The McKinsey Quarterly

FINANCIAL SERVICES

DECEMBER 2008

Asia's future and the financial crisis

The region has been hit hard but can help the world recover. Meanwhile, the global crisis is likely to spur further integration among Asian markets.

Dominic Barton

McKinsey&Company

The collapse of Lehman Brothers triggered a global credit shock that struck with surprising force in Asia. Before Lehman's failure, many looked to the region as a bastion of economic stability. After all, Asia had high growth rates, large trade surpluses, and substantial foreign reserves. Its large companies were well capitalized and the books of its banks mostly free of the subprime loans and doubtful investments afflicting their Western peers.

Yet Asia couldn't avoid the economic fallout from the troubles of Europe and the United States: the region's stock markets plummeted, its currencies weakened, and its exports to the West slowed considerably. The impact of the crisis on the financial markets and real economies of Asia has largely ended speculation about its full "decoupling" from the West. The ties still bind. But the developments of the past few months reinforce our view that Asia should move more aggressively than ever to secure its economic future and improve its resilience in future crises. Asian governments must accelerate their plans to integrate regional economies—for instance, by boosting demand at home, speeding up intraregional trade and investment, and strengthening local and regional financial markets. Only through such initiatives can Asia hope to minimize the impact of future economic dislocations, whether they originate inside or outside the region.

Asia's economies remain fundamentally sound. They will probably emerge from the global downturn more rapidly than economies in other regions will. Nonetheless, the crisis has exposed important linkages between Asia, on the one hand, and Europe and the United States, on the other. Asia depends heavily on external consumers: for example, in 2007, exports from Asian economies—excluding Australia, Japan, and New Zealand—reached a high of 45 percent of regional GDP, up a full ten percentage points since 1995.[1] We estimate conservatively that Western consumers account for about half of these exports, including both direct exports and indirect exports through a growing intra-Asian reexport trade. Moreover, Western investors remain major players in most of Asia's capital markets. Asian banks, except for those in China, are tightly linked to Europe and the United States through the interbank market and US dollar liquidity needs.

Increased exports to the United States played an important role in Asia's relatively swift recovery from the 1997–98 crisis and helped China and India become economic giants. This time, however, US consumers, with their troubled mortgages and maxed-out credit cards, probably won't provide much relief. Asia's stock and bond markets have deepened significantly since the last crisis: the value of equity and debt markets in Asia, for instance, has soared to 140 percent of regional GDP, up from 50 percent, in the past five years. But along with this deepening has come significant foreign portfolio investment, representing, for example, 30 to 40 percent of the money invested in the financial markets of Hong Kong and South Korea. As margin calls came due and investors sold shares to cover severe liquidity needs in Western markets, capital fled Asia, battering regional equities. Moreover, as Western banks began to deleverage, reducing their $2.8 trillion of credit to Asia, dollar liquidity dried up, along with interbank markets and trade finance.

Although Asia's foreign-exchange position has strengthened dramatically over the past decade, the sudden shift in foreign financing and the portfolio flows back to the West generated large exchange-rate shifts: currencies in India, South Korea, and other Asian economies depreciated significantly—by over 40 percent relative to the dollar in the case of the South Korean won. Adjustments of this magnitude caused significant losses on currency-hedging products, especially among Asia's export-oriented small and midsize enterprises. Such losses, combined with the freezing of trade finance and other serious liquidity issues, began to force some of these companies into bankruptcy.

How should Asia respond? The answer will vary from economy to economy and sector to sector. China and India, with their large and growing domestic markets, will find it easier to weather the storm than will mature economies, such as Japan, or late developers, such as Vietnam. Companies in domestically focused industries, such as telecommunications and health care, will do better than those in export-driven sectors, such as electronics and consumer goods.

Nonetheless, choices made in Asia—the source of a third of global GDP—will play a crucial role in driving a global recovery. We see three ways for the region to strengthen its own resilience and help the world recover from the crisis.

Boost demand at home

Many Asian countries have recently unveiled sweeping government spending plans; China's proposals, on the surface, appear to be the most ambitious. This is a region with huge infrastructure needs—especially in China and India and, to a lesser extent, Vietnam. Efforts to develop India's infrastructure are critical but may stall because of the tightening of credit and the weak finances of local governments. These efforts should be pursued aggressively to promote even faster growth through more rapid urbanization, much needed productivity improvements, and the multiplier effects of spending.

Asia is home to an enormous emerging middle class, which we estimate will grow by more than 800 million people within the next decade. Regional policy makers must do more—now—to unlock the spending power of this formidable group. In China, for example, private consumption accounts for only 35 percent of GDP, compared with more than 70 percent in the United States. Consumption-boosting measures, such as increased spending on social services, the liberalization of property rights, and wider access to consumer finance, will speed China's progress down the path of sustainable growth.

Accelerate intraregional trade and investment

Over the past seven years, trade within Asia has risen 75 percent faster than its trade with Europe and the United States. In fact, trade with the West is now half that of intra-Asian trade. Much of the growth, though, has come from the regional expansion of global supply chains culminating in Western markets. Asia's economies, with their burgeoning middle-class populations, must begin to see each other as end markets rather than only primarily as links in the global supply chain.

With negotiations over the Doha free-trade-development round stalled, Asian countries have shown new interest in regional free-trade agreements. More than 70 of them have been concluded among the ten members of the Association of Southeast Asian Nations (ASEAN), along with China, Japan, and South Korea.[2] Many more are under negotiation. But such bilateral deals have far less impact on trade flows than regionwide agreements do. Asia's progress in liberalizing regional trade has been too slow, and it is imperative to rebuild momentum for a multilateral solution. The region's huge infrastructure needs and growing consumer class offer ample investment opportunities for Asian capital. More should be done to tap, for use within the region, the Asian savings and reserve funds allocated to sovereign wealth–style investments.

Strengthen local and regional financial markets

Asian financial markets have come a huge distance since 1997 but must evolve further if they are to continue supporting the region's growth over the next five years. More can be done to deepen local and regional capital markets, but in a measured way that seeks to avoid the excesses that have roiled those in the West. Pension reform would provide additional long-term local capital for domestic investment. Asia must do more to put in place the right consumer-finance credit regulations and infrastructure—such as credit bureaus to ensure that the emerging consumer class can spend more, but prudently. The region could also benefit from the adoption of countercyclical financial safeguards, such as dynamic provisioning (which requires banks to build rainy-day reserves in good times for future nonperforming loans) and dynamic capital-adequacy ratios (which would increase capital requirements in boom times and reduce them in troubled ones).

These efforts alone will not suffice. When leaders from Asian and European nations gathered in Beijing last October for their annual summit, several Asian participants called for the establishment of new regional financial institutions to promote growth and stability. Thailand urged the creation of an Asian version of the International Monetary Fund, to be capitalized with $350 billion. Leaders from the Philippines and South Korea offered similar proposals and urged broader currency-swap arrangements. Such ideas are worth exploring.

In the short term, though, Asia is likelier to achieve consensus by focusing on more targeted measures. These include developing the region's bond markets aggressively, consolidating its stock exchanges, and establishing additional mechanisms for improving the consistency and approach of regional regulators.

Each of these solutions implies a capacity for coordinated action that has thus far eluded Asia. The received wisdom has long been that it is too economically and politically diverse to integrate policy in a meaningful way. European-style cooperation may not be a realistic goal. Even so, current global financial problems give the region's leaders a unique opportunity to pull together. Asia isn't the source of the crisis but could point the way to its long-term resolution.

About the Author

Dominic Barton is a director in McKinsey's Shanghai office.

Notes

[1] See Stephen S. Roach, *Pitfalls in a Post-Bubble World*, Morgan Stanley, 2008.

[2] See Alan Wheatley, "Asia's infatuation with two-way trade saps WTO," *Reuters*, June 23, 2008.

Related Articles on mckinseyquarterly.com

"A case for Asian bond markets"

"Why ASEAN's stock markets must work together"

"Taking stock: Ten years after the Asian financial crisis"

"Integrating Southeast Asia's economies"

Copyright © 2008 McKinsey & Company. All rights reserved.