

BBF Asia Must Keep Savings in the Region: ADB's Azis Says
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Dec. 9 (Bloomberg Brief) -- Iwan Azis, head of the office of regional economic integration at the Asian Development Bank, spoke to Bloomberg's Scott Johnson about how Asian countries may weather a slowdown.

Q: The ADB has developed different scenarios for Asian growth. What would a full-blown financial crisis in Europe look like for Asia?

A: We developed three scenarios on top of the baseline scenario. The first scenario is the scenario of only a euro-zone recession. And the second scenario is both U.S. and Europe in recession, but it's not creating a global financial crisis. And then the third scenario is really the worst scenario -- and that is global financial crisis.

Now, in terms of numbers, the effect on Asia if it is going to be a global financial crisis, whatever we predict for emerging East Asia in 2012, the growth rate is minus 1.8 percent. Our baseline prediction is 7.2 percent in 2012 for emerging East Asia. If there is a full-blown global financial surprise, it will be 5.4 percent. Whereas in the least of the three, which is only the euro zone is in recession, then the forecast is to be reduced by 1.1 percent. So that means 6.1 percent. That is the scenario based on the model.

Having said that, I have to explain to you what is behind the kitchen here because the model is the model. First of all, we are not assuming that there is a policy response. In other words, those numbers that I quoted are not necessarily what is actually going to be happening if each of these scenarios is taking place. As you know, let alone one full year, even if something happened next week, policy makers in Asia would respond -- either lowering interest rates or expanding budgets, whatever.

In other words, the actual growth can be better than that -- than 5.4 percent.

Q: Given these possible scenarios, what policy measures are you recommending in the short term?

A: In the short term, there's no doubt the pendulum has to move from concern over inflation towards concern over slowing growth. That means safe-guarding healthy growth is still the target of the short-term policy. Now, how do we do that? We recommend two things. One is strengthening further domestic demand. And that includes consumption as well as investment in some countries. We're talking 14 countries. Each has different, unique characteristics.

For example, for China, we're strongly suggesting consumption to increase. But for ASEAN countries, we're suggesting investment to increase because for ASEAN it's really a lack of investment that needs to change.

That is one. The second is, of course, maintaining financial stability. I don't need to explain why this is so important because Asia is still bank-based, so most of the financing of economic activities, including corporate investment, is still dependent on banks.

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Now, having said that, it doesn't mean that the non-bank [sector] is okay, no. We also recommend that Asian officials continue developing and strengthening the non-bank financial market -- for example, the equity market, the bond market and so forth.

By the way, it's good news coming from that market. Last week, we launched the Asian Bond Monitor in Tokyo. The conclusion there is it's clear the bond market in Asia has been growing significantly. The good news is, the growth is mostly coming from corporate bonds. The bond market in Asia is still dominated by government bonds. But in terms of the growth rate, it's really the corporate bonds that are growing fast. Other good news is that the maturity is moving from three-five to five-ten, so it's moving more to the long term.

As far as policies are concerned, we are recommending that governments in the region continue. This is the good time to issue because the rate is low and maturity is long. We also did a survey of investors, and their response is the same. They want governments in Asia to issue more bonds.

And the last short-term policy is really policy that I would say strengthens the intra-regional trade. There is still room for Asian countries to increase the intra-regional trade -- meaning trade amongst themselves. The share of exports from East Asia to traditional markets like the U.S. and Europe has been declining, but the share of exports to emerging markets -- including within Asia itself -- has been increasing. What we are recommending is strengthening that trend, improving that trend.

Q: How crucial is China to that regional trade?

A: It's very big, very big. If you look at the last two decades, the pattern of trade in emerging Asia is the following. There are two goods: intermediate goods and final goods. As far as the intermediate goods' trade is concerned, within Asia it's pretty big, but as far as the final goods are concerned, trade is with the traditional markets -- the U.S. and Europe. That has been happening in the last two decades. But especially after the Lehman collapse, the slowing down of the U.S. economy and now the slowing down of the European economy, the share of exports to the U.S. and Europe has been declining. The share, not absolutely. Whereas the share of Asian exports to emerging markets has increased. The governments in the region should facilitate that further.

Q: In a global recession, how would the long-term policy response in Asia differ from the short-term?

A: Oh, it's very different. In the short run, basically we are recommending moving the pendulum more toward growth, and many countries in the region have been doing it. China has lowered the reserve requirement. Indonesia has lowered the interest rate, and many other countries are doing the same thing. That's the short run, and this is precisely to mitigate the impact of a global crisis -- the Europeans slowing down, the Americans slowing down.

In the long run, the policy is structural reform. Asia now has excess saving. Most of this excess saving is invested in the financial sector, both domestically as well as abroad. And then

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that money abroad in the private sector in the U.S. and Europe was reinvested in Asia. So it's a roundtrip. We know transaction costs are high. What we are recommending is to try to make sure the excess savings stay within the region because the region still needs a lot of infrastructure financing for health, education as well as physical infrastructure, like roads and ports.

For that they need to do structural reform. Why? Because the reason why the holder of the excess savings in Asia prefers to invest in the financial sector, both domestically and abroad is that, compared to investing in the financial sector, investing in the real sector creates a lot of headaches because of regulation, the tax system, because of labor laws that are too restrictive. The business climate in the real sector has to be improved if they want to make sure the excess saving in the region is invested in the real sector within the region. That is the reason why in the long run we recommend structural reform. To improve the business climate, structural reform is not overnight. You have to do all kinds of things simultaneously - taxes, labor law, deregulation and so forth.

Q: Have those savings prevented a repeat of the 1997 crisis? How is this one different?

A: Absolutely. First of all, the source of the crisis is different. Now it's coming from the U.S. and Europe. I'm talking about the 2008 Lehman collapse and subprime, and now the recent one in Europe, starting with Greece. It's like seeing a sequel of a movie. It's a movie about excess investment. That's what happened in many Asian countries: excess investment. How could that happen, and how could they finance this excess? Borrowing abroad in foreign currency, short-term and unhedged. That brought them into crisis in 1997, and that is not the story now because the share in borrowing has been declining in emerging East Asia, especially short-term borrowing.

Q: Aren't capital outflows a concern?

A: Of course. Overall, in terms of numbers, it's not yet serious. For one, two, three countries, it has been serious. But overall for emerging East Asia it's not that serious yet.

Q: Are those countries Laos, Vietnam and Cambodia?

A: And Indonesia, too.

Q: Could that rise to a crisis level?

A: No. The reason is because other parts of the world are in trouble now. That is not nice to say, but that's a fact. If you have \$100 million now, in terms of areas of the world, where would you put it? It's emerging East Asia. So it's still a safe haven compared to the rest of the world.

Q: Could easing in the U.S. and Europe rekindle inflation in Asia?

A: Of course. In fact, the term we're using is a "balancing act" for the policy makers in East Asia. If that happens, they have to stimulate the economy, but that can reignite inflationary pressure. The difference, however, is that up to six months ago,

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the major concern was inflation, but the source of the inflation at that time was really commodity prices. Now commodity prices have been easing. Even if there is a trend of reignited inflation, I think it will not be mostly coming from the commodity prices. But precisely because the economy is recovering in East Asia, it means demand is strong, and with demand comes inflationary pressure.

Q: Which countries are best prepared to weather a crisis?

A: I would say ASEAN plus three. That is 10 plus three countries: Japan, Korea and China. These ASEAN-plus-three governments are relatively active in communicating among themselves as well as in cooperating in various policies. They do it proactively.

Q: Is there a risk of a European-style crisis occurring in Japan, where debt-to-GDP ratios are quite high?

A: Well, if you're asking of the probability, I think it's low. But it doesn't mean that we can be complacent with that. We can develop all kinds of scary scenarios. I don't think the probability is high for that. But that doesn't mean the Japanese should not pay attention. They have to pay attention, and I think they are paying attention, because once the yields spike in Japan, that's the beginning of so many things. But at this moment, we are assigning a low probability precisely because we are hearing directly from the government officials in Japan that they are doing something about it to make sure that that is not going to happen.

Q: I know the ADB expects a soft-landing scenario for China. In your models, is a hard landing possible?

A: No. Unqualified no. As I said, policymakers in China, like in other Asian countries, are usually quite vigilant. Anything they see coming from Europe or the U.S., if they see it will affect their economy, they immediately come up with a policy response.

I can give you the proof, actually. These days, people are talking about the fear of the slowing down of the Chinese economy. But that's exactly what the Chinese officials want. It's not because they're not performing well. They raised the interest rate several times. They raised the reserve requirement. So they are getting what they want. So this is just an example. If there is something bad happening in Europe, for example, Chinese officials will react. I don't think there's going to be a hard landing. I don't see any indication that points in that direction.

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