.

Figure 6. Equity markets in selected developing ESCAP economies, January 2008 to July 2009



Source: ESCAP, based on data extracted from the online services of CEIC Data Company Limited.

12. Equity markets are considered by many as a leading indicator of future economic performance, and their recovery appears to reflect the view of financial investors that growth will return to the region in coming months. It is a matter of debate, however, whether the optimism of investors regarding the future recovery is somewhat excessive and possibly led in part by the need to invest the buoyant funds available due to the unprecedented injection of liquidity to the financial sector in developed countries by their Governments.[6] Consequently, there is a risk of further volatility in financial markets in the months ahead.

13. In common with other capital flows, foreign direct investment (FDI) to the region was significantly impacted during the crisis. China, for example, attracted 20 per cent less FDI in the period January-July 2009 as compared to the same period in the previous year.[7] Foreign enterprises did not pursue investments abroad due a number of factors: (a) downward adjustment in expectations of the profitability of the investment; (b) the need of developed countries to save funds for difficulties faced in their home markets; and (c) difficulty in obtaining financing due to the credit crunch. Therefore, some reorientation will take place in the sources of FDI, as more investment comes from the relatively profitable enterprises of countries within the region.

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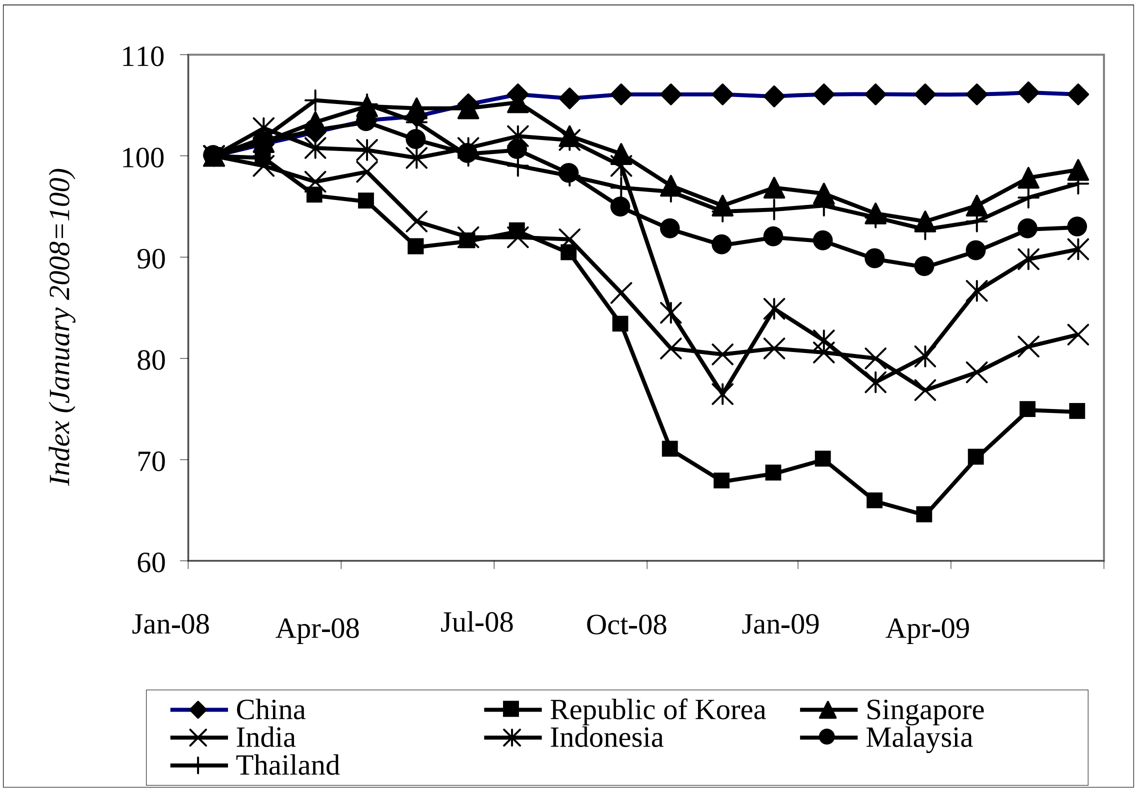
[6] See, for example, "Mixed signals from Asia's animal spirits", *Financial Times*, 14 May 2009.
[7] Terence Poon, "Foreign direct investment in China continues to slide", *Wall Street Journal*, 18 August 2009.

14. There is also a divergence in the FDI prospects of countries in the region depending on the nature of their economies. FDI is likely to be more market- and labour-seeking, aimed at tapping into buoyant domestic demand in the large economies of the region. This reorientation will come at the expense of the more traditional forms of intra-firm FDI between and within East Asian economies and South-East Asian economies that were used to establish regional production networks to supply parts and components for consumer products destined for developed-country markets.

15. As capital inflows have returned to the region, upward pressure has been placed on exchange rates, following the substantial depreciation observed at the onset of the crisis (see figure 7). For example, having depreciated substantially since early 2008, the value of the Korean won rose by almost 9 per cent in the first half of 2009 compared to end-2008.

Figure 7. Exchange rate movements in selected developing ESCAP economies, 2008-2009



Source: ESCAP, based on data extracted from the online services of CIEC Data Company Limited.

16. The onset of the crisis had seen exchange rates relative to the United States dollar and the euro decline as investors fled to the perceived safety of major global currencies, in particular the dollar. The situation has now been reversed, as concerns have grown about the future strength and role of the dollar as a reserve currency given the build-up of Government debt as a consequence of the massive bailout packages. The strength of the dollar prior to the crisis was supported to a significant degree by the investment in Treasury bonds by the Governments of Asia and the Pacific as a corollary of currency management policies to control exchange rate appreciation. The need to engage in similar policies in the coming months to manage currency appreciation and thereby encourage nascent export recovery will require Governments to make important decisions about how to reduce exposure to losses on

any future investments in dollar assets. China has been at the forefront of encouraging alternative solutions, including settling trade transactions in yuan with selected foreign partners and supporting purchases of foreign enterprises by Chinese companies.

D. Jobs and income

17. On the ground, the crisis has hit the citizens of the region most directly through its impact on jobs and incomes. Unemployment is known to operate with a lag, as enterprises first attempt alternative solutions to releasing workers, while at the end of the crisis they take time to expand entrepreneurial activity and rehire workers. Therefore the impact on employment is likely to be seen throughout 2009 and will continue even after GDP growth begins to recover. In 2008, as the initial effects of the crisis were felt, unemployment was estimated to have risen by 4.4 million.[8] As the crisis unfolds, it has been estimated that unemployment in Asia and the Pacific could increase by as much as 26.3 million workers as compared to 2007. The greatest impact has been felt in the export manufacturing sector, including garments, electronics, handicrafts and autos, as well as in tourism, finance, services and real estate. The crisis will also hit wages, and average annual real wages in 2009 could remain stagnant or even fall in countries that continue to experience low economic growth.

18. A matter of concern is that increases in unemployment in developing countries exert a far greater socio-political impact than those in developed countries due to a lack of social protection systems. Unemployment figures do not increase by as great a degree as would otherwise be the case in such a difficult economic climate, as remaining unemployed is not an option for many people if they wish to maintain their most basic needs. Therefore, in many cases unemployment figures have been kept lower as people cope by shifting from urban to rural employment and to more vulnerable and informal types of employment, including underemployment.

19. As the 1997 crisis showed, when people are affected by sudden shocks, the ones most at risk are the poor, women workers in the manufacturing sector, the youngest and oldest populations and low-skilled immigrants. A major concern has been the impact of unemployment on women workers, because the worst-affected sectors were those very sectors, such as garments and electronics, in which the labour force consisted of a large share of women workers. In Thailand, for example, female employment in manufacturing decreased by close to 130,000 (year-on-year) in the fourth quarter of 2008, accounting for 63.2 per cent of the total decrease in employment in that industry. Of special concern is the effect on youth, a group that is vulnerable to unemployment due to its relatively low skills. In some countries, in particular those with young populations, youth unemployment is expected to increase from already high levels. In the Philippines, for example, youth unemployment increased by 5.9 per cent in January 2009 (year-on-year). Prolonged youth unemployment, besides reducing overall family income levels, could also lead to long-term psychosocial problems with significant rises in suicide and crime rates. When societies are under severe stress, as in the 1997 crisis, abuse and violence against women and ethnic tensions rise.[9] Women bear the brunt of these social fallouts. The damage of a crisis therefore lasts much longer than the crisis itself. After

[8] Unless otherwise indicated, data in this subsection are drawn from G. Sziraczki, P. Huynh and S. Kapsos, “The global economic crisis: labour market impacts and policies for recovery in Asia”, International Labour Organization Asia-Pacific Working Paper Series, June 2009.

[9] See N. Heyzer and M. Khor, “Globalization and the Way Forward”, Development Outreach “Speaker’s Corner” (Washington, D.C., World Bank, 1999); and J.C. Knowles, E. Pernia and M. Racelis, “Social consequences of the financial crisis in Asia: the deeper crisis,” Economic and Development Resource Center Briefing Notes No.16 (Manila, Asian Development Bank, 1999).

the 1997 crisis, for example, economic growth resumed relatively quickly, but some countries took up to 10 years to recover the ground they had lost in the struggle against poverty.[10]

II. ASSESSING THE INCIPIENT RECOVERY

20. While the incipient signs of a recovery of growth in the region are emerging, there are concerns about its depth and speed, and about whether the nature of the recovery will resurrect old challenges as well as create new obstacles to achieving stable and sustained development in coming years. At present, the drivers of the recovery remain Government led due to the significant fiscal stimulus actions enacted across much of the region. Such stimulus is inherently time-bound due to the emerging strains on Government budgets. The key question at present is whether growth drivers can self-ignite and remain alight as the Government eases off on its throttle. Anything less could see the economy falling back quickly into a double-dip recession.

A. The search for new sources of growth

21. One aspect supporting the revival of private-sector-led growth in recent months has been a noticeable increase in the international availability of credit. This will support the revival of private investment and consumption in the region. However, trade will continue to face significant challenges without the revival of consumption demand in developed countries. The growing pressures for protectionist measures in developed countries—and potentially in developing countries—are of great concern for the recovery of the Asia-Pacific region. Their implementation would distort market-entry conditions for exports from this trade-oriented region. While explicit forms of protectionism would trigger the dispute settlement mechanism of the World Trade Organization (WTO), numerous more covert forms of protectionism are still possible. In many cases they would come under the guise of contingency protection and be permissible under WTO rules, while in other cases, subsidy programmes and other forms of preferential treatment to local purchases given as part of bailout packages could significantly alter the competitive conditions of trade for some time to come. Export-dependent South-East Asia will be the hardest hit, as will China, the region’s growth locomotive. In this respect, an early conclusion of the Doha Round in accordance with its development mandate is essential to tighten the predictability of access to export markets for developing countries and allow trade to spur economic recovery.

22. A clear route for mitigating the decline in the role of exports to developed countries in the years ahead is to increase the share of intraregional trade and domestic demand in providing markets for local producers. However, there continues to be pressure on developing countries in the region to implement protectionist measures to protect domestic jobs, or to safeguard balance of payment pressures as a result of declining exports. Maintaining the vibrancy of intraregional trade is, however, to the long-term advantage of all in the region. The approach should therefore be to continue moves to ease the ability to trade within the region through initiatives for regional trade agreements, customs unions and common markets. Such agreements are especially rewarding for smaller and poorer economies, as they facilitate the creation of supply capacities through the movement of trade-creating investments. In the past few months, the region has indeed moved to expand and broaden the scope of its network of intraregional trade agreements, particularly between the Association of Southeast Asian Nations (ASEAN) and the major

[10] See International Labour Office, “Shaping a fair globalization: perspectives and prospects for the Decent Work Agenda” (GB.303/WP/SDG/1), submitted at the 303rd session of the Governing Body of the International Labour Office, Geneva, November 2008.

economies of China, India and the Republic of Korea, adding to earlier subregional arrangements, such as the South Asian Free Trade Area, the ASEAN Free Trade Area, the Asia-Pacific Trade Agreement[11] and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation. The region nevertheless is still in the early stages of integration and there remains the need to deepen and broaden arrangements, as well as complement them with improved physical connectivity and trade facilitation.

23. As for increasing the role of domestic demand, Government stimulus measures have temporarily increased the contribution of Government investment and consumption in a number of countries. Fiscal stimulus in some countries has also acted to increase private consumption through the provision of funds directly to consumers. However, for domestic demand to increase its contribution beyond such temporary fillips, policy changes that induce a long-term structural rebalancing of economies are required. Large countries in the region have the potential to substantially increase the role of private consumption by redoubling their efforts in poverty reduction. Accounting for two thirds of the world's poor, the region has the potential to add millions of new consumers.

24. One important means of providing the poor with more disposable income is to ensure universal access to affordable basic health and education services. This frees up the precautionary savings of citizens for spending on consumption. Such a strategy is particularly effective in terms of the propensity to consume, as those most likely to engage in precautionary saving are the relatively poor, who would subsequently also be likely to spend any reduction in their required precautionary savings. China, for example, has provided an example of policy changes to significantly extend health-care provision to the general population. India has also moved to enact a law in 2009 guaranteeing basic education to its population, as well as already having guaranteed, in recent years, the rural poor the right to work for at least 100 days per year. Universal access to such services also results in more educated, healthier and thus more productive people. Nevertheless, a key concern for many countries remains the cost increases and implications for fiscal balances.

25. It is clear that small export-oriented economies will find it difficult to create sufficient new domestic demand to overcome the significant contribution currently provided by exports. For these economies, a more feasible option lies in increasing regional trade with the large economies that may further increase the role of domestic demand. Regional economic cooperation and integration should be motivated by the guiding principle of the mutual benefits of sharing each other's dynamism.

26. Despite positive moves in the direction of boosting regional and domestic demand, a circumspect view of the overall panorama for growth in the region should factor in the strong possibility of a number of years of reduced growth trajectory in developed countries, as compared to their performance before the crisis. The best-case scenario within a number of years may be that consumption demand in developed countries recovers somewhat but not to the level of the past, which was enabled through the accumulation of household debt.

27. One consequence of lower growth may be persistent higher unemployment and underemployment as well as a possible reversal in the poverty reduction improvements made hitherto. Under these circumstances, establishing social security and insurance for the unemployed and poorest will become an increasingly pressing

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[11] Previously known as the Bangkok Agreement (1975), the revised text and new name was adopted by the Ministerial Council of the Bangkok Agreement at its first session, Beijing, 2 November 2005 (available at www.unescap.org/tid/apta/ta_amend.pdf).

policy issue. Patterns of intraregional migration may also be affected. On the one hand, increased difficulty in finding work at home may enlarge the supply of migrants available to work in the region and further afield. On the other hand, previously booming economies will demand fewer workers from the region and pay lower wages. Some migrant-receiving countries have already implemented more restrictive practices. The options for formal migration have narrowed and, with fewer employment opportunities, greater discrimination and stigmatization have been encountered. According to the United Nations Development Programme, more undocumented migrants and unsafe migration can be expected if unemployment continues to rise in the region.

B. Return of inflationary pressures

28. Along with uncertainty about the depth and speed of the recovery, there are concerns that growth may be unstable and unsustainable in future years. One issue is the possible return of inflationary pressures as the recovery gathers steam. The most recent data show that by July 2009, the fall in inflation rates since the start of the crisis had nearly stabilized in many countries, with the expectation of increase in the months ahead. India, for example, was the first major economy to witness an increase in inflation since March 2009, most worryingly in food prices.

29. A critical policy issue for countries in the region will be when and how to turn off the taps of fiscal stimulus and accommodative monetary policy. Careful calibration is needed so as not to threaten incipient growth, while at the same time not allowing the start of an inflationary spiral. The latter would be self-defeating, as it would necessitate restrictive monetary policy and therefore also stop the recovery abruptly.

30. A related issue is the likely resurgence of higher commodity prices. As highlighted in the ESCAP *Economic and Social Survey of Asia and the Pacific 2009*,[12] this is a likely occurrence once the crisis subsides. There are now early signs that increasing commodity prices are coming to the fore once again. Oil prices have increased substantially in recent months. The food-fuel link means that key food prices could also be influenced upwards by this trend. The reasons behind the rise in oil prices are a matter of debate. It is not immediately obvious that prices should be high at a time of recession in much of the world. The role of speculation in the oil market has been suggested as one possible driver of part of the increase in prices.[13] The large amount of liquidity available to financial investors coupled with the belief that oil prices should be moving upwards on fundamental demand-supply factors have also played a part. It is not clear what the endpoint of this process will be; the danger is that high oil prices will threaten the nascent recovery.

31. A return of high food prices would follow quickly, thus food prices require close monitoring in coming months. As the recovery may arrive at different times across the region, an increase in prices caused by the earlier recovery of some large food-demanding economies would create a situation of higher food prices and lower growth. While high oil prices may be likely to impact GDP growth more through higher manufacturing costs and lower consumption for the middle class, higher food prices may have a far more direct impact on the least well-off sections of the population.

[12] United Nations publication, Sales No. E.09.II.F.11.
[13] See, for example, Paul Krugman, "Oil speculation", *New York Times*, Opinion, 8 July 2009; and United Nations Conference on Trade and Development, *Trade and Development Report 2009* (United Nations publication, Sales No. E .09.II .D.16), chap. II.

32. The threat of rising food prices stems from the continued food supply-and-demand imbalance in the region, as highlighted previously by ESCAP.[14] The Asia-Pacific region has yet to take adequate measures to encourage long-term increase in food production. Indeed, the motivation to take action to reverse the long-term neglect of agriculture that was clear immediately prior to the crisis in 2008 diminished with the new challenges of the crisis. Rising populations and increased consumer wealth in developing countries will continue to advance, thus making food security and sustainable agricultural development a key policy challenge for the region.[15]

III. POLICY LESSONS FROM THE CRISIS

33. A key lesson to draw from this crisis, as with all previous episodes, is that crises differ from each other, particularly in the way they transmit instability. Indeed, logic would dictate that crises would be unlikely to repeat the same patterns, as policymakers have all relevant past information and are expected to mitigate known risks before they build up to cause a crisis. Nevertheless, a comprehensive analysis of the lessons from this crisis is important so as to add to the list of known risks to the region. Over and above preventing similar risks from building up, policymakers will need to monitor new trends, which although initially viewed as benign, could eventually be the cause of the next crisis, or could evolve into a new transmission channel for the next crisis.

A. Channels of financial transmission

34. While the present crisis clearly originated in developed countries' highly leveraged financial and banking systems and their securitized assets, the transmission to Asia and the Pacific was indirect. Banks in the region had few investments in such complex financial instruments, partly as a result of the changes to the banking sector enacted after the 1997 crisis, and partly because many banks in the region lacked advanced systems and expertise to deal with such products.

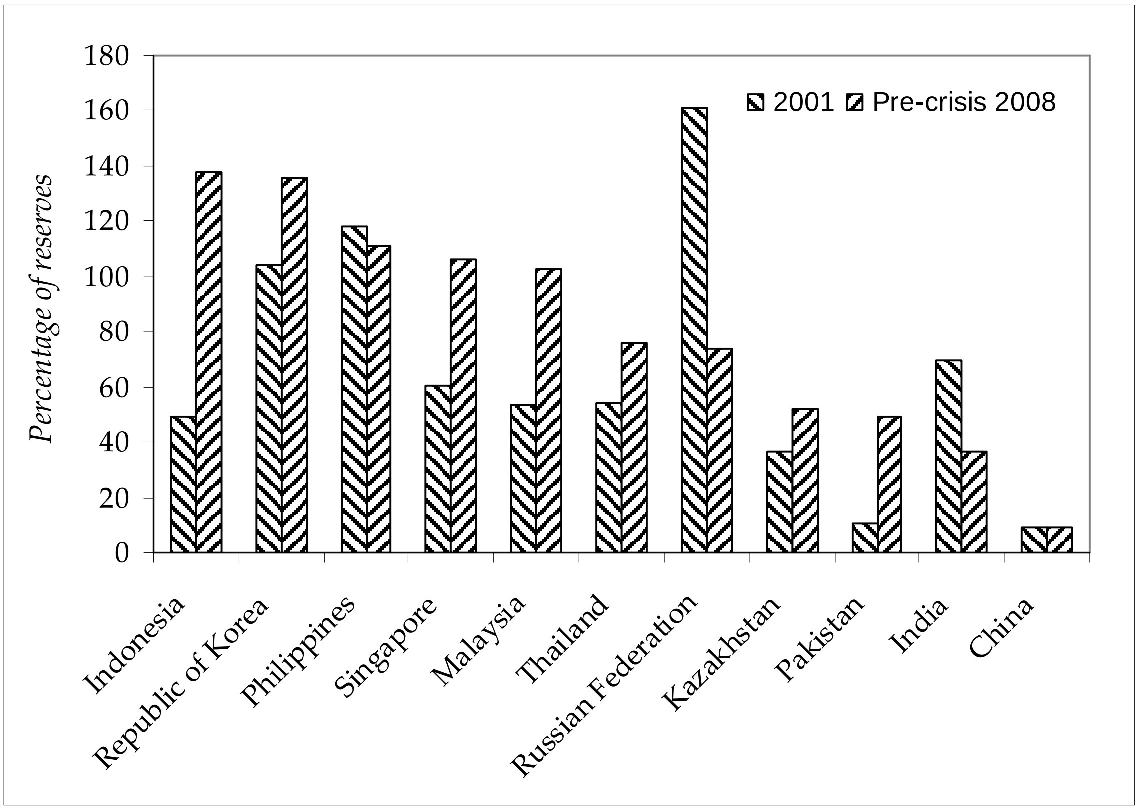
35. Instead, the region experienced the first impact of the crisis through another channel, which, as in the 1997 crisis, created instability: short-term capital flows. Policymakers had attempted to mitigate the risk from this channel by building up foreign reserves to levels sufficient to enable countries to cope with expected capital outflows. The manner in which the channel of capital flows operated in this instance, however, was different from 1997. At that time, the problem with capital flows lay more in the excessive short-term foreign debt of domestic banks and other private sector operators.

36. However, the past decade was notable for another aspect of capital flow build-up—that of foreign portfolio capital. The quantum of such flows was not necessarily manageable to the same degree as short-term foreign debt in some countries at the start of the crisis, in terms of the comparable foreign exchange reserves coverage. Figure 8 shows that, prior to the eruption of the financial crisis, Indonesia, Malaysia, the Philippines, the Republic of Korea and Singapore all had stocks of foreign portfolio investments whose value exceeded foreign reserves. When the financial instability hit, there was a flight to safety and capital exited rapidly. Responses varied: for example, in the Republic of Korea, there was a drawdown of foreign exchange reserves; Pakistan faced the most pressing difficulty in maintaining

[14] See *Economic and Social Survey of Asia and the Pacific 2009* (United Nations publication, Sales No. E.09.II.F.11), chap. II.
[15] ESCAP, *Sustainable Agriculture and Food Security in Asia and the Pacific* (United Nations publication, Sales No. E.09.II.F.12).

its currency value, and sought International Monetary Fund (IMF) support as its currency fell to an all-time low. Singapore and the Republic of Korea each agreed to a precautionary $30 billion currency swap facility with the United States Federal Reserve, while the Republic of Korea agreed to an additional expansion of existing currency swap arrangements with Japan and China to $20 billion and more than $25 billion, respectively.

Figure 8. Stock of portfolio investments as a percentage of foreign exchange reserves, selected economies, 2001 and pre-crisis 2008



Source: ESCAP, based on data extracted from the online services of CEIC Data Company Limited. International Monetary Fund, International Financial Statistics (CD-ROM) (Washington, D.C., 2009). Data for pre-crisis 2008 refers to latest available data for each country prior to the onset of crisis in September 2008.

Note: Derived from the international investment position of respective economies, including the categories of stock of portfolio investment and financial derivatives investment, excluding direct investments and other investments.

37. The lesson that may be drawn from this analysis is that the risks to currencies become apparent through a more holistic view of short-term capital flows. The traditional view that short-term debt is the main component of such flows should be tempered with the finding that portfolio capital has become increasingly important in the region and has the potential to destabilize currencies by flowing out in a similar short-term fashion.

38. The next question that arises is how best to deal with portfolio capital flows, especially in the context of vastly enhanced liquidity in developed countries. This is a matter of much debate. An uncontrolled inflow requires a build-up of sufficient reserves to buffer sudden outflows. However, building up reserves is costly due to potential exchange rate losses as well as to the loss in interest income from having to invest the funds in low-interest-earning foreign currency assets. Another option would be to manage the quantum of inflow of such funds through various methods of

capital controls. It is not obvious that a completely open capital account is necessarily appropriate from a cost-benefit analysis,[16] particularly since research has suggested that the benefits of such openness are ambiguous at best.[17] Furthermore, the relevance of an international tax to moderate the volatility of portfolio flows, the so-called Tobin tax, has been discussed in the context of problems inherent in imposing capital controls at national levels.[18]

B. Channels of trade transmission

39. The crisis has clearly demonstrated the extent to which economic growth in Asia and the Pacific is dependent on exports to developed countries. Fairly robust growth in the major domestic-demand-led economies of the region failed to make up for the export declines in the major exporting nations of East and South-East Asia, pointing to the continued dominance of developed countries as the final consumers of the region's goods. Though intraregional trade for final consumption in the region has grown strongly in the past decade, it has been from a low base and remains less important. For intraregional trade to serve as an additional source of economic growth, producers in the region will need to adjust their supply to the needs of the large and growing domestic-demand-led economies. China, for instance, is expected to increase its domestic consumption demand significantly in the coming years, resulting in a change in the composition of the country's imports towards final consumption goods while imports of intermediate goods would decline.[19]

IV. ADDRESSING POLICY GAPS: THE IMPETUS FOR COOPERATION

40. In this crisis, the current international architecture did not respond with sufficient speed or force to the distinctive problems faced by developing countries. The role of regional policymaking in crisis management and recovery has thus featured prominently. Enhanced regional cooperation, however, should not be regarded as an alternative to full participation in global economic relations, but rather as a support, filling in the gaps and putting in place building blocks for multilateral cooperation at the global level.

41. There have been two major and complementary initiatives at the global level: the Group of 20 (G20) process and the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development in June 2009. The G20 meeting in April 2009 addressed the most immediate task of restoring confidence and assisting recovery by providing international financial institutions and multilateral development banks with a package of $1.1 trillion to restore lending. The United Nations Conference was able to bring together nearly all United Nations members and thus was able to set a uniquely inclusive and comprehensive agenda for action. The need for regional cooperation to supplement global initiatives was clearly recognized in the Draft outcome document of the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development in June 2009 (A/CONF.214/3), paragraph 20 of which states:

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[16] D. Rodrik, "The social cost of foreign exchange reserves", *International Economic Journal*, vol. 20, No. 3, pp. 253-266.

[17] See, for example, M.A. Kose, E. Prasad, K.S. Rogoff and S.J. Wei, "Financial globalization: a reappraisal", NBER Working Paper No.12484 (National Bureau of Economic Research, 2006); B. Eichengreen, *Capital Flows and Crisis* (Cambridge, MA, MIT Press, 2003).

[18] Gerald Epstein, "Should financial flows be regulated? Yes", DESA Working Paper No. 77 (New York, Department of Economic and Social Affairs, 2009); and Avinash Persaud, "We should put sand in the wheels of the market", *Financial Times*, Opinion, 27 August 2009.

[19] Papa N'Diaye, Ping Zhang and Wenlang Zhang, "Structural reform, intra-regional trade, and medium-term growth prospects of East Asia and the Pacific", Hong Kong Monetary Authority Working Paper 17/2008 (December 2008).

> Given the sensitivity of regional and subregional institutions to the specific needs of their constituencies, we note the value of regional and subregional cooperation efforts in meeting the challenges of the global economic crisis and we encourage enhanced regional and subregional cooperation, for example, through regional and subregional development banks, commercial and reserve currency arrangements, and other regional initiatives, as contributions to the multilateral response to the current crisis and to improved resilience to potential future crises.

The United Nations conference was followed by the G20 meeting in Pittsburgh in September 2009, which made important progress in rebalancing the world order and giving a more influential agenda-setting role to major developing economies of Asia and the Pacific.

42. In this evolving global architecture, the importance of regional cooperation was also underlined by the Commission in its resolution 65/1 on the implementation of the Bali Outcome Document in addressing the food, fuel and financial crises. While expressing concern about the financial crisis, which had become a global economic crisis, the Commission invited the countries of the region to consider the implementation of the recommendations contained in the Bali Outcome Document, which set out several areas of regional cooperation, and requested the Executive Secretary to continue to assist members and associate members through, among other things, in-depth analysis, policy dialogue and capacity-building activities.

43. Among its activities to support member countries during the crisis, ESCAP, along with Bangladesh Bank, held the Regional High-Level Workshop on "Strengthening the Response to the Global Financial Crisis in Asia-Pacific: The Role of Monetary, Fiscal and External Debt Policies" in Dhaka from 27 to 30 July 2009, which resulted in an extensive analysis of the role of regional cooperation in supporting economic recovery. Chapter VII, paragraph 37, of the Workshop's outcome document refers to a large unexploited potential for monetary and financial cooperation in Asia and the Pacific.

44. The regional panorama for cooperation is complex, with wide-ranging regional political groupings. There is potential to evolve a broader Asia-Pacific cooperative framework for resuming economic growth in the region and preserving macroeconomic stability. Political leaders in Asia and the Pacific have articulated through various forums a vision of a unified economic space that will evolve over time. Moving from vision to action will require identifying pragmatic ways and means of moving forward—an approach in which the overall regional economic and social benefits will override geopolitical sensitivities. Some of the elements which could feature prominently in the region's agenda are discussed below.

A. The regional crisis management gap

45. This crisis brought to the fore the lack of financial tools available at the regional level, over and above those in the hands of national Governments. While some countries had built up sufficient reserves to protect their balance of payments, other countries were impacted and did not have recourse to regional sources of assistance. The funds available through the Chiang Mai Initiative of ASEAN+3, the clearest example of a regional financial cooperation scheme, remained insufficiently developed as a first source of assistance and some members found alternative sources of support, as discussed above.

46. The region now has an opportunity to press forward with a truly effective regional crisis response fund. The potential for monetary and financial cooperation in

the region remains largely untapped. The Asian Clearing Union, for example, remains limited to the clearing of settlements and does not deal with exchange rate stability. The Asian Bond Fund, another regional initiative, remains small in scale and thus still needs to evolve before it becomes a credible source of financing. Similarly, the multilateralization of the Chiang Mai Initiative reserves pool, as agreed in 2009, in its planned form could also evolve into a truly effective first line of defence for the region, if its geographical coverage, size, and functions are expanded. The Initiative's institutional structure, including its relationship with IMF, and surveillance and monitoring functions are additional issues on which political leadership from this region is needed.

47. To be effective in preventing systemic crises, a regional crisis fund should attempt to include as many countries in the region as possible. The fund should have sufficient financial resources to enable it to act as the lender of first recourse in the event of macroeconomic difficulty. The fund should ideally include support to domestic financial sectors in its remit, in addition to balance of payments support to Governments, to enable assistance to banks, as was undertaken by Governments in the United States and Europe in recent months. The fund would require a physical infrastructure with qualified staff to monitor economies prior to and during crises, as well as to devise the terms associated with lending to Governments in the region and monitor compliance with such terms.

48. Another area that lends itself to regional cooperation is trade finance. The drying up of trade finance in this crisis was not due to any shortcomings of domestic banks but rather to a generalized global unwillingness of banks to lend to each other. Central banks in the region moved rapidly to ease the availability of trade finance as the strain to exporters became clear, as did the international community through the G-20 meeting in April. Nevertheless, the reaction in Asia and the Pacific was delayed more than necessary, as it is the only region in the world without its own trade finance institution.

B. Regional funding of development gaps

49. Beyond highlighting regional actions needed for crisis management, the crisis has also exposed the need for regional cooperation in funding development gaps—a "regional Keynesianism" in which Governments coordinate their fiscal spending around a common development paradigm of inclusive and sustainable development. The region's stock of foreign exchange reserves assumes importance, in particular if funding from foreign sources is likely to be curtailed by the constrained resources available from the developed world in the aftermath of the crisis. The region's reserves are currently being invested in low-interest-earning deposits in the developed world while attractive investment opportunities exist within the region. The crisis has also highlighted the risks of excessive concentration of investment in the financial assets of the developed world. The investment of regional funds in developed countries has been encouraged by the relative lack of development of regional capital markets. While there have been some moves in recent years, far greater emphasis may be given to integrating regional equity markets and fostering the development of local-currency bond markets at the regional level.

50. One of the clearest alternative uses for some portion of these assets, both for domestic development and for increasing regional integration, lies in the massive infrastructure funding needs across Asia and the Pacific. ESCAP has been at the forefront of analysis regarding this issue over a number of years, estimating that the region requires an annual investment of $608 billion in transport, energy, water and telecommunications, and faces an annual shortfall of $220 billion.[20]

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[20] ESCAP, *Enhancing Regional Cooperation in Infrastructure Development Including that Related to Disaster Management* (United Nations publication, Sales No. E.06.II.F.13), p. 141.

C. Exchange rate stability in the region

51. Another pressing policy gap for the region which has been brought into relief by the crisis has been the lack of mechanisms for exchange rate cooperation. Prior to the crisis, major exporting economies in the region already engaged in de facto exchange rate coordination by means of tracking relative exchange rates and moving in unison so as to maintain vital trade competitiveness. During the economic recovery phase, the pressure on countries to maintain exchange rate competitiveness so as not to impair the revival of exports will increase. The risk of non-cooperation in such a situation is for a destructive round of competitive devaluations which produce no net benefit in the quantity of exports and instead result in lower domestic export receipts due to exchange rate losses for each country. The potential for exchange rate cooperation extends to the critical issue of managing exchange rate vulnerability to short-term capital inflows. Numerous mechanisms could be considered, ranging from administrative measures, for example introducing deposit requirements on capital inflows, to market-based instruments, such as levying financial transaction taxes on inflows, including taxes that vary with the maturity period of the capital inflow. Such measures need to be carried out at the regional level, as no country can institute such controls without a likely exit of capital to comparable countries that do not.

52. Asia requires a currency management system that facilitates trade and macroeconomic stability vis-à-vis both extraregional and intraregional countries. Such a system could move towards, for instance, providing both internal and external stability through a collectively managed currency float relative to currencies of major developed country trading partners, on the basis of an agreement on a common basket, central rates and bands, as well as on rules for intervention and for changes in central rates. Such an approach has the potential to produce relatively stable intraregional currency values for an initial subgroup of participating countries in the region which possess similar trade baskets, such as the major economies of East Asia. There is also an ongoing debate regarding diversifying currency reserves from the United States dollar to other currencies, or to a basket of currencies, or to IMF special drawing rights. A regional currency arrangement could eventually serve as a building block for an additional reserve currency along similar lines to special drawing rights.

53. The Committee may wish to consider the issues analysed in the present document and provide guidance on the future regional policy agenda in crisis management and recovery.

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