Pacific Economic Cooperation Council
Eighteenth General Meeting • May 12-13, 2009

Session 1: The Asia-Pacific Economic Decline: How Deep, How Long? May 12, 2009

YUEN PAU WOO, President and CEO, Asia Pacific Foundation of Canada; Chair, Canadian National Committee for Pacific Economic Cooperation: We have a terrific cast of experts to lead us through this first session on a very important topic which has the title, "The Asia-Pacific Economic Decline: How Deep and How Long?" I fully expect that our experts will give us a full and sophisticated exposition of how deep and how long this economic decline will be.

But I hope my colleagues here also will address the question of not only how deep and how long this crisis will be, but what the world will look like after the crisis. I expect well have a rich discussion on these issues in the course of this panel.

As for our speakers, starting from my immediate left, is Mr. Takatoshi Kato. He is the Deputy Managing Director of the IMF.

To his left is Dr. Park Yung Chul, Professor of Economics at Korea University, and at the end of our table, the Honorable Mauricio Cardenas, who is a senior fellow at the Brookings Institution. Their bios are very impressive. They are in your conference package and I invite you to review those details.

Mr. Yuen Pau Woo, President and CE0, Asia Pacific Foundation of Canada & Chair of the Canadian National Committee for Pacific Economic Cooperation

TAKATOSHI KATO, Deputy Managing Director, International Monetary Fund (IMF): Good morning. My presentation today will be about the global economic and financial crisis and, in particular, why the Asian region has been hit so hard. Mr. Kato's PowerPoint presentation is available at -- http://www.pecc18.org/materials/kato_pecc.ppt

The presentation is organized around five key questions. First, how hard has Asia been hit by the crisis; second, how acute are the financial market pressures; three, what has been the impact on financial institutions and corporations; four, what have been government policy responses; and finally, what lies ahead for the region and what is the role of the IMF. **[Slide 2]**

The abrupt deceleration of growth in Asia has been more rapid than in other regions

Impact of Crisis

Let me start by considering how hard Asia has been hit by the crisis. Asia has suffered considerably from the crisis. The abrupt deceleration of growth in Asia has been more rapid than in other regions, and in key countries, it has been even sharper than at the epicenter of the global crisis.

In the fourth quarter of 2008, for example, GDP in Asia, excluding India and China, contracted by close to 15 percent. **[Slide 3]** In growth terms, Asia has been hit hard because of its integration with the global economy.

Slide 4 shows how much of Asia's growth engine has depended on advanced manufacturing exports. Those countries with a larger share of advanced manufacturing and GDP have been experiencing sharper output declines.

The underlying reason is that advanced manufacturing is more cyclical than other items. We can cite Korea, Taiwan, Germany, and Japan as examples of such countries.

Collapsing demand has been transmitted through the

continued on page two

Hosted by: EAST-WEST CENTER FORMING AND INFORMING LEADERS

continued from page one

integrated supply chain with dramatic effects on intra-regional trade. Even economies that provide logistical services and finance, such as Hong Kong or Singapore, have been hard hit.

The extent of the shock also has been apparent in domestic demand. **[Slide 5]** Private investment in most countries has slowed significantly, although private consumption so far has shown relative resilience. In 1998, for example, at the time of the Asian crisis, domestic demand contracted sharply. But industrial economies were strong then and able to pull Asia out of recession quite quickly.

Mr. Takatoshi Kato, Deputy Managing Director, International Monetary Fund

Now, however, the global environment is very different. In 1998, Asian countries were helped by the robust growth, particularly in the United States and in China. But this time, the global economy universally has been suffering from a deep recession.

The story about China is somewhat different. **[Slide 6]** Like the rest of Asia, China's growth is in decline, albeit from a much higher base. What is different, however, is the resilience of domestic demand which is being supported by a timely and aggressive policy response. In addition, China's exports are more diversified.

Financial Market Impact

Asian financial markets have been significantly hit by global de-leveraging. **[Slide 7]** Net capital flows to the region shifted into reverse in the second half of last year. On the whole, the sudden stop in access to financing has been more acute for the private sector. A few countries in the region, such as Indonesia, have successfully floated bonds recently but on quite expensive terms.

For much of the region, the large buffer reserves have provided a strong cushion against further deterioration in financing conditions. Most of these economies have enough reserves to extend financing requirements through this year. **[Slide 8]**

However, even a country with a large reserve cushion can be hit hard by the crisis. Korean banks accumulated substantial short-term external liabilities in recent years.

BIS [Bank for International Settlements] statistics recently confirmed that cross-border lending was curtailed in the last four months of 2008. **[Slide 9]** Korean banks have had considerable difficulty rolling over the external debt, forcing the Bank of Korea to step in with foreign exchange swaps to alleviate the funding crisis. At the same time, foreign investors have withdrawn from domestic EPT and bond markets, leading to a substantial depreciation of exchange rates. **[Slide 10]**

Although the extensive liabilities of Korean banks have improved substantially since the beginning of this year, nevertheless, as financial activity worldwide has shrunk, the regional financial centers also have been adversely affected.

Hong Kong's financial system is contracting, particularly in areas such as asset management and brokerage services. In Singapore, bank intermediation has been affected, particularly in the Asian market, where lending to new bank customers has been contracting sharply. In Japan, stricter lending standards, wider risk spreads and the significant stock market decline have a negative impact on financial conditions.

Corporate Sector Impact

What, then, has been the impact on Asia's corporate sector and its financial institutions? The crisis is taking an increasing toll on Asia's corporate sector. Many small and medium sized enterprises borrowed heavily in recent years to expand the activities, notably as suppliers to the large manufacturing enterprises. **[Slide 11]** With the onset of the crisis, banks have immediately started to rein in their lending to these enterprises.

Large Asian corporations, like their U.S. counterparts, entered the crisis with fairly good balance sheets. When the demand shock hit, companies faced little immediate pressure to scale back their activities or cut costs. However, their profits have since declined and the liquid portion dwindled. **[Slide 12]**

> ***Collapsing demand has been transmitted through the integrated supply chain with dramatic effects on intra-regional trade***

A credit crunch, combined with sharp falling demand can quickly put the healthy corporate sector into trouble and profits can quickly evaporate. If this trend continues and demand does not recover, large Asian corporations will need to further retrench production. In the near term, the process may prove quite painful, particularly if large job losses are involved. **[Slide 13]**

Government Policy Response

Against these backgrounds, what has been the government policy response? Regional policymakers generally have responded aggressively. Central banks have cut interest rates over the last few months. These rate cuts started later than in the United States but have accelerated since last September.

However, rate cuts have been largely offset by declining inflation expectations so that real interest rates have

continued on page three

continued from page two

remained relatively constant in a number of countries. **[Slide 14]** Moreover, greater caution by banks and rising risk premiums have weakened this traditional monetary transmission mechanism. **[Slide 15]**

An exception is China, where considerable monetary policy easing has already led to a surge in lending. Some countries now are at or close to the zero interest rate monetary policy. As a result, central banks are turning to unconventional measures that have expanded banks' balance sheets. So-called credit easing measures in Japan and Korea, for example, aim to reduce risk premiums and unlock activity in the credit market.

Fiscal Stimulus

Despite these efforts, broader measures of money supply contracted and interest rates remained stubbornly high in several countries. Nearly all governments in the Asia Pacific region have introduced fiscal stimulus packages to support growth.

The average size of discretionary fiscal measures taken in the region is slightly above G20 average for 2009, and the reduction of the stimulus from 2009 is about the same at the G20 outreach. **[Slide 16]** The success of these packages will depend in part on the propensity of consumers to spend and the ability to overcome spending implementation constraints.

The IMF should provide candid, even-handed, independent surveillance[as well as] continue efforts to reinforce its lending toolkits

Then the question we should ask is what lies ahead in the region. The current crisis vividly illustrates that Asia has not decoupled from the global economy. Moreover, efforts are being made to invigorate domestic demand. The prospects of a recovery at this stage continue to hinge critically on the rebound in the global economy.

Maintaining Domestic Demand

It will be important for Asia that the world avoids a serious outbreak of protectionism, either trade or financial. There are risks for the Asian region across several fronts. First, the longer that export demand remains weak, the greater the risk that the adverse environment will feed into domestic demand.

Private consumption has so far held up relatively well, as regular markets have not yet adjusted to the new global realities. Consumption also has been helped by real income gained from lower community prices and the buffer provided by high household savings.

But our sense is that an inevitable significant adjustment in employment is coming. **[Slide 18]** Already, unemployment has started to climb across the region.

Second, the feedback loop between the financial and real sectors is expected to play out. Given the long nature of the downturn, non-performing loans are likely to rise. This will feed into bank balance sheets.

Third, the era of easy credit to finance consumer purchases in industrial countries is likely over. When the global economy eventually recovers, the level of demand for Asian manufacturing and exports could well be structurally lower for many years.

In that world, Asia's export-oriented growth strategy may no longer pay the same dividends as in the past. Asian economies need to look much more at their own domestic economies and find ways to capitalize on their comparative advantages and foster local demand.

And finally, some of the smaller vulnerable economies in Asia could fall into a full-blown financing crisis. These countries, which have not put in place a sound institutional basis for policymaking, are now going to face the leading edge of the global crisis.

"Green Shoots" of Recovery

Despite all of these risks, there is some evidence that the rate of deceleration in the global economy is abating. **[Slide 19]** In Asia's context, for example, China has seen a strong first quarter with respect to industrial production, retail sales, and credit growth. In Korea, first quarter GDP was up by point one percent. In Japan, March industrial production increased by point six percent.

Though tentative, these "green shoots" in Asia may reflect the following: First, that several regional exchange rates have depreciated since last year and this should help regional exports. Of course, this will ultimately depend on the recovery in demand in the main export market.

Second, Asian corporations have been aggressively reducing inventories and excess capacity in the manufacturing sector and so may be reaping the benefits of stabilization in global demand. And finally, the unprecedented policy response to the crisis so far has helped contain spillovers from the external shocks to domestic demand. In addition, the effects of the stimulus package may be finally kicking in.

Role of the IMF

Let me conclude by saying a few words about the role of the IMF in helping Asian countries, and more generally, the global economy rebound from the global crisis. **[Slide 20]** There was consensus at the recent G20 summit held in London that the IMF should play a pivotal role in helping the global economy overcome the current crisis.

continued on page four

continued from page three

I will emphasize four points: First, the IMF should provide candid, even-handed, independent surveillance, including monitoring of fiscal and financial policy implementation of member countries. Second, the IMF should continue efforts to reinforce its lending tool kits. In this regard, although some Asian countries have not approached the IMF for support so far, we stand ready to assist qualifying countries with our new lending instrument, which we call the flexible credit line.

The G20 also agreed that the IMF should issue up to $250 billion worth in new Special Drawing Rights [SDRs], which would augment the international reserves of all member countries, including countries in Asia.

Third, the IMF should develop an early warning system to better anticipate the crisis. And fourth, the IMF should accelerate reforms in its governance structure to better reflect global realities.Those are certainly, I think, a tall order for IMF to follow, but we are an institution of 2,500 people. We will make our best efforts to meet expectations from the various stakeholders. Thank you.

YUEN PAU WOO: Thank you. Mr. Kato, you asked a question: “Green shoots or false dawn?” I hope we’ll come back to that question before the end of this panel. Our next speaker, Dr. Park Yung Chul from Korea University.

PARK YUNG CHUL, Professor of Economics, Korea University: My presentation is a very preliminary summary of an ongoing study at the Asian Development Bank Institute in Tokyo sponsored by Mr. [Masahiro] Kawai.

The end of the crisis is near, according to some people who see the so-called “green shoots” of recovery and glimmers of hope. But I don’t see it for the next several months. In fact, for more than a year, things will get worse and to me, it’s a scary development.

Prof. Park’s PowerPoint presentation is available at -- http://www.pecc18.org/materials/park_pecc.ppt

But then just looking at this table **[Slide 2],** please note that the newly industrialized countries of Asia -- Hong Kong, Singapore, Taiwan and Korea -- have been hit harder than other countries. The question is why.

Channels of Crisis Transmission

In general, the crisis contagion has been much deeper than expected and it has been transmitted to Asia through two channels. One is a trade channel and the other one is the financial channel. Our view is that the trade channel has been the dominant one. And, in fact, the exports of all Asian countries been falling at double digit rates and so have their imports. **[Slides 5 and 6]** So the impact of the crisis through the trade channel has been very severe.

Depending on the country, the financial channel also has been very serious. But to Korea, it’s been of secondary importance. So the question is what Asian countries will do in coming months and coming years to insulate themselves against these external shocks to the region through these two channels.

Prof. Park Yung Chul, Professor of Economies, Korea University

Looking at some individual countries, the Chinese authorities are very confident that China will grow by more than 8 percent. I tend to believe this.

And, in fact, Beijing has announced it is now in the process of implementing a huge fiscal stimulus package amounting to almost 14 percent of GDP. In addition, Chinese authorities have said they are prepared to implement more stimulus packages in the coming years if necessary. **[Slide 7]**

In South Korea a few months ago, the investment banks and foreign media predicted imminent collapse of this economy, but now they claim that the worst is over. South Korea seems to be on the right track towards recovery.

One of the short-run responses of the newly industrialized countries Asian countries to mitigate the impact of the crisis has been to stimulate their domestic economies. But we still question whether they need to do more or have done too much. **[Slide 9]** This is unclear.

According to the *World Economic Outlook Report* published by the IMF in October 2008, fiscal policy may not be as effective as one might think, especially in the emerging market economies. But then the IMF’s latest report said that fiscal policies were very effective six months later. So we tend to believe the latest report. If necessary, I’m sure that Asian countries are prepared to inject more fiscal stimulus into their economies.

Policy Coordination

However, unless there is policy coordination among these Asian countries, this stimulus policy can create a leakage into savings. Policy coordination and prevention of trade protectionism therefore are essential. I am not quite confident that Asian countries will be able to prevent the rise of trade protectionism or that they will be able to coordinate their policies better than they have been able to do so far.

The preoccupation with the fiscal policy stimulus is going to create some problems **[Slide 10]**. The crisis has exposed the many serious structural weaknesses and vulnerabilities. This fiscal stimulus could corrupt some of

continued on page five

continued from page four

these weaknesses, and these countries may delay the very important institutional and the policy reforms while they are focused on fiscal and monetary expansion. And in my view, domestic stimulus must be accompanied by institutional reform but some doubt the ability of these countries to accomplish this.

"Recession Surpluses"

And, as I said before, a lack of policy coordination may cause leakages. **[Slide 11]** All of these Asian countries, including China, South Korea, and others, are going to produce huge current account surpluses, and that's not a very good development. It's known as a "recession surplus" simply because of a sharp decline in imports. These Asian countries therefore must work together to minimize the surpluses if they are going to contribute to the recovery of the world economy.

There are various regional institutions, such as the so-called ASEAN + 3 arrangement, but they have not been very effective in promoting the policy coordination to deal with these regional issues. This means that the ASEAN countries plus Japan, Korea, and China, will not be able to prevent leakage of their expansion into savings and that is going to be a very serious problem.

Asian regional institutions have not been effective in promoting policy coordination to prevent leakage into savings

Rebalancing Growth

What about the long-run response? **[Slide 12]** The question we should ask is whether Asian countries will be able to go back to the export-led growth strategy once crisis is over. There is an emerging consensus in East Asia that these nations should not try to go back to export-led strategies. Rather, they should try to rebalance their growth to rely less on exports and to rely more on domestic demand. This will require macroeconomic policy changes as well as institutional reforms, especially those aimed at eliminating bias in favor of export-oriented industries and eliminating impediments to savings and investment.

At the same time, as part of this re-balancing, Asian nations should try to allocate more resources to so-called non-manufacturing sectors, such as service industries. But I'm not sure they will be able to do so in the short run. And, in fact, if they are not able to coordinate their policies, I am concerned they will go back to what they have been doing, what they were familiar with, the strategy that was very successful before the crisis. This means they will try to accumulate more reserves to insulate themselves against the financial crisis in the future.

This is a very serious problem because in a global financial system which is dominated by the major industrialized countries, including United States and the EU, the dollar and to some extent the euro are major instruments of financial transactions. Whenever there is a crisis in advanced countries, when the advanced countries are on fire and there is a shortage of global liquidity, the emerging market economies suffer.

Default Reserve Accumulation

If we cannot solve the currency problem, which has caused the global financial meltdown for last year and a half, the emerging economies in East Asia don't have many choices to protect themselves against the imbalances and instabilities in the global financial markets. Consequently, they accumulate more reserves, which seems to be the safest and easiest way of protecting themselves. But now even accumulating large reserves is not going to afford a fool-proof way of preventing the crisis.

Nevertheless, that is the course they likely are to follow unless the major industrialized countries and advanced emerging market economies represented in G20 come up with a new global financial system or reform of the financial system in a way that prevents future crises. But I don't see that possibility.

Protectionist Threat

Another problem that I see in connection with East Asian crisis management is the avoidance of protectionism. As you remember, at the G20 meetings the heads of states on three occasions declared that when they return home, they would instruct their trade administrators to do whatever measures necessary to prevent the rise of protectionism. But then what has happened? They conveniently forgot about what they promised at these important meetings.

Thus, the rise of protectionism and the inability of the G20 to come up with a credible and reliable reform package for new international financial system create great uncertainty for the emerging market economies in Asia about what they should do to support the efforts to promote the global recovery of the economy. Thank you.

YUEN PAU WOO: Thank you, Dr. Park. We now have Mr. Cardenas.

MAURICIO CARDENAS, Senior Fellow, The Brookings Institution: Thank you very much. I'm here to talk today about Latin America and the way in which this crisis has impacted this part of the world.

Let me say in the beginning that this time around,

continued on page six

continued from page five

when we talk about financial crisis, when we talk about sharp recessions and when we talk about weak economic conditions in general, we don't think immediately about Latin America and that's good because this crisis has been different. This crisis, as we all know, did not originate in Latin America, and most importantly, so far has had a mild effect relative to what happened ten years ago. It is important to understand why this is the case this time and this is the purpose of my talk. I'm going to make just five points and I'm going to basically illustrate them with a few charts.

Dr. Cardenas's PowerPoint presentation is available at --http://www.pecc18.org/materials/cardenas_pecc.ppt

Length/Depth of Recession

The first point is on the length and depth of this recession. **[Slide 1]** We are hearing news that things are improving now. Yesterday there was a speech by Jean-Claude Trichet, the President of European Central Bank,

Dr. Mauricio Cardenas, Senior Fellow, The Brookings Institution

in Switzerland during the gathering of central bankers. He said that there were clear signs of recovery, and that the economies already have bottomed out.

This is a very important statement because it reflects the views from the central bankers of various countries. And particularly reflects the views of the leading economic indicators of the major economies of the world.

If you look at the front page of the today, you will see the indexes of leading economic indicators already showing an improvement since in some cases since March, in other cases, since April. This is good news. But regardless of that, it's also true that this crisis is a major one, mainly because of the number of countries that are going to experience a recession this year.

The *World Economic Outlook Report*, the flagship publication of the IMF to which Mr. Kato referred, has this very nice graph, which is the one that I'm showing on the left side, with the number of countries that are going to be in a recession. **[Slide 1]** That means two quarters of consecutive contraction this year. And as you can see, the number is 75, and that has no precedent in our recent history. So this is global.

And that's why when there are so many countries of the world experiencing these problems at the same time, one takes a pessimistic approach. In view of the fact that there are so many countries experiencing recessions, there are many vicious circles and the vicious circles have a lot to do with trade flows and financial flows, and also with policies that some countries adopt to fight the crisis but also negatively affect others.

"Shape" of the Recession

In spite of the rhetoric in the G20 meeting about the need to prevent protectionism, we're seeing more and more of it. The World Bank has just launched a report in which it counts all the protectionist measures that have been taken in the world. You'd be astounded to see how many countries are adopting these measures.

That's why talking about a so-called "V-shaped" recovery is probably excessively optimistic. If you were to give advice to policymakers, and particularly to policymakers in Latin America, I think the safest bet would be to suggest that this is going to be a "U-shaped" recession, that we're going to be out of this by the end of 2010 and that things are not going to happen as soon as some expect.

And, in fact, the U-shaped recovery could turn into a "W-shaped" recession. The "W" comes from the fact that some people are arguing that with so much liquidity in the world today, there is the risk of inflation. And if inflation arises, central banks will have to raise interest rates and that will decelerate the world economy again and that's why we will have this "W."

This is an argument that complements Prof. Park's, which is that China won't be able to stimulate the economy in 2010 as much as it's currently doing. Thus, China would decelerate in 2010, causing, again, a deceleration in the world economy and that's the reason for the "W-shaped" recovery. For that reason, we must say to policymakers, do not bet on the "V shape."

Latin American Conditions

The economic conditions in Latin America are deteriorating. Last January, when the IMF presented the revised forecast for economic growth, Latin America was essentially growing at zero during this year, 2009. In the latest revision of the World Economic Outlook, the IMF is projecting 1.5 percent contraction. Now, if you look at what others are saying about economic growth in Latin America, they are slightly more pessimistic. JP Morgan, for example, is projecting a contraction of 2.2 percent. **[Slide 2]**

continued on page seven

continued from page six

Some countries will suffer more than others, but in general, the contraction in the region is very generalized. But the point I want to make is that three months ago, we were forecasting essentially zero growth. So the revision in this forecast has been very fast. The big question mark is 2010, and here is where there are great differences in projections. And I'll talk about that towards the end.

My second point is that this crisis has been milder for Latin American because the region has changed. And the region has changed because it learned quite a lot from the past financial crisis. Remember that most of the economies in Latin American suffered dramatically after the Asian crisis and the Russian crisis of 1998. There were major economic contractions, major depreciations of currencies combined with high inflation and high fiscal and current account deficits.

As a result of that, many countries shifted gears, adopted inflation-targeting models to conduct their monetary policy. They adopted IMF programs to adjust the fiscal account and many countries also allowed their exchange rates to flow. That was essentially the change in the economic paradigm of Latin America. As a result of that, the economic indicators look a lot better.

Latin America structurally adjusted its fiscal accounts and reduced its fiscal deficits . . . some countries, like Chile, have emerged as paradigms of good fiscal management

Latin American Resilience

The figure on **Slide 3** shows how Latin American countries have developed greater resilience to deal with this crisis. First, international reserves, which are about $400 billion, and second, and I think most importantly, foreign debt, is now only 30 percent of GDP, having been twice that figure a few years ago. This is important and shows essentially the resilience of these economies.

Third point: You probably associate Latin America with big and large fiscal deficits, and that's probably a correct historical assessment. But it's not the reality of Latin America today. Latin America managed to structurally adjust its fiscal accounts and reduce its fiscal deficits.

In fact, some countries have emerged as paradigms of good fiscal management, like Chile, which ran large surpluses during the years of the boom. Peru also had large surpluses during years of economic boom and is now using those surpluses to finance larger fiscal expenditures to stimulate its economy.

But for the average Latin American country, things look like this figure **[Slide 4]**, which is essentially a fiscal equilibrium until last year, and now a deficit, which is about 2.5 percent of GDP. But, of course, a 2.5 percent deficit is really small relative to the deficits we're seeing in the developed world. In the U.S. case, there is a 10 percent fiscal deficit. So this is the way in which countries are responding in terms of their fiscal management, and to be more precise, this table shows what type of fiscal stimulus packages are the countries adopting and their magnitudes.

The only countries that have been able to follow the recommendation of the IMF of a 2 percent of GDP fiscal stimulus package are Chile, which did more than that, and Peru. Therefore, for the other countries the fiscal stimulus packages have been smaller and have been a combination of tax breaks and increases in government expenditures.

Also, many of these countries have used their publicly owned banks to help out corporations and to provide subsidized credit to the small and medium enterprises. This particularly has been the case of Chile and Brazil. So on the fiscal accounts, I think things look good.

Capital Flows

The major source of uncertainty is capital flows and this brings me to my fourth point. **[Slide 5]** This is a region that saves relatively little and therefore depends significantly on capital inflows to finance its investments.

Investment rates are on the order of 25 percent of GDP and they require a combination of foreign direct investment, portfolio investment, and of course, bank credit. This is essentially the main channel through which the international economic crisis could have an impact in Latin America if it suddenly causes an interruption in those capital flows.

What we see as of now is that capital flows to Latin America continued, not in the amounts and the magnitudes that we were used to seeing in the last two years, but they are still positive, which is a good outcome. And the latest figure, which is the first quarter of this year, shows a relative increase compared to last year.

So capital flows to the region have continued and essentially these have been in the form of foreign direct investment, and there is a reason for this. Much of these investment projects in Latin America are related to the energy and mining sectors. These are significantly large projects that of course cannot be interrupted on short notice. So capital flows have continued to reach Latin America.

The existence of capital flows is reflected in the fact—and this is the major difference from the last crisis—that we still have a relative low interest rate spread on the sovereign debt of Latin American countries relative to the U.S. treasuries. The spreads have not increased that much and also we're seeing that in some of these economies, the

continued on page eight

stock markets have recuperated throughout the first months of this year. So capital flows to the region, both in the form issues of sovereign bonds, foreign direct investment and portfolio investment have remained positive.

"Recovery"

Finally, some countries are already using the word "recovery," the one country that has used it the loudest and has minimized the effects of the world crisis is Brazil. There is a reason for that.

I brought the latest economic indicators for Brazil. **[Slide 6]** The interesting aspect is that manufacturing production recovered significantly in March.

Just in the case of automobile production, there was an increase in 17 percent relative to the year before. The Brazilian government argues that this has been the result of the stimulus package that essentially eliminated the sales tax on the purchases of new cars. But there is also the reason associated with better and higher consumer confidence. The latest indicators of consumer confidence Brazil, released in is April 2009, show an increase relative to March, suggesting that the economic environment and economic conditions in general are improving.

However, I think it's too early to tell. These economies are highly interconnected with the world economy and I would argue that in addition to the channels of transmission that one mentioned in the case of Asia, in the case of Latin America, there is one channel of transmission that is very important and is particularly relevant for the countries of Central America, Mexico, and the northern part of South America, and that is remittances.

Remittances

Remittances are already decreasing as a result of the increase in unemployment in the United States, the increase in unemployment in Europe, especially in Spain, and of course, the reduction of incomes in these economies. So the remittances channel is a very significant one and it's having a negative impact on the overall economic conditions in Latin America.

And on top of the remittances channel, there is another effect that is distinct in the case of Latin America relative to Asia and that's the terms of trade effect. The Latin American countries remain major exporters of commodities.

Terms of Trade

Oil, coal, agriculture products like soybeans, coffee, and the majority of these commodities have seen a significant decrease in their prices relative to their peak values in 1998. So the commodity prices channel is also operating. So that's why I think it's too early to tell that we're past the worst in terms of the effects of the crisis in Latin America.

And let me conclude by saying that giving advice to policymakers in Latin America is like going to the doctor and giving two options to treat a condition. You can have a treatment that is very strong but the treatment cannot be repeated. You can only have one dose. Or you can have a treatment that is milder and it allows you to take another dose.

Milder vs. Stronger Remedies

My recommendation is to go for the milder treatment. The reason is that we don't know what's going to happen and if we go for the strong therapy, we may end up in a situation where events unfold in a way that make this crisis continue and deepen. Then we would be left without any way of responding.

My sense is that we are going in the opposite direction. We're going for the strong therapy. The strong therapy essentially is based on a reduction in interest rates to the point that they're almost zero in real terms and therefore you cannot really re-use interest rates anymore. That's the case already for many countries in Latin America.

Also, fiscal expansion already is pushing debt sustainability to the limits, and therefore you cannot really expand again in 2010, pretty much like the Chinese case. Under those circumstances, you are left in a situation that you really have no tools to deal with unforeseen circumstances in the future. That's why we should opt for a more pragmatic approach that doesn't use all the fiscal and monetary firepower at once. **[Slide 7]**

Corporate Needs

The second piece of advice I would give relates to the fact that the epicenter of the crisis is not in the fiscal accounts of Latin American countries, which are in good shape. We now need to focus more on the corporate side and we need to understand what the needs are of these corporations in Latin America.

Many of them have become truly multinational and may have problems in the future regarding their access to financing. But we know little because we don't have as good information on the corporate side of the economy as we do on fiscal accounts. We need to keep a closer eye on what's happening in the private sector, especially in terms of their needs of financing in the future. Thank you very much.

continued on page nine

continued from page eight

YUEN PAU WOO: Thank you, Dr. Cardenas. He speaks with the passion of a former policymaker, reflecting, of course, his role in the government of Colombia.

We now have about 15-20 minutes for some discussion and questions. In terms of the question before this session—"How deep? How Long?"—I would like to ask each of our three panelists to choose the letter that they want to represent the crisis. Are we on V, W, U, dare I say L-shaped paths? Mr. Kato, can I ask you to start off?

TAKATOSHI KATO: Well, in Japan we use Chinese characters.

YUEN PAU WOO: Oh. (laughter)

TAKATOSHI KATO: Because this recession originated in the financial sector, we tend to think the recovery process will be a prolonged one. But at some stage, the U.S. real estate market will hit the bottom. Commodity prices also have declined significantly from the peak last year.

But I think various policies will get into full swing later this year. So the IMF foresees recovery in 2010, not at a spectacular pace, but a gradual recovery towards the end of next year.

YUEN PAU WOO: Thank you. Dr. Park?

PARK YUNG CHUL: I'm sure that we'll see a rising trend of global unemployment in the coming months and year. But then around this rising trend we will see fluctuations, which means a W shape.

But in my view, the size of the W-shape recession will get smaller over time. I hope I'm wrong and other people are right in predicting the earlier recovery of the global economy. We'll see a significant recovery some time next year in the 2010, but that depends upon what the advanced countries as well as emerging countries can do collectively.

YUEN PAU WOO: Dr. Park, have we reached the first trough of the W?

PARK YUNG CHUL: That will come sometime around September. In the next months there will be a little bit of the slowdown, but then the economy will improve again toward the end of this year. But who knows.

YUEN PAU WOO: Thank you. Dr. Cardenas.

MAURICIO CARDENAS: Well, this is more of an issue of calligraphy than semantics. It depends on the shape of the V or the U. My take on this is the following: The MBR committee, which states the beginning and end of recessions, stated that the beginning of the recession was January of 2008. So we've been, almost a year and a half into the recession, and its looking like a relatively long recession.

The question is are we going to start recovering very fast and therefore are we going to be out of this with positive economic growth in the second half of this year? That outcome would make it a V-shape recovery.

Or, are we going to stay with the negative growth throughout most of this year. That would make it a U-shape recession.

My take is it's going to look more like a U-shape. I would argue, however, that the second quarter of 2009 probably is going to be the front and that even though we will not see positive growth in the next quarters, we're going to see basically smaller contractions in the economy in the second half of the year. So my take is that it's a U-shape, and we won't see positive growth on a quarterly basis until next year.

QUESTION & ANSWER PERIOD

YUEN PAU WOO: Thank you, gentlemen. We have three questions already.

SERGIO LOYA, Washington, D.C.: This is for Dr. Park. You talked about institutions having to reform themselves. Can you tell us which institutions or sectors of government need to reform themselves, what type of reforms, and is it really realistic in light of the fact that we're coming out of this recession for government to make the necessary changes.

[UNIDENTIFIED]: Referring to fiscal stimulus in Japan, Prof. Park mentioned that it will be around 10 percent of GDP this year. I would like to inquire about the effectiveness of the previous fiscal stimulus when Japan was in recession several years ago and then also whether it will be the same or different this time.

Perhaps 10 percent of GDP is too small for Japan but can be too big for other countries. Could this kind do fiscal stimulus be broadened not just for Japan but for the region as a whole. Perhaps several Asian countries could collaborate in developing a trans-Asia Pacific highway system, or something, as a means of creating region-wide fiscal stimulus.

SETYANTO SANTOSA, Indonesia: I would like to invite you to share your view about the opportunity of this crisis. My second question is for Mr. Kato. As you may be aware, in Indonesia the image and reputation of the IMF is not so good. Can you elaborate about whether there is a new IMF policy that may be applicable to the country like Indonesia?

continued on page 10

continued from page nine

YUEN PAU WOO: Thank you very much. If I could ask Dr. Park to speak to the issue of institutional reform. I'll ask Dr. Cardenas also to speak a little bit about institutional reform, maybe from a Latin American perspective. And Mr. Cato, if you would address the issue of the IMF's reputation in Indonesia and the ability to provide some intellectual leadership and maybe also if you would address the question of ASEAN.

What do you see are the specific challenges for ASEAN, given that it doesn't have the size and weight of an India or a China?

PARK YUNG CHUL: The number-one priority for Asia is to break out of the crisis. There is no other option but to stimulate domestic economies. In that respect, I think what we need is regional cooperation. Every country must have a similar stimulus package.

Huge packages have been introduced by the Chinese, Japanese, Korean, and Malaysian governments. These programs will have to be coordinated so that the effects will not result in increased domestic savings.

Asian nations need to increase intraregional trade. This is the important issue in the short-run. In the long run, as I said in my presentation, I don't think it will be viable for these countries to go back to pushing out exports as they have done before so well, because the rest of the world is not going to allow them to do so.

The crisis has exposed that Asian economies require another round of institutional reform but they haven't been able to agree on region-wide solutions

They will have to rebalance growth to rely more on domestic demand, and an important element of that involves removing the bias favor of export-oriented industries. Resources must be able to move from tradable to non-tradable sectors.

Secondly, according to our experience, the flexible exchange rate system does work and in fact, this system saved Korea from the depths of the crisis to where it is right now. Thirdly, to facilitate the reallocation of resources, the rigidities of the labor markets must be eliminated. These are the major policy issues confronting Asian countries.

In my view, since the 1997 financial crisis, most Asian nations have done a great job improving existing institutions and creating new ones. The only thing that the new crisis has exposed is that these economies require another round of institutional reform. I'm very hopeful they can do it. The only problem I see is that these ten or 13 countries just haven't been able to get together and discuss these issues and then come up with some sort of region-wide solutions.

With respect to Japan, I'm sure that I'm not qualified to speak about the fiscal policy, but I am concerned about fiscal sustainability. If you continue to spend so much government money, some day you will have to pay it back and how are you going to do that? Nobody seems to worry about that issue, but sooner or later, you must.

This is not a time for lectures from Washington. This is more about Washington reforming its own institutions.

YUEN PAU WOO: Thank you. Dr. Cardenas, do you agree that some of the institutional reforms Dr. Park referred to are the same ones that need to be done in Latin America?

MAURICIO CARDENAS: I would put the emphasis here in Washington rather than in the region. There is always the need for reform and I can suggest a few areas for reform in Latin America. Labor markets are a very important area. But the key reforms today are more to the international and financial institutions. I think those are the reforms we have to focus on and I think there are two types of issues here.

First, there is the short-term issue of the capitalization of the regional development banks. The Asian Development Bank is a good example. But we also need to address capitalization of the Inter-American Development Bank so that it is better able to respond to these crises, particularly if things worsen.

In the case of the Inter-American Developmental Bank, the critical issue is the provision of additional capital from the United States. That requires congressional approval and that is why it's somewhat of a delicate issue here in Washington.

Second, there are the multilateral institutions, particularly the IMF and the World Bank. What's the point here? All of us coming from developing and emerging countries have seen at one point or another the IMF missions, and the IMF missions come to our countries and speak loudly and they speak about the conditions and they speak about things that we have to do.

We have not seen those missions going to Paris, London, Berlin, or even crossing Pennsylvania Avenue from the headquarters to the Treasury. And we need to see that.

The way for that to happen is to shift the system of representation within these organizations. There are some countries that, of course, have to gain voice and representation because they will be the ones that will be providing more of the original capital. This is not a time for lectures

continued on page 11

continued from page 10

from Washington. This is more about Washington reforming its own institutions.

YUEN PAU WOO: Well, that's a perfect segue way to Mr. Kato. Would you speak to the issue of the IMF status and reputation and quickly on ASEAN, the prospects for ASEAN?

TAKATOSHI KATO: The IMF mission team has annual consultations with the United States. Our team meets the Treasury Secretary and the Chairman of the Fed and the outcome is published. Also, the United States agreed to be a party to what we call the financial sector assessment program.

Beyond that, the issue is to have the voting structure of the IMF better reflect the relative standing of member countries in today's global economy. The governors agreed last year that another round will start sometime in 2009 and that will be an opportunity for the IMF to realize a voting structure that better reflect the current structure of the global economy.

With respect to Indonesia, the current Indonesian finance minister was a former executive director of the IMF, so the IMF maintains a very good working relationship with Indonesian authorities. But this is the year for elections in Indonesia and we are looking at the outcome of the election.

Talking about the IMF's new instrument, member countries with a good economic track record have access to a substantial amount of liquidity without exposed conditionality. Mexico, Poland, and Colombia have benefited. The IMF would welcome Asian countries with a track record of a very good economic performance to be reviewed for eligibility in this program.

With respect to ASEAN, these countries without exception are very much influenced by the current global downturn. But the current crisis produced a new policy framework aimed at producing robust domestic demand. This also is a time for ASEAN countries to explore greater economic cooperation, which we very much would welcome.

YUEN PAU WOO: Thank you. Let's take these three questions.

DAVID KAEUPER, Washington, D.C.: I was very interested in Professor Park's description of a rebalancing and I just wondered if you could elaborate just a little bit on what you mean by changing the composition of demand and production of nonnon-tradeables. Thank you.

ESTRELLA SYBINSKY, Washington, D.C.: I'm interested in hearing more about the institutional and structural weaknesses that may be concealed by a stimulus package. I believe that in any kind of reform, we'll have to address these weaknesses and perhaps commonalities, not only with the developing world, but also with the developed world.

HSIEH CHIEH CHI, Chinese Taipei: Dr. Park, you said that we should turn our focus rather from export-oriented industries to domestic demand. But in the case of Taiwan's market, Taiwan has only 23 million people, which is a rather small share of market compared to Korea, China, and other markets. What are your suggestions for small-scale markets like in Taiwan?

JEFF BEAUBIER, U.S. Environmental Protection Agency, Washington, D.C.: What effect do you think the global recovery in the stock markets will have? Almost every country in the world is up 25, 30, 40 percent; and Brazil's stock market is up 70 percent.

YUEN PAU WOO: So, the question on non-tradables, what exactly does that mean and what concrete things can be done? That's related to the question about boosting domestic demand in small economies, like Chinese Taipei.

There also was a question about risks that may come from large inflationary activity, and I would say this would apply not only in developing countries, but maybe also in the United States and elsewhere. There also was a question about the effect of rising asset prices in the stock market on global recovery. Mr. Kato?

Left to right, Prof. Park Yung Chul, Korea University; Dr. Mauricio Cardenas, The Brookings Institution; Mr. Takatoshi Kato, IMF

TAKATOSHI KATO: Let me take up the question of institutional weaknesses. As Dr. Cardenas mentioned, the IMF expressed the view that fiscal stimulus might not be as effective in the case of advanced economies because, for one thing, I think if you don't have a deep and wide bond market, the issuance of a large number of government debts can, I think, result in raising interest rates. That, in turn, might contribute to inflationary pressure and subsequent monetary tightening. And so that is what I mentioned.

continued from page 11

PARK YUNG CHUL: What I would like to emphasize is the fact that we have to make a clear distinction between export-led growth and export-led economic development.

My favorite example is the Netherlands. The Netherlands' export GDP ratio is about 70 percent, so it's one of the highest. But nobody's accusing the Netherlands of pushing out exports because of the comparative advantage and other structural characteristics. The country would have to depend upon the exports and they would have to suffer the consequences of global economic cyclical ups and downs.

The problem in East Asia right now is that most of the countries, including China and to some extent Korea, all have pursued since the early 1960s export-led growth strategies, in which the incentive system is biased in favor of export industries. There are all kinds of direct subsidies. Most of these subsidies have been phased out but there are still many of remaining.

These are the things that will have to be eliminated to promote the reallocation of resources from tradable to non-tradeables, which is dominated by the services industries. In other words, these countries would have to change the structure of the production and demand in favor of non-tradeables goods.

On the macroeconomic front, there is a need for policies that let the markets determine exchange rates, so the real exchange rate would be very close to equilibrium exchange rates. These are the things Asian countries would have to do.

That is why are these countries are preoccupied with fiscal stimulus. They tend to ignore the kind of structural reforms they must undergo because they are too busy raising funds and allocating them without really know whether they have the administrative capacity to allocate these fiscal expenditures and whether they're able to ascertain the impact of these policies.

Despite the fact that they have made a great strides in improving institutions, they still have some way to go. We don't have time to go into details of the institutions that require reform and restructuring but there are many and we know what they are.

YUEN PAU WOO: Thank you. Dr. Cardenas, Maybe on the fiscal issue.

MAURICIO CARDENAS: We all now believe that the fiscal stimulus packages are going to take out us out of the recession. But that's a belief. The idea that fiscal policy can play this role, the counter-cyclical role, is an idea that is very contested in economics to the point that it was a mainstream view in the 1960s. It's in the textbooks. It was taught at the time.

But in the 1970s and 1980s this belief was subject to a lot of criticism to the point that it was not taught in the economics programs. Now it's becoming mainstream again.

Whether this is going to have the effect that is expected or not, we don't know. But there is a risk. If we look at the recent past, the Bush Administration tried to stimulate the economy with tax cuts. President Bush didn't succeed in doing that because people just did not go out spending the tax cuts. They saved that money. Now, this is a different type of fiscal stimulus. It's much larger. It's very aggressive.

Now, what are the risks associated with fiscal stimulus? The main risk is that it is not effective. But there is another risk that one size does not fit all. This depends on a lot of specific circumstances to each country.

That's why I think the IMF's general prescription of a 2 percent fiscal stimulus is a little bit misleading because in some countries you can implement it but in others, you cannot. In some countries, you need some composition, in other countries you need a different type of composition.

But the critical element here is you have to be very aware of two aspects. One aspect is your debt dynamics because for a stimulus you need to borrow and you want to make sure that you don't push debt too high so that it becomes a very heavy burden in to future growth.

The second aspect is the institutional setting has to be able to accelerate expenditures but also retract them. When the economy recovers, you have to be able to phase out.

That may be possible in the United States, but in some developing and emerging economies, physical expenditures tend to become permanent. It's very difficult because of the politics of this to really cut back, because once you have a constituency of people used to these programs, it's very hard for politicians to say, "We're stopping this."

Let me give you one example. A favorite program for fiscal stimulus in Latin America is called "conditional cash transfers." This is money given to people conditioned on a few things, such as keeping your children in school, making sure that they get the right nutrition, etc. Taking those transfers away from the people, say $50 a month, takes a lot of courage for politicians. So that's another very important institutional problem—the flexibility of government expenditures.

Let me now shift to the issue of stock markets. We did not mention a key aspect of the transition mechanism of this crisis from the developed world into the rest of the world. That's confidence. Confidence is closely linked to the stock market performance.

People see stock prices going up. The exact number is 40 percent. This is the increase in *The Financial Times* stock exchange index of worldwide stocks except Japan.

continued on page 13

continued from page 12

So as people see that, they think, "Well, things are improving. Maybe I can increase my consumption again. Maybe I can borrow again." That channel is very important. I would not minimize the importance of the increase in stock prices as a positive sign that ultimately can have an effect on consumers' confidence.

YUEN PAU WOO: Thank you. Well, we're off to a really good start to this conference and my thanks to this panel for putting us on this very good footing. We had some crystal ball-gazing, we had some calligraphy, but above all, we had some very wise and thoughtful and sometimes very passionate discussion and analysis of the current crisis. ♦