19th ASIAN SHADOW FINANCIAL REGULATORY COMMITTEE
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PIGS out of the zone – Effect on Asian Economies and Markets

Background

History is replete with examples of economic and financial crises. Some of them are of significant order of magnitude that resulted in tremendous hardship on citizens. Examples of such crises are, the Great Depression of the 1930s and in more recent times, the 2007-2009 financial crisis that cost the US and Europe approximately 25 percent of their combined GDP. In the aftermath of a crisis, economists and policy makers analyze the event and propose reforms. However, on many occasions, the implementation of these reforms was inadequate and as a result, we are left with a certainty that the next crisis will be in the making.

European leaders argued for the need for monetary union and the creation of a single currency for the region as early as 1929. This resulted in the creation of the Euro (as the Reserve Currency) which is adopted by 17 nations in continental Europe. The Euro went into circulation on January 1, 2002. As of February 2012, with more than €890 billion in circulation, the Euro has the highest combined value of banknotes and coins in circulation in the world. The creation of the European Monetary Union is an interesting development given that there is limited fiscal union. Many economists have argued that monetary union without fiscal and political union is doomed to fail.

The Six Shadow Financial Regulatory Committees, at their recent joint meeting in Washington, DC on October 24, 2011 addressed the current European crisis, often referred to as a sovereign debt crisis. Europe faces a multi-dimensional crisis: (1) debt sustainability problems of sovereigns, (2) bank solvency problems, and (3) differential competitiveness across countries of the Eurozone. The joint SFRC's recommendations from the meeting were as follows:

- A passive strategy – It would simply envision a painful deflationary adjustment of prices and wages in the Southern economies over several years. This strategy may result in political unrest which could undermine necessary fiscal consolidation.
- Exit from the zone – It would be for some countries to leave the Eurozone immediately. This may create chaos and would be disruptive to financial markets and could undermine confidence in European institutions.
- An active strategy – It would be to engineer a higher inflation rate for the more competitive economies for several years and with deflationary pressure on the southern European economies. Over the long term, this adjustment process will lead to uniform competitiveness of members of the Eurozone.

Problems in Europe, if not resolved, could severely interrupt trade finance, thereby negatively affecting Asian (and Global) trade. Asian investors' confidence in the European market will also be negatively affected and as we have observed in the recent 2008 financial crisis, a failed investment bank can have far reaching consequences. There exists a possibility that this crisis may also trigger an equity crash in some Asian markets. In summary, left unresolved, the current European crisis may negatively affect the real and financial sectors of Asian economies.

Why should Asia care and what can Asia do about it?

The European crisis is primarily a crisis of imbalance. The Euro is undervalued from the perspective of countries such as Germany but overvalued from the perspective of countries such as Greece and Spain. It should also be noted, that for Spain, private debt is the issue, not so much public debt. Asia needs to be concerned about developments in the EU for two main reasons. First is the impact of a prolonged economic downturn in the EU countries on the economies of Asia should this crisis persist. As the economic growth of Asian countries such as China and South Korea is slowing down, the onslaught of a European crisis will exacerbate the situation. Second is the impact on capital flows to Asia given the requirements for capital in Europe.

Asia should not wait to see how things play out in the EU but should pre-empt any likely fallout through a three-pronged integrated approach at the trade, financial markets, and government level. Asia should continue to move forward towards a pan-Asian free-trade block while reducing its dependence on Europe. Asian government should refrain from "protectionist" policies that may result in hampering intra-regional trade. The greater intra-regional trade will help offset any continued downturn in demand from EU countries. This process is already well underway in a number of areas, particularly through country-to-country free trade agreements. Currently, China is in negotiations with South Korea for such an agreement but a pan-Asian approach to this issue could bring greater benefits more quickly.

Asia should also continue to push for greater development of its financial markets. Some Asian countries still have some way to go before their financial markets meet international standards. By doing this, more Asian capital will stay invested within Asia. Asian markets will be less reliant on capital flows from Europe and the United States and there will be more viable investment alternatives for excess Asian capital within Asia. Continued development of the Asian bond markets is also important to create more viable alternatives for Asian capital. The current development of the offshore RMB (Dim Sum) bond market is an important move in this direction. China will continue to cultivate this market as a step forward to an internationalized RMB. Japan is also expanding its stock market through inviting more foreign companies to list on its exchanges.

At the Government level, Asian economies need to position themselves to be able to increase demand within Asia quickly should the EU situation deteriorate to the point of having a significant negative impact on growth within the region. Standard fiscal and monetary tools can be used for this with an emphasis on infrastructure development to promote long-term growth within the region. In the event of a major crisis within the banking sector caused by defaults on loans within the EU, the surplus Asian countries should adopt contingency plans to help stem any contagion from European bank defaults to

Asian banks. This could include European countries being more open to Asian acquisitions of their struggling firms and encouraging European firms that are looking to raise funds to look toward Asian markets for their capital needs.

In conclusion, the views of the ASFRC are:

1. Without having fiscal and political union, the current European crisis may be a pro-longed and drawn out event.
2. Pan-Asian economies and authorities should not wait for the crisis to hit but to be more proactive by undertaking measures such as promoting intra-regional trade, deepening the financial markets, internationalizing RMB and Yen as reserve currencies, and engage other pan-Asian authorities to coordinate macroeconomic and macro-prudential policies.
3. Authorities should actively guard against asset bubbles and adopt prudent policies that will make the financial system more crisis resilience.