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Invited Article

# European crises and the Asian economies☆

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ABSTRACT

This paper analyses the impact of recent financial crises in Europe on the Asian economies. What is often abbreviated to GFC included three distinct crises: the 2007–2008 North Atlantic financial crisis, a 2008–2009 global economic crisis and public finance crises which became increasingly focussed on the eurozone in 2010–2012. Asia did not experience significant financial crises, and the open economies recovered relatively rapidly from the global economic crisis. The relative weight of Asian economies in the global economy, which had been increasing for several decades, grew even more rapidly in 2009–2011 as the economies of the USA and Europe faltered. This poses challenges for global economic governance, although there are constraints on Asia being a more assertive force. Problems in the eurozone hold lessons for Asia; the euro and the Schengenzone are positive responses to the emergence of increasingly complex supply chains. In a similar context, East Asia is moving hesitantly toward financial cooperation and adopting second-best approaches, such as *de facto* dollar pegs, to reducing bilateral exchange rate volatility.


This paper analyses the impact of recent financial crises in Europe on the Asian economies. Before addressing that issue, however, the first three sections argue that what is often abbreviated to GFC included three distinct crises:

1. A financial sector crisis, which was not global. The North Atlantic financial crisis of 2007–2008 hit some small economies (Iceland, Ireland), but the big news was the USA and UK and to a lesser degree some other EU members.
2. Recession in the USA and UK triggered a global economic crisis in 2008–2009.
3. Public finance crises resulted from large bail-out or stimulus packages exacerbated by falling taxes due to recession (as in Ireland, USA, UK), or to some extent coincidentally (e.g. Greece due to culmination of budget deficits fueled by cheap debt since joining the euro). If central banks are committed to low inflation, then increased budget deficits mean larger public debts and potential sovereign debt crises.

An important distinction between the first two types of crises is that the effects of a financial crisis are much longer lasting than those of an economic crisis triggered by an external shock, such as reduced demand for exports.[1]

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[1] Eichengreen (2011, pp. 386–9) provides recent references, and discusses the difficulty of determining the counterfactual with which to compare the aftermath of financial crises. Reinhart and Rogoff (2009) is the seminal historical account.

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The fourth section analyses the impact of these crises on Asian countries. The Asia-Pacific region did not experience significant financial crises. The open economies were affected by the global economic crisis, but they recovered relatively rapidly after a drop in exports and in economic growth in 2009. An important consequence is that the weight of Asian economies in the global economy, which had been increasing for several decades, grew even more rapidly in 2009–2011 as the economies of the USA and Europe faltered. This poses challenges for global economic governance, which is currently dominated by the USA and western European countries. However, there are constraints on Asia being a more assertive force, due to the competition for leadership among the larger economies and limited leadership resources in the smaller economies.

The final section focuses more specifically on the implications of the European sovereign debt crisis on Asia. It concludes that fears about the negative impact are overdrawn. However East Asian countries could learn some lessons from the EU's attempts to reduce exchange rate risk in an increasingly integrated world economy characterized by regional and global supply chains.

## 1. The North Atlantic financial crisis of 2007–2008

The USA experienced a major financial crisis in 2007–2008. The trigger was falling house prices from a mid-2006 peak, which led to the subprime mortgage crisis. The crisis was realized in April 2007 when New Century Financial filed for bankruptcy, and in the remainder of 2007 many institutions announced losses associated with delinquent mortgages. An additional component of the US financial crisis was the collapse of the investment banks, which first became apparent in March 2008 when JPMorgan Chase bought Bear Stearns in a fire sale (paying $240 million for a company worth $18 billion a year earlier) supported by a $30 billion loan from the Fed.

The US financial crisis peaked in September 2008. On September 7 the U.S. government placed Fannie Mae and Freddie Mac into a conservatorship, effectively nationalizing them at the taxpayers' expense. On 15 September 2008 Lehman Brothers went bankrupt and Merrill Lynch was bought by Bank of America. The following day the Fed announced an $85 billion rescue package for AIG, the country's biggest insurance company, in return for an 80% stake in the firm. On 25 September 2008 Washington Mutual, which had assets valued at $307 billion, was closed down by regulators and sold to JPMorgan Chase.

The US government moved quickly to provide support for the financial sector. On 28 September US lawmakers announced a bipartisan agreement on a rescue package, allowing the Treasury to spend up to $700 billion buying bad debts from ailing banks. The plan was rejected by Congress the next day, but a revised plan was passed on 3 October. On 14 October the US government unveiled a $250 billion plan to purchase stakes in a variety of banks in an effort to restore confidence in the sector. On 23 November the US government announced a $20 billion rescue plan for Citigroup after its shares plunged by more than 60% in a week. On 25 November the Fed announced that it would inject a further $800 billion into the economy to stabilize the financial system and encourage lending; about $600 billion would be used to buy up mortgage-backed securities while $200 billion would be targeted at unfreezing the consumer credit market.[2]

More or less at the same time and speed, the UK faced a financial crisis triggered by mortgage loans. In September 2007, Northern Rock sought and received a liquidity support facility from the Bank of England and in February 2008 Northern Rock was taken into state ownership; the bank's principal problem was non-performing mortgage loans. In September 2008 the mortgage lender Bradford & Bingley was nationalized; the British government took control of the bank's £50 billion mortgages and loans, while its savings operations and branches were sold to Santander. The banking crisis spread and on 3 October 2008 the UK government announced plans to pump £37 billion of taxpayers' money into three banks: Royal Bank of Scotland, Lloyds TSB and HBOS.

In September and October 2008 other large EU economies faced specific banking problems, which were met by bail-outs, but the systemic impact was nowhere near as large as in the UK. For example, the Belgian, French and Luxembourg governments contributed 6.4 billion euros to bail out Dexia, and the German government announced a €50 billion deal to save Hypo Real Estate. A much larger national crisis occurred in Ireland, whose government foolishly guaranteed all deposits in the country's main banks.[3] Relative to the size of the national economy, the largest banking crisis was in Iceland, whose banking system collapsed in October 2008, leading the government to negotiate a $2 billion loan from the International Monetary Fund, the first IMF loan to a western European country for over a quarter of a century.

Other countries, notably in Eastern Europe, experienced financial crises which were related to the difficulties of western European banks or to a sudden stop in capital inflows. In Central Asia, Kazakhstan had a financial crisis that was largely home-grown, resulting from a real estate bubble that was fueled in part by foreign depositors and that burst in 2007.

A striking feature of the 2007–2008 financial crises was that they did not have serious transcontinental contagion effects. The 1997–2008 Asian Crisis triggered a reconsideration of emerging market debts that led to crises in Brazil and Russia, with the latter contributing to the Long Term Capital Management crisis in the USA. In 2007–2008 there was no financial crisis in South America, Africa or Asia. Even countries closely linked to the US economy, notably Canada, had no financial crisis.

[2] Although there is debate about the size and use of the injection of money, the speed of the U.S. response is generally accepted to have been a big improvement over the slow and piecemeal policy response in the decade after the bursting of Japan's asset bubble in 1989 (Ueda, 2012).

[3] Governments implicitly or explicitly guarantee deposits to forestall bank runs, but the guarantees are typically limited to accounts under a certain value ($250,000 in the USA) and sometimes to domestic deposits only (as in Iceland). The Irish guarantee was unlimited (see footnote 10 below).

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