世界同時不況とアジア

～グローバルな地殻変動が迫るアジアの変革～

The Global Economic Crisis and Asia

~Challenges for the Asian Economy in a Changing World~

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1. Opening Remarks

Toyoo Gyohten

President, Institute for International Monetary Affairs

The Institute for International Monetary Affairs was established in 1995, some 13 years ago, and since then we have achieved development with the support of the Bank of Tokyo-Mitsubishi UFJ, the major sponsor of our Institute together with other entities, and we have been able to achieve very smooth development and growth in the meantime. We have around 20 research fellows, so in terms of size we are a rather small institute, but fortunately we were able to earn good recognition very rapidly here in Japan as well as outside the country.

Since its inception, our foundation has consistently been conducting research relating to international monetary and financial issues, delivering the outcome of that research to the outside world. Major themes of our research and studies include monetary and financial cooperation in Asia, European single currency in the form of the Euro and international monetary regimes, among others. From 2 years ago we have been studying Islamic finance in earnest. Not only have we conducted research and studies, disseminating the outcomes to the world, we have also accepted research fellows from foreign countries. We have participated in various research projects both at home and overseas, and organized seminars and symposiums. Therefore, we have been engaged in a very diverse range of activities and going forward we intend to continue making efforts in those areas. I hope we can count on continued warm support and encouragement from you, as you have always given us in the past.

In the spring of 2007, we saw the debacle of subprime loans, and it has been 2 years since. However, the situation remains as serious as ever; if anything, it is becoming even more serious. Why did this happen? What is this crisis about? We need to constantly look back, and look into the causes of the crisis that we find ourselves in at the moment. Needless to say, it was initiated with the bubble created in the residential property market in the United States and the subsequent bursting of the bubble which led to the subprime loan crisis. However, as I think about it, not just in the residential housing market, but in various products and instruments, bubbles had been generated, and after a while those bubbles burst. There is nothing unusual about the generation and subsequent bursting of the bubbles. Historically in many parts and countries of the world, at many different times, a similar phenomenon of a bubble and a burst has happened, but the crisis that we are faced with currently seems to be substantially different from the bubbles in the past, and there is a background cause to the current bubble and crisis that makes them different from the past ones. I think the greatest factor relates to the economic background conditions and environment that led to the creation of the bubble and subsequent bursting of it. Furthermore, I feel the economic situations behind this crisis, or bubble, were completely and intrinsically different from the past ones. Now how different are they this time? There could be many factors but here I would like to cite five major ones.

The first is globalization. In 1989, we saw the end of the Cold War and since then globalization has progressed and international flows of all factors of economic activities, including capital flows and information and corporate activities were liberalized with globalization's size and scale expanding substantially. Thus globalization, without a doubt, is one of the major factors behind the crisis that we are currently faced with.

The second is related to the first factor somewhat. We have seen revolutionary advances in ICT, Information and Communication Technology, and the advances in ICT helped substantial development in financial engineering, which resulted in the development of a variety of financial derivative products, securitized products among others. That led to the expansion of markets that trade in those financial instruments and products. The expansion was indeed explosive, not just a quantum expansion.

Third, at about the same time we saw excessive consumption in the US economy, especially in the household sector, and soaring prices of energy and other commodities. We also saw excess savings in Asia and other countries, those excesses taking place at the same time led to global imbalances in current accounts, and the reflection of that was the flow of funds in the opposite direction to finance the current account imbalances. That resulted in an excess supply of international liquidity. This excess in international liquidity was no doubt another factor generating the bubble and causing the current crisis.

The fourth factor is that as a result of the globalization and the new development of financial markets and excess availability of liquidity, the financial sector has begun to play an inordinately large role in global capitalism. Now it can be said that capitalism in the 21st century has become financial capitalism. Naturally in this world, the greed that drives people to pursue maximum profit has gripped many players in the market and, with more and more people being gripped by the greed in financial transactions and businesses, leverage was increased to an extremely high level. At the same time we have seen degeneration in business morals as reflected in enormous bonus and pay packages enjoyed by the executives in the financial sector.

The fifth factor relates to the expansion and diversification of our financial businesses and financial markets, which were accompanied by rapid increases in the risks inherent in those businesses. Despite those changes taking place in financial businesses and soaring risk levels in those business activities, the response had been inadequate on the part of the regulatory/supervisory authorities who were responsible for monitoring and overseeing those activities. Even within financial corporations, the risk management system had been quite inadequate and not up to the required level.

As a result of those factors in the background we saw the emergence and subsequent bursting of the housing market bubble. Historically speaking, as I mentioned earlier, the bubbles, or bursting of them are nothing unusual. However, unfortunately those factors in the background caused this crisis to be more serious, rapidly spreading their negative impact across the board to the real sector of the economy. As you already know so well, in terms of the financial sector, the bursting of the subprime and securitized loan products markets bubble spread immediately to other securitized products markets and the investors and traders in those financial products, both institutional and individual, were hard hit by that spread. Assets of financial institutions were impaired, causing capital shortages or undercapitalization of those financial institutions, and resulting in the decline of their creditworthiness. As a result of all this, we now see an extremely serious credit crunch taking place globally, and such situation spreading rapidly throughout the world. I think that represents the most troubling and worrying phenomenon, at least in the financial sector.

On the real sector of the economy on the other hand, the decline in housing prices reduced the household sector's capacity to consume, but the influence was not limited to that. Because of the slump in the housing industry and the credit crunch in the financial markets, the decline in demand spread more generally to all sectors and consumption dropped significantly across the board. Accordingly, corporate performance deteriorated substantially, resulting in reductions in employment, trade, and investment. All the economies of the world currently are faced with very serious declines in growth rates. As you remember, in 2005, only 4 years ago, all the economies of the world were registering positive growth rates and enjoying very strong prosperity for the first time since the end of World War II. This year, we are likely to see all the economies of the world suffering from recession; probably the most serious recession in the post-war period.

Now what measures should we take against this? The answers are quite clear and simple. There are only three things that we need to do. The first is to normalize the housing market in the United States as quickly as possible. We need to reduce defaults, foreclosures, and thereby complete inventory adjustment will work itself out. Without that, there is no chance we will see any recovery in economic activities. Second, in terms of the real economy, we must put the brakes on the economic downturn; that is to say, we need to stimulate demand. However, as you look throughout the world, very few countries have any room to maneuver their monetary policy, which means that countries cannot but rely heavily on fiscal policy to stimulate demand. In the short run, this might mean some deterioration in fiscal position and public finance, but even with that risk we need to stimulate aggregate demand to secure jobs. The third measure relates to monetary policy. Needless to say, by augmenting the capital positions of financial institutions as well as by working out problem assets, we need to achieve some improvement in the credit crunch, which is presently the most serious problem in the world.

I have just mentioned my observations and explanations from my perspective of the current global crisis, but what I would like to point out is the following: as one of the very important aspects of the crisis that we see today, it should be noted that the crisis in the financial sector and the crisis in the real economy are intricately related with the overall structural problems in defining the future of the world economy, if one looks at the situation from the medium and long-term historical perspectives. In this regard, I make the following four points.

First of all, I refer to global imbalances. What is going to happen to global imbalances after this crisis? In the past years we saw huge global imbalances. On the one hand, in the United States and especially in its household sector, there was excessive consumption, and on the other we had excessive savings in Asia. Those two situations resulted in the global imbalances that induced capital flows. However, at the same time the global imbalances supported consumption, production and exports and imports in the world, which offered prosperity for the entire world to enjoy. However, because of this crisis what is going to happen to the fundamental structure that is the world economy? If the United States cannot sustain excess consumption and tries to restore balance in the domestic economy, a similar rebalancing would have to take place in the excess savings countries or current surplus countries. That would represent a huge challenge for the entire world economy. In other words, the growth model that had been dependent on exports, or the industrial structure that supported that growth model, may have to go through a change. How should that growth model or industrial structure change? Is it feasible to achieve such a change without causing any undue social, political or economic confusion in the world?

The second point relates to financial reform. What will become of the so called Anglo-Saxon type of financial business as a result of this crisis? The business models of banks and financial institutions also might be affected. You will have to review how to manage deleveraging from the extremely high level to a more reasonable level, and how to deal with such new important players as hedge funds and investment banks. On the other hand, what sort of role will the traditional commercial banks be playing in the future? What are we to do about regulatory or supervisory regimes and institutions charged with the responsibility of overseeing and supervising those activities? In the process of this change or reform, the pendulum may swing to just the opposite direction from the process we have seen thus far in the financial deregulation, and there may be some risk of overshooting in the opposite direction over the coming 10 years. As a result of that, the regulations may be reinforced. In truth, we have already seen some nationalization of financial institutions in many countries. What is likely to happen to the overall framework and structure of regulations and supervision is another important point for consideration.

The third point relates to the international monetary regime. In the post-war period, the international monetary regime was almost completely supported by US dollar standards. What would happen to the role of the US dollar as a key currency? Of course, this is related to what would happen to the national potential and power of the United States as a key currency issuer. The financial services industry of the United States and its position in the global market may be somewhat hurt. Its net external debt position has already been worsening. So what is going to happen to the role the US dollar will play if it attracts a lot of attention and interest? Do we have any alternative to the US dollar? The answer is “probably not”, in my view. However, without any alternative to the US dollar as a key currency, what are we going to do? Realistically speaking, if the currency playing a leading role is going to be weakened and we are devoid of any currency to replace it, we are likely to see increased instability in the global financial or monetary situation.

The fourth challenge that we may see in the medium and long-term perspective is related to the global balance of power. The crisis may represent changes taking place in the global balance of power. What is clear in this context is that probably the global role that Asia is expected to play will grow larger. As you know, Asia accounts for almost one-half of the world’s population. It enjoys a very high growth rate on average, and is becoming one of the major centers of the world in terms of manufacturing production, consumption, and finance. I am sure we are going to hear from Dr. Lau in detail later, but China has developed itself remarkably. At the same time, however, Asian economies do still have numerous issues and vulnerabilities. One of the Asian economies’ most important vulnerabilities relates to their dependence on exports. 60% of the final demand of Asia comes from the advanced countries outside of Asia. Asia has been dependent for so much of its final demand on those countries, and inevitably the decline in that demand negatively affects the financial and economic conditions in Asia. As was pointed out during the Asian crisis, even today the financial industry and financial markets are relatively underdeveloped in Asia compared with our counterparts in the United States and Europe. For example, we have not seen any financial markets that could rival the New York or London markets and in terms of financial institutions, we do not see true global players being based in Asia. Third, we still see substantial income disparity among economies within Asia or within each single country here in Asia. Without efforts to even out those income differentials among economies as well as within the economies, the task of expanding the economic activities of the region will be that much more difficult.

In 1997, we experienced the Asian crisis and as I look back, prior to that crisis we saw a huge amount of short-term capital flowing into Asia. In a sense that produced economic booms in the Asian economies but once that flow reversed, the crisis ensued. What about the crisis that we see today? Prior to this crisis, there had been a surge in overseas demand, resulting in a massive increase in exports from Asia that produced high prosperity. However, once that demand from outside decreased, Asia was negatively hit and thrown into the crisis.

Then what are we to do for the future? That really is the theme of our symposium today. The first and foremost of the challenges confronting the Asian economies in the future, I believe, is the need for efforts to reduce disparities among the countries or within each single country, by increasing and upgrading the level of the lower performers. As a result of doing this, demand within the region as a whole will expand. Second, in the process of such expansion, I think it is very important to achieve some transformation in industrial structure. The industry structure in Asia has been more or less characterized by an internal, vertical division of labor, but we need to achieve some shift from that to a horizontal division of labor in order to increase final demand. Therefore, by switching toward a horizontal division of labor, I think it is very important for Asian countries to accumulate final demand within the region. Third, by nurturing financial industries and markets, we need to make use of the savings available internally for investment within Asia. Lastly, I think it is very important to double the efforts to strengthen and reinforce intra-regional cooperation among Japan, China, India, Korea, and the ASEAN countries in various aspects, while resolving their respective challenges and issues individually.

I may have spoken a little too long and too rapidly and caused some trouble for you in understanding me, but I just want to thank you for your participation today, and share with you some issues that you may contemplate as you listen to the following panel members. Thank you very much for your attention.

2. Economic Crisis and Asia: An Opportunity for Rebalancing Growth[1]

Haruhiko Kuroda

President, Asian Development Bank

Introduction

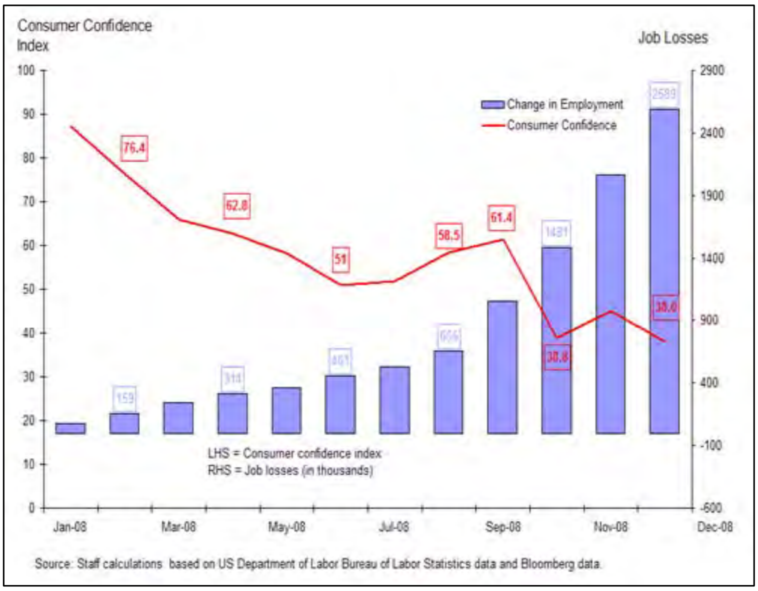
Ladies and gentlemen, it is an honor to be here to discuss with you what will undoubtedly be the defining issue of 2009.

Developing Asia has been hit much harder by the financial crisis and global recession than initially expected. Some asset classes, particularly equities, have fallen further than those in industrialized countries. With G3 countries in recession, the region's exports have slowed sharply. GDP growth is down, and some emerging Asian economies are showing significant contraction in export and a marked degree of capital outflow.

If the region is to emerge stronger from today's crisis, it must rebalance the sources of growth while securing its long-term development goals. I'll come back to this in a moment. But first, let me provide an overview of the crisis and its impact on developing Asia.

Economic crisis and the outlook for developing Asia

(Chart1) The first signs of the US sub-prime crisis appeared in June 2006, when the Case-Shiller composite index of US house prices began to fall. Since then, the index has dropped 25%. And several respected economists feel it has another 10% to go before prices return to their normal levels relative to US household incomes. Estimated losses and write-downs in global financial systems continue to rise, suggesting that the global financial crisis is far from over.

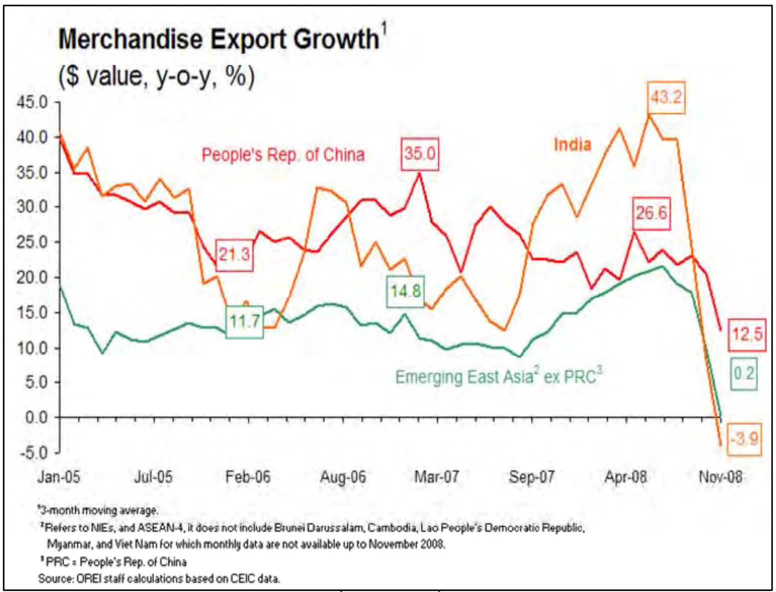


(**Chart 1**)

The spillover into the real global economy has been dramatic. G3 economies are all in recession. Major industries are in need of bailouts. In the US, unemployment

[1]For the full color charts in this text, please refer to our website.
http://iima.or.jp/pdf/sympo_speach/Mr_Kuroda_Presentation.pdf

rose by well over half a million in January, and retail sales dropped by a record 2.7% in December. With drastic cuts in household spending, business is suffering. Producer prices fell nearly 2% in December on weak demand. The IMF now projects the world economy to grow at a mere 0.5% in 2009, its lowest rate since World War II, with the US, euro zone, and Japan all contracting.



(**Chart 2**)

(Chart 2) Global demand for Asia's exports has dropped sharply, hitting at the heart of emerging Asian economies. China's exports fell about 3% year-on-year in December after years of double-digit growth. Singapore's non-oil exports were off 21%. Many other emerging Asian economies face similar fates. Growth in industrial production has plunged across the region and developing Asia's economic expansion is suffering. Fourth quarter 2008 data already show that damage is substantial. China's year-on-year GDP growth fell to 6.8% (from 9% in the 3rd quarter), the lowest in 7 years. Korea's economy contracted 3.4%. Japan, of course, is in recession.

Annual GDP Growth Rates (%)

			ADB Forecasts December 2008		IMF Forecasts January 2009	
	2006	2007	2008	2009	2009	2010
Developing Asia	**8.9**	**9.0**	**6.9**	**5.8**	**3.1**	**5.9**
Emerging East Asia	**8.7**	**9.0**	**6.9**	**5.7**	**2.7**	**5.8**
China, People's Rep. of	11.6	11.9	9.5	8.2	6.7	8.0
NIEs-4	5.5	5.6	3.5	2.4	-3.9	3.1
ASEAN-5	5.7	6.3	5.2	3.8	2.7	4.1
South Asia	**8.9**	**8.6**	**6.8**	**6.1**	**...**	**...**
India	9.6	9.0	7.0	6.5	5.1	6.5
Pakistan	5.8	6.8	5.8	3.8	...	...
Central Asia	**13.4**	**11.6**	**7.3**	**7.7**	**...**	**...**
Pacific	**2.2**	**2.4**	**4.8**	**3.4**	**...**	**...**
Japan	2.0	2.4	0.5	-0.2	-2.6	0.6
US	2.9	2.2	1.4	-0.7	-1.6	1.6
eurozone	2.8	2.6	1.2	-0.5	-2.0	0.2

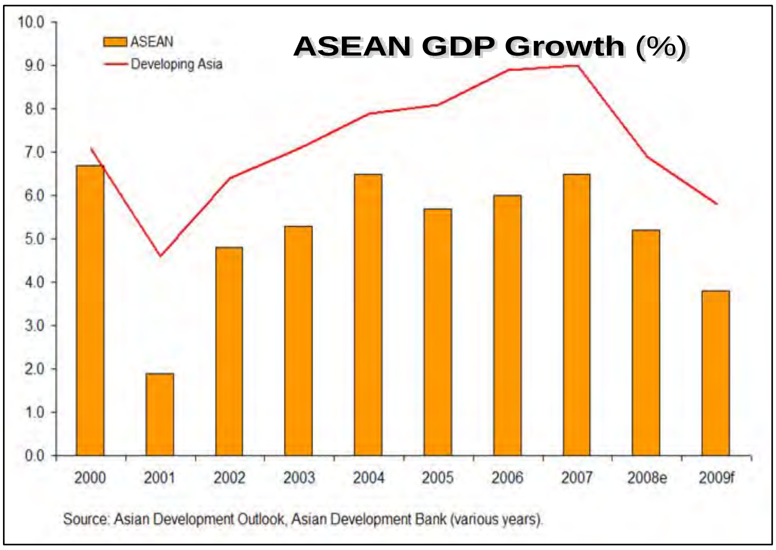
. . . = not available

Sources: Asian Development Bank; World Economic Outlook Update, International Monetary Fund (January 2009); and various national government sources.

(Chart 3)

(Chart 3) ADB's December forecast for 2009 puts aggregate GDP growth in developing Asia at 5.8%, down from an estimated 6.9% in 2008; economies in emerging East Asia are expected to grow 5.7%, off from 6.9% last year. These forecasts are below our September estimates, and our next estimates due for a release in March are likely to be down again, as the IMF forecasts this January show us a much gloomier picture for the global economy than their November estimates.

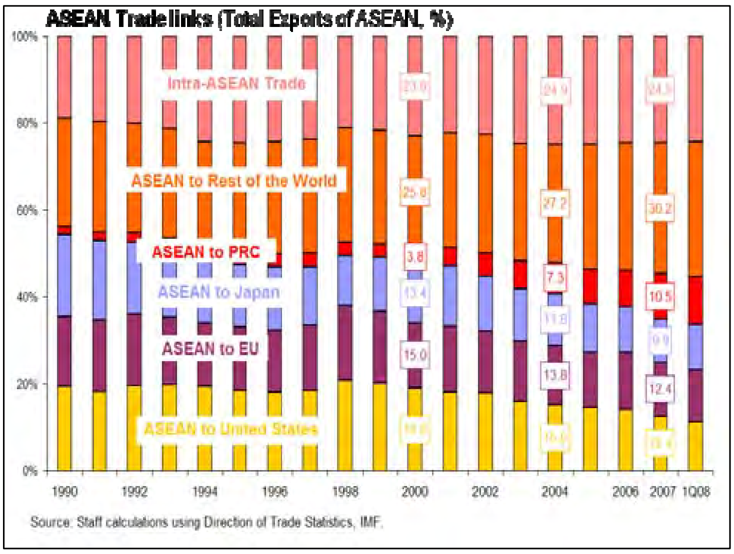
ASEAN



(Chart 4)

(Chart 4) As my distinguished colleagues will discuss the situation in China and India, let me focus on ASEAN for a moment. ASEAN is a hub of developing Asia's growing economic cooperation and integration. It aims to become an economic community by 2015—initially among its larger, middle-income members. And it is an excellent example of how the region is coping with today's crisis; where vulnerabilities and weaknesses remain; and how regional cooperation can help.

We expect growth in ASEAN to weaken to 3.5% in 2009 from last year's estimated 4.8% growth—largely due to the crisis spillover. ASEAN's growth continues to be export driven. Among its original five members, Indonesia, Malaysia, Philippines, Singapore, and Thailand, exports total about 70% of GDP. So the drop in external demand will certainly hurt growth prospects this year. Financial conditions remain a challenge as massive deleveraging continues worldwide. Capital flows are volatile. Equity prices are depressed, risk premiums are higher, and currencies have generally weakened.



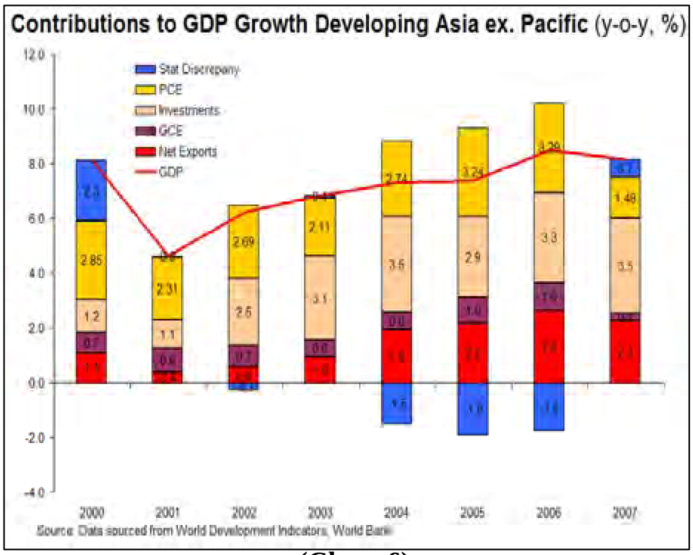
(Chart 5)

(Chart 5) The critical question is how domestic and regional demand will stand up given the sharp decline in external demand and tighter global financial conditions. A partial answer may lie in the strengthening regional ties within ASEAN itself and between ASEAN and China. Today, about 25% of ASEAN's total trade is with other ASEAN members. Trade with China has grown significantly—from less than 4%

in 2000 to almost 11% in 2007. On the other hand, G3 economies were the destination for only 35% of total ASEAN trade in 2007, down from 47% in 2000. This shows an increasing trend toward regional integration, and is a good example of how to build some resilience against the full effects of a global slowdown.

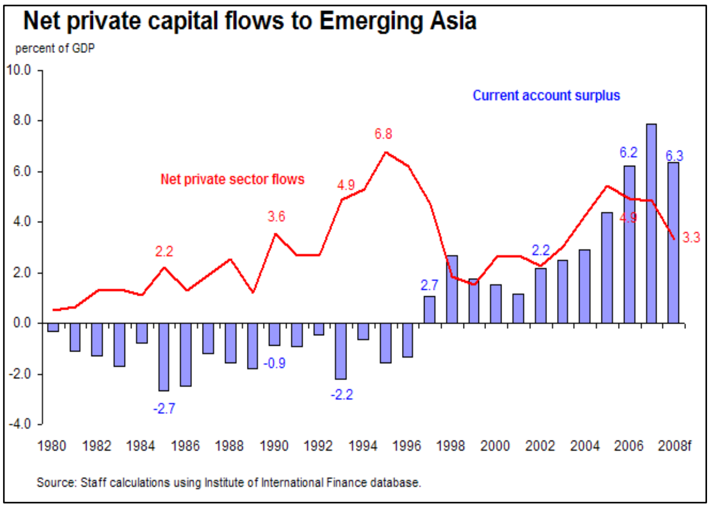
An opportunity for rebalancing

(Chart 6) There is much we can do to invigorate developing Asia's economies amid the crisis fallout. Twelve years after suffering its own devastating financial crisis, developing Asia has much healthier fundamentals. Fiscal and reserve positions are generally sound; external debt is more manageable; and exchange rates are more flexible. But vulnerabilities remain. The region's trade and financial openness strongly connects our region to global economic events—both good and bad. Despite a gradual decline in overall trade share, G3 economies still account for more than 60% of final demand for all Asian exports. The region is vulnerable to volatile capital flows. Asia has embraced and benefited from globalization. But today's global crisis also shows us the risks associated with rapid globalization, particularly in view of Asia's large reliance on exports and external funding.



(Chart 6)

(Chart 7) Just as the 1997 crisis exposed developing Asia's own fundamental imbalances and structural weaknesses, we see the root cause of today's worldwide crisis in global imbalances. The US current account deficit was $125 billion in 1996; by 2007, it had ballooned to $731 billion, or about 5.3% of GDP. And a large portion of the capital flowing to the US to finance that debt has come from emerging East Asia.



(Chart 7)

The region transformed from being net borrowers to net savers for several reasons. First, an export-led growth strategy coupled with policy changes—such as a resistance to currency appreciation, for example—led to large current account surpluses. Second, many Asian economies saw a major falloff in investment after the 1997 crisis—partly due to an investment overhang and partly because of reduced confidence in domestic financial institutions. Third, in some economies, like China, saving rates rose rapidly. This is partially the result of strong income growth, underdeveloped financial systems, and weak social safety nets creating a motivation for precautionary savings.

Global imbalances need to be corrected in an orderly fashion—not only for the US, but also for Asia and the world. As Asia's share in the global economy continues to rise, it can no longer rely on exports as a primary engine of growth. And, given the region’s critical development challenges, its savings must be channeled more effectively to meet its own development priorities. In sum, a rebalancing act will require developing Asia to build strong domestic demand and apply its resources more efficiently.

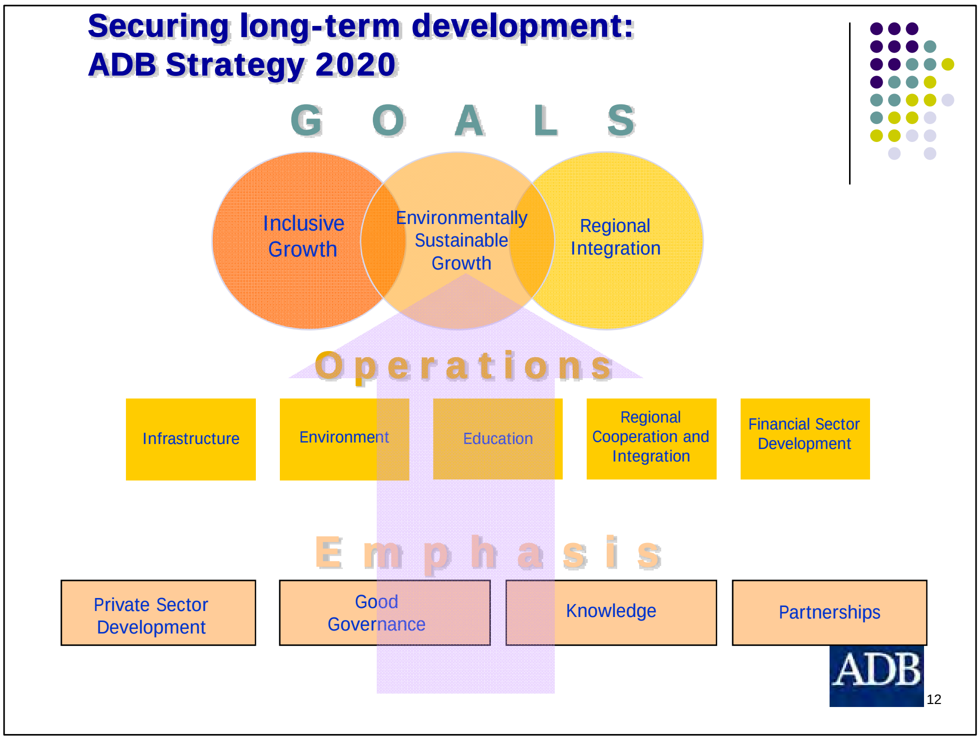
A judicious mix of monetary, fiscal, financial, and structural policies is required to both provide economic stimulus and rebalance growth. While specifics will differ across individual economies, there are some common threads to the rebalancing process: First, spending on infrastructure—both physical and social—must increase. Asia’s financing gap for physical infrastructure is estimated to be anywhere from $370–$470 billion a year through 2015. Social infrastructure—specifically on education and health care including safety nets for the most vulnerable—also requires significant attention. Second, the investment climate must improve. Upgrading corporate governance and legal frameworks for doing business should be a priority in developing regulatory reforms, harmonization, and international standardization. Stimulating private investment should remain a priority. Third, the development of small and medium-sized enterprises (SMEs) should be accelerated to generate jobs as well as strengthen domestic demand. And fourth, financial systems need to be strengthened for more efficient resource allocation. Broadening and deepening of financial systems, both at the domestic and regional levels will ease cross-border capital flows for both finance and trade integration. Better bank supervision and continued development of the region’s local currency and regional bond markets are examples.

ADB's role

ADB is responding to the global crisis by helping our developing member countries contain its immediate effects. At the national level, direct and indirect funding support can be provided through ADB operations for those developing member countries having problems raising capital from international markets. We are stepping up our operations by several billion dollars from our originally planned $12 billion in 2009, and as part of it, we are seeking to accelerate the trade finance support by boosting the size of the Trade Finance Facilitation Program (TFFP) from $150 million to $1 billion this year. We also offer support to our member countries through policy advice and technical assistance for policy implementation and institution building.

At the regional level, we have strengthened our monitoring and surveillance initiatives. And we are working closely with the existing regional arrangements—such as the Association of Southeast Asian Nations (ASEAN), ASEAN+3, and the East Asia Summit—to support the development of a coordinated regional response. For example, we are supporting ASEAN+3 countries' efforts to multilateralize the Chiang Mai Initiative, which pools members' international reserves for emergency liquidity support.

We are also working on an Asian Infrastructure Financing Initiative—an operational co-financing platform—to pool resources from development partners for infrastructure development in the region.



(Chart 8)

(Chart 8) We remain steadfast in our commitment to a poverty-free Asia and Pacific. Our long-term strategic framework—called Strategy 2020— continues to focus on five core operational areas: infrastructure, the environment, regional cooperation and integration, financial sector development, and education. For us to fulfill our mission of poverty reduction under the direction set out in Strategy 2020, ADB is now, however, facing resource constraints and requesting shareholders for an immediate and substantial capital increase. This is absolutely essential to enable ADB to play a meaningful and proactive role in the social and economic development of the region at these very difficult times.

Conclusion

Ladies and gentlemen, we expect this year to be the most challenging for Asia's leaders since the Asian financial crisis 12 years ago. But as happened then, we are confident Asian leaders will deal with the fallout with appropriate monetary and fiscal stimulus where space exists.

The region came out of its past crisis stronger. And I believe that lessons from the current crisis will lead to a more balanced growth path, which will benefit not only regional economies, but also the global community by way of contributing towards global recovery process. We at ADB, the region's key development partner, will do everything within our mandate to help them achieve this goal. Thank you.

3. Impact of the Global Financing Crisis on the Chinese Economy[2]

Lawrence J. Lau

President, Chinese University of Hong Kong

Thank you very much, Mr. Watanabe and President Gyohten. Ladies and gentlemen, it is my great pleasure to be here today. My duty is to try to discuss the impact of the global financial crisis on the Chinese economy. I have a PowerPoint which will eventually be posted on my web pages as well as the web pages of the Institute for International Monetary Affairs. I only have 15 minutes, so I will try to go pretty fast.

As you know, the financial earthquake or tsunami has affected almost all of the developed economies, especially the United States. And North America and Europe have gone into economic recession; it is not really an ordinary recession because it is accompanied by a serious breakdown of the capital and credit markets as well as bankruptcy, insolvency, and illiquidity of many major financial institutions. Very fortunately, in East Asia, despite a steep decline in the stock markets, which many of the previous speakers have talked about, the financial institutions remain relatively sound and financial stability itself is not seriously threatened. The exports have slowed, as many of the previous commentators indicated, especially following the failure of Lehman Brothers sometime mid-September of last year and in many economies, the decline was on the order of 50%; certainly in terms of the export orders received, and this has caused derivative declines in the demands for shipping, transportation, logistics, and storage services.

I think the crisis in the US and elsewhere and especially in the US will probably last for another year or two until more positive expectations are restored. In the meantime, I do not think Asia can wait for the US recovery. So while there is serious negative impact, it is really up to the East Asian countries, as Mr. Kuroda said, up to the region, to try to do something, and I think that the earlier the region can engineer an economic recovery, the better for the world.

Now, one of the things I want to talk about is really the impact on Chinese exports. We know that there has been very serious decline in export orders. But first of all, let me say the following: that is, since mid-September of last year, when Lehman Brothers failed, several things have happened. There is a sharp decline in the East Asian stock market which I will show you in the chart

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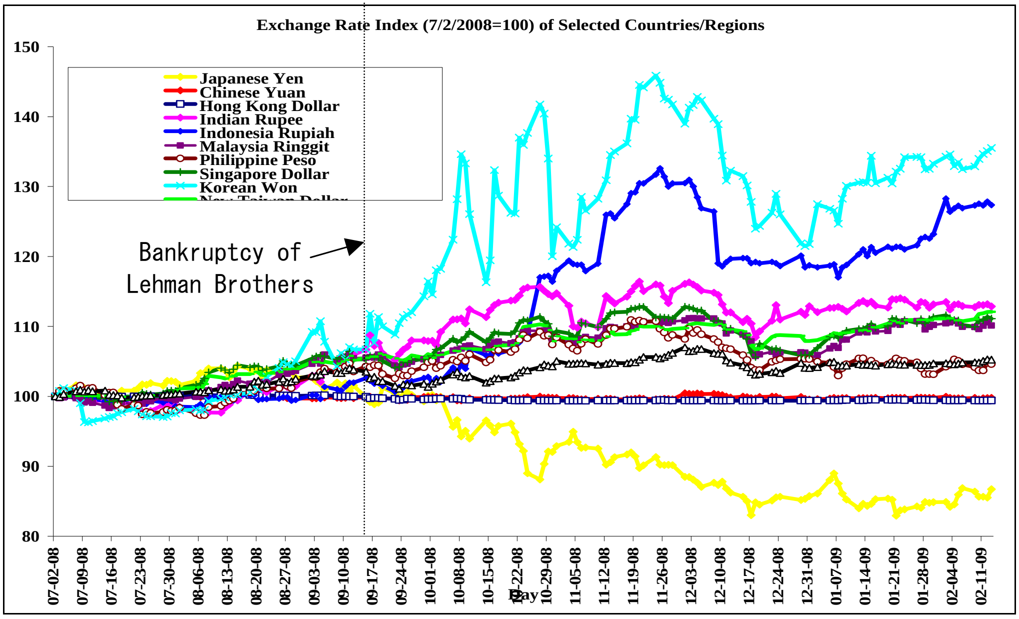
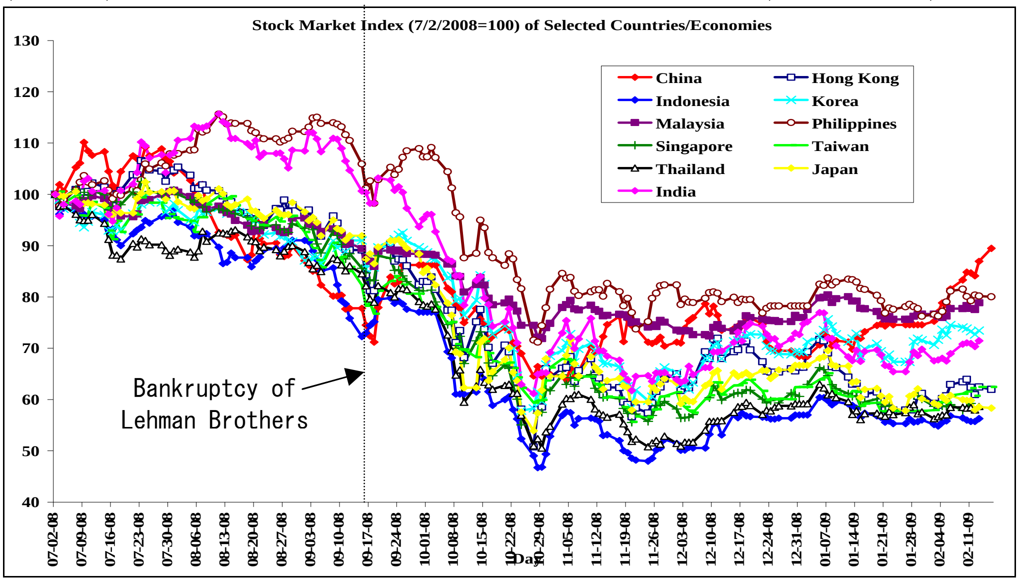
2 For the full color charts in this text, please refer to our website.
http://iima.or.jp/pdf/sympo_speach/Dr_Lau_Presentation.pdf

later, but at the same time it is also accompanied by a sharp devaluation in the East Asian currencies, with the notable exception of the Japanese yen and the Chinese Yuan and Hong Kong dollar, and for all the other markets I think the currencies have actually depreciated. You may think this is very paradoxical.

(Chart 1) Exchange Rates of Selected East Asian Economies (7/2/2008=100)

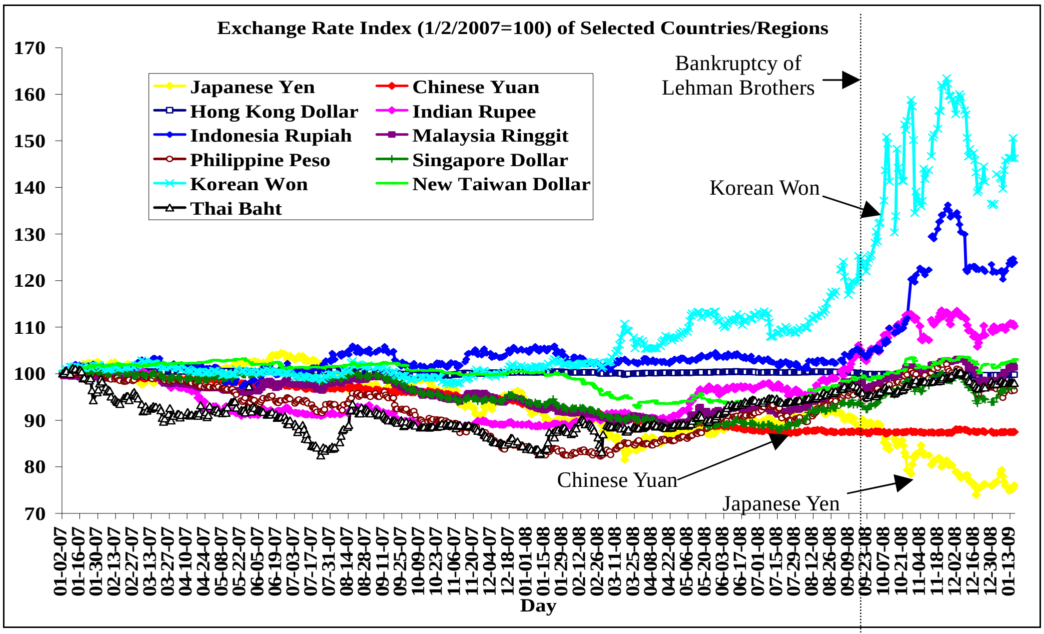


(Chart 2) Stock Market Indexes of Selected East Asian Economies (7/2/2008=100)



Why is it that the US dollar was gaining in value? And you can see this very clearly. But my explanation is a very simple one, and that is the US and other overseas investors in Asia are basically trying to repatriate their capital back home where it is needed more because of redemption and extremely tight credit conditions, and so forth. So we have two things happening. They are selling down their equity and other securities in these Asian markets and at the same time they are sending the money home, and that basically has caused the stock markets to decline as well as the US dollar to rise (Chart 1 & 2). And I think you can see that since December both the stock market and the currency markets have begun to stabilize and that basically means that phase of the crisis is essentially or more or less over because all the assets that can be sold have been sold and have been repatriated. So I think the appreciation of the US dollar relative to East Asian currencies really should not be read as a long-term thing; it is really a short-term, one-off thing. Of course, there is also deleveraging and also loss of confidence by both domestic as well as foreign investors which I call irrational panic as opposed to what Alan Greenspan said some years ago about irrational exuberance. I think many markets in Asia are probably oversold right now and hopefully with some recovery of confidence, some regaining of confidence, the markets will be stabilized.

(Chart 3) Exchange Rates of Selected East Asian Economies (1/2/2007=100)

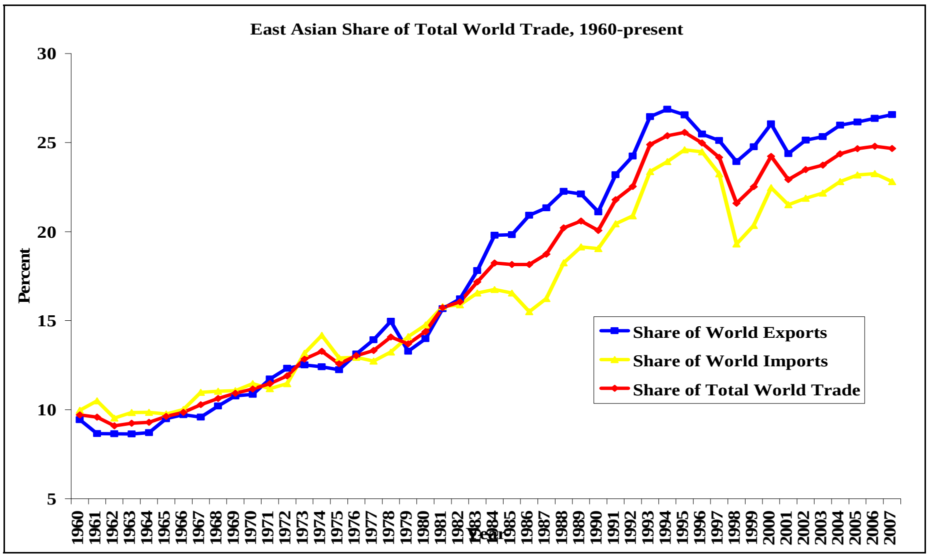


(Chart 3) Now what I have shown here, as you can see, is from 2007 to the present, and if I can bring your attention to September; you can see a huge run-up in the currency rates, which means a devaluation of most Asian currencies, but by December they have begun to stabilize, and whereas the yellow line in the chart has been appreciating all this time. This is the Japanese yen. You can see it very clearly, I would say, post-Lehman Brothers failure.

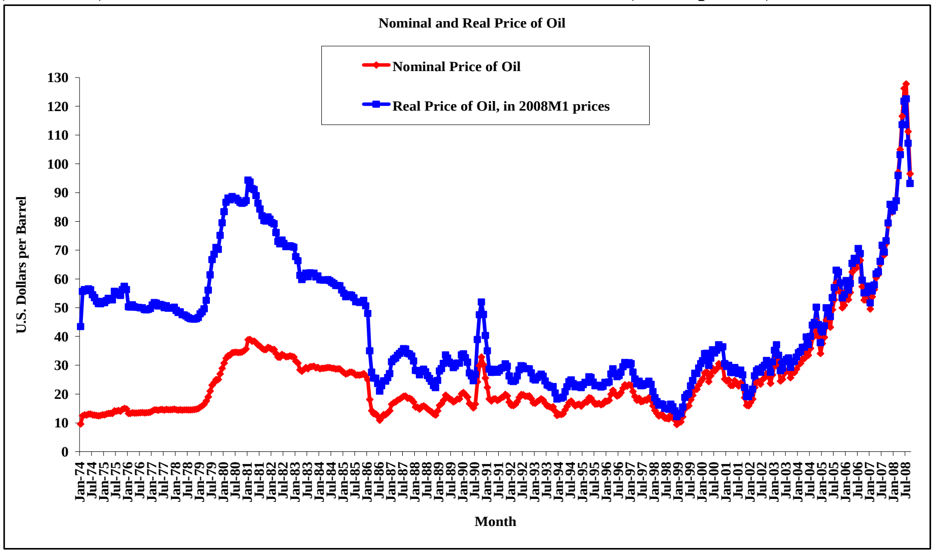
(Chart 2) Now this is the stock market index chart which actually is also very clear. If you look at the stock markets, and this is about October, we can see a huge drop in the stock markets basically post-Lehman Brothers and then they have again stabilized. So I just want to show you this so that we know what things are happening and it is really not, as some analysts will say, flight to safety. I do not think the US dollar assets are safe in the normal sense.

I do not want to talk too much about partial decoupling. I think Mr. Kuroda and Gyohten have talked about that and it is really quite clear that Asia is not completely decoupled from North America or Europe. On the other hand, it is also no longer as tightly coupled as it used to be, say, 20-30 years ago, so there is really room for independent recovery.

(**Chart 4**) The Rising Ratio of East Asian Trade in Total World Trade, 1960-present



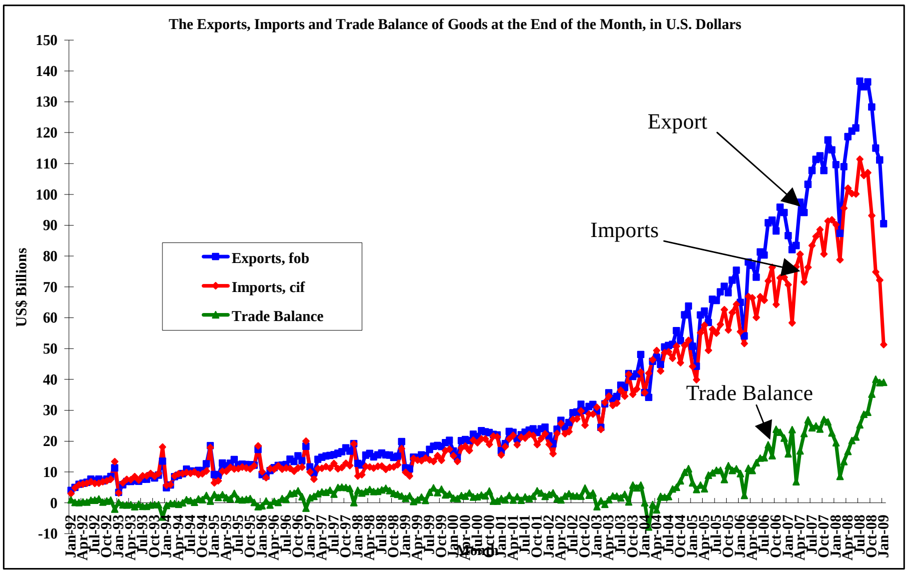
(Chart 5) The Nominal and Real World Prices of Oil (2008 prices)



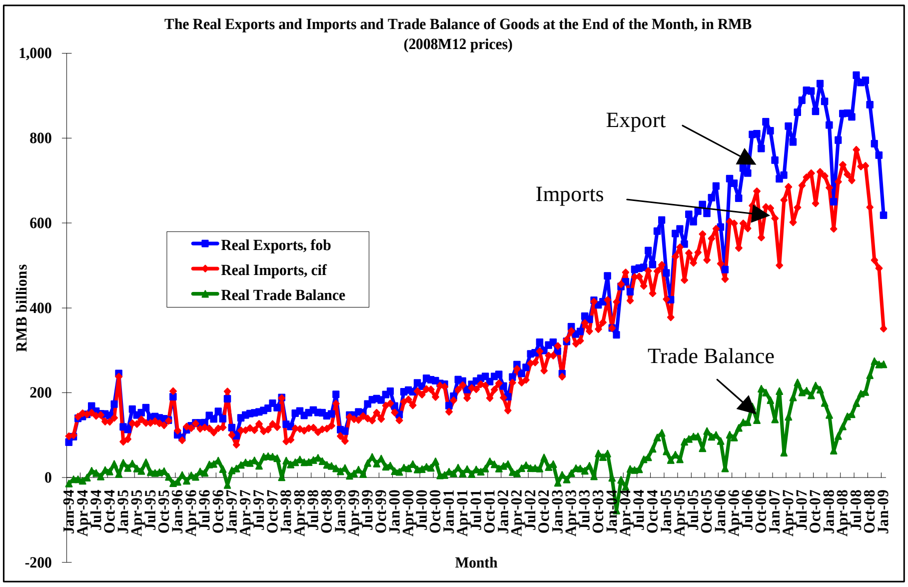
(Chart 4) This chart shows that the share of East Asian trade in total world trade has risen to 25%. So this gives some hope that East Asia can perhaps manage on its own, maybe not grow as fast as in 2007 but has a reasonable chance of maintaining reasonable growth. The oil price has fallen down and I think that is a positive development for everyone (Chart 5).

Now, my expectations are that China and India can continue growing because by and large these economies are driven really very much by internal demand rather than exports. So my view is that the 8% growth for China in 2009 is actually quite feasible; my own estimate is between 7% and 8%. I want to say a little bit about how China is really not that dependent on exports as many people seem to fear.

（**Chart 6**） Chinese Exports, Imports and Trade Balance, US$, Monthly Data



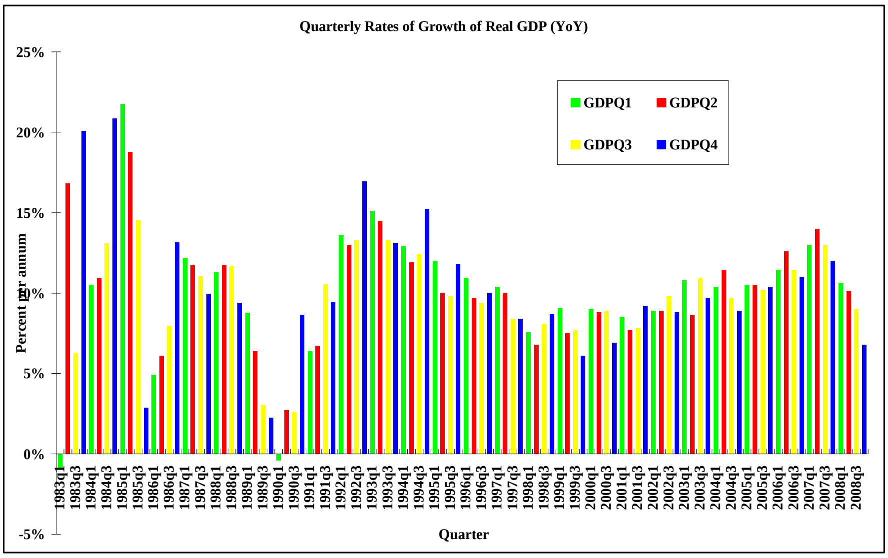
（**Chart 7**） Chinese Exports, Imports and Trade Balance, 2008 Yuan, Monthly Data



(Chart 6&7) Now what I have done in this chart is to show you the exports and imports of China. And down below in the green line is the export surplus. You can see that the trade surplus is actually vis-à-vis the world. There is really not much of a trade surplus until around 2005, and that is when the Yuan has actually begun appreciating. The global imbalances began long before that and one cannot really blame China for the global imbalances because it is really not the trade surplus vis-à-vis the US that is relevant. It is really the trade surplus vis-à-vis the world that is actually relevant for the global imbalances.

Let me say something about world exports here. The important thing is to realize following. In China, exports as a percent of GDP are about 35%. So that looks very high, but the domestic value-added content of Chinese exports is very low. Roughly speaking, for every dollar of Chinese exports to the world, only 20 cents is generated domestically, yes, domestic value added is only 20%. So, roughly speaking if you take 20% and you multiply it by 35% you get 7%. So this is approximately the contribution of exports to Chinese GDP. Now you can do some indirect contribution and so forth, and the maximum probably would be less than 15%. So the way to think about it is that if 15% of the Chinese economy does not grow and the other 85% continues to grow, it should do all right. So I think it is actually not that bad.

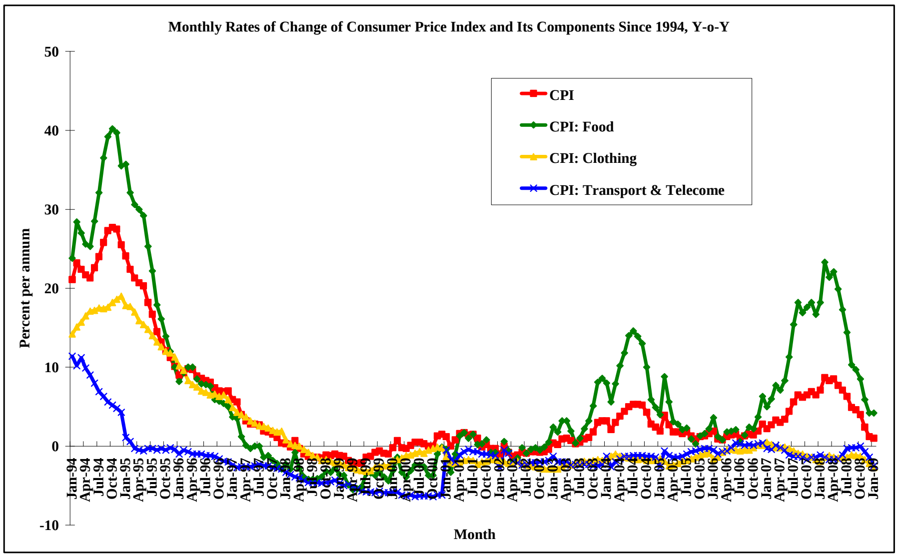
（**Chart 8**） Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y



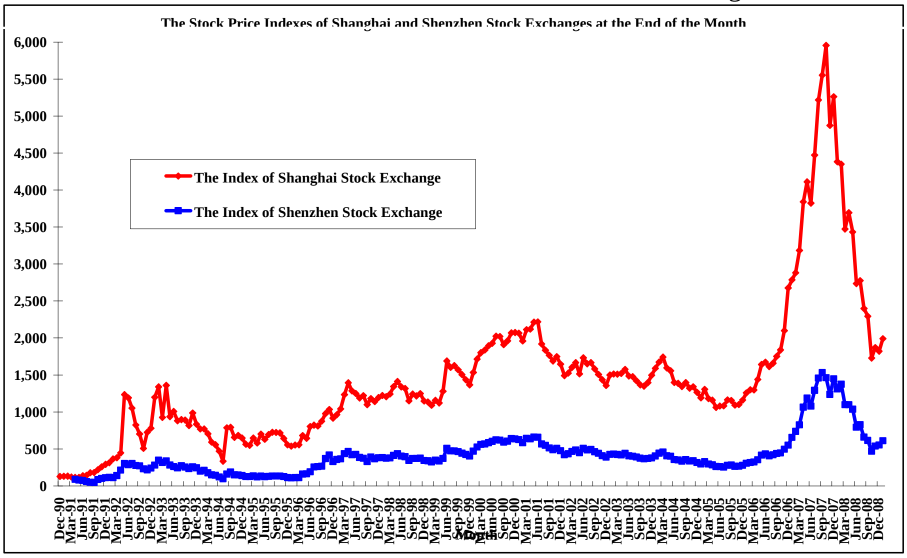
(Chart 8) The rate of growth of real GDP of China has actually slowed; it was over 11% and actually rose to 13% in 2007, and declined to 9% in 2008 and in the last quarter of 2008, the rate of growth was about 6.8% year-over-year, but the Chinese government, as you know, has launched an economic stimulus plan of almost 600 billion US dollars or 16% of Chinese GDP in 2007, spread over 2 years, namely 2009 and 2010 and the effects are expected to kick in sometime in the second quarter of this year, and my own expectation is that beginning in the second quarter or maybe in the third quarter the Chinese growth rate should go back up again. In the first quarter it might actually come down some more, or it might be flat, but I think it will probably start going up again by second or third quarter.

Unemployment has become very serious in the export-oriented regions of Guangdong, Shanghai, and Zhejiang, but exports are not uniformly distributed as well for China. It is really concentrated in several regions, and in these regions unemployment is very serious but most of the unemployed are rural immigrants, most of whom have returned to their home villages where they actually have some support. And social disturbance are likely to arise in localities where unemployment is concentrated, but if they are back in their home villages, I think that would make it easier to deal with.

(**Chart 9**) Monthly Rates of Change of the Consumer Price Index (CPI), Y-o-Y



(**Chart 10**) The Stock Price Indexes of Chinese Stock Exchanges Since 1990



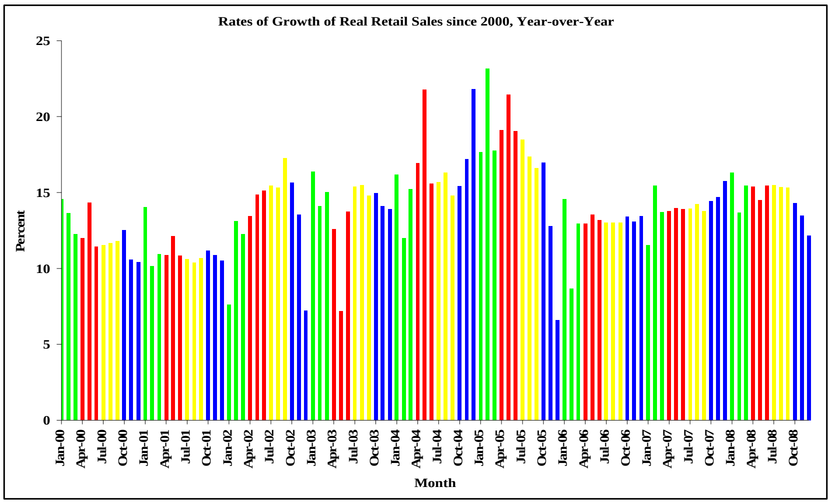
(Chart 9) Rate of inflation has remained very tame, making it possible to undertake fiscal expansion without fear of rekindling inflation, because the worst fear today facing the world is stagflation. If you have deflation and a recession at the same time, it is easier to handle than if you have inflation and a recession at the same time.

(Chart 10) The stock market in China has more or less stabilized, providing some support for business and consumer confidence. (Chart 11) Retail sales have also remained relatively stable.

Now, we might be a little worried about why exports have all of a sudden had such a huge decline, but I want to point out that the declines in exports from China as well as from elsewhere in

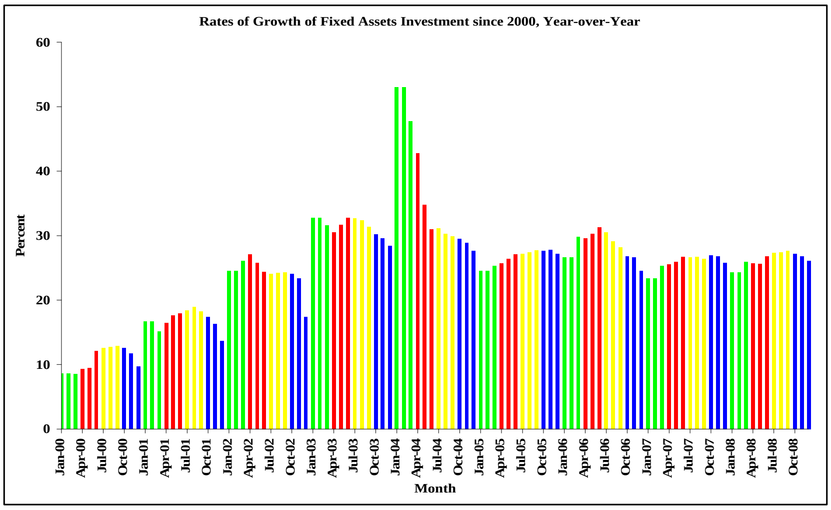
Asia are mostly caused by the credit freeze in the developed economies. For example, if you are a US importer today, it is very difficult for you to obtain financing to either issue a letter of credit or to finance your inventory, and as a result orders are not placed and people are waiting for the inventory to run down before they place a replacement order. And I think part of the export demand will come back because no matter what happens in the US, personal consumption cannot come down more than 5% on a yearly basis. I mean that has so far been proven in many recessions dating back to 1945, and it is actually also true in Japan that consumption tends to be much more stable than income.

（**Chart 11**） Monthly Rates of Growth of Real Retail Sales, Y-o-Y



So I expect this very large decline in exports to be temporary. I do not expect it to fully recover, but it should actually largely recover. And in China today there is actually evidence that the decumulation of inventory has already been completed and that firms are once again are beginning to build up their inventory investment.

（**Chart 12**） Monthly Rates of Growth of Fixed Assets Investment, Y-o-Y

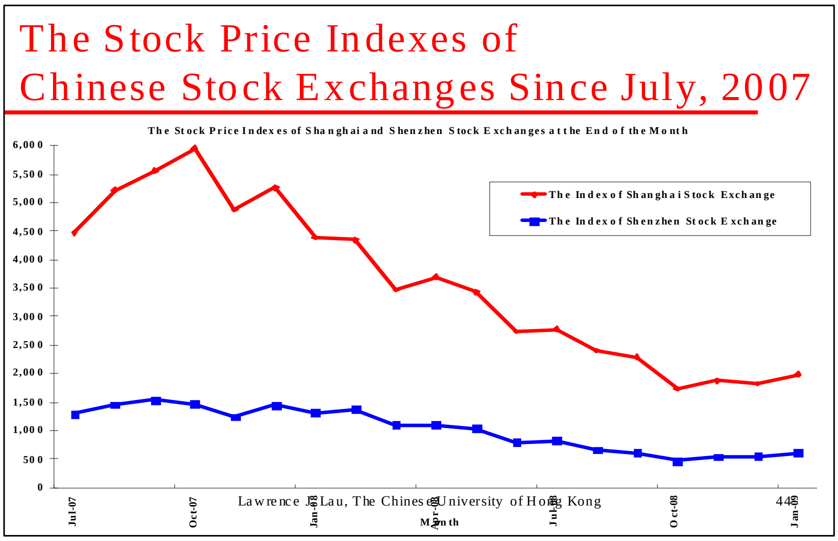


(Chart 12) Now, I do not have time to discuss this but you can see here that the monthly growth rates of fixed asset investment have actually remained quite stable.

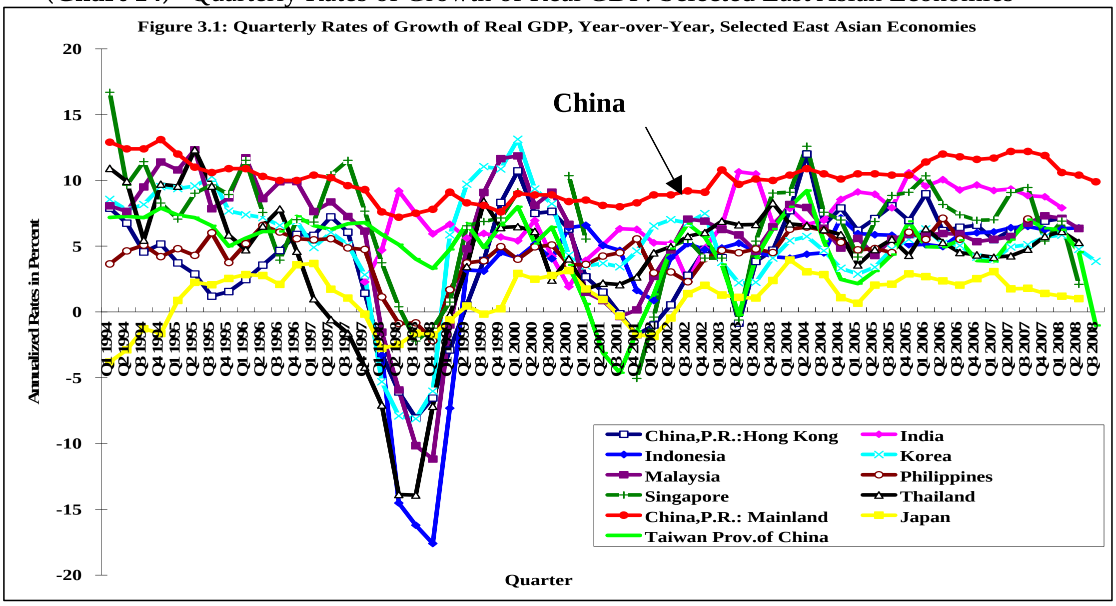
(Chart 13)Stock prices have gone hugely down, but recently it has actually stabilized and has started slowly going up.

But let me just make two points that I think are actually useful. First, I want to show you this chart (Chart 14). This shows the quarterly rate of growth or real GDP of selected East Asian economies from 1994 to the present and what I want to show you is the following.

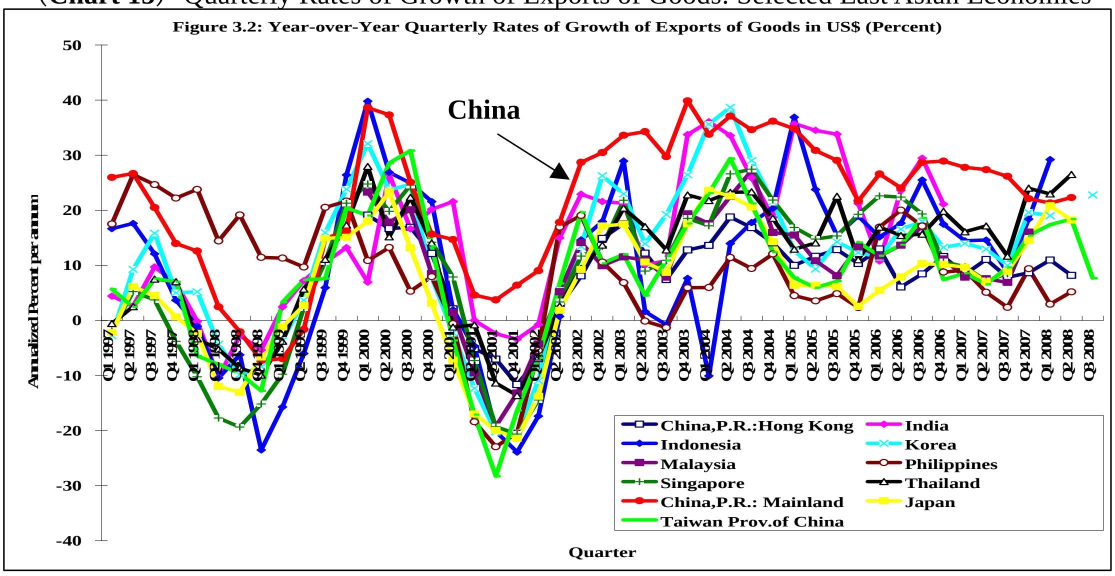
（**Chart 13**） The Stock Price Indexes of Chinese Stock Exchanges Since 2007



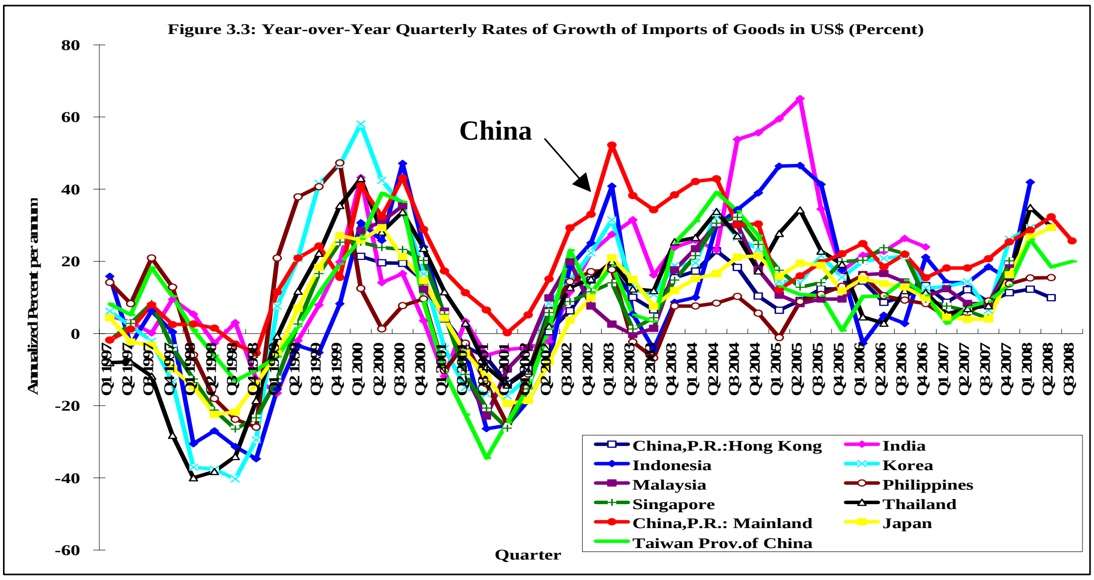
（**Chart 14**） Quarterly Rates of Growth of Real GDP: Selected East Asian Economies



（**Chart 15**） Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies



(**Chart 16**) Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

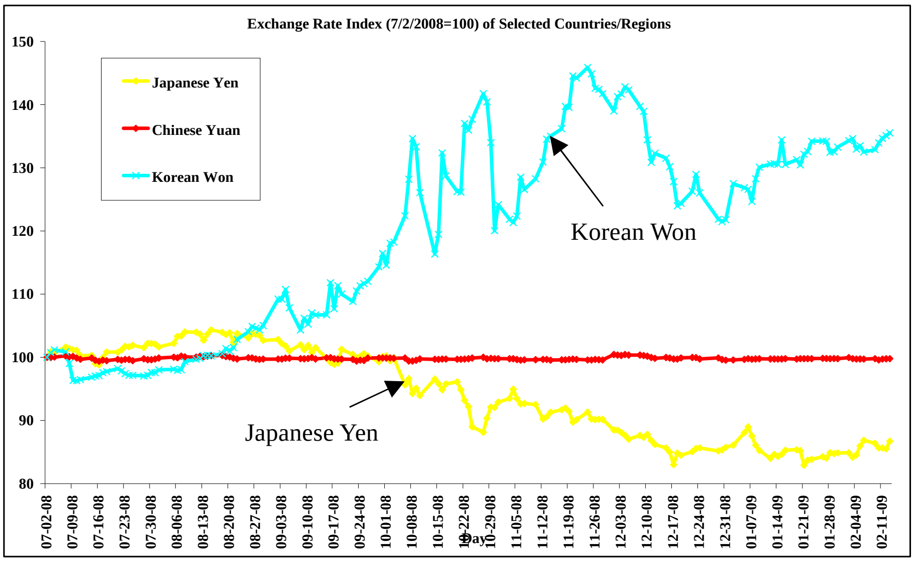


These two are charts of rates of growth of exports and imports of goods in East Asian economies respectively (Chart 15&16), and the red line up on the top is China. You can see that the fluctuations are actually pretty coincidental, that is all economy's exports and imports go up and down together, but if you look at GDP growth, the red line is the Chinese GDP, it is really very stable despite the fact that we have seen that the export-import rates of growth fluctuating together. This tells you something that the Chinese economy is relatively immune, I would not say completely immune, to what happens on the outside. But the other thing that I want to bring your attention to is to look at how sharp the declines here in growth rates were in East Asian economies during the 1997 crisis, but you should also look at how sharp the recovery is.

And this is a result, let me say, of all the East Asian economies coming down together during the crisis and when they all recovered together, the recoveries were also very sharp. And that is because they can provide the demands for one another, and I think this is what the East Asian economies should do together, is to have common simultaneous coordinated economic stimulus packages so that each country's stimulus package can stimulate not just its own domestic demand but also provide stimulus for other countries. If we do this altogether, I think we would have a much faster recovery. One really should guard against protectionism at this time; it is easy to be protectionist, but I think one must not do that.

The other important point is about exchange rate coordination. I think the central banks of East Asia have actually exercised great restraint in holding on to their US dollar assets; I mean every one of them. And I hope that nobody breaks rank because it is important that everyone continues to hold US dollar assets. That is a part of coordination. But I guess more importantly they must coordinate the exchange rates because for sustainable development, the exchange rate of East Asian countries should really have some coherence, and my own personal proposal is to try to maintain relative real parities, that is, maintain parity after taking into account the relative inflation rates. That means the true relative purchasing power of the different currencies remain unchanged, so that one can have sustainable long-term economic cooperation.

(**Chart 17**) Exchange Rates of China, Japan and South Korea (7/2/2008=100)



(Chart 17) To that extent, I think right now there is actually a huge imbalance in the sense that the Japanese yen, the yellow line, is far too high right now, and the Korean won, the blue line, is far too low, relative to long-term equilibrium. I think the governments in Asia should get together to discuss how to rationalize this because Asia cannot really recover without Japan having a stronger economy. The yen is really in some sense too high and the won is too low; together they are killing the Japanese economy.

So let me just stop here. I am optimistic about East Asia. I think that if the East Asia governments can work together, the economies will do fine. Thank you very much.

4. Impact of Global Financial Crisis on India: Collateral Damage and Response

Duvvuri Subbarao

Governor, Reserve Bank of India

Global outlook

The global economic outlook deteriorated sharply over the last quarter. In a sign of the ferocity of the down turn, the IMF made a marked downward revision of its estimate for global growth in 2009 in purchasing power parity terms – from its forecast of 3.0 % made in October 2008 to 0.5 % in January 2009. In market exchange rate terms, the downturn is sharper – global GDP is projected to actually shrink by 0.6 %. With all the advanced economies – the United States, Europe and Japan - having firmly gone into recession, the contagion of the crisis from the financial sector to the real sector is total. Recent evidence suggests that contractionary forces are strong: demand has slumped, production is plunging, job losses are rising and credit markets remain in seizure. Most worryingly, world trade – the main channel through which the downturn will get transmitted on the way forward – is projected to contract by 2.8 % in 2009.

Policy making around the world is in clearly uncharted territory. Governments and central banks across countries have responded to the crisis through big, aggressive and unconventional measures. There is a contentious debate on whether these measures are adequate and appropriate, and when, if at all, they will start to show results. There has also been a separate debate on how abandoning the rule book driven by the tyranny of the short-term, is compromising medium-term sustainability. What is clearly beyond debate though is that this Great Recession of 2008/09 is going to be deeper and the recovery longer than earlier thought.

Emerging economies

Contrary to the 'decoupling theory', emerging economies too have been hit by the crisis. The decoupling theory, which was intellectually fashionable even as late as a year ago, held that even if advanced economies went into a downturn, emerging economies will remain unscathed because of their substantial foreign exchange reserves, improved policy framework, robust corporate balance sheets and relatively healthy banking sector. In a rapidly globalizing world, the 'decoupling theory' was never totally persuasive. Given the evidence of the last few months – capital flow reversals, sharp widening of spreads on sovereign and corporate debt and abrupt currency depreciations - the 'decoupling theory' stands totally invalidated. Reinforcing the notion that in a globalized world no country can be an island, growth prospects of emerging economies have been undermined by the cascading financial crisis with, of course, considerable variation across countries.

Questions that will be addressed

India too has been impacted by the crisis – and by much more than it was suspected earlier. What I propose to do in the rest of my speech is to address the following four questions:

- Why has India been hit by the crisis?
- How has India been hit by the crisis?
- How have we responded to the challenge?
- What is the outlook for India?

Why has India been hit by the crisis?

There is, at least in some quarters, dismay that India has been hit by the crisis. This dismay stems from two arguments.

The first argument goes as follows. The Indian banking system has had no direct exposure to the sub-prime mortgage assets or to the failed institutions. It has very limited off-balance sheet activities or securitized assets. In fact, our banks continue to remain safe and healthy. So, the enigma is how can India be caught up in a crisis when it has nothing much to do with any of the maladies that are at the core of the crisis.

The second reason for dismay is that India's recent growth has been driven predominantly by domestic consumption and domestic investment. External demand, as measured by merchandize exports, accounts for less than 15 % of our GDP. The question then is, even if there is a global downturn, why should India be affected when its dependence on external demand is so limited?

The answer to both the above frequently-asked questions lies in globalization. Let me explain. First, India's integration into the world economy over the last decade has been remarkably rapid. Integration into the world implies more than just exports. Going by the common measure of globalization, India's two-way trade (merchandize exports plus imports), as a proportion of GDP, grew from 21.2 % in 1997-98, the year of the Asian crisis, to 34.7 % in 2007-08. Second, India's financial integration with the world has been as deep as India's trade globalization, if not deeper. If we take an expanded measure of globalization, that is the ratio of total external transactions (gross current account flows plus gross capital flows) to GDP, this ratio has more than doubled from 46.8 % in 1997-98 to 117.4 % in 2007-08.

Importantly, the Indian corporate sector's access to external funding has markedly increased in the last five years. Some numbers will help illustrate the point. In the five-year period 2003-08, the share of investment in India's GDP rose by 11%. Corporate savings financed roughly half of this, but a significant portion of the balance financing came from external sources. While funds were available domestically, they were expensive relative to foreign funding. On the other hand, in a global market awash with liquidity and on the promise of India's growth potential, foreign investors were willing to take risks and provide funds at a lower cost. Last year (2007/08), for example, India received capital inflows amounting to over 9 % of GDP as against a current account deficit in the balance of payments of just 1.5 % of GDP. These capital flows, in excess of the current account deficit, evidence the importance of external financing and the depth of India's financial integration. So, the reason India has been hit by the crisis, despite mitigating factors, is clearly India's rapid and growing integration into the global economy.

How has India been hit by the crisis?

The contagion of the crisis has spread to India through all the channels – the financial channel, the real channel, and importantly, as happens in all financial crises, the confidence channel.

Let us first look at the financial channel. India's financial markets - equity markets, money markets, forex markets and credit markets - had all come under pressure from a number of directions. First, as a consequence of the global liquidity squeeze, Indian banks and corporates found their overseas financing drying up, forcing corporates to shift their credit demand to the domestic banking sector. Also, in their frantic search for substitute financing, corporates withdrew their investments from domestic money market mutual funds putting redemption pressure on the mutual funds and down the line on non-banking financial companies (NBFCs) where the MFs had invested a significant portion of their funds. This substitution of overseas financing by domestic financing brought both money markets and credit markets under pressure. Second, the forex market came under pressure because of reversal of capital flows as part of the global deleveraging process. Simultaneously, corporates were converting the funds raised locally into foreign currency to meet their external obligations. Both these factors put downward pressure on the rupee. Third, the Reserve Bank's intervention in the forex market to manage the volatility in the rupee further added to liquidity tightening.

Now let me turn to the real channel. Here, the transmission of the global cues to the domestic economy has been quite straight forward – through the slump in demand for exports. The United States, European Union and the Middle East, which account for three quarters of India's goods and services trade are in a synchronized down turn. Service export growth is also likely to slow in the near term as the recession deepens and financial services firms – traditionally large users of outsourcing services – are restructured. Remittances from migrant workers too are likely to slow as the Middle East adjusts to lower crude prices and advanced economies go into a recession.

Beyond the financial and real channels of transmission as above, the crisis also spread through the confidence channel. In sharp contrast to global financial markets, which went into a seizure on account of a crisis of confidence, Indian financial markets continued to function in an orderly manner. Nevertheless, the tightened global liquidity situation in the period immediately following the Lehman failure in mid-September 2008, coming as it did on top of a turn in the credit cycle, increased the risk aversion of the financial system and made banks cautious about lending.

The purport of the above explanation is to show how, despite not being part of the financial sector problem, India has been affected by the crisis through the pernicious feedback loops between external shocks and domestic vulnerabilities by way of the financial, real and confidence channels.

How have we responded to the challenge?

Let me now turn to how we responded to the crisis. The failure of Lehman Brothers in mid-September was followed in quick succession by several other large financial institutions coming under severe stress. This made financial markets around the world uncertain and unsettled. This contagion, as I explained above, spread to emerging economies, and to India too. Both the government and the Reserve Bank of India responded to the challenge in close coordination and consultation. The main plank of the government response was fiscal stimulus while the Reserve Bank's action comprised monetary accommodation and counter cyclical regulatory forbearance.

Monetary policy response

The Reserve Bank's policy response was aimed at containing the contagion from the outside - to keep the domestic money and credit markets functioning normally and see that the liquidity stress did not trigger solvency cascades. In particular, we targeted three objectives: first, to maintain a comfortable rupee liquidity position; second, to augment foreign exchange liquidity; and third, to maintain a policy framework that would keep credit delivery on track so as to arrest the moderation in growth. This marked a reversal of Reserve Bank's policy stance from monetary tightening in response to heightened inflationary pressures of the previous period to monetary easing in response to easing inflationary pressures and moderation in growth in the current cycle. Our measures to meet the above objectives came in several policy packages starting mid-September 2008, on occasion in response to unanticipated global developments and at other times in anticipation of the impact of potential global developments on the Indian markets.

Our policy packages included, like in the case of other central banks, both conventional and unconventional measures. On the conventional side, we reduced the policy interest rates aggressively and rapidly, reduced the quantum of bank reserves impounded by the central bank and expanded and liberalized the refinance facilities for export credit. Measures aimed at managing forex liquidity included an upward adjustment of the interest rate ceiling on the foreign currency deposits by non-resident Indians, substantially relaxing the external commercial borrowings (ECB) regime for corporates, and allowing non-banking financial companies and housing finance companies access to foreign borrowing.

The important among the many unconventional measures taken by the Reserve Bank of India are a rupee-dollar swap facility for Indian banks to give them comfort in managing their short-term foreign funding requirements, an exclusive refinance window as also a special purpose vehicle for supporting non-banking financial companies, and expanding the lendable resources available to apex finance institutions for refinancing credit extended to small industries, housing and exports.

Government's fiscal stimulus

Over the last five years, both the central and state governments in India have made a serious effort to reverse the fiscal excesses of the past. At the heart of these efforts was the Fiscal Responsibility and Budget Management (FRBM) Act which mandated a calibrated road map to fiscal sustainability. However, recognizing the depth and extraordinary impact of this crisis, the central government invoked the emergency provisions of the FRBM Act to seek relaxation from the fiscal targets and launched two fiscal stimulus packages in December 2008 and January 2009. These fiscal stimulus packages, together amounting to about 3 % of GDP, included additional public spending, particularly capital expenditure, government guaranteed funds for infrastructure spending, cuts in indirect taxes, expanded guarantee cover for credit to micro and small enterprises, and additional support to exporters. These stimulus packages came on top of an already announced expanded safety-net for rural poor, a farm loan waiver package and salary increases for government staff, all of which too should stimulate demand.

Impact of monetary measures

Taken together, the measures put in place since mid-September 2008 have ensured that the Indian financial markets continue to function in an orderly manner. The cumulative amount of primary liquidity potentially available to the financial system through these measures is over US$ 75 billion or 7 % of GDP. This sizeable easing has ensured a comfortable liquidity position starting mid-November 2008 as evidenced by a number of indicators including the weighted-average call money rate, the overnight money market rate and the yield on the 10-year benchmark government security. Taking the signal from the policy rate cut, many of the big banks have reduced their benchmark prime lending rates. Bank credit has expanded too, faster than it did last year. However, Reserve Bank's rough calculations show that the overall flow of resources to the commercial sector is less than what it was last year. This is because, even though bank credit has expanded, it has not fully offset the decline in non-bank flow of resources to the commercial sector.

Evaluating the response

In evaluating the response to the crisis, it is important to remember that although the origins of the crisis are common around the world, the crisis has impacted different economies differently. Importantly, in advanced economies where it originated, the crisis spread from the financial sector to the real sector. In emerging economies, the transmission of external shocks to domestic vulnerabilities has typically been from the real sector to the financial sector. Countries have accordingly responded to the crisis depending on their specific country circumstances. Thus, even as policy responses across countries are broadly similar, their precise design, quantum, sequencing and timing have varied. In particular, while policy responses in advanced economies have had to contend with both the unfolding financial crisis and deepening recession, in India, our response has been predominantly driven by the need to arrest moderation in economic growth.

What is the outlook for India?

The outlook for India going forward is mixed. There is evidence of economic activity slowing down. Real GDP growth has moderated in the first half of 2008/09. The services sector too, which has been our prime growth engine for the last five years, is slowing, mainly in construction, transport and communication, trade, hotels and restaurants sub-sectors. For the first time in seven years, exports have declined in absolute terms for three months in a row during October-December 2008. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity in the system. Higher input costs and dampened demand have dented corporate margins while the uncertainty surrounding the crisis has affected business confidence. The index of industrial production has shown negative growth for two recent months and investment demand is decelerating. All these factors suggest that growth moderation may be steeper and more extended than earlier projected.

In addressing the fall out of the crisis, India has several advantages. Some of these are recent developments. Most notably, headline inflation, as measured by the wholesale price index, has fallen sharply, and recent trends suggest a faster-than-expected reduction in inflation. Clearly, falling commodity prices have been the key drivers behind the disinflation; however, some contribution has also come from slowing domestic demand. The decline in inflation should support consumption demand and reduce input costs for corporates. Furthermore, the decline in global crude prices and naphtha prices will reduce the size of subsidies to oil and fertilizer companies, opening up fiscal space for infrastructure spending. From the external sector perspective, it is projected that imports will shrink more than exports keeping the current account deficit modest.

There are also several structural factors that have come to India's aid. First, notwithstanding the severity and multiplicity of the adverse shocks, India's financial markets have shown admirable resilience. This is in large part because India's banking system remains sound, healthy, well capitalized and prudently regulated. Second, our comfortable reserve position provides confidence to overseas investors. Third, since a large majority of Indians do not participate in equity and asset markets, the negative impact of the wealth loss effect that is plaguing the advanced economies should be quite muted. Consequently, consumption demand should hold up well. Fourth, because of India's mandated priority sector lending, institutional credit for agriculture will be unaffected by the credit squeeze. The farm loan waiver package implemented by the Government should further insulate the agriculture sector from the crisis. Finally, over the years, India has built an extensive network of social safety-net programs, including the flagship rural employment guarantee program, which should protect the poor and the returning migrant workers from the extreme impact of the global crisis.

RBI's policy stance

Going forward, the Reserve Bank's policy stance will continue to be to maintain comfortable rupee and forex liquidity positions. There are indications that pressures on mutual funds have eased and that NBFCs too are making the necessary adjustments to balance their assets and liabilities. Despite the contraction in export demand, we will be able to manage our balance of payments. It is the Reserve Bank's expectation that commercial banks will take the signal from the policy rates reduction to adjust their deposit and lending rates in order to keep credit flowing to productive sectors. In particular, the special refinance windows opened by the Reserve Bank for the MSME (micro, small and medium enterprises) sector, housing sector and export sector should see credit flowing to these sectors. Also the SPV set up for extending assistance to NBFCs should enable NBFC lending to pick up steam once again. The government's fiscal stimulus should be able to supplement these efforts from both supply and demand sides.

When the turnaround comes

Over the last five years, India clocked an unprecedented nine % growth, driven largely by domestic consumption and investment even as the share of net exports has been rising. This was no accident or happenstance. True, the benign global environment, easy liquidity and low interest rates helped, but at the heart of India's growth were a growing entrepreneurial spirit, rise in productivity and increasing savings. These fundamental strengths continue to be in place. Nevertheless, the global crisis will dent India's growth trajectory as investments and exports slow. Clearly, there is a period of painful adjustment ahead of us. However, once the global economy begins to recover, India's turn around will be sharper and swifter, backed by our strong fundamentals and the untapped growth potential. Meanwhile, the challenge for the government and the RBI is to manage the adjustment with as little pain as possible. Thank you very much.

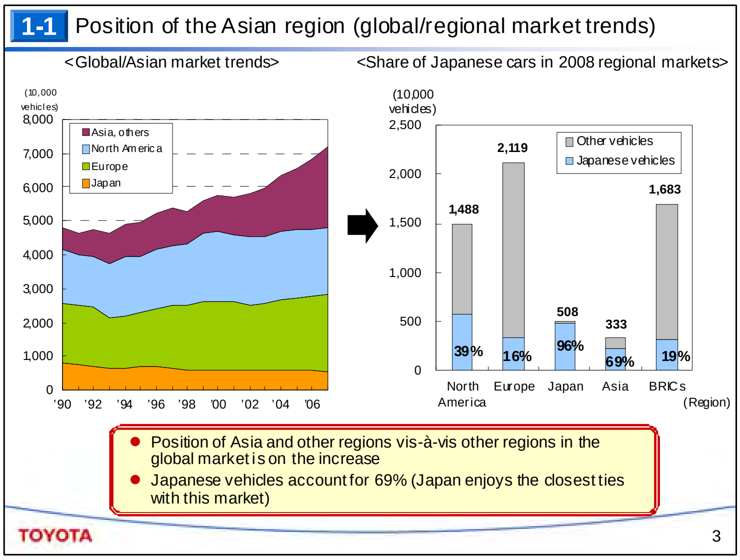
5. Structural Change Required in the Asian Automotive Industry[3]

Akira Okabe

Senior Managing Director, Toyota Motor Corporation

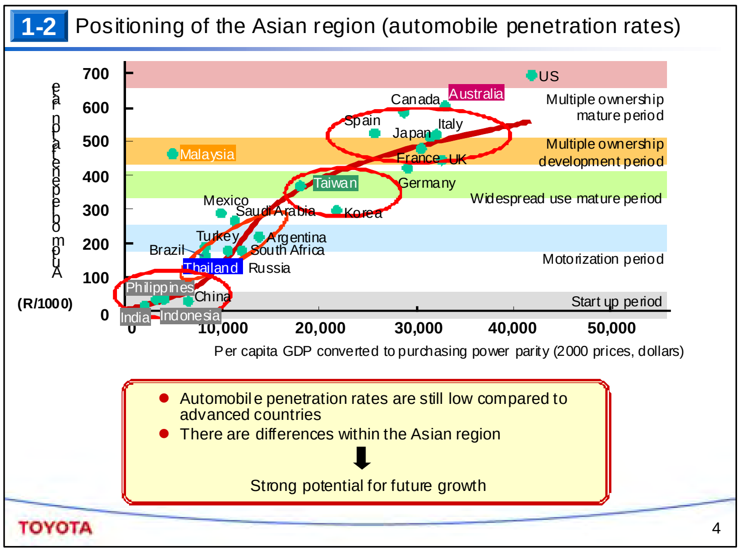
Thank you very much, Mr. Watanabe. Well, Mr. Gyohten asked me to talk about the current situation as I view it from the perspective of an automotive industry, and I have just listened to the presentations by three panelist members and my approach may be somewhat different from those taken by three preceding speakers, but please bear with me.

This slide shows what I am going to talk about – starting with the introduction to Toyota's Asian operations, I will cover four topics up until the perception of the medium and long-term environment. Now, Asia here in this context would include ASEAN countries in which we conduct production businesses, Taiwan, India, and also Australia, with which Japan has very close ties through FTA. So those will be the countries included in the Asian region.



(Chart 1)

(Chart 1) First, let me talk about the position of Asia in the automotive industry. As shown here on the left, the markets of Asia, BRICs, and the Middle East have been expanding year after year and now have their market size equivalent to the markets in the United States and Europe. As shown on the right hand side, the Asian region has now 3.3 million of market size and its share of Japanese cars is very high, revealing its close ties with Japan. India is included in BRICs on the right.



(Chart 2) This shows the trend of

(Chart 2)

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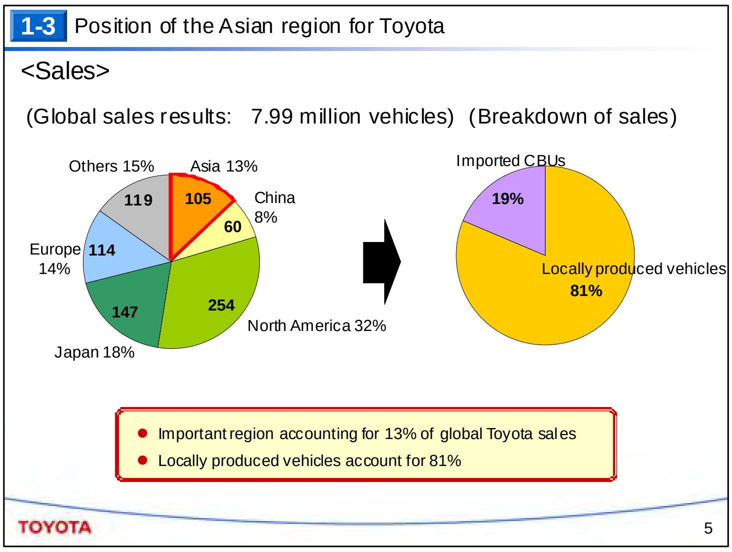
3 For the full color charts in this text, please refer to our website. http://iima.or.jp/pdf/sympo_speach/Mr_Okabe_Presentation_E.pdf

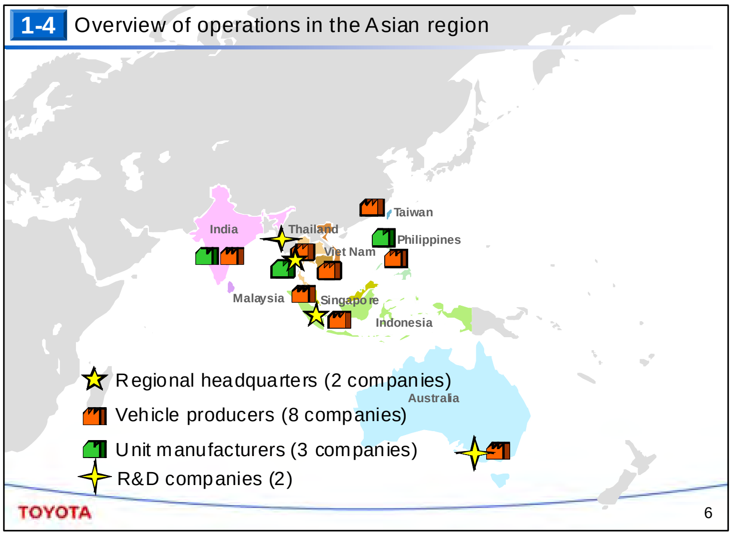
motorization in each Asian country. The abscissa shows income level, the longitude shows the vehicle penetration per 1,000 people. Motorization proceeds toward the upper right hand and you see in a little below the center Thailand which is approaching the motorization period, whereas Malaysia and Taiwan are in widespread usage matured period with more people beginning to own multiple vehicles. On the bottom left hand side, India and Indonesia are still in the start-up period of motorization. With a very large population in both India and Indonesia, we expect their markets still have a potential for explosive expansion going forward.

(Chart 3) This shows the position of Asian region in the Toyota's business. In terms of the sales, of the 7.99 million units we sold throughout the world in 2008, Asia accounts for 13% with 1.05 million units and as shown on the right pie chart, 80% of those vehicles were locally produced.

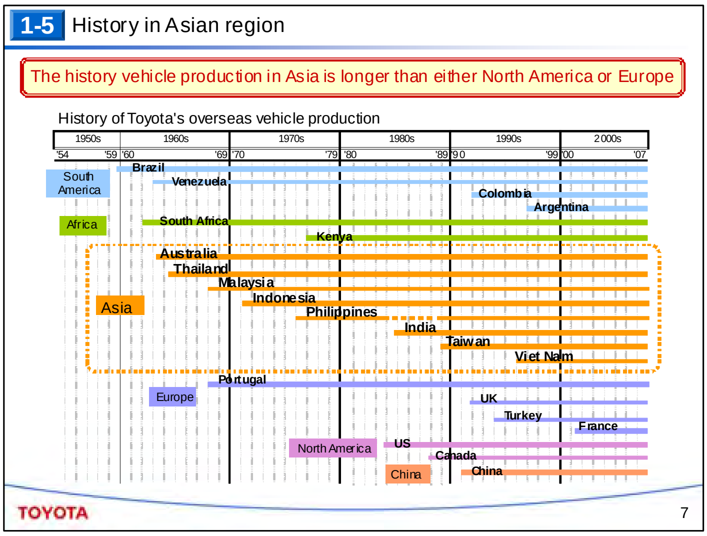


(Chart 3)

(Chart 4) In the Asian region, we have sales and vehicle production affiliates in each country. In the past, those vehicle producers mainly produced cars for domestic market, but Thailand, Indonesia, and Australia are growing their exports to the outside world to have become global bases for vehicle production. And we have three unit production companies producing engines and transmissions and they are exporting those engines and transmissions to assembly plants throughout the world. And to support and consolidate manufacturing affiliates, we have regional headquarters in Thailand and Singapore, and we have research and development bases in Thailand and Australia, so we are now enhancing our functions to make local affiliates more self-reliant.

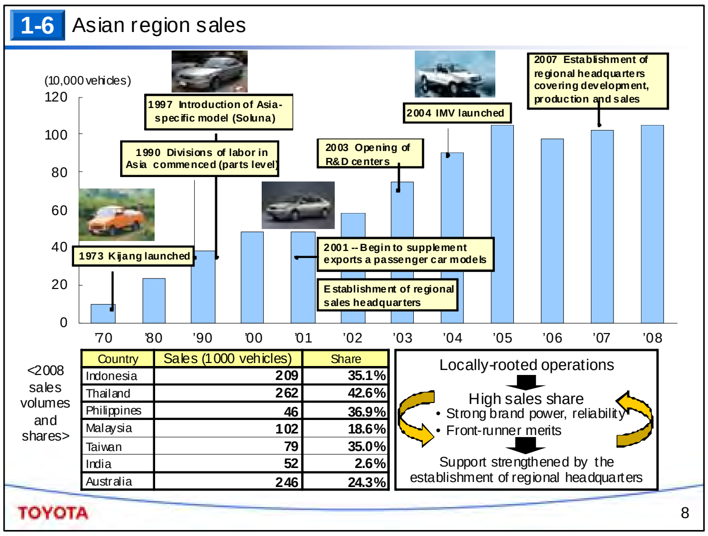


(Chart 4)



(Chart 5)

(Chart 5) This shows the history of our business in Asian regions shown in chronological table. During the 1960s we began business in Australia, Thailand, and Malaysia, and in the 70s in Indonesia and the Philippines. So we have been conducting business activities in those Asian countries in response to the local needs much earlier than in the United States and Europe. In that context, as each country and market grew and expanded, our business increased positively.

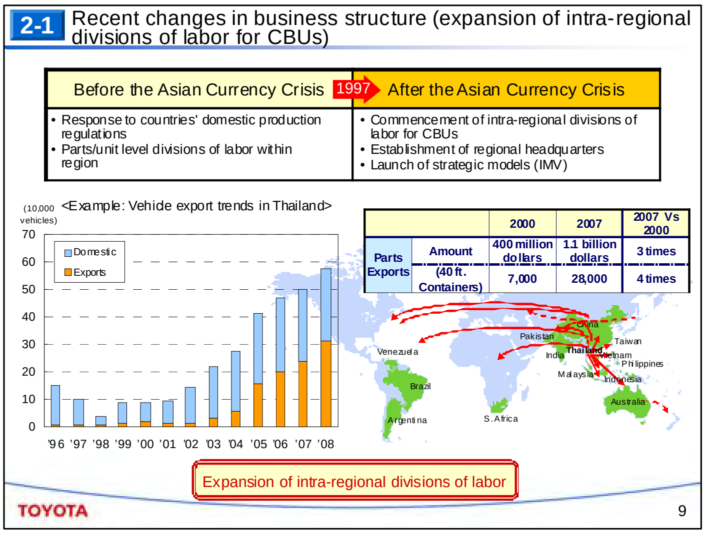


(Chart 6)

(Chart 6) In 1973 we introduced Kijang, the multipurpose commercial vehicle exclusively for Asia. Kijang was first introduced to Indonesia, and since then we have carefully responded to each government in terms of their request for investment and local production policies. During the 1990s we began division of labor in production of parts and units within the region. This was in response to ASEAN countries having regional agreement to allow export and import of parts produced within the region at low tariff rates, and this allowed us to leverage economy of scale in our production activities, resulting in rapid development. In 2001, we established the sales regional headquarter in Singapore and an R & D base as well as a production support base successively.

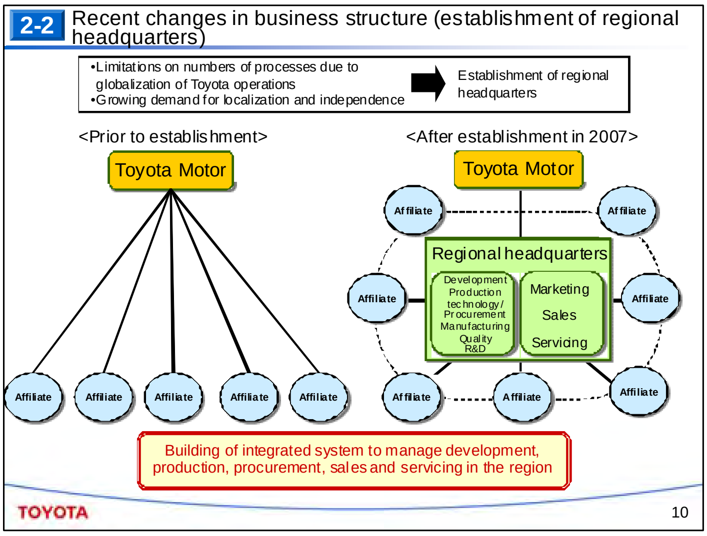
(Chart 7) Next, let me refer to the changes taking place in the recent period. This brings me closer to the topic of today's symposium. As I mentioned earlier, in the past, we mainly produced vehicles for the domestic market in line with each country's policy of domestic production of automobiles; that was the basic pattern. However, as ASEAN countries agreed on intraregional liberalization, we began fully-fledged exports of completely built-up cars within the Asian region since the Asian economic crisis of 1997, and the scale of that is shown in the graph on the left hand side.

In Thailand, we export 310,000 units which exceed the volume for domestic Thai market. As shown on the right hand side, our exports of parts increased three times the size of 2000. And in promoting those businesses, we established regional headquarters in the background of Toyota's operations becoming more and more globalized, and expanding very rapidly. The development of production resources were not keeping pace with that expansion, that is to say, our logistic line had been overextended, and therefore in the Asian and ASEAN region we urgently had to achieve localization and greater self-reliance of local operations.



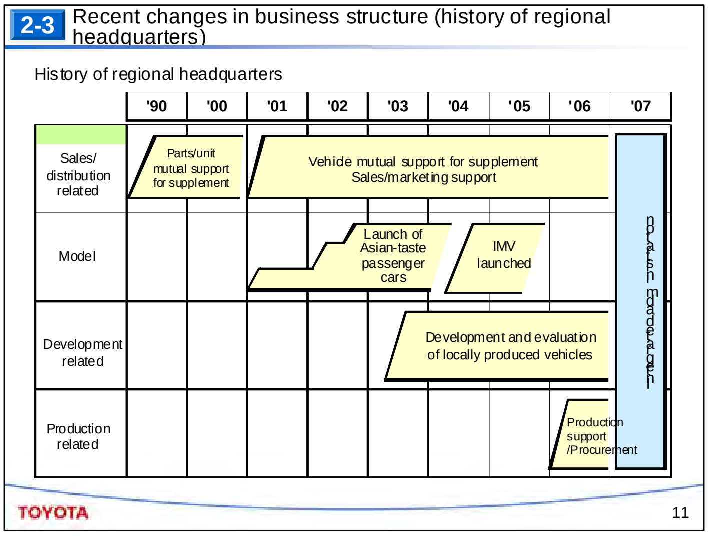
(Chart 7)

(Chart 8) And that is shown here. Prior to that, the Toyota headquarters here in Japan had direct communication individually with affiliates in each country, but with the regional headquarters established, the regional headquarters obtained opinions of local affiliates and consolidated the regional view and communicated with Japanese head office. And this allowed the business to be completed within the region practically.



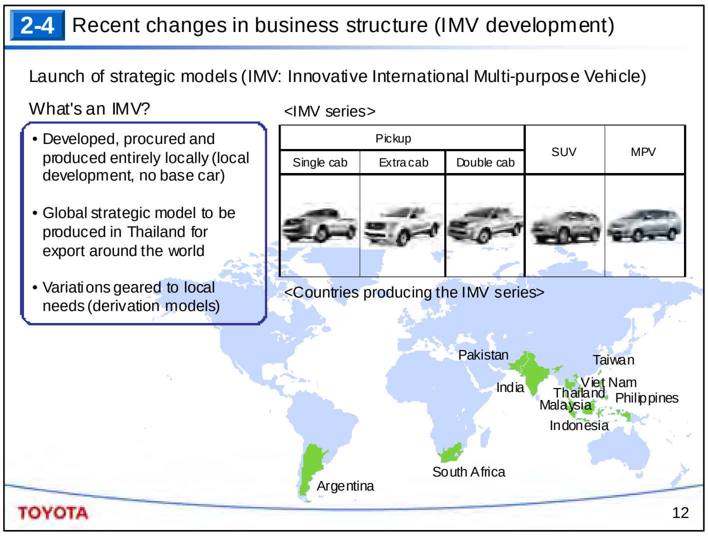
(Chart 8)

(Chart 9)This shows a history of enhancing regional headquarters. In 1990, we began to establish the scheme of supporting mutual complementary supply of parts. In 2001, we



(Chart 9)

established sales regional headquarters, and in 2003 integrated research and development function. And two years ago in 2006, we expanded them into the regional production headquarters. In 2007, we consolidated those to form integrated regional headquarters.



(Chart 10)

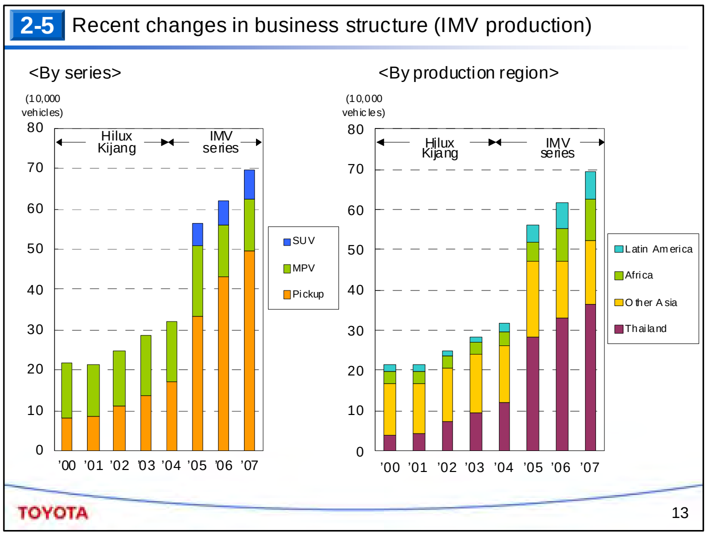
(Chart 10) The basis of that is what we call IMV which stands for Innovative International Multi-purpose Vehicle. The characteristics of this project in Thailand were to complete the activities starting from development, procurement, and production locally. This was indeed epoch-making. What do I mean by that? Prior to that, when we produced vehicles in Southeast Asian countries, the base model was developed in Japan and that base model was assembled locally with the parts supply coming from the mother plant located here in Japan. However, in this IMV project, we conducted thorough examination with respect to the ease of local manufacturing, local sourcing of parts among others, and those activities were completed locally with a local initiative.

The second characteristic was that the product was originally designed for Thailand, but it was to be exported not just within Asia but around the world. So this IMV occupied a very, very important pillar position as a strategic model for the global operation of Toyota. And the IMV spread to South Africa, Argentina, and India where the production began to be made locally. Previously the exports of the parts and the training used to be done here in Japan, but with the IMV project they were completed in Thailand. The third characteristic was that, as shown on the right hand side, we had five basic models to meet the various needs of the customers. Although frames and chassis were shared amongst those five models, the upper body of the vehicle was modified, to suit the preferences and requirement of each market, in keeping with the needs or tax system of each country.

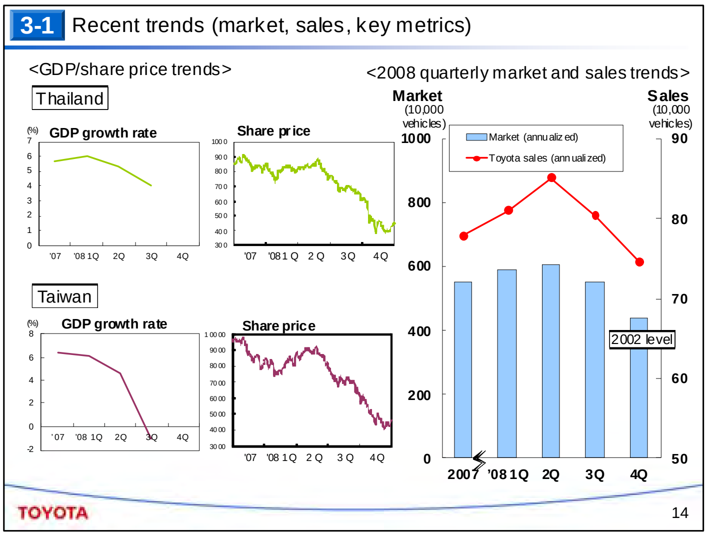
(Chart 11) As a result of that, as shown on these graphs, the IMV project has proven to be a big success showing good results in each of those countries and various variations of vehicles are currently produced in various parts of the world. As I said, we have five basic models, and the sales volume was actually three times more than we had originally anticipated. However, as we are discussing in this symposium, the global economic and financial crisis seriously affected not just Toyota’s business but automotive business in general in Asian countries.

(Chart 12) Various indicators are shown in this slide, and similar explanations have been already made by previous speakers. Especially with respect to the automobiles and consumer durables, the finance companies had to decline the application of credit in many cases. So unavailability of finance or credit squeeze prevented the customers' need to reach to the completion of sales, and that resulted in substantial drop of the market, back to the levels prevailed 7 – 8 years ago, and the decline still continues today. Every month the actual result of the market is below our expectation or projection.

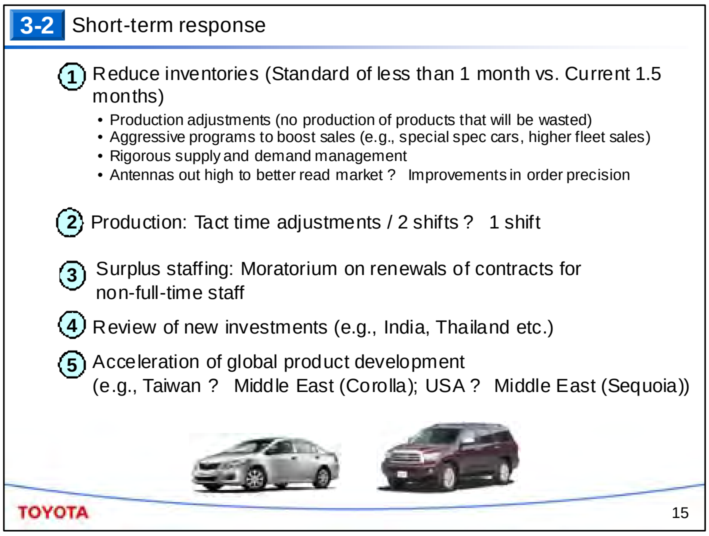
(Chart 13) So in terms of short-term measures, we are resorting to the following measures; first of all, reduction of inventories. Normally we keep the inventory level to one month or less. However, because of the substantial drop in sales, the current level of inventory is equivalent to 1.5 months' sales, or actually 2 months'. Together with the production adjustment, as often reported in newspapers, we stopped renewing in some cases contracts for non-regular employees. We have been forced to do that. We are also putting the planned new investments under scrutiny and reexamination.



(Chart 11)



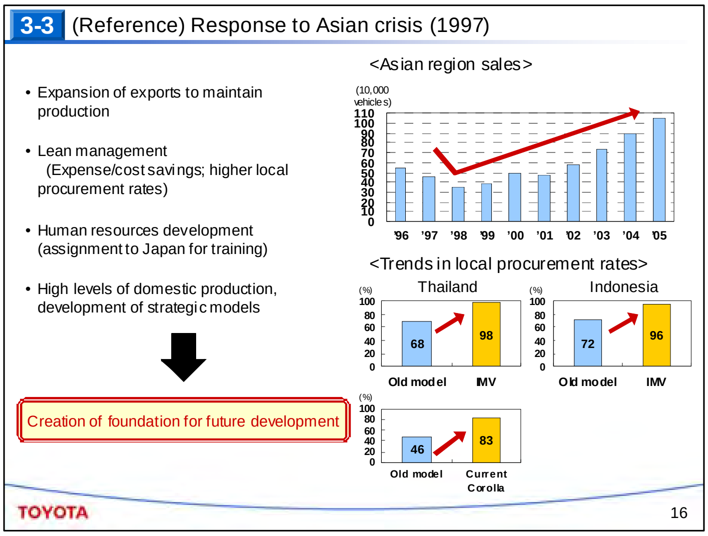
(Chart 12)



(Chart 13)

(Chart 14) Just for your reference, let me just share with you what sort of responses or measures we took at Toyota on the occasion of

Asian economic crisis back in 1997. In response to the sharp downturn in demand during the Asian crisis, we first of all started exporting vehicles from Asia, and we made ourselves much leaner, and we invited to Japan the surplus human resources which we had in Asia for training purposes. We also initiated IMV project that I explained earlier, and through this project we were able to lay the foundation for the subsequent V-shape recovery. However, this time round the crisis is not just limited to Asian region, the crisis is taking place simultaneously throughout the world, requiring us to conduct a complete overhaul of our business model and implement so-called paradigm change. That is how I recognize the current crisis.



(Chart 14)

One of the points for considering the required paradigm change would be how to address the FTAs or further liberalization. This I am sure will be dealt with or taken up in the panel discussion.

In this general context, we are confident that here in this Asian region the market will recover without doubt since Asia represents an emerging market. But the recovery that we are likely to see in Asia would be characterized by greater preference of customers for small and inexpensive cars with excellent fuel efficiency, and at the same time we will see increasing trend towards liberalization and borderless economies which will result in heightened new competitions that we have to prepare. Furthermore, we are likely to see diversification in fuel sources, not just gasoline or diesel oils that we used to use for vehicles, but in keeping with the policies of each country, we will be using diverse fuels, CNG and others.

And together with some changes in the external environment, we are likely to see some changes internally within Toyota. We will continue to enhance regional headquarters and regional business structure, and at the same time we expect the supporting industries, including parts-supplying industries, feeding into the automotive industry to grow and develop further. Unless we play an active role to contribute to the local communities and regional economies, we are not likely to see a true recovery of the markets in this region and we are determined to particularly focus in developing human resources as a top priority.

If I may focus on the paradigm change we are discussing today, as I mentioned earlier, a direction that we will pursue would be the development of locally completed models. That is to say, development and production of vehicles in keeping with the regional needs and that is not dependent on Japan will become important. In other words, the production and development of vehicles that is easy to produce locally and that uses locally available resources will be very important. In essence, it will require us the second or third round of IMV project. And at the same time, we need to develop a more self-sustaining projects grounded in Asia for our further leap forward. We will make efforts to tailor our business systems to meet the recovering demands expected in this region.

In that regard, as Mr. Gyohten mentioned at the outset, it is very important for us to achieve switch from vertical integration to horizontal integration, and that I believe holds the key in this regard. The vertical integration uses products designed and produced in Japan for advanced industrialized countries as the base and their copycat models were locally assembled in Asia. That was the pattern of vertical integration in the past. But going forward, we need to focus on horizontal integration that makes maximum use of local resources for development and production of vehicles or products distinct from those for advanced industrialized countries, and we need to develop and produce compact vehicles that cater to the local preferences and needs. The product lining must be in keeping with local regulations, tax system, and usage environment, and we also need to train local human resources for that. At the same time, we need to establish the division of labor that uses local parts as well. In terms of the availability of various resources and especially with its cost advantage, I believe India represents not only a very appealing and attractive country for production but also a country with a great potential demand for automobiles.

Thirdly, this might sound a bit premature, but I think it is very important for us to introduce the latest state-of-the-art technology as early as possible to the Asian region, leading the way to the development of a sound motorization. The earlier in the stage of motorization a country is, less investment will be required for the development of social infrastructure. And it is to these Asian countries in the early stage of motorization that we need to make early and effective transfer of know-hows and new technologies cultivated in Japan to avoid environmental damage or congestions, in my view. And in terms of fuel, CNGs, LPG, ethanol – those alternative fuels will have to be developed. In the past, development of those alternative fuels typically took place in and for the benefit of the advanced countries, but from now on we will need to reorient our product developments towards Asia and other emerging countries with accommodating their requirements and preferences.

Lastly, but not the least, to give impetus to the further motorization or further industrial development, I think we are called on to take policy measures or establish framework to serve as a trigger. Frankly speaking, the introduction of new technology entails higher costs and higher prices, and it is all the more important to consider what sort of incentive is required to achieve greater penetration or spread, how to promote horizontal division of labor, what sort of infrastructure need to be developed to nurture supporting industries. As liberalization makes headway, it is also important how the local industries should be maintained or what sort of balance should be maintained between liberalization and local industry development. I think these issues really call for very serious exchange of views with the government of each country and the private sector. That is to say, we need to work closely together with the government authorities to nurture automotive industry. Not just basing our consideration on givens, we would like to communicate and discuss on what needs to be done with the policymakers of each country in order to achieve horizontal division of labor. Thank you very much.

6. Panel Discussion

Moderated by Yoshihiro Watanabe

Managing Director, IIMA

Watanabe: This is a program where we will further deepen our discussions amongst the panelists. So far we have received insightful presentations from them but time was limited, so I think there are some issues or challenges that require more discussion, and I have prepared five issues or points for discussion.

First of all, there are two or three questions that I would like to raise in regard to the perceptions of the current situation, and also with regard to measures and responses or actions taken so far. We would also like to hear a bit more about regional cooperation and regional trade, which were cited as being very important to enhance within the Asian region. Also, we would like to have a further discussion on the linkage of Asian economies to the global economy, or find out if they are actually decoupled, one of the main themes of this symposium. Particularly, India and China seem to be the countries which can get out of the current situation independently, so decoupling may work there. Also, we would like to ask some questions concerning global paradigm transition. Given the enormous changes in the environment, what about the mid and long-term challenges that Asia will be facing? Of course, our speakers have addressed those points to some extent but especially in the cases of China, India and Japan, what kind of contribution can we make in this global environment? This is the subject matter that we will take up during this time.

First, reviewing the current situation and its impact on Asia, how do we perceive the impact that has been felt in Asia? Dr. Lau from Hong Kong, I would like to ask you first. About China and decoupling theory, I think there is some sort of a perception gap in and outside China. People seem to have different perceptions about this. Chinese Premier Wen Jiabao said in Davos that China is going to maintain 8% growth, and a fiscal and monetary program of 4 trillion Yuan was introduced. So, various actions have been taken under Wen's leadership. However, the IMF is saying that China's growth is about 6%. Now, Dr. Lau, you said earlier that exports are declining, but because of the low value added structure in China, the impact on the GDP is not all that significant, and in the meantime, asset prices are declining significantly in China, so I would like to invite further comments about the situation in China. Dr., please.

Lau: Thank you very much. I think one really has to think of the exports in two ways. One is repeating what I said, namely that the domestic value-added content of Chinese exports is actually very low, and that is a fact. And I think the Chinese government realizes that it really cannot export its way out of this crisis, and that is why the solution really is to propose an economic stimulus package that is mostly based on internal demand, and in particular on domestic infrastructural investment. So I think that is the way to go. Also, you can see that China has not really made any attempt to devalue the renminbi for the same reason, that is, you really cannot export your way out of this crisis, even if you want to. So I think that that point is really quite clear that the export is not going to do it.

And there is a short-term point that I am trying to make and that is this huge drop in exports since September is really temporary, and it is really caused by the credit tightening in the developed economies. And nobody can imagine that US demand for imports can drop by 50% on a permanent basis. That is just clearly not possible, no matter what kind of adjustment you want to make. So I think exports will recover some, but fundamentally the economic recovery in China really has to come through growth in internal demand. And there are many areas: the repair of the earthquake-damaged regions could use up a lot of resources; rebuilding schools, hospitals could also use up a lot of resources, and new urbanization in different areas would also use up a lot of resources. So I think there is still a great deal of scope for public infrastructure investment. And with inflation running very low now – it is close to 1%, I am reasonably confident that China can achieve a growth rate of between 7% and 8%.

Watanabe: Thank you very much, Dr. Lau. Many of you said earlier that in China, India, and other emerging countries recovery could come quite quickly, even earlier than the US recovery or the global economy. I would like to ask the following to Mr. Gyohten. In advanced countries, the financial sectors' loss continues to expand or continues to be registered, and without that being resolved, do you think it is difficult for the advanced countries to really achieve economic recovery? The problem started in the United States and the US government is planning to spend a huge amount of money to stimulate the economy, but despite that many people say that it will take a long time for the US recovery to take hold because it will take time for the US household sector to restore its confidence. So could you talk about the pattern of recovery in the advanced countries?

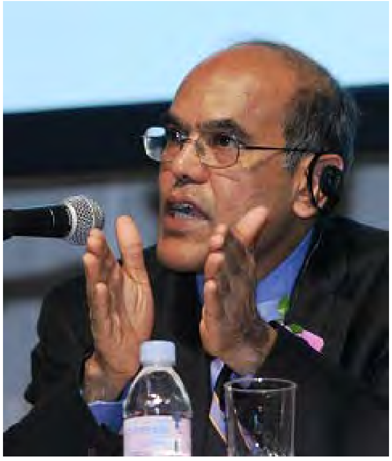
Gyohten: When it comes to the global economic recovery and especially with respect to the economic recovery in the United States, well, eventually the economy will hit the bottom and start moving upward. Are we likely to see the turning point by the end of this year or it is going to be next year? I believe we are more likely to see the recovery starting next year but judging from what is taking place currently, I think it is very difficult for us to foresee a V-shaped recovery. Even if we do see some recovery, it may be L-shaped or U-shaped at best, because for one thing, adjustment in the financial sector is likely to take some time. The process of deleveraging is indeed a very difficult and tough one which requires time. With respect to the real sector of the economy also, judging from the patterns of consumption and investment as I mentioned at the outset, we are not likely to see said consumption or investment recovering to the past levels. Taking all these facts into consideration, I do not foresee the speed of the recovery to be very fast, even if it starts next year in the United States.

Watanabe: Thank you very much. Mr. Okabe, this one is for you. With regard to the financial crisis and the sales of automobiles, the two do not seem to be really related but yet your sales are declining globally. Do you think they are related to any impact of the financial situation on auto sales credits or others? What is your take on this?

Okabe: Well, in the case of automobiles, it represents a big-ticket item for consumption next to houses. Throughout the world, the markets are consisted of three kinds of demand, new demand for the vehicles, demand for replacing the existing vehicles with new ones and demand for buying additional cars in addition to what you already have. And especially in developing countries or emerging countries, there is a greater percentage of completely new demand for vehicles. And those people buying new vehicles do have out-of-pocket financial resources to buy them, but it is rather common for most consumers to use auto loans to buy a car. Unfortunately the financial institutions offering auto loan have lately become very conservative and tightened their screening standards. That means that much difficulty for new car sales. And in the case of down payment, they now require more, for example, up to half of the price as against 20 percents in the past. And this is one of the reasons causing downturn in the auto sales. Therefore, as Mr. Gyohten had just mentioned, unless the financial sector recovers fundamentally, the installment sales industry supported by credit will not be able to see full-fledged recovery, and therefore I think this takes a little more time.

Watanabe: Thank you for that, Mr. Okabe. So the consensus is that the severe situation is expected to continue for a while. Now I will turn to the next point of discussion. Given the current circumstances, it was said that the economic actions have been taken at all countries' pleasure and they are also pursuing regional cooperative initiatives. But what further specific action must we take? First, let us take stock of the current set of actions being taken in India. Mr. Subbarao, here is a question for you.

Earlier you said India is linked to the global economy through several channels, and India is a part and parcel of the global economy. Now, India's current account is in a deficit. Fiscally, the situation so far has been rather severe but because of the declines in resources prices, there were some positives working for India. However, the reversal of capital flows or the money out of India is now, I think, making it very difficult to steer your country through this economic situation compared to the countries whose current accounts are in a surplus or whose fiscal coffers are full. I think that your situation is rather more difficult. Therefore, would you elaborate on your views about the economic actions being taken in your country and the feasibility of said actions, etc.?



Subbarao: Thank you very much. You are right that India is unique among countries, emerging economies facing the crisis because we have a fiscal deficit which has gone up now in this year because of the response to the crisis, and a current account deficit. I believe the only other country which has both these deficits is Korea. So, because of these deficits, it is even more challenging for us to manage the crisis. The IMF chief economist came to Mumbai last week, and he spoke to us. He said that they did a survey of countries about their ability to respond to the crisis and what they found was that the perception of external agents on an economy is shaped more by the current account deficit than by the fiscal deficit. So, as much as we have both the deficits, it is the current account deficit that shapes the external perception more than the fiscal deficit. To that extent, I think India is slightly better off because, as I said earlier in my presentation, as much as both the fiscal deficit and the current account deficit will be inferior to what they were last year, the current account deficit is going to be only modestly so, mainly because imports are going to shrink more than exports. So, we will be able to manage the current account deficit. That is the first response to your question.

The second response to your question is about the fiscal deficit. Yes, as I had said earlier, much of the 80s and much of the 90s, one of the big problems of India was huge and mounting fiscal deficits which ran very high. If you had fiscal deficits because governments were borrowing money to invest in infrastructure or for other capital spending, that would not have been so bad. But in India, governments both at the center and in the states were borrowing money and spending that money on what we call revenue expenditure, which is current expenditure. Now that is not sustainable. If you are borrowing money, you must invest that money so that that investment generates returns with which you can repay the loans. But if you are borrowing money and spending that money for current consumption, no matter how justified, the governments are going to increase their debt. That was what was happening in India much through 80s and through much of the 90s. So, we came up with this Fiscal Responsibility and Budget Management Act which had legally mandated both the Central Government and the State Governments to bring down their fiscal deficits. We were very much on the track to fiscal consolidation until the crisis hit us. The target fiscal deficit set by the FRBM Act is 3% of GDP for the Central Government, 3% of GDP at the aggregate for the states, so together 6% of GDP. This year, 2008-09, the expectation is that the combined fiscal deficit of the Center and States is going to be as much as 10%. So, that is a concern. And the other concern is, all right, this year we are going to spend money, we are going to borrow and spend money, but how do we wind it down in the future? That is a bigger challenge, especially in a vibrant democracy like India. Thank you.

Watanabe: Thank you very much. All of you have been emphasizing the need for regional cooperation and intra-regional trade. President Kuroda of the Asian Development Bank, I would like to ask you about this point. In your presentation, you referred to the Chiang Mai Initiative, which is a funding cooperation mechanism through swap arrangements. Also, ADB is extending its lending capacity on its own. While some countries very highly evaluate and assess the Chiang Mai Initiative, this time around it was not used. It was the US FED which offered the lending hand of swap facilities to South Korea. What do you think of the ease of use of the Chiang Mai Initiative? Is the Initiative really user-friendly? In other initiatives for regional cooperation, there is the Asian Bond Markets Initiative or the expanded trade insurance networks that have been facilitated. I would like to invite your further comments on this point. Also, there are a lot of expectations placed on you as to what you can do to enhance cross-border trading in an environment where, amongst the industrialized countries, there is a trend toward a kind of financial protectionism that gives priority to each country's agenda first. However, ADB is expanding cross-border activities on which high expectations are placed by the private sector as well as by developing countries. Now, your initiative to expand your lending lines will be a crucial part of this. I would like to ask you, what is the current status and also what are your policy views about this?

Kuroda: Thank you for your raising a few important questions. First, on the Chiang Mai Initiative (CMI) this is of course for short-term liquidity support. The total amount of bilateral swap arrangements is now about $80 billion, which is something, I think, and ASEAN +3 countries are determined to further improve the mechanism of the Chiang Mai Initiative by way of multilateralization and so on and so forth. Also, I understand they are going to substantially expand the amount of total resources under the CMI. Now, it is true that at this moment $80 billion Chiang Mai Initiative bilateral swap arrangements have not been actually mobilized. That is partly because none of the ASEAN +3 countries currently face the balance of payment crisis or liquidity crisis as some of them faced 12 years ago. And also, the existence of the Chiang Mai Initiative tends to help stabilize financial markets since a sizeable safety net could provide some confidence among market participants in the ability of those countries to manage any possible balance of payment or financial difficulty.

The second question is related to the current crisis situation. Now, even countries like Indonesia, which has still current account surplus and very low fiscal deficit, face fairly high risk premium in the capital market. I mean, actually except for China, almost all emerging economies in Asia now face very high risk premium. That means that their investments in infrastructure, education, and healthcare are very difficult to be financed in the capital market. If those countries face 600 basis point or 700 basis point of risk premiums, that would be almost prohibitive to borrow money for investment. So this is a challenge now faced by most of emerging economies in Asia.

So here is ADB, the World Bank, or JBIC. Those public sector development banks or public sector financial institutions could provide low-cost, long-term financing for development investment, infrastructure investment and so on and so forth. And certainly ADB needs a substantial capital increase because ADB's last capital increase was made in May 1994 – almost 15 years ago. Although the bank is quite sound and well managed, unless we are given more capital, we cannot expand our financial operations. So we are asking shareholders for a substantial capital increase, like by 200%, and even if 200% capital increase is agreed, only about 4% of the increase must be actually paid in. The remaining part is so-called callable capital, kind of a guarantee by shareholders. So it is a very efficient way to substantially increase development financing, long-term low-cost financing to developing countries emerging economies through relatively small amount of fiscal cost to shareholders. I am quite sure that by our next annual meeting to be held in Bali, in early May, our shareholders would agree on a substantial capital increase so that ADB could continue to provide long-term financing to developing countries and also to address the current financial crisis which actually substantially increased requests of financial assistance from emerging economies.

Watanabe: Thank you very much, Mr. Kuroda. In connection with this particular topic, I would like to ask Dr. Lau the following question that relates to the Chinese renminbi. There has been some row or a debate between the United States and China regarding the renminbi. You mentioned earlier that not just the renminbi, but also the Japanese yen was one of the exceptional currencies in the current crisis that remained stable or very strong. Regarding this row between China and the United States on the renminbi, could you elaborate on your comments to some extent or share your views with us?

Lau: Let me go back and point out the following. If you really look carefully at the Chinese trade surplus, there really was not any surplus vis-a-vis the world until 2005. One must not lose sight of that. Even though there is a large surplus vis-a-vis the United States, we know that a bilateral surplus or deficit alone really does not have any bearing on exchange rate. However, politically, the bilateral trade surplus is used by politicians all the time, but that is of no relevance here. What is really relevant is the global trade surplus and current account surplus, and I think that has actually hit a plateau and will be declining in relation to GDP. The renminbi actually has appreciated since 2005 by more than 20% and that is also a fact. So there has been an adjustment. I think that people really ought to realize this fact. I really do not believe that these imbalances can actually be helped by an appreciating renminbi, just as the appreciating yen did not help narrow the US – Japan trade deficit for the longest time; the deficit is still there.

So I think what is required are somewhat different ways of addressing these global imbalances; not through the exchange rate adjustment alone. Having said that, I think right now at this very moment what the world really needs is a stable monetary environment. The last thing you want is huge changes in relative exchange rates, and that is really behind why I said earlier that the yen is really a little too high and the won is really too low. We need to coordinate so that we come to a reasonably sustainable set of relative parities. Now, that is easier said than done, but I believe that is what needs to be done.

Now to be more practical, if you ask yourself how the renminbi could be appreciated today, that can only be done by the Chinese Central Bank selling US dollar assets and buying renminbi assets. But this is not the right time to sell US dollar assets in a massive way. So my view is that it is much better for the time being to have a stable renminbi against the major currencies in the world, especially the US dollar. However, the adjustments ought to be made by other currencies that are either I think perceived as being really too high or too low for the purposes of the global recovery.

Watanabe: Thank you Dr. Lau. Let us move on to the next point of discussion, which is one of the main themes for this symposium today, namely, the linkage, or decoupling, between the Asian and global economy. You have all given us your opinions about the linkage or decoupling, and suggested that a deep linkage exists. Within that framework the Asian economy achieved a remarkable development. At the same time you also mentioned that the Asian economy and Asian financial and monetary architecture are still vulnerable, and that there are structural weaknesses. So regarding decoupling theory, do you have any additional comments you would like to make, Mr. Kuroda?

Kuroda: Decoupling or coupling, I mean 100% decoupling or 100% coupling, both of them are of course unlikely. I mean anyway we are living in a very much globalized world. That means that major economies are interdependent. Asia may be dependent on the US and Europe, but also the US and Europe would be dependent on Asia. So interdependence cannot be denied.

On the other hand, it does not mean that you have to adopt the kind of fatalism. I mean, once US or European economies experience a kind of recession, Asian countries cannot avoid being affected, and also would experience a similar kind of recession. I do not think that is quite correct, because there are some policy measures in Asia which could mitigate the negative impact coming from US and Europe. Actually the most of the emerging economies, the developing countries in Asia have been making monetary easing as well as introducing or implementing fiscal stimulus measures.

Of course, fiscal stimulus measures would have some fiscal implications, long-term implication to debt and deficit. Also, of course, balance of payment implications of fiscal and monetary policy must be taken into account. That means that any policies, any fiscal measures, would be tailor-made in each country depending on its fiscal space, balance of payment constraints and so on and so forth. But if you look at China, India, Indonesia, and then you can find that all of them are making utmost efforts to mitigate the negative impact coming from the global financial crisis and economic downturn. And I think their policies would have some positive impact on their economic growth and the financial sector.

Thirdly, we frequently say that decoupling is not true. That is in some sense prima-facie true. Because if you look at the economic growth in the world, then you can find much synchronized movement, although, I must say that policy response could mitigate the impact. But if you look at the long-term trend, actually, Asia has been growing quite rapidly in the last 10-15 years, while OECD countries including the US, Europe, Japan have been relatively stable or stagnant. So Asian economies continue to grow and accelerate growth while OECD countries stayed relatively stable. From a medium to long-term perspective, there has been actually decoupling, particularly between Asian emerging economies versus the US, Europe, and Japan. I think you have to be careful when you criticize or argue for decoupling. You have to specify the time span and you have to specify what are to be taken into, only it's sort of natural impact or some policy response included, and so on.

Watanabe: Thank you very much, Mr. Kuroda. This debate has so far related to how one view and recognizes the current status, and from here on, we would like to turn our attention to the future course. We talked about the possible shifting of paradigms in the growth strategy, the financial system, international monetary and financial structure. What are the changes the global crisis may bring about? Especially in regard to the growth model for emerging countries in the 21st Century, how different would it be from the past models and what would be the future course of financial institutions and markets in Asian countries? Those are the topics that I would like to take up in the following part. With that, I would like to ask Dr. Lawrence Lau first, regarding the growth strategy of emerging countries.

In the past, financing through the foreign capital inflows to achieve rapid growth was the basic growth model, but some reflection on that is now taking place in my view. In that context, what would be the growth model for Asian Emerging Countries? Could you share your insight with us, Dr. Lau?

Lau: I think the East Asian countries are fundamentally quite different from other emerging countries, because they really have very high – relatively high saving rates. That really makes a tremendous difference in the intermediate to long run. Because if you borrow foreign capital as the Latin American countries do, you can actually grow very well for 6 years, 8 years, even a decade. But eventually you have to repay your lenders, and when that happens, it usually leads to a financial crisis and you devalue. Basically, you wipe out all 10 years of growth, and you start over again. But that is not the case in Asia. East Asian economies, with perhaps the exception of the Philippines, really have very high savings rates. So in some sense, they can all be self-financing if necessary. That is a very important point.

The second thing is that the East Asia has, in general, been very hospitable to foreign direct investment. And I make a distinction between foreign direct investment, which is a form of long-term capital, and short-term capital flows. I, myself, have never found short-term capital flows particularly useful for the recipient country. If you look at South Korea, it got in trouble last time in 1997 because it borrowed too much foreign currency short-term. And this time it repeated the same mistake, it has borrowed too much short-term foreign capital. And I think that if one can avoid using short-term foreign capital, one can actually achieve fairly stable growth for East Asian economies.

Finally, I want to add a point that Mr. Kuroda touched on. I agree it is necessary to try to develop a bond market for Asian countries, but my idea is not so much through a common currency, or US dollar based or even yen based bond market, but a bond market based on indexed domestic currencies. A lot of people would be willing to buy, say renminbi bonds or even rupee bonds, if they are indexed to inflation. If you can somehow work out a framework in which maybe ADB could provide some sort of slight enhancement, I think it is possible for the emerging countries to start borrowing in their own currencies, if it is indexed so that the purchaser 5 years from now on will still receive a positive real return, regardless of what is happening to the currency exchange rate or to the inflation rate.

Watanabe: Lastly, I would like to ask Governor Subbarao of the Reserve Bank of India the following question. Faced with the financial crisis in the United States and Europe, we are seeing intensification or reinforcement of regulations in these markets, whereas here in Asia regarding financial and capital markets, countries still maintain relatively tight regulations. As in the presentation made by Governor Subbarao, India has been thrown into the financial integration through liberalization, and thus the impact of the capital flows has been affecting India as well. India was not immune to the crisis. But from our perspective, in terms of the reform or opening of the economy, I think there is still some room and expectation for India to go further in that direction, opening the doors of liberalization. You still have equity ownership regulations for foreign shareholders and financial institutions and selective countries, as I understand. So, including the practical aspect of implementing regulations, what is India’s position and view regarding regulations? Governor Subbarao, please.

Subbarao: India’s position has always been that we must gradually open India to the external world. India is fully open on the current account, and we have a roadmap for capital account convertibility. Non-residents enjoy a fair amount of capital convertibility even under today’s regime, and the residents have been enjoying larger freedom under the capital account. And the policy is to integrate more fully, even on the capital account with the rest of the world. The question in the current context is, “Are we reviewing, are we revisiting, do we have any fresh doubts about capital account convertibility?” The short answer is “no.”

The long answer is the following. This crisis has thrown up some lessons about managing integration; about managing capital account integration. And we are going to learn from those lessons, and calibrate our roadmap based on the experience of those lessons. So the answer is that, yes, we are still committed to integrating with the rest of the world on the capital account. We are going to calibrate that opening based on the lessons of the current crisis.

Watanabe: Thank you very much. On this particular point, I would like to address the following question to Mr. Gyohten. It is often pointed out in the context of the current crisis that the world is now moving away from unilateralism of the United States to multilateralism. To put it in a rather extreme way, some people say that the hegemonic position of the US and the world structure based

upon US dollar is going to disintegrate, but in reality, we see the dollar appreciating. So, what will be the regime that we are likely to see in the global economies? What would be the weight of Asian economies in that regime? There seems to be some convergence of views that the relative weight of Asia will increase in the global economy, but what will be the likely picture or pattern of the global financial and monetary regime that we are going to see?

Gyohten: I believe the most important conditions would be how the US economy under the new Obama administration is going to transform. It is true that the national and economic power of the United States have not been hurt that much, but as compared with other countries, I think there has been some decline in the hegemonic position enjoyed by the United States on the global scene. When we discuss the role to be played by the US dollar through the recovery from the current crisis, it is important to see to what extent the United States is going to restore its financial institutions and financial system, and to what extent the United States can put the brakes to the unattended increase in its net external debt through the restoration of the consumption-investment balance. If the United States is successful in those endeavors to show it is following that path of recovery, even if slowly, and if that is recognized by the market players in the world, probably the confidence of the US dollar will not decline so much. If the opposite happens, in which the market could lose confidence in the policies of the new administration, there will be a huge downward pressure on the US dollar.

However, as I mentioned earlier, the greatest problem or greatest issue in that regard relates not just to the relative position of the US dollar, but to the fact that for the foreseeable future, we do not have any alternatives to the US dollar, be it the euro, the renminbi, or the Japanese yen. At least for the foreseeable future, those currencies will not have the power to replace the US dollar as a major key currency, and that makes the situation that much more difficult. Because on the one hand the future course of the US economic recovery is a bit nebulous and there is no alternative to the US dollar on the other, it means that it is likely that the world currency market and the financial market will remain rather unstable. Given such foreseen instability, I think we need to come up with measures through coordination achieved throughout the world to avoid or at least mitigate that instability. There may be various scenarios, but for the time being I believe the international financial conditions will become increasingly unstable; therefore, we should at least be prepared for that situation.

Watanabe: Thank you, Mr. Gyohten. We would like to go to the last item of discussion, which is about the mid and long-term agenda for this region. What should we be doing now? Particularly, what are the mid and long-term goals for China, India, and Japan to pursue? The damage felt in Asia has been relatively minor, and in Davos, China's Premier Wen Jiabao cited the creation of a solid post-crisis world and also the creation or achievement of financial stability as two challenges for us. Now Mr. Kuroda, what do you think are the priority issues that we should be addressing as the agenda for this region, and what is the medium and long-term agenda that we should be tackling?

Kuroda: I am quite sure that in the short run every government in Asia would try to avoid the worst kind of recession by mobilizing fiscal and monetary policies. And as I argued, of course, depending on the circumstances, I am hopeful that their efforts would have some positive impact on their economies in the short run.

Now medium to long run challenges are more difficult. You have mentioned Japan, China, and India. Japan already has a mature economy, with high per capita income, aging population, some difficult fiscal situation, so on and so forth. And her challenge is how to sustain medium term robust growth and how to consolidate its fiscal conditions in the medium to long-run and, like some European countries, aging of Japanese population is a big challenge.

Now on China; – China certainly has become very much dependent on exports for its growth, and I am quite sure that even after the US economy completely recovers from the current recession, the US would have somewhat higher saving ratio than it had for the last several years. That means that China cannot continue to rely on its exports so much to the US and other developed countries as a sustainable engine of growth. Of course, the exports continue to be very important, but not so much as it has depended for some years. And also China has huge investments already. Its investment ratio is one of the highest in the world and many economies expressed some concern about excess investment and declining rate of return of investment or capital. That means, for China, the challenge is how to increase consumption. That is to say how to reduce excess saving in the long run. This is a very tough challenge. Although I am sure that the government recognizes this challenge and eventually it would succeed in it, but it would be tough. It would take years to substantially increase consumption.

Indian economy is in some sense more balanced. Its export dependence is not so high and also it has very robust strong service sectors. And if anything, probably India should further increase exports, savings, and investment for industrial purposes, infrastructure, education, and so on and so forth.

So challenges are different, but that does not mean that these three countries as well as Korea, ASEAN and other Asian countries cannot, or should not or would not cooperate. Rather than that I think some complementarities would make collaboration, cooperation even more useful and important, and Professor Lau indicated exchange rate coordination is one of them. Asian countries should strengthen cooperation in bond market, safety net infrastructure and a lot of more cooperation areas in the coming years.

Watanabe: Thank you very much, Mr. Kuroda. We have just reached our scheduled session closing time, but that notwithstanding, I would like to invite each one of you to make one statement. The next one is addressed to Mr. Okabe. You are surely representing the multinational corporations operating in Asia, and if you have any requests for regional governments, what sort of requests do you have in terms of intra-regional policy? Would you like to see others free-trade agreements implemented or promoted on a regional basis?

Okabe: Yes, I think that will be one of the keys. Naturally it does not go with the liberalization that everything is free once the door is open. In the present day ASEAN, not just Toyota but all the automotive manufacturers are now engaged in divisional labor and it was because in the early part of 1970s Professor Yano of Keio University advocated the importance of division of labor, saying that the disparate policies should not be pursued in Asia. Asian countries wanted to have their own automotive industry, one wanted engine plants and the other wanted transmission, but since the beginning of 1980s they found that having those different parts of industries operated in different parts of Asia is not efficient enough. Therefore, the ASEAN governments took an initiative to move toward brand-to-brand complementation, a collaborative scheme within ASEAN. But no manufacturers, including Toyota Motor Corporation were able to implement the scheme right away because they had not made any capital investments to be able to even out the trade balances in the region. Therefore, since 1990 we tried to establish new plants in different parts of Asia so that we can strike a balance of trading relationship within Asia by making capital investments.

As is shown in my earlier presentation, automotive industry requires a long lead time to be established, and therefore both the government and private sector have to have close dialogue in order to implement the consistent policies, which each government should maintain even after the change of powers. The manufacturing industry requires good human resources, it means industrial base. The stable policy to nurture is required. So from that perspective, free trade will play a catalytic role, but within the framework of catalyst given what sort of pattern is pursued will vary from case to case or country to county.

So, how to strike a balance between the four challenges I presented earlier, is one important element and as Mr. Kuroda mentioned earlier, I think Japan has a very important role to play in that context. And what I would like to add in that context is that Japan must play a more proactive role for human resource development and for nurturing small and medium sized enterprises. Japan has been already doing that, but I think there are so many things we still need to do to really achieve horizontal division of labor here in Asia. So what Japan needs to do is to focus its efforts to strengthen the basic foundations. In that context, it is very important for both Japanese government and corporations to take initiatives toward further horizontal division on labor and industrial development.

I think Asia cannot live on the financial sector only. I think financial service is playing only an indirect role supporting the real activities in the economic sector. Therefore I think how to support the real economic activities through finance need to be further discussed.

Watanabe: Thank you very much Mr. Okabe. I would like to ask Governor Subbarao the following question. We just heard Mr. Okabe of Toyota talk about the potential that your country, India has in the auto industry, and it seems India has been following the East Asian type of growth model that has focused on manufacturing industry development. Are you going to focus more on that type of policy? If so, what will be the future growth model for India?

Subbarao: As I have said earlier, the main engine of growth over the last five years has been the service sector and services today constitute about, I think, nearly 60% of India's GDP. However, India has recognized that there cannot be sustainable long-term growth unless India makes a big step forward on manufacturing. So there has been a lot of emphasis and there will continue to be a lot of emphasis on the industrial sector, particularly the manufacturing sector. Not that we are going to deemphasize the service sector, but we are going to emphasize the industry and manufacturing sector as well.

The reason is the following. A lot of people talk about the demographic dividend that India is going to get, that the dependency ratio is going to come down, as there is going to be more young people. Unlike the rest of the world, there is going to be more young people, more earning age population in India that is true. The demographic profile is like that. But in order to get the demographic dividend, India will have to provide employment, jobs for these young people. That is going to be a big challenge. So in order to get the demographic dividend and in order to keep growth going, India will have to provide employment for this growing number of people and the only way of providing meaningful, effective employment to a large millions and millions of people who are going to join the labor force is to emphasize the manufacturing sector. So the manufacturing sector is going to be increasingly important for India on the way forward.

Watanabe: Thank you very much. At the end of panel discussion I would like to ask a question to Professor Lau. More recently China has been very active in engaging itself in regional cooperation and I would like to invite a comment from Professor Lau on that aspect. Dr. Lau, please.

Lau: I think China's recent more active stance reflects the seriousness of the current global financial crisis. In the past China has been quite willing to take a backseat and go along with whatever the developed countries have decided, the United States in the lead, and Euro zone, Japan and so forth. But I think the perception right now is that the United States has its hands full with its own problems and that what is going to happen particularly in Asia is very much up to the major players here. And as Mr. Kuroda pointed out, we cannot just leave things alone. I think China, Japan, Korea, and the ASEAN as well really have to collectively take things in their own hands and see what can be done to improve the situation, not waiting for the global recovery. I think the best thing that can actually happen to the extent that the Asian countries are successful; it will also help to accelerate the global recovery. That is the reason why I think China has begun to take more active position now. Because there seems to be a vacuum somewhere in Asia, it is time for China, Japan, and Korea to step up to the plate.

Watanabe: Thank you very much, Dr. Lau. Unfortunately, we have run out of time. Originally I wanted to invite questions from the audience but since we have a reception following this symposium, I hope you will find an opportunity to talk directly with the panel members and ask good questions. Fortunately, we heard stories about a very robust and vibrant China, India and ASEAN countries, and I think this crisis has further increased the relative importance and weight of this particular region, which means we have that much brighter a future to move into. I think to deliver such a message throughout the world is very important, especially to restore confidence in the economy under the current context.

I would like to thank the panel members and I would also like to thank those in the audience very much. I would like to express my appreciation for your constant support for IIMA and with this I close the panel discussion. Thank you very much.

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