ASIA-PACIFIC ECONOMIES AFTER THE GLOBAL FINANCIAL CRISIS

Lessons Learned and the Way Forward

United Nations

Edited by Alberto E. Isgut

ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

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Abbreviations

AMRO	ASEAN+3 Macroeconomic Research Office
ASEAN	Association of Southeast Asian Nations
ASEAN+3	ASEAN + China, Japan, Republic of Korea
ASEAN-5	Brunei Darussalam, Indonesia, Malaysia, Singapore and Thailand
CGE	computable general equilibrium
CMIM	Chiang Mai Initiative Multilateralization
DBK	domestic bank
FBB	Foreign bank branch
FDI	foreign direct investment
FES	foreign exchange swap
FR	foreign exchange reserves
FX	foreign exchange
FY	fiscal year
G-20	Group of Twenty
GDP	gross domestic product
GLC	Government-linked companies
GNI	gross national income
GSP	Generalized System of Preferences
GST	General Sales Tax
HDI	human development index
IMF	International Monetary Fund
LNG	liquefied natural gas
MMC	mature market countries
NEM	New Economic Model
NPL	non-performing loans
OECD	Organisation for Economic Co-operation and Development
PACER	Pacific Agreement on Closer Economic Relations
PIDM	Perbadanan Insurans Deposit Malaysia
QE	quantitative easing
RMB	renminbi
RRR	required reserve ratio
SIFIs	systemically important financial institutions
SMEs	small and medium-sized enterprises
SOE	State-owned enterprise
SP	stimulus package
SRR	Statutory Reserve Requirement
VAT	value added tax
WCM	wholesale credit market
WTO	World Trade Organization

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Foreword

There is an intriguing disjuncture between the impact of the 1997 Asian financial crisis and that of the 2008 global financial crisis on the export-oriented economies of the Asia-Pacific region.

In stark contrast to the earlier crisis, which saw the partial collapse of some regional banking sectors, a balance of payments crunch, and deep contractions in leading regional economies, such as Indonesia, Malaysia, and the Republic of Korea, most Asia-Pacific developing economies weathered the 2008 financial turbulence relatively successfully.

Developing Asia-Pacific also recovered quickly, and subsequently maintained satisfactory levels of economic growth. Yet, at the same time, many Western industrialised countries suffered the worst levels of economic hardship in more than sixty years.

The people of Asia and the Pacific have been repeatedly exposed to both simultaneous and successive natural and economic shocks. Given the importance of protecting and extending Asia-Pacific's hard-won development gains, it is clear that building resilience to multiple shocks is one of the most pressing challenges facing the region.

This then poses a number of key questions. Why were the countries of Asia and the Pacific significantly less affected by the 2008 financial crisis? What economic policies and institutional reforms contributed to this resilience? And, without positing any one-size-fits-all prescriptions, what lessons, if any, can be drawn for other countries from the measures adopted?

This book is a compilation of essays by distinguished experts and policy-makers from selected Asia-Pacific economies, providing a variety of perspectives about the impacts of, responses to, and lessons learned from the global financial crisis, by the countries of the region.

These views reflect discussions during a series of high-level policy dialogues organized by the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) – the regional development arm of the United Nations, in collaboration with central banks and Ministries of Finance and Planning of the countries in the region.

Most evident from these essays, is the importance of ensuring that governments generate and preserve the necessary policy and fiscal space to protect economic growth, employment, and development, especially in times of crisis. This enables the pursuit of countercyclical monetary and fiscal policies, including by establishing universal social safety nets to support vulnerable communities from the worst impacts.

Similarly, there is a critical need for countries to preserve stability in the foreign exchange market, and in the financial system as a whole. Large foreign exchange reserves and careful regulation of capital flows were important factors for many Asia-Pacific countries in reducing the potential disruption of capital flow volatility during the recent crisis. Nevertheless, individual countries accumulating large precautionary foreign exchange reserves has social opportunity costs, and hence strengthened regional mechanisms are crucial for addressing shared vulnerability to financial crises.

An overarching message from these essays, and from the experiences of the countries of Asia and the Pacific, is that economic growth should be protected from the impact of such shocks not as an end in itself, but to support wider sustainable development goals – improving the welfare of all the people of Asia and the Pacific.

This country-led perspective echoes ESCAP's work on the macroeconomics of resilience, which advocates for a less mechanical interpretation of macroeconomic prudence. While maintaining short-run stability, countries should be guided by the goals of long-term economic development and poverty reduction.

ESCAP provides a forum for its member States to discuss ways to enhance regional cooperation in support of sustainability and social equity. The aim of this book is to disseminate ideas and exchanges generated by policy-makers and experts from ESCAP's member States. The analyses and recommendations developed in these pages are an important contribution to the ongoing regional dialogue about building Asia-Pacific resilience to the crises of the future.

Shamshad Akhtar
Under-Secretary-General of the United Nations &
Executive Secretary, United Nations Economic and Social Commission for Asia and the Pacific

Preface

Shortly after the onset of the global financial crisis, the Economic and Social Commission for Asia and the Pacific (ESCAP) organized a series of high-level policy dialogues to discuss how countries in the region responded to the crisis and to exchange ideas on how to strengthen their resilience to future crises. The first policy dialogue, "Strengthening the Response to the global Financial Crisis in the Asia-Pacific: The Role of Monetary, Fiscal and External Debt Policies", took place in Dhaka, Bangladesh, in July 2009 and counted with the participation of high-level officials from the ministries of finance and central banks of 17 Asia-Pacific countries. Subsequent policy dialogues took place in Thimphu, Bhutan, in December 2009; Phnom Penh, Cambodia, in June 2010; Manila, Philippines, in September 2011; Nadi, Fiji, in October 2012; Yogyakarta, Indonesia, in May 2013; and Almaty, Kazakhstan, in August 2013. The majority of the policy dialogues were organized in partnership with the central banks of the host countries.

The series of policy dialogues provided opportunities for the sharing of experiences and ideas on how Asia-Pacific countries responded to the global financial crisis and how they could bolster their defenses against future crises. A unique aspect of the series is that it considered fiscal and monetary policies in an integrated manner and provided a forum for dialogues among policymakers and experts specialized in each of these areas. Other related policy areas, such as external debt management (Dhaka and Thimphu), strategies to boost competitiveness (Phnom Penh), perspectives on the G20 agenda (Manila), energy security (Nadi), infrastructure financing (Yogyakarta and Almaty), were included in response to specific requests from ESCAP partner organizations.

As countries in the region transitioned from crisis response in 2009 to recovery in 2010 and beyond, the nature of the policy dialogues changed, focusing less on the responses to the crisis and more on extracting policy lessons for the future and on longer term issues. The Manila policy dialogue had a special focus on country experiences and a number of its participants were requested to prepare and present country essays. A selection of these essays, which were subsequently revised and updated over 2012 and 2013, are published in the present volume. The timing of the preparation and revision of these essays, just a few years after the global financial crisis of 2008-2009 provided authors with enough perspective and data to properly evaluate the responses of countries to the crisis and to extract lessons for the future.

This project would not have been possible without the support and leadership of Nagesh Kumar, former Director of the Macroeconomic Policy and Development Division of ESCAP, and Aynul Hasan, Chief of the Division's Development Policy Section. Ramkishen Rajan provided initial suggestions for improvement for the country essays included in this volume. Valuable feedback and suggestions for improvement for the introduction received from Anisuzzaman Chowdhury, current Director of the Division, from Aynul Hasan, and from the authors of the country essays are gratefully acknowledged. Achara Jantarasaengaram, Kiatkanid Pongpanich, Pannipa Ongwisedpaiboon, Patchara Arunsuwannakorn, Woranut Sompitayanurak and Zheng Jian provided invaluable support in many tasks required for the preparation of the manuscript and interacting with the printer.

This volume is dedicated to the memory of Dato' Mahani Zainal Abidin, former Director-General of the Institute of Strategic and International Studies (ISIS) of Malaysia, who passed away on 23 June 2013. Dr. Mahani was a dear colleague and friend who attended many ESCAP meetings and hosted the launch of the *Economic and Social Survey of Asia and the Pacific* in Kuala Lumpur on several occasions. Even though she did not have the chance to review and update the essay on macroeconomic policies in Malaysia she prepared for the Manila policy dialogue, her essay is of such high quality that we decided to publish it posthumously, after consulting with her colleagues at ISIS, and with minimum editing. We are sure that readers of this volume will benefit from this important contribution to policy debates on the future of macroeconomic policies in Malaysia and the Asia-Pacific region at large.

Introduction

Alberto E. Isgut

Although the global financial crisis of 2008-2009 was the worst economic crisis in over 60 years for many industrial countries, most Asian and Pacific developing countries weathered it quite successfully. The resilience of the region is somewhat puzzling at first sight. In an increasingly globalized world, are not economic shocks supposed to be transmitted faster and farther than ever before? And should not the largest shock in decades affecting the central financial centres of the world cause substantial ripple effects? Yet, even those Asian and Pacific countries that were most exposed to drops in imports from the Western industrial countries and suffered significant drops in economic activity in 2009 recovered briskly in 2010. Furthermore, in contrast to the Asian financial crisis of 1997-1998, no country in the region experienced a collapse of its banking sector or a balance of payments crisis.

The purpose of the book is to explain why countries in the region were significantly less affected by the crisis than the world's most advanced economies of Europe and the United States of America, and what the main lessons are from their experience for building resilience to future crises. The majority of the essays collected in this volume are revised and updated versions of papers presented by experts from the region at a conference organized by the Economic and Social Commission for Asia and the Pacific and held in Manila in September 2011.

The authors of country essays were asked whether the view that the impacts of the global financial crisis were significantly less severe than those of previous crises, including the Asian financial crisis of 1997-1998, is correct, and – if it is correct – what were the main sources of resilience of their economies. They were also asked what economic policies should be reinforced to respond more effectively to future crises, and what reforms at the institutional and policy-making level would be the most necessary. The answers to these questions provided a rich material that makes up the content of the present book.

While, as we discuss below, there are many similarities in the impacts and responses to the crises, the country essays are representative of the region's diversity in terms of policy goals and frameworks. This diversity suggests that when it comes to discussing economic policies in the region it is not the case that "one size fits all", which makes collections of country studies such as this a valuable contribution to observers and analysts interested in the economics of Asia and the Pacific.

Table A. Real GDP during the Asian financial crisis and the global financial crisis

Country	GDP index (1997=100)					GDP index (2008=100)				
	1997	1998	1999	2000	2001	2008	2009	2010	2011	2012
Bangladesh	100	105	111	117	123	100	106	113	120	127
China	100	108	116	126	136	100	109	121	132	142
Indonesia	100	87	88	92	95	100	105	111	118	126
Malaysia	100	93	98	107	108	100	99	106	111	117
Pakistan	100	103	107	111	113	100	104	107	111	115
Republic of Korea	100	93	102	111	115	100	100	107	111	113
Thailand	100	90	94	98	100	100	98	105	105	112

Source: Author's calculations using data from World Development Indicators database.
Note: Figures expressed in per cent. Calculations based on the GDP at 1995/96 prices.

The diversity of experiences across countries in the region is clear from table A. Although it broadly supports the view that Asian and Pacific countries were less affected by the global financial crisis of 2008-2009 in comparison with the Asian financial crisis of 1997-1998, the table shows that the degree to which countries were affected by both crises varies considerably. Of the seven countries shown in the table, only two suffered contractions of their GDPs in 2009, Malaysia and Thailand, and such contractions were relatively small, of around 2 percentage points. But in 1998 four of the seven countries suffered deeper contractions, ranging from 7 per cent for the Republic of Korea to 13 per cent for Indonesia. In addition, Malaysia and Thailand recovered briskly from the crisis with large rebounds of their GDPs in 2010, which contrast with the protracted recoveries of Indonesia and Thailand from the Asian financial crisis.

The table also shows that three of the seven countries, Bangladesh, China and Pakistan, continued growing throughout both crises, although at slightly higher rates in the aftermath of the global financial crisis compared to the aftermath of the Asian financial crisis (table B). In the case of China, the impact of the crises was to slow down the country's rate of growth, by 4 percentage points during the Asian financial crisis and by 3 percentage points during the global financial crisis. Pakistan also experienced an important slowdown during the global financial crisis with its growth rate cut from 6 per cent to 3.5 per cent, but Bangladesh continued growing at similar rates during both crises. The Republic of Korea is an exception to the assessment that Asian and Pacific countries performed better in the aftermath of the global financial crisis than in the aftermath of the Asian financial crisis. Although the country's GDP did not contract in 2009, its rate of growth over 2008-2012 was lower than over 1997-2001.

Table B. Growth rates before and during the Asian financial crisis and the global financial crisis

Country	Average annual growth rates (per cent)			
	1992-1996	1997-2001	2003-2007	2008-2012
Bangladesh	4.7	5.2	6.3	6.2
China	12.0	8.0	12.1	9.2
Indonesia	7.7	-1.2	5.6	5.9
Malaysia	9.7	1.8	6.0	4.0
Pakistan	3.7	3.2	6.0	3.5
Republic of Korea	7.7	3.6	4.7	3.0
Thailand	8.1	0.0	5.3	2.9

Source: Author's calculations using data from World Development Indicators database.

In addition to its differential impacts on GDP growth rates across countries, the global financial crisis brought to the fore country-specific vulnerabilities and strengths, as well as policy issues, that deserve further attention in future. The brief overview of the book chapters below highlights specific areas of concern for each country.

Although Bangladesh's growth rate was not affected by the global financial crisis, its ripple effects slowed down the pace of progress on poverty reduction and social development. This experience highlights the need to strengthen safety nets and to ensure that poverty reduction and key social development gains are not reversed. The chapter suggests that instituting employment and labour market programmes within the framework of a basic social floor may be useful for that purpose, but strong institutional capacities are required to implement such policies effectively.

China's policy responses to the global financial crisis, the United States quantitative easing policies and the euro area sovereign debt crises were effective, but the country still has enormous policy challenges in its transition from a centrally planned economy to a market-based economy. These challenges include reducing the Governments' intervention in the economy, narrowing the widening gap between the rich and the poor, the increasing Governments' expenditures in improving people's livelihoods and speeding up the reform of the financial system.

Indonesia's policy reforms in the aftermath of the Asian financial crisis of 1997-1998 helped the country weather the global financial crisis relatively well 10 years later. When the new crisis hit, the Government had enough fiscal and monetary policy space to act decisively by providing liquidity to the financial market, relaxing regulations for financial institutions to weather the liquidity squeeze, and providing fiscal stimulus to the economy. Policy challenges to the country going forward include reducing the potential negative impact of capital inflows and meeting G-20 standards of financial sector reforms.

Malaysia's resilience to the global financial crisis is partly due, as was the case of Indonesia, to policies implemented in the aftermath of the Asian financial crisis of 1997-1998, such as adopting a more cautious stance on financial globalization and strengthening the financial sector. Other factors include the implementation of a massive fiscal stimulus package, the expansion of the China's demand for imports and the good health of financial sectors in other countries of region. The country's short-term challenges include reducing the fiscal deficit, rationalizing subsidies and managing inflationary pressures. In the medium- to long-term, Malaysia needs to overcome its "middle-income trap" of slow growth of GDP per capita and a low investment rates.

The Pacific island countries were affected indirectly by the global financial crisis through trade, capital flows and volatility of fuel and food prices. Remittances fell but not drastically, as the Australian and New Zealand economies remained strong, and the number of tourists declined slightly in 2008 and 2009 but bounced back in 2010. However, the impact of the crisis was felt more strongly by the poor, who were affected due to inflation resulting from high fuel and food prices.

The global financial crisis of 2008-2009 exacerbated Pakistan's macroeconomic difficulties associated to the global food and fuel price hikes of the previous years, with current account and fiscal deficits rising sharply and economic growth slowing down markedly. In spite of contractionary macroeconomic policies adopted under the IMF programme, macroeconomic stability remained elusive, not least because of poor policy coordination. A three-pronged strategy to move the economy out of this maelstrom focuses on prudent macroeconomic management, structural reforms, and growth-enhancing public investments.

After the collapse of Lehman Brothers, the Republic of Korea, a small open economy with deep international financial linkages, experienced a sudden stop in the massive capital inflows it had been receiving prior to the crisis. The chapter discusses the channels of transmission from capital inflows to expansion of credit and liquidity in the Korean Government and explains why even a very large accumulation of foreign exchange reserves could be insufficient to protect the economy from the impacts of a reversal in capital inflows. It argues for the need to implement macroprudential policies and describes the recent experience of the Republic of Korea with such policies.

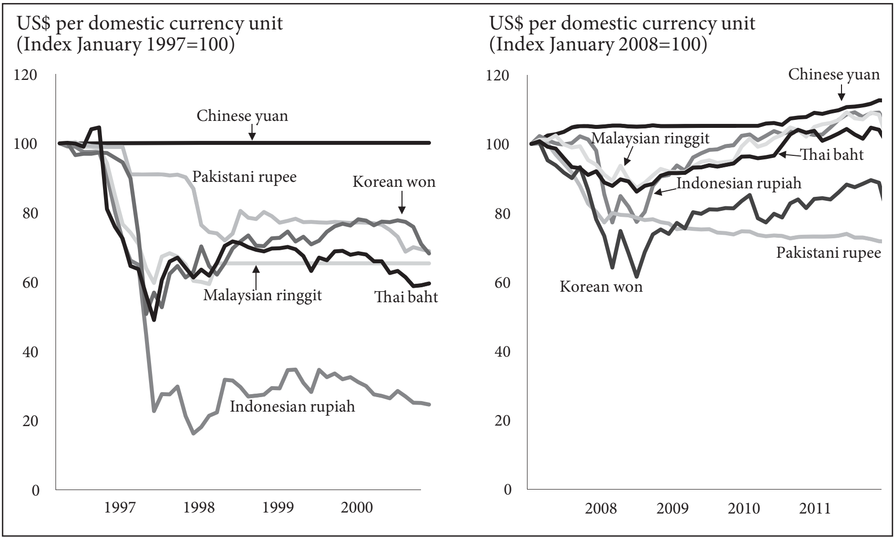
The resilience of the Thai economy to the global financial crisis was due to its high level of international reserves and to the existence of enough fiscal space to pursue expansionary fiscal policy in response to the crisis. An effective supervision and good management practices in the banking sector contributed to a low rate of non-performing loans and a high capital base. However, three years after the global financial crisis, the Thai economy was hit again, this time by devastating floods that caused the GDP to contract steeply in the 4th quarter of 2011. This second crisis highlighted the need to improve emergency and crisis resolution planning and to invest in physical and social infrastructure to mitigate the impacts of future natural disasters.

Among the many important lessons that emerge from the country analyses included in this book, the following two should be highlighted: (a) the need to preserve stability in the foreign exchange market and in the financial system, which are increasingly interrelated; (b) having enough policy space to pursue decisive countercyclical monetary and fiscal policies in the event of a sudden downturn in economic activity, including by setting up social safety nets to support specific segments of the population hit by a crisis.

With respect to the need to preserve stability in the foreign exchange market, it is worth remembering that the currencies of Indonesia, Malaysia, Republic of Korea and Thailand collapsed during the Asian financial crisis. The Malaysian ringgit lost 40 per cent of its value, the Thai baht and the Korean won lost 50 per cent and the Indonesian rupiah more than 80 per cent (figure A). Although these currencies recovered somewhat after the crisis, by the end of 2000 they were significantly lower than before the crisis. In contrast, during the global financial crisis, the Malaysian ringgit and the Thai baht dropped only 13 per cent compared to before the crisis. Although the Indonesian rupiah dropped a little more, 23 per cent, these three currencies recovered all the lost ground during 2010. The Republic of Korea won experienced a larger devaluation during the global financial crisis, of about 40 per cent, but it recovered half of that loss in value during 2011.

Collapses of exchange rates are disruptive for many reasons. First, by increasing dramatically the prices of tradables, they simultaneously push up the inflation rate and depress the domestic demand for importables and exportables, leading to stagflation. At the same time, if corporations, banks or the Government have debts in foreign currencies, the domestic currency cost of servicing those debts will also increase dramatically, leading to insolvency, bankruptcies, and the need for Governments to bailout financial institutions to minimize disruptions in the availability of credit, which could cause even more widespread damage throughout the domestic economy.

Figure A. Exchange rates during the Asian financial crisis and the global financial crisis



Source: Author's calculations based on data from Pacific Exchange Rate Service. Available from www.fx.sauder.ubc.ca.

The dramatic experiences with exchange rates collapses of Indonesia, Malaysia, and Thailand during the Asian financial crisis led these countries to accumulate vast levels of foreign exchange reserves and to implement prudential financial regulations. By the time the global financial crisis occurred, these countries' banking systems were well-capitalized and with low levels of non-performing loans, and the central banks had enough policy space to intervene in foreign exchange markets and soften the decline in value of their currencies. The problem of foreign-currency liabilities in the financial system, however, continued to affect the Republic of Korea during the global financial crisis. Although the economy remained resilient during the crisis, without experiencing a contraction, the sudden stop in capital inflows led a large drop in the value of the won and the subsequent implementation of macroprudential policies to reduce the risk of similar episodes in future.

To be sure, other way of minimizing the risks of capital outflows during a crisis is through restrictions to the movement of capital flows in and out of the country. Malaysia's controls to capital outflows during the Asian financial crisis were considered effective to stabilize the ringgit and facilitate the country's recovery. Also, the financial sectors of Bangladesh, China and Pakistan are still mostly insulated from the global financial market, implying that the main channel of transmission of the crisis to these countries was through the current account of the balance of payments.

An important difference between the Asian financial crisis and the global financial crisis was the pro-active and effective response of the monetary and fiscal authorities in such countries as China, Indonesia, Malaysia, the Republic of Korea and Thailand in the latter crisis. While the central banks of these countries lowered their policy rates aggressively between the collapse of Lehman Brothers and the beginning of 2009, their Governments announced fiscal stimulus packages to contain the adverse impacts of the crisis as soon as possible. However, the implementation of such pro-active responses required policy space, which not all countries in the region had at the time of the global financial crisis. At the time of the global financial crisis, Pakistan was receiving financial support from the International Monetary Fund under a pro-cyclical policy package that required the country to tighten its monetary policy and to reduce its fiscal deficit. An important component of counter-cyclical fiscal policies is setting up social safety nets to protect workers affected by downturns. During the global financial crisis, workers in export industries were the most affected, as the cases of Bangladesh and Malaysia illustrate.

The need to generate and preserve policy space for Governments to protect economic growth, employment and development in the event of crises is the single most important lesson transpiring the essays contained in this book. The occurrence of crises is uncertain, but their likelihood could and should be assessed by policymakers as a first step towards building resilience and minimizing their adverse impacts. The main policy failure in the Asian financial crisis of 1997-1998 was to expose economies to sudden reversals in capital inflows which eventually led to the depletion of foreign exchange reserves, uncontrollable devaluations of domestic currencies and the serious financial and economic consequences described in some of the chapters of this book. The large accumulation of foreign exchange reserves in most countries in the region and the maintenance of tight regulations on capital flows in some of them were the keys to minimizing the disruptive effects of sudden reversals of capital inflows preserving exchange rate stability during the global financial crisis of 2008-2009. To be sure, large accumulations of foreign exchange reserves have high opportunity costs (Rodrik, 2006; Cruz and Walters, 2008).[1] However, these costs should be balanced against the potentially much more serious costs of a balance of payments crisis and an uncontrolled devaluation of the domestic currency.

In future, Governments of the region should continue assessing carefully the likelihood of various crises and have in place measures to protect their economies if a crisis occurs. However, Governments should also evaluate the efficacy and costs of such measures and consider ways to improve them. In the area of preserving exchange rate stability, collective financial safety nets, such as the Chiang Mai Initiative Multilateralization, could play a larger role in future. In this area, as the chapter on the Republic of Korea suggests, it is particularly important to identify the channels and players through which inflows of foreign exchange are transformed into expansions of credit in domestic currency in order to set up proper regulatory measures. Exchanges of experiences in the area of regulation of capital flows among countries of the region with different levels of financial development could be extremely useful for the identification of best practices and to support policymakers in improving the design and execution of policies in this area.

In addition, as discussed in many chapters of this book, it is critical to strengthen prudential regulations to preserve the stability of the financial system. Financial instability, which could be described as cycles of excessive expansion of credit followed by borrowers' insolvency, could cause serious threats to financial institutions and lead to onerous government bailouts — as the United States subprime mortgage crisis attests. Financial instability could be a consequence of large capital inflows to an economy, as discussed in the chapter on the Republic of Korea, but it can also originate in the domestic economy, for example as a consequence of excessive lending for real estate development. In light of the extremely disruptive impacts of domestic financial crises on economic activity and the potentially huge fiscal costs of rescuing failed financial institutions, the importance of implementing

[1] In addition, it has been claimed that tight regulations on capital flows may adversely affect the development of domestic financial systems and the availability of credit to domestic firms. See, for example, Forbes (2007) for the case of Chile. However, the generality of this claim is questionable. For instance, Chinn and Ito (2005) showed that financial openness contributes to equity market development only when a threshold level of general development of legal systems and institutions has been attained, which has been confirmed by Klein and Olivei (2008) and Eichengreen and others (2011). Also, Aizenman (2005) found that countries that financed their capital formation with a higher share of domestic savings grew faster over the period 1970-2000.

effective prudential financial regulations cannot be overstated. This is another important area where regional cooperation in capacity-building and for the identification of best practices could be very useful.

While preserving stability of the exchange rate and the financial system are very important policy objectives, the chapters of this book also discuss extensively how Governments responded to crises using counter-cyclical macroeconomic policies. In this regard, the ability of many countries of the region to design and speedily implement large stimulus packages is remarkable and stands in sharp contrast to the experience of the same countries during the Asian financial crisis of 1997-1998. Similarly, central banks of the region acted fast and in a coordinated fashion to aggressively lower their policy rates. Looking forward, it is critical for Governments of the region to be able to respond in a similarly effective manner to future crises which, as discussed in the chapters on Indonesia and Thailand, could also be caused by natural disasters.

A final message of the book is the need for Governments to preserve important medium- to long-term developmental goals. Ultimately, a major reason for protecting economies from the impacts of crises is to avoid losses in hard-earned progress in the creation of employment and business opportunities, the reduction of poverty, and the improvement in the social conditions of the majority of the population. As pointed out in the chapter on Bangladesh, the impact of economic downturns usually falls disproportionately on the poor, not only in terms of economic distress and deterioration of poverty situations but also through the worsening of key social development indicators, such as school attendance of children and nutritional status of the household members, especially children and women. As a result, the need for policy responses in the event of a crisis to aim at preventing the deterioration of the living conditions of the weaker and vulnerable sections of society cannot be overemphasized.

Chapter 1

Bangladesh

Mustafa K. Mujeri

The powerful forces of globalization have made economies across the world so closely connected with each other that difficulties in some of them are very likely to have adverse impacts on other economies. As is well known, the global financial crisis which originated in the United States housing market in 2007 engulfed the world economy within a short period of time. The financial crisis and the consequent economic recession quickly affected almost all economies of the world, though in varying degrees. Although the developed industrial economies were the first victims, the crisis transmitted to the emerging and developing economies by 2008. The year 2009 experienced the first contraction of the global economy in the post World War II era and the severe recession continued well into 2010.

The developing economies were impacted through the finance, trade, and investment channels. Although the Bangladeshi economy showed considerable resilience against financial and real economy vulnerabilities of the global crisis and the effects of the crisis were hardly visible until the last quarter of 2008, the situation started to change as the advanced economies entered into a deeper recessionary phase by the end of 2008. As the Bangladeshi economy started to slow down, the country's growth and other macroeconomic projections were revised downwards. A major concern for Bangladesh was the social impact of the slowdown especially on poverty, health, education, and other critical social development outcomes.

Although Bangladesh was not severely affected by the global financial crisis of 2008, a number of its export sectors suffered. The Government's response was to adopt a stimulus package for assisting those sectors. However, the size of the package was rather small compared with the size of the economy because of the country's limited fiscal and policy space for accommodating the necessary increases in expenditures and for implementing the relevant programmes. In this context, it is also important to recognize that the global financial crisis hit Bangladesh – a primarily import-dependent economy – while the country was still suffering from the consequences of persistently high fuel and food prices.

This chapter examines the experience of Bangladesh in the wake of the economic crisis of 2008 with the aim of drawing policy implications and measures that the country should undertake to protect the economy from the adverse consequences of any such future events. Besides considering the macroeconomic consequences of the crisis, the chapter focuses on social dimensions such as employment and poverty. The purpose is to identify the broad elements of a possible post-crisis agenda to cope with external shocks in future and to sustain the country's development efforts.

Structure and performance of the Bangladeshi economy

The degree to which developing countries were affected by the global financial crisis depended on the structure of their economies and the extent of their integration into the global economy (Verick and Islam, 2010). The economy of Bangladesh is relatively small and characterized by a high population density, a low resource base, and recurrent natural disasters. The country's population was estimated at nearly 150 million in 2011; thus the country's population density exceeds 1,000 persons per sq. km. – one of the highest in the world. Moreover, an important share of the country's area is submerged by monsoon floods every year, and devastating floods including tidal surges and cyclones occur frequently. Despite these formidable constraints, Bangladesh has performed well, especially in recent years, showing that a country can achieve significant human and social development even at relatively low levels of income (Mujeri, 2003; Mujeri and Sen, 2006; Sen and others, 2007).

Although the overall growth performance of Bangladesh over the past three decades has not been spectacular, there has been an acceleration in growth, from 3.7 per cent in the 1980s, to 4.8 per cent in the 1990s, 5.4 per cent over 2001-2005 and 6.2 per cent over 2006-2010 (table 1.1). The figures indicate that the country has also made good progress in increasing its per capita income particularly over 2006-2010, when its growth rate accelerated to almost 5 per cent per year. The higher growth of per capita GDP of the period has come from a combination of increased economic growth and reduced population growth. The country's early demographic transition is remarkable, given its relatively low level of development. However, while the acceleration in GDP growth attained by Bangladesh has been significant, a growth rate of around 6 per cent per annum is not particularly high from an Asian perspective.

Table 1.1. Economic growth in Bangladesh

	Average annual growth rates (per cent)						
	1981-1990	1991-2000	2001-2005	2006-2010	2011	2012	2013
GDP	3.7	4.8	5.4	6.2	6.7	6.2	6.0
Population	2.2	1.7	1.4	1.3	2.5	1.3	1.3
Per capita GDP	1.5	3.1	4.0	4.9	4.1	5.0	4.7

Sources: Bangladesh Bureau of Statistics (2000 and 2001); Bangladesh, Ministry of Finance (2011).
Note: Average annual percentage growth rates for each period.

The values of the determinants of growth have also changed favourably during the period. The growth in GDP was supported by rising rates of investment and domestic savings, which increased by more than 2 percentage points between 1998-2000 and 2008-2010 (table 1.2). With the adoption of a private sector-led development strategy, the relative role of the private sector has also been increasing and private investment now accounts for nearly three-fourths of the total yearly investment in the country. The economy has become more open, with the share of merchandise trade (exports and imports) in GDP increasing from less than 30 per cent in 1998-2000 to nearly 40 per cent in 2008-2010.

Table 1.2. Selected macroeconomic indicators of the Bangladeshi economy

	Three-year averages				
	1981-1983	1998-2000	2001-2003	2004-2006	2008-2010
Gross investment	17.5	22.1	23.2	24.5	24.3
Gross domestic savings	11.7	17.7	18.3	20.0	20.2
Gross national savings	17.6	22.4	23.6	25.9	29.9
Exports	5.4	11.8	13.0	15.0	17.1
Imports	15.2	17.5	18.8	21.6	22.8
Total revenue	6.6	9.0	10.1	10.7	11.3
Tax revenue	5.3	7.3	8.0	8.6	9.0
Total public expenditure	11.4	13.7	14.8	14.8	16.2
Overall budget balance	-6.8	-4.7	-4.6	-4.2	-4.2
Current account balance	-3.8	-0.5	-0.4	0.1	2.4
CPI inflation	11.0	6.2	3.0	6.5	8.0

Sources: Bangladesh Bureau of Statistics (2000 and 2001), Bangladesh, Ministry of Finance (2011).
Note: All the indicators except CPI inflation are expressed as percentages of the GDP. CPI inflation is the average annual growth rate in the Consumer Price Index in per cent.

As for the structure of production, all three economic sectors (agriculture, industry and services) contributed to accelerating the GDP growth (table 1.3). The annual growth rate of agricultural value added increased by 2.1 percentage points, from 2.3 per cent in the 1980s to 4.4 per cent during 2007-2010, whereas the rates of growth of industry and services increase, respectively, by 1.2 percentage points and 3.1 percentage points. The structure of the economy also witnessed significant changes. The share of agriculture in GDP declined to 20 per cent in 2010 from 33 per cent in 1980. The share of industry correspondingly increased from 17 per cent in 1980 to 30 per cent in 2010, due mainly to the impressive performance of manufacturing exports and construction activities, and the share of the services sector remained unchanged at around 50 per cent.

Table 1.3. Changes in economic structure, 1981-2010

	A. Average annual growth rates			
	1981-1990	1991-1996	1997-2006	2007-2010
Agriculture	2.3	1.6	3.6	4.4
Industry	5.8	7.5	8.7	7.0
Services	3.7	4.1	6.2	6.8
GDP	3.8	4.4	5.5	6.2
	B. Share in GDP			
	1980	**1990**	**1997**	**2010**
Agriculture	33.2	29.5	25.9	20.3
Industry	17.1	20.8	25.0	29.9
Services	49.7	49.7	49.1	49.8
GDP	100.0	100.0	100.0	100.0

Sources: Bangladesh Bureau of Statistics (2000 and 2001); Bangladesh, Ministry of Finance (2011).
Note: Figures expressed in per cent. Calculations based on the GDP at 1995/96 prices.

In addition to the growth rate, the relative contribution to the incremental value added is an important indicator of the sectoral performance and their underlying dynamism. To illustrate this, the share of the absolute contribution of each sector to the incremental GDP over different sub-periods is presented in table 1.4. During the 1980s the services sector contributed nearly 50 per cent to the incremental GDP while the contribution of industry was 29 per cent and that of agriculture was 21 per cent. Over the years, the share of agriculture to incremental value added consistently declined and, between 2001 and 2010, it fell to 13 per cent while corresponding shares of industry and services increased, respectively, from 29 to 34 per cent and from 50 to 53 per cent.

Table 1.4. Contribution of different sectors to incremental GDP

	1980-1990	1990-2000	2001-2010
Agriculture	21.1	18.8	12.9
Industry	29.2	34.2	34.4
Services	49.7	47.0	52.7
Total	100.0	100.0	100.0

Sources: Bangladesh Bureau of Statistics (2000 and 2001); Bangladesh, Ministry of Finance (2011).
Note: Figures expressed in per cent.

Major reforms in economic policies

Since the mid-1970s, Bangladesh started to reverse its regime of restricted and State-controlled policy by adopting neo-liberal policies to create an open and private sector-led economy and a liberal trade regime. These reforms significantly influenced the country's socio-economic performance by changing the underlying allocative and distributive policies and shifting the sectoral allocation of resources and the ownership pattern of productive factors.

The reforms were implemented rapidly in the trade sector, resulting in significant reduction in tariff and non-tariff barriers. The principal aim of these reforms was to liberalize the external trade and foreign exchange regimes and to rationalize the trade regime by lowering tariff rates, phasing out quantitative restrictions, streamlining import procedures, and introducing tax reforms and export promotion measures.

The deregulation in the industrial sector was slow and it generated mixed outcomes. Although a dynamic and export-oriented readymade garments sector emerged, other sectors, with the exception of the pharmaceutical industry, were unable to benefit, partly because they continued facing substantial financial and infrastructural bottlenecks. The process of deregulation in agriculture covered the liberalization of the fertilizer and irrigation equipment markets, reforms in the public food grain distribution system, and a restructuring of subsidies on modern inputs. The overall impact of these policies on agricultural production and productivity was highly positive.

Social and human development

Social and human development is both intrinsic to the definition of what constitutes a good standard of living and instrumental to economic development. Education, in particular, is a powerful vehicle for improving awareness on health issues and the uptake of preventive health practices. Effective government policies to mitigate the impact of preventable diseases, to protect the poor from insurmountable costs of health care, and to ensure access to affordable, essential, high-quality health care and education are key to increase the stock of human capital and facilitate long-term economic growth.

The human development index (HDI) closely shadows the targets that all countries have endorsed as the Millennium Development Goals to be achieved by the year 2015. The HDI value of Bangladesh rose to 0.50 in 2011 from 0.30 in 1990 (UNDP, 2011). Notwithstanding the relatively slow economic growth, Bangladesh's progress in human development has been fast and stands out in the context of South Asia. Although the level of social deprivations is still high in Bangladesh, the country has made clear progress in several areas, such as in reducing fertility, bringing down child mortality and improving life expectancy. Bangladesh's progress in most areas has been higher than the average progress recorded by South Asia (table 1.5).

Although economic growth is the major tool for fighting poverty and "growth is a powerful ally of the poor, not their enemy", the issue is complex since the impact of economic growth on the rate of poverty reduction depends on the nature, strength, and other characteristics of the links that exist between economic growth and poverty. Moreover, these links are not direct, as they can be decomposed into the relationship between economic

Table 1.5. Social development in Bangladesh: a South Asian perspective

	Bangladesh	India	Pakistan	Nepal	Sri Lanka	South Asia
Total fertility rate						
1975	6.8	5.1	7.0	6.3	3.9	5.4
2011	2.2	2.5	3.2	2.6	2.2	2.6
Percentage change	-67.6	-51.0	-54.3	-58.7	-43.6	-51.9
Life expectancy at birth						
1970	44.2	49.1	49.2	42.1	64.5	49.0
2011	68.9	65.4	65.4	68.8	74.9	65.9
Percentage change	55.9	33.2	32.9	63.4	16.1	34.5
Under-five mortality rate						
1970	239.0	206.0	183.0	234.0	100.0	207.0
2009	52.0	66.0	87.0	48.0	15.0	69.0
Percentage change	-78.2	-68.0	-52.5	-79.5	-85.0	-66.7
Adult literacy rate						
1995	38.1	52.0	37.8	27.5	90.3	…
2010	55.9	62.8	55.5	59.1	90.6	62.8
Percentage change	46.7	20.8	46.8	114.9	0.3	…

Source: United Nations Development Programme, *Human Development Report* (New York, various years).

growth and the distribution of income and the relationship between the distribution of income and poverty.

One obvious conclusion that follows from the above is that the effectiveness with which economic growth translates into poverty reduction depends on initial conditions, such as the initial income distribution, the stage of development, and other socio-economic characteristics of a country. In particular, the degree of inequality determines the strength of the poverty-elasticity of economic growth.[2]

During the 1980s, the incidence of poverty declined at a very slow rate in Bangladesh, with substantial variation over different sub-periods and between rural and urban areas, but the higher per capita real GDP growth had a salutary effect on the poverty situation in the 1990s. Between 1992 and 2010, the national head-count poverty index declined from 59 per cent to 32 per cent (table 1.6). This faster pace has largely been due to higher growth of consumption during the period. The annual Household Income and Expenditure Surveys-based real per capita consumption expenditure growth at the national level increased from only 0.6 per cent during the period 1984 and 1992 to nearly 2 per cent between 1992 and 2010. A declining trend can also be observed for other poverty measures, such as the poverty gap index and the squared poverty gap index. The data show that progress in reducing the head-count index was faster in the urban areas. The rural areas, on the other hand, displayed a faster progress in reducing the depth and the severity of poverty, as captured by the poverty gap and the squared poverty gap indices respectively.

Around one-third of the poor in Bangladesh live in “extreme poverty”, a group that includes the elderly poor, disabled people, destitute persons, socially marginalized ethnic groups, and those engaged in dying occupations. The lives of the extreme poor are characterized by multiple and overlapping vulnerabilities, including long duration in poverty, often spanning generations, adverse interplays between the vulnerable ecology and chronic social disadvantages, high levels of consumption shortfalls, and food insecurity.

[2] This brings out the importance of identifying specific policy measures that can improve or at least arrest the deterioration of income inequality without adversely affecting economic growth. The potential impact on economic growth of simultaneous policies to improve income distribution is difficult to predict a priori, in view of the complexity of the relationships. The empirical evidence from East Asian countries shows that countries with less initial inequality were able to realise higher growth but inequality also increased with growth. (Birdsall and others, 1995; Feng, 2011).

Table 1.6. Recent changes in poverty and inequality

	1992	2000	2010
Head-count			
National	58.8	48.9	31.5
Urban	44.9	35.2	21.3
Rural	61.2	52.3	35.2
Poverty gap			
National	17.2	12.8	6.5
Urban	12.0	9.1	4.3
Rural	18.1	13.7	7.4
Squared poverty			
National	6.8	4.6	2.0
Urban	4.4	3.3	1.3
Rural	7.2	4.9	2.2
Gini index of			
National	38.8	45.1	45.8
Urban	39.8	49.7	45.2
Rural	36.4	39.3	43.0

Sources: Bangladesh Bureau of Statistics (2011) and World Bank (2002).
Notes: The figures are based on the Household Income and Expenditure Surveys (HIES) of the Bangladesh Bureau of Statistics (BBS). The poor are estimated using the cost of basic needs (CBN) method and are taken as those living below the poverty line, corresponding to an intake of 2,122 kcal/person/day plus a non-food allowance corresponding to the non-food expenditure among households whose expenditure equals the food poverty line. All the indicators are expressed in percentage.

With regard to income inequality, the Gini coefficient rose considerably since the early 1990s (table 1.6). Rising inequality has reduced the effectiveness of accelerated growth to further reduce poverty. Inequality increased rather sharply during the 1990s, which coincided with the period of rapid trade liberalization.

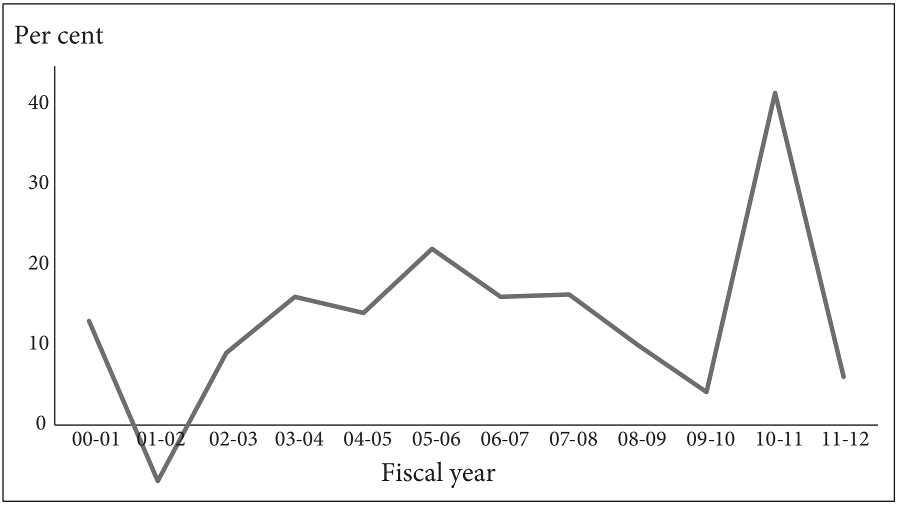
One way to promote equitable growth in Bangladesh is by building assets of the poor. Policies for that purpose should aim to expand the asset base of the poor in a broad sense, covering physical, financial, human, social, political and other forms of capital that can strengthen their bargaining power and ensure their fair access to resources, public services and decision making. This will enhance their capability to take advantage of opportunities to benefit from the country's accelerated economic growth.

Impacts of the global financial crisis

Next we turn to variables that are indicators of the strength of the economy to withstand external economic shocks such as exports, foreign exchange reserves, and external debt (Reinhart and Rogoff, 2009). In terms of external accounts, foreign exchange reserves and the debt situation, the economy of Bangladesh not only was doing well before the global financial crisis started but also remained stable during the crisis period.

During the years prior to the global financial crisis of 2008-2009, Bangladesh attained a healthy rate of growth of exports (figure 1.1). The rate of growth peaked in the fiscal year (FY) 2005-2006 and somewhat declined before the crisis. However, there was a sharper decline in the growth of exports between FY 2007-2008 and FY 2009-2010. Thus, it seems that the global financial crisis simply exacerbated a trend that was already evident before the crisis.

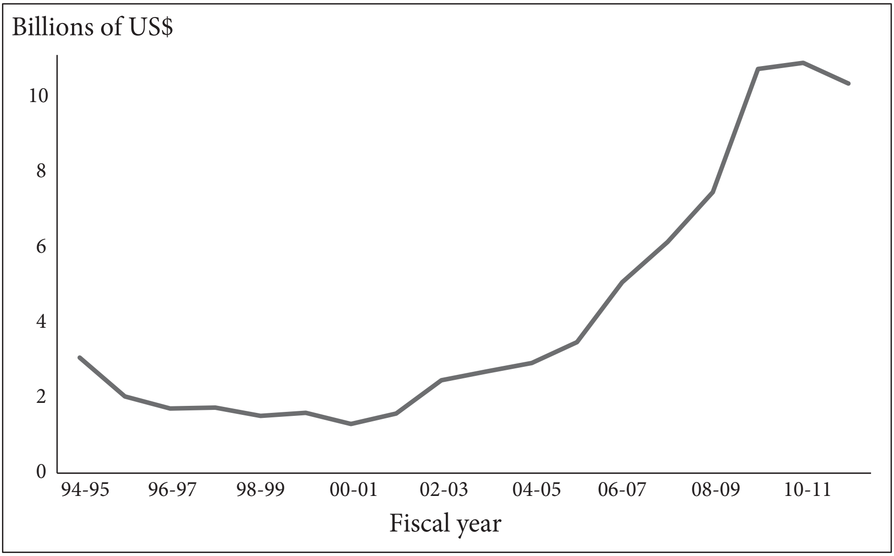
Figure 1.1. Annual growth rate of exports



Source: Bangladesh Bank (2011).
Note: Exports in US$.

As for foreign exchange reserves, there has been a sharp upward trend since FY 2005-2006 due mainly to a sharp upward trend in the growth of remittances (figure 1.2). Moreover, the reserves exceeded the minimum threshold of three months' import bill since FY 2006-2007. It also crossed the threshold of 10 per cent of GDP beginning that year. The country's short-term debt has always been a small percentage of foreign exchange reserves as well. The country's external debt situation is also sound. The total external debt as percentage of gross national income (GNI) has declined from over 30 per cent in the early 2000s to about 22 per cent in FY 2008-2009.

Figure 1.2. Foreign exchange reserves



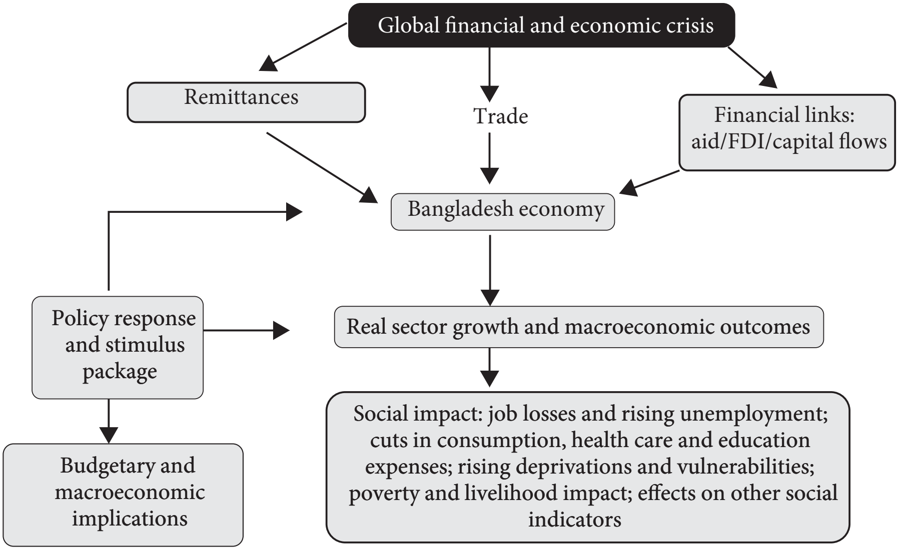
Source: Bangladesh Bank (2011).

Thus, Bangladesh had reasonably sound and stable indicators as far as the resilience factors to withstand external economic shocks were concerned.

Transmission channels of the global financial crisis to the Bangladeshi economy

There are several transmission channels through which the impact of the global financial crisis may have affected the Bangladeshi economy (figure 1.3). These can be conveniently grouped under two broad headings: (i) financial channels and (ii) trade and remittances channels.

Figure 1.3. Transmission channels of impact of the global financial crisis



Source: Adapted from Ahmed and Mujeri (2009).

Bangladesh's financial sector maintains a good health due to past reforms, and it remains highly insulated from foreign markets. The financial linkages of Bangladesh are limited because of the relatively underdeveloped nature of the country's financial markets.[3] In the aftermath of the global crisis, the country's credit market continued operating normally, without any credit crunch, and providing adequate flows of credit to the real sector. Indeed, a major concern of the financial market at that time was the low demand for bank credit as firms and consumers were forced to cut back investments and consumption in the face of slowing economic activities and limited demand.

Foreign capital inflows to Bangladesh are small because the country's capital market is not strongly linked to the global capital market. In 2009, foreign investment accounted for only 2.5 per cent of total market capitalization (Rahman and others, 2009). Bangladesh is neither a major destination of foreign direct investment (FDI) nor there exists any noticeable

[3] Bangladesh's financial system is dominated by commercial banks owning more than 95 per cent of total assets. The financial system is hardly exposed to subprime products such as mortgage backed securities and collateralised debt obligations and hence the chance of toxic asset exposure is non-existent.

trend in the flows of FDI (table 1.7). These flows exceeded US$ 1 billion in 2008, declined in 2009 due to drops in investment in the telecommunications and readymade garments sectors, and picked up again in 2010. Official aid flows have also remained mostly unchanged, while external debt is low and reserves are comfortable. In addition, a reasonably high domestic savings rate of around 20 per cent of GDP provides added cushion.

Table 1.7. Inflows of foreign direct investment to Bangladesh, 2000-2010

Year	Amount	Year	Amount	Year	Amount
2000	579	2004	460	2007	666
2002	328	2005	845	2008	1 086
2003	350	2006	792	2009	700
				2010	913

Source: United Nations Conference on Trade and Development (2011).
Note: Figures in million US$.

Bangladesh's capital account remains nonconvertible with few private transactions permitted. Therefore, private debt transactions are limited and strictly monitored by the Bangladesh Bank. Capital flows take place mostly in terms of concessional lending and FDI, while portfolio investment flows are minimal. As a result, the financial sector remains largely insulated from the risk of transmission of financial crises from abroad.

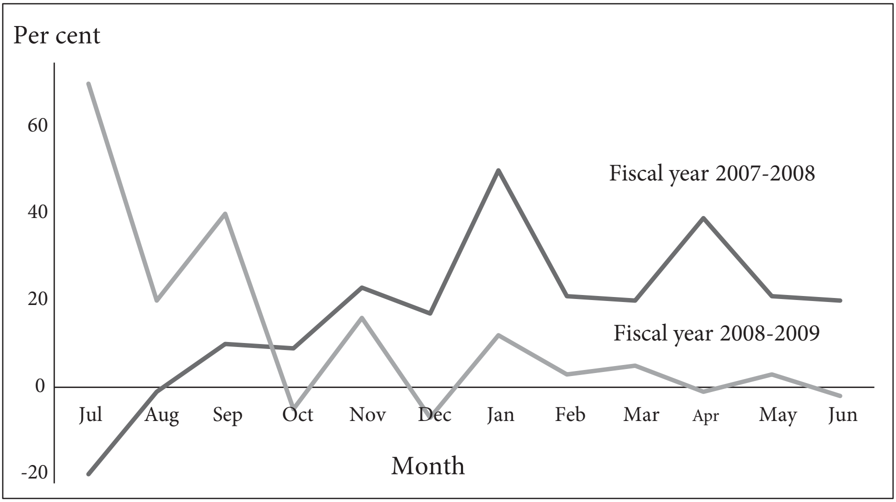
Trade and remittances linkages, on the other hand, provide important avenues through which global financial shocks are transmitted to the Bangladeshi economy. For Bangladesh, the export sector is the most vital transmission channel through which the effects of the global recession are spread. The total exports from Bangladesh rose by nearly 16 per cent in FY 2007-2008, but they declined to 10 per cent in FY 2008-2009. As table 1.8 and figure 1.4 show, there was a marked decline in the growth rate of exports since October 2008 (see also Rahman and others, 2009; Islam and others, 2011).

Table 1.8. Quarterly growth of major manufacturing exports, 2009

Commodities	Share in total exports	Export growth					
		Q1	Q2	Q3	Q4	FY2009	FY2008
Woven garments	38.0	36.7	6.5	14.3	4.1	14.5	10.9
Knitwear	41.3	52.0	4.7	10.8	3.7	16.2	21.5
Frozen food	2.9	15.7	-24.3	-32.5	-21.0	-14.9	3.6
Home textile	2.0	27.8	9.3	5.6	-9.1	7.6	13.4
Jute goods	1.7	-4.3	-32.0	-18.3	-7.2	-15.4	-0.8
Leather	1.1	-6.4	-50.2	-41.6	-46.8	-37.7	6.9
All products	100.0	42.3	-1.6	6.0	-0.6	10.3	15.9

Sources: Bangladesh Bank (2010; 2011).
Notes: Q1 is Jul-Sep 2008, Q2 is Oct-Dec 2008, Q3 is Jan-Mar 2009, and Q4 is Apr-Jun 2009. Figures expressed in per cent.

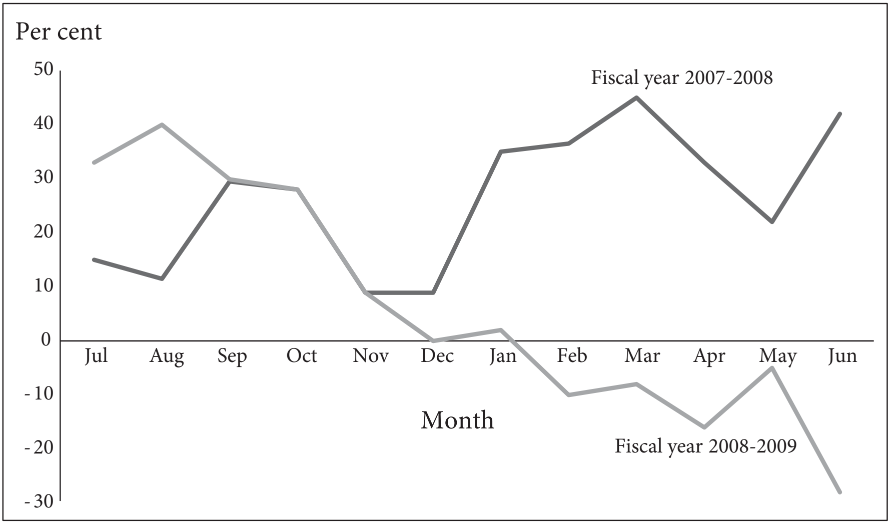
Figure 1.4. Year-on-year growth rate of exports



Source: Bangladesh Bank (2010).
Note: Exports in US$.

Two features contribute significantly to the potential vulnerability of the exports sector: the high dominance of readymade garments, which represent over three quarters of total export earnings and the high reliance of the country's exports on United States, the European Union and other developed country markets, which represent 87 per cent of the value of the country's exports. The growth slowdown in the developed countries had important implications on the demand for Bangladesh's exports, especially for readymade garments. In addition, the sharp slowdown in global growth resulted in significant declines in commodity prices, including food, oil, and metals. The net effect of global commodity price declines on Bangladesh, however, was complex, because the country benefited from the drop in oil and food prices (figure 1.5).

Figure 1.5. Year-on-year growth rate of imports

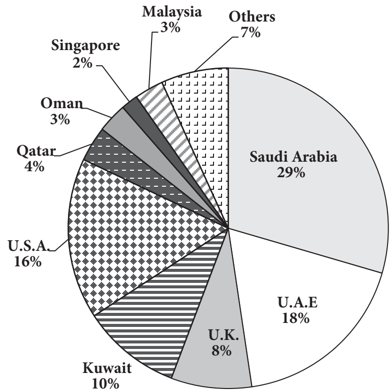


Source: Bangladesh Bank (2010).
Note: Imports in US$.

Another important channel of integration of the Bangladeshi economy into the global economy is international migration and remittances sent by the migrant workers. Remittances are the second most important source of foreign exchange earnings for Bangladesh after exports of ready made garments and continue to play a major role in the economy.

Remittances were less affected by adverse growth prospects in developed economies since less than 30 per cent of the remittances originate in the United States, the European Union or other advanced countries. In fact, nearly 63 per cent of the remittances come from the Gulf region (figure 1.6).

Figure 1.6. Major sources of remittance inflows to Bangladesh, 2009

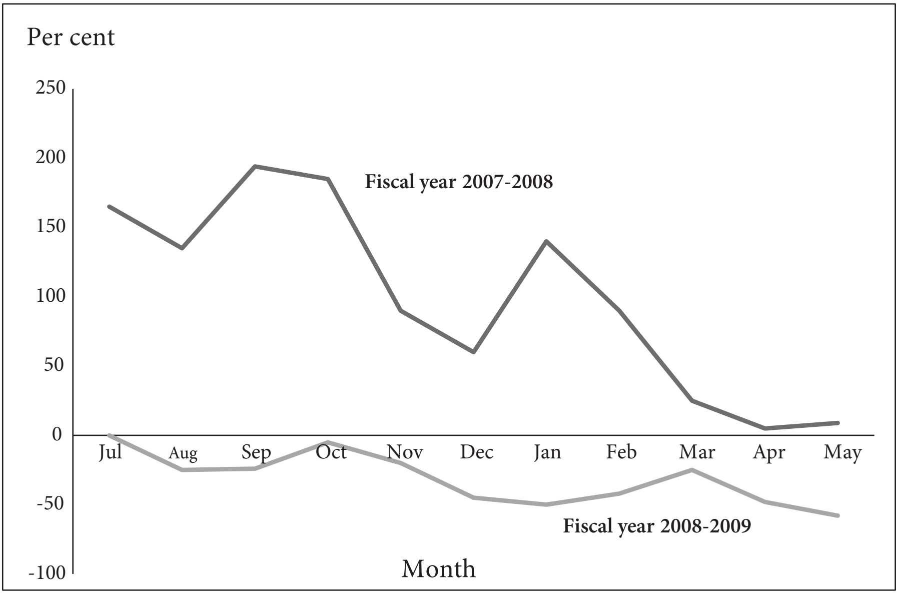


Source: Bangladesh Bank, Economic Data. Available from www.bangladesh-bank.org/econdata/index.php.

Nevertheless, since the countries that serve as major destinations for such workers, viz. those in the Middle East, Malaysia, and Singapore were adversely affected by the economic downturn, their demand for expatriate workers naturally fell. That in turn had a negative impact on the flow of migrant workers from the sending countries including Bangladesh. The number of migrant workers going abroad from Bangladesh declined from 981,000 in 2008 to 650,000 in 2009 and 427,000 in 2010. In fact, the monthly figures show a sharp decline after October 2009 and continuation of the declining trend throughout 2010 (figure 1.7).

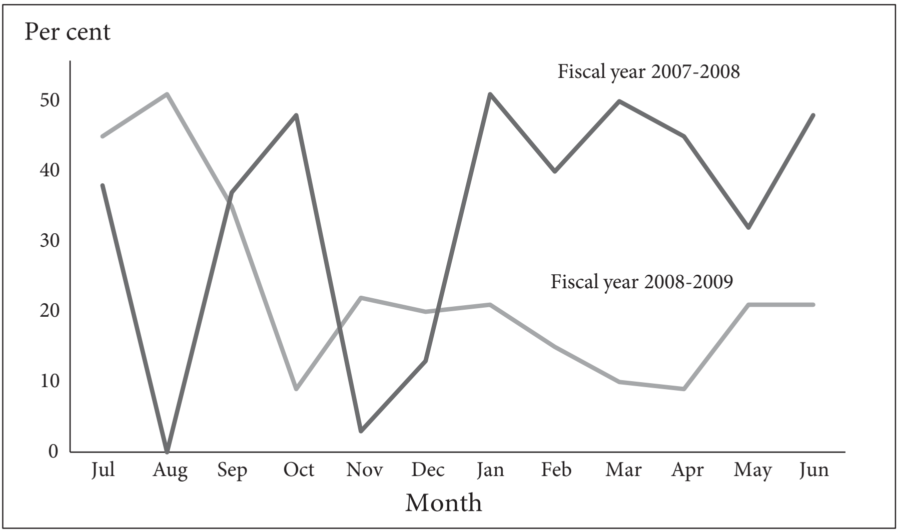
The sharp decline in the number of workers going abroad, however, was not reflected in the flow of remittances which continued its upward trend (figure 1.8). Indeed, the remittances received in FY 2008-2009 rose to US$ 9.7 billion from US$ 7.9 billion in FY 2007-2008, and then increased to nearly US$ 11 billion in 2009-2010. The absence of any rigorous analysis on the determinants of the flow of remittances to Bangladesh, however, precludes drawing any definite conclusions regarding the factors that contributed to the growth of remittances despite the sharp decline in the outflow of migrant workers. There is evidence, however, that the continued growth of remittances is related to the resilience of the non-oil GDP growth and a surge in the hiring of migrant workers from Bangladesh by the Gulf Coperation Council countries during 2006-2008 (IMF, 2010).

Figure 1.7. Year-on-year growth of outflows of Bangladeshi migrant workers



Source: Bangladesh Bank (2010 and 2011).

Figure 1.8. Year-on-year growth of remittance inflows



Source: Bangladesh Bank (2010 and 2011).

The ripple effects of the external shocks were also transmitted to the labour markets. However, lack of up-to-date data makes it difficult to provide definite evidence of such effects. During the crisis, the labour market in Bangladesh seems to have undergone significant quantity adjustments. Although open unemployment is not significant mainly due to the definition and methodology adopted to measure it, the rate of open unemployment increased to 5.1 per cent in 2009 after remaining at around 4.2 per cent since 2000. But more alarmingly, the rate of underemployment, defined as the percentage of the labour force who works less than 35 hours per week and wish to work more than 35 hours per week, increased from 24.5 per cent in FY 2005-2006 to 28.7 per cent in FY 2008-2009. An earlier study also pointed towards quantity adjustment in terms of retrenchments and lay-offs (Rahman and others, 2009). One survey of enterpreneurs conducted during the period indicates that 8.3 per cent of them resorted to laying off workers and another 5.6 per cent closed down their production units altogether (Rahman and others, 2009). New recruitment in major export-oriented sectors also slowed down considerably.

Social impacts of global financial crisis

The slowdown in the growth of exports and remittances resulted in lower GDP growth which also had social implications. The most direct impact of economic slowdown due to the global financial crisis is not only current job losses but also a contraction in future employment opportunities. The lower growth in exports is likely to lead to job cuts in the export industries and, consequently, on income loss of the workers. The decline in household income may trigger a host of changes in intra-household allocations of resources with implications on food security, nutrition, education, health care, as well as poverty dynamics and the intergenerational transmission of poverty.

Table 1.9 shows that, as a result of the growth slowdown due to the global financial crisis, the estimated losses in incremental employment were 0.1 million in 2009, 0.4 million in 2010, and 0.5 million in 2011. Thus the total loss of incremental employment in three years after which the global economy is expected to return to its normal growth path is 1 million, nearly 2 per cent of total employment in the base year.

Table 1.9. Loss of incremental employment due to the global crisis

Fiscal year	GDP growth without crisis	GDP growth with crisis	Employment without crisis	Employment with crisis	Loss of incremental employment
2008/09	6.5	5.7	52.9	52.8	0.1
2009/10	7.0	6.1	55.1	54.7	0.4
2010/11	7.2	6.7	57.5	57.0	0.5

Source: Author's calculations based on employment data from the Labour Force Survey 2005-06 assuming an employment-GDP elasticity of 0.59.
Note: First two columns in per cent. Last three columns in millions.

It is likely that much of this job loss had taken place in industry and services, which represent 15 per cent and 37 per cent of total employment, respectively. The agriculture sector, with 48 per cent of total employment, grew robustly in the absence of natural calamities and other unexpected events during the period. Much of the lost employment was in the manufacturing sector, including leather, jute goods, readymade garments, and other export industries. However, considering the resilience that the Bangladeshi economy has shown, the direct employment effect was only partially visible in the short run, since the recession-hit industries coped with the crisis mostly by reducing prices rather than the volume of exports.

The workers' losses were mostly in terms of lower wages and decline in overtime income. The employment impact in the readymade garments sector in the short run was mainly in terms of loss in incremental employment, which now employs around 3.0 million people in more than 5,000 factories.[4] Moreover, one million more unemployed persons in the economy means livelihood uncertainties for more than 5 million people in the current generation along with implications for future generations through the intergenerational transmission of poverty (inadequate food intake, low health care and education, and other key channels). Other major sectors

4 The job loss in the readymade garments sector has many other social dimensions since 90 per cent of these workers are females and migrants from rural areas. Most of these workers are low-skilled and work for low wages. IOM (2010) shows that recent migrants, who migrated less than 5 years before, usually remit around 40 per cent of their income while migrants who have been around for a longer span of time remit 26 to 30 per cent of their incomes. This remitted money is mostly sent for family maintenance and for the education of younger family members. Thus, any downturn in the income of the apparel workers is more likely to generate long term adverse impacts on nutritional and human development indicators of rural households.

which faced declines in exports due to the crisis included frozen food, leather and jute goods. The resulting production cuts hurt low-paid, low-skilled workers more, as they were the ones who lost jobs in larger proportions. The contraction in the shrimp sector, which employs around 1 million people, the majority of which are women, led to job losses in larger numbers for female unskilled workers, who have very limited alternative employment opportunities. As productive employment is the main conduit through which growth impacts poverty, the loss of employment by low-skilled workers is likely to aggravate the poverty situation.

Similarly, remittances have been one of the key drivers of poverty reduction in Bangladesh. The inflow of remittances in Bangladesh is considerably less volatile than FDI and portfolio flows.[5] There exists a strong positive correlation between remittance inflows and household expenditures in the country. Households with migrant workers tend to have higher per capita expenditures compared to those without migrant workers, both on food and non-food items and on consumer durables. Households with migrant members also save a good amount of their remittance receipts. Thus a lower growth of remittances would tend to adversely affect the growth of household expenditure and lower household savings, affecting both current household welfare and their upward mobility. Although remittances continue to grow at present, their impact will diminish if demand in the migrant–destination countries remains unchanged.[6] As such, a decline in the growth of remittance flows indicates potential income loss as well as multiplier effects of these losses in terms of investment in agriculture, education and non-food expenditures. Moreover, since there is a lag between labour migration and remittance receipts, the real impacts of the decline in the growth of out-migration are likely to be felt only in the longer term.

It is well known that any reduction in income growth is likely to have an adverse impact on poverty and other Millennium Development Goals. One option for quantifying this impact is to use the elasticity of per capita GDP growth with and without crisis and calculate the gaps in the

5 The coefficient of variation, defined as the standard deviation divided by the mean, for the ratio of various inflows to the GDP during the period 1980-2008, was 55 per cent for remittances, 138 per cent for FDI and 829 per cent for portfolio inflows. For comparison, it was 48 per cent for exports and 45 per cent for aid.

6 It is estimated that an additional migrant worker from Bangladesh generates about US$ 816 of remittance income annually. See World Bank (2009).

rate of progress in achieving selected targets. The results of such an exercise are presented in table 1.10.[7] It can be seen that the rate of reduction in the proportion of population living in poverty declines by 0.5 percentage points in FY 2008-2009 due to slowdown in per capita GDP growth as a result of the crisis. Such reduction rates are higher in the next two years. Similar impacts can also be seen in the case of poverty gap ratio and the number of undernourished people. Although the impact on educational indicators is less, mortality indicators show greater susceptibility to slower income growth. These results indicate that the global financial crisis has made it more difficult for Bangladesh to achieve poverty reduction and other social development targets.[8]

Table 1.10. Impact of the global crisis on selected Millennium Development Goals

Indicator	2005	Gaps in achieving target (percentage points)			Target in 2015
		2008-09	2009-10	2010-11	
1. Population living below the national poverty line	40.0	-0.52	-1.27	-1.02	29.4
2. Poverty gap ratio	9.0	-0.48	-1.16	-0.92	8.0
3. Population undernourished	19.5	-0.30	-0.73	-0.58	13.8
4. Net enrolment ratio in primary education, both sexes	87.2	0.03	0.08	0.06	100.0
5. Primary completion rate, both sexes	53.0	0.03	0.07	0.06	100.0
6. Under-5 mortality rate	62.0	-0.26	-0.64	-0.51	50.0
7. Infant mortality rate	45.0	-0.28	-0.68	-0.55	31.0
8. Maternal mortality ratio	290.0	-0.19	-0.45	-0.36	147.0

Source: Ahmed and Mujeri (2009).
Notes: Indicators 1-5 in per cent. Indicators 6-7 per 1,000 live births. Indicator 8 per 100,000 live births.

7 In the absence of country specific values for Bangladesh, the results use average "MDG elasticity" values for South Asia. See ESCAP, ADB and UNDP (2008).

8 One analysis indicates that the households paid a heavy cost for the economic downswing through mainly job losses, reduced incomes, and low cash commodity prices. Along with an estimated rise in unemployment by 10-15 per cent, household's budget share spent on food increased by an average of 5 per cent due to food price inflation, share on education decreased by about 20 per cent, and the share spent on health increased over a period of 12 months ending in March 2010. See Sanago (2010).

The table shows that although the impact of global financial crisis was not as severe as in other developing countries, Bangladesh experienced an adverse impact of the crisis through reductions in exports, remittances, and economic growth, which affected social equity and poverty. Analytical results using a comparative static computable general equilibrium (CGE) modelling framework of the Bangladeshi economy also lend support to the above conclusions. The analysis focusing on readymade garment exports, which is the most prominent channel of transmission through which the shocks from the global slowdown were propagated, suggests that a decline in readymade garments exports reduces manufacturing growth and hence GDP growth (Raihan, 2010). More importantly, the welfare, real consumption and poverty impacts on households are negative with proportionately larger impact falling on the poorer households. A similar result is also found in the case of a decline in remittances as a result of global recession.

Bangladesh, however, tried to cope with the crisis through appropriate adjustments in monetary policy supported by an expansionary fiscal policy stance focused on boosting domestic demand and promoting more competitive markets. The strategic thrust of the Government's policy was on spending more on education, health care, social protection, and social safety nets, which not only helped boost domestic demand but also supported broader social objectives like inclusive growth and poverty reduction. Though in the short-run, the impacts of the global financial crisis on Bangladesh seemed to be moderate, the long run impacts, especially on social indicators, are considered to be quite severe. More specifically, the slowdown in the growth rates of many macroeconomic fundamentals can stunt progress towards becoming a middle income country by 2021.

Policy response and stimulus packages

In order to mitigate the possible adverse effects of the global financial crisis, Bangladesh adopted a number of measures and policy adjustments. At the initial stage, the country's strategy was to monitor the financial situation, safeguard the country's foreign exchange reserves, and ensure a smooth flow of finance for exports, imports and the productive sectors of the economy, especially agriculture and small and medium enterprises. The prudent monetary policy of the Bangladesh Bank ensured a good balance between the concerns of inflation on the one hand and the provision of adequate liquidity to the financial system on the other. In addition, measures were adopted to correct the short term debt yield curve and "plan for tomorrow" especially in terms of dampening inflation expectations and ensuring price stability. The primary focus of the credit policy was to support the productive sectors to facilitate job creation and ensure improved functioning of the credit markets and payment systems.

In April 2009, the first package of explicit policy support, including fiscal and financial measures, was announced, and a second package was included in the budget of FY 2009-2010. The basic objective of these measures was to safeguard the economy from the adverse effects of the global recession, particularly in the developed countries. The major goals were to maintain export growth through different measures aimed at supporting export oriented industries and to ensure a sustained flow of remittances from abroad. The first package was worth Tk. 34.2 billion or US$ 495 million, around 0.6 per cent of GDP of 2009, while the second package was worth Tk. 50 billion or US$ 724 million, about 0.8 per cent of GDP. In the absence of any assessment of the implementation of the stimulus packages mentioned above, it is difficult to identify the impact that the various measures had on the performance of the economy and on the extent to which the segments of the economy that were adversely affected by the global financial crisis benefited from them. However, a few general observations may be made about the contents of the packages.[9]

First, it is claimed that the financial part of the package has been implemented fully, which should have benefited the targeted sectors according to the design of the measures. However, the size of the fiscal part of the stimulus package was rather small in relation to the country's GDP.[10] Thus, it would be unrealistic to expect any major impact from such measures. But in designing its response, the Government placed more emphasis on the policy support measures vis-à-vis the fiscal measures. It would therefore be interesting to see if those measures were able to provide the needed support

9 The points that follow draw heavily from Islam and others (2011).

10 While China's stimulus package amounted to 13 per cent of the country's GDP, Malaysia, the Philippines and Thailand allocated 7.9 per cent, 3.7 per cent and 2.8 per cent respectively. At the other extreme, India and Viet Nam allocated 0.9 per cent and 0.3 per cent respectively of their GDP for their stimulus packages. See IILS (2009).

to the economic activities that were adversely affected during the economic crisis.[11]

Second, the issue of employment does not seem to have received adequate attention in the Government's policy response. Except for either the continuation or strengthening and restructuring of existing programmes of social safety nets, there was very little in the stimulus package to support the domestic labour market. There was no provision for possible support to the workers who were retrenched from functioning enterprises or who lost jobs when enterprises went out of business. Most industries (even those in the formal sector) do not have any provision of severance pay; and nothing was done to introduce such provision for workers who may have lost jobs due to the adverse effects of the economic crisis. The issues of postponing retrenchment and of severance pay could have been linked to the augmented cash subsidy that was provided.

Third, the stimulus package could have included components on investment in infrastructure. In the past, such components proved to be effective in creating productive employment directly and indirectly, through multiplier effects, and producing a "crowding in effect" for investment in other sectors of the economy.

Fourth, the implementation of even minor measures, such as a food ration for workers in the readymade garments sector, appeared weak. Similarly, the exact nature and purpose of the Skill Development Fund was not defined, and how and to what extent it was implemented remains unclear. While such a fund could serve the general purpose of upgrading the level of skills of workers during periods of economic crisis, it could also be used to provide retraining and redeployment facilities for retrenched workers.

Fifth, since such shocks are common in market oriented economies, it would be important to create preparedness for responding to them and to adopt a longer term approach rather than reactive measures. Timeliness and speed of response is especially important from the point of view of effectiveness of whatever measures are undertaken.

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[11] No rigorous analysis is available on the implementation and impact of the various measures adopted in response to the crisis. In order to derive lessons for the future, it would be important to undertake such an analysis.

Lessons and challenges

As the Bangladesh experience shows, strong macroeconomic fundamentals are essential to shielding, at least partly, the adverse impacts of external shocks, especially in the short run. This also provides some breathing time to create necessary policy and fiscal space for protecting the real economy and addressing the social concerns. Despite the country's resilience to the crisis, the current economic outlook of Bangladesh is not devoid of challenges. The most urgent concern is the high headline inflation caused primarily by food price pressures fuelled recently by non-food price increases following administered fuel price hikes. Since mid-2010, considerable increase in energy and food prices, both domestically and globally, has exerted supply-side inflationary pressure on the economy which has also led to adverse budgetary implications by raising subsidies on domestic food and energy prices. Although energy and food prices in the global market have receded somewhat in the recent months, the possibility of their further rise in future cannot be ruled out. Moreover, the economic recovery of the United States and the euro zone countries is rather uncertain, with continuing high levels of unemployment and sovereign debt crises clouding the global economy.

In addition, rising food inflation is a matter of concern especially in bringing overall inflation down since this may have some spill over effect on non-food inflation as well. Other pressures on inflation are a strong domestic demand, high private sector credit growth, and rising consumer spending. Thus, there are multiple sources of demand-side pressures on inflation, in addition to increases in fiscal spending and the inflow of remittances.

In the domestic economy, a good performance of the agriculture and manufacturing sectors would clearly help Bangladesh in bringing inflation down from beyond its comfort level. However, Bangladesh Bank's liquidity management has to face two major challenges: injections from high fiscal deficits and how to limit domestic liquidity in the face of strong credit demand by the public and private sectors. Another major concern is whether the central bank's current efforts to maintain a stable economic environment is paying off. Central banks in most Asian countries seem to have opted to rely on a combination of stronger currencies and higher interest rates to temper a worsening inflation problem. Along with raising interest rates, most countries are using currency appreciation to tackle inflation. In the case of Bangladesh, however, the domestic currency (taka) continues to depreciate at the time of writing.

Several factors have contributed to excessive liquidity expansion in the economy during the current fiscal year. It would therefore be appropriate for the central bank authorities to explore a combination of actions for managing the liquidity situation. In this respect, it would also be important to recognize that raising the policy rates is not likely to be very effective under the present situation. The experience of several countries in the region in using central bank policy rates and cash reserve ratio to contain domestic liquidity and inflation indicates that such measures have been largely ineffective in the present situation. If interest rates are raised, growth is likely to be sacrificed. But this would not have much impact on inflation since supply-side factors are clearly not within monetary control. In such a situation, demand-side measures will pay little dividend with growth sacrificed needlessly.

While the above may be true, it is important to recognize for policy purposes that although the root cause of current inflation lies in the supply side, the way inflation works is that, even if it has a supply side and/or external source, it starts to feed on itself after a point. At the present juncture, inflation in Bangladesh seems to have reached such a situation. At this stage, Bangladesh Bank needs to give a clear signal and ensure that high inflation does not enter into the medium/long term expectations of the economic agents. If relatively high inflation is taken for granted, inflation would become a vicious cycle of its own. It is true that the shocks came from outside the monetary system, but what the central bank can do is to use its tools to contain it and ensure that it does not become a permanent feature. With high food and oil prices in the global market, the issue of equity also comes to the forefront in terms of shouldering the burden of fighting globally generated inflation by raising interest rates and reducing growth in less developed countries like Bangladesh vis-à-vis the policies of the developed countries.

The success of the policy actions would require greater fiscal and monetary coordination to ensure clear recognition of the importance of the monetary policy stance and appropriate alignment of relevant policy parameters within the overall macroeconomic framework. In addition, bringing appropriate changes in the Government's debt management strategy would be important to improve the balance between short and long term borrowing since any shift in the borrowing pattern has implications for the conduct of monetary policy.

Although in the past Bangladesh Bank has managed to bring down inflation without compromising economic growth, inflation has probably become the most vexing problem for the policymakers at present. In the backdrop of the recent financial crisis and worldwide depression followed by rising commodity prices, there exists now a great concern that inflation could undermine economic growth in Bangladesh. This concern is certainly not misplaced, especially in view of the sustained increases in food prices over the past year.

With rising incomes and population and deepening structural supply problems, food is likely to become more expensive in the world market. Similarly, with upward pressure on wages as a result of inflation, the self-fulfilling spiral will consequently feed into inflation. Mujeri (2008) shows that the nominal wage in Bangladesh is in fact closely related to inflation. With rapid urbanization, the number of the lower-middle income groups who live in urban areas is rising, and food inflation is particularly severe for these groups.

There are very few options in the face of this "multi-faceted" inflation that is causing problems in Bangladesh. Monetary tightening has almost reached a plateau, as any further tightening could severely undermine economic growth, which Bangladesh cannot afford. The build-up of foreign currency reserve also comes at a cost. The Bangladesh Bank, like central banks elsewhere, invests reserves in low-yielding debt with short-term maturities. This is primarily done to have adequate liquidity to provide effective and timely insurance in case of a liquidity squeeze. In addition, the fall in the value of United States dollar directly translates into a fall in the value of Bangladesh Bank's reserves as a large part of the country's foreign exchange holdings is dollar denominated. It is necessary to recognize that the current inflationary scenario in Bangladesh is not unique. A significant number of Asia's developing countries are struggling to come to grips with rising inflation. Theoretically, the contradictions and solutions for countries such as Bangladesh are not hard to see but the gap between theory and practice is significant.

Vulnerability and competitiveness

One of the key aspects of economic policy of Bangladesh is to focus on accelerating growth-promoting structural reforms to reduce vulnerability and enhance competitiveness. Such reform priorities cover several areas, such as tax policy and administration, public financial management, monetary and exchange operations, financial sector, and the trade and investment regime. These reforms are critical to bolster growth and reduce external vulnerability. These are also fundamental to containing balance of payments pressure which would arise from import-intensive investments necessary to tackle power, transport, and other infrastructure bottlenecks in the short and medium terms.

On the external front, despite impressive gains over the past decade, total exports were only 21 per cent of GDP in FY 2010-2011. Moreover, the exports remain highly concentrated, both in terms of products and destinations, which carries some risk. At present, although Bangladesh's susceptibility to a global downturn appears limited, its reserve adequacy is low by most measures, which makes it increasingly vulnerable to external shocks (IMF, 2011a). This suggests significant financing and adjustment needs to reduce vulnerability. In addition, Bangladesh needs to assess the equilibrium levels of its current account and its currency appropriately to keep the real effective exchange rate and the current account balance in line with macroeconomic fundamentals.

Financial sector resilience

For managing credit and liquidity risks in the financial market and promoting healthy competition and efficient performance, the Bangladesh Bank has been providing prudential guidelines and implementing reforms for ensuring proper financial regulation and supervision in a regular manner.[12] As a result, Bangladesh's financial sector remains largely immune to the global financial sector turmoil. Moreover, capital controls in Bangladesh largely insulate the domestic economy from the risk of transmission of financial crisis from abroad. The country's financial risks also remain low due

[12] For example, Bangladesh Bank took steps for fulfilling the Basel II norms of capital adequacy in a time bound manner. For details, see Bangladesh Bank (2008); Mujeri and Shahiduzzaman (2008).

to relatively strong macroeconomic fundamentals, a good health of the financial sector, and its limited exposure to foreign capital markets.[13]

In fact, the low level of global integration somewhat shielded the Bangladeshi economy from the global financial crisis. In particular, the insulation of the country's capital market and limited role of foreign portfolio investment, supported by relatively strong macroeconomic fundamentals and strengthened policy and management frameworks, ensured that the economy would be resilient to the global financial crisis and resulting economic recession.

The Bangladeshi experience points to the importance of prudent government intervention and careful regulation within the market determined incentive structures to avoid systemic distress caused by moral hazard and adverse selection in the pursuit of free financial sector nostrums. The need is to ensure a liberalized, market-based, and effectively supervised and regulated financial sector in Bangladesh. An important agenda for the purpose is to plug the gaps in regulatory and supervisory infrastructures and strengthen its regulatory regime in a comprehensive manner.

Creating the framework for a basic social floor

The experience of Bangladesh shows that, while relatively strong and stable macroeconomic fundamentals are essential for facing challenges posed by an economic crisis, they are not adequate to address the adverse impacts on poverty, income distribution, and labour market of lower economic growth. The preparedness of an economy to address the adverse social effects of an economic crisis is also important. The lessons from Bangladesh demonstrate that the impact of a downturn is transmitted to livelihoods and living conditions, especially those of the poor, fairly quickly, while the beneficial effects of recoveries take time to trickle down.[14]

13 Bangladesh's financial institutions are not exposed to complex financial derivatives and synthetic securitization instruments. The banking system is mostly separated from international financial markets, and does not have sophisticated financial products. As such, the banking sector remained free from toxic derivatives and the off-balance sheet items comprised mostly basic swap contracts with no risk of sustaining unexpected losses. Moreover, with low level of external debt (about 30 per cent of GDP and consisting mostly of concessional loans from multilateral financial institutions), strong foreign reserves, and low FDI, Bangladesh is not likely to face any perceptible asset quality problem and credit crunch in the event of any future external shocks.

14 Although economic recovery was achieved fairly quickly after the Asian economic crisis of 1997-98, labour markets in different affected countries responded with a lag. Similarly, countries (for example Indonesia, Thailand) took time to put their economies back to pre-crisis poverty reduction path. See Islam (2010); Reinhart and Rogoff (2009).

In addition, the impact of economic downturns usually falls disproportionately on the poor, not only in terms of economic distress and deterioration of poverty situations but also through the worsening of key social development indicators, such as school attendance of children and nutritional status of the household members, especially children and women (Ravallion, 2009). Hence, it is essential that these countries undertake measures directly aimed at preventing the deterioration of the living conditions of the weaker and vulnerable sections of society. At the macroeconomic level, such a basic social floor can also serve as a countercyclical policy response by providing a boost to aggregate demand, helping to maintain labour productivity, providing cushion in building human capital, and sustaining economic growth.

In this context, the lessons from different countries, including some in the developed world, indicate that the existence of automatic stabilizers in an economy can perform important roles during an economic downturn. Moreover, it becomes easier to support the poor when such instruments are already in operation in an economy. In such a situation, depending on the availability of fiscal space, it may be possible to strengthen such instruments, for instance by expanding the coverage and/or duration of unemployment benefits, or address social concerns through such programmes as employment guarantees, conditional cash transfers, and investments in rural infrastructure. A related issue is how to set goals if a country such as Bangladesh were to incorporate social dimensions more explicitly in response to an economic downturn.

In this respect, the Social Protection Floor Initiative of the United Nations proposes the following major elements: Essential services - for example geographical and financial access to essential services (such as water, sanitation, adequate nutrition, health and education, housing, and other services including life and asset saving information); and Essential social transfers - for example, social transfers (in cash and in kind) paid to the poor and vulnerable to provide a minimum income and health security. See ILO and WHO (2009).

The International Labour Organization (ILO) defines the Basic Social Security Floor to include: (i) access to basic/essential health care benefits; (ii) income security for children at least at the poverty level through various family/child benefits; (iii) targeted income support to the poor and the unemployed in the active age group; and (iv) income security for the old and the disabled — at least at the poverty level — through pensions for old age, disability and survivors. While conceptually this can be part of a country's social security architecture, in reality these may take the form of social assistance rather than social security benefits. In practice, it may be reasonable to assume that a country like Bangladesh would want to create a basic social floor below which the poor would not be allowed to fall. In such a floor, a few basic elements would be critical.

First, automatic stabilizers such as unemployment benefits which could come into play in the event of an economic downturn causing increased unemployment. One mechanism would be to introduce special employment programmes, such as public works programmes. Second, introduce/ strengthen severance pay and incentives for preserving jobs to minimize the adverse effects on the poor. Third, preserve and enhance investment in human development (especially in education and health) through various measures, for example conditional and universal cash transfers. Such instruments may be tailored to various goals that need to be pursued in a country (table 1.11).

The policy instruments relevant for each of the above goals could include: (i) guaranteed employment programme with built-in unemployment benefits so that the programme can serve the purpose of an automatic stabilizer during economic downturns; (ii) measures to encourage job preservation; and (iii) investment in infrastructure, especially where labour based approaches can be applied. Introduction of severance pay would help mitigate the adverse effects on retrenched workers. For enhancing the employability of retrenched workers, the relevant instrument would be active labour market policies (that would include measures of retraining and redeployment). Relevant instruments for protecting investment in human capital would include programmes in the areas of health and education (for example, conditional and unconditional cash transfers and other targeted programmes).

Table 1.11. Goals and instruments for addressing the social impact of economic downturns

Goals	Possible instruments
Minimise adverse effects on employment	(i) Automatic stabiliser in the form of unemployment benefits (e.g. schemes for guaranteed employment).
	(ii) Incentives for job preservation.
	(iii)Investment and adoption ofl abour based approaches in infrastructure.
Mitigate adverse effects of economic downturn on retrenched workers	Introduce severance pay
Enhance employability and redeployment of retrenched workers	Introduce active labour market policies
Protect investment in human capital	Strengthen conditional and unconditional cash transfers with particular focus on education and skill training

Source: Adapted from Islam (2010).

In view of the limited fiscal space available to the Government in most low income countries like Bangladesh, one important concern is to meet the budgetary needs for implementing the package. It is important therefore to look at options for enhancing the fiscal and policy space needed for implementing the package for which the countries could explore several alternatives such as (a) increasing the efficiency of utilization of existing resources; (b) raising additional domestic resources; (c) ensuring more efficient utilization of remittances received from migrant workers; and (d) promoting public private partnership especially in infrastructure and in undertaking active labour market policies.[15]

[15] In Bangladesh, the total cost of a package consisting of (i) a guaranteed employment programme with universal coverage of all poor households generating employment for 3.3 million persons per day and a built-in unemployment benefit; (ii) scheme for subsidizing job preservation through work sharing; (iii) scheme for introducing active labour market policies including retraining and redeployment; and (iv) provision for an increase in public investment in infrastructure especially focusing on labour based approaches and linked with the proposed guaranteed employment programme has been estimated at around Tk. 187 billion per year at 2009-2010 prices which is 2.6 per cent of the country's GDP. However, if the proposed package is dovetailed into the existing programmes, then the incremental cost would be reduced to around 45 per cent of the above amount. For details, see Islam and others (2011).

The lessons from Bangladesh points out that strong macroeconomic fundamentals alone are not adequate from the point of view of social dimensions of development. The macroeconomic strength may remain disconnected from the performance with regard to social dimensions like employment and poverty during a period of global financial crisis. This suggests that greater attention to social dimensions is necessary for developing a post-crisis agenda for low income countries in order to ensure development with a social face and for strengthening capacity to respond to possible economic crisis in future. In this context, a package of employment and labour market programmes within the framework of a basic social floor may serve useful purposes for which it is not too difficult to create the necessary fiscal space even when using the country's own resources if the country is prepared to make a serious effort to attain its revenue potential. While having appropriate policies are important, strong institutional capacity is required to implement the policies efficiently and effectively.

In addition, several counter measures may be considered for mitigating the adverse impact of financial crisis. First, apart from increasing internal demand for stimulating growth, more inputs to livelihood protection especially for the poor and the disadvantaged households are necessary. For example, economic stimulus packages may be rolled out emphasising the efforts to protect people's livelihoods by directing support to different areas such as education, health, housing, infrastructure, ecological protection, environmental remediation, and rural development. Second, adjustment in a macro-policy framework may be introduced such as tax rationalization, financial market adjustments, price stabilization, and livelihood support to poor households. If necessary, subsidies may be raised for key public welfare sectors and communities in distress. Third, a proactive employment policy may be adopted especially by providing support to small and medium enterprises and service sectors. The Government may need to play the role of the driver of employment generation by raising public investment and giving incentives for self-employment and business start-up initiatives. For the purpose, the Government may expand occupational training opportunities for laid-off workers and rural workers, and provide job assistance for groups in difficulties of employment and zero-employment families. Fourth, public services and social protection measures may be strengthened and expanded in order to support the provision of basic needs to the vulnerable households.

Finally, more inputs should be given for poverty reduction along with strengthened implementation of village-based development and integrated approaches for poor areas.

The obvious need would be to follow proactive fiscal and appropriate financial policies, intensified institutional reform, provide support for small and medium enterprises, improve social security system, increase support for low income households, and enhance implementation of poverty reduction policies. However, in view of the fact that the safety net coverage usually remains quite limited relative to the size of the total poor population in most low income countries like Bangladesh, the traditional programmes to specifically target the crisis-affected households may not be adequate, especially for those who might be better placed than the structurally poor households in terms of their endowments and access to economic opportunities. However, as the impacts of a crisis take hold, there may be a good case for extending or deepening certain types of existing programmes (for example public works programmes) in specific areas, regions, or sectors. Extending coverage among the urban poor, for instance, may address an important need given that the urban poor is likely to be one of key affected groups and the coverage of existing safety net programmes usually remains extremely low in urban areas.

Interface between fiscal and monetary policy

Obviously, in a country like Bangladesh, both fiscal and monetary policy are essential components of overall macroeconomic policy and thus share the country's common goals like a reasonable degree of macroeconomic stability, high economic growth, and rapid poverty reduction. All these objectives may not always be in harmony. A key challenge for policymakers is to ensure appropriate coordination of fiscal and monetary policy such that the policy focus remains relevant.

In practice, the interface of fiscal and monetary policy may be analysed in the context of public debt, especially in terms of the choice of alternative modes of financing of fiscal deficit, such as bond financing and money financing, leaving aside the issue of foreign financing. As is well known, fiscal deficit can be financed either through bond issuance or money creation. While bond financing entails placement of government debt in financial markets, either in domestic or foreign markets or both, money financing involves changes in the monetary base due to changes in net central bank credit to Government. Furthermore, such financing of the fiscal deficit may be at market determined rates or at concessional rates, may be voluntary or non-voluntary, or may have other characteristics.

The important issue is that each form of financing fiscal deficit has its specific consequences and hence implications for monetary policy. For example, the reliance on domestic credit has implications for credit availability for the private sector, interest rates, and the monetary base. On the other hand, reliance on foreign borrowing has implications for the management of the external sector. Non-voluntary financing may crowd out the private sector. This shows that, in addition to the degree of monetization of fiscal deficit, important concerns for fiscal-monetary policy interface cover issues relating to determining the desired financing mix of fiscal deficit that ensures macroeconomic stability. In this context, it is important to recognize that there exist many other channels of liquidity creation, other than monetization of government deficit, such as expanding net foreign assets, conducting open market operations, and adopting other monetary instruments.

There are several channels which link the fiscal and financial sectors in Bangladesh. These include, for instance, the Government's borrowing programme; guarantees extended by the Government; and the Government's investment in the financial sector. Of these, the borrowing programme of the Government is relatively large, both in gross and net terms. The banking sector holds majority of the outstanding stock of government securities. In addition, the scope of money financing of deficit vis-à-vis bond financing also needs to be considered in assessing fiscal-financial linkage.

At the policy level, three important constraints on the operational autonomy need action in Bangladesh. First, continued fiscal dominance, including large temporary mismatches between receipts and expenditures of the Government warranting large involuntary financing of credit needs of the Government by the Bangladesh Bank. Second, the dominance of State-owned financial institutions and non-financial public enterprises, which blurs the demarcation between funding of and funding by the Government vis-à-vis the public sector as a whole. Third, the relatively underdeveloped state of the financial markets, which blunts the effectiveness of monetary policy.

Bangladesh also needs to effectively face the "open economy trilemma" of trade-offs among open international flows of capital, effective monetary policy, and stable exchange rate.

Under the present circumstances, fiscal empowerment appears to be essential for obvious reasons. Although the existing level of fiscal deficit may be considered manageable, the space available for meeting unforeseen circumstances appears rather limited. More specifically, the nature of fiscal dominance does constrain the effectiveness of monetary policy to meet unforeseen contingencies, maintain price stability, and contain inflation expectations.

It also needs to be recognized that there is no ideal level of fiscal deficit, and the critical factors are: How is it financed and what is it used for? The fact, however, is that the fiscal policy determines the size of the debt and government debt provides the most critical link with monetary policy. On the other hand, the composition of debt is determined by the debt management policy. The monetary impact depends on who holds the debt and how the holding changes with policy and the consequent impact on aggregate demand.

In a country like Bangladesh, the basic objective of interface of fiscal and monetary policy should be to achieve a balance between total social demand and supply for ensuring movement toward the common goals of social development. This requires not only aggregate balance of supply and demand, but also balance in the structure of supply and demand. Effective coordination of fiscal and monetary policy has a strong ability to regulate both the volume and the structure of supply and demand in the economy. In general, the focus of monetary policy adjustment is on aggregate balance while the focus of fiscal policy coordination is on the structure, so that the two need to complement each other in order to achieve a basic balance between total social demand and supply objectives. Coordination of the two policies should be conducive to development, measured not just by how fast output growth is achieved but, more importantly, by expansion of productive capacity, rise in economic efficiency, and success in promoting balanced economic structure.

In view of the complex nature of the interface, the coordination between fiscal and monetary policy has several dimensions. At the macro level, the issue is whether the specific fiscal-monetary policy mix, such as the level of the fiscal deficit, the pattern of financing, or the extent of monetization, is with the macroeconomic objectives being pursued. Similarly, it would be necessary to ensure that the operating procedures of fiscal and monetary authorities, including debt and cash management, are consistent and mutually reinforcing.

While both fiscal and monetary policies need to support each other, it is also important to maintain their relative independence, especially to strengthen their regulatory effect. In general, monetary policy adjustment takes longer period and the adjustment process of fiscal policy is relatively short. The aim of policy adjustment should be to take full advantage of both sets of policies taking into account the health of the economy and the characteristics of specific macroeconomic situation.

Concluding remarks

Although fluctuations in economic activities are normal in market-based economies, the frequency and severity of such fluctuations have increased in recent decades. It is important to identify the potential challenges and effective responses based on lessons learned from past experiences in order to adopt counter-cyclical measures to deal with economic downturns and bring the economy back to the path of sustained economic growth. This is especially relevant for Bangladesh since it belongs to the high exposure countries, and its fiscal capacity is limited to withstand the shocks of adverse external events. Bangladesh cannot be complacent and treat such experiences as a short-term aberration in its pursuit of market-based development paradigm. In this context, it is important to strengthen the country's preparedness for undertaking counter-cyclical policies in response to such crisis and create necessary fiscal space and institutional capacity to face such events in future.

The analysis of social impacts of global crisis in Bangladesh reveals that the global financial crisis can adversely affect a country's progress toward achieving poverty reduction and social development goals including the Millennium Development Goals. This highlights the need to re-launch more determined efforts in achieving the stipulated goals. Thus the countries like Bangladesh face difficult and complex challenges. In these countries, along with providing stimuli to growth, the Governments must also make efforts to strengthen safety nets and ensure that poverty reduction and key social development gains are not reversed. In such efforts, while the Government is the key actor, a shared paradigm is necessary in which global and regional partnerships could foster technology diffusion and capacity building for inclusive and sustainable growth. This is the time for the developed countries to keep their commitments to share required resources for achieving the Millennium Development Goals from which the developed countries have as much to gain as the developing countries like Bangladesh.

Chapter 2

China

Yide Qiao

The objective of this chapter is to describe the impacts of the global financial crisis on the Chinese economy and the country's policy responses. Particular attention is paid to China's unique growth characteristics and the challenges it faces after the crisis. The following sections provide background information on the characteristics of the economic growth pattern in China, investigate the impacts of the global financial crisis on China, describe the Chinese policy response to the crisis, and analyse the challenges facing China in its transformation of growth patterns and economic structural adjustment.

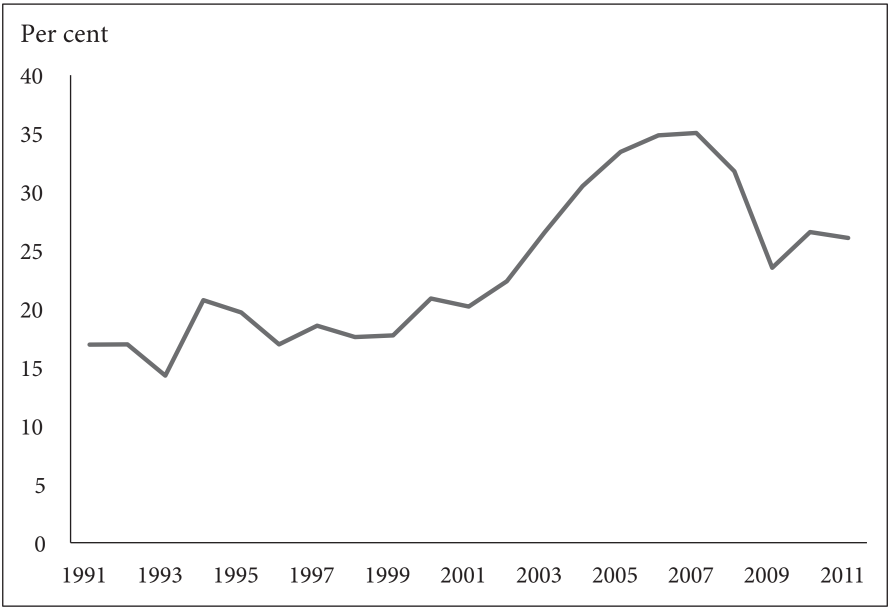
The characteristics of economic growth in China

The nature of the Chinese economy can be summarized as having two distinct features: developing and transitional. "Developing" refers to the fact that the country was poor when it started to implement reforms and open up its economy in 1978, and it is still not rich today despite being listed as the second largest economy in the world. Its gross domestic product (GDP) per capita is US$ 4,400, which is defined as upper-middle income by the World Bank. "Transitional" means that China has been, and still is, in the transitional stage of moving from a central planning economy to a market based one. The Government of China still owns hundreds of large companies in important industries, such as energy, telecommunication, mining and the like, while private businesses are playing an increasingly important role in terms of providing employment and tax revenue, and in contributing to economic growth. Some industries such as finance have been strictly regulated. Furthermore, the Government of China continues to play an important role in mobilizing and allocating resources to the areas it considers important.

An export oriented strategy has been adopted since the end of 1970s, following the same steps of "four small dragons" (Hong Kong, China; the Republic of Korea; Singapore; and Taiwan Province of China). It was based on utilizing the country's large pool of low-cost and relatively educated labourers to create increasing capacity to meet the needs of the developed nations and the rest of the world. The country's comparative advantage in labour-intensive products contributed to making exports the driving force of economic growth.

Figure 2.1 shows that the ratio of the country's exports to GDP increased since the early 1990s and that the increase was more rapid after 2001, when China entered the World Trade Organization (WTO) and its exports grew at more than 30 per cent per year. China overtook Germany as the largest exporter in the world in 2010, and its exports reached US$ 3.6 trillion in 2011. The fast growth in exports was accompanied by a change in the trade structure. Manufactured goods increased their share in total exports to 95 per cent in 2011 (figure 2.2).

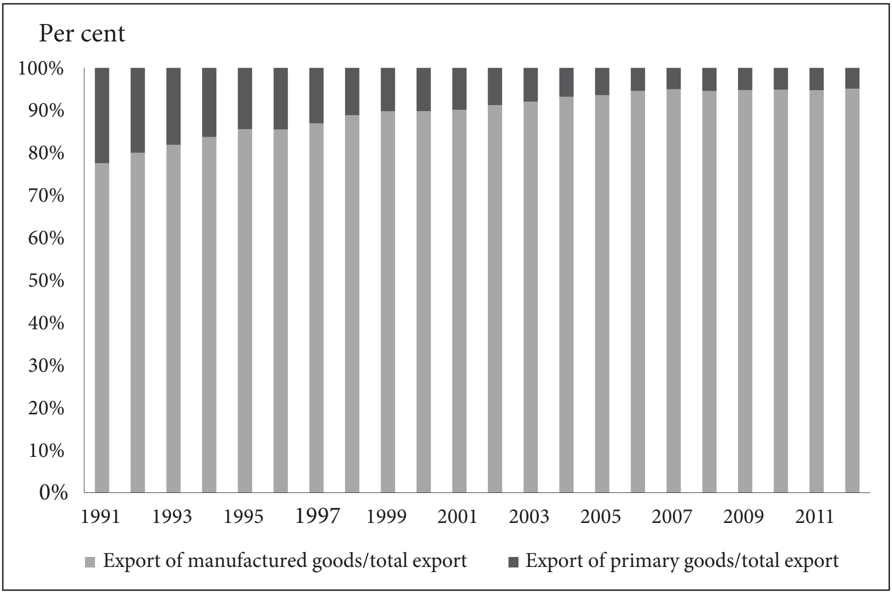
Figure 2.1. Exports, as a percentage of GDP



Source: General Administration of Customs, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

The importance of exports to the economy is reflected not only in its direct contribution to the GDP but also in an associated expansion of investment, which also contributes to increasing the GDP. That is the reason why China's growth pattern is regarded as export-oriented, even when exports are not very high as a share of the GDP.

Figure 2.2. Share of manufactured and primary goods in total exports

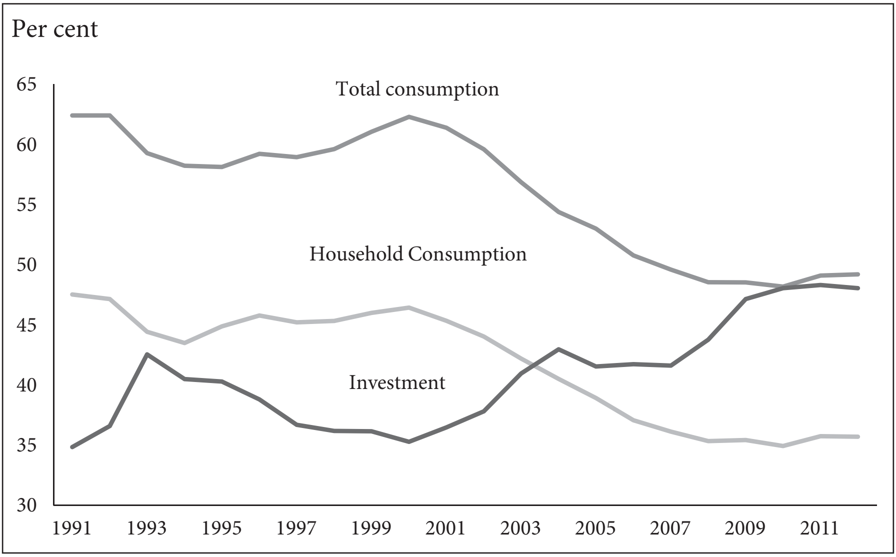


Source: General Administration of Customs, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

Figure 2.3 shows the shares of investment and consumption in the GDP. The share of investment increased steadily to 48.6 per cent in 2010, while the share of total and household consumption decreased, respectively, to 47.4 per cent and 33.8 per cent of the GDP in 2010, which are very low even compared to other developing nations. There are several reasons for this phenomenon. First, foreign demand leads to expansion of domestic capacity which requires investment in manufacturing and infrastructure. Second, as employment increases in manufacturing, rising family incomes push up domestic demand, which generate needs for more investment. Third, the savings rate in China of around 50 per cent of the GDP, one of the highest in the world, provides sufficient funding for investment. And finally, the strong administrative strength of the Government of China helped the country implement investment projects, particularly in the aftermath of the global financial crisis, even though heavy government intervention is not always beneficial to the economy.

It is not surprising that with a high savings rate and a low level of income the share of consumption went down steadily from more than 60 per cent in early 1990s to less than 50 per cent now. This does not mean that consumption has not increased. On the contrary, it did grow rapidly. The total retail sales of consumer goods – an indicator closely related to consumption – has grown around 15 per cent every year for many years. But as investment grew much faster than consumption, the share of consumption in the GDP shrank over time.

Figure 2.3. Share of investment and consumption in GDP



Source: National Bureau of Statistics, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

As we discuss below, the export-investment driven pattern of economic growth in China is related with the dimension and the size of negative impacts of the global financial crisis.

The impacts of the global financial crisis

At the first stage of crisis starting from the collapse of the Lehman Brothers, financial institutions in the developed nations were busy repairing their balance sheets resulting in an ensuing credit crunch and a slowdown in capital formation which in turn led to a stagnation of the advanced economies. With quantitative easing (QE) policies undertaken twice by the Federal Reserve in the United States, the developed economies were struggling to recover until the middle of 2011 when the euro sovereign debt crisis broke out in an unprecedented way. The second stage of the economic turmoil has shadowed the prospect of the recovery in these countries and the growth of other nations.

The evolution of the crisis brought three waves of external shocks to the developing countries including China. A description of them will be detailed below.

The first wave of shocks

At the beginning of the crisis, observers and economists in China were primarily interested in the potential losses of Chinese investments in foreign financial institutions and on the degree to which Chinese financial institutions would be affected. But such losses were modest because Chinese investment and business abroad were still small, and domestic financial institutions were not affected much because of the relatively closed nature of China's financial markets.

However, the sudden drop in the number of orders received by Chinese exporters immediately after the debacle of Lehman Brothers made it clear that the Chinese economy would slow down. Table 2.1 shows that the growth rates of imports and exports became negative since October 2008. With foreign trade down, it was inevitable for economic growth to start declining. The GDP in the first half of 2008 still grew robustly at 12 per cent, but growth went down to 9.6 per cent in the fourth quarter of that year and to 6.6 per cent in the first quarter of 2009 (figure 2.4).

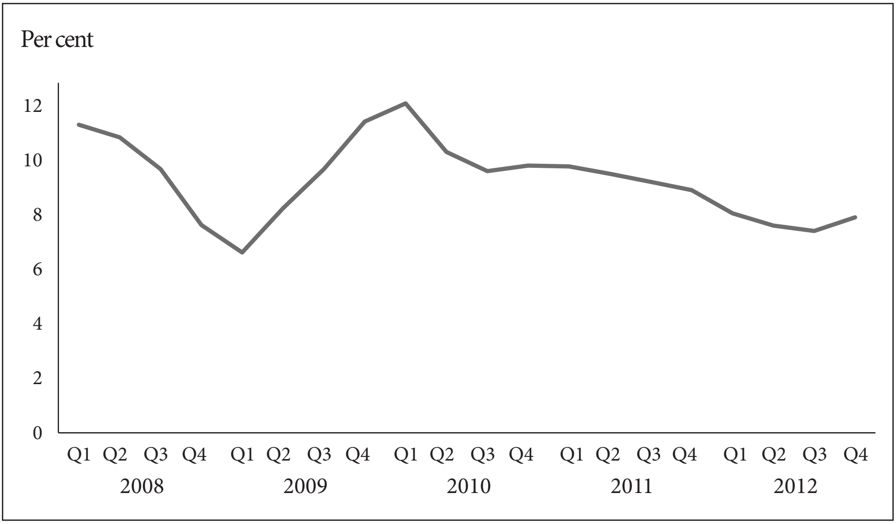
As a result, employment was affected. Unemployment rates went up mostly among migrant workers from the countryside to the cities, but the unemployment rate among registered city residents changed little. According to statistics issued by the Ministry of Human Resources and Social Security, around 20 million migrant workers in the cities lost their jobs and went back home in the countryside during the winter of 2008 and the spring of 2009. The ratio of jobs provided to the ones demanded declined from 0.98 in 2007 to 0.85 in the fourth quarter of 2008. Thus more people were looking for fewer jobs available at that time, a situation that policymakers were obviously concerned about.

Table 2.1. Growth rates of imports and exports, September 2008 to December 2009

	Percentage change, year-on-year		Percentage change on previous month	
	Imports	**Exports**	**Imports**	**Exports**
Sep-08	20.9	21.3	0.8	1.2
Oct-08	15.4	19.1	-13.1	-5.9
Nov-08	-18.0	-2.2	-19.5	-10.4
Dec-08	-21.3	-2.8	-3.6	-3.3
Jan-09	-43.1	-17.5	-28.9	-18.6
Feb-09	-23.8	-25.7	17.0	-28.3
Mar-09	-24.9	-17.1	19.4	39.1
Apr-09	-22.8	-22.6	9.9	1.8
May-09	-24.8	-26.3	-4.4	-3.5
Jun-09	-13.0	-21.4	15.7	7.6
Jul-09	-14.9	-22.9	8.7	10.4
Aug-09	-17.1	-23.1	-7.2	-1.6
Sep-09	-3.8	-15.0	17.1	11.8
Oct-09	-6.8	-13.7	-15.8	-4.5
Nov-09	26.3	-1.2	9.0	2.6
Dec-09	55.6	17.6	18.8	15.0

Source: General Administration of Customs, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

Figure 2.4. GDP growth

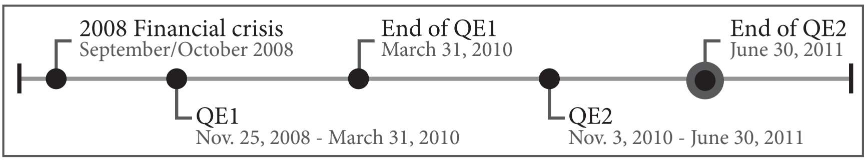


Source: National Bureau of Statistics, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

The second wave of shocks

Figure 2.5 describes the timeline of QE1 and QE2 taken by the Federal Reserve to cope with the credit crunch and recession during the global financial crisis. The Federal Reserve injected US$ 1 trillion of liquidity into the market through QE1, 3 months after the fall of Lehman Brothers, while a total amount of US$ 600 billion has been pumped into the market through QE2. These two policy actions of the Federal Reserve, particularly the latter, resulted in huge spillovers to other nations through rising commodity prices and flows of hot money, which created high inflationary pressures on the Chinese economy. Indeed, China's inflation rate steadily went up from around 3 per cent at the beginning of 2010 to 6.5 per cent in July of 2011, as seen in figure 2.6.

Figure 2.5. Timeline of QE1 and QE2

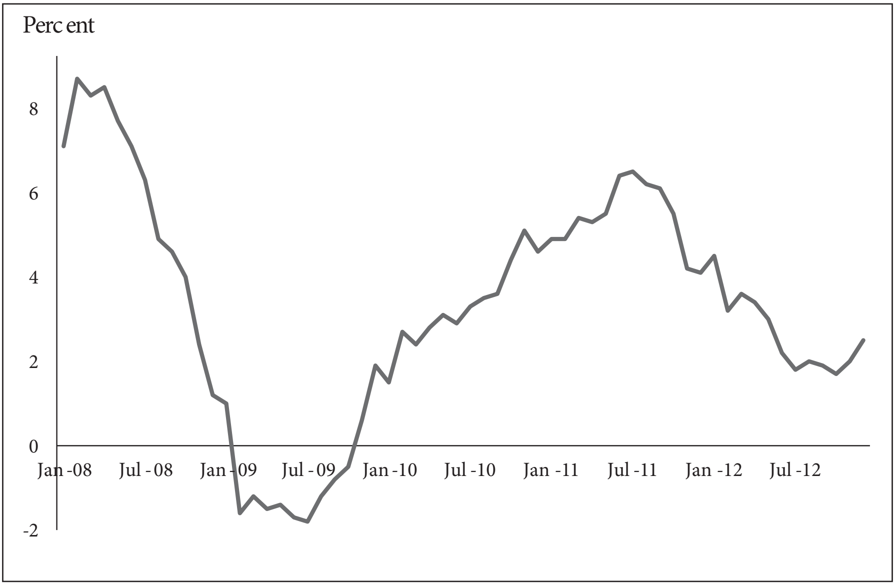


Source: Bankrate.com

The third wave of shocks

The downgrade of the credit rating of the United States sovereign debt, mainly due to a political deadlock, and the worsening of the euro sovereign debt crisis in the middle of 2011 signalled the beginning of the second stage of global financial crisis. With an anaemic economic recovery in the United States and much of the eurozone going into a recession, the world economy seemed like it was on a downward spiral. China was not spared from this trend. Its GDP growth rate was 9.4 per cent in the third quarter of 2011, the lowest since the first quarter of 2010. The growth rate of China's exports also slowed down. The country's trade surplus decreased 16 per cent in June-October 2011 compared to the same period in 2010. The cooling of the economy was also reflected in a declining inflation rate (figure 2.6).

Figure 2.6. Inflation rate, January 2008 to December 2012

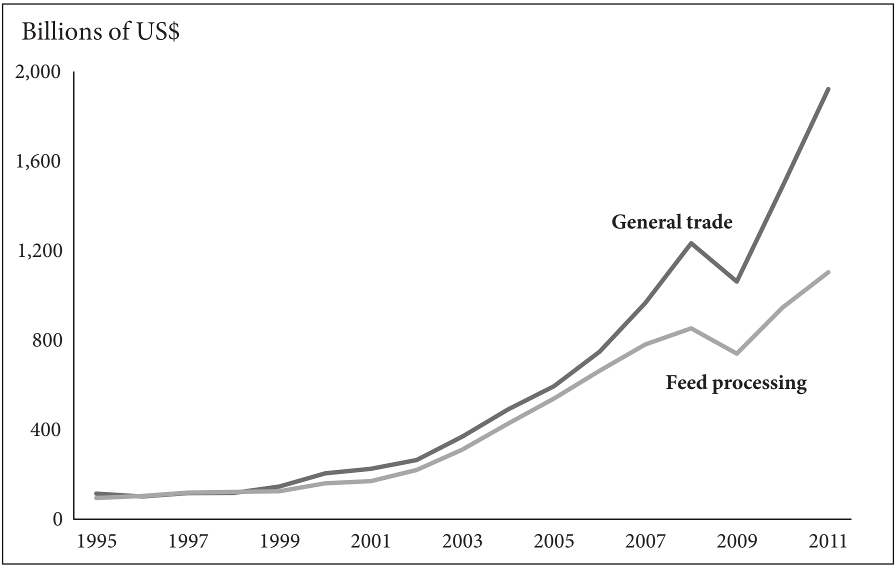


Source: National Bureau of Statistics, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

The pattern of foreign trade changed during the global financial crisis. China's foreign trade can be divided into general trade, processing trade and others. General trade grew faster than processing trade during the global financial crisis (figure 2.7). However, the trade surplus from processing trade steadily increased from US$ 221.7 billion in 2007 to US$ 351.6 billion in 2011 while the trade surplus from general trade declined from its peak in 2007 to a negative level in 2009 (figure 2.8).

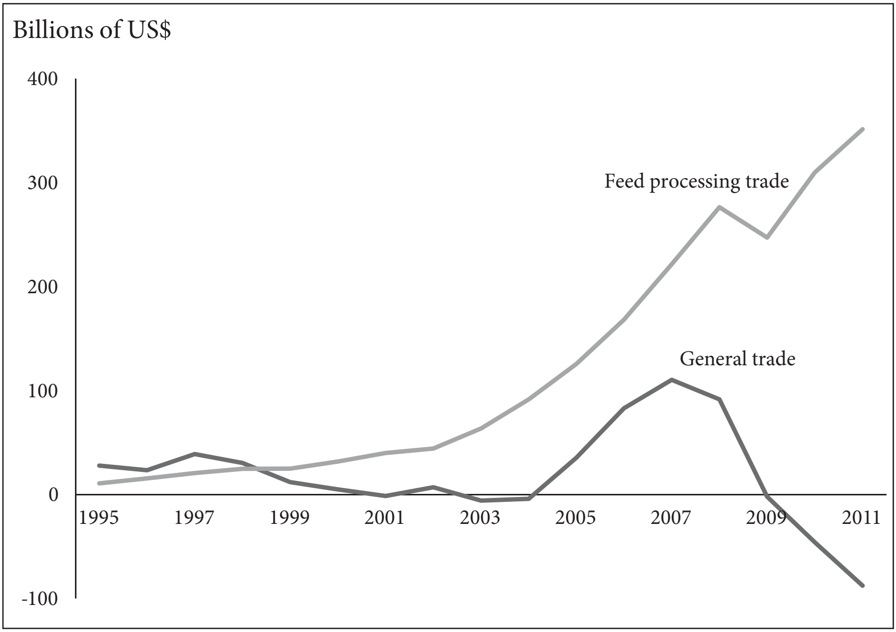
The trade balance of the other categories has been in deficit. Therefore, China's trade surplus comes exclusively from processing trade. The reason for this phenomenon is that China needs to import large quantities of commodities annually, the prices of which increased steeply since 2009. In other words, the terms of trade in China has been worsening in recent years.

Figure 2.7. General trade versus feed processing trade



Source: Macroeconomic Information Network.

Figure 2.8. The pattern of the trade balance



Source: Macroeconomic Information Network.

The policy response of the Government of China

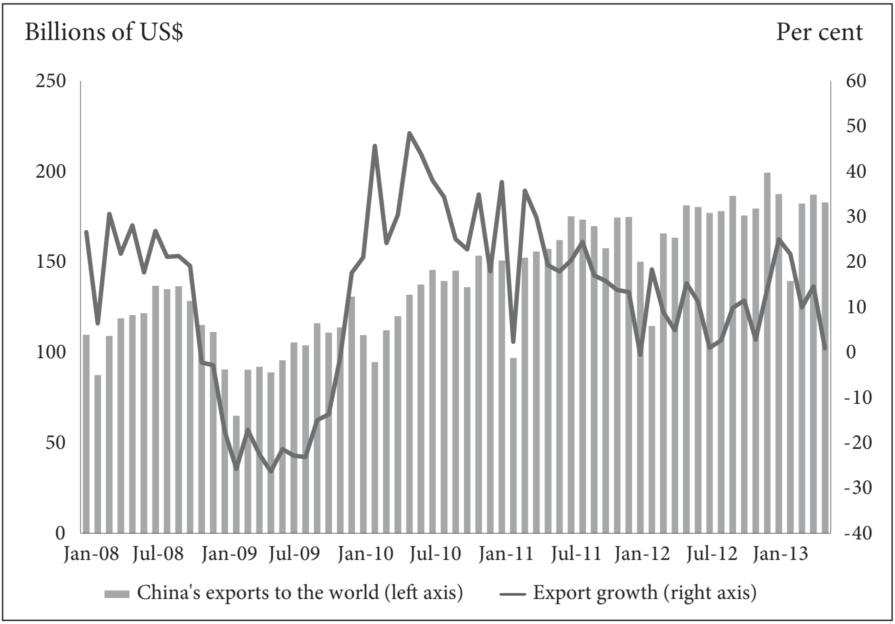
China's mechanisms and processes of decision making on economic affairs played an important role in shaping the policies to deal with the impacts of the global financial crisis. At the end of every year, the Central Committee of the Communist Party organizes an economic working meeting to decide a general position or main theme of economic policies for the next year. The Central Committee usually sends several teams to the provinces and lower administrative units to investigate specific issues it considers important. Sometimes the members of the Political Bureau themselves might head these teams. For example, Premier Wen Jiabao went to Wenzhou, Zhejiang Province in October 2011 to do a field investigation on the difficulties of small and private companies to finance their activities. Following field investigations such as this, a team is usually assembled to prepare a draft policy proposal, which is subsequently sent to provincial governments for comments and suggestions. Two or three of the most senior officials from each province attend the economic working meetings of the Central Committee, and they subsequently deliver any decisions made to subordinate economic working meetings at the provincial level. Thus the policy decisions of the central Government can be carried out by Governments at different levels. Table 2.2 summarizes the main information on the economic working meetings between 2008 and 2011. The outcomes of these meetings result in well-defined and carefully worded general positions of macroeconomic policy for the following year, which provide a solid guidance to maintain or change the policy direction as the national leaders expect. Often a minor change in the wording might signal a turning point in the policy direction.

To relieve the negative effects brought by the first wave of shocks of the global financial crisis, the Government of China announced the famous 4 trillion yuan renminbi (RMB) stimulus package of October 2008. The central Government provided RMB 1.1 trillion from its own coffer while the provincial and local governments chipped in the rest. It was estimated that the total amount eventually reached RMB 10 trillion, including fiscal spending and borrowing from banks. A substantial part of the package consisted in investments in infrastructural projects, such as highway, high speed railways and electricity plants. Some of these projects were newly set up, while others were previously planned but not implemented yet. These projects were the main contents of the "proactive fiscal policy" defined at the economic working meeting of the Central Committee of the Communist Party in 2008.

A "moderately easy monetary policy" was also announced to combat the global financial crisis. It consisted of five consecutive cuts by the People's Bank of China of the basic interest rate (one year lending rate) between September and December of 2008 and of a 200 basis points cut of the required reserve ratio (RRR) between June and December of 2008.

Due to the swift action taken by the Government of China and the size of the stimulus package, China's policy response to the crisis was successful in supporting economic activity. The growth rate of foreign trade from the third quarter of 2009 began to go up and has been back to pre-crisis patterns in 2010 and for most of 2011, bouncing from negative values in 2009 (figure 2.9). GDP growth experienced a "V" shaped recovery, bouncing back from 6.6 per cent in the first quarter of 2009 to 11.9 per cent in the first quarter of 2010 (figure 2.4).

Figure 2.9. The export rebound in China after the global financial crisis



Source: General Administration of Customs, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

The main problem that China had during the second wave of shocks was the rising inflation, as noted earlier. In response, monetary policy aimed at reducing the liquidity surplus. For that purpose, the People's Bank of China raised the policy interest rate five times between October 2010 and July 2011. In addition, the bank increased the RRR eleven times between January of 2010 and June 2011 Another domestic factor pushing up inflation was a shortage of some agricultural products, particularly pork. In response, the Government undertook various measures, including a subsidy to increase the supply of these products, which were effective in relieving inflationary pressures. As a result the inflation rate declined steadily from its peak to 4.1 per cent in December of 2011 (figure 2.6). In combating the economic downturn that appeared in the last wave of shocks, the People's Bank of China announced at the end of November of 2011 that the RRR would be reduced 0.5 per cent from December 5, which meant that the RRR for large banks will be 21 per cent while the corresponding rate for medium and small banks would be 17.5 per cent.

The challenge of transforming China's economic growth pattern

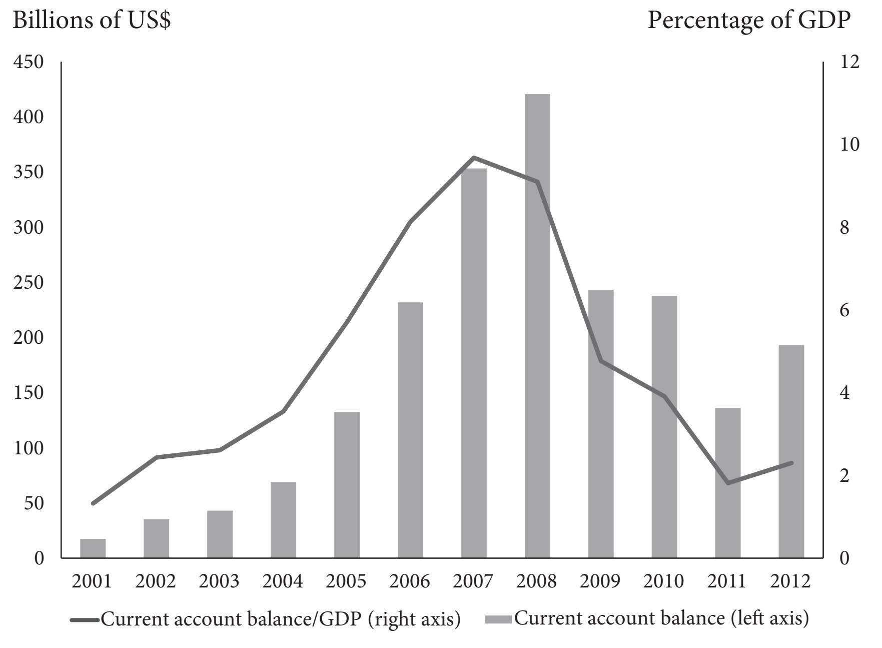
There is general agreement that it is not easy for any policymaker to strike a good balance between dealing with current economic issues and making the necessary structural adjustments for the long run. While the Government of China managed to protect the economy from the impacts of the global financial crisis, whether or not it has also made significant progress in making structural adjustments is still unclear.

More than a decade ago, the ruling party has advocated the necessity of making economic structural adjustments and transforming the growth pattern. The Twelfth Five-Year Plan that stared in 2011 emphasized the need "to make sure that new and outstanding progress achieved in scientific development and substantial progress obtained in the transformation of the model of economic development in the next five years. It should insist that a strategic adjustment of economic structure become a main direction of accelerating transformation of the model of economic development… It is necessary to construct a long lasting mechanism to expand domestic demand and to promote transforming economic growth through more dependency on the coordination between consumption, investment and export." (China, National Development and Reform Commission, 2011, p. 5).

While some progress has been made in this regard, there are still a lot of challenges ahead left to be met. Particularly in 2011, the weakening of the overseas market due to the global financial crisis dragging on and the rising labour costs have pushed Governments at all levels and the business community to turn their attention inward and to tap the potential of the domestic market. In fact, according to the Minister of National Development and Reform Commission, the contribution of domestic demand to economic growth reached 101 per cent in the first three quarters in 2011 (Zhang, 2011). In particular, the contribution of the final consumption to growth increased from 32.7 per cent to 47.9 per cent between the first three quarters of 2010 and the first three quarters of 2011, while the contribution of capital formation declined from 55.5 per cent to 53.4 per cent during the same period. On the other hand, the current account to GDP ratio declined from its peak of 9.7 per cent in 2007 to 3.9 per cent in 2010 and 1.8 per cent in 2011 (see figure

2.10). A caveat is that it is not clear whether these changes represent a turning point for future trends because they could also be explained by the reduction of foreign demand and worsening terms of trade.

Figure 2.10. Current account balance, 2001-2012



Source: State Administration of Foreign Exchange and National Bureau of Statistics, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

Challenge 1: reduce the Governments' intervention in the economy

The strength of the Government of China is a double-edged sword. While it can mobilize enough resources quickly to solve pressing issues as seen during this crisis, it can also crowd out private investments and ruin social activity and creative initiatives. Local governmental officials have strong motivation to channel investments for the sake of their promotion in the future, which could provide a platform for corruption, rent seeking and lower efficiency. For example, during the global financial crisis, local governments took advantage of the stimulus programmes to increase expenditures, particularly in construction projects, which resulted in large increases in their levels of indebtedness. The total debt of local governments reached RMB 10.7 trillion by the end of 2010, and led to a rise in non-performing loans (China, National Audit Office, 2011). The high level of expenditures of local governments is also a major reason why the ratio of investment/GDP has been so high. A related problem is the lack of transparency and overseeing of governmental spending, which is a major reason why people are dissatisfied with the functioning of Government, even if their living standards have been rising. Overall, there is still a long way to go to fulfil the objective of transforming the Government's focus from construction to the provision of services to the public.

Challenge 2: narrow the widening gap between the rich and the poor

According to official data by the National Bureau of Statistics, China's Gini coefficient stood at 0.474 in 2012, showing a relatively large gap in income distribution.[16] The increasing income gap is mainly due to the growing disparities between residents in the cities and in the countryside. Official statistics show that the income gap between them was 3.33:1 in 2009, which would have been bigger if the calculation had taken into account differences in wealth. Narrowing the income gap is needed both for increasing social justice and for transformation the growth pattern. It is well known that the marginal propensity of consumption of the poor is higher than that of the rich. Thus, raising the income levels of the poor is an effective way to increase domestic consumption. Another reason for the high saving rate in China is the absence of a comprehensive social protection mechanism, which would make it imperative for families to save for their children' education, the family's medical care, or for retirement. To reduce these precautionary motives for saving, the Government of China should take measures to raise the income levels of ordinary people and the coverage of social benefits.

To support income levels, 24 out of 31 provincial governments increased the minimum wage, with an average growth rate of 22 per cent in 2011. Another way to increase real incomes is through the tax system. Currently, most of China's tax revenues come from indirect taxes, such as

[16] Yang Lina, "Gini coefficient release highlights China's resolve to bridge wealth gap", Xinhuanet, 21 January 2013. Available from http://news.xinhuanet.com/english/china/2013-01/21/c_132116852.htm.

turnover business taxes, which are regressive. If more tax revenues come from direct taxes such as corporate income taxes and taxes on natural resources, the incomes of ordinary people actually will be raised. As for individual income taxes, the deduction level was raised from RMB 2,000 to RMB 3,500 per month since September 2011. However, this applied only for salaries and there is still room to adopt the same policy for other incomes.

According to the 2010 census almost 50 per cent of the population lives in cities. But not all urban dwellers enjoy the same level of social benefits. Urban dwellers are divided into residents with population registration and migrant workers from the countryside without registration. Migrant workers cannot get the same benefits as city residents. For example, they can only obtain limited or no retirement benefits, and their children are not allowed to take an entry exam for college in the cities they are working. Indeed, the barriers to get a population registration in the cities, particularly in the large ones, are practically insurmountable. It is a great challenge for the Government of China to pave the way to let his 220 million migrant workers totally integrate into the cities (China, National Committee of Population and Family Planning, 2011).

Differences in wealth between farmers and urban residents are very large because of differences in land prices, which allow the Government to benefit substantially. When a piece of land is to be used for construction, the Government has the right to buy it at a very low price by law, and subsequently it can sell it to a developer at market price, which is usually much higher. This situation has created many disputes with farmers living in city suburbs, whose land can be bought by the Government at low prices. To reduce these conflicts the Government of China has considered revising the laws to let farmers share part of benefits from the land sale.

Challenge 3: increase Government expenditure in people's livelihoods

Improving the structure of government spending and tilting it to improve people's livelihoods is another area where the Government should take policy actions in order to complete the transformation of the growth pattern. The Government of China has already increased its spending in education, medical care and social security, but the increase has not been big enough and fast enough. For example, the education law formulated more than a decade ago stipulated that 4 per cent of GDP has to be spent towards education each year, but unfortunately this goal was never attained. The reform on health and medical care started several years ago and made some progress to provide a minimum medical insurance to farmers, but the coverage and the subsidy are very limited. Although about 97 per cent of farmers are covered, the subsidy per person was only RMB 240 in 2012 (Chen, 2012).

Challenge 4: speed up the reform of financial system

Another major challenge China is facing today in transforming its growth pattern is to speed up the reform of its financial system. Generally speaking, the financial system in China is still rigid and less than efficient in transforming savings into effective investments. Indirect financing still occupies a higher share of total financing than direct financing, which means that banks dominate the financial industry. The Government of China is the largest shareholder and, therefore, controls almost all of the large commercial banks listed in domestic and international stock markets. Although it is not always easy for small and medium enterprises (SMEs) everywhere to get a loan from a bank, the dominance of Government-controlled large banks in the banking industry has aggravated the difficulties for SMEs in China. On the contrary, State-owned enterprises (SOEs) can easily get loans at low interest rates due to their financial strength and political power. During the period of credit tightening in 2011, these SOEs borrowed money at low rates, and then made loans to SMEs at higher rates.

Improvements in Chinese capital markets are very much needed. The bond market is less developed because the issuance of corporate bonds is strictly regulated, while no municipal bonds exist at all. Companies have to wait for a long periods of time, often years, to be approved from regulators to conduct an initial public offering. However, like in the case of getting a bank loan, SOEs can get approval relatively easily. In addition, the financing function of stock market is overemphasized compared to the interests of investors. Law violations such as frauds, cheatings and inside trading have occurred occasionally, hurting the reputation of the market and its performance. The performance of the Chinese stock market in 2011 was the second worse in the world (Index of Shanghai Stock Exchange – 21.68 per cent, Index of Shenzhen Stock Exchange – 28.41 per cent), although the Chinese economy has outpaced the rest of the world. With the new Chairman of the Security

Regulatory Commission, a respected banker, in place a while ago, it is hoped that the security market will be on a healthy road ahead.

Since China began to reform its foreign exchange rate mechanism to take a managed floating system in July of 2005, the RMB has appreciated steadily. In its Report to Congress, the United States Department of the Treasury concluded that "from June 2010, when China moved off of its peg against the dollar, through 16 December 2011, the RMB appreciated by a total of 7.5 per cent against the dollar. Because inflation in China has been higher than in the United States, the RMB has appreciated more rapidly against the dollar on a real, inflation-adjusted, basis reaching nearly 12 per cent since June 2010 and nearly 40 per cent since China first initiated currency reform in 2005" (United States Department of the Treasury, 2011, p. 18). Though the United States Congress still strongly criticized China for undervaluing the RMB, nobody will realistically expect the Government of China to abandon its principles of "progressive, manoeuvrability and initiative", particularly at a time when the ratio of current account surplus to the GDP is well below 4 per cent. It is fair to say that the motivation behind continuing the reform of the foreign exchange regime will come less from pressures from outside than from demands of economic transformation inside. The Government of China should intervene less in the foreign exchange market and expand the band of daily fluctuations, which are currently 0.5 per cent of both sides from the middle line. That way the foreign exchange rate will more accurately reflect the real value of the RMB compared to other currencies, and it will better balance the interests of the tradable and nontradable sectors of the economy. A more flexible foreign exchange regime will also pave the way for further opening up the capital account of the balance of payments. All of these reforms are preconditions for completing the internationalization of the RMB, which in turn is a very important step for China to become a real power.

Concluding remarks

Because China is an export-investment driven economy with relatively closed financial markets, the global financial crisis affected the economy mainly through the trade and investment channels but not through volatile capital flow. China was the first nation among the G20 to take quick actions to relieve the negative effects brought by the global financial crisis. The country's policy responses were effective and successful, which contributed to help other nations, developed or developing, to stave off the negative impacts of the global financial crisis.

It is important for China to continue its efforts to turn the current "soft landing" of its economy into sustainable and steady growth by pursuing its economic transformation. The challenges the country faces are tremendous, especially taking into account its population of nearly 1.3 trillion people. If China successfully deals with these challenges and transforms its growth pattern, it will move forward to become a high income country. Otherwise, it will inevitably fall down into the so-called "middle income trap".

Chapter 3

Indonesia

Mohamad Ikhsan and Cicilia A. Harun

An important lesson from the 2008-2009 global financial crisis and its aftermath is that the world economy is highly interdependent with multiple sources of growth and new powerful links, both between developed countries and developing countries and among developing countries. A new structure of the world economy is underway, and the crisis has obviously accelerated the change in the global economic landscape in which the developing countries have acquired greater importance in global economic growth and a greater share of the global economy. Nearly half of the growth today is created by the developing countries. By increasing their importance in the global economy, developing countries have a bigger role in determining the state of the global economy. The current recovery process will not follow a smooth path as uncertainties are increasing. Hence it is very important for developing countries to respond and navigate through the current turmoil because any crisis (for instance, the ongoing European economic crisis) has the potential to escalate and derail the recovery process in the developing world.

Indonesia is an interesting case. It has experienced two severe crises, in the mid-1960s and 1997-1998, while it has successfully avoided two threatening episodes, the mid-1980s collapse in energy prices and the 2008-2009 global financial crisis. As Basri and Hill (2010) have pointed out, this success relates to the quality and resilience of the country's institutions, the Government's economic management credentials and the adaptability of the business and household sectors.

This chapter discusses experiences, lessons learned and challenges faced by Indonesia in the recent crisis. Indonesia provides a unique situation, in which it was the country that suffered the most during the Asian financial crisis of 1997-1998 but was among the strongest in weathering the recent crisis. This chapter discusses what went wrong then and what went well in the recent crisis.

Indonesia and the economic crisis of 1997-1998

Since the late 1960s and with the notable exception of the Asian financial crisis of 1997-98, Indonesia has generally been able to navigate relatively well through any economic crisis. As a result, Indonesia was one of the 13 countries in the world - identified by the Growth Commission under the leadership of Nobel Laureate Mike Spence, which was able to maintain its economic growth at least at a 6+ per cent over 30 years (Growth Commission, 2008). The country's progress in GDP growth was also reflected in other social indicators such as the poverty rate. In the 1960s, about two thirds of Indonesia was living below the poverty line. Now only 11 per cent of Indonesian households are below the official poverty line (Ikhsan, Rural poverty, forthcoming).

During the Asian financial crisis, Indonesia was the worst-affected country, with output contracting sharply and open unemployment and poverty increasing significantly. This was largely due to the fact that during the Asian financial crisis Indonesia experienced not only an economic crisis but also a political crisis and to some extent a social crisis as well. The political crisis – which eventually led to a transformation in the Indonesian political landscape from an authoritarian to a democratic regime – is the most important factor.

The roots of the 1998 crisis started earlier in the middle of 1997 when severe "El Nino" weather hit the Indonesian agriculture sector. Agricultural production, particularly rice, was depleted and caused a hike in food prices which in turn translated into a sharp increase in the inflation rate. Agricultural supply shocks reduced domestic demand through a decline in both rural sector incomes and the purchasing power of Indonesian households. As shown by Ikhsan (Labour market, forthcoming), the main factor in the significant rise in poverty incidence since 1996 was El Nino – not the financial crisis. But the weakening of domestic demand continued when the financial crisis hit the investment and the construction sector, a sector which most of the rural population depend upon as a supplementary source of income for their livelihoods.

The other key cause of the crisis was capital flight, which was spurred by a confidence crisis and a social crisis as some riots hit the Chinese minorities who are relatively dominant in the economy. The massive capital flight caused a sharp depreciation of the Indonesian rupiah. About 30 per cent of domestic banks' outstanding loans were in foreign currencies and one-tenth of the loans were to the real sector (Ginting and Aji, forthcoming). Thus, the massive rupiah depreciation led to a collapse of the Indonesian banking sector which was then transmitted into the real economy, causing many domestic firms particularly property, construction and import substitution manufacturing to come to a halt.

Compared to other affected Asian countries, the recovery of Indonesia's economy was slow, as a result of the breakdown of economic institutions and the mismanagement of the crisis. As Basri and Hill (2010) stated: "the IMF 'over-managed' the crisis, by demanding fiscal austerity and excessive policy conditionality, in addition to displaying a lack of political sensitivity at key moments. The weakened power of President Soeharto along with his decision to form a relatively non credible cabinet made the policy management even worse (p.15)."

The post Soeharto administrations – except during the administration of Abdurachman Wahid – managed the economy relatively well and took four important sets of actions (Ginting and Aji, forthcoming). First, the Government decided to recapitalize the banking sector to prevent the total collapse of this important economic institution. An adverse consequence of this policy was that the Government debt increased dramatically. The government debt to GDP ratio rose from 23 per cent before the crisis, in 1996, to above 100 per cent. To reduce the debt burden, a consistent fiscal consolidation was enacted by gradually reducing the budget deficit from 2.4 per cent of GDP in 2001 to 0.1 per cent of GDP in 2008.This effort was driven by improved revenue collection, reduced subsidies, especially untargeted fuel and electricity subsidies, and lowered risk premiums and interest rates. This fiscal consolidation was supplemented by an effort to improve financial management by replacing two Dutch-inherited budget laws with a series of new modern budget and treasury laws in 2003. Reduced budget deficits along with accelerated economic growth and an appreciation of the rupiah resulted in a sharp decline of the government debt to GDP ratio to about 30 per cent in 2010.

The second important reform milestone helped address the core problem, i.e. the financial sector. The Government, through the Bank of Indonesia as the regulatory agency, introduced a new regulatory regime by focusing on risk-based supervision and consolidated supervision of groups of banks, rather than traditional monitoring of compliance with regulations by individual banks. The result was quite promising. Indonesia made progress in strengthening its supervision capacity, off-site monitoring, early warning systems, corporate governance, and responsibilities of boards of directors and management (Lindgren, 2006). Although the efficiency of financial intermediation still needs enhancement, the performance of the banking system continued to improve following a series of regulatory reforms and reforms to supervision practices introduced after the Asian financial crisis.

Third, inflation surged to about 80 per cent at the peak of the Asian financial crisis, but Bank Indonesia managed to restore inflationary pressures to single digits in 2000. However, inflationary pressures retuned again shortly thereafter – partly because of fuel price policy adjustments in 2005 and 2008. To improve inflation management, Bank Indonesia adopted an inflation targeting framework in June 2005. After experiencing double digit inflation in 2005 and 2006, inflation in Indonesia fell to 6.4 per cent in 2007, although the unexpected surge in international food and energy prices pushed domestic inflation to 11 per cent at the end of 2008.

Finally, the country's external position continued to improve. The current account has been in surplus in recent years due to good export performance driven by high commodity prices and strong demand. Consistent with the positive current account position, international reserves holdings have increased sharply, to over US$ 65 billion in June 2008. As in other countries, precaution is the other important motive for accumulating reserves in Indonesia (Ruiz-Arranz and Milan, 2008). In addition, the rupiah has become more flexible to changes in the economic fundamentals. This, together with increasing international reserves, has reduced the country's vulnerabilities to external shocks.

Indonesia and the economic crisis of 2008-2009

As stated before, Indonesia weathered the 2008-2009 global financial crisis relatively well. First, even though economic growth slowed down, it has remained positive at 4.5 per cent during 2009. The slowdown period was also limited to two quarters beginning in Q2 2009. Since then, economic growth recovered and remained stable around 6 per cent. Second, both poverty incidence and open unemployment have continued to fall. The incidence of poverty was down to 12.5 per cent in March 2011 compared to 14.1 per cent in 2008 while open unemployment fell to 7.4 per cent in February 2011 compared to 8.5 per cent in February 2008. Third, the balance of payments recorded a surplus generated by a record expansion of exports which was driven by both commodities expansion and a recovery in manufacturing exports. The surplus in the external balance resulted in an accumulation of foreign exchange reserves, which improved confidence in financial markets, particularly in the foreign exchange market. In the past, Indonesian FOREX market was excessively sensitive to news and shocks. Now, those sensitivities have reduced significantly, allowing the Bank of Indonesia to conduct sterilization policies more smoothly.

Comparing indonesia's experiences during these two crises, several distinctive factors can be identified as sources of Indonesian resilience during the global financial crisis. They range from macroeconomic management to microeconomic fundamentals. The regional economic environment also contributed to Indonesia's resilience during the global financial crisis.

First, from a macromanagement point of view, Indonesia enjoyed greater flexibility to implement aggressive monetary and fiscal policies. Indonesia, like most other Southeast Asian countries, had implemented sound macroeconomic and fiscal policies for over a decade. As a result, the region had a relatively strong fiscal position and low debt levels that allowed Governments to implement larger fiscal stimulus measures. This situation is entirely the opposite of the 1998 Asian financial crisis, where most countries were forced to respond to the crisis by adopting fiscal austerity and/or tight monetary policy.

More importantly, East Asia is relatively competitive region with relatively skilled labour, very flexible labour markets, and relatively adequate infrastructure in most countries. Such competitiveness is a favourable factor for economies to rebound in the face of economic crises because factors of production can be redeployed relatively quickly in response to changes in relative prices such as a large devaluation of the national currency.

The Asian financial crisis in 1997-1998 taught the countries the importance of a healthy financial sector. As mentioned previously, a set of reforms had already been implemented to strengthen the financial sector, and to better finance the economic sectors.

- When the crisis hit in 2008, most banks in Indonesia had a very low level of non-performing loans – a very different situation compared to 1997-1998. And the condition of the banking sector continued to improve during 2009-2011. In fact, most of the Indonesian banks recorded massive profits in 2010 and were able to strengthen their capital base.
- Financial intermediaries and financial markets improved and good corporate governance has been the rule. To make sure that good corporate governance is in place, as part of the economic reforms, the Government of Indonesia sold some of its shares in State-owned banks to capital markets. The Government also re-privatized bailed-out banks, the dominance of State-owned banks eroded, and competition in the banking sector gradually improved.
- The crises in 1997-98 created a larger Government and central bank debt market. This development has allowed the central bank to implement a more efficient monetary policy. The government debt market can also provide a benchmark for the private debt market to become more efficient.
- The accounting and auditing standards of intermediaries and borrowers improved. Investors are better informed. There is also better information on small borrowers since Bank Indonesia established a public credit bureau in 2006. To improve better access to information, Bank Indonesia also encouraged the private sector to open a private credit bureau.
- Overall, prudent regulation and supervision from Bank Indonesia is much better than in the 1990s even though the Bank Century case reveals that more efforts must be made to improve banking supervision.
- Banks in the region had little exposure to the United States or the European Union housing market.

Other distinctive difference between the two crisis periods is that households and firms were not over-borrowed during the global financial crisis and thus were in a better position to sustain consumption and investment. Households' savings-investment behavior in the current crisis is almost the opposite of the 1997-98 crisis. During the previous crisis, many countries faced overconsumption and investment through the bank and financial sector channels, which led to a real appreciation of the exchange rate.

In addition, in 1998 the level of reserves was relatively limited, at US$ 23 billion or only 50.6 per cent of short-term debt. In contrast, in 2008, the level of reserves reached US$ 51.6 billion or 140.2 per cent of short-term debt. The self-insurance practices adopted by Indonesia – and other Asian Countries – proved to be rewarding. Even though Indonesia lost about US$ 6 billion of its reserves in 2008, they quickly recovered. In May 2009 reserves went back to their pre-crisis levels of around US$ 57 billion, and they continued to pile up since then. Following the recovery in capital inflows, the rupiah recovered much of the loss experienced during the market turmoil of late 2008 and early 2009, and it reached its pre-crisis value nine months after the global financial crisis.

China played a role in stimulating demand in the region. Intra-regional trade in Asia – led by China – went up from 32 per cent of total exports in 1995 to 50 per cent in 2008. Therefore, proximity to China and China's strong growth helped the region. In addition, rapid trade liberalization in the region improved market access, enlarged markets, attracted more investment and contributed to higher incomes in the region.

To conclude, we summarize what Indonesia has done in response to the global financial crisis using a public finance framework (Aizenmen and Pinto, 2011). The first column in table 3.1 addresses the primary objectives of the crisis responses of Indonesia – and other emerging countries – which is consistent with all three generations of crisis frameworks. To address the first generation of crisis response, which is related to public debt sustainability, Indonesia committed to adopt a sound fiscal policy by maintaining a sizeable primary fiscal surplus and improving the composition of expenditures and revenues. To finance necessary public investments, the Government plans to gradually reduce the energy subsidy and shift savings from the subsidy toward expanding financing for public goods, including upgrading infrastructure.

Table 3.1. Evolving crisis responses in Indonesia since the 1998 Asian financial crisis

Goal	Policies	Comments
1. Maintain fiscal sustainability (First generation)	Raise primary fiscal surpluses since 2000 and continue at least until 2014	Some have criticised this approach since it is not able to address the infrastructure deficit and other important public investment. Raising the primary surplus might be good in the short term but might not be good in the future because it reduces potential future growth and tax bases.
	Improve the quality of spending by improving expenditure composition	While the level of Indonesian debt is already low at below 30 per cent, maintaining some level of deficit is still justifiable.
	Continue to strengten the revenues side by adopting tax and non tax administration reform	
	Strengthen fiscal institutions"	
2. Insure against shifting market sentiment and possible sudden stop and reversal (Second generation)	Build up foreign exchange reserves	No clear definition of "ideal" foreign reserves.
		Optimal foreign reserve levels will depend clearly on the ability of Bank Indonesia to affect private debt, flexibility of the exchange rate, and the extent of currency mismatches
		Bank Indonesia has very significant room to reduce the need to build up future reserves by improving reserve management."

Table 3.1. Evolving crisis responses in Indonesia since the 1998 Asian financial crisis (continued)

Goal	Policies	Comments
3. Lower contingent liabilities associated with private sector (Third generation)	Maintain flexible exchange rates	A flexible exchange rate regime will reduce incentives for currency mismatches.
	Monitor private external borrowing and currency mismatches	Potential contingent liabilities are still large since government still holds a majority of state banks which control 40 per cent of Indonesian banking assets
	Strengthen financial institutions	Government still distorts energy market prices including the electricity price. Sizeable contingent liabilities involved.

The Government along with Bank Indonesia protected the vulnerability of the economy by self-insuring the economy against market sentiment and possible sudden stops by building up foreign reserves. The level of international reserves was US$ 110.1 billion or 6.3 months of import and government foreign debt payment at the end of 2011. Investor confidence and positive market sentiments continued to build up despite slow progress in microeconomic reforms and potential problems of Bank Indonesia's balance sheet.

Finally, to prevent a recurrence of third generation type crisis – lowering contingent liabilities associated with the private sector which are related to the possibility of a bail-out, as happened during the 1998 Asian financial crisis – the Government committed to a flexible exchange rate regime and continues to strengthen financial institutions. While the primarily focus is on the health of State-owned banks – which still control over 40 per cent of banking assets – since 2006 the Government expanded the scope of financial reforms into non-financial institutions. Although no significant progress was made until recently, having a more diversified financial market is appealing not only to strengthen its resilience but also to improve its efficiency.

The crisis and the real sector

Increasing confidence in the real sector should be important in creating a good and sustainable investment climate. This said, the crisis in 1997-1998 had reduced the investment appetite of not only foreign investors but also the domestic banking system. The real sector has maintained positive growth since the crisis, and even weathering the crisis of 2007-2008. However, as recorded by Bank Indonesia in its annual report of the Indonesian economy of 2009, the real sector has also reduced its demand for financing. In the past, the reliance of the financial system for financing has provided a bitter taste for the corporate sector during the Asian financial crisis when banking liquidity vanished from the market. Self financing in fact has played a major part in the development of the corporate sector. A Bank Indonesia survey in 2009 revealed that the share of internal financing remained in the range of 60 per cent since after the crisis of 1997-1998, whereas the share of domestic bank loans was 21 per cent. The Gross Fixed Capital Formation approach also indicated that prior to the crisis, the share of bank loans reached 31.8 per cent, whereas internal financing was just 12.4 per cent. The composition changed to 16.1 per cent for bank loans and 46 per cent for internal financing in the 2008 period. The balance sheets of listed companies also revealed the use of liquid assets and retained earnings as sources of financing, as reflected by the decreasing share of inventory to total assets and increasing share of retained earnings to total assets. The ratio of banking credit to GDP in September 2011 is less than 30 per cent, with banking institutions taking almost 80 per cent of the entire financial system. This is a significantly lesser number compared to Malaysia and Singapore that already reached above 100 per cent. The reliance on self financing was one of the reasons the corporate sector was relatively unhurt by the liquidity squeeze in the financial market due to the global financial crisis. This characteristic of the corporate sector will remain the strength of the real sector in facing the uncertainties from the global crisis nowadays. However, if this phenomenon sustains, and corporate sector continues to resort to its own balance sheet for growth, it will have limited capacity to accelerate its growth and contribute significantly to the job creation and the productivity of the economy.

The World Bank recorded a 12 per cent annual growth for Indonesian manufacturing sector within 1990-1996, which also contributed to one-third of the overall GDP growth. However since the crisis, between 2001 and

2010, manufacturing only grew below 5 per cent annually. The drop is due to the decline in the appetite for investment and lower domestic demand post the Asian financial crisis. The resort to self financing as mentioned above also contributed to the declining growth of manufacturing. Since the oil and gas manufacturing only counts for less than 8 per cent of the entire manufacturing sector (in 2010), it is good to concentrate on the non-oil-and-gas manufacturing. The sub-sector wood and wood products and sub-sector basic and fabricated metal are identified as having negative average annual growth during 2001 and 2010.

With the recovery and economic growth since the Asian financial crisis, it is not surprising that the sub-sector within non-oil-and-gas manufacturing sector with the highest growth is vehicles, machinery and electronics due to the increase of purchasing power. Transportation and communication sector has also registered impressive growth rates between 2001 and 2010 with an average annual growth rate of above 12 per cent. The flow of foreign direct investment (FDI), especially in the form of relocation of factories with labour-intensive manufacturing activities into Indonesia, is projected to drive the manufacturing sector of Indonesia. This is mainly due to the increase of wages in China, which drives companies to relocate factories to Viet Nam and Indonesia that still offer lower wages. Recent data from Investment Coordinating Board of Indonesia suggests that there is an increase of 107 per cent year-on-year from realization of foreign investment in manufacturing activities, especially in textiles, leather good and footwear sub-sector as well as vehicles, machinery, and electronics sub-sector.

Another driving force that can pick up the manufacturing activities in Indonesia is the strong domestic demand despite the declining growth in most other countries in the world. This is considered very important especially with the expectation of persistent low foreign demand for export of manufacturing products as a result of continued recession in the developed countries. The World Bank (2011) reported that the strong growth of domestic demand has contributed to the strong growth in basic metal, food, chemicals and automotive parts as the domestic market dominates demand in these industries. Until world demand recovers, since Indonesia only produced basic manufacturing goods, Indonesian manufacturing industry will continue to cater mostly the domestic market. Therefore a breakthrough in the manufacturing industry is going to be needed to produce manufacturing products that involve high technology. With the comparative advantage in the labour market, Indonesia will have to produce export-worthy high-tech products in order to accelerate growth in manufacturing sub-sector. Therefore, efforts to encourage product research and development in the manufacturing industry are important.

Role of monetary and exchange rate policy

After the Asian financial crisis of 1997-1998, Bank Indonesia was given independence with the enactment of Law No. 23/1999. The bank then holds sole authority on the monetary, banking and payment system. Since the crisis, the central bank implemented inflation targeting and established the financial stability wing. The crisis experience, especially with what happened in the banking system, has provided a lesson that monetary and financial stability are two sides of a coin and that one cannot be established without the other. After massive restructuring work was done to the banking system, Bank Indonesia focussed on prudential regulatory reform and adopting the international standards of Basel II. The financial stability wing of the central bank started to run the macroprudential surveillance since 2003 to detect systemic risks as early as possible.

Since the inflation targeting was adopted in 2005 by the monetary authority (Bank Indonesia), interest rates has been lowered. With the improving fundamentals, after the managed floating rate was abandoned in August 1997, the exchange rate reached a steady state at around 9,000 rupiah per United States dollar.

When the global crisis peaked with the global liquidity squeeze at the final quarter of 2008, with the exception of a few banks, the banking institutions were able to weather the crisis. Non-performing loans (NPL) was below 5 per cent (gross NPL at 3.95 per cent), and average capital adequacy ratio (CAR) of 16 per cent as of August 2008. Indonesian banking institutions were not exposed to the subprime mortgage products and they had very little exposure to structured products. Therefore, the banks did not experience a devaluation of asset prices. Nevertheless, the capital markets experienced a fire sale mostly from foreign investors because of liquidity crunch. This caused government bond prices to decline. To overcome this situation, Bank Indonesia temporarily allowed banks to switch their government bonds from trading portfolio to hold-to-maturity so that they do not have to experience the temporary devaluation of bond prices when they have to do valuation of their trading portfolio. With the decline of liquidity, to avoid panic behaviour of the depositors, the Deposit Insurance increased the limit of the amount of deposits that can be insured.

To help the rupiah liquidity in the market during crisis, Bank Indonesia: (a) cut the overnight repo rate from BI Rate plus 300 basis points (bps) to BI Rate plus 100 bps, and adjust the deposit facility rate from BI Rate minus 200 bps to BI Rate minus 100 bps; (b) extend the window for fine tune operation from 1 to 14 days to 1 to 3 months; (c) simplify the calculation of rupiah reserve requirement to 7.5 per cent of the third party deposit; and also expand the definition of assets that can be pledged as collateral for discount window operation with Bank Indonesia. To help the liquidity of foreign exchange during the crisis, Bank Indonesia (a) extend the tenure of FX swap from maximum of 7 days to 1 month; (b) commit to supply forex to domestic firms through the banking system; (c) lower the reserve requirement for forex from 3 per cent to 1 per cent; and (d) lift the daily limit for short-term offshore debts.

The withdrawal of liquidity also caused a significant decline of international reserves during the fourth quarter of 2008 of almost 10 per cent. However, since then, Indonesia has doubled the amount of international reserves, equivalent to more than 6 months of import and foreign debt payments. Indonesia is joining the crisis countries in accumulating foreign reserves in order to build cushion to face future crises. The countries in the East Asian region have gained so much experience in dealing with severe economic crises that they are more than willing to unite to establish stability for the regional economy. The Chiang Mai Initiative (CMI) is one example. CMI is aimed to provide emergency balance of payment support. It was initiated with series of bilateral currency swap agreements among the nations, with the possibility of establishing a pool fund for the region to fight currency speculation. The CMI has since escalated to multilateral arrangements called CMI Multilateralization (CMIM).

Lessons from the financial crisis

What has the recent financial crisis taught us? The first lesson to draw is that financial sector development including its integration to the global financial system can be an important catalyst for economic development, but this should be done gradually after the necessary institutional changes are in place. We have learned from the previous crisis of the importance of developing adequate supervision systems that can keep pace with market development. The global financial crisis has reminded us to keep a balance between real sector development and financial sector development.

The second lesson from the global financial crisis is on the direction of economic development strategies in general. The crisis underscores the importance of keeping a balance between strong domestic demand and export promotion. The integration of the domestic economy and the global economy into global production chains should be part of our national development strategy. However, we should not forget to integrate our economy internally. Having a strong and efficient domestic economy can enhance the competitiveness of our products in global markets.

A third important lesson is that being proactive has really paid-off. One reason for the success of Indonesia in navigating this current crisis has been the preparedness of the Government. They started to prepare for the crisis as the first signs of turmoil emerged, allowing us to adjust some policies early on and before many of our neighbours. They also took some risks in securing financing for the budget as markets were asking for a premium on capital, which allowed us to aggressively use fiscal policy to counter the crisis.

A fourth lesson is on the relationship between the food crisis and the financial crisis. Incidentally, both the Asian financial crisis in 1997 and the recent global financial crisis were accompanied by food crisis. In 1997, the effects of El Nino depressed food and agricultural production in many countries including Indonesia and Philippines. As a result, the poverty rate increased significantly. In 2008, food production per capita reached its highest level in Indonesian history. Indonesia attained, for the second time, self-sufficiency in rice. The availability of sufficient rice domestically helped to insulate Indonesia from the spikes in rice prices in early 2008. As a result, we were not only able to continue to record a declining trend in poverty, but also in unemployment.

In conjunction with its social impact, we also learned that handling the impact of the crisis was easier because social safety nets were already in place and the Government was able to scale them up quickly as needed. The significant impact of the Asian financial crisis on poverty was partly caused by the unreadiness of social safety nets. In 2008, the situation was very different.

Indonesia had put in place over the past few years strong foundations for a social safety net programme, ranging from food subsidy to cash transfers etc.

Challenges ahead

The recent crisis experience has left many issues on the table. In the short run, Indonesia faces the challenge of increasing international confidence in the economy to establish economic and financial stability. Sound fundamentals and diversified economic activities proved to be the strength of the Indonesian economy in weathering the crisis. Indonesia is among the emerging markets that have been beneficiaries of capital flight from the developed countries.

There are several challenges faced by Indonesia both in the medium and long term. On the macroeconomic front, in the short run Indonesia has to deal with capital flows. Managing capital inflows is quite challenging, particularly if the larger portion of the inflow of capital is still in the form of portfolio investment. There is a need to shift a portion of short-term investment into longer-term investment in the form of foreign direct investment (FDI). In the meantime, in order to avoid the risk of sudden reversal, Indonesia has to avoid bubble conditions by establishing more transparent financial markets, and more diversified financial products.

The country also needs to address the problem of inflation. Even though in the recent period, Indonesia was able to cope with inflation acceleration, Indonesia has struggled to keep inflation at the level of its regional peers. The level of inflation in Indonesia is the highest among the Association of South East Asian Nations (ASEAN)-5 countries. In addition, inflation in Indonesia is considered to be more volatile. The average headline inflation in 2006-2010 was recorded at around 6.8 per cent, lower than the 1996-2000 period (20.9 per cent) and the 2001-2005 period (10.2 per cent). This figure is even lower than that of the pre-crisis period in 1991-1995 (8.8 per cent). Looking at the components, it is clear that decreasing core inflation has been the main contributor to the declining trend in headline inflation after the Asian financial crisis, whereas volatile food and administered components have still showed a higher degree of volatility. Despite inflation targeting, in a number of occasions, inflation has still exceeded Bank Indonesia's target, due to volatile food prices and fuel price adjustments. Indonesia's inflation, being relatively higher than that of its trading partners, tends to produce real appreciation of the rupiah, reducing competitiveness of the tradable sectors over time.

Several studies seem to suggest that the causes of the Indonesian inflation differential vis-à-vis other countries in the region include various structural factors, such as strong inflation inertia and political instability, combined with expansionary monetary policy and currency depreciation (IMF, 2006). As a consequence of the strong inflation persistence, reducing inflation requires maintaining a consistent monetary framework and asserting the credibility of the policy framework. This persistence of inflation could imply that the convergence process to lower regional inflation rates might be slow and costly in terms of economic growth. To reduce this cost and accelerate the convergence process, the central bank has an important role to play, building its credibility and thus affecting the formation of inflation expectations. Aggressive supply side policy like efforts to close the infrastructure gap could also address this problem of persistent inflation. If the relatively high costs, particularly logistic costs in Indonesia, can be brought down, economic agents would change their beliefs that inflation can still fall. Thus, it is obvious that inflation targeting per se is not enough to address inflation in Indonesia. It requires strong coordination between the monetary authority and the Government.

Another challenge is how to make fiscal policy more effective. Historically, sound fiscal policy has become a policy culture among Indonesian policymakers including members of the parliament. In addition, the public financial law limits the general government budget deficit to 3 per cent of GDP. Typically, to effectively respond to a crisis, government spending needs to occur in a sufficiently timely and sizeable manner. The experience in Indonesia including the current budget is that most of government expenditures are spent in the last quarter of the financial year. In addition, the Government fails to spend as much as planned, particularly for infrastructure projects. The other problem of the government budget is the quality of spending. Almost 30 per cent of the spending goes toward an expensive fuel and electricity subsidy. The energy subsidy for 2011 alone amounted to around 6 per cent of GDP which is more than the allocation for capital spending. Should half of the energy subsidy be reallocated to well-performing line ministries like public works, the problem of infrastructure gap would be partly addressed. The main problem of budget allocation is clearly not a technical one. Instead, it relates to the political spectrum faced by the Government during the democratic transition period.

Indonesia has also experienced a serious problem in addressing the infrastructure gap. After being neglected during the fiscal consolidation period, most infrastructure is in a poor condition both in terms of quantity and quality. The Government has put forward several special efforts to address this issue. First, they increased the budget portion for infrastructure. However, since most of the spending was stuck in energy, the amount of (infrastructure) spending still remains far below the minimum needed. Second, realising that the Government on its own would not be able to provide adequate infrastructural-financing, the Government made special efforts to encourage public-private partnerships (PPPs) in the infrastructure sector. It started by demonopolising State enterprises by amending the laws which prohibit private sector participation. Most of the laws have been amended but in practice little progress has been made since many intermediate officials are still reluctant to allow private – particularly foreign – firms to realize their investment.

In general, Indonesia must put forward continuous efforts to create a better investment climate by improving the investment regulations, establishing better services to investors especially in licensing and taxation, and setting up a strong legal system to solve conflicts in business. Indonesia also needs to establish a credible capital market with diversified financial products and improved transparency, establish coordination among financial authorities with the objective of strengthening the banking system, capital markets and other non-bank financial activities (financing and leasing companies, insurance, pension funds, mutual funds, pound shops), including increasing the role of the financial system in contributing to sustainable development.

In the medium-to-long-terms, Indonesia needs to formulate and implement strategies toward macroeconomic rebalancing for robust, inclusive and sustainable growth. Specifically, Indonesia has to pay special attention to the poor by devising the best policy for poverty alleviation as well as elimination of the poverty trap through better education. Indonesia has to intensify infrastructure development and maintenance in order to keep the momentum of economic growth. Indonesia's geographical endowment also necessitates efforts to improve connectivity inter- and intra-islands to reduce development gaps between the regions in Indonesia as a top priority. The contribution of the financial system is also important, and Indonesia has already embarked on a national financial inclusion programme to facilitate financial broadening along with the objective of providing equal opportunities for the poor and/or those with no access to financial services to increase living standards. This programme has to be done with special care as to minimize moral hazard problems that may potentially become systemic risks in the future. As a G-20 member, Indonesia is committed to comply with international standards within the framework of global financial reform. Bank Indonesia and the Ministry of Finance have been participating actively in the international meetings on global financial reform organized by the Bank for International Settlements and the International Monetary Fund.

The most difficult part of policy management is how to overcome the democracy transition process. As mentioned before, Indonesia has conducted three major reforms in responding to the Asian financial crisis in 1998 namely, economic reform, political reform from an authoritarian regime into a democracy and a big bang decentralization. Judging from the magnitude of the reforms, the current outcomes both in terms of macroeconomic and social indicators are considered as a success. However, the transition period has left Indonesian policymakers with several uncertainties when implementing policy (Ikhsan, 2007). The first stem from the political transition to democratic Government. No clear majority has yet emerged and this is not expected until the political environment has matured — in another 10-15 years. Indonesia's political fragmentation is likely to limit the capacity of the Government to implement the necessary but difficult policies particularly during the crisis period. The political fragmentation has cost the Government when they failed to pass one important law of financial safety nets in 2009.

The effectiveness of policy implementation is also hampered by the lack of (implementation) capacity of local governments. The country has undergone a big bang decentralization, moving from highly centralized to the other extreme (highly decentralized) in a very short period. Decentralization has changed the coordination, accountability and capacity of Government in terms of policy formulation, implementation and service delivery. Even though decentralization aims to improve the effectiveness of policy and service delivery, in reality, over 10 years since the implementation of decentralization, this has not been easy. The coordination is more difficult because of multiple stakeholders and multiple axes along which coordination is needed, and at the same time we also face a situation with dispersed and multiple vertical and horizontal lines of accountability with relatively weak incentives (for local governments) to follow rules. On the other side, the capacity to implement at local levels is highly unequal and generally weak.

The effectiveness of policy clearly depends also on the credibility of the Government and its policymakers. Building credibility is difficult when the foundation of trust is low. The issue of trust is particularly important in Indonesia. Not only do the local and central governments often not trust one another, but the people often do not trust the Government (and vice versa). This lack of trust seriously complicates policy formulation and implementation. Even when the rules are agreed upon, considerable misunderstanding takes place with regard to the notions of authority and responsibility.

A specific challenge for the region is related to global financial reform and the Group of 20 (G-20) agenda for strong, sustainable and balanced growth. Indonesia, along with the other countries in the region, is committed to increase regional and international cooperation in financial surveillance and improved early warning systems for potential systemic risks. This can be done by strengthening regional cooperation in the platform of ASEAN and ASEAN+3, specifically in developing and expanding the CMIM arrangement. Given the increased integration of the financial market in the region, there is a need to have a workable regional financial stability framework. In addition, Indonesia can take advantage of its membership in the G-20 in order to push forward several issues related to establishing a level playing field, cooperation in knowledge and information sharing within G-20 and other fora that can be done through meetings of the representatives of the Central Banks and Ministries of Finance. Establishing balance between the objectives of global financial reform and economic growth is still important in the less-developed-to-poor countries, as global financial reform may tend to put prudential measures as top priority while neglecting the need for financing development. One size cannot fit all. Reform has to be customized to the needs of each country.

Concluding remarks

One common lesson learned all over the world is that although financial liberalization can be an important catalyst for economic development, the process should be done with prudential measures to avoid excessive risk taking and moral hazard behaviour. The recent crisis proved that even developed countries could still fail to address this concern and let systemic risk linger too long, causing major distress to the financial system. With the current integration of the global financial market, financial distress in one country could be channelled immediately to other countries. While the current crisis originated in the United States and Europe, the general conditions in the Asia/Pacific region should not make countries in the region feel complacent. Indeed, in the second round of the 2007-2008 crisis, some countries in this region still suffered from the decline of growth. As the East Asian region is becoming more integrated, more concerted efforts in dealing with cross-border crises are highly recommended. Although in the short run, a country can benefit by solely paying attention to restoring its own economic stability, we have learned from recent events – notably the eurozone crisis – that instability in one country can adversely influence the entire region. More cooperative arrangements in cross-border crisis prevention and resolution is urgently needed in the Asia-Pacific.

Chapter 4

Malaysia

Mahani Zainal Abidin

Malaysia experienced two major economic upheavals in recent years: the global financial crisis of 2008-2009 and the Asian financial crisis of 1998. They are quite different, however, when we look at their respective causes, impacts and responses. The 2008-2009 crisis came from the developed countries, the United States and the European Union, its impact was transmitted through the real sector, and recovery was achieved by a large fiscal stimulus to boost the domestic economy. The 1998 crisis started in East Asia and it affected the financial sector, which resulted in a severe contraction of the domestic economy. Malaysia's response to the 1998 crisis was unconventional at that time – the country imposed capital controls, pegged the ringgit and expanded the domestic economy by lowering interest rates and introducing fiscal stimulus programmes.

Malaysia successfully recovered from both crises, but the first one was much more painful than the second one. The successful recoveries showed that Malaysia has resilience and that the policy measures implemented worked. However, it is important to compare the two experiences because of their different context and response measures. In a way, the 1998 crisis prepared Malaysia for future upheavals – the country became more cautious on financial globalization, particularly regarding short-term capital flows, and it strengthened significantly its financial sector. Looking at Malaysia's experience from a broader regional perspective reveals that other Asian countries also recovered quickly due to massive fiscal stimulus injections, the expansion of Chinese and regional demand, and the good health of the regional countries' financial sectors. Moreover, East Asian countries did not face balance of payment problems; in fact they had strong trade surpluses.

Notwithstanding the rapid recovery from both crises, Malaysia has short-term and long-term challenges if it is to achieve its target of achieving developed country status by 2020. Since 2000, growth has been moderate, private investment has been low, and per capita income growth has been minimal. This has led many to characterize Malaysia as a country caught in a middle-income trap. In the short-term, reducing the fiscal deficit, rationalizing subsidies and managing inflationary pressure are priority tasks for the Government. But to address the country's long-term challenges, the Malaysian Government launched the New Economic Model (NEM) in 2010. The NEM has three goals to be achieved by 2020: transforming Malaysia to a high-income country, attaining inclusive growth, and ensuring that growth is sustainable. The NEM recognizes that it has to find a balance between an export-oriented strategy with extensive links to the global economy and a push to expand the domestic economy.

This paper analyses the impacts of the 2008-2009 global crisis and Malaysia's responses. It also summarizes the sources of Malaysia's resilience in managing crisis and draws out lessons by comparing the experiences of 2008-2009 and 1998 crises. The paper concludes by discussing both immediate and longer-term issues that Malaysia needs to address if it is to regain its high-growth path.

Impact of the 2008-2009 crisis on Malaysia

While the epicentre of the global financial crisis of 2008-2009 laid in the United States, it brought enormous consequences for the world economy. The crash in global aggregate demand negatively impacted a number of sectors and markets in the Malaysian economy. The overall GDP growth rate of Malaysia fell to 0.2 per cent in the last quarter of 2008. In 2009 the economy entered a recession, with contractions of the GDP of 6.2 per cent, 3.9 per cent and 1.2 per cent, respectively, in the first three quarters of the year (table 4.1).

Table 4.1. Impact of the 2008-2009 global crisis on growth in Malaysia

	2007				2008				2009			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Real GDP growth	5.7	5.9	6.8	7.5	7.5	6.7	5.1	0.2	-6.2	-3.9	-1.2	4.6
Electronic production growth	0.1	-4.8	1.5	1.4	-0.1	4.7	-5.9	-20.1	-28.8	-26.9	-17.3	5.8

Source: ESCAP calculation based on IMF data, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.
Notes: Growth rates between one quarter and the previous quarter annualized and expressed in per cent. Data in constant price of 2000.

While in developed countries the impact of the crisis was initially felt on the financial sector and later on the real economy, the opposite was true for Malaysia, where the real sector was the first point of impact. The contraction in export demand as the developed markets were gripped by recession caused a steep drop in Malaysia's highly export-dependent manufacturing sector. Of all the sectors of the Malaysian economy, manufacturing contracted the most, with declines in the GDP of 8.9 per cent in the fourth quarter of 2008, 17.9 per cent in the first quarter of 2009 and 14.5 per cent in the second quarter. Overall, exports fell by 10.6 per cent in the fourth quarter of 2008 and 15.5 per cent in the first quarter of 2009. Although the trade balance, measured by deducting imports from exports and dividing the balance with the total of exports and imports, improved to 15.6 per cent in the first quarter of 2009 from 12.1 per cent in the fourth quarter of 2008, which is partly due to the high import content of the goods exported, the combined decline in exports and imports resulted in a severe recession in manufacturing. The largest manufacturing industry, i.e. electrical machinery, recorded the highest contraction because of its high dependence on exports. Also, its GDP started to drop earlier than that of other sectors, by 5.9 per cent and 20.1 per cent respectively in the last two quarters of 2008.

Investment and consumption

Aggregate private investment started to fall at the end of 2008. Indicators such as investment in capital goods, machinery for industry and transport equipment, import of intermediate goods and manufacturing project approvals all pointed towards a decline in investment activities.

The crisis has also had adverse implications for foreign direct investment flows, both inward and outward. Inward foreign direct investment had risen steadily over the period 2003-2007. However, because outward direct investment from Malaysia had risen faster than direct investment inflows since 2003, Malaysia experienced a negative net direct foreign investment inflow over the period 2006-2007 (table 4.2). FDI inflows into Malaysia started to fall during the third quarter of 2008 and remained low throughout 2009. The prime sources of contraction were North America, Central and South America, and Northeast Asia. Inflows from the United States fell from RM 1,100 million in the first quarter of 2007 to RM 445 million in the first quarter of 2009. Because of the decline in FDI inflows from traditional sources, the Government sought inflows from other, non-traditional sources. Given the growing cost differentials between Malaysia and late-comer countries, such as China and Viet Nam, attracting FDI into high value-added activities in the country would require the upgrading of its high-tech infrastructure.

Table 4.2. FDI inflows into Malaysia

	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
FDI inflows into Malaysia	2.8	13.4	9.8	5.21	7.18	16.0	2.03	-0.81	0.43	1.14	2.58	-3.54
Capital outflows from Malaysia	2.1	13.5	14.8	10.1	12.4	15.9	21.76	0.38	2.62	6.23	11.73	7.58
Net FDI	0.63	-0.11	-5.02	-4.84	-5.19	0.11	-19.73	-1.19	-2.19	-5.09	-9.15	-11.12

Source: Bank Negara Malaysia. Available from www.bnm.gov.my/index.php?ch=111&pg= 1016&ac= 2&bb=bop.
Note: Figures in billions of ringgit.

The rate of growth of final consumption expenditures fell gradually over the whole of 2008, turned negative the first quarter of 2009, and recovered slightly to 1.1 per cent in the second quarter. While public consumption slowed down to 3.4 per cent growth, private consumption fell by -0.8 per cent in the first quarter of 2009 (table 4.3). The reason why public consumption slowed down rather than contracted was due to the execution of government expenditure already committed through the Ninth Malaysia Plan.

Table 4.3. Consumption growth during the crisis period

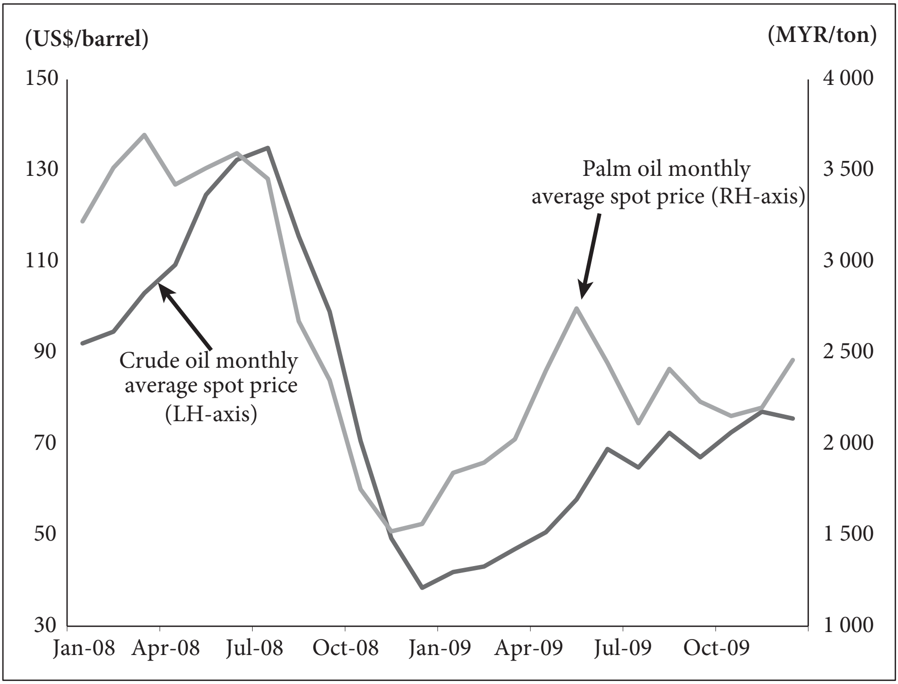
	2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Final consumption expenditure	11.2	8.6	7.7	6.3	-0.1	1.1	2.8	1.7
Private consumption	11.5	9.4	8.7	5.6	-0.8	0.4	1.1	1.5
Public consumption	10.0	5.3	3.5	8.6	3.4	4.2	10.4	2.5

Source: ESCAP calculation based on Department of Statistics data, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.
Note: Growth rates between one quarter and the previous quarter annualized and expressed in per cent. Data in constant price of 2000.

Commodity prices

The crisis also triggered a slump in commodity prices from their high in the first half of 2008 (figure 4.1). As a result, the incomes of key sectors in the Malaysian economy, such as palm oil and petroleum, were affected. Prices of crude palm oil for local delivery and exports dropped sharply between the first quarter of 2008 and the fourth quarter of 2008, but rose steeply over the first and second quarters of 2009. Crude oil prices fell between the second quarter of 2008 and the first quarter of 2009 before going up in the second quarter of 2009. Export prices of oil followed a slightly different pattern, falling from the third quarter of 2008 and rising in the second quarter of 2009, while the prices of liquefied natural gas (LNG) fell from the fourth quarter of 2008 until the second quarter of 2009.

Figure 4.1. Evolution of key commodity prices during the crisis period



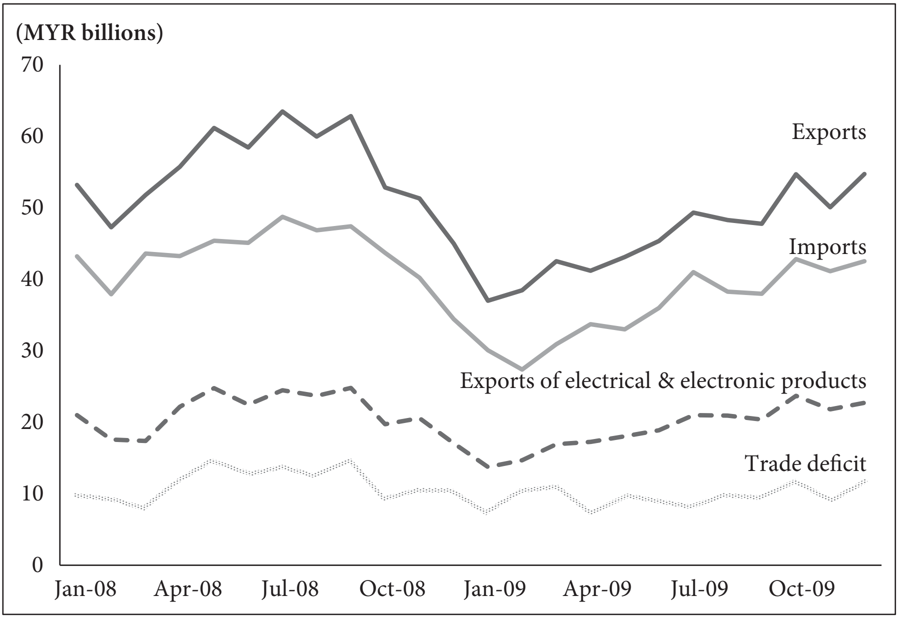
Source: Malaysia Palm Oil Board and Indonesia Directorate General of Oil and Gas, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

The sharp recovery in palm oil prices, driven primarily by the revival in GDP growth in China and India, augurs well for the Malaysian economy. However, the growing deficit in net exports of gas suggests that this natural resource may soon be exhausted. Given that the cost of various government subsidies depend positively on oil and gas prices, the recovery of such prices is likely to have a severe bearing on government finances in the medium- to long-term. In addition to the need to rethink the Government's subsidies on gas given to independent power suppliers, it is important that the Government reduce its dependence on oil and gas, both of which are non-renewable commodities.

Trade

Malaysia experienced a contraction in both exports and imports from the fourth quarter of 2008 (figure 4.2). The trade balance improved marginally in the first quarter of 2009 but dropped again in the second quarter. The figure shows the effects of the decline in external aggregate demand, the main channel through which the global financial crisis affected the Malaysian economy. Exports of electronics, Malaysia's major exports, faced a severe contraction. Other sectors that experienced sharp contractions were wood products, petroleum products, toys and sporting goods, and chemicals. Given the significance of electronics to manufacturing employment, its decline had serious consequences.

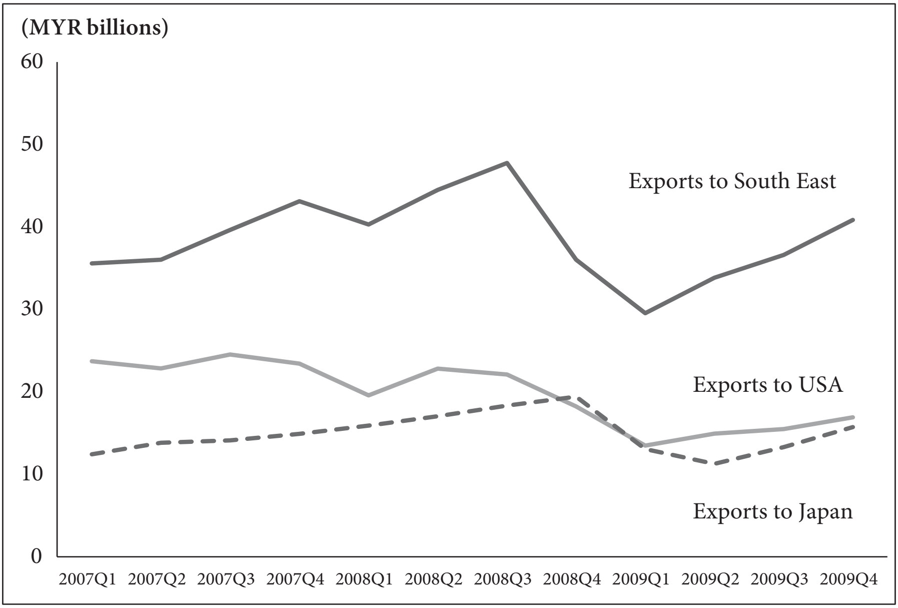
Figure 4.2. Exports and imports of Malaysia during the global crisis



Source: Department of Statistics data, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

The contraction in exports to the United States, the epicentre of the crisis, was the most severe, and it started at the end of 2007 (figure 4.3). Exports to Japan contracted in the first and second quarters of 2009. Exports to all ASEAN countries, except to Brunei Darussalam, fell in the first two quarters of 2009. The sharp decline in exports to key markets in the first two quarters of 2009 left the Malaysian economy in a precarious situation.

Figure 4.3. Exports to major trade partners during the global crisis



Source: Department of Statistics data, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

Currency and financial markets

The financial sector remained strong in Malaysia despite the collapse in exports, a fall in oil prices, and a contraction in GDP over the first two quarters of 2009. The capital and currency markets also remained steady over the first two quarters of 2009. The ringgit only depreciated slightly against the U.S dollar, due to capital outflows in the second and third quarter of 2008. The mild impact of the global financial crisis on the currency can be attributed to the healthy level of international reserves held by the Malaysian treasury.

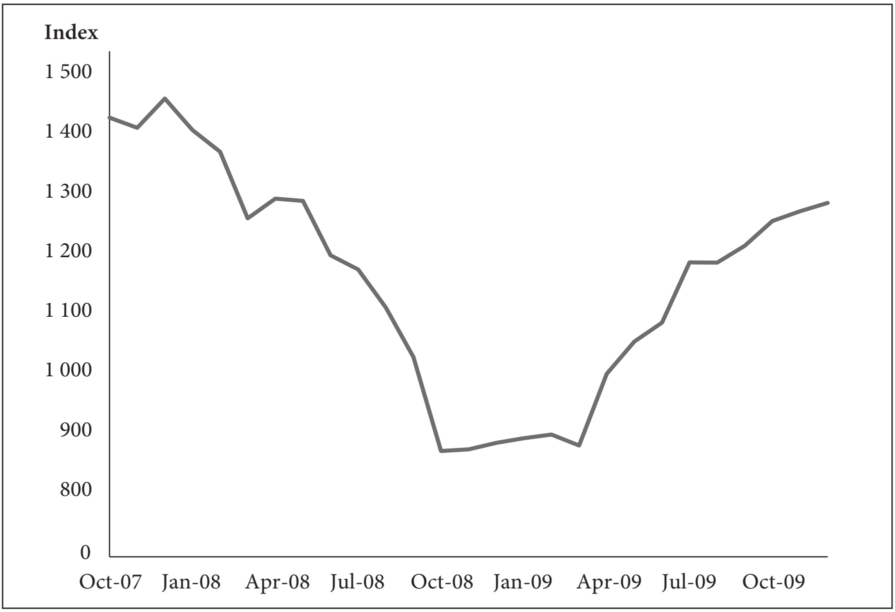
Liquidity levels in the country remained high with low NPLs, which have given the Government considerable financial stability. The prudent and conservative regulations on investment banks and finance houses, which were designed to reduce NPLs following the 1997-98 Asian financial crisis, were retained to good effect. The NPL over total loans ratio was rather low and fell continuously between 2007 and 2009, in spite of the global financial crisis (table 4.4). This financial stability offered the Government the space to pursue expansionary policies to expand domestic demand. Despite the excellent NPL record achieved, the environment for investment nevertheless continued to deteriorate because of falling aggregate demand.

Table 4.4. Non-performing loans

	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NPL to total loans ratio	8.2	7.6	6.8	6.5	6.1	5.4	5.0	4.8	4.6	4.5	4.4	3.7

Source: Bank Negara Malaysia, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.
Note: Figures expressed in per cent.

Figure 4.4. FTSE Bursa Malaysia composite index



Source: Bursa Malaysia, obtained from CEIC Data Company Limited. Available from http://ceicdata.com.

Despite the ending of capital controls, regulations by the Finance Ministry have ensured that the contraction in aggregate demand arising from a collapse in exports did not trigger a bearish run on the stock market. As a result, Bursa Malaysia remained fairly steady in 2009, although the index fell almost continually between January 2008 and March 2009 (figure 4.4). News of the Malaysian economy entering a recession following a second quarter dip in GDP did not dampen the stock market – in fact the index grew strongly from May 2009.

Retrenchments and income

With diminishing exports and GDP, layoffs and pay cuts took place (table 4.5). As a result, unemployment rate rose to 3.7 per cent in 2009 after a moderate rise from 3.2 per cent in 2007 to 3.3 per cent in 2008. Given its strong exposure to export markets, manufacturing was the worst hit sector. Between 2008 and 2009 manufacturing employment fell by 4.8 per cent, wages and salaries by 4.3 per cent and productivity by a large 14.8 per cent. Total retrenchments in manufacturing reported for 2008 and 2009 were double those of 2007.

Table 4.5. Retrenchment of workers from 1 October 2008 to 13 May 2009

Type	Local workers	Foreign workers	Total
Permanent retrenchment	17 943	7 185	25 128
Voluntary separation scheme (VSS)	7 601	870	8 471
Temporaty lay-off	7 222	974	8 196
Pay-cut	25 183	9 201	34 384
Total	57 949	18 230	76 179

Source: Ministry of Human Resources of Malaysia.

Measures to mitigate the negative effects

The initial government reaction to the global financial crisis was to relax monetary policy. The lowering of the overnight policy rate (OPR) from 3.5 per cent in 2007 to 2 per cent in February 2009 was done only after the full impact of the global crisis began to be felt in Malaysia. By that time, inflationary pressures, which took place in the earlier part of 2008, had dissipated with the collapse of oil and other commodity prices. The reduction in the policy rate was accompanied by a 50 basis points lowering of the Statutory Reserve Requirement (SRR) to 3.5 per cent, to reduce the cost of intermediation.

The Government also introduced a deposit insurance scheme run by Perbadanan Insurans Deposit Malaysia (PIDM), following the footsteps of other countries in the region that introduced guarantees for bank deposits to allay fears of a collapse of financial institutions and to discourage capital outflows. Malaysia experienced large capital outflows from March until September 2008. As a result, as a pre-emptive measure, a full guarantee of all ringgit and foreign currency deposits in financial institutions was implemented. Regulated by BNM, this guarantee was managed by PIDM and ran until December 2010.

The Government unveiled two stimulus packages: the first one (ESP 1), worth RM 7 billion (US$ 1.9 billion) or 1.04 per cent of the GDP, was launched in November 2008, and the second (ESP 2), which was RM 60 billion (US$ 16.2 billion) or 9 per cent of GDP, was launched in March 2009. ESP 1 was targeted to cover the year 2009, while ESP 2 was meant for 2009 as well as 2010. ESP 2 became necessary amidst heightened concerns that the economic deterioration was going to be very severe, as indicated by estimates from the IMF and World Bank, both of which had downgraded their world GDP forecast many times. Countries such as China and Japan had also anticipated a severe downturn and had introduced much larger stimulus packages.

Nearly 43 per cent of Malaysia's first stimulus package was allocated to infrastructure projects such as the upgrading, repairs and maintenance of public amenities, including schools, hospitals, roads, dwelling quarters for police and armed forces, and police stations. It also covered the building of low-cost houses, public transport and high-speed broadband infrastructure. ESP 1 was funded by savings from a reduction in petrol subsidies, and aimed at ensuring the wellbeing of citizens, developing quality human capital, and strengthening national resilience. While projects related to these three goals varied in nature, they focused primarily on construction and infrastructure, transport, banking and finance, and education.

The second stimulus package was 8.5 times larger than the first one, and almost half (48 per cent) of it, or RM 25 billion, was directed towards assisting the private sector through bank guarantees for small and medium enterprises. Another 32 per cent was allocated to infrastructure, but a substantial portion of this sum was for maintenance rather than for new spending on public facilities. Food, toll and fuel subsidies, support for low-cost housing and for retrenched workers took up 17 per cent of the spending, while the remaining 3 per cent went towards reducing unemployment and increasing job and training opportunities. Although RM 60 billion was announced for ESP 2, the actual spending in 2009 and 2010 was only about a sixth of that sum: RM 3 billion for tax incentives and RM 10 billion for strategic investments by the national sovereign wealth fund.

ESP 2 focused on four main areas: reducing unemployment and increasing employment opportunities, easing the burden of citizens, assisting the private sector to face the crisis, and building capacity for the future. These four goals overlap, and their implementation involves several ministries and/or agencies in most of the identified projects.

The focus of the first goal was to curb the ripple effect of increasing unemployment by means of training and creating employment opportunities. Accordingly, the Government announced that it was working jointly with the private sector to create training and employment opportunities for 100,000 retrenched workers and unemployed graduates. In addition, 50,000 vacancies and 13,000 contract posts were open in the public sector. Other measures included providing welfare assistance to retrenched workers, extending opportunities for graduates to further their education at Masters and PhD levels, and introducing the graduate PROSPER scheme to develop young entrepreneurs.

The second goal was to increase the disposable income of low- and middle-income households through subsidies to cancel out increases in the prices of daily food staples, measures to encourage home ownership, issue of Shariah-compliant Government Savings Bonds, and improvements in public infrastructure. Measures encompassed in the second goal also aimed at improving school facilities, providing micro-credit programmes for farmers and agro-based businesses in rural areas, improving facilities at day care centres for children and the elderly, as well as at women's shelters, ensuring the welfare of retrenched workers through tax incentives, and providing incentives for banks to defer repayments of housing loans.

The third goal focused on the business community, through initiatives such as the creation of the Working Capital Guarantee Scheme and the Industry Restructuring Loan Guarantee Scheme. The levy for the Human Resource Development Fund (HRDF) was reduced. A new organization, Danajamin National Berhad, was established to help private companies access the bond market to finance their activities. In the transport sector, measures include promoting the automotive sector through an auto-scrapping scheme and assisting the aviation industry through a rebate of 50 per cent on landing charges for all airlines. In addition, an accelerated capital allowance was introduced to encourage investment, and companies were allowed to carry back their losses to the immediate preceding year, which would postpone income tax payments and improve cash flows. The threshold for the windfall profit levy on palm oil was increased. Tourism was promoted by diversifying tourism products, upgrading infrastructure, improving home-stay programmes, and approving work permits for skilled spouses under the Malaysia My Second Home Programme.

The fourth goal refers to capacity building for the future and it covers investments, off-budget projects, the creative arts, and the effective management of government financial resources. Specific measures on investment include more funds from Khazanah National Berhad for domestic investments in areas such as telecommunication, technology, tourism, agriculture and life sciences, as well as those in Iskandar Malaysia. Also covered are private finance initiative (PFI) projects in areas such as infrastructure and biotechnology.

Other than the stimulus packages, the Government also implemented measures to restructure the economy and improve its competitiveness. Policy announcements include liberalizing 27 services sub-sectors, removing the 30 per cent Bumiputra participation quota in certain businesses and the 25 per cent Bumiputra requirement for listing purposes, and deregulation of the Foreign Investment Committee guidelines. In addition, the Government set up Ekuiti Nasional Berhad as a private equity fund to ensure meaningful and effective participation by Bumiputras.

The Government also strengthened the country's social safety net during the crisis. The allocation for the Malaysia Social Safety Net programme was raised from RM 350 million to RM 850 million in 2008. An important aspect of this social support programme is the Federal Welfare Aid given via the Social Welfare Department under the Women, Family and Community Development Ministry. This programme was also revised and a new Social Safety Net Card was introduced in February 2009. The definition of hardcore poor, who are entitled to welfare aid, was revised from a household monthly income of less than RM 430 to RM 720 in Peninsular Malaysia, from RM 520 to RM 830 in Sarawak, and from RM 540 to RM 960 in Sabah. These amounts serve as a guide or as the initial entry point for aid eligibility. Final approval depends on case-by-case checks by welfare officers who assess factors such as the living condition of the families, the number of children and dependants, age of the applicant or head of household, physical disabilities, and health conditions due to disease or illness.

Sources of resilience

Malaysia's response to the crisis has been conditioned by two previous events: the recession of 1985-86, which was initiated by a collapse in the prices of primary commodities, and the Asian financial crisis of 1997-98, which began as a result of portfolio capital and currency movements. In many ways, the decade leading up to the latest crisis was characterized by efforts to ensure that the economy would be able to withstand strong financial shocks to the system. For an open economy like Malaysia, maintaining a flexible exchange rate and monetary independence in the face of increasingly large capital flows is important. To better manage the surges in capital flows, which have become more prevalent, the range of market-based instruments for monetary policy operations has been increased. Given the rise in intra-regional trade and investment flows, greater importance has also been accorded to stability of the exchange rate against regional currencies. Policymakers have tended to err on the side of caution since the Asian financial crisis, as evidenced by the large amount of excess savings and international reserves accumulated. While the Government did run continuous budget deficits in the 2000s, these were juxtaposed by inordinately large balance of payments surpluses of up to 15 per cent of GDP.

In the financial sector, following the Asian financial crisis, consistent efforts have been taken to consolidate the banking sector through mergers and acquisitions and increased capitalization. The overcrowded banking sector, which had 58 financial institutions, was consolidated into 10 banking groups with larger capital requirements. When the global financial crisis finally manifested itself in late-2008, the balance sheets of Malaysia's financial institutions were one of the strongest, with low NPLs ratios and loan-deposit ratios well below 90 per cent. The level of capitalization of the Malaysian banking system remained high, with a risk-weighted capital ratio of 14.7 per cent at the end of December 2009 (end-2008: 12.6 per cent). In the Asian financial crisis large amounts of volatile capital left the country through the combined loss of market confidence and the activities of currency speculators, and Malaysia learned the lesson to accumulate large foreign reserves. It also took a more cautious approach to financial liberalization and set out guidelines and plans in the Financial Sector Masterplan and Capital Market Masterplan, both introduced in 2001.

At the time of the global financial crisis the indebtedness of corporations and households relative to the value of financial assets was falling rather than rising. Exposure to foreign loans was also kept to a minimum. Malaysia was very cautious about approving the use of complex, innovative, yet risky financial instruments such as collateralized debt obligations. The exposure of the domestic banking system to sub-prime assets was thus limited. The prudential measures put in place not only strengthened corporate governance but also insulated Malaysia from over-leverage and over-exposure, which in turn helped to contain the negative effects of the global financial crisis.

Malaysia was fortunate to have entered the global financial crisis with a significant proportion of its economic growth contributed by domestic sources, particularly private consumption. Even though domestic demand did not adequately insulate the economy from recessionary effects, it did help blunt the force of the shocks to trade and investment. Private consumption turned out to be highly resilient, dropping the least among the components of aggregate demand. Imports of consumption goods fell by a mere 4 per cent in the first quarter of 2009, while the food and beverages component actually rose overall by 11 per cent. Other private consumption indicators, such as revenues from the sales and service taxes, registered large increases in the first quarter of 2009. In contrast, imports of investment goods declined by almost 8 per cent and intermediate goods imports fell by 35 per cent during that quarter. The crisis was thus felt by corporations and producers much more than households and consumers.

To Malaysia's advantage, the country's capacity and resilience in managing these sizeable and volatile financial flows had been fortified in a number of ways. First, the country's economic fundamentals remained healthy and the financial markets were more diversified and developed. This has enhanced the ability of the financial system to absorb capital inflows and outflows, thereby minimizing disruptions while ensuring that the capital flows can be effectively intermediated. Second, the managed float regime accorded the necessary flexibility for the ringgit to adjust to changing conditions. Since exiting from the fixed exchange rate regime, the managed float regime has served the economy well by providing a good balance between flexibility and stability. Third, the ability to manage domestic liquidity has also improved significantly, supported by a wider range of instruments to conduct monetary operations and having in place better surveillance and information system. This ability to manage liquidity effectively meant that financial flows have a limited impact on financial intermediation and the level of economic activity, and that the risk of a build-up of large imbalances in the economy has been significantly reduced.

Over the years, Bank Negara Malaysia maintained a pre-emptive approach to monetary policy. Earlier in 2008, inflation was on the rise due to the sharp and significant increase in food and energy prices. The policy rate, however, was left unchanged because the Bank considered that the food and energy price increases were largely supply driven and that raising interest rates under these conditions would have had a limited impact in containing inflation. More importantly, the Bank also assessed that the Asian economies would be affected by spillover effects from the global financial crisis, given their strong trade links with the developed economies. In addition, given the high percentage of food and energy in total consumption, higher prices in these categories would be contractionary. While there were considerable uncertainties, the balance of risks was that growth would slow in the twelve-month period beginning in mid-2008. That was the main consideration in the decision to maintain interest rates despite expectations that the Bank was going to tightened monetary policy. Subsequently, as the global economy contracted, the Bank's decision to maintain interest rates was not only justified but also created appropriate initial monetary conditions to provide support to the domestic economy.

Comparison with the 1997-1998 Asian financial crisis

The transmission of the impact of the 2008-2009 global financial crisis to the Malaysian economy was different from that of the Asian financial crisis of 1998. This time, the transmission was through the real sector, namely exports, investment flows and prices of exports, while the channel of transmission of the 1998 crisis was through the financial sector. This time the real sector was the first point of impact, while the financial sector was almost not affected. Although exports suffered a massive collapse in 2008-2009, the economic decline was much smaller than in 1998, when exports increased substantially in ringgit terms because of the sharp depreciation. The sharp GDP contraction in 1998 was precipitated by large capital outflows, a large depreciation of the ringgit and troubled domestic financial and business sectors. That time the priorities were to stabilize the exchange rate and reduce capital outflows, which resulted in the introduction of a pegged exchange rate and capital controls. With these measures in place, the domestic situation stabilized, allowing fiscal stimulus and a relaxed monetary policy to be implemented to boost domestic demand. The situation in 2008-2009 was different because Malaysia had sufficient reserves to support the ringgit amid large capital outflows and the financial and business sectors were strong. As such, the policy response was targeted only at expanding domestic demand through fiscal stimulus and lowering interest rates.

The two crises – the 1998 Asian and 2008-2009 global – had differing impacts on the Malaysian economy and provided some very useful and pertinent lessons. In the 1998 crisis the external shock had caused severe consequences for the Malaysian financial sector whereas the export sector was only marginally touched. And in fact it led the recovery process. On the other hand, in the 2008-2009 global financial crisis, the Malaysian financial sector escaped the spillover effects of the collapse of the developed countries' financial sector. Likewise, the movement of the ringgit was very different between the two crises – in 1998, the ringgit depreciated by 45 per cent causing massive damage to the economy, which prompted the imposition of capital control and the pegging of the ringgit. In contrast, the movement of the ringgit was mild in the 2008-2009 crisis. There are several lessons from these crises:

- The health of the real sector in the major markets for Malaysia, the developed markets, has an important and immediate impact on

Malaysian exports. In this case the issue of competitiveness and the state of Malaysian export industries are secondary because the collapse in global demand will automatically result in a fall in demand for Malaysian exports and will lead to economic slowdown or even a recession.

- Because of Malaysia's heavy dependence on exports, a revival from economic slowdown is very dependent on external demand, be it regional or global. Recovery by expanding domestic demand may not be as quick because measures such as public sector infrastructure investment or tax incentives will take time to produce the required results.
- The state of the domestic financial sector is critical in determining its ability to withstand global shocks. If it is strong and well governed, the impact of external volatility will be manageable.
- Building safeguards is important to reassure domestic and foreign constituencies that the economic fundamentals are strong. In this regard, sufficiently large international reserves, low short-term external debt and a realistic exchange rate are some of the fundamentals that maintain public and investors' confidence.
- It is important to differentiate between external shocks that affect short-term demand for exports and the long-term competitiveness and strength of the external sector. The state of the external sector is determined by the competitiveness of the export industries, the strength of the domestic financial sector and the attractiveness of the investment climate. If the external sector is uncompetitive, medium- and long-term growth will be jeopardized because exports may not be able to be restored to their previous position after recovering from an external shock.
- The public sector financial position was a major factor in stimulating domestic growth to offset declining external demand. With strong surplus or capability to mobilize funds, the public sector had to take a leading role to stimulate the domestic economy when the private sector was weak. However, having the funds alone is insufficient – the public sector must also act quickly for pump priming the economy. In 1998, the Malaysian public sector was in a better financial position than in 2008, but due to political differences measures to stimulate

the economy took longer to implement and could not prevent the economy from experiencing a sharp contraction.

Short-run challenges

The two stimulus packages implemented during the 2008-2009 global financial crisis caused the fiscal deficit to balloon. The country's fiscal deficit was 4.8 per cent of the GDP in 2008 and 7.6 per cent in 2009. The New Economic Model (NEM) proposed by the National Economic Advisory Council (NEAC) urged that the fiscal deficit should fall to near-balance by 2020. Apart from the stimulus packages, the rising fiscal deficit had been caused by the increasing amount of subsidies for fuel and various price-controlled items. Globally, prices are constantly rising, making subsidies on price-controlled items more costly. The subsidies were meant to support vulnerable groups, but they benefited a wider group, including the well off. The large government outlay on subsidies – mostly funded by petroleum proceeds – is not sustainable. The retail price of essential goods and services in Malaysia does not reflect market prices. Price controls and subsidies distort price signals resulting in overconsumption and waste.

The private sector also became ever more reliant on government subsidies, which are numerous, complex and expensive to administer. Such support by the public sector to the private sector is not leading to innovation and high levels of private investment. As a result, domestic and foreign investors have a vested interest in maintaining low value-added production. Adding to that burden are the numerous tax incentives granted by the Government. While tax incentives are necessary measures to encourage private investment, they contribute to foregone tax revenues if used indiscriminately.

Historically, Malaysia's development expenditures depended greatly on revenues from natural resources. Export duties on tin, palm oil and rubber, for example, substantially financed the early five-year plans. From the mid-1970s, the contribution from oil and gas rose and now accounts for about 40 per cent of the total government revenue. The Government should reform its revenue sources. With the depletion of oil and gas reserves, a more diversified tax base is needed to compensate for the expected future reduction in the share of revenue from these commodities. The tax base should be diversified, among other ways, by implementing the goods and services tax. Revenue collection should also be strengthened by developing and implementing an effective technology-based revenue collection and management system.

Another major challenge for Malaysia is to revive private investment. The Asian financial crisis of 1998 caused significant outflows of foreign portfolio investment (FPI) and foreign direct investment (FDI), as well as a fall in overall investment. But during the decade following the Asian financial crisis aggregate investment levels as percentage of the GDP continued to decline and private investment stagnated. The absence of private domestic investment is further evidenced by developments in the external accounts. In recent years, the balance of payments of Malaysia has seen persistent current account surpluses, which reached almost 18 per cent of GDP in 2008. While this current account surplus was largely offset by the accumulation of net foreign assets, there was also an increasing capital account outflow for financing Malaysian investments abroad.

Although FDI inflows into Malaysia recovered reasonably well, this rebound has not translated into higher levels of aggregate investment. It has been highlighted that tax incentives, which have been Malaysia's traditional measure to spur private investment, have grown in number, variety and complexity over time. Such subsidies are an obstacle to phasing out low value-added industries and services and boost domestic private investment in high value-added products and services. The heavy presence of Government and Government-linked companies (GLC) in some industries has discouraged private investment. In addition, cumbersome and lengthy bureaucratic procedures have affected both the cost of investing and the potential returns on investment. A persistent shortage of skills has also had an impact on investment.

Macroeconomic rebalancing and strategies for robust, inclusive and sustainable growth

From 1990 to 1997, the Malaysian economy grew at an average annual rate of 8.1 per cent, compared to only 5.6 per cent from 2000 to 2010. This performance gave rise to the immediate and widespread comment that Malaysia's growth had lagged and that growth is on a downward trend. The private sector's role is much smaller now – in 1995 private investment expanded annually by 32.8 per cent compared to only 12.3 per cent in 2007. As Malaysia becomes a knowledge economy, its services sector is expected to play a bigger role in economic growth. Unfortunately this transformation is slow. The share of services in GDP increased only 2 percentage points between 1997 and 2007, to 53.6 per cent. Nevertheless, tourism and new services industries such as

Islamic finance, education, health services, air transport and logistics have become significant contributors to the national economy. Malaysia remains in the mid-level range of competitiveness benchmarking since 2000. Based on the World Economic Forum Competitiveness Index, out of 131 countries, Malaysia's position declined from 29th in 2003 to 31st in 2004, improved to 19th in 2007 but slipped again to 21st in 2008.

Some argue that Malaysia has not got back to its previous high growth path and is caught in the middle income country trap. Malaysia is facing strong competition at both ends of the scale: in the areas of its traditional strength and in new fields that can be the source of its future growth.

Malaysia reached middle income country status in mid 1990s. Its economic structure is balanced: a well-developed manufacturing alongside a commercial agriculture sector and a potentially strong services sector. It is also a resource-rich country with oil, gas and primary commodities. Yet, Malaysia is still a low-wage, low-skill and resource-based economy. In the 1990s Malaysia was narrowing its economic gap with the Republic of Korea; Taiwan, Province of China; Hong Kong, China; and Singapore but unfortunately this gap has now become wider. This growing gap is particularly noticeable in the growth rate of per capita income, technological capabilities, human capital development and the creation of high value-added jobs. Malaysia's annual real per capital income growth rate of 3.6 per cent (in 2000-2007) is lower than those of the Republic of Korea (4.7 per cent) and Singapore (4.3 per cent).

A key challenge for the country is to secure a sustained high growth rate. The opposing trends of continuing with low-cost, low-skill activities and making little progress in transforming into a high-productivity economy will only produce low growth in the future. Is Malaysia in danger of not meeting its own target of being a developed country by 2020?

The Government has launched the New Economic Model (NEM) in 2010 to propel Malaysia into the ranks of high income countries by 2020. Per capita income is expected to double from the present US$ 7,000 to US$ 15,000 by 2020. The other two goals of the NEM are inclusive and sustainable growth. In order to achieve these goals Malaysia needs to generate sustained high growth. In this regard, the sources of growth, human capital capacity, technology and the price system are among the keys factors that need to be addressed.

Unlike the 1998 crisis, the 2008-2009 global financial crisis called into question Malaysia's outward development strategies because of the gloomy prospects for trade growth as a result of the economic difficulties of its two major markets – the United States and the European Union. Before the Asian financial crisis, Malaysia was very positive about globalization and its close integration with the international economy. However, the recent crisis has demonstrated that a decline in global demand can make Malaysia vulnerable because of the country's heavy reliance on global trade. Therefore, improving and refocusing its outward-oriented development strategy can help Malaysia mitigate the impact of future external financial crises on trade and bring sustained high growth. The country's goals should be:

(i) To have a balanced export structure. Presently Malaysia's exports come from three major groups – manufacturing, mining and primary commodities. In the past this structure produced a good counter balance: when one component suffered a slowdown, the other groups grew quite well because they had different consumers and demand cycles.

(ii) To accelerate the expansion of services exports. Malaysia has made good progress in promoting services exports – tourism is a major export earner and the Multimedia Super Corridor is focusing on IT and business off-shoring services. Other services exports that have been identified are Islamic finance, health and education services and air passenger transport services.

(iii) To upgrade existing exports – both the manufacturing and primary commodity exports should be upgraded to incorporate higher value-added and innovation.

(iv) To diversify markets. This diversification is important especially in view of the moderate growth prospects – and consequently of demand for imports – from the country's traditional markets.

(v) To continuous improving the investment climate to attract FDI.

Notwithstanding the importance of outward orientation, it is imperative that Malaysia undergoes a macroeconomic rebalancing that expands domestic demand while at the same time improves its global competitiveness and links. Switching to domestic demand can only be a long-term strategy because

Malaysia has to increase its domestic market and purchasing power first before that strategy can be effective.

The future prospects of the Malaysian economy will hinge on its own internal conditions. Strong macroeconomic fundamentals, such as low national and foreign debts, a sound fiscal position, low inflation and unemployment, current account surpluses, high international competitiveness, capability for R&D and technological development and availability of skilled workers are key fundamental factors for growth. Enhancing human capital is certainly a move in the right direction, but this effort must go beyond education and has to be linked to labour market policies and to expected changes in the demand for labour. If the supply of human capital is not matched with industries' needs, there will be unemployment, a trend that has already emerged, and under employment.

Technology and innovations are fundamental catalysts for an economy moving up the value chain because they create high value-added. Many measures to acquire and develop technological capabilities and capacities have been introduced, but success is still limited. Fostering a culture of innovation is essential if competitiveness is to be sharpened. Malaysia needs to combine technology-driven and market-driven approaches to innovation to be ahead of other countries, lead in strategic technologies and quickly capture market shares in growth products and services. For this, the country should continue to invest in technology-driven innovations by supporting research in basic sciences as well as in R&D. At the same time, Malaysia should also acquire technologies and improve them to meet market demand.

The price system is mired in subsidies, price controls, licensing requirements and quotas and it needs to be revised to reflect the market signals. Price controls and subsidies began with the noble aim of supporting production and investment to promote domestic output and to alleviate the impact of price increases on the poor but they have allocated resources inefficiently and affected Malaysia's competitiveness.

It is also important to pursue an inclusive growth agenda. Malaysia has achieved significant improvements with regard to poverty reduction. The incidence of absolute poverty was cut from about 50 per cent in 1970 to almost 20 per cent by 1987. All ethnic groups recorded progress in poverty reduction. Even with the slower growth following the Asian financial crisis, the incidence of poverty continued to decline, reaching 3.6 per cent in 2007. Relative poverty, however, rather than absolute poverty, is the challenge for Malaysia. Relative poverty in 2008 was 19 per cent, slightly higher than 15 years before. Recent data shows a growing gap between the rich and the poor. While overall income disparity lessened as measured by the Gini coefficient, from 0.459 in 1997 to 0.441 in 2007, the disparity seem to have increased over the past decade for certain groups and the disparity among the urban group remains high with no improvements in the last decade. Moreover, the results of household income surveys suggest that only the top 20 per cent of Malaysian income earners enjoyed income growth since 1990. On the other hand, average incomes of the bottom 40 per cent have grown the slowest, reaching an average of RM 1,222 in 2008.

To address poverty and inequality issues that inhibit the achievement of inclusive growth, human capital development efforts should be intensified. Massive investments have been made in education and training, but a more targeted approach should be pursued. Education and training are essential to improve the job prospects of the poor and those in the rural areas, but disparity in the availability of quality education between rural and urban areas remains. Therefore, access to quality training and skilling courses, especially in rural areas and marginalized urban centers should be increased. The training system must produce skills that meet the needs of industry. More technical and vocational schools should be built to cater for the non-academically inclined students. Training and skills development is key to expanding the talent base, as it allows workers to undergo continuous improvement, particularly those that may be displaced from low value-added jobs during the country's economic transformation.

The social safety net for the poor and the vulnerable must also be strengthened. Despite the various measures implemented during the global financial crisis, several weaknesses remain. Subsidies for food, fuel, and other products comprise about 60 per cent of social protection spending in Malaysia in 2010. Yet these subsidies benefit the well-off more than they benefit the poor, because of their non-targeted nature. More importantly, workers are not protected, or at best are poorly protected, from the risks associated with unemployment, illnesses, disability and old age. Unemployment insurance is absent, health insurance programmes for the poor have a narrow reach, and 35 per cent of the employed are outside the pension system. A stronger social safety net should provide support to cushion the impact of future economic crises.

Ideally, such safety net would include effective targeting mechanisms and a clear and consistent focus on the needy.

Growth should also be sustainable in the long term, so that the expansion of wealth of the current generation is not achieved at the expense of future generation. The NEM emphasizes that natural resources should be preserved and a green economy policy be developed. Current trends in energy intensity and carbon emission are not yet in line with sustainable growth aspirations. Policies to encourage cost-based pricing of environmental resources to improve the efficiency of usage of fuels and water and the provision of incentives to promote "green" innovation and conservation of biodiversity should be introduced.

Chapter 5

Pacific Islands Developing Economies

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The Pacific island countries are small developing economies, the challenges of which are well documented. Such challenges are similar in many ways, but also varied as these countries are different in terms of population size, land area, culture and natural resources. Although the Pacific island countries were not directly or immediately affected by the global financial crisis of 2008-2009, they took precautions to cushion any potentially adverse effects. Isolated and small, the Pacific island countries developed strong economic ties with the outside world, particularly in sectors such as tourism and fisheries. In addition, the Pacific island countries have maintained strong links with their diaspora communities in Australia, New Zealand and the West Coast of the United States, whose remittances came as an unexpected but welcome support during the crisis years.

Background

The Pacific island countries are a diverse group of countries with varied levels of development. The indicators for achieving the Millennium Development Goals are also mixed (Flore-Smereczniak, 2011). They can be broadly grouped into three categories and they represent a diverse group (table 5.1). The first group of smaller Polynesian countries such as Niue, Samoa, Tokelau, Tonga and Tuvalu are mostly on track to achieve the Goals. Tonga and Tuvalu, however, may not be able to achieve Goals 5 and 6. The second group of countries comprise the small Micronesian States. They include Kiribati, Marshall Islands, Nauru and Palau. Nauru and Kiribati are not on track to achieve several Millennium Development Goals. These countries have extremely poor growth rates. The third group includes the Melanesian countries, viz. Fiji, Papua New Guinea, Solomon Islands and Vanuatu. These countries have significant resources, but they are the most problematic in terms of political stability, governance and socio-economic issues. Papua New Guinea, which is the largest of the Melanesian countries, is unlikely to achieve many of the Millennium Development Goals despite its high rates of economic growth in the last few years.

Table 5.1. Characteristics of the Pacific Island States, 2008

	Population	Population growth	Population density	Urban population	GDP per person
Melanesia and Timor Leste					
Fiji	853	1.7	47	51	3 306
Papua New Guinea	5 995	2.5	13	14	943
Solomon Islands	489	2.8	17	17	684
Vanuatu	215	2.6	18	24	1 799
Timor-Leste	1 029	3.9	69	27	346
Polynesia					
Cook Islands	22	1.7	91	70	7 549
Niue	2	- 2.4	7	33	4 364
Samoa	186	0.4	66	23	2 277
Tonga	102	0.6	142	24	2 176
Tuvalu	10	0.6	381	48	1 346
Micronesia					
Micronesia (Federated States of)	111	0.4	159	22	2 205
Kiribati	101	1.8	138	48	703
Marshall Islands	65	0.0	636	67	2 363
Nauru	10	0.1	482	100	3 500
Palau	20	0.8	85	12	671
Comparators					
Low income countries		1.6	85	12	671
Middle income countries		1.0	45	53	6 564

Source: AusAID (2008); ESCAP (2011a).
Note: Population growth rates are for 2000-2009a. Column 1 in thousands. Columns 2-4 in per cent. Column 5 in US$.

Lessons learned

It is true that Pacific island countries did not suffer much immediately and directly after the crisis. But the indirect effects were beginning to impact some of them in 2009. For some countries, this continued until 2010, when the world economy started showing signs of a rebound. While tourist numbers and remittances declined, it was not a drastic reduction. While the continued global financial instability has remained a serious concern, the Pacific island countries are not expected to be affected directly. Indirectly, however, if the Australian and New Zealand economies are affected due to the eurozone crisis, then the Pacific island countries could be affected through declining demand for their exports, impact on remittances from these two countries and the possibility of decline in the number of tourists.

In assessing the impact of the global financial crisis, the Asian Development Bank (2009) pointed out several transmission effects, which explained some of the adverse impacts that were to later reach the shores of the Pacific island countries. In Solomon Islands, Papua New Guinea and Vanuatu, the declining world prices of agricultural commodities lowered incomes for small holder plantations. Rural areas dependent on tourism experienced a decline in incomes with fewer arrivals or less spending. The demand for transport and other goods and services used in rural production weakened, affecting a range of rural businesses in formal and informal sectors. The urban economies in some of the larger countries such as Fiji and Papua New Guinea suffered a decrease in demand as remittances to urban households declined, and demand for tourism and other services such as international shipping were affected. In addition, private investment also declined in some countries. This affected government revenue, and in some cases poverty alleviation programmes and infrastructure investment had to be wound down or suspended.

Source of resilience and policy responses

In terms of direct effects, the Pacific island countries weathered this because of the nature of their financial systems (table 5.2). The Pacific island countries have small financial sectors characterized by a small number of banks and a limited number of non-bank financial institutions. Apart from Tonga, many have their own national retirement funds where it is compulsory for workers to contribute. The majority of the banks in the Pacific island countries are Australian-owned, and the Australian financial system has been very stable and largely unaffected by the collapsing financial institutions in the United States. Most of these Australian banks have good risk management strategies, with high interest spreads and profits. In addition, most Pacific island countries have some forms of capital controls, and this further mitigated the risks.

The main policy response to the global economic crisis in many of the developed countries was fiscal and monetary policy stimulus to create domestic demand. Many economists of the Keynesian tradition take heart from this as they believe that markets may have failed in some of the instances. However, if one looks carefully at some of the instruments of fiscal policy to stimulate demand, one finds that they are not necessarily against the principle of market-oriented policies. In fact one may consider some of the actions as aid-for-trade measures, thereby supporting some of the market-oriented reform, although stimulus packages differ from country to country and are embedded in their own unique contexts.

Table 5.2. Financial sector indicators

	Fiji	Kiribati	Samoa	Solomon Islands	Tonga	Vanuatu
A. Size of the banking sector in 2007						
Central bank assets	3.4	-	0.2	5.1	3.5	3.5
Deposit money bank assets	73.9	-	69.8	50.6	45.5	132.6
Other financial institutions assets	100.2	-	53	27.1	14.5	9.3
Total financial system assets	177.5	157	123	82.8	63.5	145.4
B. Composition of non-bank financial institutions						
Other financial institutions assets	100.2	-	53	27.1	14.5	9.3
Of which development banks	13.8	-	12.1	0.3	13.9	0
Of which provident fund	64.2	-	32.2	25.5	0.6	9.3
C. Indicators of financial depth in 2007						
Liquid liabilities (M2)	56.8	0	46.5	43.8	58.5	107.5
Private credit by deposit money	44.1	0	44.1	28.5	65.8	47.2
Private credit by deposit money Banks and other financial	48.3	0	44.1	33	65.8	47.2
D. Foreign ownership of banks						
Number of banks (foreign-owned)	6 (6)	1 (1)	4 (3)	3 (3)	3 (3)	4 (3)
Assets of foreign-owned banks	100	100	85.7	100	100	88
Assets of state-owned banks	0	0	14.3	0	0	12

Source: IMF Article IV consultations.

Note: Indicators in headings A, B and C in per cent of the GDP. Indicators in headings D except the number of banks, expressed in per cent of the total assets of the banking system.

In most Pacific island countries monetary policies are primarily used for preserving international reserves as a result of fixed exchange rates (Yang and others, 2011). Amongst the Pacific island countries, only Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu operate independent monetary policies (table 5.3). Some countries tried to lower official cash rates to reduce interest rates and stimulate investment. Other countries, such as Fiji and Vanuatu, reduced the required reserve ratios to increase lending to consumers and investors.

Table 5.3. Monetary policy frameworks in Pacific Island countries

Country	Monetary objectives	Monetary target	Main monetary instruments	Exchange rate regime
Fiji	Promote monetary stability and a sound financial structure; foster credit and exchange conditions conducive to an orderly and balances economic development	Broad money (M2)	OMO; discount windows; policy rate	Pegged to a basket (US$, AUD, Euro, etc.)
Papua New Guinea	Achieve and maintain price stability and financial system stability, and promote macroeconomics stability and economic growth	Broad money (M3)	OMO; discount windows; policy rate	Float
Samoa	Promote sustainability real economic growth by maintaining price stability and international reserves viability	Broad money (M2)	OMO; discount rate reserve requirements; repos	Pegged to a basket within a ±2 percent band (NZD, AUD, US$, Euro)
Solomon Islands	Promote monetary stability and a sound financial structure; foster financial conditions conductive to orderly and balanced development.	Broad money (M3)	Liquid asset requirement; foreign exchange surrender	De facto peg to the US$
Tonga	Maintain internal and external monetary stability; promote a sound and efficient financial system; support macroeconomic stability and economic growth.	Broad money (M2)	OMO: statutory reserve deposit; credit ceilings	Pegged to a basket with monthly adjustment band of up to 5 percent
Vanuatu	Maintain low and stable inflation rate and maintain a sufficient level of official foreign exchange reserves.	Broad money (M2)	Statutory reserve deposit; OMO; rediscount rate	Adjustable peg, linked to an undisclosed transactions-weighted basket

Source: Yang and others (2011, p. 5).

Exchange rate management is another challenging area that the small economies of the Pacific island countries have to grapple with. For many of the Pacific island countries, who are dependent on exports of primary products and on tourism, maintaining the competitiveness of their exchange rate is vital and more critical in the current economic environment. In fact, the Pacific island countries faced similar challenges after the 1997 Asian financial crisis and managed to use exchange rate management tools to weather the negative impacts of that crisis. Many of the Pacific island countries also identified exchange rate management as a tool to navigate through the crisis. Fiji, in particular, saw exchange rate management as a major issue in managing its foreign reserves.

The Pacific island countries also received a steady flow of remittances, which provided a source of support to families to cushion the declining income from reduced exports and the erosion of purchasing power through inflation. In particular, Tonga, Samoa, Fiji and Kiribati found this to be an import source of resilience (see table 5.4). Fiji's remittances receipts between 2004 and 2007 have been around 6 per cent of GDP, but declined in subsequent years (Prasad, 2011). The actual amount of remittances received in some of these countries is higher than the official figures because they are transferred through informal channels. Remittances support consumption and to a lesser extent productive investment.

Table 5.4. Remittances inflows as a percentage of GDP in selected Pacific Island economies, 2004 to 2009

	2004	2005	2006	2007	2008	2009
Fiji	6.4	6.1	6	4.7	3.3	5.1
Kiribati	7.4	8.8	11.9	8.2	7.6	6.0
Papua New Guinea	0.1	0.1	0	0	0.1	0.1
Samoa	18.7	20.9	24.5	22.4	24.8	25.9
Solomon Islands	9.9	8.5	11	7.3	6.2	7.4
Tonga	41.8	40.3	31.8	33.9	28.8	24.1
Vanuatu	1.5	1.4	1.2	1.0	1.2	1.0

Source: ESCAP (2011b).

Trade policy

Only Papua New Guinea, Solomon Islands, Tonga, Fiji and Vanuatu are full WTO members. There are four regional trade agreements which have some specific impacts on Pacific island countries. Two of these are agreements among Pacific island countries themselves: the Melanesian Spearhead Group Trade Agreement (MSG), which includes Solomon Islands, Fiji, Vanuatu and Papua New Guinea; and the Pacific Island Countries Trade Agreement (PICTA), which includes all Pacific island countries except Marshall Islands and Palau. The Pacific island countries have also been negotiating economic partnership agreements (EPAs) with the European Union, and so far only Fiji and Papua New Guinea have signed interim EPAs to ensure continued access of their sugar and tuna to the EC market. Other Pacific island countries, such as Kiribati, Solomon Islands, Tuvalu and Vanuatu, continue to benefit from the European Commission's Generalized System of Preferences (GSP) programme and concessional free trade. However, although the Pacific Agreement on Closer Economic Relations (PACER) has been signed, progress in the negotiations of PACER Plus has been difficult with Fiji currently suspended from the Pacific Forum and therefore unable to participate in them.

The implication of the current crisis on exports can be better understood by analysing the trade figures for the Pacific island countries. These figures show that there is little intra-regional exports: only 15 per cent. This is likely to be further affected as demand for exports from the Pacific island countries decline generally due to falling incomes in developed economies. For remittance-dependent economies, such as Tuvalu, Kiribati, Samoa and Tonga, the decline in imports caused by lower remittances can have implications for the overall trade volumes.

The bulk of the exports and imports of the Pacific island countries are from five sources: Australia, New Zealand, United States, China, Singapore and Japan. Table 5.5 shows trade share in the GDP of the Pacific island countries. Because of the large trade share, for most Pacific island countries a decline in trade volumes will have a direct implication for the GDP. A decline in the volume of trade can also have serious consequences for the level of government revenues. While many of the Pacific island countries have been concerned about trade liberalization and loss of revenue as a result of this, even without liberalization revenue could decline due to lower import volumes.

Table 5.5. Trade and tariff revenues

	Trade share of GDP (2011)	Tariff to total revenues		Tariff revenues from ANZ
		Total	From ANZ	
Cook Islands	111.0	15.1	12.2	6 460 122
Fiji	101.5	17.4	4.9	35 173 983
Kiribati	87.3	23.0	14.3	7 917 941
Marshall Islands	83.3	21.3	2.2	718 881
Micronesia (Federated States of)	64.7	17.7	0.6	267 186
Niue	-	2.9	2.8	399 982
Palau	53.8	-	-	-
Papua New Guinea	111.9	3.6	1.4	17 735 890
Samoa	64.3	25.0	14.0	15 042
Solomon Islands	124.8	9.0	3.7	3 072 816
Tonga	45.8	33.3	17.2	9 845 417
Tuvalu	79.9	-	-	-
Vanuatu	48.6	27.1	17.2	12 398 316

Sources: ESCAP (2012); Nathan Associates (2007).
Notes: First three columns in per cent. Last column in US$.

Table 5.5 also shows the volume of tariff revenues of Pacific island countries as a per cent of total government revenues. While some countries such as Papua New Guinea, Fiji and Solomon Islands are increasingly moving away from dependency on tariff revenue to other indirect forms of taxes such as the value-added tax, others still see tariffs as an important source of revenue for the Government. However, even for the bigger countries which have moved towards value added tax (VAT), the scope of increasing revenue will not materialize in the short- to medium-term. Therefore, it is estimated that countries will suffer from losses of revenue as a result of further liberalization of their trade regimes. This has been one of the concerns of the Pacific island countries for some time and many are still contemplating the policy responses to further trade liberalization expected under the PACER Plus negotiation with Australia and New Zealand.

Agricultural policies

For many of the Pacific island countries, increasing trade by trying to increase manufactured exports not based on agriculture, fisheries and forestry, is unlikely to yield good results. For Fiji, the export of garments is on the decline, and this trend is likely to continue with the decline in demand for these exports in Australia and New Zealand. In addition, as Australia and

New Zealand further liberalize their trade, competition for these manufactured exports to these countries would increase, with bigger and cheaper exporters such as China and India likely to displace countries like Fiji.

The potential, therefore, rests with the agricultural sector. The Pacific island countries can build a comparative advantage in agriculture, especially in tropical fruits and vegetables, through proper marketing. This is a strategy that has worked well in tourism and bottled water. For bigger countries such as Fiji, Vanuatu, Solomon Islands and Papua New Guinea there is a great potential to raise the export of agricultural goods in the short- to medium-term. Some of these countries reverted to an aggressive agricultural production and promotion strategy as a direct response to the worsening economic crisis.

Fiji had to cope with two crises – the lingering impact of military coup of 2006 and the global financial crisis. One of the strategies it adopted was putting an emphasis on agriculture. This was in response to the increase in global commodity prices. Fiji has been able to increase its output of rice and other traditional root crops such as taro and cassava. Vanuatu also has the potential to raise its agricultural output. The Vanuatu Agricultural Development Bank started its operations in 2008 and it is likely to put emphasis on increasing agricultural productivity. This would be a prudent policy option given that Vanuatu is also experiencing growth in tourism and some of the increase in agricultural production could feed the tourism industry and help ease the import demand in that sector. While Papua New Guinea has used its mineral and oil income to raise its public spending as an overall response to the crisis, it could also concentrate on agriculture.

In addition, boosting agricultural production could also support the Pacific island countries food security, for which agricultural and fisheries production should address the needs for domestic consumption. It is therefore important that infrastructure spending on the agricultural sector should be increased. Such investment could pay off quickly and handsomely in the form of job creation and foreign exchange savings. In addition, attempts should be made to address often binding constraints to agriculture such as land tenure, high labour costs and marketing infrastructure.

Social protection policies

It was generally perceived that Pacific island countries took a less pro-active approach in addressing the social impact of the global financial crisis (Green, King, and Miller-Dawkins, 2010). Samoa reduced its spending on education and education, respectively, by 8 per cent and 14.9 per cent in the 2009-2010 budgets. The Minister of finance in Samoa attributed this to the impact of global crisis and said that "for small Pacific States like Samoa, we cannot avoid being affected given our highly open economy and weak fiscal resilience, which combined leave us with little protection to cushion the impact of the economic downturn". This sums up the situation for most Pacific island countries. As economies experience low growth rates, many of these countries will find it difficult to allocate resources for various social protection policies.

Current challenges

Pacific island countries survived the worst effects of the global financial crisis, but they have several critical challenges that they need to address. These include the fluctuating global commodity prices and rising fuel prices fuelling inflation in many of them. Pacific island countries continue to face critical macroeconomic challenges such as rising government budget deficits, declining government revenue and difficulties to sustain export growth to ensure sustainable levels of economic progress. In addition, they also face hurdles in achieving the Millennium Development Goals, meeting targets for social protection policies and dealing with regular natural disasters. For some, political and social instability is a major problem. During 2007-2008 inflation increased in many of the Pacific island countries as a result of rising external food and energy prices. Inflation was highest in Fiji, Papua New Guinea and Solomon Island. Another challenge for the Pacific island countries in the future will be to improve their current account and fiscal balances. Foreign reserves will also have to strengthened as many Pacific island countries do not have adequate levels and could be in difficulty if terms of trade deteriorates.

Policies for the future and lessons learned

In the medium-term, the Pacific island countries will need to pay a lot of attention to maintaining appropriate levels of fiscal balances and foreign reserves to ensure that they are able to respond in a robust manner in the event of a future economic crisis. The use of expansionary fiscal policy provides little room for comfort for most Pacific island countries except probably Papua New Guinea and Vanuatu which have adopted prudent fiscal policies over the past few years and had reserves to meet contingencies in the event of the crisis (Jayaraman, 2011). Furthermore, loose monetary policy will not work, as most Pacific island countries having independent currencies do not have well developed financial sectors and hence have a weak monetary policy transmission mechanism. Thus, the Pacific island countries' central banks responses to global economic downturn have been largely ineffective (Jayaraman, 2009).

In addition, the Pacific island countries will have to adopt a cautious monetary policy stance to avoid credit booms. The Pacific island countries are currently characterized by rising inflation and weak economic growth. In the case of Fiji, interest rates are low and banks are flush with liquidity, but there is also a low level of confidence in the economy which is reflected in a weak demand for credit from the private sector. Much of the inflation in the Pacific island countries is driven by global price rises, except in Papua New Guinea, where domestic demand may be driving inflation, in which case tightening of monetary policy may be required. The Pacific island countries need to ensure that that the exchange rate management supports export-led growth. However, their exchange rates are pegged to baskets of currencies of their major trading partners, providing an important nominal anchor for price stability.

Some of the key issues that would continue to confront the Pacific island countries are the impact of climate change, natural disasters, fluctuations in commodity, fuel and food prices, and political instability in some of them. In terms of fiscal policy, the Pacific island countries will have to reduce their budget deficits and direct their expenditure towards the goal of building productive capacities in their countries. Many of the Pacific island countries need to invest significant amounts in social and economic infrastructure. In particular, health and education infrastructure will need a lot of investment in countries like Solomon Islands, Vanuatu and Papua New Guinea.

Concluding remarks

Like many other small island States, the Pacific island countries weathered the adverse impact of the global financial crisis. This is mainly due to the fact that they have smaller and less developed financial systems, which offered them protection from exposure to global financial markets. The Pacific island countries have their financial systems linked to Australia and New Zealand through the major banks owned by Australia. The stability of the Australian banks provided another buffer. And many Pacific island countries have exchange controls and, with a few exceptions, limitations to foreign borrowing.

However, improving the resilience of the Pacific island countries to future economic and financial shocks will be an ongoing challenge because of the volatile nature of external shocks. Although the Pacific island countries largely escaped the direct impact of the financial crisis on their domestic financial system, many of them were affected indirectly, and they will continue to experience shocks in the future. Most of the indirect effects came through trade, capital flows and volatility of fuel and food prices. Among the Pacific island countries, remittances fell but not drastically, as the Australian and New Zealand economies – from which about 50 per cent of the remittances originate – remained strong. In addition, while tourist numbers declined slightly in 2008 and 2009, they bounced back in 2010 and are is likely to grow on a sustainable basis in the future. This is again largely due to the strong Australian and New Zealand economies, which account for 60 per cent of tourists to the Pacific island countries.

However, an excessive reliance on tourism and remittances by some Pacific island countries pose potential risks. The outlook for the Pacific island countries' major trading partners, Australia and New Zealand, does not look too bright. If their economies decline, it could affect the amount of remittances and tourist numbers to the the Pacific island countries. The other risk for the Pacific island countries is reduced policy space resulting from large current account and fiscal deficits. This reduced policy space would limit the ability of Governments to cushion the impact of any unexpected future global shock, as well as giving poor signals to investors.

The Pacific island countries will have to continue to improve their infrastructure, look for new sources of economic growth and reform their governance structures to improve accountability. While many would argue that the Pacific island countries have limited opportunities for industrial and export diversification, there are opportunities for the bigger island countries to do so. There is enough product space in the area of agriculture, fisheries and forestry for countries to diversify production and exports. In addition, more efforts will have to be made at the political level to accelerate the integration and connectivity of countries within the region. Meaningful regionalism and integration with Australia and New Zealand, as well as pooling resources to improve trade amongst Pacific island countries, could also help build resilience in the future.

Chapter 6

Pakistan

Rashid Amjad and Musleh ud Din

Starting in the second half of 2007, the Pakistani economy began to show distinct signs of slowing down and started experiencing serious pressures on its fiscal and balance of payments situation. Growth in the economy took a sharp downward turn. By early 2012 the economy still had not recovered and remained mired in deep stagflation – characterized by low growth and high inflation. Economic policies that were adopted, including the ones under the International Monetary Fund (IMF) programme since November 2008, appear to have been of little help in reversing this situation.

Why has the Pakistani economy not been able to break out of stagflation? What fundamental factors have been responsible for this situation? Why has Pakistan been the laggard among the countries in South Asia and the larger Asia-Pacific region, which were able to relatively recover faster from the global financial crisis? What measures are needed to move out of this maelstrom? This chapter attempts to answer these questions. Its fundamental message is that the Pakistani economy faces serious structural imbalances which make it very vulnerable to external shocks and are primarily responsible for its stop-go cycles of economic growth (Amjad and others, 2011; McCartney, 2011). The economic problems the country faces, as we show in this chapter, are basically structural in nature and not just due to cyclical movements in the global economy.

Pakistan's recent economic performance

Understanding the dynamics of the Pakistani economy has never been easy. Time and again the country's economic performance has proven its critics wrong. With relatively low levels of investments and savings, its growth performance has been reasonably impressive though not spectacular. During 1970-2010, its average rate of growth was a healthy 5 per cent, though its growth path has always moved in stop-go cycles.

During 2002 to 2007, Pakistan had been witnessing a phase of impressive growth with moderate inflation (table 6.1). There were no real signs that the economy was about to falter, though there was some unease expressed about the economy's susceptibility to external shocks (Amjad, 2007). Indeed, official circles were upbeat about the economic performance with claims that Pakistan had finally freed itself from its past heavy reliance on external borrowings and was on a path of achieving self-reliant sustainable growth. It was therefore somewhat of a rude surprise when the Pakistan economy suddenly plunged into a deep economic crisis in 2007-2008.

Table 6.1. Economic performance of Pakistan

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
GDP growth	2.0	3.1	4.7	7.5	9.0	5.8	6.8	3.7	1.7	3.8	2.4
Fiscal deficit	4.3	4.3	3.7	-2.3	-3.3	-4.3	-4.4	-7.6	-5.3	-6.3	-4.7
Current account deficit	1.8	0.4	0.5	1.2	-4.0	-6.5	-6.6	-9.0	-7.8	-6.5	0.4
Inflation	3.1	3.3	2.9	4.6	9.3	7.9	7.8	12.0	20.8	11.5	14.1

Source: Pakistan, Ministry of Finance, Pakistan Economic Surveys (various issues) and State Bank of Pakistan, The State of Pakistan's Economy - Quarterly Reports (various issues).
Note: GDP growth and inflation expressed in per cent. Fiscal and current account deficits expressed as per cent of the GDP

What is perhaps not well-known is that the Pakistani economy faltered not with the onset of the global financial crisis in the second half of 2008 but before that, when the economy was hit by an unprecedented increase in global oil and food prices in 2007-2008. This shock forced policymakers to adopt contractionary policies to stabilize the economy. These measures were reflected in the budget adopted in June 2008 for 2008-2009. Though not officially acknowledged, the agreement appeared to have been reached with the IMF for support, even though the IMF programme was signed later that year in November 2008.

The basic question then is not just about the impact of the global recession on the economy of Pakistan. Equally, and perhaps more important, is the vulnerability of the economy to the oil and commodity price shock that preceded the global recession. It is then quite pertinent to ask whether the Pakistani economy would have actually fared not too differently from its other South Asian neighbours in terms of deflecting (and subsequently recovering faster from) the global financial crisis in the absence of the oil and commodity price shock. To try and answer this question we start by examining the Pakistani economic performance post-2000 in terms of economic growth and the movement of key macroeconomic indicators (table 6.1).

The turnaround in the Pakistani economy post-2003 was preceded by a sharp compression as the new Musharraf government entered into an IMF agreement in 1999 in the face of a possible debt default and very high fiscal deficits. The Pakistani economy in the 1990s had not performed well as successive democratic Governments were unable to push through the needed reforms and successfully complete any of the IMF support programmes they had entered into. The nuclear explosion in May 1998 had also led to a sharp decline in donor assistance. This situation was worsened by the impact of the Asian financial crisis.

The Musharraf government used the period under the IMF programme to bring in a number of important reforms covering the financial sector, monetary management, and taxation reforms. The economy rebounded as business confidence increased with gross domestic product (GDP) growth climbing to 9 per cent in 2004-05 from just 2 per cent in 2000-2001.Total investment at around 20 per cent of GDP in 2004-05 also became more respectable, though domestic savings continued to remain low (around 8-10 per cent of GDP) with the gap being made up by foreign savings.

The growth momentum, however could not be sustained as the very forces that had helped propel the economy post-2001 were also in many ways responsible for bringing to an end the boom which peaked in 2004-05. Cheap money supply led to a monetary overhang (Janjua, 2005) that fuelled inflation and the rise in oil prices stoked inflation further. In the face of rising inflation and increasing oil imports (cheap credit had led to large increases in sales of energy–intensive products like automobiles, motorcycles, air-conditioners etc.) the Government began to put brakes by raising interest rates and reducing the money supply.

The unprecedented increase in global oil and food prices that followed in 2007 put the Musharraf government in a quandary as macroeconomic imbalances started to build up and economic activity took a sharp hit in a context of rising political instability. By March 2008, when the new Government took office, the economy had slid into a full blown crisis with ballooning fiscal and current account deficits, sharply rising inflation, and dwindling foreign exchange reserves, which were fast depleting by almost US$ 1 billion a month with total reserves at around US$ 16 billion. With the economic situation fast deteriorating, the new Government was left with no option but to seek the support of the IMF and signed a Stand-By-Arrangement in November 2008. The key elements of the stabilization programme were a reduction in fiscal deficit, which included cuts in public spending, a tight monetary policy with a 200 basis point increase in interest rates to 15 per cent, and a flexible exchange rate regime which resulted in a 25 per cent depreciation of the rupee vis-à-vis the United States dollar. But in spite of these stabilization efforts, Pakistan was not able to lift itself out of stagflation due to a combination of factors, including policy slippages, the most notable being the lack of coordination between fiscal and monetary policies, the inability to introduce key structural reforms including the non-implementation of the reformed General Sales Tax (GST), security problems, and crippling energy shortages.

Impact of the global recession and policy responses

The global financial crisis came at a time when the economy was already under stress due to the terms of trade shock resulting from the global food and fuel price hikes. The global financial crisis amplified Pakistan's economic difficulties with a marked slowdown in economic growth coupled with a sharp rise in the current account and fiscal deficits, a spike in inflation, the depletion of foreign exchange reserves, and pressure on the domestic currency. As a result, economic growth witnessed a sharp downturn from an average of 7.3 per cent during 2004-07 to 3.7 per cent in 2008, further slowing down to 1.7 per cent in 2009 as private investment took a hit on heightened security concerns.

With the external accounts already under strain, Pakistan experienced a deterioration in the current account balance, which widened to 9 per cent of GDP in 2008 and put pressure on the domestic currency.

This was accompanied by a sharp rise in the fiscal deficit from 4.4 per cent of GDP in 2007 to 7.6 per cent of GDP in 2008, as public revenues dwindled with a slowdown in economic growth. In an effort to curtail the fiscal deficit and being unable to cut sticky current expenditures, the brunt fell on the public sector development programme, which fell from nearly 5 per cent of GDP to less than 2 per cent – with adverse consequences for long term competitiveness and productivity. High fiscal deficits financed through borrowings from the State Bank, coupled with a tight monetary policy, led to crowding out of private investment in a high interest rate environment. Due mainly to a lack of coordination between fiscal and monetary policies, the tight monetary policy failed to curb inflationary pressures in the economy, and the inflation touched an all-time high of 20 per cent in September 2008. Though it fell subsequently to nearly 12 per cent, it remained until the second half of 2012.

Pakistan's policy response to the crisis was largely dictated by the IMF programme, under which Pakistan was committed to adopt tight monetary and fiscal policies to restore macroeconomic stability. In response to sharply rising inflation, the monetary policy was considerably tightened, which hurt private investment though its impact on inflation remained muted as the latter was driven as much by supply bottlenecks as by demand pressures due to heavy government borrowing. The IMF agreement also required a sharp reduction in fiscal deficits from 7.4 per cent of GDP in 2008-2009 to 4.2 per cent in 2009-2010 and further to 3.3 per cent in 2010-2011. The tight fiscal and monetary policies dictated by the IMF left little space for macroeconomic adjustments needed to revive the process of economic growth.

Key findings

Based on the foregoing discussion, three key findings emerge. First, the Pakistani economy was vulnerable to external economic shocks due to its initial conditions, including macroeconomic and structural imbalances that acted as shock amplifiers. Second, despite contractionary policies prescribed under the IMF programme, Pakistan failed to address macroeconomic imbalances due mainly to poor macroeconomic management. Third, the impact of the financial crisis was considerably mitigated due mainly to some shock absorbers in the economy, including a sound financial system, reliance on consumption rather than exports, and a healthy inflow of remittances.

Pakistan's vulnerability to external economic shocks stemmed from a high concentration of exports in cotton and textiles, heavy reliance on external financing, high current account deficits coupled with a de facto open capital account, low foreign exchange reserves and a weakening domestic currency. All these factors combined to make Pakistan especially prone to cuts in external financing and a slack in global demand for cotton and textiles products.

Though Pakistan's macroeconomic policy response was constrained by the IMF programme, poor economic management was largely responsible for the failure to correct macroeconomic imbalances, which continued to pose a risk to the revival of economic growth. First, overdependence on monetary policy to contain the inflationary pressures was a mistake. While a tight monetary policy stance failed to curb inflation, it hurt the growth process by stifling private investment on the back of high interest rates. Inflation remained stubborn as it was driven by high fiscal deficits and supply bottlenecks, including unprecedented power shortages that crippled economic activity. Second, the fiscal policy response was insufficient, especially revenue generation, and mainly resulted in cuts in development expenditure that were critical to sustain economic growth.

Given Pakistan's adverse initial conditions, the impact of the crisis would have been much greater had it not been for some shock absorbers that helped contain the fallout from the crisis. First, a sound financial system that was largely insulated from global financial upheavals helped limit the transmission of financial shocks to the domestic economy. Second, Pakistan's reliance on domestic consumption rather than exports provided a cushion to the domestic economy against a slump in demand in the west. Third, Pakistan continued to receive healthy inflow of remittances that provided a critical support to its balance of payments.

The above discussion also helps to explain why Pakistan was unable to deflect the crisis, as was done by its South Asian neighbours – most notably India and Bangladesh. The initial conditions in both India and Bangladesh were much healthier than in Pakistan. The macroeconomic situation in both the countries was characterized by robust growth, low fiscal deficits, low inflation, and comfortable current account and reserves positions. The strong macroeconomic fundamentals not only enabled these economies to withstand the external shocks but also provided them the necessary policy space to counter the potential adverse impacts of the crisis.

Concluding remarks

The most pressing challenge facing Pakistan today is to break out of the current prolonged spell of stagflation. At the same time, there is a need to reduce vulnerability to emerging pressures on the balance of payments, especially when the global economic outlook continues to be uncertain with the United States still in a phase of slow recovery and the eurozone taking a hit on account of the debt crisis of some of its members.

Pakistan has endured a series of supply shocks resulting from consecutive floods, unprecedented energy shortages, and a difficult domestic security situation. Consequently, economic growth remains below potential and is unlikely to pick up unless reforms are undertaken to remove supply side bottlenecks, especially the alleviation of energy shortages. Recent research (Malik, 2012) has shown that the roots of the energy crisis lie in poor governance, indicating that the problem can be mitigated to a significant extent by bringing about improved economic management in the energy sector. Pakistan needs to grow at 7-8 per cent per annum to provide employment opportunities to its growing labour force, and this is possible only if structural reforms are undertaken to put the economy on a higher growth trajectory on a sustained basis (Pakistan, Planning commission, 2008).

Tackling inflation is another important challenge. Although inflation has moderated in the recent period, inflationary pressures persist, especially at a time when domestic oil prices have increased and domestic currency has weakened considerably. On the external front, with weakening exports, Pakistan's balance of payments have come under pressures which are likely to intensify as loan repayments to the IMF become due. Worse still, the global economic outlook does not present a very optimistic scenario as the United States is still struggling to recover while the eurozone is mired in a fast spreading debt crisis that threatens the very survival of the euro itself. In this scenario, deft macroeconomic management would be required to protect the economy from adverse external shocks.

To move the Pakistan economy out of the maelstrom requires a three-pronged strategy focussed on macroeconomic management, structural reforms, and drivers of economic growth.

First, prudent macroeconomic management is essential to put the economy on the path of sustainable growth. There is an urgent need for a better coordination between fiscal and monetary policies to restore macroeconomic balance and secure price stability. Though government borrowing from the central bank has been curtailed in recent months, the Government has resorted to borrowing from the commercial banks that are accompanied by massive liquidity injections by the central bank. This practice tends to crowd out private investment while making it difficult for the monetary policy to control the rate of inflation. Also, there is a need to carefully calibrate monetary policy to balance the objectives of price stability and economic growth.

Second, Pakistan has been unable to implement key structural reforms due mainly to a lack of political consensus. There is, therefore, an urgent need to develop a consensus on reforms paving the way for the implementation of much needed reforms in all segments of the economy especially resource mobilization, restructuring of the State-owned enterprises, and the energy sector. In particular, the inability of the Government to raise sufficient revenues has been the root cause of Pakistan's economic troubles and there is thus an urgent need for reforms in the taxation system including the introduction of Reformed GST, removal of poorly targeted subsidies, and restructuring of the State-owned enterprises to curtail their huge losses.

Third, there is a need to undertake critical public investments particularly in infrastructure, energy, and human resource development which are important drivers of economic growth. The fact that the public sector development programme has been curtailed in recent years in efforts to restore fiscal discipline does not augur well for the country's long term competitiveness. There is a need to channel public spending towards more productive expenditures to foster productivity growth on a sustained basis.

Chapter 7

Republic of Korea

Kyungsoo Kim

Financial globalization makes peripheral countries, especially small open economies with deep international financial linkages, vulnerable to credit shocks originating from the core countries. Regardless of their economic fundamentals, many emerging market countries (EMCs) were severely hit by the global financial crisis. In fact, one may even say that financial globalization has led to collateral damage, instead of the collateral benefits promised earlier (Kose and others, 2006). The Republic of Korea is a good example. This vulnerability has two specifics. One is the so-called capital inflows problem – that is the vulnerability of the economy and its financial system to massive capital inflows which could be suddenly stop. The other is the potential for high volatility in the foreign exchange (FX) market.

The capital inflows problem may be characterized by procyclicality, aperiodicity, and the risk of currency and maturity mismatches. Since the Asian financial crisis, countries in the region assigned high priority to building their foreign exchange reserves. However, simply relying on self-protection is either too costly or even impossible. During the global financial crisis, as Aizenman and Sun (2009) accurately described, many central banks instead of releasing foreign reserves to stabilize their FX markets, were forced to balance the 'fear of floating' and the fear of losing reserves.

Procyclicality emerges through various channels, such as asset price inflation, real exchange rate appreciation and lending booms. This chapter emphasizes the role of central banks in injecting liquidity into the financial system. When surges in capital inflows are intermediated into local-currency-denominated liabilities, an active maturity transformation is expected: borrowing short and lending long. In order to maintain current monetary policy stances, central banks tend to accommodate credit booms. The Republic of Korea's financial data strongly supports the financial procyclicality hypothesis (Kim, Kim and Park, 2010), which is also confirmed by international panel data (Kim, Kim and Park, 2011). The implementation of interest-rate-oriented monetary policy frameworks fosters financial procyclicality.

Aperiodicity of massive capital inflows makes it hard for policymakers to deal with the capital inflows problem (Kaminsky, Reinhart and Végh, 2004). While the capital inflows problem can be easily identified ex-post; it is difficult to predict ex-ante. Accordingly, prudential measures, including a financial safety net, should aim at alleviating the costs of a crisis rather than preventing the crisis. However, prudential measures are much easier said than done because they may be easily evaded or yield unintended consequences. In this context, identifying systemically important financial institutions (SIFIs) is what matters the most. In addition, the difficulties of participants in an FSN scheme to differentiate bad luck from bad policy in countries requesting assistance may make them reluctant to contribute much, which could make the size of the scheme smaller than optimal. Nevertheless, in the context of massive capital inflows that are aperiodic, procyclical, and accompanied by the risk of currency and maturity mismatches, alternative options to preserve financial stability may come only at the cost of financial repression.

Structural underpinnings

The Korean economy used to recover fast from past crises, such as the first and second oil shock of the 1970s and 1980s, the external debt crisis of the 1980s and the Asian financial crisis in the 1990s. The reason is that shocks to the Republic of Korea's economy sharply depreciated the won (KRW), and the exchange rate deprecation combined with aggregate demand contraction led to huge trade surpluses. After the recovery of the export industry, consumption recovered as well, after a certain time lag.

However this traditional cycle became less apparent in recent times because of the country's deindustrialization, characterized by the loss of over a million manufacturing jobs over the last two decades. Relative to the advanced countries, deindustrialization in the Republic of Korea has proceeded in a short period of time. As a result, the services industry never had an opportunity to restructure and ended up with overemployment and inefficiency. Although manufacturing represents a high share of the GDP, 30.6 per cent compared to 58.2 per cent for services in 2010, in the same year the services industry employed four times more workers than manufacturing. According to a study by the Bank of Korea, it took 30 years, on average, for developed countries to decrease the share of employment in manufacturing by 10 per cent, but for the Republic of Korea it took only 14 years, which implies that the deindustrialization of employment has been over twice as fast (Bank of Korea, 2007).

Because of the country's deindustrialization, the global financial crisis has left deep scars on the Republic of Korea's economy. The reason is that the services sector remained stagnant, even when manufacturing exports recovered. The consequence has been stagnant employment growth and a limited number of decent jobs available, which have led to a bigger gap in income and increasing polarization. A lower growth rate of GNI led to declining domestic demand, which had a detrimental effect on the services sector. When the crisis occurred, the exchange rate skyrocketed and caused a deterioration of the purchasing power of the population, resulting in drop of the real GNI growth. The impact of such drop was concentrated on consumption expenditure, the most important component of domestic demand, in which the service sector heavily relies on.

The Republic of Korea's economy after the global financial crisis

In addition to the problem of deindustrialization mentioned above, an equally important factor leading to a weaker recovery from the global financial crisis is increasing levels of household debt. Financial liberalization after the Asian financial crisis made consumer finance very popular, and household debt has grown continuously since 2000. The ratio of household debt-to-disposable income, an indicator of household's capacity to service debt, climbed to 155 per cent in 2010 from 130 per cent in 2005, and is the highest among the OECD countries.

Since 2002, household debt has depressed consumption. In the Republic of Korea, mortgage loans account for the most important household debt. The share of mortgage loans in household loans by banks had also sharply increased from 60.9 per cent in 2007 to 65.9 per cent in 2010 (Igan and Kang, 2011), and of the 67.8 trillion won increase in household loans supplied by the banking sector, 93 per cent consisted of mortgage loans. Considering that the household debt usually causes real estate prices to rise, the Republic of Korea's Government reacted to control household debt. In September 2002, the Government introduced loan-to-value ratio regulation which limits the mortgage loans to a certain proportion of the property value. In August 2005, it introduced a debt-to-income ratio regulation that interlocks mortgage loan into the borrower's income.

However, there is no clear-cut evidence that these regulations contributed to control the growth of household debt. The fundamental reason for the increase in household debt may be found in the prolonged period during which interest rates remained low. From September 2008, the Bank of Korea's policy rate lowered to 2 per cent from 5.25 per cent and stayed at that level for 17 months, which was unprecedented. From November 2009, based on the policy rate, the real interest rate remained negative. Too long and too low interest rates probably encouraged the relentless increase in household debt. This policy may also have caused inflation as a side effect. From the fourth quarter in 2010, inflation which reflected higher import prices and food prices spread to core inflation. While rising inflation has a positive effect on employment, it leads to depressed real wages.

Household debt and inflation limit options for monetary policy. In order to reduce inflation, the policy rate should be increased, but a policy rate hike would aggravate the debt burden. While it is important to reduce inflation, it is equally important for the real interest rate not to overshoot. The importance of the coordination of monetary and fiscal policies cannot be overemphasized because government spending is a significant factor that can fill in for a decreasing share of consumption expenditure. The Government's role in mitigating social disparities after the Asian financial crisis was important, and government expenditures continue to increase after the global financial crisis.

The capital inflows problem

Procyclicality is the most notable feature of the capital inflows problem. Regardless of the level of income and the size of nations, net capital flows are strongly correlated with the business cycle. Of course, not all capital flows are procyclical. While portfolio investment and banking sector's external borrowing tend to be highly procyclical, foreign direct investment

(FDI) is less so (Contessi, DePace and Francis, 2008). Small open economies with deep international financial linkages, such as the Republic of Korea, are more likely to suffer from severe procyclicality. According to Schindler's (2009) de jure financial integration index of 91 countries from 1995 to 2005, the Republic of Korea ranked 44th. In Asia, the Republic of Korea is the third most widely open country after Hong Kong, China, and Japan, and its ranking exceeds that of the United States (47th).

Table 7.1. Flow of foreign exchange funds

	Uses of FOREX liquidity				Sources of FOREX liquidity		
	2007	2008	2009		2007	2008	2009
External assets	27.8	-69.7	111.5	External liabilities	108.2	-16.1	42.6
General government	3.0	-10.6	0.8	General government	21.5	-10.6	23.1
Monetary authority	15.1	-56.4	95.8	Monetary authority	12.3	9.5	4.3
Banks	13.2	6.3	0.9	Banks	56.3	-23.5	4.3
Others	-3.5	-9.0	14.0	Others	18.2	8.5	11.1
Overseas direct investment	19.7	20.3	36.4	Foreign direct investment	1.8	3.3	2
Overseas equity investment	52.6	-7.1	2.1	Foreign equity investment	-28.9	-33.5	48.1
Financial derivatives	-5.4	14.8	3.1	Others	0.2	-0.2	-0.1
Other capital account	2.4	-0.1	-0.3	Current account	21.8	3.2	61
Other investment	8.2	-3.3	-5.3				
Errors and omissions	-2.1	2.0	1.0				
Total	**103.1**	**-43.2**	**153.6**	**Total**	**103.1**	**-43.2**	**153.6**

Source: Author's calculation using data from Bank of Korea, *Current Economic Issues,* and Bank of Korea, *Economic Statistics System*.
Note: All figures are in billions of US$.

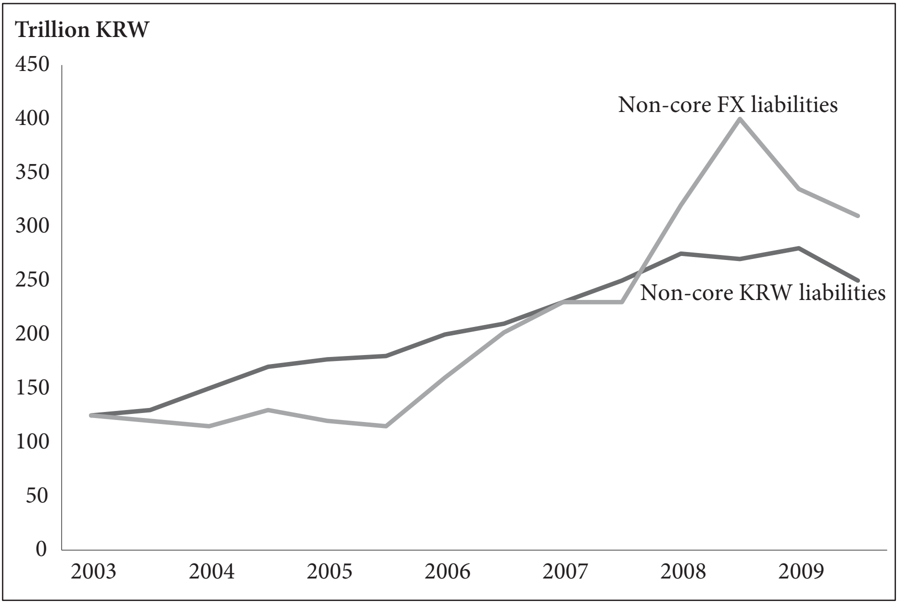
The Republic of Korea's foreign currency flow of funds in 2007 and 2008 are reported in table 7.1. In 2007, foreign liquidity worth US$ 103 billion flew in. In that year, the Republic of Korea's economy bore fresh liabilities worth US$ 108 billion, or 10.3 per cent of the GDP, comprising of US$ 33.8 billion in the form of portfolio investment in securities issued by the Government and the monetary authority, US$ 56.3 billion of external borrowing by the banking sector and US$ 18.2 billion of external borrowing by the non-banking sector. That year, external assets increased by less than US$ 28 billion, US$ 15 billion of which were absorbed by the monetary authority as foreign reserves, and overseas equity investment by domestic residents set a record of US$ 52.6 billion.

In 2008, after Lehman Brothers collapsed, the Republic of Korea's economy fell into a rapid downturn cycle generated by a sudden stop and reversal of the massive capital inflows of the previous year. Between 2008 Q4 and 2009 Q2, the year-to-year GDP growth rate was negative, and it reached and annualized value of almost -13 per cent. A massive deleverage of over US$ 43 billion or about 4.6 per cent of the GDP concentrated on the banking sector, which was not able to roll over its debt and had to pay back US$ 23.5 billion. In that context, the efforts of the monetary authority to stabilize the foreign exchange markets by selling more than US$ 56 billion in foreign exchange appeared insufficient, but a central bank's swap arrangement with the United States Federal Reserve was effective in stopping the attack on the won (Baba and Shim, 2011).

Examining table 7.1, some important implications can be obtained. First, the capital inflows problem may emerge regardless of the exchange rate system. It can be argued that FX market intervention, even if not in a large scale, can generate greater capital inflows by providing an implicit guarantee on the stability of the exchange rate. But as noted by Valgreen (2007) for the case of Iceland, a country that ran pure floating rates and was exposed to huge foreign capital inflows, flexible exchange rates do not guarantee financial stability either. Second, because of the mismatch between external assets and liabilities that takes place when capital inflows are recycled into the domestic economy, the size of the gross capital inflows is important – larger capital inflows, larger mismatches.

Capital inflows are typically intermediated into local-currency-denominated liabilities. Figure 7.1 shows non-core, or non-deposit, FX and won liabilities of the Korean banking sector. With the deleveraging process started immediately after the collapse of Lehman Brothers, non-core FX liabilities shrank drastically. In addition, the deleveraging had a spillover effect on the KRW credit market. This phenomenon, often referred to as a double drain, was unprecedented, and non-core KRW liabilities dried up even though the Bank of Korea aggressively reduced policy interest rates. Financial linkages between domestic and international banks, as discussed below, are behind this phenomenon.

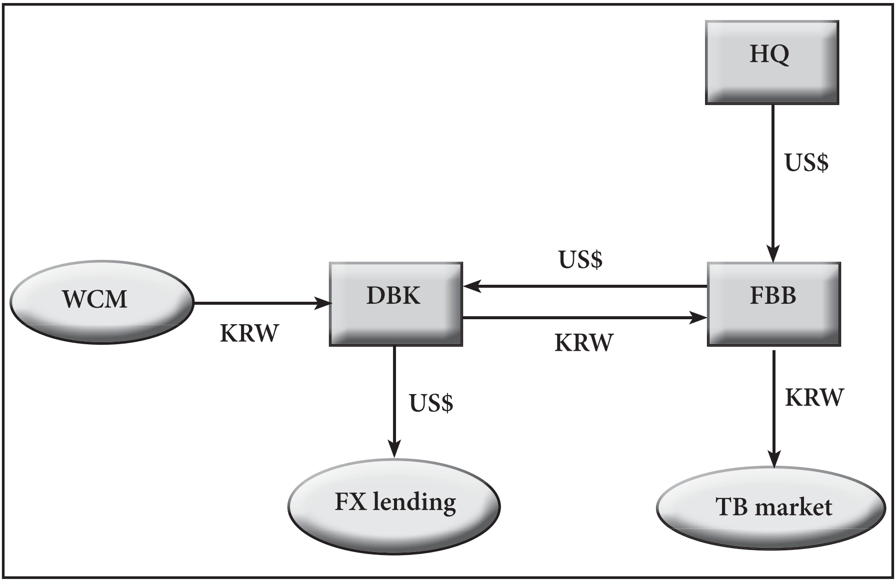
Figure 7.1. Non-core liabilities of the banking sector in the Republic of Korea



Source: Author's calculation using data from Bank of Korea, *Current Economic Issues* and Bank of Korea, *Economic Statistics System*.

Figure 7.2 illustrates the way in which foreign capital inflows are intermediated through foreign exchange swap (FES) arrangements between a domestic bank (DBK) in the Republic of Korea and a foreign bank branch (FBB), the most important channel for injecting FX liquidity into the Korean financial system. Borrowing from its head office, FBB supplies dollars to DBK through a FES. Then DBK engages in FX lending. In return, DBK funding from the wholesale credit market (WCM) supplies KRW to FBB and FBB invests in Treasury Bonds. Therefore, the inflow of foreign capital causes an increase in domestic credit. Through FES, both parties effectively borrow short term assets and invest in longer term assets; thus a maturity transformation takes place.

Figure 7.2. Foreign exchange swap arrangements and maturity transformation



Source: Kim, Kim and Park (2011).

An important consequence of the massive maturity transformation that took place during the boom period was that the yield curve – which shows yields or interest rates across different contract lengths (2 month, 2 year, 20 year, etc.) for a similar debt contract – flattened. The reason is that with DBKs borrowing short term and FBBs investing in longer term assets there was an upward pressure on short-term interest rates and downward pressure on long-term interest rates. In this context, the central bank typically acts to reduce the gap between the short term rates and the policy rate through open market operations, in order to maintain its current monetary policy stance. Through open market operations, liquidity is injected into the system. Therefore, monetary policy accommodates the credit shock – credit causes liquidity.

Under what circumstances does the central bank maintain its policy stance and accommodates a credit shock? It happens when financial cycles do not match with business cycles and the central bank is given the mandate to react to the business cycle, for instance by pursuing price stability, rather than to the financial cycle. Inflation targeting monetary policy is a good example. Using financial data from the Republic of Korea, Kim, Kim and Park (2010) showed that monetary policy accelerated the procyclicality of capital inflows. This is indeed the consequence of any form of interest-rate-oriented monetary policy framework. Kim, Kim and Park (2011), based on panel data collected from 14 countries specifically adopting floating exchange rate regimes and inflation targeting monetary policy under the policy rate framework, verified this fact.

Risk of currency and maturity mismatches

In EMCs, currency mismatches are often accompanied by maturity mismatches, which could lead to a twin crisis (Kaminsky and Reinhart, 1999). Data for the Republic of Korea shows that there is a positive correlation between the growth in the external debt and the degree of maturity mismatches. But knowing this risk, why would the external debt increase so fast? And why it should be mostly short-term debt?

There are several logical explanations for heavy reliance on short term indebtedness. One is lenders' concerns. Foreign lenders prefer short-term contracts, either to monitor debtors' actions (Jeanne, 2009) or to charge a higher risk premium on long-term bonds than on short-term bonds, making it cheaper for emerging economies to borrow short term (Broner, Lorenzoni and Schmukler, 2010). From the borrower's point of view, short-term debt could provide flexibility to switch to other lenders if borrowing conditions improve in the future (Mama, 2007). Or the reason could be related to moral hazard incurred by lenders and borrowers alike.

Dealing with the capital inflows problem

In the aftermath of the global financial crisis, various policy options have been considered to mitigate the impacts of future global financial shocks, including financial safety nets and macroprudential policy. Capital controls have also been reconsidered as an option for coping with surges in capital inflows, though many observers suggested that they should be the last resort in a pecking order of policy arrangements (Ostry and others, 2010).

There have been many debates on the excessiveness of foreign exchange reserves (FR) accumulated by EMCs after the Asian financial crisis. In retrospect there is no doubt that large accumulations of FR provided a first line of self-defense against the deleveraging process initiated after the global financial crisis. The size of the FR matters, however, and the benefits do not come without costs. For example, Rodrik (2006) argued that EMCs over-invested in the costly strategy of reserve accumulation and under-invested in capital account management policies to reduce their short-term foreign liabilities. His criticism may be best addressed by what the Republic of Korea experienced on the onset of the global financial crisis. Judging from its foreign debt and asset structure as a whole, the economy of the Republic of Korea should not have suffered a foreign liquidity shortage. However, because of the risks of currency and maturity mismatch concentrated in its banking sector, the FX liquidity of the Republic of Korea was highly vulnerable at the onset of the global financial crisis, even when the country had the world's sixth largest volume of FR.

The link between hoarding FR and short term external borrowing is related to the Guidotti-Greenspan rule, according to which short-term external borrowings should be absorbed as FR. But such a rule may encourage banks to rely on short-term borrowing excessively. Indeed, empirical evidence suggests that FR and short term debt of the banking sector cause each other. Based on data from 46 EMCs over the period 2000-2007, Kim (2011) showed that after controlling for other macro variables, FR accumulation does not mitigate the risk of maturity mismatches, and it may accentuate the pro-cyclicality of capital inflows. In addition, the Guidotti-Greenspan rule can cause moral hazard because the risks associated with borrowing or lending are socialized while the returns are privatized. In order for FR to be a useful buffer, prudential regulations should be imposed.

Macroprudential policy

Although banks in EMCs engage in hedging activities, their economies as a whole are unable to hedge the risk of currency and maturity mismatches. Therefore, an insurer of last resort, the central bank, should serve as a stopgap to prevent banks from being illiquid in times of crisis. In that case, the banking sector, the insured, should pay an appropriate premium to the central bank, the insurer. Without the payment of such a premium, social and private optimality of external borrowing would not be the same. Alternatively, one could argue that private external borrowing creates a negative externality on domestic asset prices, or more broadly real exchange rates (Jeanne and Korinek, 2010; Aizenman, 2010). Instead of a risk premium, a Pigouvian tax that targets borrowing activities that cause negative spillover effects could mitigate the capital inflows problem.

After the global financial crisis the Government of the Republic of Korea strengthened FX-related prudential measures. These measures included mandatory minimum holdings of liquid FX assets for banks and new standards for FX derivatives' trading risk management. FX forward transactions of corporations were limited to a maximum of 125 per cent and later 100 per cent vis-à-vis physical trade to prevent excessive FX hedging. Government also introduced new ceilings on FX derivatives positions linked to bank's capital and the use of FX bank loans has been restricted to overseas operations. Most recently, the Government of the Republic of Korea imposed the so called 'Macro-prudential Stability Levy on non-deposit FX liabilities of the banking sector'. Although it is too early to assess the impact of such measures, at the time of writing the data suggests that they are effective (Bank of Korea, 2013).

To effectively implement these macroprudential policies, it is necessary to identify systemically important financial institutions (SIFIs) to which such policies would be applied. In the case of the Republic of Korea, FBBs are important agents supplying foreign liquidity and, therefore, they should be considered SIFIs. The prudential measures imposed on FBBs will definitely discourage their short term external borrowings. However, their head offices may circumvent these regulations by engaging directly in transactions with DBKs, thus exploit the regulatory arbitrage created by such a levy. To avoid this problem, the head offices should also be identified as SIFIs. Another issue related to prudential measures is capital controls. Prudential measures are intended to strengthen the resilience of the financial sector to prevent excessive risk-taking and to limit systemic risks, while capital controls aim at reducing cross-border movements of capital. The difference is that FX-related prudential measures discriminate according to the currency while capital control measures discriminate based on the residency of the parties to the transaction.

During 2009-2010, the economy of the Republic of Korea ended up with an enormous current account surplus of US$ 61 billion, which can be seen as typical of the macroeconomic adjustment made in the wake of the global financial crisis. Furthermore, unlike the period preceding the crisis, the accumulation of external assets was much greater than external debts. Thank to country's macroprudential measures, the banking sector's external debts diminished significantly. In the three years between the third quarter of 2008 and the third quarter of 2011, the short term external debt borne by the banking sector shrank by a third, while foreign investors' portfolio investment expanded. If this shift is the result of market reactions to the prudential measures on the banking sector, we can say that these measures proved to be effective.

Collective FSN

The international financial market is less integrated than the domestic financial market, and there is no supranational legal authority overlooking cross border contracts. Therefore, the binding constraint of international debt repayment is the willingness rather than the ability to pay, which makes international debt contract incomplete (Eaton and Gersovitz, 1981). A more complete international debt contract would be possible to arrange if bad luck was distinguishable from bad policy. In such a case, debt restructuring contingent on bad luck with good policy could make both creditors and debtors better off. According to Jeanne (2009), the verifiability of policy quality could be enhanced by appropriate collective action at the international level. In that respect, the pre-arranged lending programme introduced by the IMF in March 2009 called "flexible credit line" (FCL) aims at improving the verifiability of policy quality of countries with strong track records but faced with balance of payments pressures and could protect them from contagion in the event of a global financial crisis. As for regional financial arrangement (RFA), the Chiang Mai Initiative Multilateralization (CMIM) established in 2010 is a self-managed reserve pooling arrangement of worth US$ 240 billion which includes a surveillance secretariat, the ASEAN+3 Macroeconomic Research Office (AMRO).

Notwithstanding their usefulness, the size of collective FSN such as IMF funds and RFAs has remained constant as a share of GDP but declined drastically compared to the size of the external shocks (IMF, 2011b). As a result, the accumulation of FR is still the most important insurance against global liquidity shortages, and reform on global FSN is very much needed. However, such reform is difficult because EMCs and mature market countries' (MMCs) have different interests. The latter want a well-functioning FSN in order to reduce the demand for foreign reserves as self-protection and, therefore, contribute to global rebalancing. However, a well-functioning global FSN needs to limit moral hazard, which would require imposing verifiable guidelines for sound policy for borrowers, which is unpopular among EMCs. As a result, the accumulation of foreign reserves may continue to be the preferred option for EMCs, leaving exchange rate adjustments as the second best option for MMCs.

Concluding remarks

Accumulating foreign reserves, macroprudential measures, and collective financial safety nets are key options for managing large capital inflows. The accumulation of foreign reserves is an important way of self-protecting against deleveraging. But it causes significant costs and without accompanying prudential measures, it may risk provoking even larger capital inflows. Collective financial safety nets can be useful substitutes for foreign reserves, even though they may be less than perfect.

Properly designed and implemented prudential policies should alleviate the risk of short term external borrowing. To that extent, the economy can be less dependent upon an insurer of last resort - the role of the monetary authority in providing FX liquidity in times of crisis. However, such prudential measures should be well designed, correctly implemented and minimal in distortion. Otherwise, they could prevent domestic financial market system from functioning properly and bring about only short-term relief at the cost of the longer-term benefits of an efficient financial system. In addition, in order for macroprudential regulations to work well, regulatory arbitrage among countries should be minimized. For that purpose, it is essential that national regulatory frameworks are consistent across borders.

Inconvertibility of the EMC currency lies at the root of the capital inflows problem. It makes it difficult to hedge exchange risk at the national level, and a country with deep international financial linkages should accumulate exorbitant amount of foreign reserves. Besides, the country is exposed to an exorbitant volatility of exchange rates in the presence of various shocks when it is unable to hedge its debt. Naturally, currency internationalization should be the final destination of capital inflows management.

Recently in an attempt to curb excessive foreign currency debt the Government of the Republic of Korea has implemented policy measures on the banking sector such as introducing new ceilings on FX derivatives positions and imposing macro-prudential stability levy on FX borrowing by banking sector. It is too early to assess the impact of such measures accurately but as of now the data suggests that they are effective. Foreign currency debt of the banking sector has been visibly reduced. Instead, portfolio investment has increased.

However, past experiences of capital regulation in many countries suggest that despite signs of an improvement in the short-run there is little room for complacency in the medium- to long-run. In a country like the Republic of Korea, where industry is the engine of economic growth, the potential demand for FX hedging is enormous. Without currency internationalization the country would suffer even more from the capital inflows problem in the future.

Chapter 8

Thailand

Boonchai Charassangsomboon and Pisit Puapan

This chapter analyses Thailand's experiences during the global financial crisis of 2008-2009 and during the flood crisis of late 2011. Given that Thai economy relied significantly on external demand, it was negatively affected by the adverse external environment arising from United States sub-prime financial crisis and the subsequent global economic slowdown that took place in late-2008 and the first half of 2009. As a result, Thailand's GDP contracted by 4.1 per cent in the 4th quarter of 2008 and a further 6.1 per cent in the first half of 2009. But despite these large economic contractions, the Thai economy recovered rapidly in the second half of 2009, supported by government stimulus policies as well as by the gradual recovery of the global economy.

Major government policies implemented to stimulate the domestic economy were a mid-2009 supplementary budget worth 1.1 per cent of GDP and the Strong Thailand Investment Programme worth THB 1.3 trillion or 14 per cent of GDP. Moreover, unlike during the Asian financial crisis that erupted in Thailand in 1997, the country was well-positioned to cope with economic volatility because of its strong economic fundamentals and sound financial system.

Strong economic fundamentals and external sector resiliency in Thailand can be attributed to accumulated current account surpluses and high levels of international reserves. On fiscal policy, the Thai Government had maintained strong fiscal discipline, which resulted in low public debt levels prior to the global financial crisis and allowed for fiscal space to pursue expansionary fiscal policy in response to the crisis. The country's sound financial and banking systems at the time of the crisis was the result of effective supervision and good management practices, which were reflected in a low level of non-performing loans (NPL) and a high capital base. Moreover, domestic commercial banks had a minimal exposure to toxic foreign assets.

A few years after the 2008-2009 global economic crisis, another shock hit the Thai economy, this time arising from severe flooding across the northern and central plains of Thailand during the second half of 2011. The adverse impacts of the floods were felt in the manufacturing, construction and tourism sectors and caused a 8.9 per cent contraction of the GDP in the 4th quarter of 2011. In order to prevent future flood crises, the Government announced investments in water resource management projects worth over THB 350 billion and a THB 2.27 trillion public investment programme over the 2012-2016 period.

Thailand's experience during the global financial crisis

The global financial crisis of 2008-2009 was the second major economic crisis that affected Thailand over the past decade. The first economic crisis of 1997-1998 was home-grown resulting from years of economic bubbles, an inappropriate policy framework, and inadequate financial regulation, but the second major crisis came as an external shock to the Thai economy. Given the severity of the domestic crisis of 1997-1998, the level of production took over 5 years to recover its pre-crisis level. However, the impact from the second crisis arising from United States financial woes was far more short-lived. Its damaging effects were felt mostly in the export sector, particularly during the 4th quarter of 2008 and the first three quarters of 2009, during which exports contracted by an average of 15.5 per cent year-on-year, but the economy recovered briskly during 2010.

Thailand is a small open economy highly dependent on foreign trade and investment. Thus, it is not immune – or "decoupled" – from the ill-effects of the global financial crisis. The issue is how the effects from the global financial crisis transmitted to the domestic economy. When the subprime market melt down took place, it firstly affected major financial institutions in the United States and Europe, creating a credit-default shock to the financial markets, followed by a sudden decline in global stock markets, and finally resulting in a contraction of the real sector's output of industrialized countries. In general, Thailand was mostly spared in the first round of the economic shock of late 2007, when the United States sub-prime mortgage problems started to emerge after the decade-long United States housing bubble burst in the second half of 2006. At that time, it became evident that major United States-based financial institutions that were directly exposed to sub prime lending had financial problem. Fortunately, only few Thai financial institutions held such financial instruments; therefore, the initial impact of the crisis was not felt in Thailand in 2007 and much of 2008 except for periodic gyrations of domestic financial markets.

However, the meltdown of Lehman Brothers and the spread of financial and credit crises around the world in September 2008 ignited a devastating impact on the global economy, and Thailand was also severely affected. Initially, during the 4th quarter of 2008, Thailand's financial and stock markets became volatile and fell dramatically, as a result of a retreat of foreign funds worth more than US$ 2 billion. Subsequently, Thailand was affected by real economic shocks emanating from its trading partners.

The Thai economy started to experience a sharp contraction in its exports after November 2008. As a result, economic growth contracted by 4.1 per cent in the last quarter of 2008, lowering the overall rate of growth for 2008 to 2.5 per cent. The real sector worsened with a deep decline in early 2009. GDP growth dropped by 7.0 per cent in the first quarter, by 5.2 per cent in the second quarter and by 2.8 per cent in the third. Despite a recovery in the last quarter, with 5.9 per cent growth, Thailand's economic growth in 2009 contracted by 2.3 per cent, the first economic contraction since the Asian financial crisis in 1998.

Since the Asian financial crisis, Thailand's economic expansion has become even more dependent on its external sector, with international trade, measured as export plus import, reaching over 120 per cent of the GDP in recent years. After the initial shock from the global financial crisis in late 2008, the volume of exports of goods and services experienced a large reduction of minus 9.3 per cent in the last quarter of 2008, while the volume of imports of goods and services recorded a low expansion of merely 2.2 per cent. These figures represented a substantial decline from the previous quarter, during which export and import volumes grew by 9.8 per cent and 15.4 per cent, respectively. In terms of value, the country's export fell 14.2 per cent between 2008 and 2009, while imports fell 25.3 per cent. Much of the trade contraction concentrated on industrial products, particularly electronics and electrical components, and automotives and vehicles, and exports to traditional markets in the United States, Europe and Japan were hit the most.

Private consumption in Thailand was also negatively affected by the global financial crisis. With the falls of external sector's revenue, private consumption expenditure contracted in most of 2009. Indeed, private consumption was able to grow moderately at a rate of 2.2 per cent in the last quarter of 2008, but it started to contract at -2.1 per cent in the first three quarters of 2009. It started to recover in the last quarter of 2009, when it grew 1.6 per cent. Favourable factors for this improvement include early signs of global economic recovery, a gradual rise of farm income as a result of price increase for agricultural products, and boosting consumer confidence due to the approval of the Government's first stimulus package worth approximately 1.1 per cent of GDP and comprising cash transfer programmes and other quick-disbursing projects to the needy and low income groups.

Private investment was hit hard by the global financial crisis of 2008-2009. In the fourth quarter of 2008 it contracted 3.4 per cent, and over the four quarters of 2009 it contracted 19.1 per cent, 15.3 per cent, 11.3 per cent and 6.2 per cent, respectively, resulting in an average drop of 13.1 per cent in 2009. Investment in machinery and equipment contracted the most, 15.3 per cent, while investment in the construction sector contracted by -5.1 per cent. On the production side, the most severely affected sector was manufacturing, which contracted 6.9 per cent in the fourth quarter of 2008 and 6.1 per cent over 2009, the first year manufacturing experienced negative growth since 1998. Because the manufacturing sector is the largest component of Thailand's GDP, its decline hit the Thai economy hard. However, the traditional agricultural sector was able to withstand the impact from the global crisis by growing at a moderate rate of 1.3 per cent in 2009.

The global financial crisis of 2008-2009 affected employment. Thailand's labour force was growing at an annual rate of around 1.5 per cent before the crisis, but the growth rate was minus 1.9 per cent in the last quarter of 2008 and the situation worsened during the first two quarters of 2009 before a mild recovery in the third quarter of that year. Thailand's unemployment rate has usually fluctuated between 1 and 2 per cent, but it reached 2.3 per cent or 900,000 unemployed persons in early 2009. However, employment conditions quickly improved with the economic recovery in the fourth quarter of 2009, and the unemployment rate returned to a normal level of 1 per cent by the end of 2009. Employment data suggests that the global financial crisis affected most people in the manufacturing and services sectors and less in the agricultural sector.

As far as the financial sector is concerned, the global financial crisis had impacts both on international financial assets held by financial institutions in Thailand and on financial markets. The former impacts were low because Thai financial institutions have very low exposure to foreign assets. At the end of October 2008, the value of commercial banks' foreign securities stood at US$ 2.4 billion, which accounted for only around 1.2 per cent of their total assets. Among these foreign assets, banks invested largely in safe and liquid foreign sovereign bond, and their exposure to risky debt securities such as collateralized debt obligation (CDO) was only 0.04 per cent of the total banking assets. Moreover, Thai banks were well-capitalized with a capital ratio of 15.7 per cent, well above the minimum capital requirement of 8.5 per cent. As a result, Thailand's banking system experienced very small direct negative impact from global financial crisis. Moreover, Thai commercial banks had a sound financial condition, with low outstanding NPLs. The second channel of crisis impact was the capital market, which had been more severely affected. Foreign portfolio investment outflows from Thailand amounted to US$ 5.3 billion during the first half of 2009, which resulted in a decline in the Stock Exchange of Thailand (SET) market capitalization from 7 trillion baht in October 2007 to 3.2 trillion baht in November 2008.

Money and foreign exchange

After the collapse of Lehman Brothers in September 2008, which shocked global financial markets, the money market in Thailand faced a minor liquidity tightening. As Thai banks were in a strong financial position, with minimal exposure to foreign toxic assets, worries lied on the general liquidity situation rather than on risks emanating from bad bank assets. These worries led to an increase in the interbank rate of between 40 and 60 basis points between September and November 2008, while the interbank spread over the rate of government Treasury bills was between 20 and 100 basis points between July 2008 and April 2009. The liquidity situation returned to normal by the middle of 2009, as the Bank of Thailand pursued an accommodative monetary policy.

The impact of the crisis on liquidity was small because there was excess liquidity in the Thai banking system and banks did not need to rely on foreign money. Indeed, the ratio of loans-to-deposits was less than 0.9 in 2008 and 2009 compared to 1.2 in 1997. The capital outflows largely came from the panic sale of US$ 2 billion in stocks during the first 3 quarters of 2008. Because of the comfortable level of liquidity in the banking system and the country's large amount of international reserves, over US$ 105 billion, the capital outflows during the crisis had trivial impacts on liquidity in the money and foreign exchange markets.

Between 2006 and mid 2008, the value of the baht kept strengthening from 40 per United States dollar to 32 due to the country's strong macroeconomic conditions and capital inflows caused by yen carry trades. Starting in April 2008, however, the weakness of United States financial institutions caused massive withdrawals of capital from Asia, which resulted in a weakening of the baht to 34.3 by September 2008. Although the baht weakened vis-à-vis the United States dollar, its value moved in line with other currencies in the region. The main reason is that Thailand faced fewer capital outflows than other Asian countries such as the Republic of Korea. In addition, the Bank of Thailand successfully managed and limited the volatility of Thailand's currency. However, the risk appetite of international investors recovered since May 2009, leading to capital inflows into Thailand's stock market and an appreciation of the baht to 33.3 per United States dollar by December 2009.

Between July 2007 and July 2008, the monetary policy rate, the one-day repurchase rate, was kept low at 3.25 per cent to stimulate the economy, but it was raised to 3.75 per cent between July and August 2008 to slowdown rising inflation caused by commodity price bubbles. In October 2008, the monetary policy committee maintained the policy rate amid inflation concerns, in spite of the global financial crisis, but on 3 December 2008, the policy rate was sharply cut down by 1 per cent to 2.75 per cent in order to aggressively respond to global crisis, and it was subsequently cut until it reached 1.25 per cent in April 2009. Although Thailand's stock prices increased significantly before 2008, the price-earnings (P/E) ratio was around 17 by December 2007, much lower than that of other Asian markets. By the end of 2008, the P/E ratio fell to 7. The lower stock valuations were caused not only by the global financial crisis but also by local political instability.

Due to the relatively small market capitalization (a low 3.4 trillion baht during February-March 2009) and low liquidity, foreign investment has significant impact on Thailand's stock market. Between January 2005 and June 2007, foreign investors came back to the Thai market after their departure during 1997 Asian financial crisis. During this period, foreigners had accumulated Thai stock worth B 329 billion. However, between August 2007 and February 2009, foreigners dumped their equity investment in Thailand worth 243 billion baht. As a result, the Stock Exchange of Thailand (SET) index dropped from its peak of 884 points in May 2008 to the lowest point of 413 in March 2009 or 53 per cent decline. This indicated that although the crisis was originated in the United States, the global financial crisis can severely hit Thailand's stock market due to the capital flight to safe haven and liquidity problems.

While the direct impact of the global finance crisis on Thai banks was minimal, the secondary impact caused by a sharp drop in exports was not too damaging. In light of the 1997-1998 Asian financial crisis experience, domestic banks were worried about the decline in the quality of their loan portfolios resulting from the decline in demand in key sectors such as manufacturing exports and tourism. However, the rate of NPLs – which had been decreasing continuously since a peak of 45 per cent in 1998 – increased only slightly, from 5.3 per cent in the fourth quarter of 2008 to 5.5 per cent in the first quarter of 2009. In addition, although the volume of loans to the corporate sector and to SMEs dropped in the 2nd and 3rd quarters of 2009, consumer lending including credit cards, mortgages and automobiles continued to grow despite the crisis. Overall, beside a slight decline in asset quality, Thailand's banking sector remained financially healthy, and banks continued making profits during 2009 despite the drop in the country's GDP.

Domestic supply shocks from the flood crisis in late-2011

Starting in June 2011, heavy flooding due to typhoons and persistent rainfall turned into a major economic and social crisis which affected first northern Thailand and subsequently the Chao Praya River basin and Bangkok. The impacts of the flooding were particularly severe in high-economic activity areas in the central region of the country, where hundreds of lives were lost, millions of people were displaced, public services were disrupted and critical infrastructure and production facilities were badly damaged.

The agriculture sector faced severe negative impacts because the Central plains region is one of the most productive areas for farming in Thailand. In addition, when the floods occurred major cereal crops were in the field, with paddy rice at the initial- to mid-growing stage and maize at an advance critical flowering stage. More importantly, flooding coincided with the peak of the tourism season in Thailand, which triggered additional revenue loss. As a result of the floods, foreign tourist arrivals to Thailand contracted by 4.7 per cent in the 4th quarter of 2011, in contrast to an expected growth of 10.5 per cent.

However, the most damaging impact of the floods on the Thai economy was due to the closures of seven industrial areas, which needed to halt manufacturing production for a sustained period of time. Japanese investments made up the bulk of these operations, and it was mostly specialized in two main sectors in which Thailand had become a regional hub in the regional supply chain: auto parts & electronics. As a result, the floods caused a massive supply-chain disruptions resulting in shutdowns of major auto producers in other parts of Thailand, such as the Eastern Seaboard, even though they were less affected by the floods. As far as electronic is concerned, Thailand is the world's second major producer of hard disk drives (HDD) after China, contributing one-fourth of the world's total production. Therefore, the flood disaster caused a 28 per cent quarter-on-quarter drop in the global HDD production in the 4th quarter of 2011, disrupting the global computer production supply chain. In the automotive sector, Thailand is the main production base for auto exports in Southeast Asia, with an annual production capacity at 1.7 to 1.8 million units and exports of vehicles and auto parts worth over US$ 18.5 billion, which represents 9.5 per cent of the country's total exports. Thus the flood crisis had a cascading effect on automotive assembly and production in Thailand and elsewhere, forcing major auto conglomerates to cut production, particularly in Japan.

The impact of the floods in Thailand could be categorized into two types: (a) Damage of assets, such as housing and household goods, hospitals and schools, roads and bridges, ports and airports, etc. and (b) Losses of production caused both by the destruction of production capacity and by higher costs of production in agriculture, manufacturing, commerce, and tourism, as well as by higher operational costs and lower revenues in basic public services such as education and culture, health, electricity, water supply, etc. The second type of impacts resulted in a 8.9 per cent drop of the GDP in the last quarter of 2008 and a modest growth of 0.1 per cent in the first quarter of 2009. In addition to these GDP losses, damage to the major industrial bases in Thailand, including seven industrial estates in Ayutthaya province, located north of Bangkok, which resulted in closures of hundreds of factories, damaged buildings and infrastructure facilities, were officially estimated at 1.3 trillion baht (US$ 42 billion) or 14 per cent of GDP.

Policy responses

Initially, during the September 2008 panic in the United States financial market, the Bank of Thailand calmed down Thailand's banking system by providing sufficient liquidity to the banking system and stabilizing the exchange rate. In response to the global demand slump, the Bank of Thailand aggressively reduced its policy interest rate from 3.75 per cent to an unprecedented low level of 1.25 per cent by April 2009. Under the Bank's inflation targeting regime, the decision to reduce the policy interest rate was supported by less concerns about inflationary pressures resulting from the dramatic fall of commodity prices and by the slowing down of economic activities during the crisis. In addition, the Thai Government adopted Keynesian-style fiscal policy measures to urgently increase domestic demand and counteract the adverse impact of the crisis on exports. The Government's fiscal policy response consisted on two stimulus packages, which are described below:

First stimulus package

The first stimulus package, which was announced in January 2009 and started to be implemented in March 2009, consisted of 3 components: increased spending, tax reduction measures, and financial measures as follows:

Increased spending

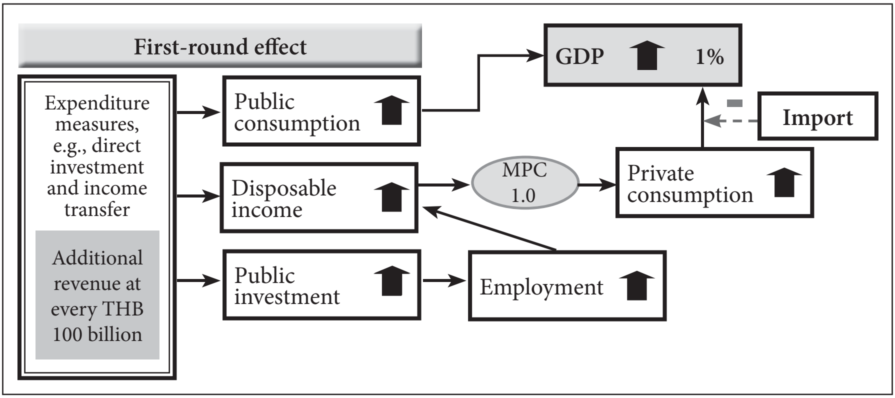
The Thai Government announced a package worth THB 115 billion of supplementary spending in mid-January 2009. The key idea was that an effective fiscal stimulation required the Government to inject money as quickly as possible into low-income households because of their high propensity to consume extra income – which implies a high value for the fiscal spending multiplier. This option was considered better than increasing spending in public investment because of the often significant delays in the disbursement of funds and in the implementation of public investment projects. Therefore, the Government targeted consumption expenses of seven groups of people: farmers, low-income earners, parents, SMEs, community-based enterprises, senior citizens and self-employed.

The first group of projects included in the package aimed at reducing expenses and increasing disposable income. Among them, a free education project worth THB 19 billion paid the tuition fees, books, uniforms, and materials of 8.5 million students. The project expanded the number of years of free education from 12 years to 15 years by adding 3 years of pre-school education from May 2009. Low-income earners making THB 15,000 or less per month received a one-time cash handout of THB 2,000. The total cost of this cash transfer, the fastest way to increase spending via private consumption, was about THB 18 billion baht. Senior citizens over 60 without a pension programme received a THB 500 monthly living allowance. This programme provided benefits to about 5 million senior citizens and had a total cost of THB 9 billion. In addition, THB 13 billion were allocated for temporarily cutting the cost of living of low-income households by providing 6 months of free electricity and water supply for small levels of monthly consumption, as well as free bus and train rides.

The second group of projects aimed at improving public infrastructure in rural villages. THB 2 billion, THB 1.5 billion and THB 1 billion were provided, respectively, to small water resource development projects, asphalt road projects of 490 kilometres and village health centres development projects. The third group of projects aimed at increasing the productivity of unemployed workers. It included a training programme for unemployed workers worth THB 6.9 billion. This programme covered 240,000 unemployed workers and offered over 100 training programmes as well as a THB 5,000 living allowance per month. The fourth group of projects supported community development and community-based enterprises through the THB 15 billion Sufficiency Economy Village Fund. Under this project, the Government distributed THB 1 million for villages to finance their own projects. The Village Fund, which supports fiscal decentralization, aims to promote grass roots participation in the fiscal decision-making process.

As far as the impacts from Thailand's fiscal stimulus package, the Ministry of Finance estimated that every THB 100 billion increase in government spending would generate positive economic impact of 1.0 per cent of GDP compared to the baseline. The transmission mechanism is described in figure 8.1.

Figure 8.1. Transmission mechanism of stimulus package 1 (SP1)



Source: Fiscal Policy Office, Ministry of Finance, Thailand.

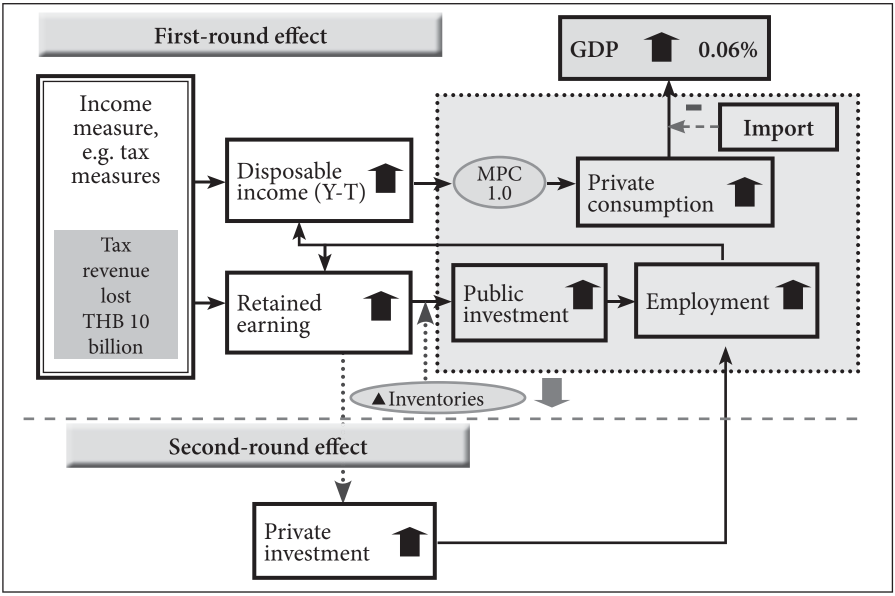
Tax reduction

On 20 January 2009, the Government announced a THB 50 billion tax reduction plan to complement its proposals to increase spending. This plan targeted home owners, SMEs, community enterprises, and tourism operators. To increase new home purchases in 2009, the Government increased the income tax deduction on new home purchases from THB 100,000 to THB 300,000. In addition, the Government announced that the tax rate and registration fee for property transfers would be reduced. These two measured are estimated to have stimulated the purchase of 50,000 new homes but resulted in a THB 36.5 billion decline in government revenues. The beneficiaries of these measures are home buyers, property developers, construction material producers, banks, and construction workers.

In addition, the Government aimed at reducing the tax burden for SMEs, community enterprises, small hotels and debt restructuring firms by increasing the minimum corporate taxable income from THB 60,000 baht to THB 1 million per year. Moreover, income tax deductibles for corporate training activities and seminars held in Thailand increased from 100 per cent to 200 per cent of the spending on training in order to promote local tourism. Given the low number of foreign tourists visiting Thailand during the global financial crisis, hotels and resorts were available for training activities and seminars.

The Ministry of Finance estimated that every THB 10 billion in tax reduction would generate a positive economic impact of 0.06 per cent of the GDP, compared to the baseline. The transmission mechanism of tax measures is summarized in figure 8.2.

Figure 8.2. Transmission mechanism of tax measures

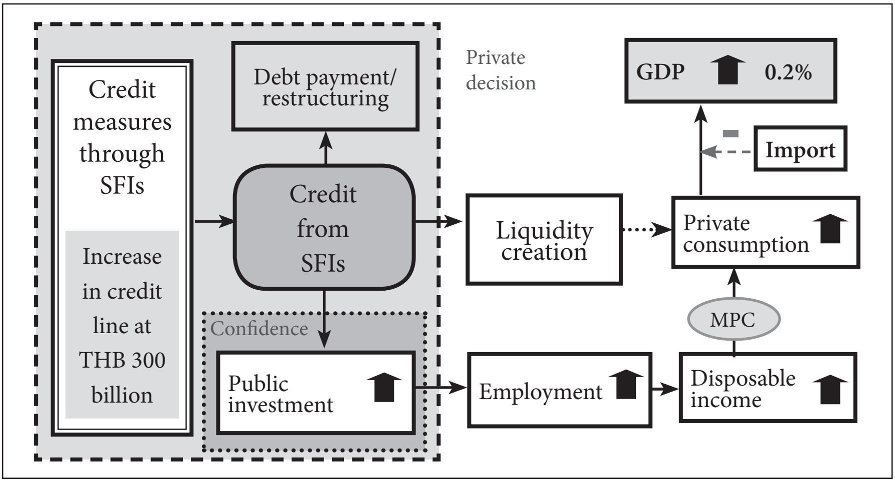


Source: Fiscal Policy Office, Ministry of Finance, Thailand.

Quasi-fiscal policy

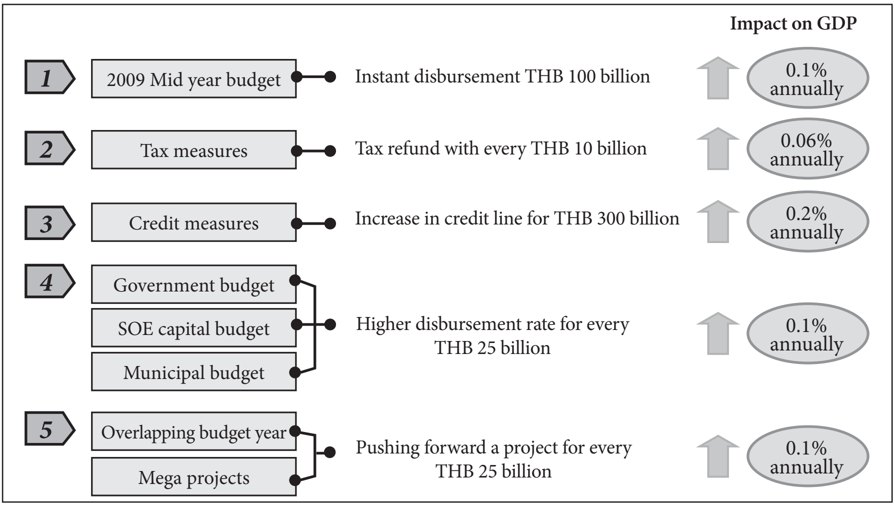
The Government also implemented quasi-fiscal policy measures through its public financial institutions. For farmers, the Government not only planned to spend about THB 150 billion from regular budget to support prices of agriculture products such as rice, corn, rubber, tapioca, fruits and palm, which faced sharp declines, but also increased the financial support for its agricultural bank so that it could provide additional loans worth THB 110 billion. For SMEs and exporters, the Government provided credit guarantees to encourage more bank lending. The Ministry of Finance estimated that every THB 300 billion increase in domestic credit would generate a positive economic impact of 0.2 per cent of GDP compared to the baseline. The transmission mechanism of quasi-fiscal policy can be described in figure 8.3.

Figure 8.3. Transmission mechanism of credit measures through SFIs



Source: Fiscal Policy Office, Ministry of Finance, Thailand.

Figure 8.4. Total effect of SP1 on GDP growth



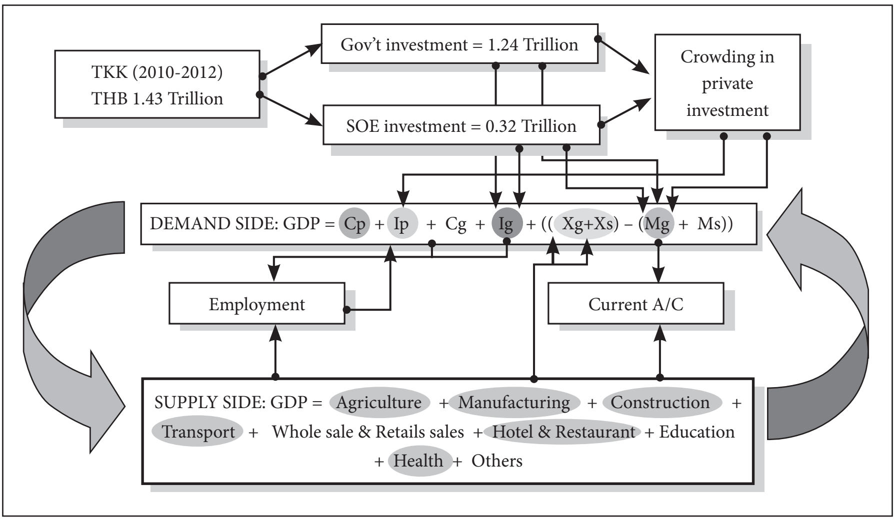
Source: Fiscal Policy Office, Ministry of Finance, Thailand.

In summary, the impact of first stimulus package on the economy can be summarized in figure 8.4, which shows that the GDP would increase 1.5 per cent annually in addition to the baseline scenario.

Second stimulus package

In mid-2009, the Government announced a second stimulus package, referred to as the "Strong Thailand Programme" or, more informally, as SP2. The bulk of this programme for the period 2010-2012 was to be financed off-budget. The total cost of the programme was THB 1.46 trillion, THB 1.11 trillion of which were allocated to government projects and THB 321 billion to investment projects of State-owned enterprises. The programme funded tens of thousands of investment infrastructure programmes nationwide, with the objectives of (i) reviving economic growth in the short-term and (ii) raising the country's productivity and competitiveness in the medium- and long-term. Besides the need to counteract the adverse impacts of the global financial crisis, the need to boost investments in infrastructure was due to the fact that such investments had been low since the Asian financial crisis of 1997. The transmission mechanism of the second stimulus package is described in figure 8.5.

Figure 8.5. Transmission mechanism in SP2 to GDP growth



Source: Fiscal Policy Office, Ministry of Finance, Thailand.

Nearly 60 per cent of the SP2 package consist of "hard" infrastructure – transport and logistics, mainly roads and rail, and irrigation projects. When the package was announced, the Government argued that it would support a growth rate of up to 4 per cent in 2010 and 5 per cent or more in 2011-2012, provided that the disbursements were kept on track. In the pre-crisis years of the 1990s, total investment made up around 40 per cent of the GDP, 10 per cent public investment and 30 per cent private investment. However, during 2004-08, public investment made up only between 5.3 and 5.9 per cent of the GDP and private investment was only between 16.6 and 17.5 per cent of the GDP. Therefore, the implementation of SP2 would simultaneously serve to increase domestic demand and to promote national infrastructure development.

Flood crisis policy responses

The Thai Government adopted a three-pronged strategy to address the flood crisis and prevent future crises. First, the Government provided compensation and other measures, such as debt moratorium, tax reductions and incentives, and soft loan for reconstruction and rehabilitation, to people affected by the floods. Second, the Government proposed to invest 350 billion to improve flood prevention and water management. Third, the Government proposed a THB 2.27 trillion investment programme, worth 20.5 per cent of the GDP, over the next 7 years to enhance infrastructure and logistics in Thailand. These investments in disaster risk reduction will help minimize economic losses and impacts to local communities from future floods.

Lessons learned and future direction of Thai economy

The major lessons learned for Thailand from the 2008-2009 global financial crisis are that (1) sound macroeconomic policy and management are crucial for economic resiliency; (2) government stimulus programmes should be implemented in a well-targeted and timely manner, without compromising transparency; (3) medium-term fiscal sustainability should be maintained so that Government has fiscal space in times of crisis; and (4) financial and banking supervision should aim at balancing the objectives of financial stability and innovation.

The lessons learned from the flood crisis are that (1) non-economic shocks such as climate and weather shocks can have significantly negative consequences in the domestic economy; (2) dealing with unexpected natural disasters requires ex-ante emergency and crisis resolution planning and coordination, as well as post-crisis effective implementation of rehabilitation measures; and (3) the Government should make necessary investments in physical and social infrastructure to mitigate the impact from natural disasters and climate change.

In the medium- to long-term the Thai Government aims at restructuring the economy toward quality-growth and sustainability through the following strategies:

- *Achieve stability through sound macroeconomic management*. Priority will be given to financial management under appropriate and timely monetary policy, and a surveillance mechanism for economic fluctuations and a comprehensive warning system will be established. There is a need to improve efficiency in the management of foreign capital flows and in the collection of public revenues. A more effective budget allocation and management will also be crucial in preventing fiscal risks and in enhancing the operational efficiency of State-owned enterprises. The private sector will be encouraged to participate more in investment in infrastructure and public service provision and the fiscal capacity of local governments will be improved.
- *Enhance the country's competitiveness with a freer and fairer competitive environment*. The country's competitive edge will be strengthened through the development of financial and capital markets, along with the improvement of the workforce. The development of an efficient intellectual property system will facilitate further research and development, knowledge transfers and applications to commercial purposes, generating benefits for communities and for society as a whole. In addition, the development of high quality infrastructure and logistic systems will strengthen the efficiency of domestic and international connectivity consistent with international standards. To boost energy security it will be vital to increase the utilization of clean energy, to develop alternative sources of energy, and to improve energy efficiency. Reforming the business legal framework, relevant rules and regulations will also be essential to facilitate healthy competition and to enhance efficiency in a manner compatible with global changes and trends.

- *Develop connectivity in transport and logistics systems under regional cooperation frameworks*. This will be achieved through the development of efficient transport and logistics services meeting international standards, and by the improvement of relevant rules and regulations for the transportation of goods and people. It is also important to enhance the capacity of human resources in transport and logistics businesses and to promote economic connectivity both across borders and linking domestic production poles.
- *Utilize science, technology, innovation and creativity as fundamental factors for economic restructuring*. Economic restructuring will emphasize research and development, technology transfer and applications leading to commercialization of innovations and improvements in the quality of life. The service sector will be restructured to increase its value creation and to become more environmentally friendly. The creative economy, including creative business, creative cities and creative industries, will be promoted, and value creation in the agricultural sector will be enhanced through innovation and green production processes. There is also a need to use science, technology and creativity to promote quality and sustainability in the industrial sector and to make Thailand's development increasingly knowledge-based and environmentally friendly. The public and private sectors will cooperate to create an improved enabling environment to facilitate value creation through the provision of appropriate infrastructure and facilities, thus encouraging technology development and innovation.

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ASIA-PACIFIC ECONOMIES AFTER THE GLOBAL FINANCIAL CRISIS

Although the global financial crisis of 2008-2009 was the worst economic crisis in over 60 years for many industrial countries, most Asian and Pacific developing countries weathered it quite successfully. The resilience of the region is somewhat puzzling at first sight. In an increasingly globalized world, aren't economic shocks supposed to be transmitted faster and farther than ever before? And shouldn't the largest shock in decades affecting the central financial centres of the world cause substantial ripple effects? Yet, even those Asian and Pacific countries that were most exposed to drops in imports from the Western industrial countries and suffered significant drops in economic activity in 2009 recovered briskly in 2010. Furthermore, in contrast to the Asian financial crisis of 1997, no country in the region experienced a collapse of its banking sector or a balance of payments crisis.

The purpose of the book is to understand why countries in the region were significantly less affected by the crisis than the world's most advanced economies of Europe and the United States, and what are the main lessons from their experience for building resilience from future crises. The majority of the essays collected in this volume are revised and updated versions of papers presented by experts from the region at a conference organized by the Economic and Social Commission of Asia and the Pacific in Manila in September 2011.

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