Adjusting to the Financial Crisis: How Emerging Markets and Developed Economies Have Fared

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Abstract

This article provides an overview of how the G3 (USA, the euro area and Japan) and Asian emerging markets (EM Asia) have fared following the outbreak of the financial crisis in 2008. The article shows that EM Asia weathered the crisis much better than the G3 for a number of reasons. First, EM Asia had little direct exposure to the failed financial institutions and it was therefore 'only' hit indirectly through a sharp decline in trade and through a rise in financial market turmoil. Second, leading EM Asian nations adopted government stimulus packages that in many cases were bolder than in the G3, which helped to cushion the sharp decline in exports. Third, as a result of the reforms following the Asian crisis, EM Asia had healthy government finances and significant foreign exchange reserves, which also helped. Because the financial crisis was triggered by the bursting of a housing bubble in the USA, the article also analyses the extent to which the same could happen in China, where house prices again are rising. Finally, the article discusses the new activist monetary policy in Japan that aims to bring an end to deflation.[1]

Keywords: *financial crisis, government stimulus, recovery, future challenges*

Introduction

This article provides an overview of how the global economy has fared following the financial crisis that culminated in September 2008 with the crash of Lehman Brothers. The article first outlines the adjustment of the USA, the euro area, and Japan (the G3 economies) and then follows an analysis of the emerging market economies in Asia (EM Asia) with a particular emphasis on China, India and Asean-4 (Indonesia, Philippines, Thailand and Malaysia).

The research here shows that EM Asia weathered the financial crisis much better than the G3 regardless of which parameter we look at. The G3 had for example a sharp decline in gross domestic product (GDP) whereas the large EM Asian countries only had a slowdown in economic growth. Some of the small and very open Asian economies also went into recession, but EM Asia is today far ahead of where it was when the crisis struck. In the same vein, EM Asia suffered only a minor increase in unemployment whereas the G3 as a group has high unemployment. The most battered area is southern Europe, with Spain reporting 26 per cent economy-wide unemployment and more than 50 per cent youth unemployment. This situation is a direct threat to social stability and to the survival of the euro and therefore also poses significant risks to EM Asia's exports to Europe. Due to the much better performance of EM Asia, the rise in government budget deficits has also been much smaller, whereas all G3 countries have significant deficit and debt problems.

The marked difference in the adjustment to the crisis reflects a number of factors. First, the crisis was made in the USA and Europe and not in Asia. The initial shock was therefore smaller in Asia as these countries had little direct exposure to the failed financial institutions and toxic assets. EM Asia was 'only' hit indirectly through a sharp decline in exports and capital inflows and through a significant rise in financial market turmoil. Second, leading EM Asian nations adopted government stimulus packages that in many cases were bolder than in the G3 nations (IMF 2013a). This is certainly the case for China. The strong countercyclical fiscal policy combined with highly accommodative monetary policy helped EM Asia cushion the sharp decline in exports, which in many cases amounted to more than a 50 per cent decline (quarter-on-quarter, annualized rate). Third, as a result of the reforms following the Asian crisis, these countries had healthy government finances and considerable foreign exchange reserves, which also helped them to weather the storm.

Following the outline of how these economies have fared, the article goes on to discuss two policy issues in Asia of high importance to the rest of the world as well. Because the crisis was triggered by the bursting of a housing bubble, we discuss whether and to what extent the same could happen in China where housing prices are elevated. Next we analyse the new activist monetary policy in Japan that aims to bring an end to deflation and restore the Japanese economy after more than two lost decades.

The next section briefly outlines key characteristics of the financial crisis. The third section outlines the adjustment of the G3 and the fourth section analyses how EM Asia has weathered the crisis. The fifth section analyses current issues, including elevated housing prices in China and the new Japanese macroeconomic strategy. The last section briefly concludes the paper.

The Financial Crisis: Overconfidence and the Collapse of Housing Prices

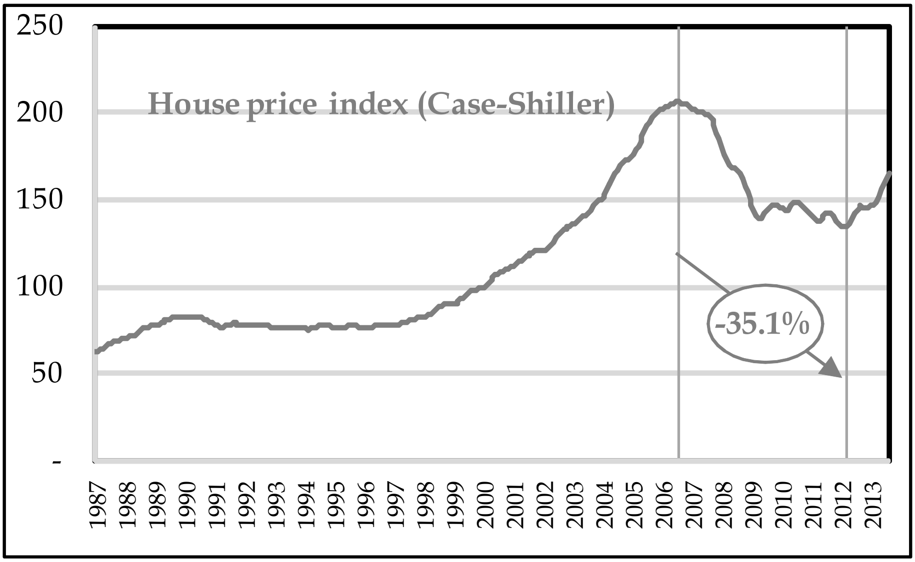
The roots of the crisis go back to a long period of low interest rates and excessive risk taking spurred by new financial products that allowed homeowners, banks and investors to borrow extensively without a solid backing of equity capital. When the crisis struck, a large number of financial institutions had too little equity capital. Governments therefore had to bail them out and many investors had to deleverage quickly through fire sales of assets. All of this led to a further downturn in asset prices and the economy.[2]

In response to the 2001 recession, the US Federal Reserve reduced the Federal Funds Rate to 1 per cent, down from 5.5 per cent prior to the recession. The Federal Reserve's interest rate cuts led a global monetary policy easing trend, reflecting that other countries were also hit by the downturn in the USA. Moreover, as the world economy operated with very little inflation pressure due to the integration of China into the global supply chain, central banks could maintain low interest rates over a longer period than what is normal.

There is little doubt that this is an important explanation of the sharp run-up in house prices in almost all advanced economies. On top of this, financial institutions undertook a number of innovations that made it possible to buy real estate with a very small down payment, if any at all. The problem with these innovations became obvious in the US sub-prime market in late 2006 and early 2007. The sub-prime loans were often given in anticipation that house prices would continue to rise. In many cases the loans were so-called 'teaser loans' with low and even negative repayments at the beginning of the loan.[3] The idea was that even though many of the new homeowners could not afford to buy a house, rising house prices would eventually solve that problem. However, as house prices started to flatten out in the fall of 2006 and later nosedive (Figure 1), many sub-prime borrowers could no longer service their debt and delinquency rates rose to unprecedented levels. This marked the beginning of the global financial crisis.

In the sub-prime segment, delinquency rates rose to almost 30 per cent. Investors who had purchased these mortgage loans, often securitized, therefore started to report large losses. These investors were mainly US and European banks and pension funds. Interestingly, large creditors of the US trade deficit, including China and Japan, had very little exposure to these assets. These countries were mainly investing in US

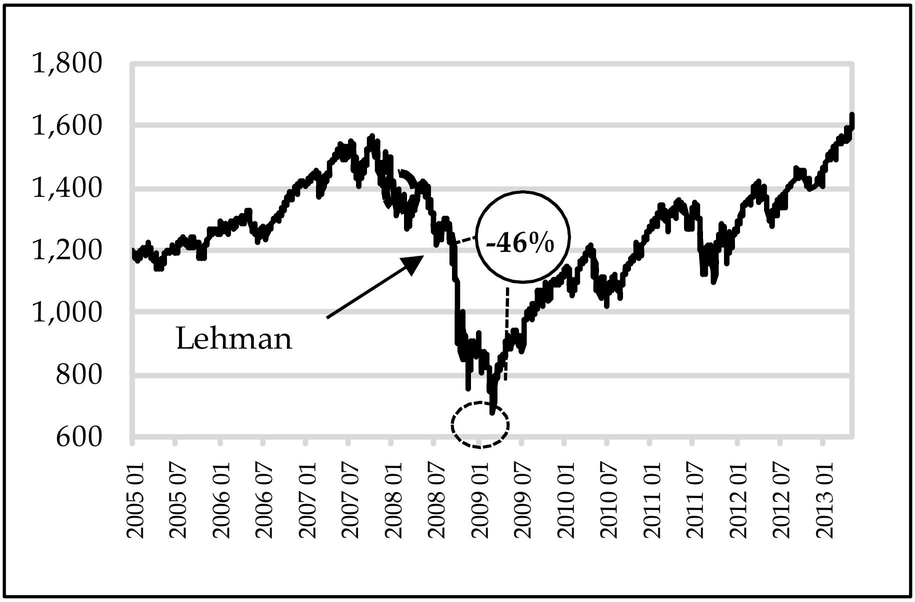
FIGURE 1: US Boom and Bust Housing Prices in the 20 Largest Cities



Source: S&P Case-Shiller (2013).

government bonds, which explains why EM Asia, to a large extent, was not directly affected by the financial crisis. However, as a result of the large losses in the US and European financial institutions, credit started to dry up and several banks, including Merrill Lynch and Bear Stearns, came under severe pressure and were close to collapsing when they were

FIGURE 2: The US Stock Market: Crash and Recovery of the S&P 500



Source: Bloomberg (2013).

taken over by Bank of America and JPMorgan, respectively.[4] This was, however, only the beginning of the crisis as it turned out that it was not only the sub-prime but also the prime market that was in trouble. Fannie Mae (Federal National Mortgage Association) and Freddy Mac (Federal Home Loan Mortgage Corporation), the biggest lenders in the prime market, therefore started to report huge losses on their books. This explains why the world's largest mortgage institutions later were rescued by the US Treasury.

Other financial institutions were also under water. AIG, the world's largest insurance company, had extended its business into complex risk products, which led to large losses as well. The US Treasury decided to rescue AIG in September 2008 to avoid larger, systemic consequences.

Increasing stress in financial markets led to soaring interbank interest rates. The decision by the US authorities not to rescue Lehman in order to avoid excessive moral hazard came as a shock to markets. The Lehman collapse on 15 September 2008 triggered a sharp decline in confidence as the whole banking sector realized that it could no longer be sure that the authorities would step in and save even systemically important institutions. This triggered massive fire sales of stocks, and from 15 September 2008 and until the market bottomed out on 6 March 2009, the S&P 500 declined by no less than 46 per cent (see Figure 2). Moreover, as other countries also suffered from their own financial crises, rooted in losses at home or abroad, we had a full blown international financial crisis, the worst since 1929.

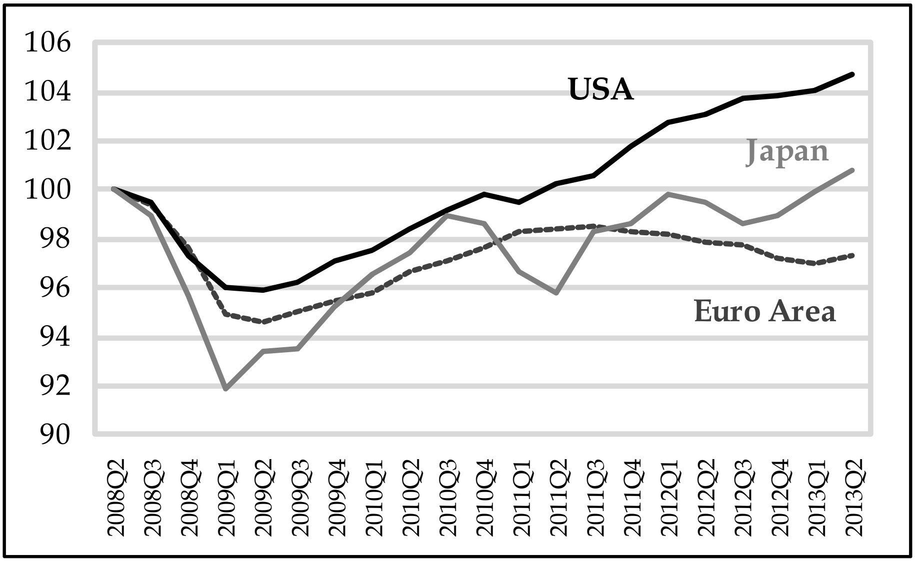
Adjustment by the G3 to the Financial Crisis

As a result of a near collapse of financial markets and the ensuing credit crunch, advanced economies went into deep recessions. The sharp decline in economic activity set in from Q2 2008 and lasted until Q1 2009 (see Figure 3).

The downward spiralling of the G3 economies was amplified by the banking sector's desperate need for cash, which not only led to a sudden stop in credit flows but also to fire sales of stocks. According to Eichengreen and O'Rourke (2009) stock markets, industrial production and global trade were diving faster from summer 2008 to spring 2009 than during 1929-1930. The significant decline in global trade was a strong blow to EM Asia since this region had become the world's leader in production and export of manufactured goods.

Plummeting asset prices and a fast contraction in production and trade had the potential to trigger a 1930-like depression but due to ef-

FIGURE 3: Real GDP for USA, Japan and Euro Area, 2008 (Q2=100)



Source: Eurostat (2013).

fective policies, the majority of advanced economies escaped this scenario, though not all. The GDP in Portugal, Italy, Greece and Spain has continued to decline and these countries are now struggling with mass unemployment. In the case of Spain, the general unemployment rate stands at 26 per cent and youth unemployment exceeds 50 per cent. In Greece, the worst affected country, GDP is down by more than 20 per cent. Southern Europe was ill prepared when the crisis struck due to structural problems, including significant competitiveness problems.

To avoid a repeat of the 1930s, central banks were quick to cut interest rates and they also injected massive amounts of liquidity into money markets. By the end of 2008, leading interest rates in the G3 countries were cut to emergency levels, where they have stayed since then. Governments soon followed course by undertaking fiscal stimulus packages, which mitigated the consequences of the sharp contraction in private sector demand. Table 1 summarizes key features of the countercyclical fiscal policy in leading nations, including China. We shall later get into more detail with China's efforts in this area.

Due to the countercyclical policies, the majority of the advanced economies slowly began to recover in Q2, 2009 (see Figure 3). The recovery has, however, been much weaker than what is normally observed following recessions due to deleveraging that has led consumers to hold back on spending in order to rebuild their financial wealth. This also explains why companies have been reluctant to undertake new investments.

TABLE 1: Fiscal Stimulus Packages

Country	Size of plan	Breakdown	Comments
USA	5.5% of GDP US$787 billion	Spending by federal government: $ 95 billion Transfer to local government: $ 279 billion Transfer to individuals through social security, unemployment insurance, food stamps: $ 127 billion Tax cuts: $ 286 billion	Most of the plan was implemented in 2009. US fiscal policy has been contractionary since 2010.
China	14% of GDP US$586 billion/ RMB 4220 billion	Infrastructure: 38% Earthquake reconstruction: 25% Welfare: 10% Rural development: 9% Technology advancement: 9% Green energy: 5% Education: 4%	To be spent 2008-2010. Below we discuss the IMF's estimate of the effects on GDP growth.
Japan	6.4% of GDP Yen 32,400 billion	A series of stimulus plans in 2009-2011: Government spending on a wide range of projects. Tax cuts designed to boost spending and employment support. In addition, loan guarantees for companies not included.	Japan has since 2011 undertaken additional fiscal stimulus plans not included in the 6.4%, cf. later.
Germany	3.0% of GDP €82 billion	Investment in infrastructure and tax reductions.	Two packages to be spent in 2008 and 2009.

Note: For the USA and Germany: OECD (2009) is the source. For Japan, I use IMF (2010a) since the OECD's numbers only include policies up to March 2009 and since Japan, unlike the USA and Germany, has implemented several packages after that date. China is covered by IMF (2010b) and *Financial Times*.
Sources: OECD (2009); IMF (2010a); IMF (2010b); *Financial Times* (2009a, 2009b).

As a consequence of the significant decline in GDP, government tax revenue has fallen in all economies. Moreover, as stimulus policies enacted into law in 2008 and 2009 were costly, government deficits shot up (see Table 2).

TABLE 2: Government Deficits in the G3, 2007-2012 (in % of GDP)

	2007	2008	2009	2010	2011	2012
USA	-2.7	-6.7	-13.3	-11.2	-10.0	-8.5
Euro Area	-0.7	-2.1	-6.4	-6.2	-4.1	-3.6
Japan	-2.1	-4.1	-10.4	-9.4	-9.9	-10.2

Source: IMF (2013c).

The sharp increase in budget deficits meant that public debt started spiralling upward (see Table 3). The US debt burden is up by almost 40 percentage points since the crisis struck. Interestingly, euro area debt is up by less than 30 percentage points but the debt problem is highly uneven and reflects to a significant extent the crisis in southern Europe. Japan's government debt has reached an unprecedented level but is entirely a domestic issue as all the debt is held by Japanese citizens. The Japanese situation is, however, unsustainable. The IMF (2013d) notes that Japan needs to cut its deficit by no less than 11 per cent of GDP in order to put debt-to-GDP firmly on a declining path (see also the last section).

TABLE 3: Government Gross Debt Burdens in the G3, 2007-2012 (in % of GDP)

	2007	2008	2009	2010	2011	2012
USA	67.2	76.1	89.7	98.6	102.5	106.5
Euro Area	66.4	70.2	80.0	85.4	88.1	92.9
Japan	183.0	191.8	210.2	215.3	230.3	237.9

Source: IMF (2013c).

Since 2009, the G3 countries have aimed at rolling back fiscal deficits. In spite of this, debt burdens will continue to increase over the coming years due to deficits and weak growth. As a result of the belt tightening, fiscal policy is now reducing spending in the G3 as a whole, which in part explains why the recovery has had difficulty taking off (see IMF 2012 for a discussion).

In addition to the negative growth effect of the tight fiscal policies, companies have been reluctant to invest because of a bleak outlook, including high uncertainty about the future. The risk that the USA was going to fall over the fiscal cliff at the end of 2012 weighed heavily on the business outlook; the euro crisis has also taken its toll, in particular after the debt sustainability of Spain and Italy came into doubt following the bailout of a number of smaller member states including Greece, Portugal and Ireland. As the distrust in Spain and Italy's public finances accelerated in 2011, interest rates rose to more than 7 per cent, which in view of the declining GDP and high debt, is unsustainable. The debt crisis led to a double-dip recession in Europe. Preliminary evidence suggests, however, that the euro area may have just escaped recession in the second quarter of 2013.

The euro crisis has also led to speculation about the future of the euro. It is widely agreed that the survival of the euro in its present form is highly dependent on developments in Italy and Spain. If policies in these countries fail to achieve debt sustainability and maintain support by the general public, these countries could end up in a default, which most likely would lead to a break-up of the monetary union in its present form.

The risk of this scenario has, however, been reduced significantly over the short term by the infamous European Central Bank (ECB) announcement in 2012: 'We will do whatever it takes to save the euro', signalling that the ECB was now willing to act as the lender of last resort. As a result of this, Italian and Spanish interest rates plummeted and it became much cheaper for these countries to fund their large deficits.

In the medium and longer term, however, the task is still the same: Italy and Spain must bring their debt burdens on a sustainable path, which is challenging for countries that continue to be in recession and that can only improve competitiveness through wage restraint. Whether the large Mediterranean countries will manage to solve these problems within the framework of a common currency in Europe is still uncertain.

What is not uncertain is the negative effect the euro crisis has had on the rest of the world, including EM Asia. As noted by JPMorgan (2013b), exports out of EM Asia to Europe in 2013 are back to the level recorded in 2010. A collapse of the euro area is therefore also considered to be the most important external risk for China (see IMF 2013b).

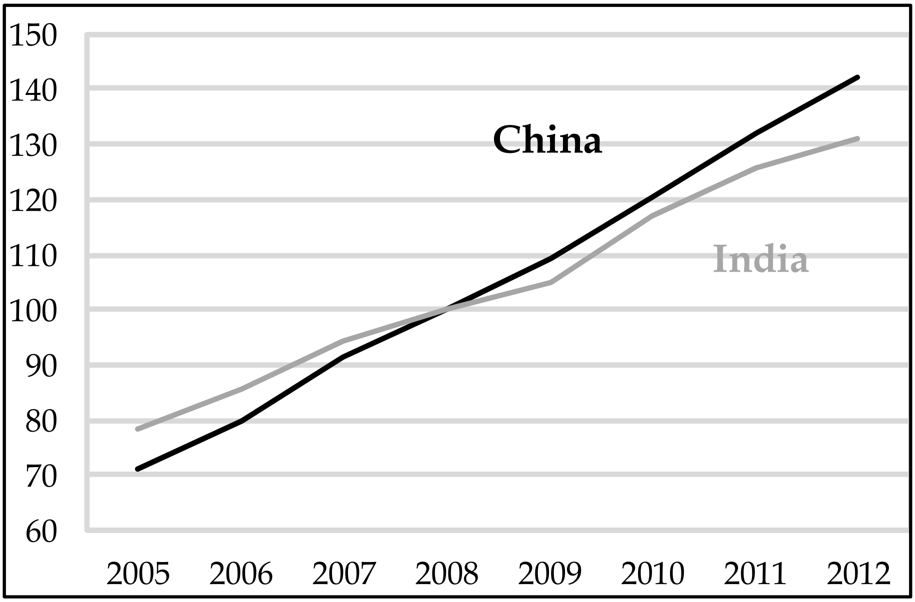
Before we turn to EM Asia, let us finally add a few observations on the US fiscal policy issue. The US fiscal imbalances have been addressed in two steps. First, Congress agreed at the end of December 2012 to raise the income tax on high earners and to discontinue the payroll tax cut. These policy changes took effect at the beginning of 2013 and are estimated to withdraw around 0.5-1.0 percentage points of GDP. It was then agreed to embark on a wider overhaul of the budget in the first months of 2013. However, since the parties have not been able to reach agreement, automatic spending cuts were rolled out 1 March 2013. Within this fiscal year these cuts will amount to withdrawing about 0.5 of a percentage point of GDP growth. At present, the US fiscal stance is therefore estimated to reduce economic growth by around 1.0-1.5 percentage points.

The risk that this could get amplified through private consumption cutbacks has so far not materialized as consumers have been resilient, reflecting significant wealth effects following strong gains in stocks and house prices (JPMorgan 2013a). The strong rebound in asset prices is likely, to a large extent, to reflect the Federal Reserve's QE3 programme, which amounts to buying mortgage bonds worth USD 85 billion every month. This programme helps to keep long-term interest rates down, which stimulates the recovery in the housing market (see Figure 1). This programme also spurs the stock market by making stocks more attractive for investors. The activist monetary policy is therefore an important pillar in the recovery as the fiscal stance will withdraw spending from the economy regardless of how Congress decides on the budget. Because of the importance of the USA in the global economy, US monetary policy is therefore also of great importance for EM Asia (see also the discussion below on Indonesia and India).

Adjustment by EM Asia to the Financial Crisis

Because the financial crisis was made in the USA and Europe and not in EM Asia, and because EM Asia had little direct exposure to the distressed banks and toxic assets, EM Asia was 'only' hit indirectly by the crisis. The main channels were through a sharp decline in trade and capital flows and through a significant rise in financial market turmoil. This section explains how EM Asia tackled the significant blow to its exports and in many cases actually managed to grow during the global downturn.

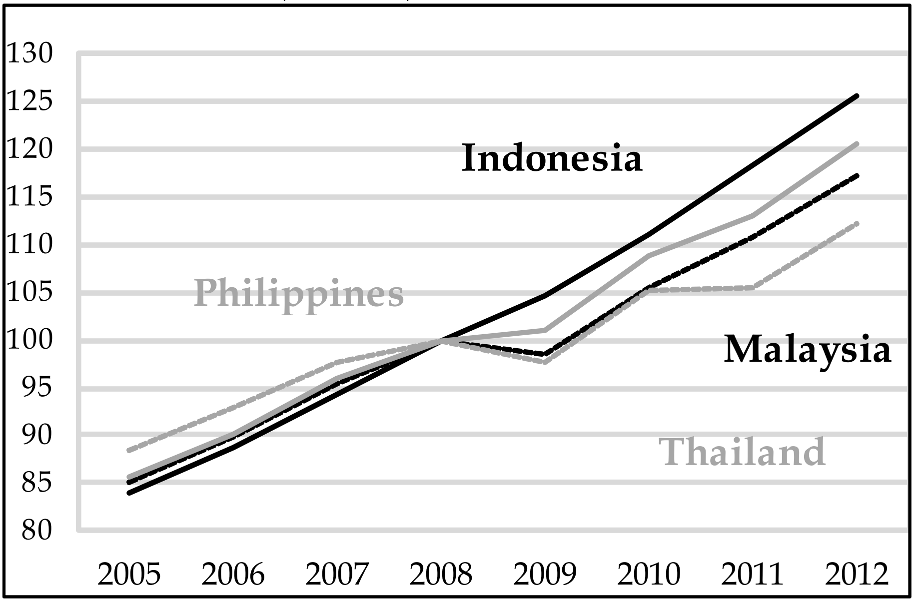
FIGURE 4: Real GDP for China and India (2008=100)



Source: IMF (2013b).

We begin by looking at the two largest economies: China and India. Together they account for more than 70 per cent of GDP in EM Asia. Due to their size, the adjustment of these economies is of immense

FIGURE 5: Real GDP for Indonesia, Malaysia, the Philippines and Thailand (2008=100)



Source: IMF (2013b).

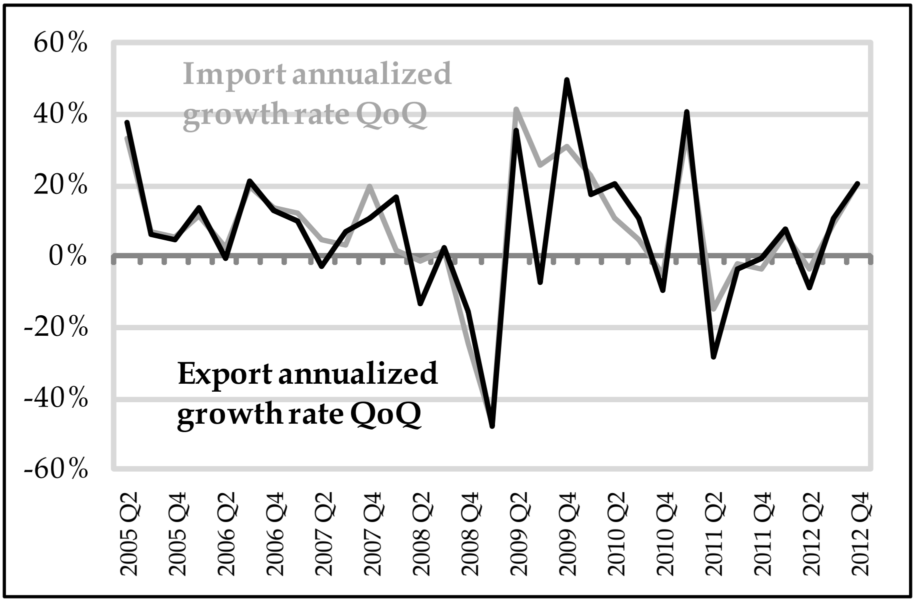
importance to the whole region, reflecting the strong intra-Asia supply networks and trade links.

Let us take a helicopter perspective and look at annual data that smooth out quarterly changes. It is obvious that the two largest economies weathered the financial crisis much better than the G3 (see Figure 4), as both China and India posted significantly higher GDP in 2009 than in 2008. For both countries, however, there is a tendency for growth to trend downward. This is most obvious for India. India is currently growing at about 5 per cent, significantly below pre-crisis levels. China's growth has also come down, as shown by the straight GDP line in Figure 4 (a straight line signals declining growth unlike an exponential curve signalling constant growth). China is currently targeting an annual growth rate of 7.5 per cent.

In comparison to China and India, the smaller and more open Asean-4 economies of Malaysia and Thailand were hit much harder by the downturn. It took them about a year to recoup the initial loss in GDP. The other two Asean-4 countries, Indonesia and the Philippines, fared better and suffered only a minor decline in GDP growth (see Figure 5).

The transmission of the crisis to Asia came to a large extent through trade. The deep crisis in the G3 triggered a sharp contraction in the developed world's imports of goods produced in EM Asia and elsewhere. China, the world's largest exporter, saw its exports plummet close to 40 per cent in Q4 2008 relative to Q3 (annualized rate; see Figure 6). The

FIGURE 6: China's Export and Import Growth (quarter-on-quarter annualized rate)



Source: WTO (2013).

downturn accelerated in Q1 2009 with exports declining by almost 50 per cent relative to Q4 2008 (annualized rate).

As noted by Eichengreen and O'Rourke (2009), global trade declined faster in this period than during the crisis in the late 1920s and early 1930s. Because a significant part of China's exports is re-export of processed imported intermediate goods, imports declined by almost the same percentage as exports. However, since China was running a big trade surplus, the sharp contraction in trade had a strong negative effect on the Chinese economy. In addition, falling exports also meant lower productivity growth as the export sector is leading relative to sectors producing only for the home market, including agriculture and services.

To fill the significant gap in aggregate demand, the Chinese government enacted into law a bold stimulus package outlined in Table 1. Within this framework, China's investment grew at an unprecedented rate. According to the IMF (2010b), China's investments grew by 20 per cent in 2009, which is double the annual average of the last three decades.

Investments were particularly strong in infrastructure, rising by 44 per cent in 2009. This expansion was by and large financed by issuing bonds and by bank credit. Real estate investments also gradually picked up in 2009 and investment in the manufacturing sector increased by 30 per cent, despite a significant decline in exports. The surge in investment contributed with an unprecedented 8 percentage points to GDP growth in 2009 (IMF 2010b).

The bold size of the intervention combined with highly accommodative monetary policy shows that China gave its economy the biggest boost to demand among the leading nations. By adopting this giant investment plan, China also changed strategy from being primarily an export-led economy to an investment-driven economy.

China's countercyclical policy had a number of important effects. First, it helped to cushion the adverse trade shock on the Chinese economy, including avoiding a recession. In spite of that, many small and medium-sized businesses outside the state-owned sector came into difficulties and many went bankrupt or had to seek emergency financing from non-official sources. This marks the beginning of extensive shadow banking in China. Second, the activist policy also quickly led to a rebound in China's imports. The strong import recovery benefitted not only neighbouring Asian economies but also the rest of the world including commodity exporters Australia, Brazil, Chile and several African countries. China's import recovery is a reflection of its bold stimulus policy and of the strong countercyclical policy in the G3, which allowed China to resume its export activities. Without a rebound of exports out of China, we could not have had a strong recovery of China's imports.

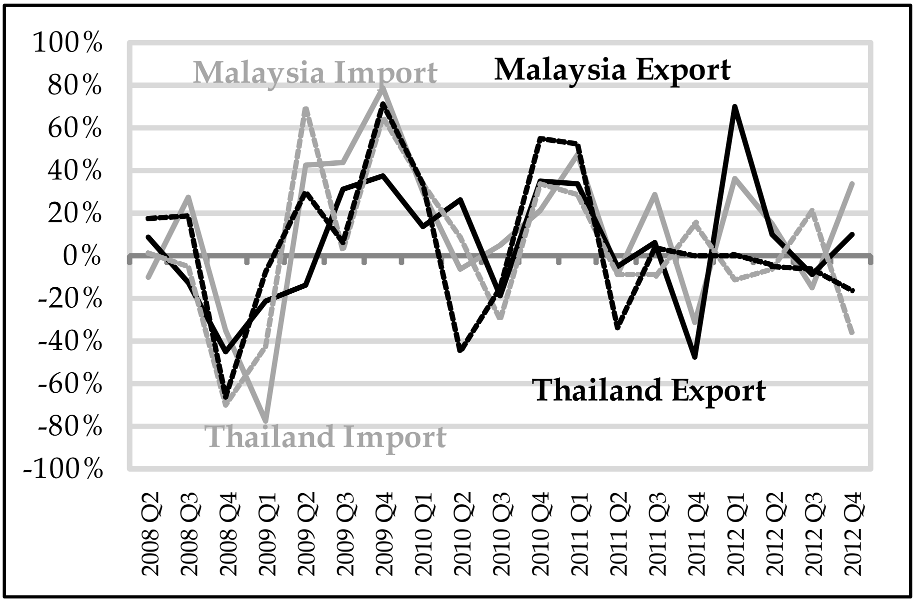
The significant demand boost in China and the G3 helped the smaller EM Asian nations recover from essentially a free fall in trade in late 2008 and early 2009. Figure 7 shows how Malaysia's trade plummeted by more than 60 per cent in Q4 2008 (quarter-on-quarter annualized rate). Figure 7 also shows that Thailand's external trade was hit very hard with a decline in imports in Q1 2009 of around 80 per cent (annualized rate). Thailand's trade was hit much harder during the financial crisis than during the flooding in late 2011.

In addition to the stimulus efforts by China, many of the other Asian economies also adopted countercyclical policies that helped to smooth out the adjustment process. In a study of how the Asian economies adjusted to the crisis, the IMF concludes that:

> In the last decade, most Asian economies have pursued more countercyclical fiscal policies than in the 1980s and 1990s. In the aftermath of the 2008-

> 09 global financial crisis, for example, policymakers took several fiscal measures to cushion the downturn, in contrast with the 1997-98 Asian crisis. …Econometric analysis…finds that when real GDP per capita declined by 1 percentage point relative to its trend, real government expenditure per capita increased on average by 1 percentage point, versus only 0.3 percentage point for the period 1980-2011. (IMF 2013a: 38)

FIGURE 7: Malaysia and Thailand's External Trade Growth (quarter-on-quarter annualized rate)



Source: WTO (2013).

Following the implementation of these stimulus policies, EM Asia went through a strong recovery that later led to a significant pick-up in inflation. That triggered a tightening of monetary policy in several EM Asia economies. This was certainly the case in China where consumer price inflation peaked at around 7 per cent in 2011. China tightened monetary policy through increases in the banking sector's reserve requirements, interest rate hikes and through decrees to the banking sector to limit credit growth. In addition, China also implemented various policies that directly aimed at cooling a hot real estate market. These policies eventually reversed the upward trend in inflation, which is now hovering slightly below 3 per cent in China. India, however, is still struggling with excessive inflation near double-digit levels and with a real economy that has had difficulty in taking off since the crisis struck.

EM Asia as a whole managed to weather the crisis without creating large government deficits. Fiscal deficits are on average close to 2 per cent of GDP. These deficits are matched by current account surpluses of roughly the same size. These economies continue therefore to be in a strong macroeconomic position as they have modest government debt burdens and sizeable foreign exchange reserves.

But not all Asian countries are in an equally strong macroeconomic position. India suffers from persistent high inflation (close to 10 per cent), a government deficit around 5 per cent of GDP and a current account deficit of about the same magnitude. Indonesia is also running a sizeable current account deficit and Indonesia therefore also needs to import capital to finance the current account deficit. In periods of financial market turbulence and distress, capital importing countries are vulnerable to changes in sentiment among foreign investors. The considerable outflow of capital from both India and Indonesia over the summer of 2013 illustrates this point. In response to the discussion in the USA of reducing the Federal Reserve's QE3 programme, which most likely would raise interest rates, both countries suffered from massive capital outflows as US-based investors, including hedge funds, reduced their leverage. As a result, both India and Indonesia experienced double-digit declines in the value of the rupee and rupiah, respectively. In both cases the central banks raised interest rates to stem the outflows and stabilize the financial sector. The negative side effect is higher financing costs for businesses and this affects in particular small and medium-sized firms that export little to the rest of the world. These countries are therefore poised for lower growth for a while, that is, until the positive effect on exports starts to kick in.

As we shall later discuss the risk of a hard landing in China, it is worth noting that China's overall macro situation is favourable, with a current account surplus at 2.4 per cent in 2012, total external debt at only 9.1 per cent, and a government budget deficit at 1.6 per cent (all in per cent of GDP). Moreover, China's stock of foreign reserves stood at USD 3.3 trillion at the end of 2012. Housing prices are elevated in major cities and pose risks to macroeconomic stability (see below). Local government finances are often reported to be under stress in parts of China and the maturity of loans has also been extended in several cases to soften the debt service burden. That said, the transparency of local government finances is low. The same goes for the balance sheets of state-owned enterprises in general. The overall risk exposure of the government sector is therefore uncertain as there is no consolidated balance sheet that integrates all activities within the public sector.

From a global growth perspective, it should be noted that China alone has contributed with more than 40 per cent of global growth since the outbreak of the financial crisis (JPMorgan 2013b). That said, there is little doubt that China and EM Asia in general could have performed better without the double dip in Europe. The double dip is weighing heavily over the region as EM Asia's exports to the euro area have reverted to the 2010 level, which to a large extent explains why the growth contribution from net-trade in China is now hovering around zero, unlike in previous years where the trade sector was a driver of growth (JPMorgan 2013b). However, the decline in growth trend is also likely to reflect that the investment-led growth strategy finally has run into problems with diminishing returns after 30 years of double-digit GDP growth. Going forward, it is therefore also the government's strategy to rebalance the economy towards a higher share of consumption by expanding social security, health care and the welfare system.

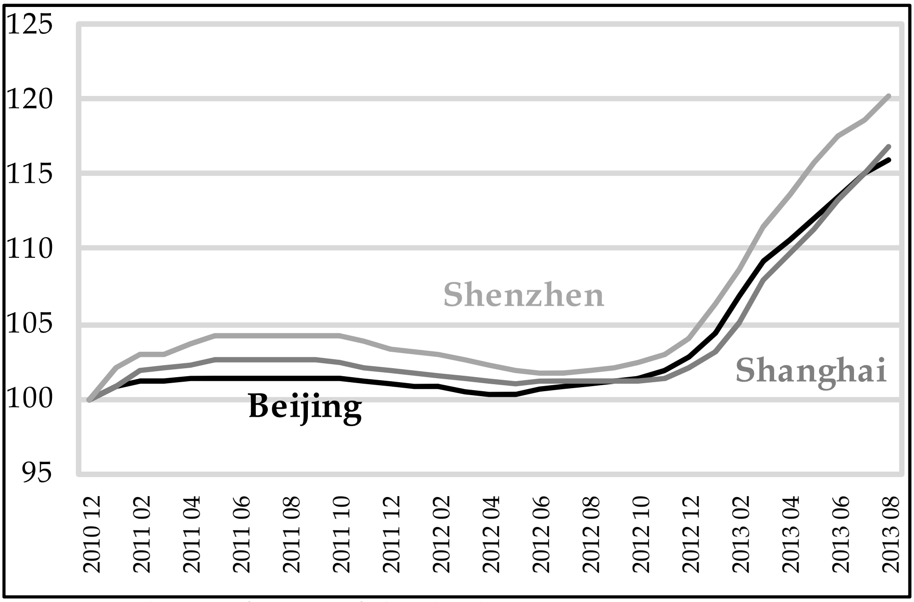
Current Macroeconomic Policy Issues and Dilemmas in China and Japan

China weathered the crisis well and the government was therefore able to deliver on its key economic goals: growth and job creation. Indeed, it is common to argue that in the absence of democratic elections, the Chinese government derives its legitimacy from achieving satisfactory economic progress. Translated into hard numbers, the government has to deliver at least 7 per cent annual growth to maintain social stability, according to conventional wisdom. It is in light of this overriding priority that one should understand the government's position taking in a number of policy issues and dilemmas.

In spite of the success in macroeconomic policy-making, growth is trending down. This also explains why the government has been reluctant to curb surging housing prices. As noted by the investment bank UBS in *Financial Times* (2009c): 'the leadership has a dilemma—they don't want a property bubble but at the same time they don't want to kill the sector and see property activity drop in the current weak environment.'

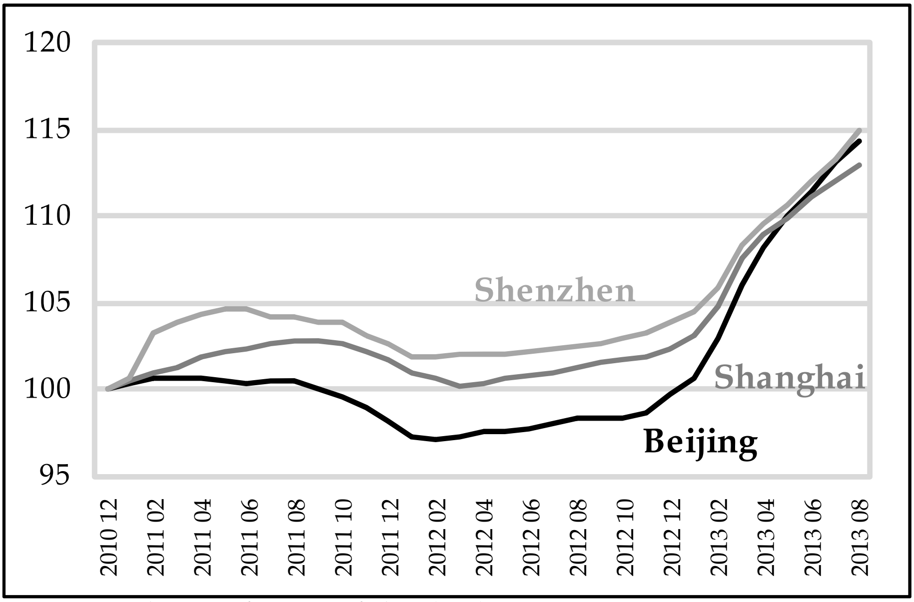
Figures 8 and 9 show that real estate prices in Beijing, Shenzhen and Shanghai have risen by double digits since late 2012. The surge in prices is hard to justify by fundamentals since the return from investing in real estate, defined as the potential rent relative to the property value, is significantly below bank interest rates. Citizens who buy apartments for investment purposes must therefore buy in anticipation they will continue to appreciate in value.[5] As anecdotal evidence suggests, this

FIGURE 8: Price Development of Newly Constructed Residential Buildings, M12 2010=100



Source: National Bureau of Statistics of China (2013).

FIGURE 9: Price Development of Existing Residential Buildings, M12 2010=100.



Source: National Bureau of Statistics of China (2013).

motive is the dominating one for a large number of buyers and the housing market appears to be in bubble-like territory.

The government has taken steps to cool the market through restrictive lending practices in the regulated banking sector and by setting limits on how many apartments investors can buy, but these efforts have not been effective.[6] The government's efforts are frustrated by extensive shadow banking, that is, by lending outside the official banking system. According to the IMF, 'about half of financial intermediation now takes place outside traditional banking channels in less well supervised parts of the financial system' (IMF 2013a: 16). Moreover, the IMF expresses concern over the rapid pace of credit growth. Recent data for the broadest measure of credit growth shows that credit growth rose by large double-digit numbers during the first half of 2013. Because a fast growing share of this credit growth is flowing through the less supervised banking system, it is likely that loan quality is declining.[7] Moreover, the fast credit expansion could very well fuel a further surge in real estate prices and eventually create a mega bubble in the market. The central bank therefore also hiked financial conditions in June 2013 in order to slow credit growth. In order to offset the negative effect on GDP growth, the government also announced a mini stimulus package with emphasis once again on infrastructure investments and on lowering taxes for small businesses. This intervention shows that the government is highly concerned about maintaining growth at or above the threshold needed to maintain social stability.

In a discussion of the likelihood and consequences of a hard landing, triggered by a collapse of the housing market, it should be noted that the typical Chinese investor and homeowner is likely to be less indebted than US and European investors were prior to the outbreak of the financial crisis. First time homeowners are, for example, asked by the bank to come up with 30 per cent down payment and for buyers of a second apartment, the down payment is much larger. However, in an economy with rapid credit growth there is little doubt that the loan-to-value ratio is increasing, although the deep-rooted Chinese tradition of having large savings suggests that we are far from the household indebtedness in the West prior to the bursting of the bubble. Because of that, a significant decline in real estate values in China is likely to have less dramatic effects on the economy as homeowners do not have to deleverage as much as they did in the West. It should also be noted that the Chinese government has an enormous self interest in preventing a hard landing since this could threaten its monopoly-power status and endanger its privileges as hundreds of millions of citizens will be strongly affected because the housing market is where most citizens have parked their savings. Because the government also possesses a range of tools it can mobilize to steer the economy out of the worst scenarios, a hard landing seems fairly unlikely, at least over the next couple of years. Growth between 7 and 8 per cent seems therefore to be the most likely outcome (see also the projections by the IMF 2013b and Zhang and Zhang 2013).

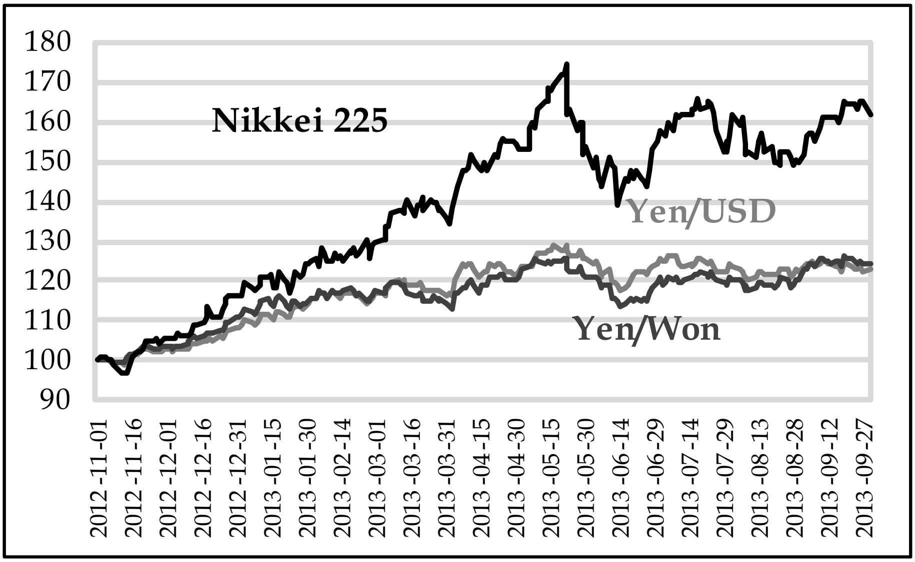
Let us turn to Japan and the remarkable policy change under the new Abe-led government. The new strategy has three components, labelled 'arrows' in the jargon of Abenomics. The first is a significant quantitative and qualitative easing programme that promises to double the monetary base within two years.[8] The goal is to hit a 2 per cent inflation target and end the deflation period of two lost decades. The second component is a new stimulus programme at JPY 10.3 trillion that aims at lifting GDP by 2 per cent while creating 600,000 new jobs. The third is a plan that aims to boost Japan's competitiveness through reforms in product and labour markets. The details of the third arrow have not yet been revealed in any great detail.

The strategy of the Abe government has been to restart Japan's economy through a big devaluation without triggering instability, including retaliation from other countries. As shown by Figure 10, the yen has also depreciated by around 25 per cent against the US dollar and the won since late 2012. This has helped to stimulate exports and the policy should therefore also provide a boost to Japan's economy, including inflation expectations. If the plan works as intended, it could also generate positive spill-overs to the whole region arising from a stronger Japan (see the IMF 2013d). Japan's new strategy was proposed years ago by Krugman (1998) and Bernanke (1999), but that was before the ballooning of the Japanese government debt.

There is evidence that the strategy has started to work. GDP rose by 4.1 per cent in Q1 2013 and by 3.8 per cent in Q2 (annualized rates), lifted by stronger exports and private consumption. This has fuelled expectations of higher profits, which explains the significant increase in the stock market. Figure 10 shows that the stock market, from its trough on 13 November 2012 to its peak on 22 May 2013, is up by more than 70 per cent when measured in yen. Since then, the market has lost momentum and is actually drifting down a bit (Figure 10).[9]

Volatility in both stock and bond markets has, however, gone up, reflecting market nervousness about the outlook of the strategy. On

FIGURE 10: Indexes for JPY/USD, JPY/Won, and Nikkei 225 (M11 2012=100).



Source: Bloomberg (2013).

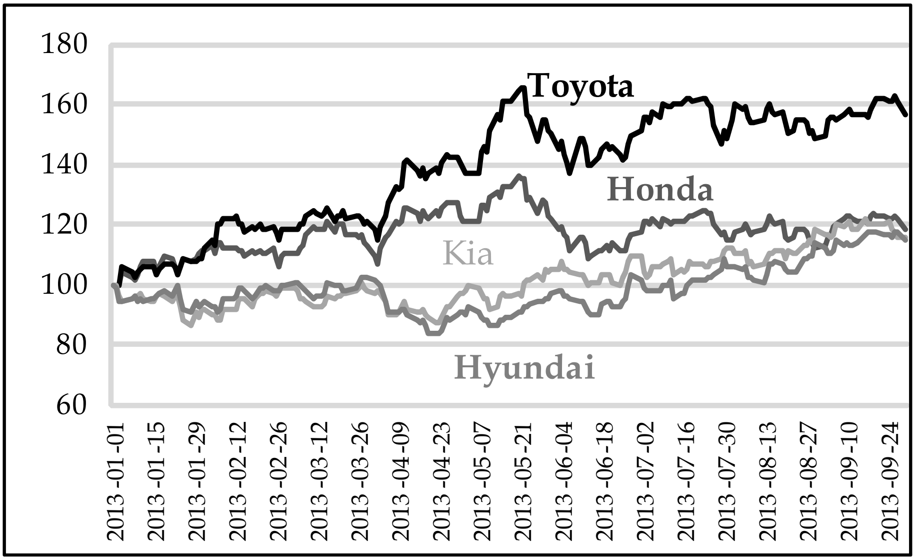
23 May, the Nikkei 225 fell by 7.3 per cent. The sell-off was apparently triggered by weak Chinese manufacturing data and the Fed's announcement that the US QE3 programme could be scaled back soon provided the real economy continues to improve. The bond market has also been highly volatile. The Bank of Japan (BoJ) initially announced that the programme would lower interest rates, thus pushing investors into riskier assets, including stocks. However, BoJ also said it aimed at 2 per cent inflation, which should lead to higher nominal interest rates. The result has been that interest rates have been volatile and it is still too early to detect a clear trend in the bond market.

The development in interest rates medium to long term depends crucially on inflation and inflation expectations. The latest data on CPI inflation is for August 2013, and the data point to annual headline inflation of 0.8 per cent. Japan, however, is still stuck with deflation when energy and food prices are eliminated from the CPI, but preliminary evidence shows that core prices (excluding imported energy and food) have stopped falling as much as they did before. In other words, Japan's current inflation is not yet driven by higher domestic wages and salaries but reflects the big yen depreciation that has sent import prices up. For Japan's strategy to be successful and bring an end to deflation we need to see persistent increases in core prices driven by stronger wages and salaries.

Let us then briefly discuss a few risks to the strategy. A significant rise in interest rates represents an important risk if not accompanied by a substantial and lasting improvement in economic growth. Rising interest rates weaken the banking sector's capital adequacy as it leads to declines in the value of banks' bond portfolios. As banks hold a significant portion of the government's debt, the effect on the health of the banks' balance sheets should not be ignored. A rise in interest rates without a significant improvement of the economy will also worsen the government's debt burden. If the discrepancy between the funding interest rate and the economy's growth only widens by 1 percentage point, the government's debt burden increases by 2.4 percentage points. This is implied by the formula for the change in the government debt burden. Recall, the change in the debt burden d(B/Y) equals the primary deficit (G-T) as a per cent of GDP (Y) plus the interest rate (r) minus the economy's growth rate (g) times the debt burden (B/Y): $d(B/Y)=[G-T]/Y + [r-g](B/Y)$.[10] With a debt burden at 238 per cent of GDP, a rise in (r-g) by 1 percentage point triggers an increase in the debt burden by 2.4 percentage points. In Japan's case it should also be noted that the primary deficit stood at 9.3 per cent in 2012 (IMF 2013c), which adds further to an already ballooning debt burden. A vicious circle of increasing interest rates and falling bond prices could lead to difficulties for the government in financing its large deficit and rolling over its huge debt now at close to 240 per cent of GDP. While this may seem unlikely in view of Japan's strong tradition of funding at home, it is striking that the new bond buying programme occasionally has been accompanied by a rise in bond yields showing that private investors willingly have reduced their positions in Japanese debt in spite of the BoJ's commitment to an unprecedented buying spree. If the strategy fails to achieve the desired macroeconomic effects one cannot rule out that investors will sell out of Japanese bonds and move into foreign bonds in response to a higher government default risk.

Another risk is that other countries, including South Korea and Taiwan, will retaliate against the big Japanese yen depreciation as they to some extent compete for the same export markets.[11] This is certainly the case in cars but also in many consumer electronics goods. Figure 11 shows that Hyundai and Kia recently have had a poor stock market performance relative to Toyota's performance. Toyota's share price in late September 2013 is up by close to 60 per cent relative to January 2013. Kia and Hyundai are up by less than 20 per cent, a bit below Honda's development.

FIGURE 11: Toyota, Honda, Kia and Hyundai on Local Stock Exchanges (1 January 2013=100)



Source: Bloomberg (2013).

How is China affected by the big yen devaluation? China to some extent actually benefits from the cheaper Japanese currency as China imports a considerable amount of Japanese intermediate goods that are processed and later re-exported. However, since China also competes with Japan in exports of consumer electronics, the net effect on China is ambiguous.

Retaliation could take place through counter devaluations, trade disputes and discrimination against Japanese companies when bidding for contracts, including public procurement.[12] Because of the huge size of Japan's QE programme it is likely that there will be considerable capital outflows from Japan, which could spur elevated pricing in other markets, including Hong Kong's real estate market, which has doubled over the last four years and it could also make it harder for the Chinese authorities to rein in the extensive shadow banking due to potential hot money coming in from Japan.

The new strategy in Japan is therefore not without risks of destabilizing public finances at home and markets abroad. However, there is also a significant upside potential assuming that the third arrow in the plan will effectively manage to reform Japan's labour and product markets.

Concluding Comments

This article has shown that EM Asia weathered the financial crisis much better than the G3. EM Asia is today far ahead of where it was when the crisis struck. By contrast, the USA and Japan have only recently recouped the GDP loss in 2008-2009, whereas Europe is still below the pre-crisis level.

As a result of the better performance in EM Asia, the rise in government budget deficits has also been much smaller, whereas the G3 has significant deficit and debt problems. EM Asia as a region continues therefore to be in a strong macroeconomic position, with modest fiscal deficits around 2 per cent of GDP matched by current account surpluses of about the same size and sizeable foreign exchange reserves. India and Indonesia stand out as exceptions.

India has a government deficit close to 5 per cent of GDP, a current-account deficit of about the same magnitude and suffers from inflation close to 10 per cent. Indonesia is also in a less favourable position, with a sizeable current account deficit. Both countries are therefore in need of foreign finance and that makes them vulnerable to changes in foreign investor sentiment. Over the summer of 2013, India and Indonesia suffered significant capital outflows as foreign investors began to fear higher interest rates in the USA. The capital outflows led to sharp currency depreciations and defensive interest rate hikes by the central banks. The financial turmoil and the hike in interest rates are likely to slow growth over the short term.

A key reason why EM Asia as a whole weathered the financial crisis well reflects the reforms initiated in response to the 1997 Asian crisis. These reforms led to a build-up of considerable foreign exchange reserves and to healthy government budgets that allowed EM Asia to implement bold countercyclical policies when the crisis struck. The healthy macro stance, the stimulus packages in EM Asia and in the G3, including the sharp interest rate cuts, helped EM Asia quickly recover from essentially a free fall in trade. However, it is important to emphasize that EM Asia has not decoupled from the G3. The double dip in the euro area is weighing heavily over the region and exports to Europe have now reverted to levels observed in late 2010. Moreover, the recent capital outflows from India and Indonesia show that countries with current account deficits in particular are sensitive to changes in foreign investor sentiment.

In spite of the successful crisis management, GDP growth in China is trending down partly because of the double dip in the euro area but also reflecting diminishing returns to capital accumulation. This also explains why the government has been reluctant to curb surging housing prices. Because the rental yield from investing in real estate in the big cities is significantly below bank interest rates, the market seems driven by expectations of future price increases. The fast credit expansion that took place until recently, had the potential to trigger a further surge in real estate prices and eventually foster a mega bubble in the market. Due to this, over the summer of 2013, the government adopted bold measures to rein in the acceleration in credit growth, well aware that this development could fuel a boom-bust housing cycle and increase the likelihood of a future hard landing. So far the government has demonstrated that it has the necessary tools to steer the economy to a softer landing, with GDP growth in the range of 7 to 8 per cent.

Under the new Abe-led government, Japan has implemented a remarkable new strategy that aims at bringing an end to deflation through a massive quantitative easing programme, fiscal stimulus and a plan that aims to boost Japan's competitiveness through reforms in product and labour markets. The details of the last element of the plan have not yet been revealed.

The hope is to restart Japan's economy through a big devaluation; so far the yen is down by around 25 per cent relative to leading currencies. There is evidence that the strategy has started to work. GDP rose more strongly in the first two quarters of 2013 than previously, mainly reflecting stronger exports and private consumption. This has fuelled expectations of higher profits, which explains the very significant increase in the stock market. However, the new strategy is not without risks of destabilizing public finances at home and markets abroad and it could also lead to retaliation from competitors. There is, however, a significant upside potential assuming that Japan will effectively manage to reform its rigid labour and product markets. As there has not yet been any legislation in this area, it is too early to say whether the strategy will be successful in the long term.[13]

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NOTES

1 I have benefited from comments from participants at an Asia Business Forum Seminar, Copenhagen, 2013 and from discussions with colleagues. I wish in particular to thank Michael Jakobsen, Svend E. Hougaard Jensen, Ari Kokko, Niels Mygind, Emil Verner and Finn Østrup. I am solely responsible for views and errors in the article.

2 See Minsky (1977) for theoretical work on financial crises that captures very well the 2008 crisis.

3 See Shiller (2008) for more information on the sub-prime market, including its growth, and Risager (2009) for delinquency rates.

4 China's large sovereign wealth fund CIC had, however, invested in Morgan Stanley, an investment that also led to substantial losses.

5 To illustrate let us consider a typical apartment in Beijing in a location between the 3rd and 4th ring (highway around the city). These apartments are now sold for around RMB 40,000 or more per square meter, according to anecdotal evidence. The price for an apartment of around 60 square meters is therefore about RMB 2.5 million. The gross monthly rent that can be obtained is around RMB 5,000 and the net rent is around RMB 4,500 after deduction of association fees, etc. The yield is therefore only slightly above 2 per cent. Interest rates on 3-6 month time deposits are around 4 per cent.

6 In March 2013, the State Council announced that it will strictly enforce the new 20 per cent capital gains tax that is relevant if the apartment for sale has been owned less than five years. The capital gain policy has been adopted in all major cities. Besides this rule, Beijing for example also now has a rule that prevents singles from owning more than one apartment, whereas families can have two apartments. Foreigners cannot buy property in China and Chinese citizens can only buy in Beijing if they have lived there for five years or more. The down payment for the first apartment is 30 per cent and 70 per cent for the second. Moreover, the financing cost for the second apartment is 10 percentage points above the normal bank lending rate.

7 Declining loan quality means lower ability to service the loans in SOEs, local governments and the private sector, including real estate developers and private investors.

8 The programme is enormous and amounts to buying bonds worth yen 7-8 trillion (USD 70-80 billion) each month. Relative to the size of the economy, this is a much bigger programme than the US QE-3 programme.

9 Last observation is 28 September 2013.

10 In this formula, r is the nominal interest rate and g is the nominal GDP growth rate. We could also work in real terms: in this case r should be the real interest rate and g the real growth rate. Note, the end result for the change in the debt burden is the same.

11 The same goes for Germany.

12 The South Korean finance minister was quoted in the international press as having said that the won's appreciation against the yen is a larger issue than the ongoing conflict with North Korea.

13 After the paper was completed in September 2013, the Abe government announced that fundamental labour market reforms, including moving ahead with a more liberal hiring-firing regime in companies, have been taken off the agenda. However, since Japan needs to address these issues, it is still highly uncertain whether the Abe government can undertake sufficient reforms of the ailing economy.

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