



Economic Developments in the EU, East Asia and the US, 2007-2008

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Introduction

Never before have we seen such a sudden and profound reversal of fortune. The world economy has moved in the time span of only a few months from a condition of robust growth, from commodity shortages and steep price rises, to the complete opposite – collapsing prices, almost invisible consumer demand and declining public confidence, particularly in the banking sector. Governments have reacted more swiftly than ever before and have been quick to realise the severity of the problem. In the early part of 2008, the world was confronted with the problem of sky-rocketing commodity and food prices, global surplus imbalances between energy producing and energy consuming countries and the threat of global inflation. At the same time, banks were rushing to generate short-term profits on the backs of little publicised and even less well understood financial instruments. Finally, the failure of one small sector of the loans industry, the sub-prime housing loan market in the US, spread to all parts of the global economy. Based on the knowledge gained in the last economic depression, conventional wisdom holds it that the same prescriptions can also

remedy today's problems, albeit with some modifications and improved coordination between countries.

The financial crisis in the US and the European Union (EU) has now spread to the real sector in these economies. In 2009, shrinking consumer demand is pushing the US, the EU and Japan into a recession. East Asian countries will not be spared from the spill-over effects of the turmoil in these parts of the world. For East Asia it is important to learn the lessons from the experiences of the US and the EU so as to allow the region to respond adequately and to help build a more stable and sustainable interlinked global economy.

Commodity prices and inflation

In 2007 and in the first half of 2008 commodity, mineral and food prices surged upwards. This development created major global concerns because it caused global inflation. In July 2008, the oil price hit US\$147 per barrel and was forecast to reach US\$200 per barrel by the end of 2008. The price for palm oil also reached an all time high of



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US\$1237 per tonne in March 2008. Since those days, prices of commodities and food items have collapsed. Minerals such as steel and gold have followed a similar pattern with prices first increasing and then decreasing. Even more alarmingly, food prices rose too bringing with it the threat of social tensions. Prices for wheat, rice and corn increased by more than 30% between mid-2007 and mid-2008. In some parts of Asia, the situation led to riots and long queues of consumers who feared a rice shortage. Many East Asian governments have resorted to subsidising food retail prices to ensure that these essential items remain affordable to their people. However, some East Asian countries could not afford the heavy burden of subsidy of oil and gas, and

were forced to increase the prices of these products. The latter led to sharp increases in prices generally. Table 1 below shows the inflation rate of selected countries during the first quarter of 2008, with many reaching record levels.

The dramatic increases in the price of commodities, minerals and food products were caused by a combination of factors; speculation, the growing demand by emerging countries such as China and India, a shortfall of production, and the alternative use of food crops to produce biofuel. Rising global inflation stirred the fear of stagflation, namely high inflation rates coupled with stagnant growth and high unemployment rates.

Table 1: Countries experiencing record inflation

	Inflation rate	Highest in
US	4.1 (1Q/08)	16 yrs
European Union	3.8 (Mar/08)	10 yrs
Australia	4.2 (1Q/08)	17 yrs
China	8.7 (Feb/08)	11 yrs
S. Korea	3.9 (Mar/08)	7 yrs
Singapore	6.7 (Mar/08)	26 yrs

From September 2008, we witnessed a sudden downturn in the hitherto upward trend in commodity, mineral and food prices. In October 2008, the price of oil had fallen to US\$86 per barrel which meant a 41% drop since its peak in July 2008. By January 2009, the price of oil had dropped even more dramatically to below US\$40 per barrel. Likewise, minerals and food prices also fell.

Lower prices eased inflation and provided relief to governments in terms of decreasing subsidies and to the general public as goods and services became more affordable. Many countries also lowered their interest rates, which had earlier been increased in an effort to battle rising inflation. However, for commodity producing countries such as Indonesia and Malaysia, lower commodity prices led to lower export revenues which, in turn, negatively affected government funds.

The US financial and economic crisis

The problem of rising inflation witnessed in the first half of 2008 suddenly receded in the face of the collapse of the global financial system in the third quarter of 2008. Although the stress in the US financial system could be detected as early as 2007, the total ramifications and high severity of the threat were not clear at that time.

The US became the epicentre of a global financial turmoil which quickly spread to the EU. Financial institutions

in the UK, Germany and France became early casualties of the crisis. The bankruptcy of Lehman Brothers, one of the world's biggest investment banks, severely affected public confidence in the financial system. Banks became much more reluctant to lend to one another. As a result, the global financial system nearly came to a halt and credit almost dried up. In addition to Lehman Brothers, many other major financial institutions needed to be rescued; Fannie May and Freddie Mac, the USA housing loan providers were nationalised through a capital injection by the US government of US\$100 billion each. There was also a government bail-out of AIG, a global insurance company, the sale of Merrill Lynch (a top investment bank) to the Bank of America, the sale of Wachovia Mutual (a major lender in the US) to JP Morgan (another major investment bank) and most shocking of all, the sale of Bear Stern to JP Morgan for US\$2 per share. In addition, the remaining two US investment banks were transformed into commercial banks.

The US Treasury and Federal Reserves took the unprecedented move of proposing a package to help troubled US financial institutions. The US\$700 billion worth 'Troubled Asset Relief Program' (TARP) which will buy toxic assets of financial institutions was welcomed but has not met the objective of restoring market confidence. Furthermore, TARP may not be big enough in value to remove enough toxic assets so that the financial institutions can begin to lend again. Many of the implementation problems related to TARP are not yet fully resolved. Many observers also believe that the toxic assets actually exceed the size of the rescue package. Thus, more money may be

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required to return the US financial system to normal and, more importantly, to provide relief to the sub-prime borrowers. Lower interest rates are hoped to encourage re-payments and banks are urged to work out loans re-payments with borrowers to minimise default.

However, the injection of liquidity by the US government was not enough to calm the markets and to restore public confidence. Measures to deal with the problem, namely the rescue of troubled financial institutions, the injection of liquidity and the lowering of interest rates, have failed to halt the deteriorating situation. The injection of liquidity also failed in its objective of allowing banks to lend again. To overcome this problem, the Federal Reserve Bank introduced the unprecedented measure of lending directly to companies. The situation is no longer just a liquidity problem but has turned into a crisis of confidence. 'Cash is king' as banks would prefer not to lend but to preserve capital. Similarly, consumers would rather save their money than spend it.

The crisis in the financial sector quickly spread to the rest of the economy, or, as some analysts would have it, the 'real economy'. However, recent events have shown in the clearest possible way that the banking sector is very much integral part of the real economy and has the power to 'infect' otherwise healthy sectors. The impact of the troubled banking sector on the rest of the economy is also referred to as 'from Wall Street to Main Street'. The measures adopted in order to solve the problem in the financial sector failed to arrest the loss of consumer confidence and public spending. Although the Federal Reserve Bank slashed interest rates to 0.5% per annum

consumer spending continues to slide. This is caused by a number of factors, primarily limited access to credit and the collapse of house prices, which traditionally play an important role in supporting loans and thus consumer spending. Personal wealth, savings and pension entitlement were strongly hit by the 36% decline of the world-wide stock market valuation in 2008. Although a fiscal stimulus programme with direct cash transfer to individuals was introduced, its impact was minimal. Weak consumer demand has taken a very heavy toll on the automotive industry. The three auto giants – General Motors, Ford and Chrysler – have asked for a huge government bailout to stay afloat. Unemployment rates have also increased.

Contrary to expectations and long established wisdom, the US dollar exchange rate rose in relation to other currencies, with the exception of the Japanese Yen. Continued purchases of US Treasury bonds ensured continued capital flow into the US. The repatriation of capital to meet redemption by savers in equity funds in the US and to reinforce the financial position of parent companies increased the demand for US dollar. However, in the long run, the US dollar may weaken because of the deep economic contraction and the huge need to finance the recovery programmes.

The financial and economic crisis in the EU

Financial institutions in the EU were among the first to be affected by the problems in the US, because they were

linked to the US financial sector through liberalisation that allowed financial instruments to be traded across borders. The system of financial engineering that has been developed in the last 10 years has created complex financial instruments in order to put prices at risks. These include the following.

- Future contracts which lock in participants to buy or sell assets.
- Options which pay a premium for rights to exercise option to buy or sell should prices move in a specified direction.
- Swaps which issue bonds in one currency and exchange (swap) them for another currency, creating lower interest rates for borrowers.

These instruments have one common characteristic; with a small initial position, they can multiply the amount at stake, which then leads to much larger exposure.

Securitisation is another popular financial instrument which spread the effects of the financial meltdown from the US to EU. Asset-backed securities are collateralised debt obligations where loans were bundled into packages and then sold to outside investors. The US sub-prime loans were bundled together with other financial assets to become new financial products. With good ratings, these products were then bought by insurance companies, banks, local authorities and pension funds in the originating and even in other countries.

There were a number of casualties in the EU. For example, Britain had to nationalise the Northern Rock bank, the German government had to bailout Hypo Real Estate with a €35bn credit guarantee, and Fortis, a Belgian-Dutch financial group, came under stress. As the EU's banking problems were

unfolding, the European Central Bank injected €95bn worth of funds to provide liquidity for the system and for banks to continue lending. EU governments also guaranteed bank deposits and have agreed to widen their fiscal deficits.

A well-coordinated response was taken by the 15 EU zone countries. The EU along with the national governments of its member states are considering a relaxation of the present cap imposed on each nation's fiscal deficit. A higher fiscal deficit is one way to stimulate growth.

The crisis is taking a particularly heavy toll on the UK economy. Low consumer demand has resulted in the closure of retail business. For example, the iconic Woolworth high street UK retailer recently closed its shops nationwide. The UK also saw unemployment levels rise, particularly in the financial sector.

The Impact of the global financial and economic crisis on East Asia

With the exception of Japan, the impact of the global financial crisis on East Asia is so far limited. Learning from the experience of the 1998 financial crisis East Asian countries have strengthened their financial sector by introducing more stringent practices of governance and by building up the capital base of their financial institutions. East Asia's financial sector has also adopted a more cautious approach to financial liberalisation which helped minimise the region's exposure to more complex but also riskier financial instruments. Consequently, only a few of

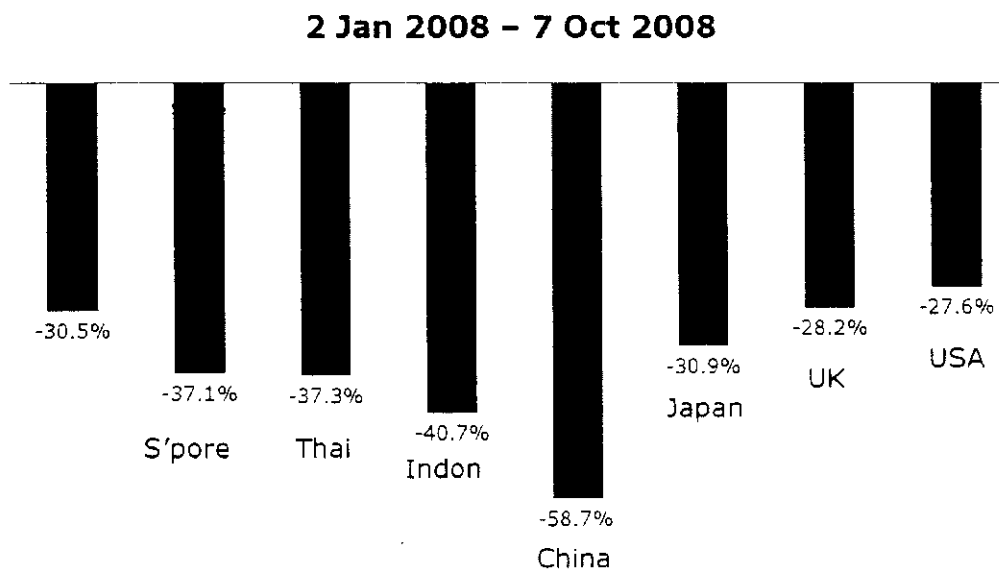
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the East Asian banks and other financial institutions suffered losses from the US sub-prime loan defaults. These institutions' capital bases were not impaired and they could continue lending.

East Asia, however, has not totally avoided the effects of the sharp stock markets decline in developed countries. The stock market drops in East Asia were in fact larger than the decline in the US and UK as shown in Figure 1 below. For the period from 2 January to 7 October 2008, the Shanghai stock market (China) fell by 58.7% as compared to a 27.6% decline of the Dow Jones (US). Similarly, ASEAN stock markets suffered large reductions between 30% and 40%. This contagion effect was immediately felt on the same timescale as the falls in US and EU

stock markets, which shows that East Asian markets have not de-coupled from the US and EU as previously claimed. Global investors became more risk averse and withdrew their investment in emerging markets as the latter were considered more risky. Instead, funds were reinvested in safer investment instruments or in the markets of developed countries. Many of these investors were also forced to liquidate their investment in East Asia to meet redemptions in their home countries. Up to October 2008, East Asian stock markets had a cumulative net capital outflow of more than US\$15 billion whereas in 2007 the region recorded a net capital inflow of more than US\$16 billion.

Figure 1: Performance of Selected Stock markets



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By contrast the global financial and economic crisis took longer to affect the real sector in East Asia. The strong local financial sector provided a buffer. Since financial institutions were not affected, the credit system continues functioning, which in turn helped preserve business and consumer confidence. The impact on the East Asian real sector will instead be felt more closely through exports; direct and indirect East Asian exports to US are large. Although some analysts had formerly believed that China's high economic growth would make East Asia less reliant on the US and EU, the US economic slowdown in 2008 and the lower export performance from East Asia have discredited the theory that East Asia has de-coupled from the US. Hence, East Asian countries with large export exposure will likely to be hit the hardest.

Table 2 shows the degree of trade dependency of East Asian countries. Singapore tops this list with a Trade to Gross Domestic Product (GDP) ratio of 397%, followed by Hong Kong at 356% and Malaysia at 161%. Therefore, it is not surprising that Singapore's non-oil exports plunged by 14 % in August 08 (year-on-year) due to a smaller demand for electronic exports. Malaysia's export growth in August 2008 stood at its lowest rate in five months, moderating to 10.6% (year-on-year) which was less than half the 25.3% growth in July and 20.8% export growth in the second quarter of 2008. China is facing a similar situation with export levels significantly decreased. News reports indicate serious social problems in China's export processing zones where many factories have been closed because there is no export

demand. It remains to be seen how the Chinese government will respond to the challenge of rising unemployment.

Table 2: East Asian Dependency on Trade

2007	Trade/GDP (%)
Singapore	397
Hong Kong	356
Malaysia	161
Taiwan	120
Thailand	110
South Korea	74
China	64
Japan	15

Another immediate impact of the global financial crisis has been the fall in value of most East Asian currencies. The exception is the Japanese Yen which has appreciated significantly. Unlike the 1998 Asian financial crisis, this time around East Asian countries could not take advantage of their depreciating currencies to increase their exports because the demand for exports has declined.

Growth prospects

It is often asked whether these financial and economic troubles will lead to a global recession or whether they might even lead to a depression. A depression is any economic downturn where real

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GDP declines by more than 10%. A recession is an economic downturn that is less severe. The Great Depression in the United States lasted from August 1929 to March 1933 during which time real GDP declined by almost 33%. Another less severe depression took place from May 1937 to June 1938, when real GDP declined by 18.2%. The worst recession since those times took place from November 1973 to March 1975, when world real GDP fell by 4.9%. Using this definition, countries such as Finland and Indonesia have suffered depressions in recent memory. The current global financial and economic crisis could be called a recession and it is unlikely that it will deteriorate into a depression. This view is supported by the International Monetary Fund (IMF) which has ruled out the return of the Great Depression. The coordinated and prompt response by the world's leading countries will help prevent this crisis from worsening. However, this is the first time that the key global economies – the US, the EU and Japan – are all experiencing a recession at the same time.

In October 2008 the IMF predicted that world economic growth would fall from 5.0% in 2007 to 3.9% in 2008 and then even lower to 3.0% in 2009. This is shown in Table 3 below. However, these forecasts had to be downgraded further in November 2008 because of rapid economic deterioration. In its latest published outlook, the IMF predicted that the US economy will contract by 0.7% in 2009; the EU economy will decline by 0.5% while Japan will suffer also a decline of 0.2%. In 2009, the World economy is predicted to grow at a slower rate of 2.2%.

Presently, it is estimated that the world's largest banks may need US\$ 675 billion in fresh capital over the next few years to recover from the credit crisis. The seriousness of the crisis prompted the world's central bankers and finance ministers to gather in Washington DC in October 2008 to discuss a global response to the credit crunch amid the worst financial crisis to hit advanced economies since the 1930s.

Table 3: IMF marks down global real GDP forecasts (%)

Countries	2007	2008	2009(f) October 2008 estimate	2009(f) November 2008 estimate
ASEAN	6.3	5.5	4.9	4.2
Japan	2.1	0.7	0.5	-0.2
India	9.3	7.9	6.9	6.3
China	11.9	9.7	9.3	8.5
US	2.0	1.6	0.1	-0.7
EU	3.1	1.7	0.6	-0.5
World	5.0	3.9	3.0	2.2

Source: IMF World Economic Outlook Database

In this global turmoil, East Asia remains as an engine of growth, albeit a slower running one than before. China and India are the key drivers for growth in 2009, with the former estimated to grow at 8.5% and the latter at 6.3%. These growth rates are below past levels achieved, and in the case of China, there are concerns that the current rate of expansion is not sufficient to create jobs for the new entrants into the labour market. Slower economic growth in China will have serious implications for intra-regional trade as the country has become a major trading partner for many countries in the region. For example, China has overtaken the US as Japan's largest trading partner.

Following the general trend, growth projections for ASEAN economies in 2009 have also come down. ASEAN is expected to grow by 5.5% in 2008 and by 4.9% in 2009. In the latest IMF forecast, ASEAN economies are expected to grow by 4.2% in 2009.

Nevertheless, Singapore is already in a technical recession (experiencing two consecutive quarters of negative economic growth in 2008) and its GDP estimate for 2009 is between minus 2% and minus 5%. Being a small and a very open economy, the impact of the reduction of global demand on Singapore exports was far greater than on other ASEAN countries which have a more balanced economic structure. The sizeable domestic populations of Thailand, Malaysia, Indonesia and the Philippines may boost their domestic economies and help create domestic demand as a way of compensating for the fall in exports. In addition, given its role as a regional financial centre and its extensive linkages to the global financial system Singapore also suffered the most among the ASEAN countries from the financial crisis.

Conclusion

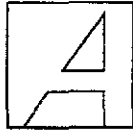
East Asia will surely be adversely affected by the financial and economic crisis in the US and the EU. The impact on East Asia's financial sector is likely to be limited to those with large export exposure because the region's financial institutions and systems were strengthened after the 1998 Asian crisis. However, East Asia is at risk in terms of financial flows and its international reserves which are invested in the US and the EU. The most strongly felt effects for East Asian economies and markets were liquidity problems; US and European investors withdrew capital from East Asia in order to cope with cash flow problems in their own countries. The large fall in the East Asian stock markets is a sign that capital from developed countries has moved out from the region.

However, East Asia is not the only region experiencing this outflow. Capital has moved out from most emerging markets. Most East Asian countries have sufficient international reserves to finance the outflow. These large reserves were built after the bitter experience of the 1998 Asian crisis. However, Korea, Indonesia, and the Philippines may face the greatest risks in terms of financial flows because the size of mobile capital relative to their foreign exchange reserves is higher than in other East Asian nations.

East Asia is beginning to feel the economic impact of the global crisis. Since exports are crucial to most East Asian countries, falling demand for East Asian products from the US and the EU will seriously affect the region's

growth prospects and its socio-economic welfare. A slowdown for labour-intensive exports such as textile and wearing apparel, furniture, footwear, toys and selected electrical and electronic products will mean higher unemployment rates which will hinder East Asian's efforts to boost domestic demand. Unemployment or wage cuts will also have far-reaching implications on social dimensions because East Asia does not have a well established social security system to act as a safety net.

The prompt and well coordinated response by the world's major economies in dealing with the financial turmoil has significantly helped prevent the world from going into a deeper recession or even a depression. Lessons have been learned. Unlike the Great Depression that needed a world war to bring back full employment in the US and the UK, led by the US and the EU this time many governments intervened. Massive liquidity was loaded into the financial systems to ensure that market confidence remained intact. Interest rates were lowered to record levels to lower the cost of capital. Similarly, the world's major countries should quickly coordinate measures to deal with the problems in the real economy, namely falling consumer demand and businesses in distress. While East Asia may be able to experience positive growth in 2009, predictions of further deterioration of the global system will make the region's outlook much less positive. Therefore, it is imperative that East Asia works closely with the US and the in bringing back growth.



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❖ **MAIN TOPICS**

10th EU-East Asia Think Tank Dialogue, 13-14 October 2008

Yeo Lay Hwee & Willem van der Geest

The ASEAN Charter and Implications for East Asian Regionalism

Carolina G. Hernandez

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Mahani Zainal Abidin

Asia-Europe: Quest for Change vs. Preference for Status Quo – The
roles of Regionalism, Inter-regionalism, and International Global
Governance

Michael Reiterer

The Role of Leaders in an Era of Globalisation: the need for
better cooperation among the Asia Pacific, North America and
Europe

Bernhard May