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Beyond the Global Recession
: Rebalancing Economic Growth [1]

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Has the global recession hit the bottom ?

The global recession currently appears to be bottoming out as a result of broad fiscal and monetary stimulus measures undertaken by governments in various parts of the world. The case of China is especially notable, given that its RMB 4 trillion economic recovery plan has been implemented so effectively that there are now concerns that it might lead to overheating. With the resumption of import growth, China's recovery is also fueling the recovery of trade within the APEC region.

The downturn has decelerated in the US, widely considered as the epicenter of the crisis, but it has now experienced four consecutive quarters of negative growth, with the second quarter posting a one percent decline over the previous quarter, seasonally adjusted on an annualized basis. Third quarter growth is expected to be positive, as inventories are restocked. US housing market statistics show construction and sales appearing to bottom out. Although there is yet not much cause for optimism, prices have stopped to decline in certain regions despite excess inventory.

The IMF recently revised upward its real global GDP growth forecast, adjusting by 0.6% its previous April forecast of negative 1.4% for 2009 and positive 2.5% for 2010.

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[1] This paper is the script of a speech delivered at the 3rd ABAC Meeting on August 25th, 2009 in Da Nang City, Vietnam.

However, the real economy and trading activities have yet to reach bottom and the pace of recovery remains very sluggish. It seems that continued support from fiscal and monetary measures is still needed.

Are financial markets stabilizing?

Financial markets have recently stabilized, with spreads narrowing in response to government actions, including the swift and drastic lowering of interest rates, massive liquidity injections, credit easing and capital infusions to financial institutions. The market for issuance of corporate bonds and notes also appears to be recovering. However, massive government intervention has left the public sector holding the risks.

A number of major US financial institutions have already paid back the public funds they received from government after having taken the stress tests and strengthened their capital positions. However, as the downturn in the real economy now exceeds the original stress test scenario, the risk of worsening bad debt problems in the banking system over the coming months is growing. Actual purchases of toxic assets by the Public Private Investment Fund have been much lower than originally planned. This tells us that much more time would be required to dispose of non-performing assets.

Second quarter results for US and European banks indicate that bad debts in the retail and corporate banking sectors are larger than previously assumed, with loan loss provisions being raised dramatically. In most cases, such losses are being covered by profits from investment banking and trading operations. From this we may conclude that financial institutions are still in the process of getting their management back on track. As US and European banks remain cautious on lending, it will be important for us to continue monitoring the situation with respect to the need for further capital injections and measures to dispose of bad debts in the financial sector and thus maintain financial market stability.

Assessment of fiscal and monetary policies and exit strategies

The IMF is forecasting fiscal deficits in the G-20 for 2009 and 2010 to exceed pre-crisis (2007) levels by 5.5% of their combined GDP. Breaking down this figure, discretionary measures in response to the crisis will contribute 2% for 2009 and 1.6% for 2010, while automatic fiscal stabilizers, such as decreased tax revenues due to the recession and increased payments for unemployment insurance and other social services will account for the rest. Expansionary fiscal policies are likely to push up 2009 growth for the combined G-20 by somewhere between 1.2% and 4.7%.

The US Congressional Budget Office (CBO) estimates that the US 2009 fiscal deficit could reach up to US$ 1.8 trillion as a result of the downturn in economic activities and

stimulus spending. Beyond 2009, the deficit is expected to stay above the US$1 trillion level until 2011. We hope that, as we see the light at the end of the tunnel, governments will be able to reverse these expansionary policies. However, it is important to bear in mind the lesson from the Great Depression that premature tightening of fiscal policy could prolong the crisis. In other words, regulators need to ascertain the appropriate timing of exit strategies.

Exit strategies for monetary policy are also currently under discussion, with due consideration being given to how they can be implemented without bringing confusion to markets. For this to be achieved in a way that promotes medium-term stability, exit strategies need to be reinforced by other measures to promote healthy financial regulation, sustainable fiscal policies and price stability, as monetary, financial and fiscal policies revert back from crisis to normal mode.

The global economy will continue to face downside risks

Although the recession seems to be bottoming out in industrialized economies, the pace of recovery is sluggish and downward risks remain. In the US, for example, recovery will be weak and the economy will likely hover below the potential growth level, as the increase in unemployment accelerates. The prospect of worsening performance of financial institutions as bad assets continue to pile up with higher unemployment and more bankruptcies presents additional downside risks to asset prices.

Policy makers are likely to face new demands for additional measures if current fiscal stimulus measures prove to be inadequate once they run their course in the coming year. This in turn could generate concerns about the impact of larger fiscal deficits and drive up long-term interest rates, which would increase the risks to recovery. Continued weakness of demand in industrialized economies will have significant impact on developing economies, with fragile markets coming under increased financial stress.

An issue for APEC: Rebalancing economic growth

Domestic demand cannot rely indefinitely on support from tax cuts and government spending alone. At a certain point, governments will need to shift their focus away from short-term stimulus measures toward policies that address medium-term concerns and the rebalancing of economic growth. As the impact of stimulus measures fades, private sector demand needs to increase in order for growth to be sustained. This would require the US economy to shift away from domestic consumption-driven growth toward export-driven growth, and Asian surplus economies to go in the other direction, from export-driven growth, to one that is based on the expansion of domestic demand.

Given this situation, the key political challenges today are financial sector stabilization in the advanced economies and the growth of consumer demand in Asian emerging surplus economies. Declining investments and increasing corporate bankruptcies in the aftermath of the crisis are threatening to lower potential economic growth. To prevent this from happening, we will need to improve the environment for funding, by promoting financial stability and supporting corporate expansion. Surplus economies, in accordance with their respective domestic priorities which may differ from one another, will need to improve social safety nets, including pension and health and unemployment insurance systems in order to encourage households to shift from savings to consumption. These should be complemented by measures to revitalize private sector investment.

APEC economies will be keen to see continued growth in China, which benefits the region. The region's growth potential could also be enhanced through increased financial and economic cooperation.

An important concern under the current situation is the risk of governments taking uncoordinated steps in introducing changes to financial regulations. Reckless activities of financial institutions taking advantage of financial innovations certainly played a significant role in the making of the global financial crisis, and provide a clear argument for adjusting regulations to new market realities. However, introducing regulatory changes without sufficient consideration and dialogue with the market would equally be a folly, particularly in the case of measures that would further increase the pro-cyclicality of current regulatory frameworks.

Another issue is the mixing of efforts to rescue financial institutions with protectionist measures that unduly favor domestic firms over their foreign-owned competitors. Greater international cooperation in implementing policy responses will ensure the right balance between regulation and innovation and promote the strengthening of financial institutions in the region.

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