

Chapter 2

Crisis Impact

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Abstract Asia's quick recovery after the global financial crisis raises an important question as to how a region that had suffered during the crisis could make a turnaround and break out of the recession ahead of other regions. This chapter argues that emerging Asia had built up enough resilience through extensive reform of its financial, corporate, and public sectors since the 1997–1998 Asian financial crisis. The region's banking sector was not heavily loaded with non-performing assets, it did not indulge in acquiring US toxic assets, and maturity and currency mismatches in balance sheets had been by and large under control. Governance, transparency, and the financial soundness of the corporate sector had all improved. On macro-economic policy, greater flexibility of foreign exchange rate systems softened the impact of the liquidity crunch. Finally, the depreciation of the region's currencies against the US dollar during the height of the crisis subsequently helped to improve the competitiveness of exports to propel East Asia's recovery.

Keywords Global financial crisis • Asian financial crisis • Trade and financial channels of contagion • Economic and social impacts of the crisis

JEL Codes F42 • F31 • F32

2.1 Introduction

The 2008–2009 global financial crisis and its subsequent manifestations, particularly the eurozone sovereign debt and banking sector crisis, have been another painful reminder to emerging economies in Asia that they are part of a world where global finance is precarious, and that no matter what they do, there is a limit to their security against financial crises. The repercussions of the crisis were varied in their scope and impact, but many economies in the region, especially Hong Kong, China;

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Japan; the Republic of Korea; Malaysia; Singapore; Thailand; and Taipei, China have suffered severe recession and financial turbulence that have interacted to complicate crisis management and recovery.

Despite its initial virulence, the crisis appears to have been short lived. Since the second quarter of 2009, East Asia engineered an impressive rebound ahead of other regions, although recent developments in and outside the region cast doubts as to whether this resurgence can lead to a full-fledged recovery.

This chapter reviews the short- and long-run impact of the 2008–2009 global financial crisis on East Asian economies. Section 2.2 examines the causes and short-run consequences of the crisis in East Asia. It focuses on the macroeconomic impact of the contagion of the crisis and searches for the factors that have propelled the rebound. Section 2.3 reviews the relative importance of the two channels of contagion in transmitting the effects of the financial meltdown in North America and Europe—the trade channel and the financial market channel. Section 2.4 describes the economic and social impacts. Section 2.5 describes the environmental impacts. Section 2.6 analyzes the factors behind the economic resurgence. It concludes that, despite the large fiscal injections throughout the region, it appears that the recovery in some countries has been driven by external demand. Section 2.7 examines the long-term effect of the crisis and the prospects for rebalancing growth that is expected to reorient the development strategy to allocate more resources to the non-tradables sector. Conclusions are in Section 2.8.

2.2 Short-Run Impact of the Global Financial Crisis: From Crisis to Recovery

2.2.1 Crisis Contagion: Export Collapse and Recession

Amid the deepening global economic crisis, East Asia¹ appeared to have suffered less from the global crisis compared to other regions as late as in the third quarter of 2008. Until then, it was expected that East Asia would weather the crisis relatively better than other regions. In emerging East Asia, overall economic fundamentals were reckoned to be sound: robust growth, stable prices, healthy fiscal balances, current accounts in surplus, and large holdings of foreign exchange reserves. And the crisis had originated in the US. Unlike those in Europe, the region's financial institutions were sound and more profitable as they held a lot less US toxic assets. Capping it all, there was a growing argument that decoupling of East Asia from the cyclical movements of the rest of the world had taken root (World Bank 2007; Anderson 2007). In view of this economic strength, it was believed that the region would remain a favorable destination for foreign direct and portfolio investments

¹ Here, East Asia is defined as the region comprising ASEAN plus the People's Republic of China, Japan, and the Republic of Korea (ASEAN+3).

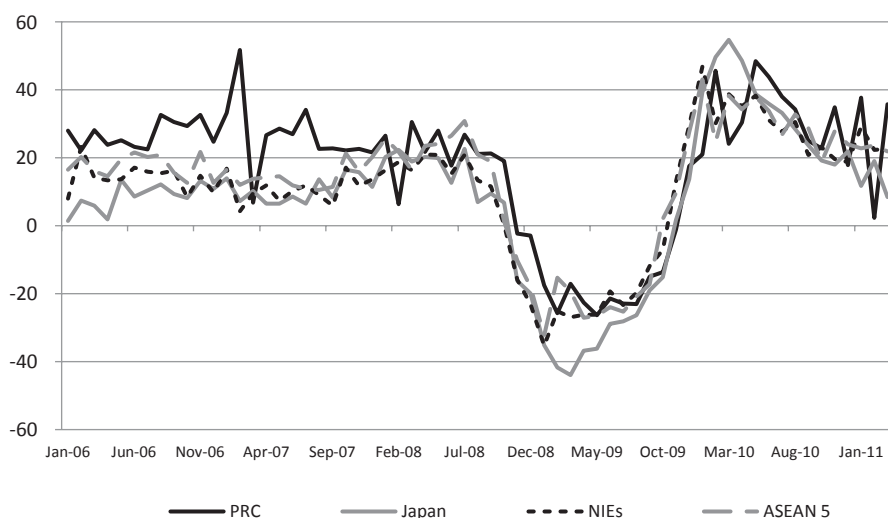


Fig. 2.1 Export growth in East Asia (% change). (Notes: *ASEAN* Association of Southeast Asian Nations, *NIE* newly industrializing economy, *PRC* People's Republic of China. Calculations are annual growth rates on a monthly basis. ASEAN 5 refers to Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam. NIEs refers to Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China. Sources: International Monetary Fund, International Financial Statistics database, available at: <http://www.imfstatistics.org/imf/>; CEIC Data, available at: <http://ceicdata.com>. Accessed 28 March 2012)

even during the crisis. Indeed many forecasts, including the November update of the *World Economic Outlook* (IMF 2008) echoed the prevailing optimism as they suggested that, as a whole, East Asia would deliver robust growth while the US and eurozone would be struggling with the prospect of a contraction of their economies from 2009.

But during the fourth quarter of 2008 following the bankruptcy of Lehman Brothers in September, East Asia took a turn for the worse: many economies slid into a recession deeper than anticipated, and the Republic of Korea and Indonesia faced significant financial shocks. Although the degree of the decline differed from country to country, from September 2008 to the second quarter of 2009, all of East Asia's emerging economies saw the rates of their export growth plunging into negative territory (Fig. 2.1) and, in most cases, falling output (Fig. 2.2), in some cases quite sharply. Reflecting the collapse of domestic demand and exports, and a steep fall in the prices of oil and other raw materials, import demand plummeted more throughout the region. As a result, practically all East Asian economies were generating surpluses during the same period. Not surprisingly, inflation rates fell and in Japan deflation returned. The overall macroeconomic deterioration was serious enough to dash much of the hope that East Asia would serve as a regional engine of growth strong enough to moderate the downturn of the global economy.

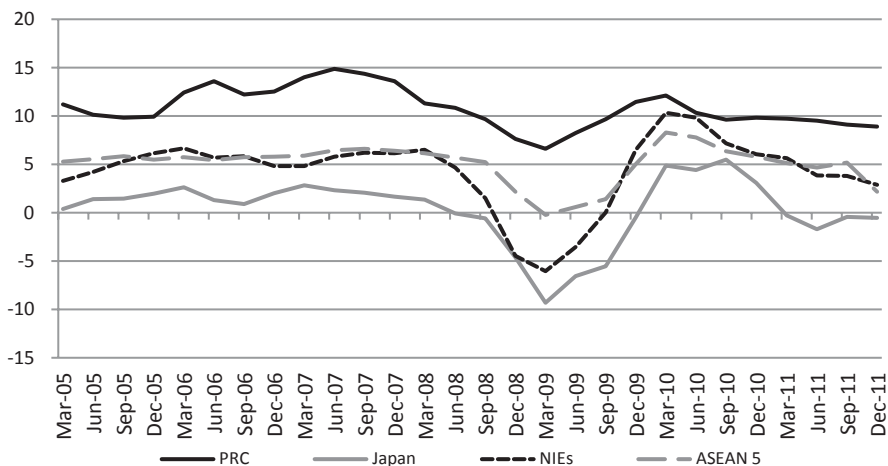


Fig. 2.2 Real gross domestic product growth in East Asia (% change). (Notes: *ASEAN* Association of Southeast Asian Nations, *NIE* newly industrializing economy, *PRC* People's Republic of China. Calculations are annual growth rates on a quarterly basis. ASEAN 5 refers to Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam. NIEs refers to Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China. Source: CEIC Data, available at: <http://ceicdata.com>. Accessed 13 April 2012)

2.2.2 Financial Instability

East Asia's financial markets also displayed considerable instability since the outbreak of the global financial crisis. Stock prices nosedived throughout the region and exchange rates, except for the Japanese yen (which appreciated) and those pegged to the dollar, generally depreciated against the US dollar and exhibited higher degrees of volatility than before until the second quarter of 2009 (Figs. 2.3 and 2.4). Sovereign spreads over US Treasuries widened dramatically, and CDS premia, a measure of the quality of financial liabilities, also soared, before dropping early in 2009 (Fig. 2.5).

In this bleak crisis landscape, banks and other financial institutions were cutting back their lending operations by recalling existing loans, let alone granting new ones—as the availability of both local and foreign currency liquidity evaporated, future economic prospects looked dim, and their losses were piling up. Most damaging was the drying up of trade credits, which further slashed sagging exports. Some countries such as the Republic of Korea suffered large capital outflows as many foreign investors were liquidating their holdings of East Asian financial assets to buy into more liquid assets such as US Treasuries, to deleverage, and to cover their losses back home. These outflows were combined with the pessimistic economic outlook to weaken and generate expectations of further depreciation of the currencies of these countries vis-à-vis the US dollar, inducing further capital outflows. Amid the financial deterioration, most emerging economies held up well, but the Republic of Korea could not ward off a liquidity crisis that broke out in the

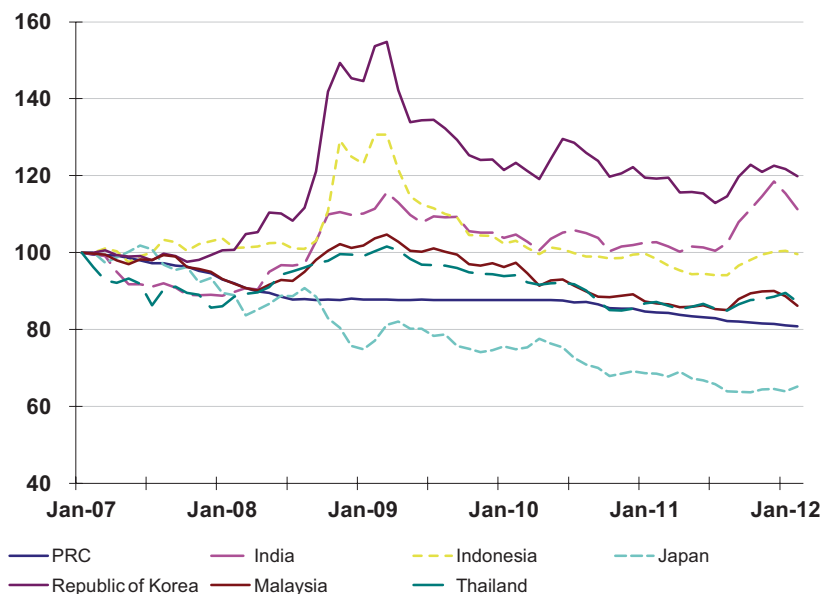


Fig. 2.3 Exchange rates against the US dollar of East Asian economies. (Note: *PRC* People's Republic of China. Source: Asian Development Bank, Asia Regional Integration Center Economic and Financial Indicators database, available at: http://aric.adb.org/macro_indicators.php. Accessed March 2012)

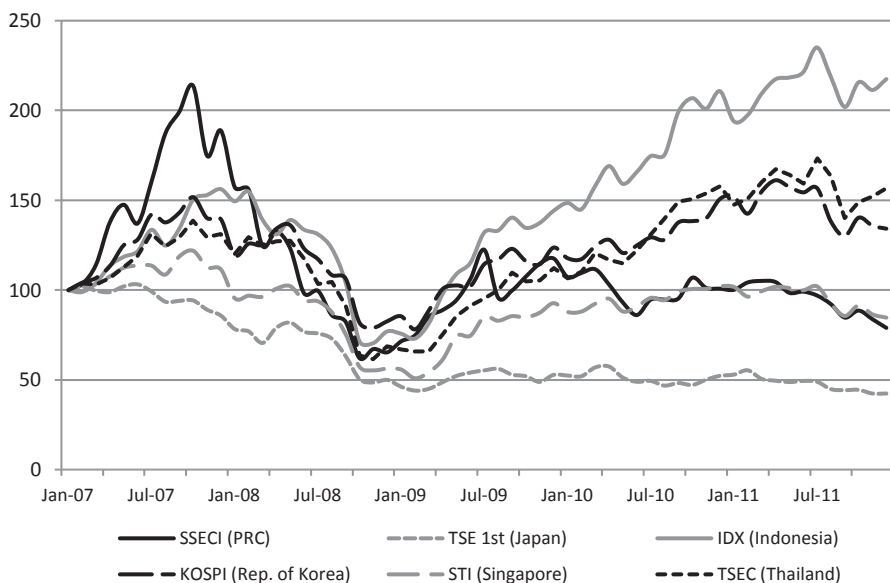


Fig. 2.4 Stock price movements in East Asia. (Note: *IDX* Indonesia Stock Exchange, *KOSPI* Korea Stock Exchange, *PRC* People's Republic of China, *SSEC* Shanghai Stock Exchange Composite Index, *TSE* Tokyo Stock Exchange. Source: ADB Asia Regional Integration Center Economic and Financial Indicators Database, available at: http://aric.adb.org/macro_indicators.php. Accessed 13 April 2012)

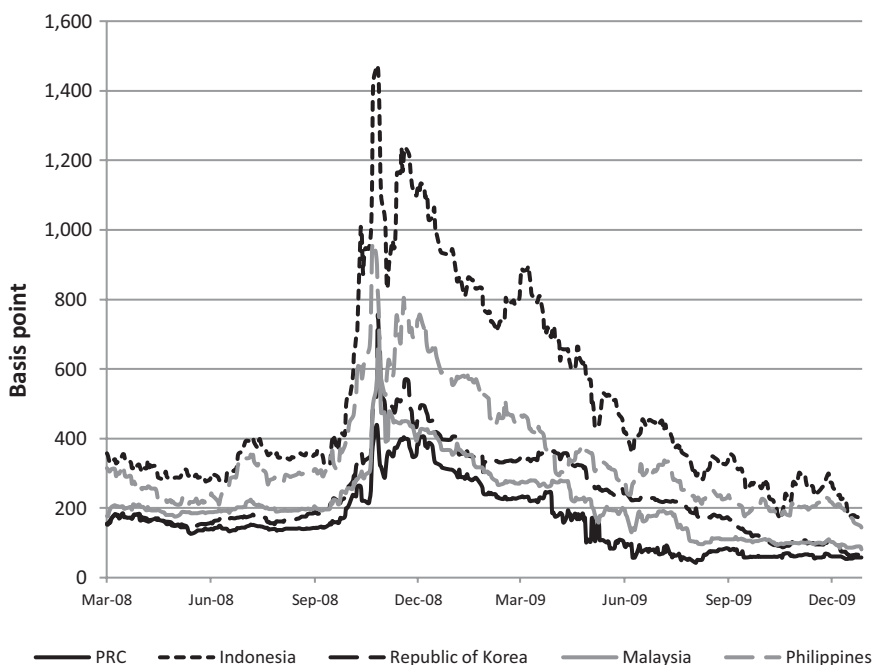


Fig. 2.5 Sovereign spreads: foreign currency denominated sovereign bond spreads (versus US treasury notes, in basis points). (Note: *PRC* People's Republic of China. Source: Korea Center for International Finance, available at: <http://www.kcifny.org/Statistics/Database.asp>. Accessed 14 March 2010)

fourth quarter of 2008 and lasted for about six months. During this period, the crisis inflicted large output and reserve losses on the Republic of Korea, caused a massive depreciation of its currency, and one time posed the systemic risk of insolvency of financial institutions.

2.2.3 *Rebounding: Astounding?*

Against all odds, beginning in the second quarter of 2009, East Asia staged an impressive rebound. As shown in Figures 2.1 and 2.2, the rebound was impressive, and has once again revived the hope that the region will be leading the way out of the crisis for the global economy. It has rekindled the debate on the decoupling of East Asia from the consumers of the US and Europe. However, export growth has slowed steadily since then, reflecting continued weakness in both the US and Europe, suggesting that, once again, decoupling has been shown to be a myth, at least in cyclical terms.

The severity of the impact of the crisis varied from country to country. The ASEAN original five (Indonesia, Malaysia, Singapore, the Philippines, and Thailand)

coped with the crisis better than other neighboring countries as, in aggregate, they registered positive growth in 2009. The GDP of the PRC grew almost 9% in 2009—more than the PRC authorities forecast—to the point where the PRC was threatened with inflation of asset and consumer prices. The Asian NIEs (Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China), which were battered the most by the crisis, made a strong comeback. Monetary authorities of the PRC; the Republic of Korea; and Hong Kong, China, became increasingly concerned about building up of inflationary pressure and have begun formulating an exit strategy. Nevertheless, these developments do not add up to provide any empirical evidence either supporting or disputing the decoupling phenomenon. It may also be premature to conclude that East Asia's recovery is strong enough to pull the global economy out of the recession.

Figure 2.2 presents annual rates of GDP growth of emerging Asia on a quarterly basis. There is indeed a clear indication of a V-shaped recovery in emerging Asia. What then are the sources of demand that have powered the rebound? Export growth resumed since the early months of 2009, and the large fiscal stimulus packages most East Asian countries introduced late in 2008 contributed to growth as well. At the same time, East Asia saw the return of foreign lenders and investors. Capital inflows into the region picked up again, easing US dollar liquidity shortages.

In subsequent sections, this chapter attempts to bring to light some of the factors that may account for the initial sharp downturn and an equally swift revival in emerging Asia. For this purpose, this chapter examines the relative importance of the two channels—trade and finance—of crisis contagion to gauge the extent to which some of the structural features of the economy below have contributed to deepening and recovering from the crisis in East Asia: export dependence, share of manufactures in total exports, degree of deregulation and openness of financial markets, and flexibility of the exchange rate.

2.3 Channels of Crisis Contagion

2.3.1 Trade Channel

Dependence on and Dominance of Manufactured Exports If there is one defining feature of East Asia, it is the region's export orientation. A large falloff of exports to the markets of the US and the European Union (EU) on which East Asia heavily depends for growth would therefore wreak havoc on its economy, and it has. Compared to a decade earlier, it is true that the region has become less reliant on the two markets as a result of trade integration in the region, but, taken together, the US and EU still accounted for a combined 35% of its total exports in 2008. Although its impact would be less damaging than before, a recession in both regions, which accounted for 46% of global GDP in 2008, would certainly ripple through to East Asia via the trade channel to depress its growth. It was therefore not surprising that,

at the early phase of the crisis, exports of these mostly export-oriented East Asian economies were dropping at double-digit rates (Fig. 2.1).

Not only the size of exports relative to GDP but the product structure of exports also mattered in transmitting the external shocks. As shown by Blanchard (2009), compared to economies with a diversified mix of export products, those that concentrated heavily on a limited number of manufactured export goods, which are highly cyclical, have been hit harder by the crisis. The Republic of Korea, Singapore, and Taipei, China, of which exports are heavily concentrated in manufactures, experienced a deeper slowdown than others such as Indonesia and the Philippines, which export relatively more agricultural and other non-manufactured products. A case in point is the Republic of Korea's export product makeup.² In 2007, 57% of its total exports were in four industries—automobile, shipbuilding, electronics, and chemicals. Over the past decade, the top 10 export products comprised more than 65% of the Republic of Korea's total exports. Given that the income elasticity of import demand is higher for manufactured than non-manufactured imports (Goldstein and Khan 1985), a global recession would therefore bring down export earnings of countries such as the Republic of Korea more than those of other economies.

2.3.2 *Decoupling and the PRC Factor*

If the decoupling had taken root before the crisis, then one would expect that East Asia could have remained relatively immune to or spared partially at least, the effects of adverse shocks originating in countries outside the region such as the US. Although a number of studies quoted earlier suggest that East Asia was becoming more insulated from the cyclical movements of the US, Europe, and other regions, the increase in intraregional trade among East Asian economies in 2007 and 2008 did not appear to have moderated the impact of the 2008–2009 global financial crisis (Grunwald and Hori 2008). In fact, the worsening of the economic crisis had weakened much of the empirical ground of decoupling before being resurrected after the rebound has taken place in the region. To be sure, even before the crisis, some had gone so far as to denounce it as a myth.³

² It should be noted, however, the heavy concentration has an advantage too: once a full recovery begins, output growth will accelerate.

³ Consistent with the theory of international product fragmentation, ADB (2008) concluded that the story of decoupling, or uncoupling in their terminology, was no more than a myth. The report showed that emerging Asia is closely tied to global goods markets and impulses run from the US, EU, and Japan backward through the region. Another empirical study by Haltmaier et al. (2007) also challenged the role of the PRC as a regional engine of growth. It shows that external demand continues to be an important source of growth, and in particular for more advanced economies in the region. The PRC has become a more independent source of demand in recent years, but it is still more of a conduit importing parts and components from other countries in the region and assembling them into final goods to be exported. Ahearne et al. (2006) also show that the PRC and a group of other East Asia's emerging economies maintain a complementary relationship in which their export expansion is driven by, among other factors, global growth.

The structure of intra-regional trade in Asia is often compared to a conveyor belt carrying parts, components, and other intermediate inputs produced by Japan and other Asian economies to the PRC for assembly and exports to the rest of the world.⁴ In this conveyor system, the PRC serves as the export platform where it imports more from other East Asian economies and exports more to the rest of the world. Up until the second quarter of 2009, the conveyor belt had been slowing down, if not coming to a screeching halt, as the PRC had cut down its imports substantially, dispelling the notion that the country could serve as a regional engine of growth. In 2007, total exports of the 12 East Asian economies (ASEAN plus Japan and the Republic of Korea) to the PRC amounted to US\$ 416.6 billion, compared to US\$ 365.2 billion to the US. In 2008, growth of exports to the PRC of Japan, the Republic of Korea, and ASEAN 5 had all turned to negative, before the reversal took hold in early 2009.

Despite the loss of exports, the slowdown of growth in the PRC was only been moderate, which suggests that much of its current recovery has been powered by the expansion of domestic demand supported by fiscal stimulus packages, which has in turn absorbed relatively larger amounts of imports from other East Asian countries than before.⁵

As shown in Figure 2.6, since the first quarter of 2009, there was a surge in the PRC's imports, the bulk of which has been coming from other East Asian emerging economies. The share of East Asia in the PRC's total imports rose to 45 % in the fourth quarter of 2009, from 43 % earlier. However, the trend since then began to decline again, partly reflecting increased resource imports from other regions.

The data on intra-regional trade in ASEAN+3 countries up to 2008 also show that economies in the region were trading more among themselves than in the past. This trend appears to have continued largely because the PRC has been capable of absorbing a growing share of exports of other Asian countries. In the process, the PRC has strengthened its foothold as a hub for regional trade in East Asia. This increase in intraregional trade has not been able to cushion the decline in their exports to the rest of the world, but contributed in part to staging a recovery. Nevertheless, it is too early to conclude whether East Asia's business cycle will be increasingly independent.

⁴ Athukorala and Kohpaiboon (2009) argued that international product fragmentation—the cross-border dispersion of component production and/or assembly within vertically integrated production processes—is an important driving source of the deepening intraregional trade integration in East Asia. Since the final destination of assembled goods is more likely to be elsewhere, for example, the US or Europe, he argues, that “product fragmentation has made the East Asian growth dynamism increasingly reliant on extra-regional trade.” If this is the case, a negative shock in the US or Europe would reduce imports of final goods from East Asia, thereby affecting the region's business cycles and undermine the decoupling argument. Furthermore, since the bulk of these exports to the PRC represent a derived demand for the PRC's exports to the US and EU, when the PRC's export figures are adjusted, the US is still an important export market for ASEAN+3.

⁵ Jia (2010) provided detailed effects of the fiscal stimulation package on output, income, and investment published by the National Bureau of Statistics.

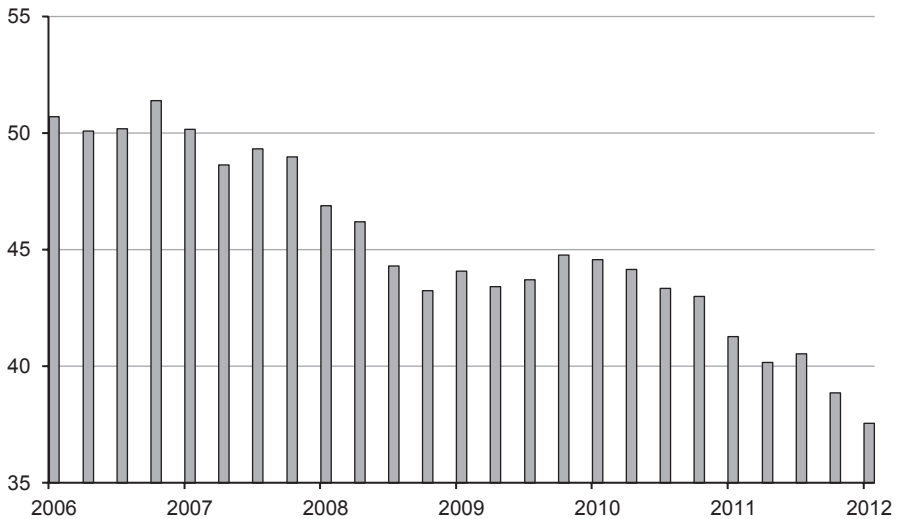


Fig. 2.6 Exports from major Asian countries to the PRC as share of PRC total imports. (Note: PRC People's Republic of China, ASEAN Association of Southeast Asian Nations. Source: CEIC Data, available at: <http://www.ceicdata.com/>. Accessed 5 July 2012)

It is also too early to tell whether the PRC domestic demand led-growth would be sustainable and if it can be, whether it will boost intraregional trade enough to lay down a firmer base of decoupling. Most of the empirical studies on decoupling cover the period before the current crisis. As a result, they do not shed much light on whether the PRC would be able to provide enough demand for imports from other emerging economies to help emerging Asia withstand a significant slowdown in the global economy.

2.3.3 Finance Channel

The adverse impact of financial turmoil with its origins in the US has spread to East Asia through cross-border financial transactions. It has rendered many regional financial markets dysfunctional, exacerbating the economic downturn brought on by the export decline throughout the region. The severity of the contagion was varied in scope and impact from country to country. The Republic of Korea was the only country that fell victim to a debilitating liquidity crisis during the fourth quarter of 2008 following the bankruptcy of Lehman Brothers in September of the same year. In the aftermath of the 1997–1998 Asian financial crisis, the Republic of Korea had embarked on financial deregulation and opening, which included phasing out controls on capital flows. In 2006, the Republic of Korea's policymakers stepped up deregulation of capital outflows in part to restrain appreciation of the won. The deregulation deepened and diversified the Republic of Korea's financial ties with

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