ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Working Paper 129

June 3, 2009

MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

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Asia and the global economic crisis: Challenges and opportunities

Allianz

Working Paper No. 129

Asia and the global economic crisis: Challenges and opportunities

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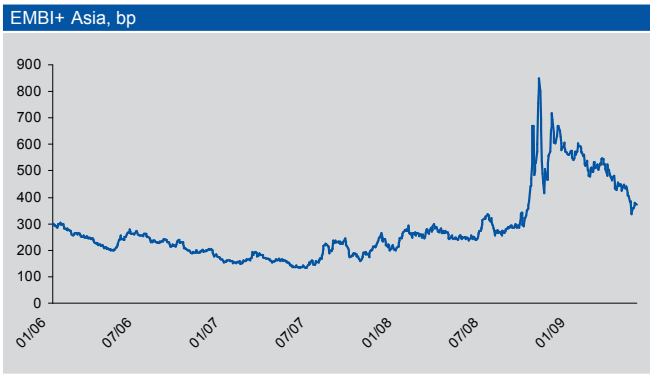
1. REGIONAL ECONOMIC OUTLOOK

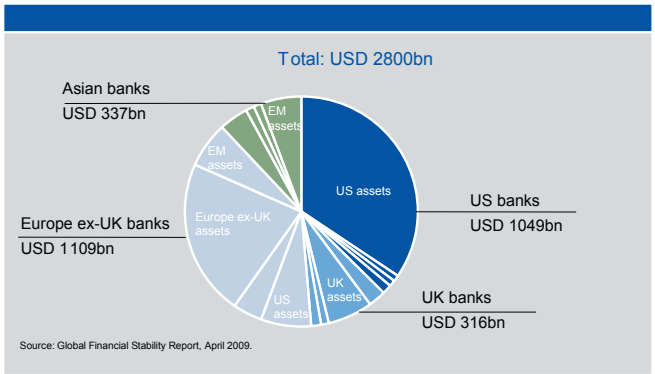
In recent years economic development in the emerging markets of Asia has been driven chiefly by booming exports. Between 2004 and 2008 real gross domestic product (GDP) in the region rose by an average of 8% per annum, catapulting Asia to what is by far the most dynamic region in the world. But now, with world trade languishing under the global financial and economic crisis, Asia is feeling the full brunt of its reliance on exports. Everywhere in the region shipments abroad are in free fall, triggering an economic slump the likes of which we last saw during the 1997/1998 Asian crisis. Region-wide we are forecasting economic growth of 2.7% for this year (against 6.3% in 2008), which is very modest by Asian standards; and that this has not turned negative is down to the heavyweights China and India. With the exception of Indonesia, all other major emerging markets are set to shrink this year, some of them substantially. But in all probability Asia will be spared a protracted period in the doldrums on the grounds of its relatively robust banking system, record currency reserves, low foreign debt and hefty current account surpluses in the past years. Of course, the Asian emerging markets are not a homogenous group of countries. Consequently the factors just mentioned apply more to one country and less to another. In South Korea, for example, the corporate sector has quite a high level of foreign debt.

The following two charts illustrate how Asia has escaped the financial crisis itself relatively unscathed. Risk premiums on Asian foreign currency sovereign bonds have now narrowed appreciably following an extremely sharp jump in autumn 2008. Asian banks also have little exposure to distressed assets, as the IMF figures on the potential write-offs for Asian banks underscore. However, as the third chart shows, Asia, along with other emerging market regions, will have to cope with the fact that private capital inflows will be substantially lower than in recent years.

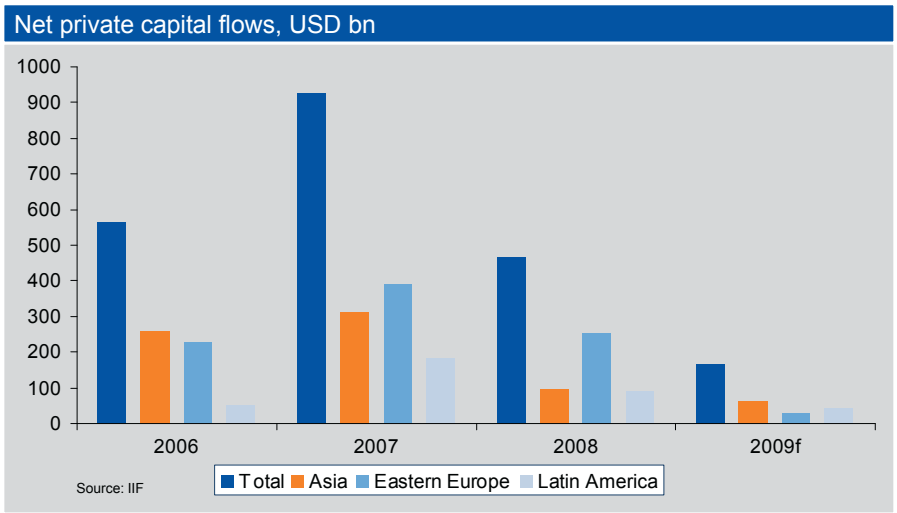
Spreads on Asian bonds almost back to pre-crisis levels



IMF's estimated bank writedowns



Capital flows to emerging markets collapse



What is striking about the current situation in Asia is the very marked gap in performance between the individual countries. Our growth forecasts for 2009 currently range between +6.5% for China and -6% for Singapore. Of course, wide national differentials also exist in other regions, but they generally refer to whether a country is looking at contraction of just 1% or as much as 10%. One Asian country really feeling the pain of the present crisis is South Korea. For this year we are penciling in GDP contraction of 3.5%. Following a dramatic slump in business activity in the fourth quarter of 2008, due mainly to a sharp downturn in investment and extremely anemic exports, the economy stagnated in the first quarter of this year. We do not expect it to pick up until the second half of 2009, when world trade also starts to claw its way back. The marked depreciation in the South Korean won versus the US dollar and Japanese yen should certainly be a help. Although in recent weeks the won has made up some of its previous losses, it is still trading a good 25% lower versus the Japanese currency than last summer. This naturally boosts the South Korean export industry's competitiveness.

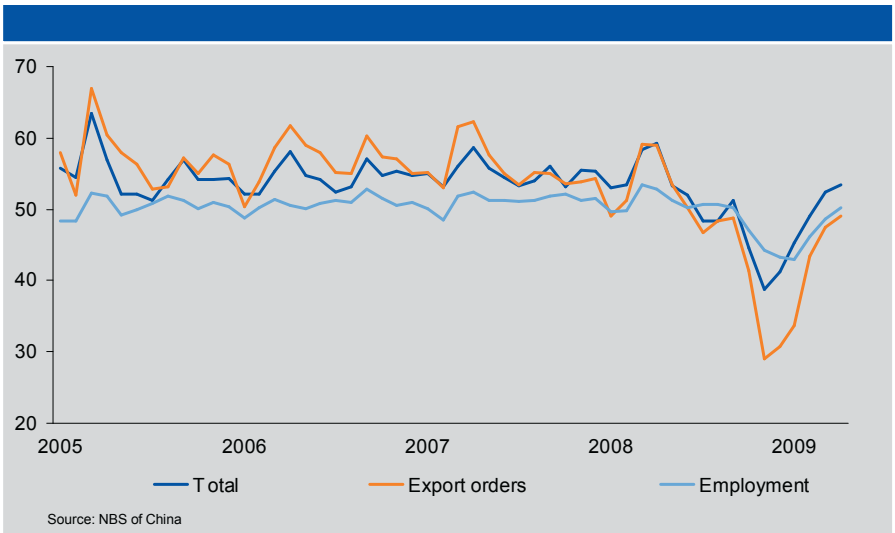
Development of Asian currencies vis-à-vis the US dollar

China: Worst already over

The Chinese economy lost a lot of steam in the course of last year. Whereas real GDP growth in the first quarter of 2008 was still powering ahead by 10.6% year-on-year, by the fourth quarter it had slowed to barely 6.8%, slipping further in Q1 2009 to 6.1%. The repercussions of this plunge are considerable, with an estimated 20 million migrant workers forced to return to their home provinces after losing their work in the former boomtown regions along China's eastern seaboard and in the south of the country. The situation on the labor market in general is extremely tense with the current level of growth not enough to provide the jobs needed, particularly for the new entrants to the workforce. Oxford Analytica estimates that more than 60% of this year's university graduates will be unable to find employment.

The government in Peking is doing its utmost to stem the economic tide. Last autumn it unveiled a two-year fiscal stimulus package worth the equivalent of 14% of China's GDP. And the evidence now coming in increasingly suggests that the biggest Asian emerging market is actually starting to recover its economic poise. This is true, for example, for industrial production which accelerated again somewhat in the early months of 2009 having lost considerable steam towards the end of 2008. Bearing in mind the fairly close correlation between industrial production trends and economic growth, the latest data signal a revival in economic activity. This is also borne out by the latest figures from the Purchasing Managers' Index (PMI) for the manufacturing sector compiled by China's National Bureau of Statistics. The PMI has since rebounded from its November 2008 low of 38.8 points to breach the expansion threshold of 50 points for the second consecutive month in April 2009.

Chinese purchasing manager index signals turnaround

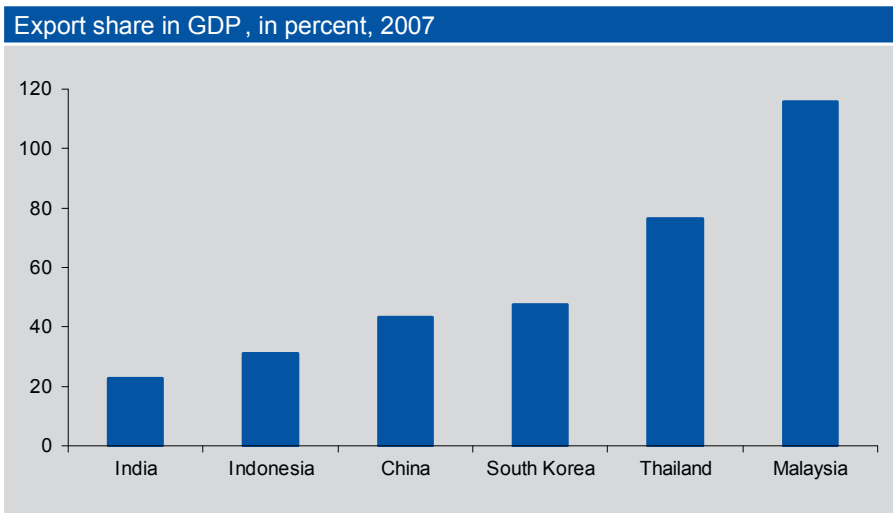


All told, we assume that the Chinese economy has already put the worst behind it – which is not to say that we are reckoning on a powerful upsurge. Persistently sluggish export demand for months to come is likely to act as the major curb. Nor do we expect the credit-driven growth in domestic demand to be sustained for all that long – the government's fear of a lending glut jeopardizing the stability of the financial system will presumably put paid to that. For 2009 as a whole we are factoring in real economic growth of 6.5%.

India: Relatively small export sector keeping economic fallout in check

The Indian economy is naturally also feeling the pinch of the global crisis. However, given that exports make up only around 20% of India's gross domestic product, the collapse in world trade is denting its macroeconomic development far less severely than in other Asian emerging markets. The still-strong domestic focus is thus proving a comparative strength in the present situation.

Heavy reliance on exports in Asia



Even so, the economic slowdown is also exposing India's economic weaknesses. Aside from the industrial sector's heavy reliance on the stock market and foreign investors to fund its capital expenditure, the major Achilles' heel is the state of government finances. With a public debt-to-GDP ratio in excess of 75%, India is perched on quite a high mountain of debt even by international standards. The problem is not new. But government has at least managed gradually to trim back the budget deficit in the past few years – albeit due chiefly to abundant tax revenues rather than strict spending discipline. In the last fiscal year the deficit will presumably have mushroomed again to almost 8% of GDP, pushed up not least by the government's economic stimulus program, after having fallen in the previous year to a record low of 3.3%. Concern over the further development of government finances will have been one of the chief reasons for the renewed upturn in the long-term interest rate trend in recent months. Yields on ten-year Indian government bonds had initially dipped sharply from more than 9% in August 2008 to just over 5% by year's end, only to return to a steep upward path since the beginning of 2009. At the end of March they even briefly topped 7%.

Roller coaster ride of Indian bond yields

Indian 10yr.government bond yield, in percent

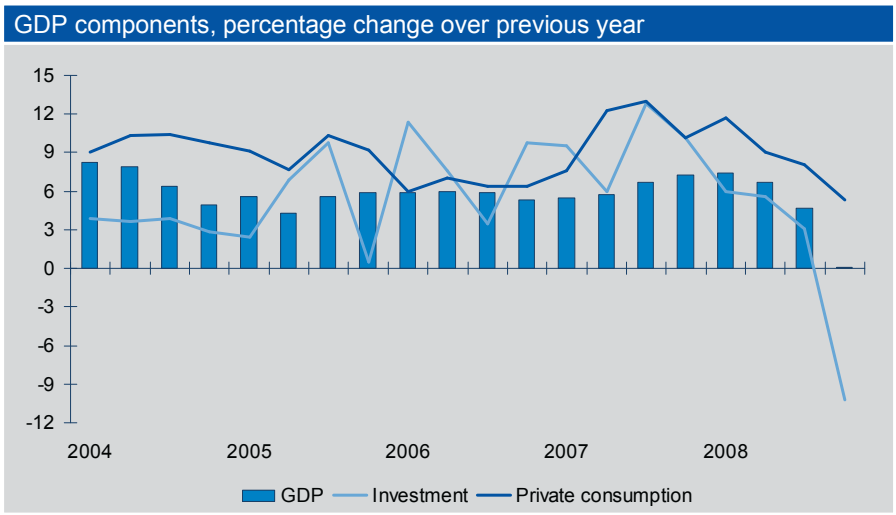
The Indian central bank is supporting the government's policy measures to stabilize the economy with substantial interest rate cuts. Since last October the bank has trimmed its key rate by 425 basis points to 4.75%, the lowest level since autumn 2004. This anticyclical economic policy, coupled with the size of the domestic market, will cushion the downswing. Even so, at just 4.5% this year we expect real economic growth to be only a little more than half the average of the past five years.

Southeast Asia: Mixed picture

Central banks and governments in Southeast Asia are similarly trying to contain the impact of the global financial and economic crisis on their countries by loosening their monetary policy and launching national stimulus packages. This year, Indonesia will probably be the only of the three big ASEAN states (Indonesia, Malaysia and Thailand) to notch up positive economic growth. Domestic demand has proved fairly robust so far and, given the size of the home market, this is keeping the negative repercussions of slack foreign demand on economic growth in check. We are looking for real GDP growth this year of around 3.5% (2008: 6.1%).

Malaysia's economy has been severely hit by the collapse in world trade. The ratio of exports to gross domestic product is way over 100%. In the course of 2008 economic expansion shuddered to a complete halt. Having grown by 7.4% year-on-year in the first quarter of 2008, activity in the fourth quarter relapsed into stagnation. Investment and exports suffered a massive slump. In the first half of this year, too, we expect Malaysia's economic development to remain sluggish. Only with the stabilization in world trade that we are penciling in for the second half-year is business likely to pick up. On average for 2009 we expect GDP to decline by 2.5% (2008: +4.6%).

Malaysian economy slams on the brakes



At the end of last year Thailand's economy contracted sharply, with real GDP in Q4 2008 shrinking 4.3% on a year earlier. Versus the previous three months, the seasonally adjusted drop worked out at fully 6.1%, a quarterly slump on a scale unparalleled even during the 1997/1998 Asian crisis. This was, of course, triggered by rock-bottom world trade. Thailand, too, is heavily geared to exports, which top 75% in relation to gross domestic product. But there were also domestic reasons behind the severe economic slump at the end of 2008. The conflict that flared up again in the fourth quarter between the so-called 'red shirts' (supporters of the former Prime Minister Thaksin Shinawatra) and the 'yellow shirts' (followers of the government camp) is putting pressure on the economy, not least through dwindling tourism receipts. For 2009 as a whole we are forecasting real GDP contraction of 3.5%.

Our summary for the region as a whole is that while countries with large, robust domestic markets will see their growth slow significantly this year, they will arguably be spared the economic contraction that we predict for the smaller countries heavily dependent on exports. As world trade finds its feet again, we expect the entire region to pick up as from the second half of 2009. Economic growth of 5.6% in 2010 should be more than twice as high as this year.

GROWTH RATES IN EMERGING ASIA

- real GDP, percentage change over previous year -

	2006	2007	2008	2009[1)]	2010[1)]
China	11.6	11.9	9.0	6.5	7.0
India	9.7	9.0	6.5	4.5	6.5
Indonesia	5.5	6.3	6.1	3.5	4.0
Malaysia	5.8	6.3	4.6	-2.5	3.5
Singapore	8.4	7.8	1.1	-6.0	3.0
South Korea	5.1	5.0	2.5	-3.5	3.5
Thailand	5.2	4.9	2.6	-3.5	3.0
Emerging Asia	8.8	9.0	6.3	2.7	5.6

[1)] forecast.

2. CAN ASIA HELP PULL THE WORLD OUT OF RECESSION?

The global economy finds itself in the grip of an exceptional situation at present, with both the industrialized countries and the emerging markets mired in a deep recession – a double whammy we have not seen since World War II. In latter years the emerging markets of Asia have grown considerably in economic stature. This, coupled with the fact that Asia is the only region currently still able to boast positive economic growth, leads us to ask whether Asia can help extricate the rest of the world from recession.

GROWTH RATES IN MAIN ECONOMIC REGIONS

- real GDP, percentage change over previous year -

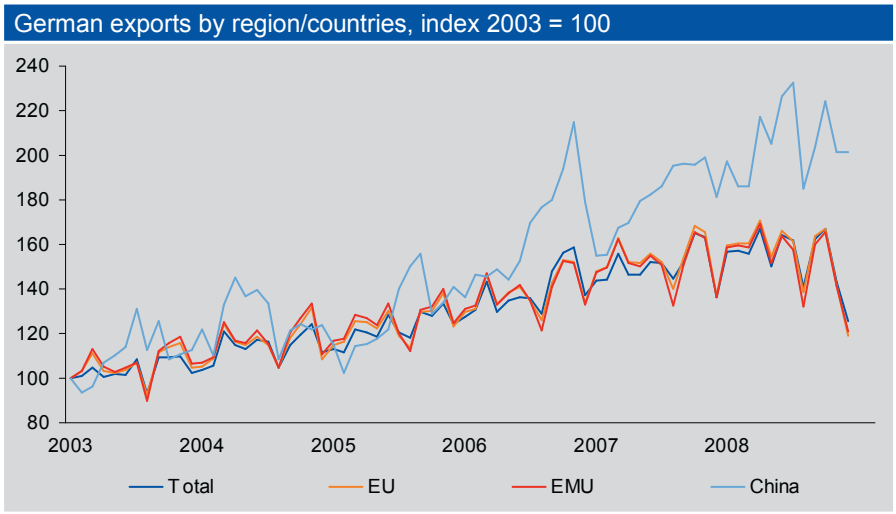
	2006	2007	2008	2009[1)]	2010[1)]
Industrialized countries	2.8	2.4	0.7	-3.2	1.7
European Union	3.2	2.9	1.0	-3.2	1.4
Euro area	2.9	2.6	0.8	-3.2	1.6
Germany	3.0	2.5	1.3	-3.9	2.4
USA	2.8	2.0	1.1	-2.3	2.1
Japan	2.1	2.4	-0.7	-6.6	1.6
Emerging markets	7.3	7.4	5.2	0.9	4.1
Asia	8.8	9.0	6.3	2.7	5.6
Latin America	5.2	5.5	3.8	-0.7	2.3
Central and Eastern Europe	6.7	6.9	4.7	-3.5	1.8
World	3.9	3.7	1.9	-2.1	2.4

[1)] forecast.

Today the Asian emerging economies unquestionably wield greater economic clout than only a few years ago. Between 1998 and 2008 the region significantly upped its share of global value added from 9.3% to 14.5%. More than half of the Asian share is currently contributed by China alone. Stable growth in Asia would therefore certainly help the world pull out of recession. Assuming that economic growth in Asia over the coming quarters reverts to an annualized rate of around 5.5%, this would represent a growth contribution to global output of fully 0.8 percentage points.

Even in the present phase, growth in Asia is at least partly absorbing the shockwaves of global recession, as a glance at Germany's foreign trade statistics illustrates. Trade with the Asian emerging markets has clearly taken some of the sting out of the collapse in Germany's total exports. Whereas German shipments to neighboring EMU and EU countries in Q4 2008 already plummeted very severely, by 8.3% and 9.6% respectively, deliveries to China did at least continue to turn in strong increases, with a plus of 8.7%. In the months ahead, too, trade with China should prove comparatively stable. Countries exporting competitive capital goods, of which Germany is one, will benefit from China's economic stimulus package, one important focus of which is infrastructure investment.

German exports to China escape downward drag



3. ASIAN GROWTH MODEL SET TO CHANGE

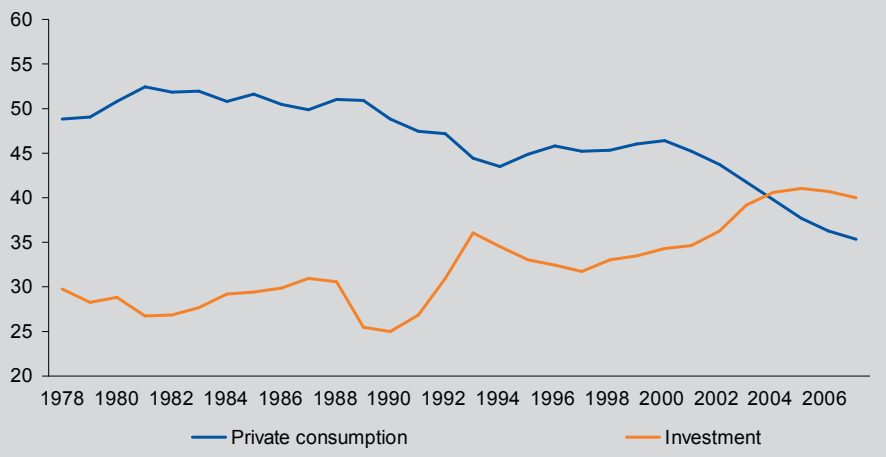
Asia's growth model is characterized by a strong focus on external trade. Its export success story can be explained largely by the availability of a huge potential labor force and considerable wage cost advantages vis-à-vis its international competitors. And it has been buoyed on the currency front. The Asian emerging markets' currency relations with the US have frequently been dubbed the 'Bretton Woods II' system, harking back to the fixed exchange rates and massive foreign exchange market interventions for the major international currencies in the post-World War II years. But unlike the official Bretton Woods regime that lasted into the 1970s, Bretton Woods II is an informal, non-contractual arrangement featuring the US as the core country with the Asian emerging markets on the periphery. The Asian currencies are undervalued relative to the US dollar to facilitate exports by these countries and smooth their integration into the global economy. So far the Asian countries have used the resulting trade surpluses versus the US to purchase American securities. This, in turn, has maintained exchange rate relations and kept interest rates low for the United States.

Not all that long ago various economists were prophesying a long life for this arrangement. But in 2009 the picture looks quite different. American imports are contracting dramatically. The Asian countries are no longer able to export as much and their trade surpluses are falling. In the foreseeable future it is unlikely that the US will re-emerge as the source of such powerful demand and import growth. To put it plainly, in future the US is unlikely to reprise its role as 'consumer of last resort' in a similar way. Given America's importance as a sales market for Asian products, this inevitably implies momentous changes for the Asian growth model. If Asia's emerging markets hope to continue growing so buoyantly, they must focus more on domestic demand, something that can certainly not be achieved overnight. On the contrary, it is a mission that will take years. We can therefore expect the Asian emerging markets to try and keep their exchange rates relatively low versus the greenback to begin with.

Taking China as an illustration, potential strategies to beef up the domestic economy and make economic growth less dependent on exports can be depicted. That there is need for action is already evident from the fact that private consumption has gradually faded into the macroeconomic background in the past years. In the early 1980s it still made up a good 50% of gross domestic product, but by 2007 the share had fallen to a scant 35.4%, which is very low by international standards. Normally, consumer spending is equivalent to between 50 and 70% of a country's GDP. So how can Chinese households be persuaded to embrace greater consumption?

Chinese private consumption steadily losing importance

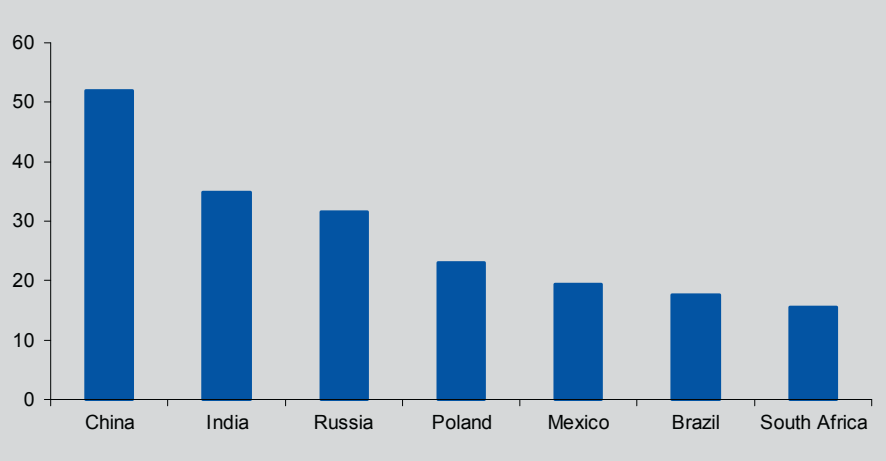
Share in GDP, in percent



Apart from an improvement in incomes, strategies need to concentrate on China's extremely high savings rate. The aggregate savings rate is comprised of savings by the household, corporate and public sectors. In the case of China savings total more than 50% of gross domestic product. No other big emerging market notches up anywhere near such high savings. According to recent analysis by the Asian Development Bank (ADB) for 2006, more than 26 percentage points of this alone was accounted for by companies, over 15 percentage points by private households and considerably less than 10 percentage points by the public sector. This gives rise to two conceivable economic policy approaches.

Asian emerging market countries save the most

Gross national savings, in percent of GDP, 2007



A larger private share in companies and their profits

In China, as in many other Asian countries, savings by the corporate sector are the driving force behind the very high overall level of savings. Failure to transfer at least part of these corporate earnings to private households has negative effects on personal consumption. In China comparatively few shares in companies are available for purchase by the general public, which naturally considerably restricts the scope for any transfer payments. A further constraining factor is that even listed companies often prefer to retain their profits and plough them back into capital investment instead of distributing them to shareholders in the form of dividends. The logical conclusion for policymakers must therefore be to encourage companies to pay out more dividends. This could be achieved, for example, through making alternative sources of funding more attractive to companies by enhancing financial intermediation and improving capital market efficiency. We discuss development of the local bond markets in greater detail in Chapter 6. Government should also introduce ways of increasing private participation in the companies themselves. These measures would be sure to strengthen the links between corporate earnings, household incomes and consumer spending.

Development of the social security systems

In the course of political transformation the social security systems dating from the Communist era have, for the most part, gone by the board. But new, fully-funded insurance programs are still in their infancy. Much of the substantial saving is thus purely precautionary in nature. Moreover, deposits with banks are the primary savings medium for private individuals, but these yield only a low rate of interest – often, indeed, below the level of inflation. So far hardly any investments have been permitted abroad – leaving only the local stock market, which has become increasingly overheated in recent years, in which to place capital, aside from bank deposits. As a result, the only way of achieving a certain target capital is to save more.

People in China would arguably only consider channeling considerably less capital into savings and more into consumption if the social welfare systems offered them a more reliable and better developed safety net. There are at least signs of this now in the health system. Government recently revealed plans for massive healthcare expansion with the long-range aim of creating basic provision for everyone by 2020. In the coming three years alone China intends to plough around EUR 93bn into development of the health sector. According to official statistics, at present only about 180 million Chinese, or roughly 2/3 of the urban population, possess health insurance. However, the broad mass of people have no cover and are consequently obliged to put funds by for all eventualities.

In terms of financial provision for old age, too, the Chinese are still left very much to their own devices. Only about 200 million of the altogether 1.3 billion Chinese currently pay into the state pension system. Following the pension reform introduced in 1997 the pension system rests on the World Bank's three-pillar model and is based on a hybrid form of pay-as-you-go and fully-funded systems. Contributions by employees and businesses are paid into a social fund as well as into individual accounts. But as with the health insurance program, only urban residents so far have access to pension insurance. To address this problem, the economic stimulus package approved in autumn 2008 provides for a pilot pension insurance project in rural areas, designed to benefit 10% of the rural population.

To summarize, we therefore see two conceivable ways in which the Chinese government could successfully pump-prime private consumption: through greater private participation in the corporate sector and development of the state social welfare systems. By implementing these measures government could leverage huge consumer spending potential. There is no doubt that consumption could become the Chinese economy's growth engine. This would naturally also benefit China's industrial sector, which would then be certain to focus greater attention on the local sales market. But it will be some years before this happens.

4. GROWTH CONVERGENCE IN ASIA?

The pace of growth in the Asian emerging markets in recent years has varied greatly from country to country. On average most of the countries notched up annual growth rates between 4 and 10% over the last five years. There are also some still quite yawning gaps between the prosperity levels reached in the individual countries. In South Korea GDP per capita is already a good USD 19,000, while in China it does not even hit USD 3,300. How likely is the convergence of growth rates across the region in the foreseeable future? The following discusses some factors that influence economic growth in general:

- Level of prosperity: The more prosperous a country has already become, the lower its growth rates will tend to be going forward. For this reason alone we can assume that China will not be able to sustain double-digit rates of expansion in the long term. This goes at least some way towards explaining the divergence in recent years (e.g. South Korea vs. China).

- Regional integration: Trade relations between the individual countries have become much closer in the past years, acting as a spur to growth. Looking at the region ASEAN+3 (ASEAN states plus China, Japan and South Korea), intraregional trade climbed between 1980 and 2006 from 30.2% to 38.3%. If we consider the whole of East Asia (excluding Japan), the figures paint an even clearer picture, soaring from 22.7% to 45.8%. These strong increases are, however, due chiefly to intermediate products. When it comes to finished goods, the region still looks first and foremost to the US and EU as sales markets. Will integration progress further? The creation of an 'East Asian Community' in one form or another is by all means realistic, although cooperation would probably be confined to specific areas. The assignment of central decision-making powers to a higher-level Community institution seems rather unlikely. Also conceivable would be the establishment of a regional free trade area. But we see no chance of the creation of a customs union, i.e. a regional trade area with a common external tariff structure. The ASEAN states have committed to build an ASEAN Community by 2015, consisting of an economic community with a single internal market. But even this does not provide for a common customs policy vis-à-vis non-members.

- Infrastructure: In many cases the infrastructure cannot keep up with the Asian emerging markets' rapid pace of growth. Over time that may lead to serious capacity constraints. India, for one, exhibits infrastructure shortcomings, with energy generation as an example. In the fiscal year ended March 31, 2009 government fell woefully short of its original target to increase energy generation capacities in the country by 11,000 megawatts. In a recent study Oxford Analytica estimated that the government managed to jack up capacities by just 4,900 megawatts.

- Demographics: There can be no doubt that a shrinking population imposes limits on an economy's potential growth. This demographic problem is not faced by the highly developed industrial countries alone, but increasingly also by the emerging markets. Even in China, in the not too distant future the population will start to contract. The United Nations estimates that the number of people of working age between 15 and 64 will peak in 2015. Then the potentially employable population is forecast to drop by almost 100 million up to 2050. In the short term that will not imply any curtailment of growth. But in the long-term the pool of labor will dry up significantly, lending urgency to such issues as skills, education and a higher workforce participation rate by older people.

- Environmental protection: Asia's high, industry-driven economic growth in the past years has had an enormous impact on the environment. To prevent this turning into a constraining factor for production, it is vital to exploit energy efficiency potential, in respect of which the emerging markets still understandably lag way behind the industrial nations. But environmental protection is gaining considerably in importance, which is very positive in terms of sustainable growth. It will also help maintain environmental industries (incl. solar energy and wind power) as an important growth sector in countries like Germany.

- Political and social stability: There is no shortage of potential conflicts liable to call a country's stability into question and cloud its growth prospects, at least temporarily. Every year several thousand protests are staged in China, some of them violent. Although these are regionally narrowly ring-fenced, were the economic lull to persist for longer than expected there would certainly be a danger of the protests and unrest spreading across larger sections of the country. In Thailand, political turmoil is threatening to have sustained negative repercussions on further economic development. In Indonesia, the government must shape up to the constant challenge of defusing potential tension between the various ethnic population groups. And finally, there is also a raft of potential political conflicts between individual countries within the region, with the fraught relations between China and Taiwan or North and South Korea as the most conspicuous.

What implications does all this have for the momentum and possible convergence of growth in Asia? And directly related to this, what does it mean for the harmonization of prosperity between the individual countries? There are quite evidently a large number of growth drivers ensuring that economic development in Asia will remain extremely dynamic in the coming years. But there is also a string of factors that will tend to curb economic growth in the region over the long term. On balance, we expect to see the bandwidth of growth rates narrow, so that in this respect there really is a likelihood of convergence in growth. Instead of fluctuating within a margin of 4 to 10%, the Asian emerging markets will possibly grow by between 3 and 7%. But this also means that in the medium and long term the adjustment of prosperity levels between the individual countries will not progress as rapidly as before. The race to catch up will probably flag somewhat. So from this angle we cannot reckon on particularly rapid convergence.

China demographics

The Chinese government's increased efforts to further develop the welfare system are not only part of the measures to combat the economic crisis; very importantly, they are also dictated by demographic trends: Within the next 20 years the proportion of over 65 year-olds in the total population will more than double. By 2030 more than 230 million Chinese will be over 65, and more than 40 million of these aged 80 and older. (Today there are 109 million over-65 year-olds, roughly 19 million of whom are over 80.) At the same time the number of people of employable age between 15 and 64 will peak in 2015. Up to 2015 their number will increase by another 35 million to just below one billion, but by 2030 it will probably have fallen by about 15 million to 983 million. The old-age dependency ratio will almost double by 2030: for every 100 people of employable age between 15 and 64 there will then be 23 people of retirement age. At present the ratio is 100:11. Around 2030, demographers also predict the onset of the expected population decline.

This trend is a direct result of the one-child family policy launched in 1979 under Deng Xiaoping. At that time only the national minorities were exempted from this regulation. However, in rural areas the one-child policy is not always enforced as strictly as in urban areas. In 1950 the birth rate averaged 6.1 children per woman, and even in the late 1970s it was still 2.9; meanwhile, it is officially stated at 1.7 children. Indeed, in Shanghai the average birth rate has dropped as low as 0.6 children per woman.

In the past years there has been frequent discussion in the media on the social competence of the one-child generation. Nonetheless, going forward a large part of this generation will be confronted with caring not only for its parents but for its grandparents too. Known in China as the '4:2:1' phenomenon (four grandparents, two parents, one child), it has come about as better medical care and the general rise in living standards have lifted life expectancy from not quite 41 years in 1950 to 73 years today. By 2030 the figure is projected at 77 years and still rising.

This has sparked debate on easing the rigid one-child policy. But area-wide development of the welfare system must be driven forward regardless. With a view to its long-term sustainability, fully-funded elements should be assigned a central role, given that the working age population is expected to decline up to 2050 by almost 100 million and the old-age dependency to climb to 38%.

5. ON THE WAY TO A NEW WORLD MONETARY ORDER

There is no doubt that Bretton Woods II is partly responsible for the build-up of global imbalances. In future the US will probably no longer act as 'consumer of last resort'. The Asian countries' trade surpluses with the US will decline, giving them ever less cause to recycle these surpluses by buying US paper, which in turn has kept US interest rates low. Bretton Woods II has failed.

Already there is a lesson to be learned from this: In the long run keeping exchange rates artificially stable is an ill-fated policy. But what will now replace Bretton Woods II? A few months ago the governor of China's central bank, Zhou Xiaochuan, suggested using the Special Drawing Rights (SDR) of the International Monetary Fund to fashion a new global reserve currency. What motives does China have for making such a proposal? The reputed economist Paul Krugman rightly remarked that China is caught in a dollar trap. China could model its currency reserves on the composition of Special Drawing Rights whenever it wishes, even without turning SDRs into the world's reserve currency. But the problem is that to do so China would have to offload some of its huge dollar holdings, which would drive down the greenback's value and result in asset losses for the People's Republic. The transition to Special Drawing Rights as the global reserve currency would have the advantage for China that the IMF and the major central banks would be at pains to ensure stable parities during the transition process. China could thus correct the composition of its currency reserves at no great risk to itself.

But the idea of setting up Special Drawing Rights as a new global currency is not favored by Chinese monetary policymakers alone; it is also endorsed by such well-known economists as Joseph Stiglitz. The former World Bank chief economist believes that the dollar reserve system is unstable and has deflationary effects. A regime based on SDRs is non-inflationary, he argues, and would be easy to implement within the next twelve months.

The reasoning is not convincing, though. Paul Krugman argues logically that Special Drawing Rights are not real money. They are units of account whose value is determined by a basket of currencies consisting of the dollar, yen, euro and pound sterling. But an institution cannot decide on an international currency; an international reserve currency is the one that most international investors trust and are prepared to invest their money in.

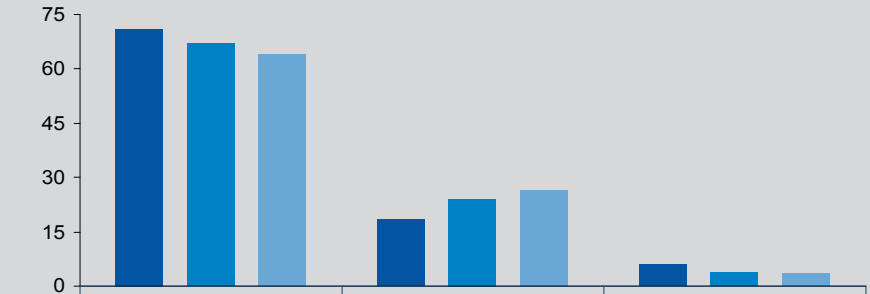
In the long run this trust can be gained only through stability-oriented economic policies. That of course implies that any key currency is ultimately exposed to competition from other major currencies whose countries are possibly pursuing better economic policies. Competition is a decisive factor in success as an international investment and reserve currency.

At the moment the dollar's big rival is the euro, not SDRs – Paul Krugman is right about that, too. The only reason the US currency has been able to maintain its lead on the euro so far is presumably that the EMU member countries do not present a united front in some policy areas and integration of their financial markets is not yet sufficiently advanced. In the next few years the euro will probably continue to gain ground on the dollar as an international investment and reserve currency – especially with the Asian currencies poised to loosen their ties to the greenback. But further advances in the single European currency's importance presuppose ongoing

financial market integration in the European Monetary Union, a stringent stability policy by the European Central Bank to mop up excessive liquidity once the financial market crisis is over, and convincing moves to consolidate budgets in the EMU member states.

Increasing importance of the euro in currency reserves

Share in the allocated reserves, in percent (global)



	USD	EUR	JPY
2000	71.1	18.3	6.1
2005	66.9	24	3.6
2008	64	26.5	3.3

There is much to suggest that further down the line we will have not one global reserve currency but a juxtaposition of two or three big currencies. In two or three decades a tripolar global monetary system featuring the dollar, euro and renminbi could certainly become reality.

6. FINANCIAL CRISIS – AN OPPORTUNITY TO DEEPEN LOCAL BOND MARKETS

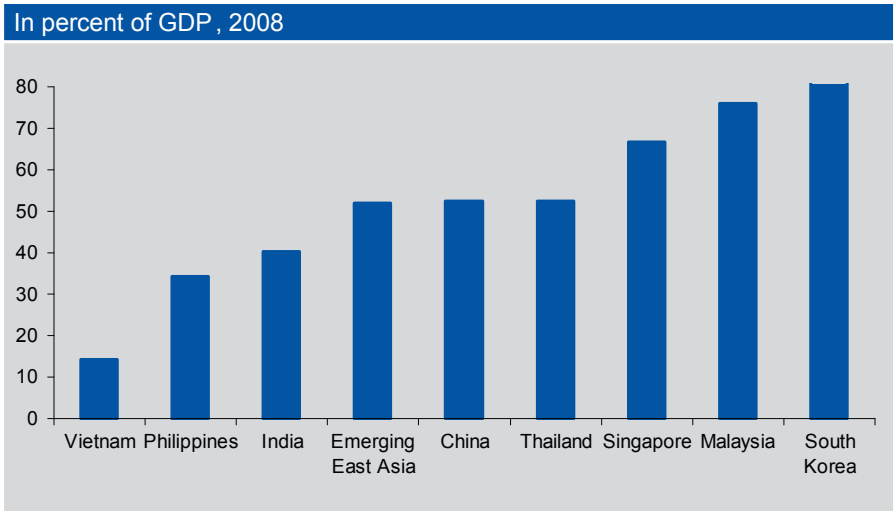
First things first: The current financial and economic crisis is not likely to prejudice the further development of local bond markets in Asia; on the contrary it could encourage the process, along with regional integration of the local markets. But for this to succeed, it is up to policymakers to put the necessary institutional framework in place. That includes the gradual easing of capital controls without jeopardizing the stability of the local financial systems.

The Asian bond markets have registered remarkable rates of growth in recent years – although admittedly from a very low base. By international standards these markets are still quite small, with the banking sector continuing to dominate financial intermediation. Added to which, sound public finances in the region have not exactly fostered the development of a market in government bonds. Latin America serves as a very good example of quite the opposite trend. Over the past decades many Latin American states have accumulated quite a hefty mountain of debt. Again and again individual countries (some of them more than once) could no longer manage to revolve this mountainous debt. They defaulted and were then forced into debt rescheduling. Due not least to the Latin American countries' high funding requirements – at least in the past – they generally possess well-developed local bond markets. To avoid any misunderstandings: low public-sector debt is of

course positive as such. But it is not necessarily conducive to the development of local bond markets.

The latest figures from the ADB highlight just how small the local bond markets still are: as a percentage of gross domestic product they account for just slightly more than 50% in East Asia. In Indonesia and Vietnam the shares are only 13.6% and 14.2% respectively. South Korea has at least reached 85.7%, while China is almost perfectly in line with the regional average of just over 52%. By comparison, Japan's bond market is almost twice the size of its economic output. Bond markets in the Asian emerging economies are dominated by the public sector. On average across all the countries, public bonds make up roughly ¾ of the total paper outstanding. In only a few exceptional cases, such as South Korea and Malaysia, can the corporate bond market compare with the government bond segment in terms of volume. In South Korea it is in fact even larger.

Size of the local bond markets in Asia



The current crisis is not likely to put the brakes on further development of the local bond markets in Asia; it could even act as a spur, with the expected increase in the volume of issues as just one indication. Both public authorities and companies will seek to satisfy more of their borrowing requirements through the local bond markets. We can assume, for instance, that the governments in the Asian emerging markets will finance a large part of the economic stimulus programs they have announced by issuing government bonds. The ADB estimates total public sector borrowing requirements this year at more than USD 300bn, against just over USD 100bn last year. Of course these funds will also be sourced through the international markets and not just locally. So far Indonesia, the Philippines and South Korea have already floated US dollar bonds. But in view of the still considerably higher cost of financing with foreign currency government bonds, the bulk of this year's funding will probably be raised through the local bond markets.

Companies, particularly those whose size would actually give them access to the international bond markets, are also likely to tap more local markets to roll over their existing debt or borrow fresh capital. Still high risk premiums for corporate bonds

mean the international markets are not necessarily the most attractive option at present, and in periods of high market volatility some businesses will undoubtedly baulk at the exchange risk that foreign currency issues entail.

So what can the individual countries do in the current environment to power development of their local bond markets? There follow some basic considerations.

- Liquidity: A lack of liquidity remains the crucial problem for bond markets in Asia. The turnover ratio is frequently taken as a measure of market liquidity. It shows the extent of trading in the secondary market relative to total bonds outstanding. ADB statistics for last year flag meager liquidity on the market for government bonds in countries such as China, Indonesia, Malaysia and South Korea, with a turnover ratio of less than 1. This will doubtless be due partly to the expanding industry in retirement products, which is naturally constantly in search of long-term investment facilities in the form of government paper on an already sparse market. As a rule representatives of this sector act as buy-to-hold investors. The situation is even worse with regard to corporate bond liquidity. In some countries the turnover rate in 2008 was not even 20% of the total volume of bonds outstanding. One factor making abundant liquidity so important is that bonds can be bought and sold without immediately triggering severe price fluctuations. Liquid markets lower the transaction costs for issuers and investors. The issue of how to increase liquidity is closely related to the subjects of "benchmark yield curve" and "market opening", which we shall now address.

- Benchmark yield curve: The creation of a reliable and liquid benchmark yield curve forms the basis for any functioning bond market. As a rule government paper serves as the benchmark on the grounds of its comparatively low default risk. This yield curve is essential to the development of a market in corporate bonds because without it there is no way of risk-adequate price-setting. But this in turn presupposes that government itself will engage in sufficient and regular issuing activity across the entire yield curve. The Asian emerging markets could use their increased borrowing requirements to 'construct' the benchmark yield curve, so to speak. In the process they would make it easier for corporates in their countries to access the local bond market.

- Market opening: A broad investor base is another crucial aspect for bond market development. Capital controls restrict foreign investors' commitment and narrow the investor base. Markets largely sealed off from abroad are often dominated by buy-to-hold investors. As a result, liquidity on the secondary market is scant, volatility high and the bid-ask spreads wide. Gradual market opening could significantly stimulate capital flows between the countries in the region, contributing to closer regional integration of the local bond markets. However, this step-by-step process should be flanked by measures to strengthen the individual countries' financial systems.

- Infrastructure: The Asian Bond Market Initiative launched in 2003 by the ASEAN+3 group is committed to strengthening the local bond markets and channeling more regional savings into the region itself. Improving the infrastructure of the bond markets plays a pivotal part in this. Considerable progress has unquestionably been made in the past years on local markets, as illustrated by clearing and settlement. But the hoped-for closer integration of the various local bond markets requires further action on the infrastructure at regional level.

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