“Eurasian Contagion: Age of Fiscal Tightening”

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1. Introduction

Europe is on the brink of major financial crisis. Sovereign debt crisis, which started in Greece in October 2009, has evolved into a financial crisis in the Euro Zone. At best, it takes several years before all fiscally weak governments recover to a fiscally sound status. In the mean time, a major economic slowdown will occur due to region-wide fiscal austerity and credit shrinkage due to weakened banks due to lost values in sovereign bond portfolio. If the euro is broken up in one way or the other, it would sent a shock wave to the rest of the world, much severer than the Lehman failure in September in 2008. Indeed, it was only three years earlier when the global financial crisis, which was characterized as once in one hundred years, occurred due to the financial crisis in the United States and Europe. At the time, G20 Summit recommended a concerted fiscal expansion to fight against a major threat of the revival of the Great Depression.

Instead of the complex securities (CDOs and CDO squared) that had subprime mortgages as underlying assets that caused the Global Financial Crisis, straight-forward, simple sovereign debts in the Euro Zone issued by fiscally weak governments because the epicenter of financial earthquake.

At the time of global financial crisis, Asian banks were rather complacent until Lehman Brothers filed for bankruptcy, since they had little exposures to subprime related CDOs. The government also thought that their economies were basically immune to the subprime crisis, since banks were sound and resilient, and they have accumulated foreign reserves for their self-insurance against currency volatility. However, once the Lehman Brothers failed, the US and European economies severely contracted due to financial panic. Their production, investment, and consumption contracted sharply, and so did imports. Those countries that exported to the US and Europe were severely hit by decline in export demand. The most severely hit were the Asian exporters of high-quality consumer durables and semi-durables, such as automobiles. Japan, Singapore, Korea, and Taiwan were in this category.

Now a major shock that would be comparable to the global financial crisis of 2007-09 (GFC) may occur if and when the euro breakup occurs. A severe contraction of Europe will affect the global economy and Asia cannot avoid adverse impacts. This time, things may get worse and prolonged than the GFC. First, fiscal stimulus, which was effective in preventing GFC from transforming into the Great Depression, cannot be employed this time, since the source of the problem is too much fiscal deficits and government bonds. The market is demanding fiscal austerity as a cure to the problem, so that more fiscal spending cannot be a solution. Of course, monetary easing can help, but the interest rates have been low and near zero since the post-Lehman easing. Basically, ammunition to battle a major recession has not been replenished since the last war.

The rest of the paper is organized as follows. Section 2 discusses the financial channel of contagion, while Section 3 discusses Trade Channel. Section 4 explains options that Asia has to counter contagious shocks from Europe. Section 5 is devoted to a discussion on financial safety net. Section 6 concludes.

2. Contagion: Financial Channel

Contagion from the Euro Zone to the rest of the world, in particular Asia, may come via two channels, Financial and Trade. The Financial channel has many conduits. First, if Asian banks may be exposed to downgraded European sovereign bonds, they may suffer a serious squeeze on their profitability, if not already. However, this does not seem to be the case. Asian banks do not seem to have large Euro Zone bonds. Second, Asian banks, with relatively good balance sheets, are in fact flooded by request from European banks to purchase their assets. This can be an opportunity for Asian banks if they know what is undervalued and what is not. Third, European banks are selling their global assets to bring home cash and liquidity to help their cash position and build up capital ratio. Profit taking and withdrawal of European banks lending to Asia may cause declines in bond and equity prices, if not already. Depreciation of Korean won (or non-recovery from the post-Lehman low) may be due to the quick exit by European banks. The higher the ratio of European bank lending, the lower the financial asset prices may be. Fourth, more generally, the European situations may disseminate pessimistic sentiments to the rest of the world, across-the-board. The risk appetite is receded and capital flows to safe heaven. The yen appreciation may be a result of such a movement of capital.

After all, Asian banks and Asian policy makers are complacent about the financial channel from Europe. This is very similar to what they were just before the Lehman Brothers failure. Having no financial channel does not shield the region from contagion of the European crisis.

3. Trade Channel

What made Asia to suffer in the post-Lehman period was trade collapse (See Baldwin, 2009). A similar development is feared. The prospective decline in output activities in Europe in 2012, partly due to fiscal austerity, will disproportionately hit Asian countries with higher export ratios to Europe. China may be one of the countries that will severely suffer from a decline of exports to Europe. However, the Asian region is very much trade-integrated with supply chain of manufacturers. Parts and semi-finished goods are passed on with value-added many times until it reaches the final assembler in the region. Some of this supply chain was keenly recognized in the Great East Japan Earthquake in Japan in March 2011 and the flood in Thailand in November 2011. Hence, the decline in exports to Europe will be felt not only in countries that exports finished goods to Europe but in Asia at large.

China may play an amplifier of the European shock, rather than a stabilizer, this time.

The real estate boom in China has worried policy makers and policy measures have been applied to stabilize, or even to cause a decline in, the real estate prices. The growth rate of China will decline in 2012 partly due to a decline in exports to Europe and partly due to a policy restraint on the real estate boom and possible economic overheating. A slowdown in China will cause decline in exports to China from neighboring countries. This is indirect effects, through China, of the European contagion.

4. What can Asia do?

Given the contagion to come, what can Asia do? First, for Asian banks, this may be opportunities rather than hardship. It may be a golden opportunities to acquire assets, subsidiary operations, or even capital of European banks. Especially, European banks' Asian operations may be good assets to buy, due to familiarity for Asian banks. However, at the same time, capital ratios may be raised, not only among SIFIs but also in all internationally active banks, to avoid adverse reputation effects in the future.

Asian asset prices, including stock prices, bond prices and the exchange rates, may suffer large declines, if Europeans continue to sell Asian assets. The best defense against domestic financial markets decline and volatility at this point is monetary easing, if the exchange rate is not too much undervalued. To put support to asset prices, which is affected not by the own fundamentals but by external shocks, may be prudent options for monetary authorities. In most Asian countries, with a notable exception of Japan, the interest rate has still room to come down. The room can be used to stimulate the economy and to support the financial sector in this turbulent period.

For the exchange rate, some Asian currencies are undervalued and some others are overvalued. Given the high trade integration in Asia, the exchange rate to be considered is the deviation from the weighted average of Asian currencies, not the bilateral rate like the exchange rate vis-à-vis the US Dollar. (See for example the AMU deviation index, RIETI (2011).) If the degree of deviation widens quickly away from the average of Asia, there may be a ground for foreign exchange intervention.

Would it be wise to use fiscal policy? Yes, if the country still has "fiscal space" in fiscal deficits and debt/GDP ratio. However, given that the current crisis occurred from sovereign debt, overuse of fiscal policy may invite credit rating downgrade or, even worse, attack by hedge funds and investment banks, even in Asia.

The risk now is the global recession in 2012 due to "concerted" fiscal tightening. G20 Summit that was so enthusiastic about "concerted" fiscal stimulus in the wake of Lehman Brothers failure (G20 Summit in London) is conspicuously silent about what to do this time. Of course it is not easy. On the one hand, the source of problem, i.e., too much sovereign debts, has to be solved. On the other hand, doing correct policy measure for individuals together may not be an optimal solution.

Asia may be spared of a blunt of recession, if Asian countries collectively stimulate through whatever policy measure they feel comfortable. Those countries with high government debt should refrain from fiscal stimulus but use monetary easing; those countries with already high inflation or overheating may just hold to take hit in exports to go back to normal.

5. Safety Net

Korea hosted G20 Summit in November 2010 with emphasis on the importance of building the "financial safety net." This was based on Korea's experience of surviving the two financial crisis, one in 1997-98, and another in 2008-09. Some mechanism, either global or regional, should be introduced to help an "innocent bystander" who is hit by a crisis that originates from another country or region, Korea argued. The call for the safety net did not receive a rave review at the time. It was ironic that European countries participated with enthusiasm, since they would become in need of large funding.

European Financial Stability Facility (EFSF) was created on the decision made in May 2010 with an aim at helping Portugal and Ireland. A bailout package for Greece had been arranged by IMF and EU countries, prior to EFSF. At the time of Seoul Summit, the size of EFSF, guarantee commitments from the euro area member countries for a lending capacity of 440 billion euro, was sufficient, and European members did not feel to discuss the safety mechanism in general. The new initiative by Korea was not treated as an important continuing agenda in the G20 Summit in Cannes in November 2011.

EFSF became a focus of hope in October 2011 when the European leaders came out with plan to boost the size of EFSF to a lending capacity of 1 trillion euro by leveraging up. The CEO of EFSF, Klaus Regling, flew to China and met with Chinese leaders on October 28, 2011, asking for contribution. China seems not to warm to the proposal of buying EFSF leveraged securities.

Back in August/September 1997, Asia proposed to establish Asian Monetary Fund (AMF). After Asian countries put together a rescue package for Thailand in August, they wished create a mechanism to contribute to a rescue pot automatically, rather than *ad hoc* meeting. The AMF was opposed by the United States and the IMF, on the following ground. First, Asians are too nice to each other, so that they cannot come up with a tough conditionality by themselves. The bailout should be coordinated by the IMF who is a ruthless truth-teller. If the rescue is handled by the region as an option, the "soft conditionality would become a serious problem, and the country would not come to IMF. Second, the duplication of surveillance work, which is professionally done by IMF, by the regional organization would be inefficient. Third, if only one country falls into a crisis, maybe the rest of the region can pitch in funds to rescue the country. But often the crisis is regionally contagious. If a whole region is affected, not enough number of countries is left on the rescue side. The rescue fund is best organized at the global level.

Many Asian policy makers were discouraged that the safety net was rejected by the "west." However, now many Asians feel that some of the criticisms Asia received in 1997 may be applicable to EFSF.

There are other parallels between 1997 and 2011. Asians at the time of the Asian currency crisis bitterly criticized short-selling and credit rating agencies that were behind the curve and exacerbated the crisis rather than forewarned the crisis. The west countered saying that there is a fundamentally good reason why speculators attack the currency or countries. Short-selling is a good market indicator where the fundamental problem lies and countries or banks should take the warning seriously. Credibility of credit rating agencies did not fade even with protests from Asian countries. They thrive in Basle II as objective, market evaluation of assets. Now both short-selling and credit rating agencies are condemned in Europe.

Asia, which failed to establish AMF, has been slowly building up swap network, known as Chiang Mai Initiative (CMI) since May 2000. In 2010, it became a multilateral arrangement, Chiang Mai Initiative Multilateralized (CMIM). In addition, a secretariat for regional surveillance, Asian Macroeconomic Research Office (AMRO) is established in 2011. The Asian regional safety net is not tested yet, unlike EFSF. However, CMIM and AMRO should carefully study what is happening in Europe and learn lessons from EFSF for benefits and limits of a regional safety mechanism.

6. Conclusion

In order to get out of the current crisis, Europe has to do more in solving the fundamental problems, and there is little Asia can help. Fiscal austerity is unavoidable, but the downward pressure in aggregate demand has to be countered by more monetary easing. With a promise of fiscal union in the near future, a lender of last resort role of ECB should be activated, if necessary.

It seems absolutely essential to distinguish a fundamental problem, i.e., Greece, and a liquidity crisis by contagion, i.e., Italy and Spain. Treatment of the two should be different. For Greece, much more aggressive hair cut (including those held by ECB) may become necessary. Banks that suffer from capital losses from Greek bonds should be injected with capital by respective governments. The liquidity crisis can be dealt with by the lender of last resort function.

Asia faced with possible contagion from Europe should coordinate among themselves to minimize damages. Prudent monetary and fiscal policies, with possible use of intervention are recommended. Closer cooperation, both in trade and finance, is a key. Activating CMIM may become necessary if the contagion becomes severe. It should be discussed how any potential obstacles in implementing CMIM should be removed.

References:

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