

Asia and the Financial Crisis



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Introduction:

The turmoil in the international financial markets of advanced economies that started around mid-2007 has exacerbated substantially since August 2008. The financial market crisis has led to the collapse of major financial institutions and is now beginning to impact the real economy in the advanced economies. As this crisis is unfolding, credit markets appear to be drying up in the developed world. With the substantive increase in financial globalization, how much will these developments affect India and other Asian emerging market economies.

Effect of Global Economy:

A number of commentators have suggested that if the liquidity crisis continues, there could be an extended recession or worse. The continuing development of the crisis has prompted in some quarters fears of a global economic collapse although there are now many cautiously optimistic forecasters in addition to some prominent sources who remain negative. The financial crisis is likely to yield the biggest banking shakeout since the savings-and-loan meltdown. Investment bank UBS stated on October 6 that 2008 would see a clear global recession, with recovery unlikely for at least two years.

The Brookings Institution reported in June 2009 that U.S. consumption accounted for more than a third of the growth in global consumption between 2000 and 2007. "The US economy has been spending too much and borrowing too much for years and the rest of the world depended on the U.S. consumer as a source of global demand." With a recession in the U.S. and the increased savings rate of U.S. consumers, declines in growth elsewhere have been dramatic. For the first quarter of 2009, the annualized rate of decline in GDP was 14.4% in Germany, 15.2% in Japan, 7.4% in the UK, 18% in Latvia, 9.8% in the Euro area and 21.5% for Mexico.

Some developing countries that had seen strong economic growth saw significant slowdowns. For example, growth forecasts in Cambodia show a fall from more than 10% in 2007 to close to zero in 2009, and Kenya may achieve only 3-4% growth in 2009, down from 7% in 2007. According to the research by the

Overseas Development Institute, reductions in growth can be attributed to falls in trade, commodity prices, investment and remittances sent from migrant workers. This has stark implications and has led to a dramatic rise in the number of households living below the poverty line, be it 300,000 in Bangladesh or 230,000 in Ghana. The World Bank reported in February 2009 that the Arab World was far less severely affected by the credit crunch. With generally good balance of payments positions coming into the crisis or with alternative sources of financing for their large current account deficits, such as remittances, Foreign Direct Investment (FDI) or foreign aid, Arab countries were able to avoid going to the market in the latter part of 2008. This group is in the best position to absorb the economic shocks. They entered the crisis in exceptionally strong positions. This gives them a significant cushion against the global downturn. The greatest impact of the global economic crisis will come in the form of lower oil prices, which remains the single most important determinant of economic performance. Steadily declining oil prices would force them to draw down reserves and cut down on investments. Significantly lower oil prices could cause a reversal of economic performance as has been the case in past oil shocks. Initial impact will be seen on public finances and employment for foreign workers.

Asia and the Financial Crisis

Countries in Asia are increasingly worried about what is happening in the West. A number of nations urged the US to provide meaningful assurances and bailout packages for the US economy, as that would have a knock-on effect of reassuring foreign investors and helping ease concerns in other parts of the world. Many believed Asia was sufficiently decoupled from the Western financial systems. Asia has not had a subprime mortgage crisis like many nations in the West have, for example. Many Asian nations have witnessed rapid growth and wealth creation in recent years. This led to enormous investment in Western countries. In addition, there was increased foreign investment in Asia, mostly from the West. However, this crisis has shown that in an increasingly inter-connected world means there are always knock-on effects and as a result, Asia has had more exposure

to problems stemming from the West. Many Asian countries have seen their stock markets suffer and currency values going on a downward trend. Asian products and services are also global, and a slowdown in wealthy countries means increased chances of a slowdown in Asia and the risk of job losses and associated problems such as social unrest.

Impact on Asian EMEs

In contrast to the previous episodes of global turmoil, EMEs have exhibited relative resilience, though equity market and exchange rate pressures have intensified in recent days. So far, the investment sentiment is positive for the Asian EMEs reflecting their strong economic performance and, for some countries, favorable investment opportunities associated with elevated commodity prices, though they have adjusted downwards in recent times, while being somewhat volatile. Credit policy reforms, better structuring of banking sector debt and improved fiscal positions have also played their role making the EMEs resilient from the crisis. In addition, large foreign exchange reserves, particularly in Asia, also provide a degree of protection against possible sudden stops.

Another factor that could be of relevance for this favorable situation is the relatively smaller presence of foreign banks in the Asian banking sector. This is evident from the fact that the share of banking assets held by foreign banks in these economies generally lies between 0 and 10 percent (Global Development Finance, 2008).

The spillovers to the EMEs from the current global financial market crisis have occurred mainly in and through financial markets, reflecting the relatively high level of integration of such markets in the global financial system. In this respect, there have been four major spillovers, viz., (i) a rise in the price of risk; (ii) a reduction in international bond issuance; (iii) a sell-off in equity markets; and (iv) some unwinding of carry-trade positions. The major EMEs in Asia have been recording surpluses on the current account in recent years, with the exception of Korea and India. Thus, the vulnerability of Asia, other than Korea and India, is relatively contained to that extent. It is in this context the foreign exchange markets in India and Korea have experienced greater pressure in recent times. Overall, while the real sector in the major Asian EMEs has held

up relatively well, it needs to be recognized that the financial crisis in the US has deepened significantly over the past couple of months and there are signs of its spreading to the mature economies in Europe. The deepening and widening of the financial crisis is already getting reflecting in elevated volatility in the financial markets of key EMEs and widening of spreads of the EME assets. Although a large amount of liquidity has been injected by the central banks of the major advanced economies, short-term market rates remain well above policy rates. Financing costs for the EMEs have increased over the past few weeks and could thus deteriorate in the coming months. If the financial crisis were to linger longer and the economic activity in these regions slows down significantly, the adverse impact on the real economies in the major EMEs could turn out to be stronger than that has been observed so far. According to the IMF's latest World Economic Outlook (October 2008) (IMF, 2008b), major advanced economies are already in or close to recession and the recovery is likely to be unusually gradual. Global output growth (at purchasing power parity (PPP) exchange rates) is now seen at 3.0 per cent in 2009, down from the likely 3.9 per cent in 2008 and the robust growth of almost 5 per cent each during 2006 and 2007. Growth in advanced economies is projected to decelerate from an average of 2.8 per cent during 2006-2007 to 1.5 per cent in 2008 and only 0.5 per cent in 2009. Policy rates have been cut in a coordinated manner, an unprecedented move, by central banks of major advanced economies on October 8, 2008 in view of the substantial downside risks to growth.

Conclusion :

Asian countries have seen their stock markets suffer and currency values going on a downward trend. Asian products and services are also global, and a slowdown in wealthy countries means increased chances of a slowdown in Asia and the risk of job losses and associated problems such as social unrest. Thus, financial headwinds - both through reduced capital flows, widening of spreads and elevated volatility in domestic financial markets of the EMEs and through weakening of demand in major advanced economies - have increased downside risks of the major EMEs, especially for the relatively more open economies in the region.

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