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The Crisis and Asia/India

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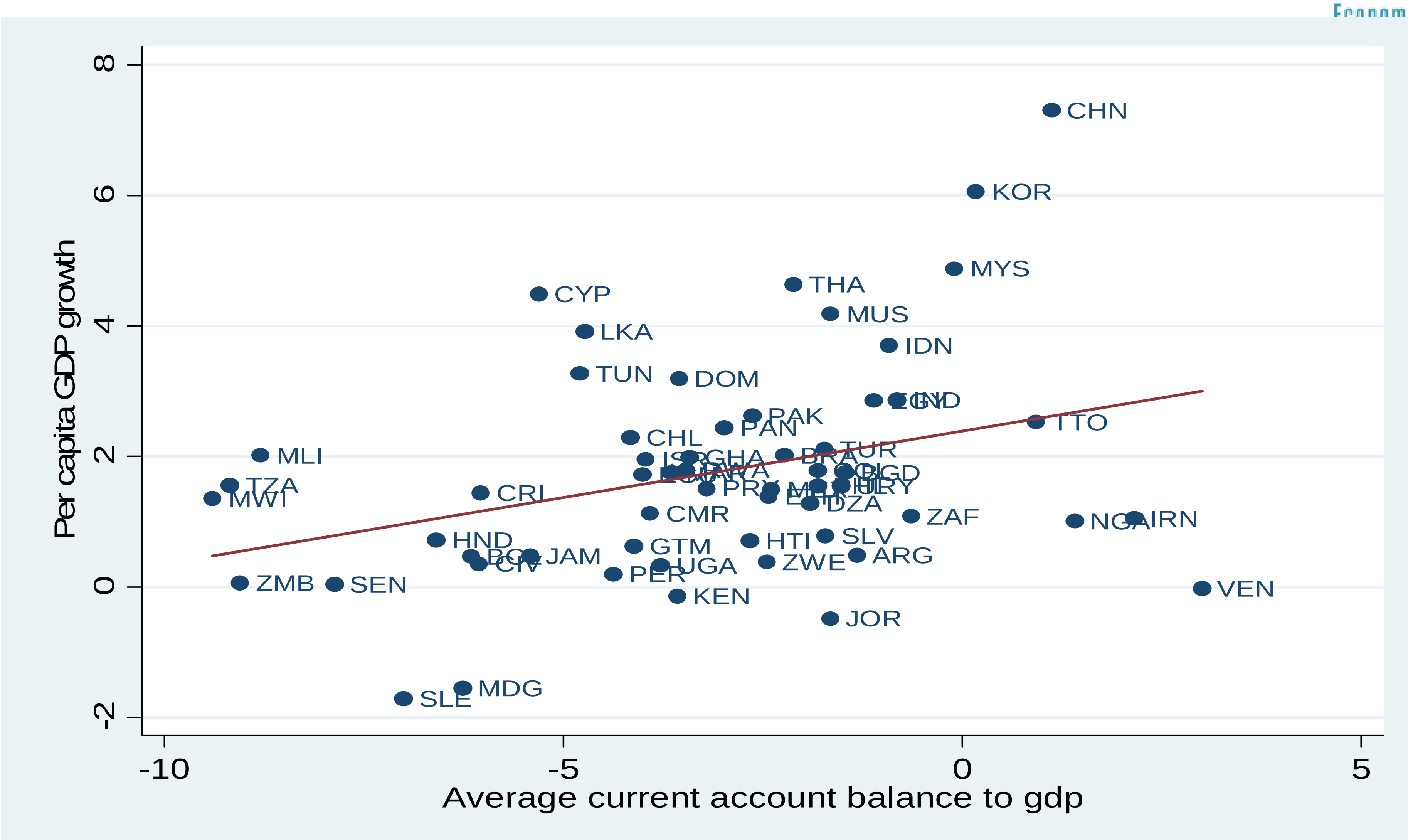
The Crisis as a Natural Experiment

- Three broad emerging market models
- <u>Model 1</u>: Lots of trade and foreign capital: Finance Fetish (Eastern Europe: Latvia, Hungary, Romania, Poland, Mexico? etc)
- <u>Model 2</u>: Lots of trade but little capital: Mercantilism (Exemplar: China)
- <u>Model 3</u>: Bit of Both: (India, Brazil)
- Model XX: Neither trade nor capital: Autarky (Myanmar/North Korea)

Model 1: Foreign Finance Fetish



- Prasad, Rajan, Subramanian, Brookings Papers on Economic Activity, March 2007

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Models 2 and 3: Financial Impact

- Greater impact in countries that were more exposed to foreign finance (i.e. in Model 3)

EM Currencies have weakened

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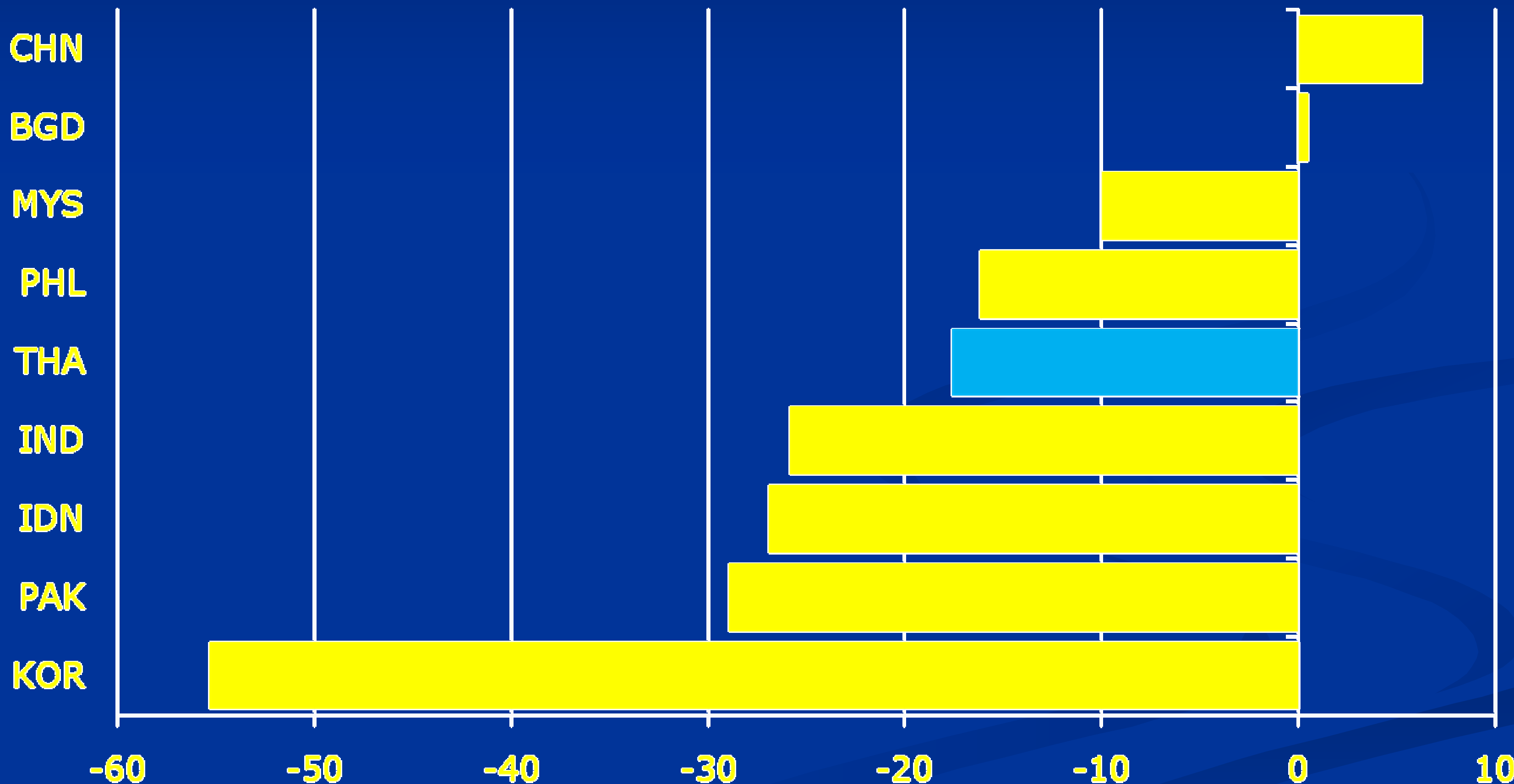
Exchange Rate Change

2008YTD change in percent 1/



Source: IMF International Financial Statistics

1/ Negative change implies depreciation

Models 2 and 3: Trade Impact

- Greater impact in countries more exposed to exports (i.e. in Model 2)

Growth Impact

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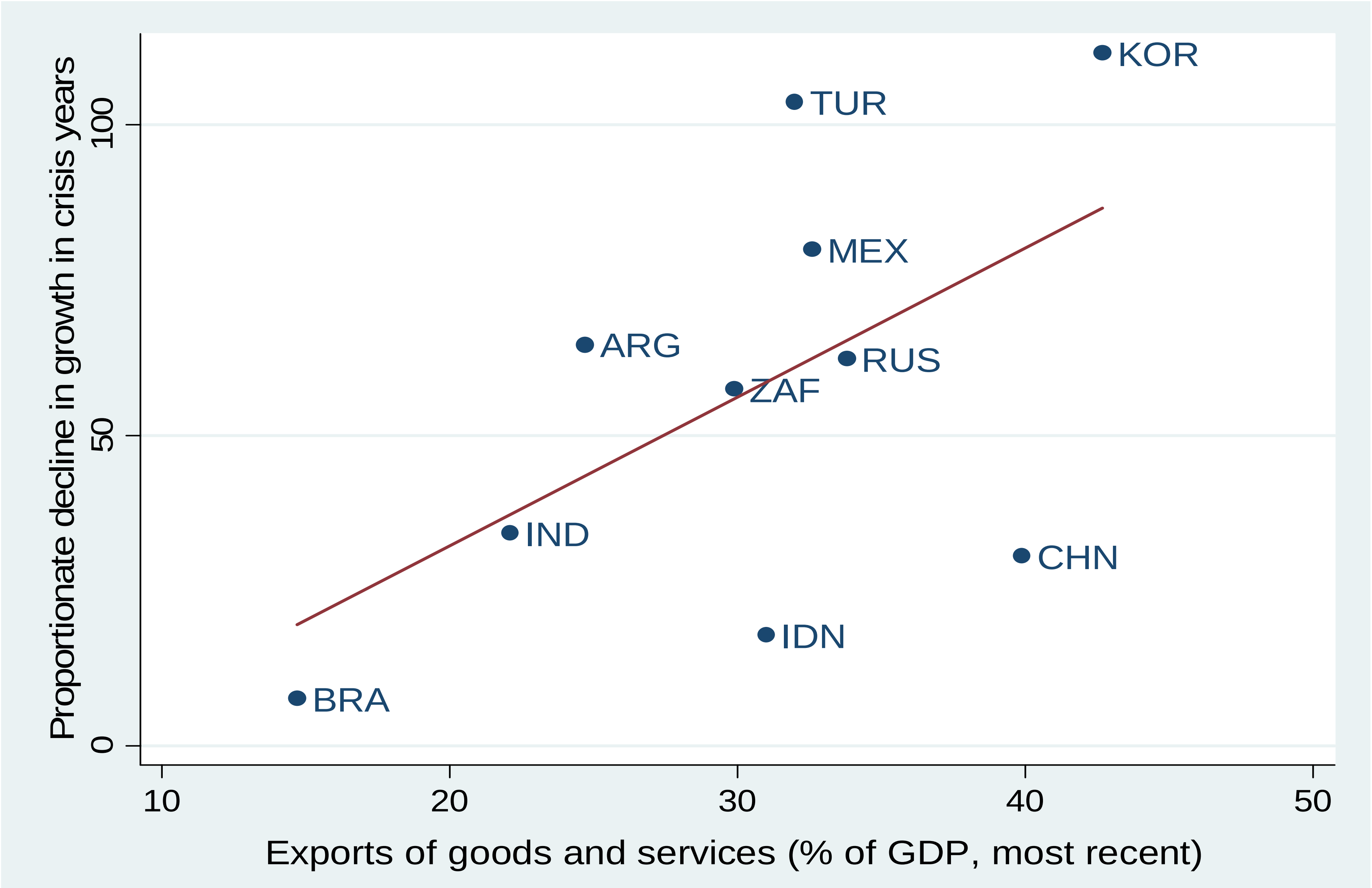
Country	Pre-crisis	Crisis		Decline in growth 2008-09 (% of 2005-07 growth)	Decline in growth 2009 (% of 2005-07 growth)
	(avg. 2005-07)	(avg.2008-09)	2009		
Italy	1.3	-1.4	-2.1	205.1	263.6
Japan	2.1	-1.5	-2.6	167.6	221.2
United Kingdom	2.6	-1.1	-2.8	139.8	206.0
Germany	2.1	-0.6	-2.5	128.8	220.2
France	2.1	-0.3	-1.9	114.4	191.3
United States	2.6	-0.4	-1.6	113.6	162.0
South Korea	4.8	-0.6	-4.0	111.5	183.9
Canada	2.9	-0.3	-1.2	108.6	141.4
Spain	3.7	-0.3	-1.7	106.7	145.7
Mexico	3.7	0.8	-0.3	80.0	108.0
Russia	7.3	2.8	-0.7	62.3	109.6
India	9.4	6.2	5.1	34.2	45.9
China	11.3	7.9	6.7	30.5	40.7
Brazil	4.1	3.8	1.8	7.5	56.2

Growth decline related to export openness



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Policy Response: Monetary

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- Aggressive monetary policy response across Asia (Models 2 <u>and</u> 3) but watchful in Latin America (Mexico and Brazil)

- India not UK or US the first to do quantitative easing: monetizing the fiscal deficit

Asia: Aggressive monetary policy response

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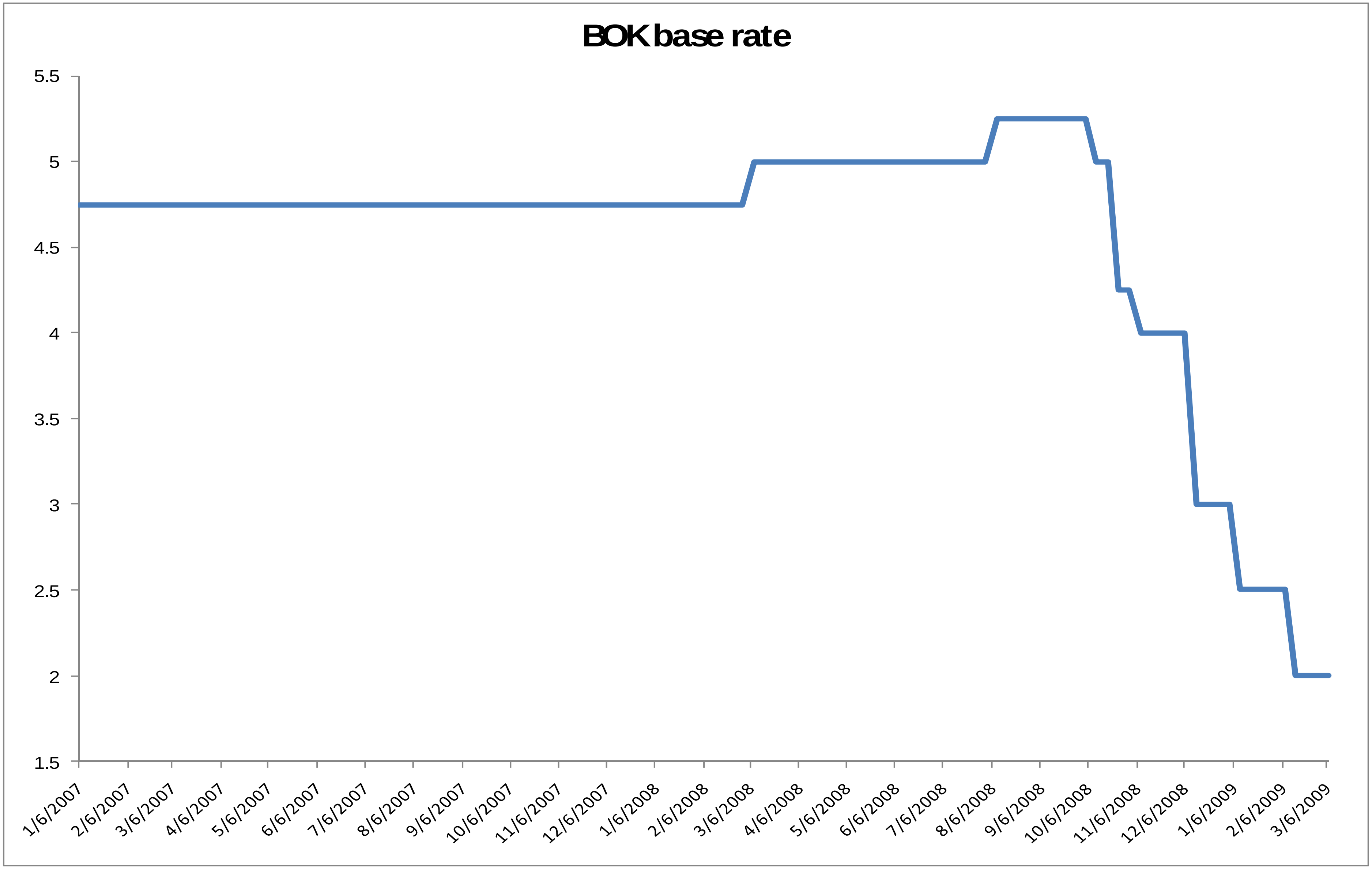
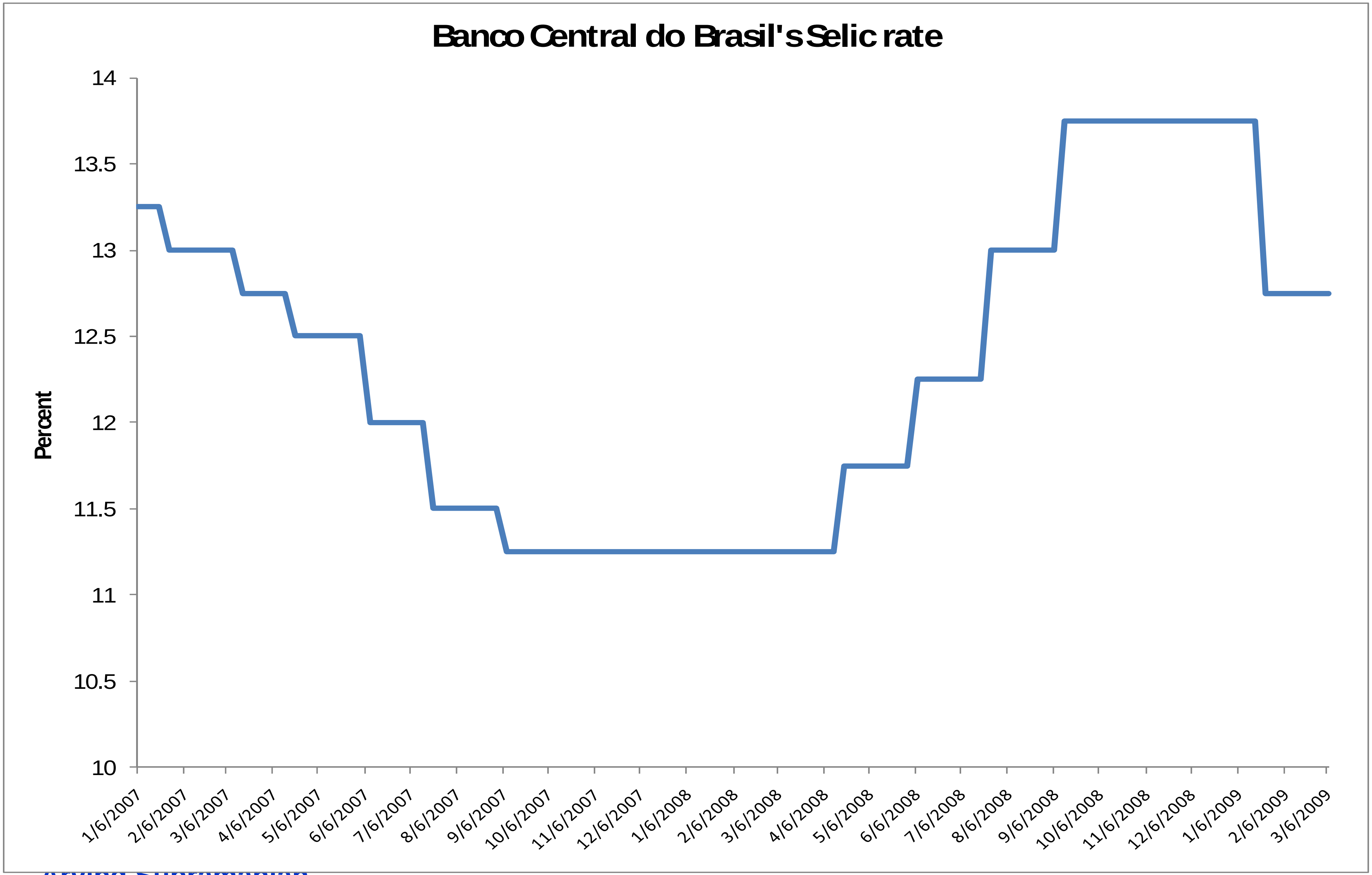


Brazil: Cautious monetary policy response



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Policy Response: Fiscal

- China is the gold standard (low public debt: 20% of GDP) plus strong state capacity

- India hobbled because of high debt (>80% of GDP) and weak state capacity

Fiscal Response

Country	Fiscal Stimulus (% of GDP)		
	2008	2009	2010
Brazil	0.0	0.3	0.2
Canada	0.0	1.5	1.3
China	0.4	2.0	2.0
France	0.0	0.7	0.0
Germany	0.0	1.5	2.0
India	0.0	0.5	n/a
Italy	0.0	0.2	0.1
Japan	0.4	1.4	0.4
Mexico	0.0	1.0	n/a
Russia	0.0	1.7	n/a
South Korea	1.0	1.5	0.3
Spain	3.1	1.1	0.3
United Kingdom	0.2	1.4	-0.1
United States	1.1	1.9	2.9

Lessons

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- Fundamentals matter (external indebtedness, reserves, corporate sector etc etc)

- Asia able to use monetary policy without fear of losing investor confidence (especially of residents)
  - Key difference between Asia today and Asia in the 1990s and between Asia today and emerging Europe today

- Model 2 versus Model 3: Cost-benefit

- Mercantilism more resilient financially (self-insurance), produces a lot of growth during good times but is more vulnerable in bad times

	Model 2	Model 3
	Mercantilism	Bit of Both
Growth in Good States	Better	
Financial resiliency in Bad States	Better	
Growth in Bad States		Better

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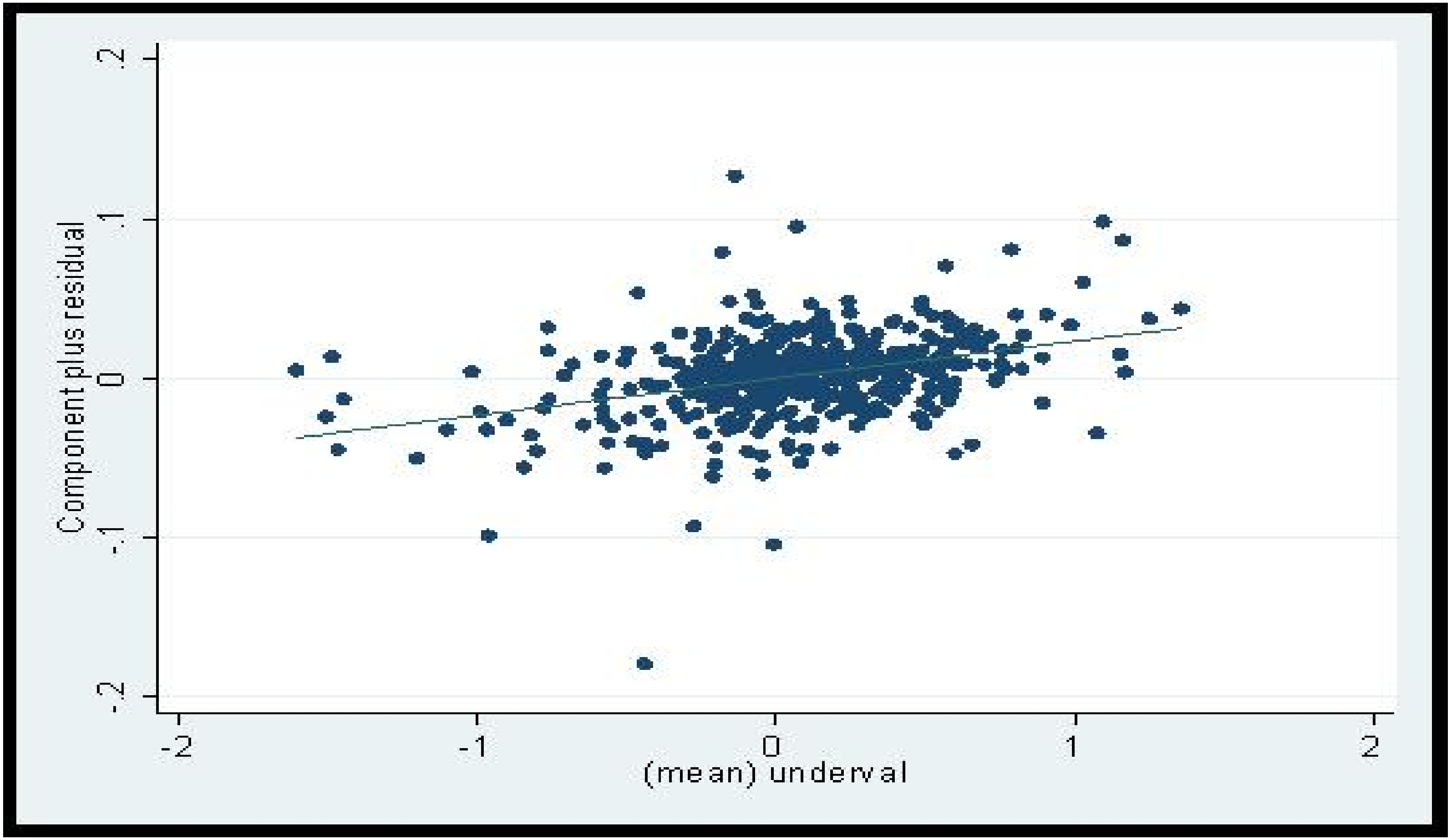
Undervaluation and Growth: Rodrik



Lessons

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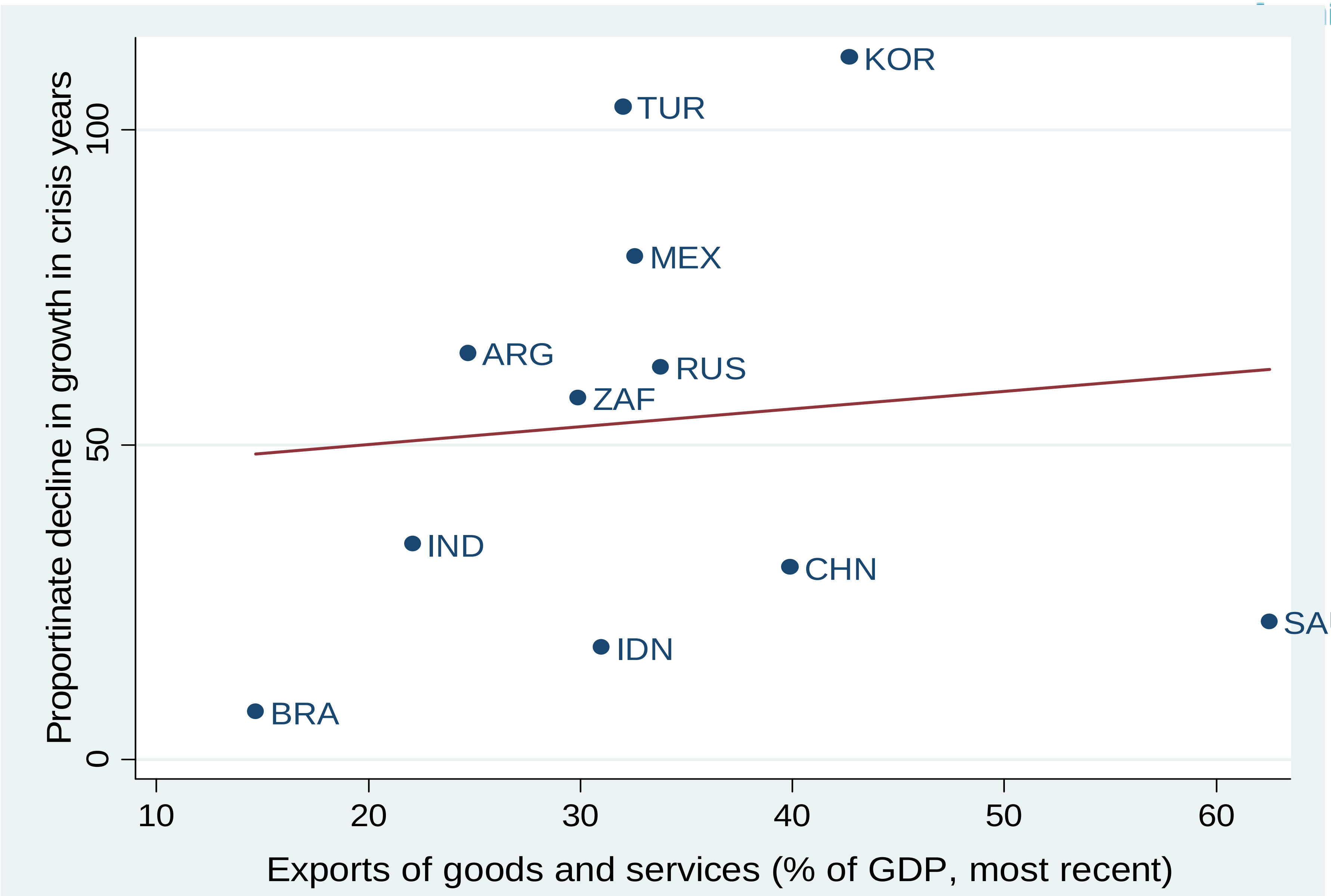
- But if boom-time economic management is good (like in China but unlike in India), some of the growth costs even in the bad times can be “managed.” Mercantilist model looks not too bad
- Problem, of course, is systemic (individual versus collective interests)
- If all countries or even a few big countries adopt mercantilism, what are the systemic consequences…? Deflation, trade frictions…

Growth decline related to export openness



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