

“Eurasian Contagion?: Age of Fiscal Tightening”

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Outline

- Introduction
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- Trade Channel
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- Difficulties
- Conclusion

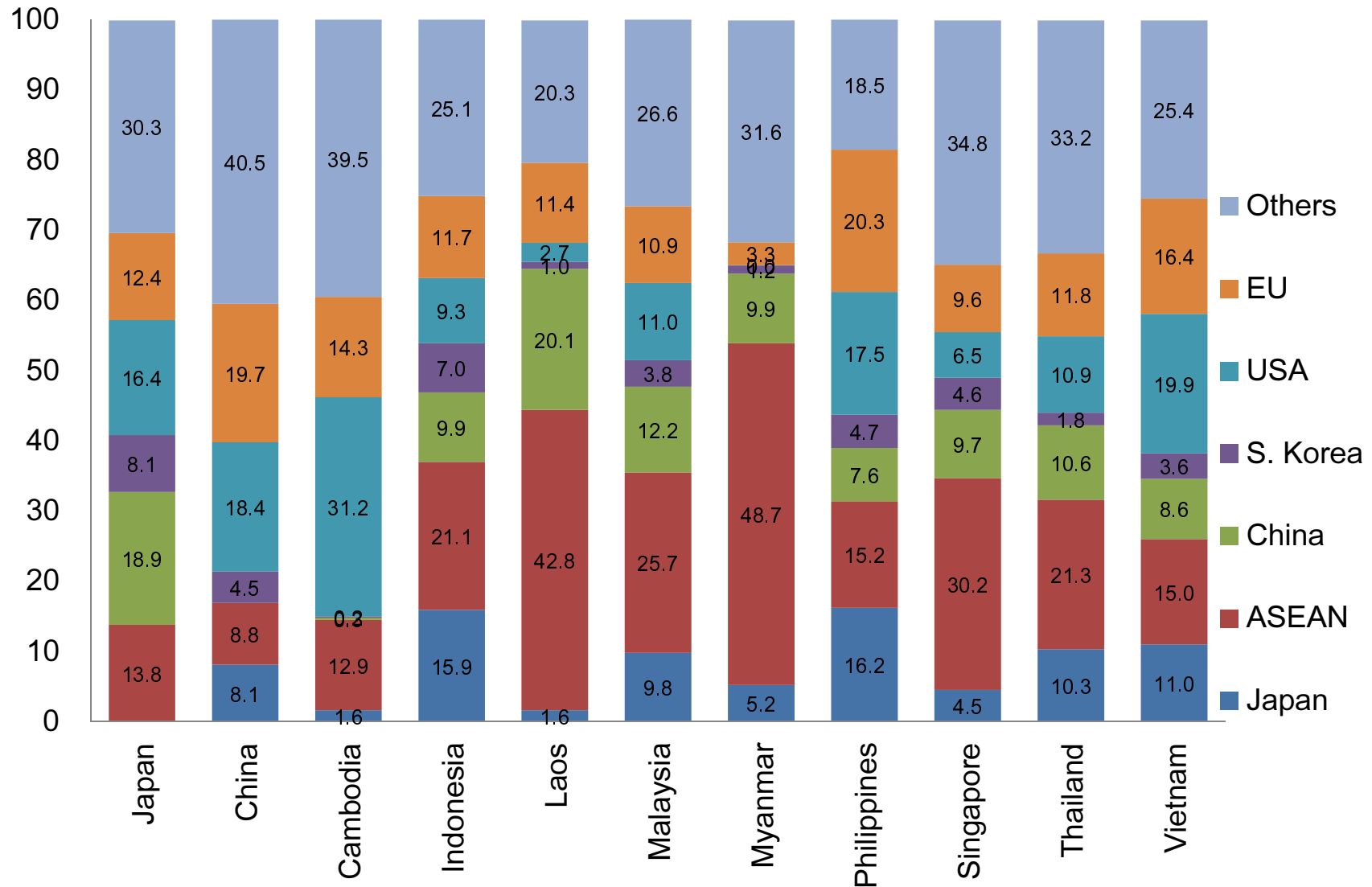
Contagion: Financial channel

- Financial Channel
 - Asian Bank assets' direct exposure to Greek and Italian bonds → Not really
 - European Bank withdrawal: Equity and bond market sales, leading to price declines, possibly; and cut lending to Asian banks → yes for some countries; Korean won depreciation
 - Pessimistic sentiments: global contagion of stock price declines → yes
 - Bad assets from European banks to US banks, to Asian banks → Possible
 - Portfolio rebalancing by large investors, appreciating US\$, Swiss Fr and Japanese Yen → Yes

Contagion: Trade channel

- European growth slows down (or even negative)
→ Exports to Europe goes down → Asian exporters will suffer
 - This was most prominent in the post-Lehman period
- European growth slow down → Chinese exports to Europe to decline → Asian exports to China goes down → Asia suffers
 - China is in the phase to apply break to real estate price inflation

Whom to export?(2009)



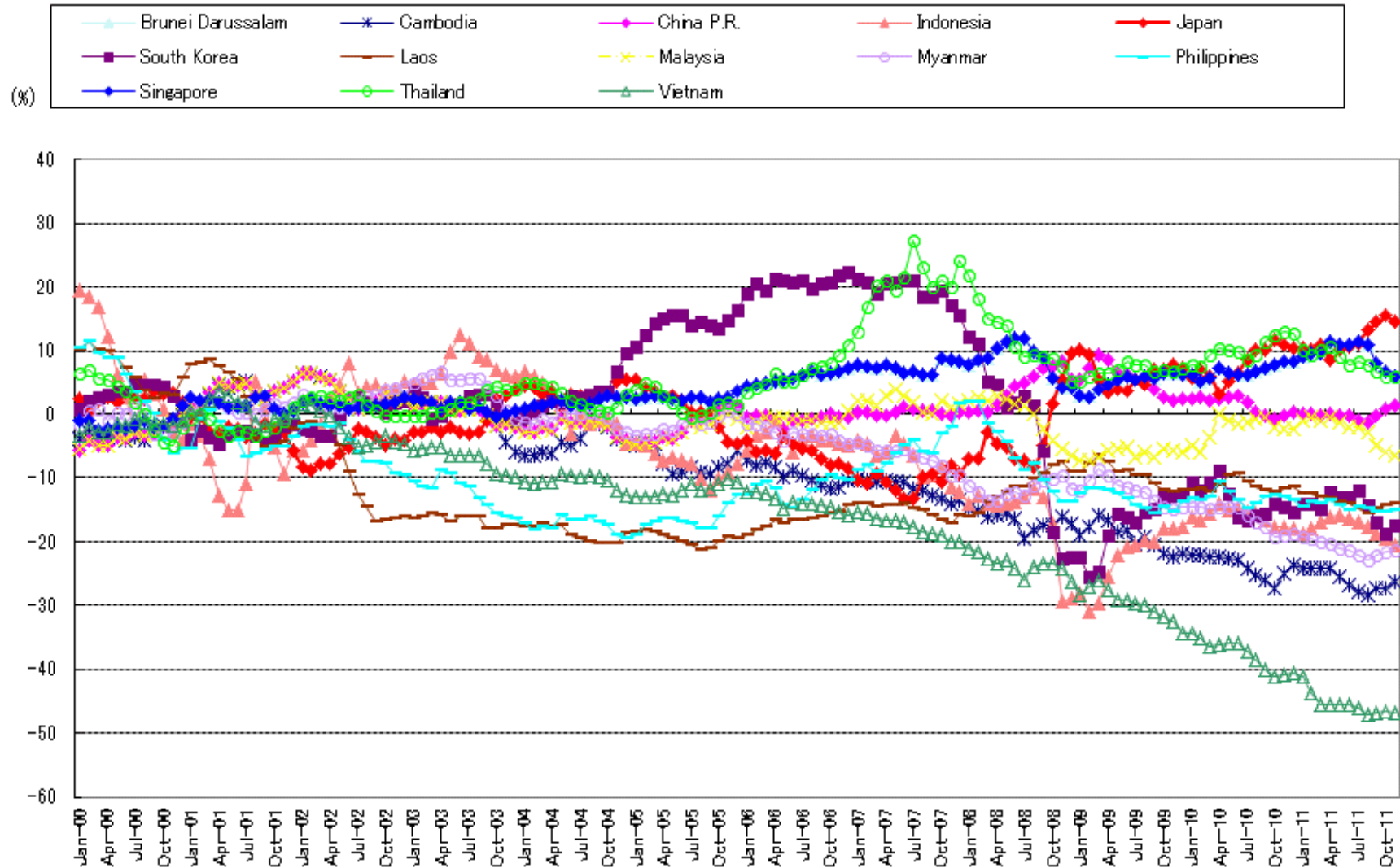
Source: Direction of Trade Statistics July 2010 (Website of IMF)

What can Asia do?

- <banks> Provide ample liquidity to own banks; force them to make their capital ratio higher, just in case
- <exchange, stock, and financial markets>
 - Intervene the foreign exchange market if necessary
 - Use AMU deviation index
 - Massive monetary easing (QE) if necessary
- <fiscal easing or tightening>
 - fiscal stimulus only when debt/GDP ratio is low;
 - if debt/GDP, fiscal deficits are high,

AMU deviation index

Figure 3. Nominal AMU Deviation Indicators
(benchmark year=2000/2001, basket weight=2004-2006, monthly)



Global risk

- Global Simultaneous fiscal tightening
- European economic slowdown and spillovers to the rest of the world through financial and trade channels
 - Fiscal stimulus like after the Lehman failure (London G20) will be impossible
 - Could Asia endure exports decline?
- European banking crisis and spillovers to the rest of the world
 - Could Asia be immune from the global banking crisis?

Regional Facility

- What would be a good regional safety net?
- AMF, 1997, criticized (by IMF, US)
 - Soft conditionality: Asians are too nice to each other and cannot impose tough conditions. You need someone outside to be a ruthless truth-teller
 - Duplication: IMF is already there. Why do you need another surveillance unit?
 - Regional contagion. One country crisis can be helped by others in the region. But, what if a crisis becomes region-wide? No one will be left on the helping side
- EFSF (or ESM) 2011
 - *ditto*

Concluding Remarks

- Europe should solve its fiscal and banking problems with decisive actions
 - Fiscal austerity in countries that are attacked
 - Promise of fiscal union in several years
 - ECB intervention in Italian and Spanish bonds, IMF program for these countries, if necessary
 - Much larger (80%) debt reduction for Greek bonds
 - Capital injection to banks
- Asian countries
 - Lending to IMF, on to European countries
 - Stimulate domestic demands by monetary easing