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Beyond the global financial crisis

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It would seem that vigorous government and central bank responses to the crisis may be starting to have their desired impact on markets and the economy. While I would seriously caution against breaking out the champagne at this point, it would be a good time to consider the long-term implications of the current situation and the strategic responses they require.

Given that monetary and fiscal measures would need to be replaced at some point by private demand for recovery to be sustained, cleaning up banks' balance sheets and structural reforms to revive lending, investment and consumption should be given priority. Two important lessons from Japan's recent history are worth heeding.

The first lesson: no banking system recovery is possible without cleaning up bad assets. Even as financial asset prices have significantly risen from rock-bottom prices, the risk of another sell-off remains, given the fragility of major financial institutions. With unemployment and corporate bankruptcies continuing to rise as property prices decline, banks' balance sheets are likely to further deteriorate. Only through the disposal of bad loans can confidence in the banking system be restored and the downward spiral between asset prices and the real economy brought to a halt. The cleaning up of banks' balance sheets is best followed by transparent disclosure of asset quality to dispel any uncertainty.

Regulatory reforms are definitely needed to address weaknesses that have led to the crisis. In particular, macro-prudential policy frameworks need to be strengthened. However, authorities must find the right balance between promoting financial system stability and ensuring the efficiency of financial services. This could be achieved through close dialogue with the private sector, thorough analysis and careful introduction of measures. A case in point is the proposed increase in capital requirements, which may do more harm than good at this point when the banking system remains fragile and the sustainability of economic recovery remains uncertain.

The second lesson: beware of a “false dawn” (quoting from BOJ Governor Shirakawa). Japan's mistake, which led to its “lost decade,” was to assume that the recession was mainly cyclical in nature, and that stimulus measures could simply be lifted once the end of the recession was in sight. In fact, however, the recession was brought about by structural changes. An ageing population combined with weak social safety nets began to pose constraints on consumption growth. The failure to introduce structural reforms cost Japanese companies their competitive edge, especially in the fields of new services and technologies.

Consequently, the economy slid back into recession once stimulus measures were withdrawn, and Japan came to depend mainly on exports as a source of growth. To ensure recovery, fiscal stimulus measures should be undertaken together with structural reforms, and designed in a way that supports adjustments to demand- and supply-side changes in the economic structure. Exit strategies need to be identified that will neither disrupt economic recovery nor create new bubbles.

Now is also a good opportunity to look at some long-term issues in light of the crisis. One is the rebalancing of economic relations across the Pacific. Heightened levels of consumption and leverage in America and Asia’s excessive focus on exports and savings have fueled global economic growth during the past several years. The crisis has put a stop to this unsustainable combination, and with consumption in the US expected to remain stagnant as consumers adjust their balance sheets over the next few years, Asia will be under pressure to shift to a growth model based on unlocking its huge pool of savings.

This will be a tall order, given the underdevelopment of Asia’s social infrastructure, its ageing societies and the complexity of shifting from export-driven to domestic demand-driven growth strategies. Authorities will have to address the constraints that discourage domestic consumption, as well as increase the pace at which savings are invested in key activities, especially infrastructure development. Asia’s bond markets will be an important component of this strategy, but as commercial banks will continue to play the dominant financial role in the near future, it would be important to avoid introducing regulations that would restrict bank lending during this time.

Another long-term issue is the continuing search for a more stable international monetary system. Recent developments have led many, including several central banks, to worry about the future of the US dollar. In economic terms, the world has long ceased to be dominated by the US, and the crisis has triggered institutional changes that reflect the increasing diversity of the global economy, such as the growing role of the G-20.

Within Asia, economic and financial cooperation and integration are moving forward at a steady pace, with the expansion of the Chiang Mai Initiative and continuing efforts to develop and integrate financial markets. Discussions on creating a single Asian currency are ongoing, although given the tremendous diversity in development stages, political systems, cultures and historical experiences within the region, it will be a very long-term goal.

There is no doubt that the US dollar continues to be the key global currency today and will remain so in the foreseeable future. However, a more stable international monetary system could be achieved if, one day, the US dollar, the euro and a new single Asian currency could form a happy trio.

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