

Title: Laying foundations for stable order

Source: The Straits Times, Singapore

Date: 26 March 2009

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ST-NUS BUSINESS SCHOOL SERIES ON GLOBALISATION

Laying foundations for more stable order



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kept interest rates low in the United States and encouraged over-consumption by Americans.

At the microeconomic level, perverse incentives in the financial sector led to the gross underestimation of the risks of default. Unsound instruments were purchased without due regard for their underlying risk.

When the housing bubble finally burst in 2007, major financial institutions in the US and Europe that were directly exposed to mortgage-backed securities failed. The downward spiral in asset prices decimated bank balance sheets and a major credit crunch followed as the deleveraging process took hold. The end result was a global economic recession.

It is now evident that the proposed reforms need to address not only the underlying causes of the crisis, but also protect the real economy from the excesses of the financial sector. There are at least three areas that deserve careful attention.

First, financial markets need to identify and manage systemic risks better. Perverse incentives in the industry need to be monitored. And the shadow banking sector must be regulated along the same lines as the core banking sector.

It is also clear that credit rating agencies should avoid conflicts of interest, and better information needs to be provided to institutional investors so they can verify the ratings of credit agencies.

And perhaps more importantly, we need one or more international institutions to monitor systemic risks in the global economy.

Second is the question of whether central banks should lean against asset price bubbles when setting monetary policy. This is a complex issue because it is difficult to judge ex ante whether asset price levels are the result of a bubble or the outcome of economic fundamentals. Moreover, central banks do not have enough tools to control asset prices along with inflation and growth. For example, the US Federal Reserve trades off inflation and economic growth when it uses its interest rate lever to conduct monetary policy. Adding another target like asset price levels would make the policy trade-offs potentially unmanageable.

Third is the issue of large current account imbalances. According to the International Monetary Fund, surplus countries accumulated more than US\$2 trillion (S\$3 trillion) in reserves last year. Four entities accounted for 84 per cent of this total: oil exporters (40 per cent), China (20 per cent), Germany (14 per cent) and Japan (10 per cent). On the debit side, six countries - Australia, Britain, France, Italy, Spain and the US - accounted for 70 per cent of the overall deficit.

There are a number of risks associated with large global imbalances. They fan asset price bubbles and also raise the

risk of exchange rate instability, if there are unexpected capital flow reversals.

The current global imbalances stem in part from the export-led growth strategies of the emerging economies. One result of persistent trade surpluses is the build-up of huge foreign reserves. In the initial stages of economic development, accumulating reserves is a sound strategy because in the absence of a huge middle class, the natural way to drive growth is through exports to developed economies. And in the absence of mature capital markets to allocate such savings to the highest yielding investments, it is inevitable that most of the reserves are invested in developed nations. But how much is enough?

Once basic insurance needs are met to pay for imports and buffer against exchange rate instability, developing economies should concentrate on developing their capital markets and investing in their infrastructure, including education and health care, areas with high social rates of returns.

In other words, having grown richer, emerging Asia should be driven more by domestic sources of demand. Only then can Asia become the solid third leg of a tripod world that includes the US and euro zone, and truly "decouple" from the West.

The financial reform agenda is long and challenging. However, history has taught us that crises are an important part of the evolutionary process of creative destruction, the occasion for outdated and inefficient institutions to change into better ones. To be sure, we will face other financial stresses in the future and there will be a need for further reforms of the financial system.

But if the reforms we adopt now are fundamentally sound, and if emerging Asia hastens the development of its domestic economies, there is an excellent chance the global economy will emerge from the current financial crisis far healthier and more stable than it was.

Lim Chin is a professor at the NUS Business School. Bernard Yeung is dean of the school. This is the concluding essay in the ST-NUS Business School Series on Globalisation.