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Managing the crisis

Yiping Huang Are Chinese policy makers getting it right?

Yongsheng Zhang China's testing for a major role on the world stage

Rod Eddington Australia being not spared but prepared to manage the worst

Iwao Nakatani Japan's change in paradigm to rescue the ailing economy

Soogil Young South Korea's test of political leadership

Hadi Soesastro Indonesia the unlikely star

... and more

EAST ASIA FORUM *Quarterly*

From the Editor's desk

Welcome to the first issue of *East Asia Forum Quarterly* (*EAFQ*).

EAFQ has grown out of *East Asia Forum* (EAF) online which over the past year has developed a reputation for providing a platform for the best in Asian analysis, research and policy comment on the Asia Pacific region in world affairs. *EAFQ* aims to provide a further window onto research in the leading research institutes in Asia and to provide expert comment on current developments within the region.

Our first issue brings together essays by influential commentators on the outlook for countries around the region as they confront the next phase of the global financial crisis.

Analysing the crisis and the response by the nations in the region, one conclusion readily reached is that East Asia could not readily step up to the mark in responding to the crisis because its regional structures are still not up to the task of effective global participation. This issue therefore sets the agenda for our next magazine – on how that regional architecture might be turned more effectively to the purpose of responding to the big problems of the day in their global context.

The *East Asia Forum Quarterly*, like *East Asia Forum* online, is an initiative of the East Asia Forum (EAF) and its host organization, the East Asian Bureau of Economic Research (EABER) in the Crawford School of Economics and Government in the College of Asia and the Pacific at the Australian National University.

It draws on the research base at the ANU to link together over 40 leading institutes in East and South Asia in research and discourse on public policy and international affairs in the region.

Peter Drysdale

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East Asia's moment of truth

PETER DRYSDALE

Last year was a year of dramatic change in the East Asian economy, a defining moment for East Asian leadership. The economy went into sharp reverse everywhere. What wasn't evident at the time was that the seeds of economic deceleration in China had been sown before the effects of the American and European financial crisis started to wreak their havoc. The speed of economic reversal caught even the most experienced observers by surprise.

Bubbling not far beneath the surface of the economic ferment were powerful currents of political change. Last year was also the year in which China stepped decisively if awkwardly on to the world stage.

Its economy, at the beginning, was remarked upon as the driver of a historically unprecedented boom which saw world energy, food and raw materials prices jump to astrospheric heights. It hosted the Olympic extravaganza in Beijing, showcasing China's remarkable achievements since it opened to the world alongside its rich heritage of culture and history. But the troubles in Tibet in the lead-up to the Olympics put a searing spotlight on the disjuncture between China's achievements and its political development, deflected somewhat by the devastating earthquake in Sichuan which called forth huge reserves of national spirit and

PICTURE: PHOTOGRAPHER NAME

Chinese Premier, Wen Jiabao, at the World Economic Forum in Davos.

international goodwill. By the end of the year, growth had collapsed from 2007-based projections of 13 per cent for the year to 6.8 per cent end year-on-year, with national output virtually stationary in the last quarter.

Japan continued in stasis until it too was skittled by the collapse in America. Until the world fell down, the rest of the region, including Australia, that most East Asian of the East Asian economies, was pre-occupied with managing all aspects of the China boom – the pressure on energy, resource and food markets, the macroeconomic pressures, the looming foreign economic investment and commercial presence – and beginning to think about its long-term political consequences. India too was more and more caught up in the wave.

Never should the East Asian economy have been more conscious of that its role on the world stage

and the need to re-position quickly to manage the global system consequences of its own economic success and the dangers that the huge imbalances that had been created on the way now presented to its sustainability. East Asia bore no responsibility for America's squandering the beneficence of East Asia's success – the apparently never-ending supply of cheap credit negligently guarded by the private and public custodians of the developed world's financial system. But in this and in many other global system-making or system-destroying economic and political affairs, East Asia now had significant prudential responsibility and it failed at every stage to exercise it.

Despite the emergence of East Asia – China, Japan and the rest of East Asia through to Australia and New Zealand reaching out to India – East Asia could not step up to the mark because its regional structures are still not up to the task of effective global participation. The stage is still set for the wrong play – the trivia of regional FTAs and 'mickey-mouse' financial cooperation. In East Asia, like elsewhere in the world, the risks that we now face, not only economically but also politically, are a consequence of failure in the architecture of governance, including regional architecture that frustrates a coherent East Asian and international response to the big problems of the day in their global context.

That's an issue for another day, but it is a day fast approaching, including the need to deal with the political consequences of shifting regional economic power.

What do the splendid reviews of developments in the Asian economies and polities tell us about how East Asia might nonetheless see this thing through?

There are two things: one about what is playing out in the region; the other about the global response and East Asia's role in it.

In the region, apart from countries with leeway like Australia and Indonesia making the very best of a bad hand, the most important questions are about what has happened and what might happen in China. The press lurches from breathlessly reporting of one disaster to another, and there are more of them to come. But among the best analyses we have so far are here.

The Chinese economy is likely to turn around much more quickly than the bulk of pundits predict, despite the mayhem in the rest of the world. There has been a huge boost to spending in China and there's more to come. The problems in China are very different from those in America, Europe and Japan where stagnation will be more difficult to shake. China is an economy much more like Japan was in the Great Depression in the 1930s. Then, Japan released huge numbers of rural workers back to the countryside and cut wage costs in manufacturing dramatically while holding on to permanent workers there. In wage and price flexible Japan, output held up, formal unemployment hardly rose and Japan outcompeted the industrial world in international markets. The Chinese economy has similar characteristics with the capacity to bounce back in the same way. These are the kind of responses and pressures that we might expect in China, good for bounce-back but difficult to manage internationally without massive global reflation.
As Huang says, whether all that is sustainable beyond a few years will very much depend on whether the structural reforms, particularly in the financial market, are attended to and whether the world can get its act together.

And that brings us to the other critical issue: managing the international collective response to recovery from the crisis.
This crisis is as large a crisis as the Great Depression, measured in terms of the collapse in world asset values thus far.

First, let's count the blessings. Times have changed. Policy knowledge has improved substantially despite the misdirected inclination abroad to dump on economists when cooler counsel needs to prevail. Government is bigger in the economy and better positioned to get things back on track. And the biggest weakness, the ill-shaped structure of global architecture to deal with the issues the world confronts, has had the right-shaped tin shed of the G20 delivered to it, from which we will see a more effective and comprehensive response.

So if there's one thing that East Asia can and should do urgently, it is to get behind its representatives in the G20 and forge an agenda on macro-stabilisation and financial reform that leads the way out of the crisis, as no other region is better placed to do it. And 'disappointed states' states of Europe need to be pushed into understanding and accepting the reality that their claim for over-representation in world affairs cannot be allowed to knock the long-term program of work through the G20 on the financial crisis and other global issues off course. EAFQ

India faces the harsh reality

RAJIV KUMAR

The Paris-based International Energy Agency's (IEA) recent report includes revised forecasts for world oil demand in 2009. IEA's shocking estimate is that global demand for oil in 2009 will decline by half a million barrels per day (bpd) than in 2008! This is based on the IEA's estimates that global economic growth will be a mere 1.2 per cent for all economies after being revised downwards from the nearly 3 per cent forecast earlier.

This implies that OECD economies will post a negative growth in 2009 and emerging economies are also likely to achieve only moderate GDP growth. China is expected to grow only at 6.5 per cent, the lowest rate in eight years, despite the massive stimulus that the authorities announced at the end of last year. Given the weakness in Chinese and US demand, global oil prices are likely to remain extremely soft this year.

What are the implications for India?

First, the reality of an unprecedented global economic downturn and absence of any recovery in 2009 should now be recognized. The impact on India's economic prospects for this year and the next should be carefully and urgently worked out. There is currently lack of real appreciation amongst Indian policy and opinion makers of the severity of the global economic downturn. Some, like Surjit Bhalla, continue to insist that India's economic performance in 2009 will be better than in 2008. This is dangerous because it diverts attention from the measures that need to be taken to try and mitigate the impact of the global downturn and prevent domestic demand plummeting. The implementation of public sector infrastructure projects needs to be put on a mission mode. If the previous home minister can held accountable for the Mumbai debacle, those in charge of infrastructure and economic ministries should also be held accountable for their poor performance and compromising the country's economic security Better to take action now, rather than wait for the young, educated and unemployed taking to the streets. It does not take long for demographic dividend to be converted to a demographic crisis.

The second implication is that the government needs to use this window of low global oil prices to take the much needed step of decontrolling the prices of petroleum products. This will remove, once for all, this vexed issue from the realm of partisan politics. There is a cabinet decision of May 2003 to dismantle the administered oil price mechanism. This was held in abeyance first by the NDA government and thus by the present government. It is disingenuous to argue that dismantling oil price controls will harm the poor. Deserving beneficiaries, who do not by any stretch of imagination include motorcycle and car owners, can be easily protected by properly targeting the subsidy through either cash transfers or a system of smart ration cards. These will permit them to secure their supplies of kerosene and LPG at lower prices from all designated outlets that would be directly subsidized by the government. Price decontrol, along with the assurance that it will never be brought back, will attract domestic and foreign investment in all the segments of the petroleum sector. Getting rid of oil price controls will contribute to improving the investment climate directly and also boost business confidence in general. So this should be announced now, along with a further price cut.

Getting rid of oil price controls will contribute to improving the investment climate directly and also boost business confidence in general.

The third implication is that the economy needs to be closely monitored so there is advance action rather than a reactive response to worsening conditions. In the unfortunate absence of a full-time

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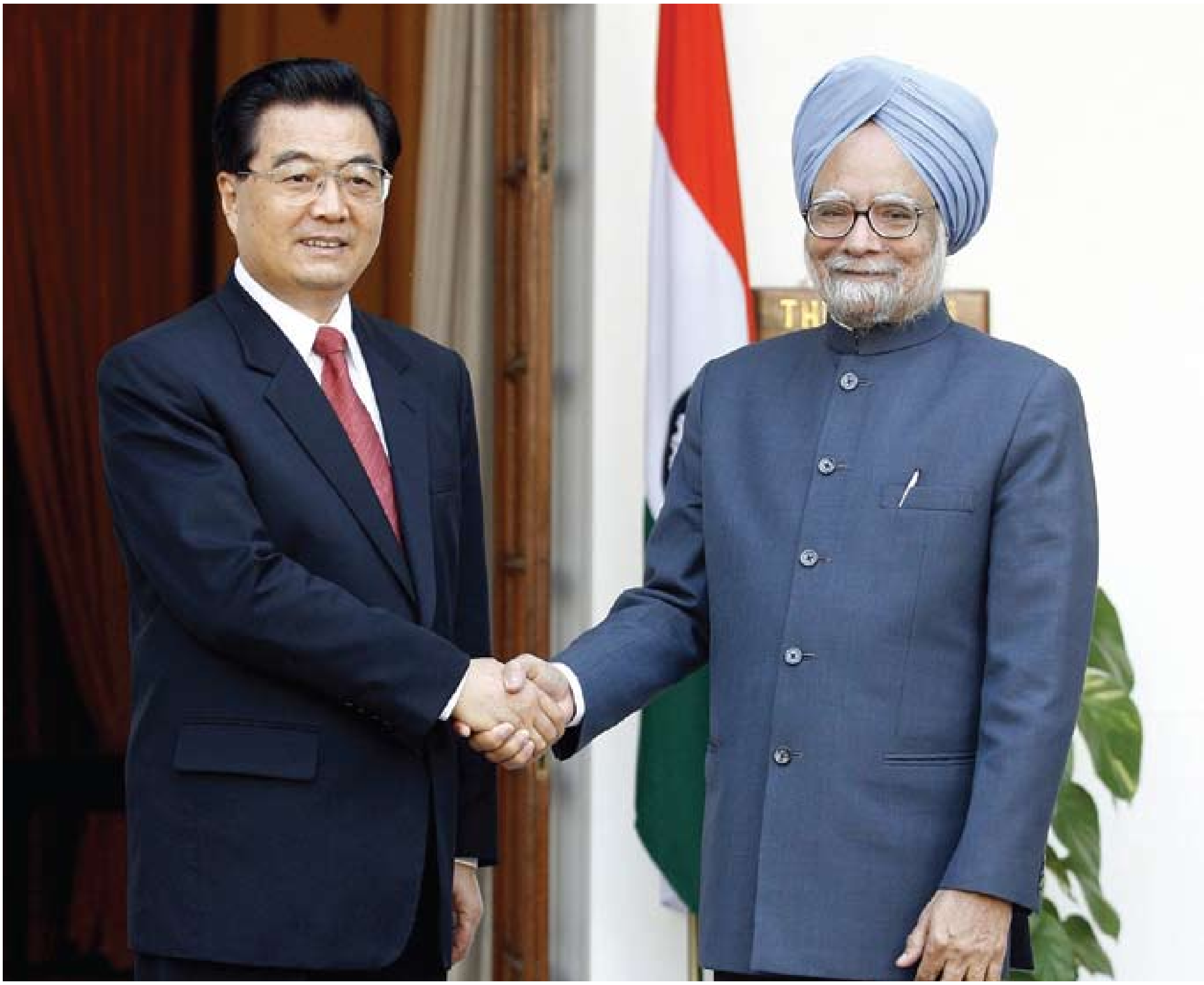

India's Prime Minister, Manmohan Singh, meets with Chinese President, Wen Jiabao.

finance minister, a mechanism should be established under the Prime Minister to monitor the implementation of the stimulus package and also to undertake some much needed reforms. Such monitoring would for example have revealed that non-food credit has actually contracted both in November and December. The contraction has been of the order of Rs 30000 crore compared to October levels. On Friday 16 January, commercial banks parked nearly Rs 39 000, under the reverse repo window, which is more than seven times the amount (Rs 5035 crore) borrowed from the RBI at repo rates. This amply demonstrates commercial banks inability or unwillingness to advance credit. It is important at this stage for the RBI and the government to discuss with the banks the reasons that are preventing banks from advancing credit despite the liquidity that is now at their disposal. Simply ordering the banks to lend more will only increase the share of directed lending which inevitably results in rising levels of non-performing assets. RBI needs to explain the reasons for which it still pays a 4 per cent interest on funds parked with it when it wants the banks to lend more. And the government should immediately consider lowering the guaranteed returns on small savings and employees provident fund so that the cost of deposits can be brought down. There will hardly be any recovery without bringing down the cost of capital for the large body of investors, especially small and medium enterprises. EAFQ

PICTURE: PHOTOGRAPHER NAME

'Vietnam faces structural challenges, but the policy response is lacking'

Vietnam: a switch from growth to stability

DOAN HONG QUANG

Vietnam began the year 2008 with high expectations. There was exuberance at the admission to the WTO and record growth of 8.5 per cent was recorded in 2007. The government set an even higher target in 2008, aiming for growth at 8.5-9 per cent.

Events took a seemingly unexpected turn. Signs of overheating, already evident at the end of 2007 amidst the asset bubble and rising inflation, became more and more visible towards the end of the first quarter.

The VN index lost almost 45 per cent of its value in just the first three months. The CPI was already running at 9.2 per cent for the first quarter, corresponding to a year-on-year rate of nearly 20 per cent, much higher than in neighbouring countries. Inflation rose from month to month and peaked in August, when the year-on-year rate reached 28.3 per cent.

To some extent, the price hike resulted from the surge of world prices, especially food and fuel prices. With a very open economy and a stable exchange rate, price rises in international markets were transmitted directly to domestic prices. Vietnam still maintains controls over prices of some essential goods and services, but the evidence shows that there were close correlations between the movements of international and domestic prices in controlled commodities.

The overall increase of world prices aside, the macro turbulence in Vietnam in the fist half of 2008 was essentially home-made. Policy responses were slow and not directed at the factors behind the price hike in 2007. Of particular concern were the large inflows of foreign indirect investment and the extraordinary (and related) high rate of credit growth.

In March 2008, the year-on-year rate of credit growth reached 63 per cent, driven largely by excess liquidity and speculative investment in the stock market and the real estate sector. Massive capital inflows caused upward pressure on the Vietnamese Dong, which threatened to reduce the competitiveness of exports. In response, the State Bank of Vietnam (SBV) bought more than 10 billion U.S. dollars in a single

year and consequently injected large amount of cash into the economy.

Vietnam was thus confronted with the 'impossible trinity' of simultaneously trying to maintain a virtually fixed exchange rate, an open capital account, and an independent monetary policy. Attempts to sterilize interventions in the foreign exchange market did not succeed and the accumulation of reserves led to an expansion in the monetary base.

A potential adverse impact of high inflation in the presence of stable nominal exchange rate is the loss of competitiveness for the Vietnamese economy against its trading partners. As inflation in Vietnam was much higher than in its main trading partners, there was a significant appreciation the Vietnamese Dong in real terms. There was also the threat of a widening trade deficit, already at 15 per cent of GDP in 2007, and weaker export growth.

High inflation and the resulting instability prompted the government of Vietnam to act and, in March 2008, a stabilization package was launched. The package saw a switch in priority from high growth to stability and included credit tightening, spending cuts and above all, a reduction in the growth target to 7 per cent, much lower than the initial figure set at the end of 2007. Credit growth was to be brought down to 30 per cent in 2008 by a number of measures, notably the sharp increase in the benchmark interest rate, from 8.75 to 12 per cent in May, then 14 per cent in early June. Greater flexibility was also imposed on the exchange rate.

The package also included contractionary fiscal policy measures such as cutting government spending, cancelling inefficient public investment projects and postponing new projects. By May 28, ministries, provinces and the state economic groups had reportedly decided to postpone, delay or stop nearly 1000 projects, equivalent to 7.8 per cent of the total investment budget.

The stabilization package seemingly worked well in dampening the overheated economy. Credit growth was brought under control. The three month moving average of CPI declined rapidly after May and the consumer price index declined after October.

Yet as Vietnam barely struggled out of the home-made turbulence, the world financial crisis caused the broader economic environment to deteriorate dramatically. Like many other open developing economies, Vietnam was inexorably engulfed by the crisis. The adverse effects of the global downturn were visible in the last few months of 2008. Exports declined in 3 consecutive months after September 2008, and only increased slightly in December. Although FDI commitments reached a record of US$ 64 billion, three times those of 2007, FDI disbursement has slowed in recent months. Perhaps the most visible effect has been seen in manufacturing employment. Reports from a sample of 461 firms in Ho Chi Minh City showed that more than 20 per cent of the workers of these firms have already lost their jobs. Nonetheless, the number of reported strikes increased rapidly in 2008.

Against the backdrop of a global recession, an expansionary package was introduced at the end of 2008. Loosening monetary policy saw interest rates cut to 8.5 per cent over a short period of time. A stimulus package of US$6 billion was proposed that includes substantial tax reductions and investment in infrastructure. Important social protection measures, including introduction of unemployment benefits and a 50 per cent increase in the poverty line, were part of the package. The consensus, however, was that appropriate intervention should have economic stability as the first priority. Inflation remained high at 23 per cent in 2008, and the stimulus package should avoid causing another wave of price surges.

Overall, Vietnam performed relatively well in 2008. GDP grew at 6.23 per cent and registered FDI reached a record high. Exports grew much better than those of neighbouring countries, at nearly 30 per cent, even though the increase in world prices played an important role in this achievement.

This year will be more challenging for Vietnam. The crisis in 2008 revealed serious structural weaknesses in the economy. Vietnam is an economy in which growth is still highly dependent on external demand and external financing. With high levels of current budget deficits, trade deficit and inflation, and decreasing oil revenues, the room for manoeuvring aggregate demand is likely to be limited. The hotly debated stimulus package barely touches upon these structural weaknesses, and is likely to foster inefficiency and waste public resources if not properly designed and implemented. Above all, the delayed and ad-hoc responses to overheating and price overshooting, and conflicting stimulus package proposals are all evidence that Vietnam still lacks an effective mechanism for informed and systematic policy-making. EAFQ

Are Chinese policymakers getting it right?

YIPING HUANG

China enters 2009 in a vastly different situation from what it was in a year ago. At the beginning of 2008, the biggest macroeconomic challenges were overheating and inflation. Now, they are a slump in growth and deflation.

This sea change within a matter of 12 months had no single cause. The People's Bank of China (PBOC) continued to tighten monetary policy aggressively during the first half of 2008, including significant rate hikes and rapid currency appreciation, in order to control inflation. But global recession was probably a far more important contributor to the reversal of China's macroeconomic trend. Since mid-2008, industrial production has decelerated sharply, power generation has collapsed, and even the growth of exports turned negative in recent months. The Purchasing Managers' Index (PMI) already pointed towards a deep manufacturing recession in China.

The latest data have prompted many market economists to revise down significantly their 2009 GDP forecasts. This is probably an overreaction. First, current headline production and GDP data overstate the slowdown in underlying demand. Growth of fixed asset investment has only moderated slightly, growth of retail sales held up quite well, and trade surpluses actually surged. According to the Deputy Governor

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'Deflation is likely to return and corporate earnings will suffer greatly.'

of PBOC, Yi Gang, the difference is explained by inventory adjustment. Given the collapse of commodity prices and the darkening clouds surrounding the economic outlook, companies began to slash their material inventories, leading to faster slowdown in production than in demand. Once inventory adjustment ends, probably during the first quarter of this year, according to Yi Gang's estimation, production could rebound sharply.

More importantly, the government still has the will and capability of supporting growth at around 8 per cent. Some economists have argued recently that the Chinese government won't be as successful as 10 years ago because now 37 per cent of the economy is directed to exports and 60 per cent of the economy is accounted for by the private sectors. It is true that the Chinese economy is a lot more market-oriented today. But that by no means implies that the state's ability to influence economic activities has diminished significantly. The state still controls 43 per cent of fixed asset investment and 60 per cent of banking assets. Fiscal revenues as share of GDP increased from 11 per cent in 1997 to 21 per cent 2007. In early November, the State Council announced a package of RMB4 trillion to stimulate domestic demand in 2009-2010. In the following months, provincial governments proposed investment plans totaling Rmb25 trillion, which is equivalent to 100 per cent of 2007 GDP.

All recent official statements confirm that maintaining 8 per cent growth has become a political as well as economic policy priority. And we can be confident that the government can achieve this goal, at least for the next year or two.

> Unfortunately, the biggest challenge will probably occur after 2010. Essentially this is because the current stimulus packages are likely to be effective in supporting growth, but are probably sub-optimal in improving growth quality.

This sounds like a very positive story. But that's not the end of it. The government should be able to support growth, but it won't be able to support profits or income. In fact, deflation is likely to return and haunt China again in 2009. During the past 10 years, China suffered from a deflation problem twice - first during the 1998 Asian financial crisis and second following a mild recession in the U.S. in 2001. During both episodes, deflation was directly caused by collapse of export growth and emergence of overcapacity. If the same causation still exists, then we are likely too see much more serious deflation in 2009 — not only are exports a much greater component of GDP, but the collapse of external demand will be more severe and broad-based.

Deflation can create room for more aggressive policy easing. But it's bad for profits, investment and, therefore, employment and income. In other words, we are likely to see a soft landing in headline growth but a hard landing in corporate earnings. It will be tough for investors, who will likely need to focus on those GDP proxies (such as utilities), low-income elasticity items (such as consumer staples) and beneficiaries of stimulus packages (such as commodities).

Unfortunately, the biggest challenge will probably occur after 2010. Essentially this is because the current stimulus packages are likely to be effective in supporting growth, but are probably sub-optimal in improving growth quality. For years, the government has been trying to rebalance the growth model, reducing reliance on exports and investment. But of the RMB4 trillion announced by the State Council, at least three quarters of the package are for investment projects (RMB1,800 billion on railways, highway, airports and power grid, RMB1,000 billion for post-earthquake reconstruction Rmb280 billion for low-rental housing). The RMB25 trillion projects proposed by provincial governments are almost exclusively for investment expenditures.

The massive spending will surely ensure the government's 8 per cent growth target will be met. But it may bring its own problems. First of all, the massive increase in investment is likely to make China's growth model even more unbalanced. Of course China still needs more infrastructure, but imagine what happens if it invests an amount equivalent to the size

A minimum 8 per cent growth has become the universally accepted target in China. It has almost become a religion - everybody believes it, but nobody can explain exactly why. The most authoritative answer is social stability.

of 2007 GDP within two years, not to mention the inefficiency, waste, bad planning and even corruption problems. More importantly, this kind of stimulus package is not sustainable. So the ideal scenario is that the world economy recovers before the stimulus packages end. Then the export engines can operate at full speed again. And GDP growth can return to high gear.

There is one small problem. After this crisis, import demand from the US is likely to fall. As Citigroup forecasts, the US household saving rate is expected to rise from around 1 per cent last year to 5-6 per cent over the next two years, while the US current account deficit may fall from 4.5 per cent of GDP to around 2 per cent. This could mean that China may not be able to export as much as it used to before the crisis. And in order to maintain rapid growth, China will again be forced to turn to boosting domestic demand. China and other Asian economies were able to export their way out of recession after the 1998 Asian crisis, but they won't be able to do the same this time around. For all these reasons, the government needs to focus more on boosting consumption than on promoting investment during the current round of stimulation.

A minimum 8 per cent growth has become the universally accepted target in China. It has almost become a religion - everybody believes it, but nobody can explain exactly why. The most authoritative answer is social stability. In order to maintain social stability, China needs to create 10 million jobs (inclusive of 8 million new labor market entrants) every year, and that translates into 8 per cent growth.

This argument has a number of problems. Firstly, the correlation between job creation and GDP growth is clearly non-linear, depending on the structure of economic growth. Building railways and highways do not really create many urban jobs, and certainly not sustainable urban jobs. And during the 1990s, new job market entrants were about 8 million a year. New entrants fell to about 5 million during the current decade and may fall into the negative during the next decade. So perhaps the growth rate necessary to sustain full employment will also fall over time?

If social stability is the primary policy objective, perhaps it would be more effective to attack the problem directly? For instance, spending most of the RMB4 trillion or even RMB25 trillion on social security, tax cuts or even giving out consumption coupons would be more effective for maintaining social stability. If low-income households receive better income support and migrant workers become entitled to unemployment benefits, then it wouldn't be that devastating even if growth dropped below 8 per cent. In fact, because that would improve social security and income distribution, it should also boost consumption over time. To be fair, the government has been making efforts to improve social security and income support. The RMB4 trillion package contains spending items such as rural social security and healthcare. Policymakers have also been designing new measures to improve pensions and minimum income support, to increase farmers' income, and to improve healthcare and other social welfare systems. But the spending committed to these items looks tiny compared to investment expenditure. One reason for this bias is because the impact of infrastructure spending on growth is felt much faster. Yet it may also be related to the political system - in a democratic system politicians may be more willing to cut taxes since it helps election prospects, whilst in an authoritarian system big image projects are much more effective in facilitating promotion.

China is likely to maintain 8 per cent growth over the next year or two. But deflation is also likely to return and corporate earnings could suffer greatly. The biggest challenge will be after 2010. Even if the global economy recovers by then, China may still be forced to adjust toward domestic demand when stimulus measures run their course.

Policymakers are already aware of the structural problem. Hopefully they will make efforts to optimize sources of growth over the next two years, while lifting rates of growth, and that could make the post-2010 transition smoother. But so far this outcome remains only a hope. EAFQ

World financial crisis: a view from Japan

YOICHI FUNABASHI

PICTURE: PHOTOGRAPHER NAME

'The magic is over.'

So said French Foreign Minister, Bernard Kouchner, referring to the financial crisis that originated in Wall Street and the battered global standing of the United States.

Under a formula of low interest rates and financial leverage, the US government and investment banks choreographed an asset-inflated housing-bubble boom, enabling Americans to go on a spending free-for-all on the strength of debt.

That alchemy no longer works.

The credit crunch spread from the financial arena to the automotive sector, along with discount stores and government, eventually hitting family finances hard and dragging the global economy into recession.

Against this backdrop, Americans elected Barack Obama, a Democratic Senator from Illinois, as the country's first black president.

'America is a country where everything is possible again,' said former British Prime Minister Tony Blair of Obama's victory.

In this historic outcome, Blair surely must have glimpsed the magic of democracy through 'choice' by the people.

Turbulent changes have confronted the United States and elsewhere throughout 2008.

Iceland was part of the story. The crisis facing the Big Three U.S. automakers shows that the very foundation on which the auto industry stands, not only in the United States but elsewhere in the world, has been drastically shaken.

Global climate change and the deepening energy crisis are prodding the world to shift from a petroleum-dependent, automobile-based civilization to low-carbon societies: we see the stirrings of this change through efforts like those to promote solar power generation.

In our neighbourhood, China is on a path to becoming a global power, while burdened by its infringements of human rights, media control, income gaps and environmental degradation. Symbolically, a man dubbed 'the Olympics prisoner', a former factory worker, was charged with inciting subversion of state power after protesting alleged medical malpractice and calling for 'human rights, rather than the Olympics'. The Chinese authorities are also working to control and even formulate 'public opinion' on the Internet.

Japan and the rest of the world are becoming inseparably and intricately linked. People's lives and jobs are affected by developments not just in Wall Street, the City of London or Shanghai but in Dubai, Mumbai, Peshawar, Lagos and even in the Arctic.

The global financial crisis will likely further drive Japanese workers, who are increasingly shifting to non-regular positions, as the traditional Japanese employment system flounders, into a situation where workers become little more than drifting, discrete sand particles.

The reality of the ever-liquefying workplace and the condition of the new working poor is exemplified, for example, by a 39-year-old man who asked an NPO for help with only 100 yen in his pocket after having to hop from one piecemeal job to another. A day in the life of a middle-aged freight trucker involves spending 12 straight nights in the vehicle delivering goods for a lower-echelon subcontractor.

What lies at the root of these problems are the fraying 'public' systems.

Public infrastructure is coming apart at the seams as we see the many problems in medical care, pension, education and public safety.

Rebuilding the 'public sector' is indispensable to reviving capitalism, even though there is no alternative to capitalism but capitalism itself. Making up for deficiencies in the market requires imposing rules of fairness in the market, maintaining jobs for workers and providing stability for societies.

Robust public systems are essential for that purpose.

The first step to realize it is to give the nation an opportunity to choose a clear policy platform and an administration.

The open seams in public systems can also be seen in the weakening functions of debate (analysis, commentary and proposal) on public policies, despite a flood of information.

The challenge in 2009 is to contribute to the debate on the choices that now have to be made.

Yoichi Funabashi is Editor-in-Chief of the Asahi Shimbun, a leading Japanese daily, and one of Japan's foremost commentators on foreign affairs and public policy. EAFQ

Balancing the long with the short

PICTURE: PHOTOGRAPHER NAME

Australian Prime Minister Kevin Rudd's first year in office was nothing if not challenging

GEOFFREY BARKER

The Australian Labor government's first full year in office became a momentous political and economic challenge as it moved to deal with the impact of the deepening global financial crisis while seeking to advance national foreign policy and security interests. By year's end it seemed inevitable that Kevin Rudd's government would be judged primarily by its economic management over 2009-10.

But Rudd remained committed to expanding Australia's role as an activist, if largely conformist, middle-power. Despite changes of emphasis, and new multilateralist initiatives, he left little doubt that there would be more continuity than change in Australian foreign and defence policies while the government's economic management would be cautious, orthodox but consistent with giving a nudge to global big spending stimulatory economic policies.

A clear mark of Rudd's caution was the minimal greenhouse gas reduction targets announced towards

the end of the year. The decision pleased Australian business, but it seemed at odds with the fanfare and the bloated rhetoric that surrounded Rudd's early prime ministerial decision to sign the Kyoto accord.

In broad strategic terms Rudd Labor in 2008 was trying to balance and to respond to the short-term and long-term challenges facing Australia. The major short-term challenges were economic: the financial crisis, falling employment, and concerns within Australia's ageing population over superannuation and savings losses. The long-term challenges were geo-political: historic demographic and economic shifts that could diminish Australia's regional and global relevance, the rise of China and India as major regional powers, and the global impact of climate change.

These short-term and long-term challenges were connected. The geo-political implications of the financial crisis were coming into focus by the end of the year, although questions were clearer than answers. What would be the security consequences of a major collapse of Chinese economic growth? Would the world economy be able to avoid devastating protectionism? Would Australia face more markedly authoritarian, ambitious and expansionary regional states and leaders if the world economy did not recover reasonably quickly? And how would climate change impact on global security and security relationships.

The Rudd government's response to the economic crisis, like that of most countries, was to introduce stimulatory economic packages to encourage spending. At the end of the year the packages totalled some A$22 billion with promises of more to come if necessary. At the same time interest rates tumbled as the Reserve bank moved to ease the economic pain of home-buyers with mortgages. The government claimed Australia could still avoid recession and a deficit budget, but it was going to be a close-run thing if it did.

> A clear mark of Rudd's caution was the minimal greenhouse gas reduction targets announced towards the end of the year.

Rudd proved an inveterate traveller in the pursuit of Australian diplomatic and security interests. His efforts were perhaps most dramatically focused when he attended the G20 meeting on the economic crisis in Washington in November, but his travels took him to the US, Britain, China, Japan, Malaysia, South Korea, Singapore, Indonesia, New Zealand, Romania, Belgium, Peru, and Afghanistan.

In multilateral mode Rudd proposed, with little promise of immediate success, the establishment of an Asia-Pacific security community; he established a commission under former Labor foreign affairs minister Gareth Evans to pursue the eventual elimination of nuclear weapons; he launched a new bid for an Australian seat on the United Nations security council.

In bilateral mode he stressed the importance of Australia's relationship with the US and was delighted by Barak Obama's election. He also sought to use his knowledge of China and its language to advance Australian interests in the middle kingdom. Rudd responded quickly to criticism that he had ignored the importance of Japan, and made a hastily organised visit to Tokyo.

Rudd made it clear that he would not modify the massive rearmament program put in place by the former government –although it remains to be seen how the demands of the financial crisis will affect Australian plans to spend tens of billions of dollars on new fighter aircraft, surface ships and submarines. Canberra defence orthodoxy maintains that Australia has to maintain a technological edge over regional powers because the country has a relatively small population from which to draw its military forces. How successfully it can continue to do is still unclear.

A national security policy statement released late in the year was received with faint and generally damning praise and a definitive statement of long-term national security policy is expected in a new defence white paper due around March 2009. A major issue for Rudd will be how to respond to expected US pressure to commit more troops to Afghanistan.

The future of the Rudd Labor government already looks like being determined by how successfully it can balance the inter-connected demands of economic crisis management with the demands of defence and security management in a dynamic and uncertain regional security environment. This will not be an easy job.

China: testing for a major role on the world stage

PICTURE: PHOTOGRAPHER NAME

The Olympics pushed China to centre stage, but it still needs to address key issues.

YONGSHENG ZHANG

The Chinese people had high expectations for a smooth and fruitful year at the beginning of 2008 – the year of the Beijing Olympics, the 30th anniversary of China's reform, and a number in Chinese culture signifying good luck and good fortune.

As it turned out, 2008 was a year in which there was as much bad luck as good. In February, southern China was lashed by a severe snow storm; in March, social turmoil in Tibet; in May, the devastating earthquake hit Sichuan; and the Olympic torch was met by protests in some Western countries.

The Olympics in August were a stand-out and government and land reforms were welcomed. But after the Olympics, the world was thrown into economic crisis, and China had to turn to fighting the rapid onset of economic recession. The poisoned milk scandal also took place.

These were no trivial tests of the achievements of 30 years of reform. The scale of China's growth and its speed is without precedent in world history. But the question remains: how resilient to natural and social disasters is the new China? And what further reforms are needed to assure a harmonious role in the world?

The two natural disasters that preceded the Olympics revealed China as a large economy, but not a strong one. The snow storm left millions of travelers and families

shivering and stranded, and a large part of the country in shambles, its people exposed to the vagaries of nature.

The deadly 8.0 M Sichuan earthquake on 12 May, claiming almost 100,000 lives, also exposed the fragility of Chinese infrastructure – despite the worldwide admiration of China's rescue efforts and the formidable courage and compassion of the Chinese people at its epicentre. During the first couple of days, no contact was possible with the outside world from the earthquake zone and many lives were lost because of poor rescue equipment and the collapse of low-quality buildings.

The melamine milk scandal broke in July and by November China reported an estimated 300,000 victims: many infants died from kidney stones and other kidney damage. The World Health Organization referred to the event as one of the largest food safety events it has had to deal with in recent years.

The milk scandal exposed a host of problems: poor governmental supervision, inadequate law enforcement, and the power of special interests amongst them. The milk scandal also exposed a more general problem of food safety in China, and China has moved to adopt stricter measures to ensure the food safety. After all, GDP is only part of the story of development: people's lives, protection and living standards are the ultimate purpose of economic development.

With the Olympics, China moved to centre stage in living rooms around the world.

As China stepped up onto the international stage, the inevitable question was how should China seek to understand the world, and how should the world seek to understand China. The Beijing Olympics was a good first test in examining this question.

As the Chinese people were preparing to show their hospitality to the world, the torch relay was met by violent protests in some western countries about a range of political issues. Some western politicians even called for a boycott of the opening ceremony. This caused many Chinese people to rethink the relationship between China and the west.

Eventually, China hosted an 'exceptional' Olympics with a spectacular opening ceremony, and efficient organization, involving thousands of dedicated volunteers. The Olympics saw many western people change their view of China after experiencing the reality in China and seeing Chinese people up close. Thanks to the Olympics, China has also become a more open and tolerant, as well as a more tolerated, society.

In 2008, China restructured government through the creation of 'mega-departments'. The number of ministries was reduced from 31 to 27. The target is to establish a service-oriented government and improve governance efficiency through streamlining the overlapped functions of different government departments.

An important milestone event in 2008 was the land reform at the 3rd plenum of central committee of CPC. The duration of farmer's land use right was extended from 30 years to 'long term', and farmer's interests and rights are to be strictly protected under new laws. Though the transaction of land use rights is not the focus, the door is now open for transaction in land and for capitalist agriculture.

Other major reforms included: value-added tax reform to eliminate the overlapping taxes and encourage equipment investment, and fuel tax reform to abolish the road maintenance fees and other charges.

This was a year to test the ability of China's economic team in tackling new and complex economic problems. Though these tests were huge and are ongoing, 30 years of experience in policy development has created, it is fair to say, a considerable legacy in policy management skills within the leadership team.

At the beginning of last year, the priority of macroeconomic policy was to control inflation and prevent overheating of the economy (so-called two 'prevents'). The Chinese boom was driven by export-oriented growth and related investment spending. Two interdependent steps were required: one to balance China's trade surplus through RMB appreciation, reducing export-tax rebate, and other trade policies; the other to transform China's economy from export-oriented to domestic market based growth. If it hadn't been for the financial crisis, the expectation was that this might be achieved smoothly within 3 to 5 years.

Mid-year, there were already signs that overheating was no longer a serious problem, and China's economic growth was about to slow. The central government promptly adjusted the policy from 'two prevents' to 'ensure stable economic growth and control inflation'. Monetary and fiscal policies were relaxed accordingly.

In the fourth quarter, the world economic crisis deteriorated rapidly and China's downturn was

worse than expected. The central government initiated 4 trillion yuan economic stimulus package in November and introduced measures to stimulate consumption and exports.

The estimated 9 per cent growth in 2008 is not bad, but many investors suffered in the stock market collapse as the Shanghai Composite Index plummeted by 65.5 per cent. The ups and downs of international commodity market also had a negative impact on the Chinese economy and taught Chinese investors a serious lesson on market risk.

The most immediate challenge is to tackle the current economic crisis and hold growth up at around 8 per cent in 2009. The medium and long term challenge is how to improve China's market system and political institutions.

This year is the 60th anniversary of the foundation of the People's Republic of China. The economic blueprint for 2009 was outlined at the three-day Central Economic Work Conference at the end of 2008. The primary goals are 'ensuring high growth, expanding domestic demand, and upgrading the economic structure'.

The growth target in 2009 is set at 8 per cent. Though 8 per cent would be the lowest growth rate in China since 1997, it would be a relatively high growth in the context world recession. The biggest uncertainty for China's own performance is where the world crisis heads in 2009.

The inflation target is 4 per cent. If exports continue to drop, there could be deflation but the proposed reforms in the resources sector could be inflationary. The acceleration in government spending could also translate into inflation.

As China stepped up onto the international stage, the inevitable question was how should China seek to understand the world, and how should the world seek to understand China

Though China's trade surplus in November 2008 reached a record high, the overall contribution of the trade surplus to its GDP growth is likely to have been negative or zero in 2008. Though the transformation of China's economic growth pattern requires balanced trade, trying to achieve trade balance through the financial crisis would have a negative effect on the economy. In 2009, China will try every effort to stimulate its export.

The biggest challenge is employment. China needs to create about 10 million new jobs each year to absorb labor growth. A sizable proportion of the unemployed are migrant workers who have land in their hometowns. This is one reason why China is very cautious in dealing with the issue of land privatization. Access to land plays a role in security for migrant workers.

The 4 trillion yuan stimulus package ushered in an 'active fiscal policy and appropriately easy monetary policy'. Government and government-related investment is growing quickly, but private investment remains in the doldrums. A major problem for China's economic growth is how to stimulate private investment (a core element in growth in the past) and private consumption.

The key will be further reform. The recession actually provides the chance to wind up the momentum of reform in 2009. Expanding the domestic market and upgrading industrial production requires reforms in line with 'liberalization, deregulation and decentralization'. These reforms are necessary to make the market system work better.

To stimulate private investment, China needs to get rid of barriers to entry barriers in sectors that are monopolized (such as telecommunications, transport, urban utilities, financial sectors, healthcare, education), and reform its investment system. To expand domestic consumption, social security and healthcare system must be reformed. As inflationary pressure is alleviated, energy and resource price reforms can also be introduced.

If economic power can be called hard power, then what China most needs to improve is its 'soft power' through strengthening institutions and instigating a cultural renaissance. China is a country with 5,000 years of civilization. It was one of the most prosperous countries in the world until industrial revolution in the 18th century. The economic success in the past 30 years has imbued the Chinese people with a strong sense of optimism and confidence in the future. A civilization that has survived 5,000 years, can now build a culture compatible with the pillars of modern civilization in a globalised world: a strong market economic system and democracy. EAFQ

A test of political leadership

PICTURE: PHOTOGRAPHER NAME

South Korean President Lee Myung-bak: getting Korea's economy back on track is a political challenge.

SOOGIL YOUNG

Lee Myung-bak, the candidate from the conservative Grand National Party, won the Presidency of the Republic of Korea on 17 December 2007, with an unprecedented margin over his main opponent. The landslide victory provided a strong mandate for him to undo most of what had been done by his populist predecessor, President Roh Muh-hyun.

Roh had sought to undo what he thought were the injustices that the engineers as well as the beneficiaries of Korea's industrialization between the 1960s and 1990s had built into the economic and political system.

Roh's favourite keyword to describe the economy was 'polarization,' a phrase meant to highlight what he believed to be deepening divisions in the Korean economy and society: between big Chaebol businesses and small and medium enterprises; between the rich (whom he considered morally corrupt) and the middle class and the poor; and between the populous and dynamic greater capital region around Seoul and the vast but 'hollowing-out' countryside.

Roh pursued regulation of Chaebol businesses while offering strong, though not necessarily effective, support for SMEs, a punitive tax policy for the rich and redistributive measures for the lower income class, including pro-union policies and a policy of curbing scholastic competition among ranking secondary schools (which he thought discriminated against students from this income class), as well as a number of initiatives to force dispersion of the government offices, public corporations, and industries over to the countryside and away from the greater capital city region. These policies were the prescription of the 'progressives' who argued for regulation of big business, and redistributive tax and budget policies, most of which embodied a rejection of small government. This 'redistribution' strategy was constantly criticized and opposed by the 'conservatives,' consisting of the politicians aligned with the big business groups, the business groups themselves and many independent opinion makers, who argued for an 'economic-growth first' strategy.

The irony is that the various symptoms of polarization which Roh's redistribution-first approach was meant to ameliorate in fact worsened, rather than eased, under his watch, causing widespread discontent and anxiety over the state of the economy. Given the failures of the progressives' economic policy agenda, perhaps any candidate from GNP could have won the election. But Lee's landslide victory owed much to the expectations that he had generated among the voters, as the

former successful CEO of a major big corporation, Hyundai Construction, that he would restore the growth and dynamism for the economy. His pledge to realize a growth rate of 7 per cent during his five year term was the anchor of these expectations.

The performance of the Lee government in managing the economy in 2008 has been disappointing. It is not so much the failure to deliver a high growth rate per, but more the headstrong and heavy-handed pursuit of high economic growth, including the ill-advised attempt to depreciate the won against the US dollar in order to artificially boost exports as the main growth engine, and other policy bungles. These policies caused serious confusion in the foreign exchange and financial markets and exacerbated the inflationary pressure being fed by the rising prices of oil and natural resources. It had to be abandoned with the growth forecast for the year revised downward to 4 per cent even before the onset of the global financial crisis.

There were other developments which undermined the market and people's confidence in the ability of Lee to deliver on his promises. The most serious was the political fiasco in pushing the removal of the prohibition on the import of American beef that had been put in place in response to the discovery of a cow infected with BSF (mad cow disease) in the US. This policy reversal was agreed with the US government in April in a manner that appeared to indicate that it was a political gift from President Lee to President Bush, intended to appease the Congressional critics of the Korea-US FTA at the expense of the public health concern for

The current crisis has exposed fault lines in the lending practices of the commercial banks toward housing construction projects.

the Korean people. As if to confirm this suspicion, the agreement was reached and announced just one day ahead of the Camp David meeting between the two presidents. Leftist NGOs and some media, who had been unhappy about Lee's victory, fanned these suspicions so effectively that the mass candle-light protest demonstrations over the subsequent two months came quite close to toppling the government. Lee's policy team, including the ministers in charge of health and agriculture, were so inept in responding to the attacks and demonstrations that they only exacerbated the situation. A failure of Korea's representative democracy during the parliamentary transition period contributed to Lee government's political crisis. The situation began to improve in late June when he issued an apology to the people, replaced some of the ministers, and renegotiated the beef deal with the US.

The global financial crisis, which began to affect the Korean economy in September has now gripped Korea, causing a sharp depreciation of the won against the dollar, The battering the stock market, followed by a serious credit crunch, continued downward adjustment of the growth rate forecast for the economy in 2009 from 4 per cent to 3 per cent, and further to 2 per cent, with the IMF calling for a growth rate of 2.0 per cent at the end of November.

The current crisis has exposed fault lines in the lending practices of the commercial banks toward housing construction projects and for the small and medium construction companies engaged in those projects. Getting wiser over time through trial and error, the government has in recent weeks and months taken a series of measures to recapitalize the banks and restructure the construction industry, in addition to introducing a series of broad measures to stabilize the foreign exchange, financial and capital markets, and to stimulate aggregate demand.

Fortunately, the reform and restructuring measures which were undertaken in the wake of the financial crisis which hit Korea in 1997-1998 has made Korea's corporate and financial sectors more resilient so that, with those macroeconomic policies and the plumbing operations on the financial sector mentioned above, the Korean economy is likely to avoid sliding further in 2009.

The real challenge facing the Korean government next year is to undertake reform measures that will help enhance the longer-term growth potential of the economy. The current crisis could discourage the government from thinking long-term and pursuing fundamental reforms. However, the current crisis can serve an important catalyst in overcoming the vested interests opposed to reforms and help the government push those reforms with a success.

It seems that President Lee has already seen this opportunity and is focused on trying to do just this. His agenda now is the removal of some politically-motivated regulation affecting big businesses and real-estate transactions; across the board tax cuts, including cutting corporate tax, reform of the public corporation sector, including downsizing of many such corporations, taming of the labor unions and the teachers' union, and as much undoing of the forced balancing of regional development as possible. In addition, he has announced, he is embarking on a vision for low-carbon green growth of the Korean economy as a long-term development strategy, proposing not only to cut carbon emissions so as to become an active participant in the post-2012 climate change regime, but also to create new growth engines out of low-carbon green industries and technologies, in order to realize high growth ambitions for the Korean economy long-term.

All these measures to enhance the fundamentals of the Korean economy will feed back into the prospects for investment and growth in 2009 and beyond, and should help restore growth dynamism. This requires effective policy implementation, and calls for the exercise of better political leadership on the part of President Lee to have his own party rally behind him and to secure the support of the opposition parties for reform efforts. In the final analysis, getting the Korean economy back on track is a political challenge – that of creating the political will to push, through the current economic crisis, the reforms to enhance the growth potential of the economy. The Koreans will be tested on how they handle this challenge in 2009. EAFQ

Not spared but prepared to manage the worst

PICTURE: PHOTOGRAPHER NAME

Australian Prime Minister Kevin Rudd: despite maintaining a strong banking sector, productivity growth in Australia has slowed substantially.

SIR ROD EDDINGTON

Australia began 2008 hoping that the growing global financial crisis might pass it by. Our major trading partners in Asia were in better shape than their American and European counterparts and our underlying economy was sound. All this is still broadly true, but it is clear that the Asian economies in general and the Chinese economy in particular are not as 'decoupled' from the global economy as many thought. Australia has not been spared from many of the economic challenges other nations face as its Asian partners struggle with problems of their own.

The new Australian Federal Government under Prime Minister Kevin Rudd has worked hard at home and abroad to lessen the economic fallout following the global financial crisis. The Australian economy has slowed significantly and this foreshadows increasing unemployment in 2009. Keeping that increase as small as possible is a priority for businesses and governments alike.

The climate change challenges remain a major issue across the nation. Ross Garnaut's report – the Garnaut Climate Change Review – has been followed by a Government initiative to reduce greenhouse gas emissions. The ensuring debate has sometimes generated more heat than light but the journey has begun and government and business will need to work together to find the best outcome.

As promised, the new government recognized the many hardships suffered by indigenous Australians since European settlement in the late eighteenth century. In apologising to them on the nation's behalf, Prime Minister Rudd began a new chapter in the journey of Australian reconciliation.

Australia's banks have fared much better than most of their global counterparts. Sound management

and sensible regulation have combined to underpin their position. They have their challenges too, but they are manageable. The last year has underlined just how important a sound banking system is to a nation's economy.

The year ahead – 2009 – brings with it plenty of economic uncertainty. However, Australia is well placed. Lower interest rates and energy costs help, and the Government's fiscal stimulus is well timed. Australia's strong trading links to Asia are broad and soundly based. They reinforce the strong government-to-government ties in the region that have been a priority for successive Australian governments.

Australia's banks have fared much better than most of their global counterparts.

Australia's challenges will require focus. National productivity growth has slowed substantially. Skills training and education must be re-energised if the country is to remain competitive. After several years of rapid growth, commodity prices will fall across the board. Hopefully, better weather will give the nation's farmers some much needed relief after a string of years of drought reduced agricultural production. Parts of the national infrastructure are badly stretched and the resulting congestion is costly to both the economy and the community.

These and other challenges must be met if Australia is to emerge from 2009 stronger and more robust. EAFQ

Resilience from a low base

JOSEF YAP

The Philippine economy slowed down sharply in 2008. GDP growth in the first three quarters of 2008 fell to 4.6 per cent, compared to 7.5 per cent in the same period a year ago. The jump in the inflation rate following a sharp rise in food and fuel prices was the first big setback. Inflation averaged 9.4 per cent in the first 11 months of 2008 after recording only 2.8 per cent in 2007.

Another factor was the sharp deceleration in construction activity following a surge related to the 2007 elections and the initial implementation of President Macapagal-Arroyo's ambitious infrastructure program. The US recession, which officially began in December 2007, was also a likely contributor to the slowdown.

The economy seems continue to slow further following the chaos in the global financial system and the recession in major economies including Germany, Japan, Singapore and Hong Kong that has followed. Key multilateral agencies are unanimous in the view that the Philippines will see lower economic growth in 2009. The IMF, the World Bank and the ADB all forecast growth around 3 per cent, or at most 3.5 per cent. Growth in 2008 is estimated at 4 per cent or a touch over. In 2007 it was well over 7 per cent.

The major reasons for pessimism are the likely lower growth in personal consumption expenditure largely due to a slowdown in overseas remittances; sluggish investment owing to the uncertain economic environment; and a drop in export growth rate due to a fall in global demand. The economies in East Asia are likely to continue to be affected by the aftershocks of the global financial crisis. The virtual freeze in liquidity in US and European financial markets has stopped and, in many cases, reversed capital flows to emerging and developing countries.

The immediate impact of the liquidity squeeze in international capital markets was a rise in the price of risk—as measured by bond spreads—a sharp drop in equity prices, and exchange rate volatility. The foreign currency government bond spread for the Philippines jumped from 155 basis points in June 2007 to 549 basis points in November 2008. The main index of the Philippine stock market fell by 45 per cent between December 2007 and November 2008. The exchange rate was also volatile, with the peso depreciating by 16.6 per cent between March 1, 2008 and November 30, 2008 after appreciating by 39 per cent against the US dollar between September 20, 2005 and February 29, 2008.

These developments are unlikely to have a lasting impact on the real sector. Rather, the Philippine

PICTURE: PHOTOGRAPHER NAME

The Philippine financial sector remained steady, but the economy has slowed.

economy may actually be spared the brunt of the fallout from the global financial crisis. Like many economies in East Asia, the Philippine financial sector has avoided serious damage. The relative resilience of regional banking and financial systems in East Asia reflects a number of factors, including: 1) the very limited direct exposure of the region to subprime and other related securitized products; 2) relatively strong bank balance sheets with a return to profitability—as impaired loans from the 1997/98 Asian financial crisis have been worked off; 3) improvements in risk and liquidity management; 4) strengthening of supervisory and regulatory systems; and 5) moves by banks into new and profitable domestic business lines such as consumer lending. The move into consumer lending implies an absence of the strong search for yield that led many banks and other financial institutions in industrialized countries to take on too much leverage and risk.

Ironically, the resilience of the Philippine economy is due to factors that limited its growth during the past 3-4 decades. The synchronized economic recession among major global economies will clearly lead to lower exports and foreign direct investment. Philippine exports, however, have relatively low value added in terms of contribution to GDP. FDI has not played the same critical role as it did in Malaysia, Thailand, Indonesia, China and Vietnam. Meanwhile, domestic private investment has been moribund during the past 10 years and there is little room for further deterioration. Remittances are still expected to grow between 6 to 10 per cent in 2009 and this remains a substantial source of growth since remittances are equivalent to 10 per cent of GDP. The improved inflationary picture should also help cushion the economic slowdown.

Another favorable development is that unemployment rate in 2008 rose only slightly to 6.8 per cent in 2008 from 6.3 per cent in 2007. This is also much lower than the unemployment rate over the past 20 years. The performance in the fourth quarter of 2008 will provide a clue as to the trajectory of the economy in 2009. A fourth quarter GDP growth above 4.5 per cent will augur well for a higher than forecast 2009 GDP growth, closer to 4 than 3 per cent. This outcome should hardly be a cause for satisfaction on the part of policymakers. The Philippines has one of the worst records in terms of poverty alleviation in East Asia, importantly it has not yet broken out of its low-equilibrium growth trap. EAFQ

The unlikely star

HADI SOESASTRO

Indonesia entered 2008 on a note of optimism. In the previous year, the economy grew by 6.3 per cent, better than its neighbours (with the exception of Vietnam and China). The government aimed at achieving 6.5 per cent growth in 2008. While, at the end of 2008, there are a great many anxieties about the impact of the global financial crisis on Indonesia and the region, the latest estimates suggest that Indonesia could still grow by 6 per cent in 2008. It could end up being a star performer in the region. This, the minimum growth rate to produce sufficient jobs, may be difficult to maintain in 2009.

Indonesia is an open economy, and must remain open. Although its banking system is much stronger than a decade ago, the economy remains vulnerable to a sudden halt and reversal of external financial flows.

Fortunately, the country faces this economic challenge with a much improved political situation at home. In 2008, Indonesia is entitled to celebrate a decade of democratization. It has undergone a remarkable political transformation. It successfully conducted democratic elections in 1999 and 2004 at the national level and, since 2005, has seen over 450 local elections take place without major incident. The fourth most populous country, home to the world's largest Muslim community can also pride itself on being the world's third largest

A great deal of Indonesia's attention still has to be devoted to its internal development. Poverty and growing inequalities continue to be the main problem.

democracy. It is fitting that in December 2008, through its initiative, Indonesia hosted the Bali Democracy Forum, attended by 32 Asian countries (including Australia), with the aim of fostering democracy in the region. This was a major initiative that provided an opportunity for regional countries with different political systems to talk about a subject that is considered sensitive. At the end of the Forum, participants agreed to strengthen democratic systems in Asia and to hold annual meetings at the ministerial level in Bali. This will likely boost Indonesia's international standing, at least in the politico-diplomatic realm. As Time magazine observes (22 September 2008), Indonesia 'has emerged as Southeast Asia's unlikely star.'

There is the view that Indonesia must play a more pro-active role in its own immediate neighborhood, through ASEAN. It must, therefore, provide a leadership role in faithful implementation of the ASEAN Charter in accordance with the spirit that emanated from the ASEAN Bali Concord II of 2003 that aimed at creating an ASEAN Community. This was the condition under which the Indonesian parliament ratified the watered-down ASEAN Charter. It remains to be seen how committed Indonesia will remain in reality –rather than in rhetoric—to ASEAN as it may have already outgrown ASEAN. By becoming a member of G-20, it will have to take up additional responsibilities to help shape global solutions to global problems.

Be that as it may, a great deal of Indonesia's attention still has to be devoted to its internal development. Poverty and growing inequalities continue to be the main problem. Fortunately, domestic socio-political conditions have seen steady improvements that will enable the country to better organize itself in dealing with those challenges. Major social conflicts have been resolved in many parts of the country. Pluralism, reflecting the society's underlying social diversity, remains largely intact, although this cannot be taken for granted.

The country is entering an election year (2009) and a lot of political maneuvering is already taking place. This tends to complicate and frustrate policy making that already suffers from the devolution of power to local governments under the policy of decentralization and

PICTURE: PHOTOGRAPHER NAME

Indonesia President Susilo Bambang Yudhoyono: reforms now need to be implemented.

regional autonomy implemented since 2001. Corruption has become even more widespread as social control in the regions is still weak. President Yudhoyono (SBY) has launched his anti-graft policy since taking office, but the task remains enormous. He has maintained credibility in his anti-corruption campaign by allowing an in-law to be jailed on corruption charges.

Economic reform could suffer in an election year. In May 2008 the government has laid down a comprehensive economic reform package (Presidential Instruction No.5/2008) that incorporated the measures to implement Indonesia's commitments under the ASEAN Economic Community Blueprint of deeper regional economic integration. The global financial crisis and its impact on Indonesia could threaten the implementation of these reforms. But the President pledged at the G-20 Summit, as well as at the APEC leaders meeting in Peru last month, that the country will not raise trade barriers. He will have to make sure that the bureaucracy takes these commitments seriously: the record on this score has not been all that good.

To sum up, Indonesia in 2008 has laid sufficient groundwork to move ahead in the years ahead. The key challenge is to build on the achievements by further implementing the reform plans and measures to which commitment has been made. Mechanisms are often not there, capacity is frequently absent and leadership may not be forthcoming. Being an open economy, and given its active engagement in various regional and global forums, Indonesia will have to make its own efforts to overcome those shortcomings; hopefully with a little encouragement from abroad. EAFQ

Gearing for recovery

SIOW YUE CHIA

PICTURE: PHOTOGRAPHER NAME

Singapore remains stable, but growth is certain to slow.

Singapore is one of the most politically stable countries in Asia and continued to be so in 2008. But the past year marked the downside of globalisation, as the economy went through the turbulence buffeted of sharp hikes in global commodity and oil prices and the unfolding financial fallout of the US sub-prime crisis and the onset of global recession.

Trade in goods and services amount to over 300 per cent of Singapore's GDP. Soaring global energy and food prices as well as domestic real estate and stock market bubbles and higher government service fees raised the CPI inflation rate to 7.5 per cent in June 2008 (a 26-year high) and an average 6.8 per cent for the first 10 months of 2008. The Monetary Authority of Singapore (MAS) pursued a strong dollar policy to ameliorate the effects of higher import prices and the government introduced various subsidies, rebates and cash handouts to lessen the hardships on low income and vulnerable households. Thankfully, global commodity and oil prices are now on a sharp downtrend and the CPI increase is expected to return in 2009 to the trend rate of 1-2 per cent.

External demand for Singapore's goods and services has plummeted. Expecting a more difficult year, the GDP growth for 2008 was initially forecast to grow at 4-6 per cent (as compared to actual growth of 7.7 per cent in 2007). Growth was on target

in the first half year, with 4.5 per cent, but export demand plummeted in subsequent months. Singapore succumbed to negative growth in July, the first country in Southeast Asia to do so. The year is expected to end with a growth rate of about 2.2 per cent, the slowest since 2001, and to turn negative in 2009. In recent months, retrenchments have been rising, notwithstanding exhortations to employers by government and unions to cut salaries and wages first rather than to retrench.

During the high inflation, the monetary authorities allowed the Singapore dollar to appreciate more rapidly against the US dollar. With inflation abating and worsening economic growth, a steady exchange rate is being pursued. On the fiscal front, Singapore enjoyed a huge budget surplus in the fiscal year 2007. Singapore is fortunate in that it has accumulated sizeable reserves in its boom years to buttress the economy in its lean years. In recent months, the government has embarked on massive additional spending on households and on infrastructure projects. The government also pledged to spend S$2.3 billion (US$1.5 billion) to help firms get credit.

Singapore is fortunate in that it has accumulated sizeable reserves in its boom years to buttress the economy in its lean years. In recent months, the government has embarked on massive additional spending on households and on infrastructure projects.

Two other major developments in 2008 are Singapore's increased outward investments, particularly by its sovereign wealth funds (SWFs), and the active pursuit of free trade agreements (FTAs). Globally, SWFs have become very large, very visible and very controversial because of their lack of transparency in respect of the size of their holdings and investment strategies, causing concern in some countries that investments may be undertaken for geopolitical motives. Singapore's SWFs (Government Investment Corporation and Temasek) are profit-motivated, but they are making media headlines for their overseas acquisitions in OECD countries as well as in Asia. On the FTA front, Singapore has concluded and implemented several bilateral FTAs as well as those with ASEAN and ASEAN+1 countries. In view of Singapore's inability to influence the conclusion of Doha negotiations, seeking better market access bilaterally and regionally appears to be strategic. Reflective of its free trade position in the WTO, Singapore is prepared to open up its markets for goods, services and investments almost without reservation and hence negotiations have usually been concluded much faster than those by other countries.

Going forward into 2009, there is uncertainty about how deep the recession will be, depending on how the global and regional environments pan out. However, there is no pressure towards protectionism. Many policies and measures have been put in place to stimulate the economy and minimise the impact of the crisis on vulnerable households and businesses. More measures are expected in the next government budget, to be announced in January 2009.

Three measures undertaken to date are worth noting. First, a government-subsidised and labour-union supported training and retraining programme for the unemployed and currently employed to prepare them for the new economy and skill requirements that will emerge after the recession. Second, the bringing forward of several infrastructure projects shelved during the high inflation period as well new infrastructure projects targeted at improving Singapore's economic competitiveness and an environmentally-friendly lifestyle. Third, as growing international and regional competition has eroded Singapore's competitive advantage in many sectors, identifying new areas of dynamic comparative advantage, including in education and healthcare, and providing urban solutions for clean energy, water and environment have been given priority. EAFQ

The end of a year of political troubles

PISIT LEEAHTAM

Despite the initial optimism with the return to democracy, 2008 was a year of political instability and internal conflict for Thailand. Former PM Thaksin, who remained abroad after the coup d'etat, returned as his political party won the election. But he and his wife fled again to escape the court processes on his corruption charges. There has been an amazing series of events, including civil disobedience against the government, dissolution of political parties, the dissolution of the ruling People Power Party, the barring of two Prime Ministers from holding office and the closure of two international airports in Bangkok.

The two main actors in these developments are the People's Alliance for Democracy (PAD) and the United Front Against Dictatorship (UDD). The PAD (in the yellow shirts) is comprised of middleclass citizens, urban elites, academics, state union leaders and a broader coalition of those against Thaksin. The UDD (in the red shirts) comprises lower income earners, taxi drivers, the rural population in Northeast Thailand, and Thaksin supporters. The PAD and yellow shirts movement started in 2005 when Thaksin sold his shares in Shin Corporation to Temasek without paying taxes. The anti-Thaksin demonstrations ended then when the military stepped in September 2006 and installed a caretaker government. The caretaker government established a special investigation into corruption cases against the former PM Thaksin and his wife, which bought open over 13 charges of corruption against Thaksin.

In 2007, a new constitution was pronounced that laid the process for the caretaker government to return power to the people by calling a general election. Howerver, it turned out that the People Power Power (PPP), the party that replaced Thai Rak Thai, won a majority of the seats in the parliament. Samak Sundaravej, a close ally of Thaskin, became the Prime Minister. Samak tried to get Thaksin out of trouble by attempting to change the constitution to provide him with amnesty or nullifying the corruption charges and this again provoked a second anti-government movement. PAD escalated issues by seizing the government compound in order to force the Prime Minister Samak to resign and call a new general election. Samak was later forced to resign as he was found guilty for earning significant income in a commercial activity as the presenter of a TV cooking show. Consequently, Somchai Wongsawat, a brother-in-law of Thaksin, was installed by the coalition as prime minister.

> Thai households, corporations, banks and the government are not leveraged and have been cautious of financial risks. There has been no real estate bubble in Thailand in 2008.

Meanwhile, Thaksin was found guilty by the Thai Supreme Court of conflict of interest over a government land purchase scandal. Thaksin, together with his wife, got the Court's permission to visit the Olympic Games, and took that opportunity to jump bail. He used his connections through a firm of international lobbyists to present himself in the international mass media as a statesman being forced to live in exile abroad by the military. However, he was not able to live in his luxurious home in the UK, as the British government revoked the entry visa on his Thai diplomatic passport.

In Thailand, anti-government demonstrations finally peaked in October as the government tried to crack down on protesters with

PICTURE: PHOTOGRAPHER NAME

Anti-government protesters shout slogans during a protest at Suvarnabhumi international airport in Bangkok on November 25, 2008.

teargas and bombs, resulting in deaths and many injuries. Angered by the government's retaliation, the PAD decided to escalate by seizing the two international airports in Bangkok. As the political situation grew from bad to worse, inflicting severe losses to the economy, the Constitutional Court found PPP and its coalition partners guilty of electoral fraud. Prime Minister Somchai was barred from the office.

A major breakthrough occurred when a faction of the PPP party, led by Newin Chidchob, decided to defect from the Thaksin led coalition to join with the Democratic Party. Abhisit Vejjajiva, aged 44 and Eton and Oxford educated as well as the leader of the Democratic Party, was voted into the Prime Ministership on 15 December.

Thailand's economy was already burdened by the internal political turmoil of the last 3 years, as foreign investment and government programs were disrupted. On top of this, it was hit with rising inflation from oil and food prices in the middle of 2008, just like many other economies. The inflation rate hit 9 per cent, although the country kept growing at a decent rate of 4-5 per cent in the first half of the year. Thailand was not directly affected by the subprime problem in the US

and the fall of Lehman Brothers. Thai banks have little investment in Collateralized Debt Obligation (CDO). The stakes which Lehman Brothers held in Thai firms were also not substantial. And, importantly, there was no bubble in the stock market, as in other booming economies.

Unlike the crisis in 1997, Thai households, corporations, banks and the government are not leveraged and have been cautious of financial risks. There has been no real estate bubble in Thailand in 2008 and the Thai public and private sectors tried to stay away from seeking external funding.

Thailand currently has US$100 billion in foreign exchange reserves with moderate current account surpluses and a sustainable level of public debt to GDP of 36 per cent. Despite these good fortunes, the Thai economy is not immune from external shocks, as foreign investors repatriate investments. The Stock Exchange of Thailand (SET) index has fallen approximately 30 per cent from the beginning of 2008. Thai firms are believed to be blessed with strong fundamentals, cash flow, and positive earnings. Thai stocks are under-valued at a price-earnings ratio of 7 and book value less than one but foreign investors are discouraged from investing in the Thai markets, mainly because of political problems. Thailand began to feel the real economic impact when the two international airports were closed down in December. It was estimated that the closure of the airports resulted in losses of US$ 100 million from tourism, logistic, and transportation related businesses. Many Thai hotel operators had their occupancy rates down from 80 per cent to 50 per cent during peak season. It will be difficult to bring back not only investors' confidence but also tourists' confidence in Thailand going forward.

The major challenge for Thailand in 2009 is political stabilisation. It is not certain whether the new government can cope with the pressure from former PM Thaksin and his supporters while they seek to resolve growing political and economic problems. It is a high mountain for a relatively young leader like Abhisit to climb, to restore political stability and ensure the continuity of his government while he weathers the storm of internal conflicts, the global economic crisis, social political problems, and the separatist movement in the South. The positive side of the current government is that it has backing from the army, bureaucracy, and the business community. The veteran politicians in the party are also fully behind the new Prime Minister despite internal rifts stemming from the displeasure on the allocation of cabinet seats.

The GDP growth rate for 2009 is projected to be 2 per cent. The closures of the airports in 2008 will definitely affect the sentiment of foreign investors and outsiders adversely. The government has realized the problem and will use monetary and fiscal means to revive the economy. The government will most likely rely on spending on mega projects and infrastructure to boost the economy in medium term. The global economic slowdown will decrease demand for Thai goods in the US, UK, and Japan. But exports from Thailand are mostly necessary goods such as foods and daily used items that could still be in demand. Despite the fact that 70 per cent of the Thai GDP comes from exports, Thailand has a diversified export base so that it will not be heavily affected from the lower export orders from the main industrial country markets. A positive factor is that inflation rate will be lower due to declining oil prices, which will also bring down product costs and living expenses.

Though it is difficult to be totally confident, there is some light at the end of the tunnel of the political troubles in Thailand, and that is bound to help the economy. EAFQ

Many Thai hotel operators had their occupancy rates down from 80 per cent to 50 per cent during peak season. It will be difficult to bring back not only investors' confidence but also tourists' confidence in Thailand going forward.

PAKISTAN

A year of extraordinary challenge

ISHRAT HUSAIN

PICTURE: PHOTOGRAPHER NAME

Pakistan's President Asif Ali Zardari holds up a picture of his late wife Benazir Bhutto before addressing the 63rd United Nations General Assembly in New York September 25, 2008.

Pakistan faced a number of serious challenges in the year 2008 — more than any other country in the region. The transition from military rule to a democratically elected political regime was difficult. The terms of trade sent shocks to the economy through severe fluctuations in oil and commodity prices, the quality of economic governance was sub-optimal and Pakistan's 'frontline' status in the war against terror proved to be exceptionally disruptive. The assassination of Pakistan's leading politician, the highly respected Benazir Bhutto, created a huge vacuum in the political landscape. Although the general elections were held peacefully and were (by and large) fair and transparent the loss of the top leadership of the winning party led to a long unsettling period marked by prolonged uncertainty.

On the regional front, aggression from Taliban and Al Qaeda, which has so far been limited to the ungovernable and hostile terrain of the border areas between Pakistan and Afghanistan, spilled over to some of the settled districts of the North West Frontier province, including Peshawar, causing immense loss of life and property, and widespread fear amongst the general populace. On the eastern borders, however, the new government, reiterated the policy of strengthening friendly relations with India, and initially made some positive overtures.

Both the previous and interim governments in 2007 and 2008 compromised the sound economic management that was characteristic of Pakistan in the new millennium, largely for the sake of political expediency. Crucial decisions to adjust the economy in light of domestic and external shocks were postponed.

The incoming government also did not take corrective measures in a timely manner. As a consequence, macroeconomic stability caved in, both external and fiscal imbalances became too onerous to contain, investor confidence eroded and credit rating agencies lowered Pakistan's sovereign rating. This hesitation lingered over a six month period of agony,(in which foreign exchange reserves were depleted by more than half, the currency depreciated by 25 per cent, the stock market lost almost $50 billion in market capitalization, inflation reached 25 per cent and government borrowing from the Central Bank touched a record high), the Government decided to enter into a standby agreement with the IMF in November 2008. The silver lining in 2008 was Pakistan's reformed banking sector, which proved resilient in withstanding the tremors from the global financial crisis.

This 22-month agreement with

the IMF will form the framework through which economic policies will be pursued, and it is envisaged that macroeconomic stability will be restored in this period.

However, economic growth projections have been lowered to the 4-5 per cent range for 2009. Consequently, unemployment and poverty are likely to resurface after undergoing consistent decline over the past seven years. If the Government adheres to the performance targets agreed to with the IMF, and maintains fiscal discipline, it is likely to pull itself out of this trough and once again reach the 7-8 per cent growth rates that were recorded between 2002 and 2007.

However, the recently heightened tension between India and Pakistan in the aftermath of Mumbai does not augur well for the economy. Pakistani troops are already stationed on the western borders with Afghanistan. If relations with India take a turn for the worst it is likely that troops will have to be deployed on the eastern border too. The concomitant rise in security and defense expenditure would put a huge strain on public finances, impairing Pakistan's ability to meet fiscal deficit targets and putting it well off the track mandated by the IMF agreement. Hopes of a revival in foreign direct investment to fill the domestic saving/investment gap in 2009 under an improved economic management scenario will also suffer setbacks.

To avoid this scenario from materialising, there is an urgent need for Pakistan and India to return to the composite dialogue they have been pursuing for the last several years. EAFQ

A year of economic and political reversals

BOON HUAT QUAH

The Malaysian economy was not spared any damage in 2008, a year that will be remembered as a period of turbulence, when a deadly cocktail of bad US sub-prime loans, the financial-liquidity crisis, high commodity prices and soaring inflation buffeted the global economy.

Against a backdrop of quarter-by-quarter falls in the country's economic growth rate, 2008 was more about rare economic highlights than milestones.

In early 2008, Malaysia's last two economic corridors, the Sabah Development Corridor and the Sarawak Corridor of Renewable Energy were launched to bring further social and economic development to the economically backward states of Sabah and Sarawak in East Malaysia. These economic corridors, including the three launched earlier in Peninsular Malaysia – Iskandar Malaysia, the Northern Corridor Economic Region and the East Coast Economic Region – aim to ensure a more regionally balanced socio-economic development of the nation. There are, however, criticisms of the speed of implementating projects.

In early June the government announced that it would remove controls on the price of petrol and allow fluctuating prices; a move that was unprecedented, given that the surge in global oil prices resulted in a ballooning fuel subsidies bill. Petrol subsidies were not totally removed, only decreased, and petrol pump prices were revised from time to time to reflect market price movements.

In December, the government announced that it would set a ceiling price at RM2.70 a litre, and give a subsidy of 30 sen per litre if the market price moved above RM1.90 a litre. Any fall in the market price to below RM1.90 a litre will result in the imposition of a tax, the quantum of which is still being discussed.

The central bank's Overnight Policy Rate was kept at 3.50 per cent over the first three quarters of 2008, even though GDP quarterly growth had been moderating successively, from 7.1 per cent to 6.7 per cent to 4.7 per cent. In November, the central bank finally reduced its OPR by 25 basis points to 3.25 per cent.

Recently published third quarter data indicate that the country's overall balance of payments recorded a deficit of RM31.5 billion, as compared to a surplus of RM26.2 billion in the previous quarter. This deficit was due largely to a significant drop of RM61.5 billion in the capital and financial account. In the previous quarter, the drop had been just RM12.3 billion. The current

PICTURE: PHOTOGRAPHER NAME

The Malaysian Stock Market in Kuala Lumpur: as the crisis deepens, political change looks likely.

account balance, on the other hand, remained positive with a surplus of RM38.7 billion, a slight increase from the surplus of RM37 billion recorded in the previous quarter.

The fuel subsidy cut in June resulted in inflation soaring to 7.7 per cent in that month, compared to 3.8 per cent in the previous month. Compounded by escalating food prices, the inflation rate rose further to 8.5 per cent in July. By November, the inflation rate eased to 5.7 per cent.

In November, Malaysia finally announced a 7 billion-ringgit economic stimulus package to avert recession in 2009. The package has been criticized by some quarters as too late, and too little to adequately contain the impact of the global economic crisis on Malaysia. Criticism has also been leveled at how the 7 billion ringgit will be spent, as the package will go mostly to towards the construction and upgrading of low-cost housing units, schools, roads and public amenities.

The results of Malaysia's 12th general election on 8th March 2008, which has been hailed as a 'political tsunami,' a 'political near-revolution,' and one that its citizens will be talking about for years, revealed an immense groundswell of public opinion against the ruling government and/or a rejection of race-based politics. Liberals regard it as a new dawn for democracy in Malaysia, a positive move towards constructive political development, and good for the nation's long-term future.

For the first time since Malaysia gained its independence in 1957, the ruling coalition government lost its crucial two-thirds supermajority, which for a long time had enabled it to amend the constitution at will to its own advantage. On top of that, the government lost five of 13 state legislatures, as compared to only one in the 2004 election.

For the quiet Malaysian, the political change had been long in coming. There have been persistent complaints that the government has not done enough to tackle massive institutionalized corruption, issues of poor governance, non-tranparency, ethnicised politicking, and religious and ethnic insensitivities. Many share the view that the government has lost touch with the very people who voted them in.

The message of the loose coalition of opposition parties was loud and clear: that they are a viable alternative, and would tackle the issues uppermost in people's minds. The success of the opposition alliance can be attributed to its ability to use new technologies such as blogs, mobile phone text messages and YouTube during the 2008 election, a milestone in Malaysian politics, to circumvent tight media control by the government.

Malaysia appears to have been forced by the success of the opposition parties in the 2008 election to embark on a bout of democracy. Already there are signs of change within the ruling coalition, as change will be necessary to its continued political survival.

But after a half century in power, it is hard to change, and there is much internal resistance to it, so UMNO's days may at last be numbered. EAFQ

India faces an ugly environment in 2009

SUMAN BERY

The recession now present in advanced economies seems set to continue for a while yet.

The annual Neemrana conferences on the Indian economy provide a valuable opportunity to take stock of the state of the US and world economies, and the implications of global developments for the Indian economy.

The conferences are held annually at the Neemrana Fort Palace hotel in Rajasthan. They are co-hosted by NCAER and ICRIER. International (primarily US) participation is organised by the NBER, arguably America's most respected network of academics engaged in research on issues of economic policy. The format is designed to encourage informal, off-the-record discussion on a range of current issues in economic policy.

This year marked the tenth anniversary of the conference, amidst the most challenging environment the global economy has faced in that decade. Despite the roaring boom of the past few years, past conferences had repeatedly warned of the unsustainability of two structural trends, namely the size of the US current account deficit and the decline in the US household savings rate that lay behind it. However, the depth of the crisis in the US financial system and economy, and its global impact was difficult to anticipate even as recently as a year ago.

PICTURE: PHOTOGRAPHER NAME

As protectionism seems to be on the rise, India faces its own problems.

Prior to the conference, my initial assumption was that the worst was probably behind us as far as the slowdown in the major economies was concerned. The discussion at the conference, particularly with regard to the US and European economies, suggested that this was no more than wishful thinking, and that considerable pain lies ahead. (There was relatively little discussion of the prospects for the Japanese and Chinese economies, but these are unlikely to improve the picture.)

Quite apart from the overall assessment of the short-term outlook, however, was the nature of the analysis that led to these sombre conclusions. In the case of the US, the underlying mechanism at work is a massive re-pricing of risk by financial institutions following the unexpectedly high default rates on sub-prime mortgages that began to be evident some two years ago.

This repricing of risk has led to the destruction of household financial wealth in the two principal assets held by American households, residential real estate and equities. Between these two, the estimated reduction in overall household wealth is of the order of ten trillion dollars.

Historical estimates suggest that this would lead households to cut back their consumption by around 4 per cent of their reduced wealth, just as the past enhancement of this wealth led to major increases in consumption during the boom. The estimated cutback in consumption alone represents a negative 'demand shock' of approximately 2.5 per cent of US GDP, or $400 billion.

Compounding this withdrawal of demand is the slowdown in housing construction: a million fewer housing starts represents a further withdrawal of some $200 billion in demand. So the 'demand gap' that needs to be filled just to replace these two sources is in the order of $600 billion on an annual basis, without taking into account other destruction from demand either in terms of (net) exports or reduced corporate investment, both of which are likely under present conditions. The only silver lining is the relief household budgets will receive as a result of lower fuel prices.

Under normal circumstances, both monetary and fiscal policy would be available to offset such sharp 'autonomous' decreases in final demand. Unfortunately, despite Herculean efforts by the Federal Reserve, monetary policy is not generating any traction because of the seizure in the credit markets, itself largely related to uncertainties on the valuation of housing-related securities.

Monetary policy is not generating any traction because of the seizure in the credit markets, itself largely related to uncertainties on the valuation of housing-related securities.

No effective floor has so far been placed under house prices, despite several proposals to do so. The impact of house price declines on the balance sheets of financial institutions is enhanced in the case of the US by the fact that, in most states (and unlike the situation in other advanced countries), mortgage loans are 'non-recourse': that is to say, they are only secured by the value of the house, and are not secured by other assets of the borrower. Approximately 25 per cent of all houses with mortgages are now worth less than the value of the mortgage that they bear, encouraging homeowners to surrender their homes and walk away from the loan. This additional supply further depresses prices. So there is no immediate reason to see a return to normality in US credit markets, at least not until a floor is found, or is placed, under housing and equity markets.

The past and likely future inefficacy of monetary policy therefore puts the entire burden for replacing the 'missing demand' on fiscal policy. Yet the prospective design of the Obama fiscal stimulus package came in for criticism both as to its scale and as to its composition. If the advertised figure of $775 billion over two years is accurate, then on an annual basis the injection of demand is only half as large as is needed. To the extent that a portion of the relief is in the form of temporary cuts in income taxes, recent evidence suggests that such cuts tend to be saved rather than spent, particularly in an environment where households are busy rebuilding their balance sheets. If the demand 'hole' is not adequately plugged, then second-round multiplier effects could worsen the downturn.

The US remains central to the global recovery. The story from Europe is gloomy for many of the same reasons but also for two additional ones. Several of the smaller countries have very high levels of debt already and are likely to be penalised by the markets for expansionary fiscal policy. And members of the Eurozone lack the instrument of exchange rate adjustment. There is the additional factor that the leading European economy, Germany, which does have fiscal space, remains unconvinced of the efficacy of fiscal stimulus.

Finally, despite G-20 protestations to the contrary, there is considerable expectation that protectionist tendencies are likely to intensify in this global climate. All in all it is an ugly environment for India to face as it struggles with its own issues of internal security, corporate governance and general elections. Welcome to 2009!

Disappointed expectations but hopes head north

YOON YOUNG-KWAN

PICTURE: PHOTOGRAPHER NAME

The financial crisis has made progress difficult in key areas, like the Korea-US FTA.

The Korean people had high expectations at the beginning of 2008 that the new conservative government of Lee Myung-bak would bring fast economic growth and political stability. There were high hopes that President Lee's pragmatic and conservative approach, in contrast to his predecessor's ideologically oriented and progressive policies, would restore a balance in the overall direction of the Korean society.

Most Koreans and foreign observers, however, were surprised as they witnessed President Lee's popularity plummet in a matter of months. His government's negotiation over the beef trade with the United States was severely criticized by domestic NGOs and the progressive opposition groups, who were able to mobilize huge crowds in anti-government demonstrations on the streets of Seoul. Their gripe was that policy leaders had neglected people's concern over the health issues and given too much away to the US negotiators despite a serious danger of mad cow disease with beef imports from the States. Though it turned out that there was no scientific evidence that corroborated the arguments of its critics, the Lee government had suffered a serious political blow.

The onset of the Korean economic crisis over the recent months makes it more difficult for President Lee to recover from the political setback caused by the US beef negotiation. Most Koreans still have vivid memories of the severity of the financial crisis ten years ago. This time the economic crisis is caused by external factors such as the US financial crisis. Even a few months back, not many Koreans would have expected this kind of serious economic convulsion. Korean business leaders are now warning that this is a more serious crisis than the crisis of 1997-8. Korea's expected economic growth rate for 2009 has been downgraded a few times by the economic think-tanks in the recent few months from around 4-5 per cent to 1-2 per cent.

So the biggest challenge for the Korean people in 2009 will be how to overcome the economic crisis. The government has been doing its best to stimulate the economy and boost domestic demand by lowering interest rates and expanding public spending. It also has been increasing the social safety network for the unemployed people.

The Korean government is also working hard to get the Korea-US FTA ratified by both the Korean national assembly and the US Congress because the FTA has very important political and security implications for the alliance over and above any economic benefits. But the current crisis of three big US auto companies, the generally grim economic situation in the United States, and President-elect Obama's skepticism about the Korea-US FTA are all working against these efforts. How to achieve the goal of ratification of Korea-US FTA will be

a big challenge for the Koreans in 2009.

The other important challenge for the Koreans in 2009 is denuclearization of North Korea. Six years have already passed since the second nuclear crisis began in October 2002. Much precious time was squandered without progress in negotiation until President Bush, for the first time, permitted his negotiator Christopher Hill to meet North Korean counterpart Kim Kye-Gwan on a bilateral basis in January 2007. Following that, North Korea began cooperating with the United States, disabling Yongbyon Plutonium facilities and reporting nuclear related materials in 2008. Yet it would not budge on the issue of verification, which is the key part of the whole denuclearization process. Probably, the North Koreans are waiting for the inauguration of the Obama administration, expecting a better deal with the new U.S. negotiation team. They may have sweet memories of the thawing relations with Clinton's democratic administration in 2000 when there were exchanges of visits by high-level officials from both countries.

Will there be a successful negotiation between the Americans and the North Koreans in 2009? Will the US administration be able to mobilize enough political capital to focus on and make significant progress with the nuclear deal with North Korea despite the many other urgent tasks awaiting its attention? Will the North Korean leader, Kim Jong-il, despite his health problems, be able to make the strategic decision to give up nuclear option as Qaddafi once did?

Most Koreans and international observers would like positive answers to these questions in 2009. EAFQ

PICTURE: PHOTOGRAPHER NAME

The Nikkei Index board: drastic changes may have to be made to the Japanese economy.

Change in paradigm to rescue the ailing economy

IWAO NAKATANI

The shock of the worldwide financial crisis over the past year has affected Japan more or less to the same degree that it has the rest of the world.

The drop in the price of stocks and other financial assets has been enormous, in spite of the Japanese financial sector being relatively unexposed to the sub-prime business, as against the financial sectors in America or Europe. The Nikkei Average, for example, fell from 15,156 yen in January 2008 to 6994 yen in October 2008, a drop of some 54 per cent. Many commercial banks are trying to squeeze their lending in response to the deterioration of their balance sheets, producing a serious credit crunch in the domestic economy.

At the same time, the yen has appreciated from 110 yen against the US dollar in January to 87 yen in December, an appreciation of more than 20 per cent. The yen has also appreciated significantly against other major currencies: it was only 160 yen per Euro in January but it rose to 114 yen per Euro in October. These changes have affected Japan's export industries seriously and there will be more of the same in the coming year. The Japanese economy

is still export-oriented in character and the sharp decline experienced by export industries like automobiles and electronics will do major damage to the economy in the coming year.

A positive factor for Japan (though not for resource-rich countries like Australia) has been a decline in the price of commodities, including crude oil and iron ore, towards the latter half of 2008. This drop in resource prices, together with an appreciation of the currency, is certainly a huge plus for the Japanese economy, which is a large net importer of resources.

On balance, however, Japan's economy has suffered a great deal from the world economic stagnation in 2008.

The challenge for Japan in 2009 is finding a way to stop the slide in its sharply deteriorating economy. A much more active fiscal policy is needed, given the current economic conditions, but this would mean further accumulation of government debt, which is already at a critical level of more than 180 per cent of GDP: level of debt that is one of the very worst in the world.

It seems like what is now required to rescue Japan's highly depressed economy is a radical shift of its strategic economic policy: from one based on neo-conservative economics and the philosophy of small government to one based on Keynesianism and welfare state ideology.

This paradigm shift appears inevitable not only in Japan but in many other countries, after more than 30 years of market fundamentalism being dominant and classical doctrines against government intervention holding firm. EAFQ

Positioned to weather the global shock

PICTURE: PHOTOGRAPHER NAME

Singapore must stress the importance of free trade to the global economic community.

ENG FONG PANG

Singapore's economy grew by 7.7 per cent in 2007. Growth was broadly based, jobs plentiful and inflation low. The official forecast a year ago was that growth would slow to around 5 per cent in 2008 as external demand would likely weaken. As it turned out, this forecast was revised downwards several times as economic conditions deteriorated in response to a rapid deceleration of external demand. Singapore's economy, officially in recession having shrunk two quarters in a row, appears likely to end up with a growth rate of less than 2.5 per cent in 2008.

Singapore's current recession is different from its two previous economic contractions in 2001 and 2003. In both periods, no synchronized global downturn engulfed both developed and emerging economies. In the current recession, recovery is likely to be modest and slow. The large fiscal stimulus packages in the developed economies, especially the United States, as well as those announced by China, Japan and other Asia Pacific countries will boost domestic demand and restore consumer confidence but they will take time. For Singapore, as for its neighbors, the deepening global recession will likely last well into 2009.

The government has pledged $1.5 billion to help firms get credit. It will run a bigger budget deficit. It will announce in January 2009 a package

of measures to stimulate domestic demand and create jobs. In many ways, Singapore is well-positioned to ride out what is likely to be a prolonged global recession and weak regional demand for its goods and services. Its public finances are sound and it can run budget deficits without increasing the tax burden of future generations. The large pool of foreign workers – about one in four workers in Singapore is a non-citizen – provides a buffer against a sharp rise in unemployment. Over the years, the wage system has become more flexible, with a greater proportion of wages paid as a variable component. Employers can adjust costs better and so need resort less to job cuts.

Commodity and oil prices have fallen sharply in tandem with the spreading global recession. Inflation in Singapore, which was at a record high in the first half of 2008, has moderated. The outlook is for prices to rise by 1-2 per cent in 2009, down from 6 per cent in 2008.

The government has projected GDP growth to be between plus two and minus one per cent in 2009. This forecast may turn out to be optimistic if countries take measures to protect their industries. Several countries including India and Brazil have already raised tariffs to protect key industries. Others may follow. A retreat from free trade would endanger the concerted efforts governments are making to revive global demand. For its part, Singapore will use every opportunity it has to stress the importance of free trade to global prosperity.

With the world struggling to cope with the worst recession in half a century, Singapore has its work cut out as APEC chair for 2009. EAFQ

PICTURE: PHOTOGRAPHER NAME

Microeconomic reform is needed for PNG to hold on to gains from a commodity boom.

From economic boom to gloom?

AARON BATTEN

PNG had another interesting year in 2008. The first half of the year saw economic growth remain strong as the country continued to benefit from yet another boom in the price of its commodity exports. High resource prices underpinned a significant expansion in the manufacturing, construction and agriculture sectors. Towards the middle of the year, however, poor monetary responses to a prolonged growth in domestic liquidity, coupled with a continued strong external sector, meant that inflationary pressures began to increase, with inflation rising to 13.5 per cent in September 2008.

September, of course, also marked the onset of global financial crisis. Barring a couple of jitters on the PoMEX, PNG's economy weathered the direct impacts of the crisis relatively unscathed. In large part this was because of the healthy supply of foreign exchange reserves and domestic bank liquidity built up over previous years which gave the financial sector sufficient flexibility to cope with any adjustment costs.

The flow on effects of the crisis have led to a large downturn in the price of many of PNG's key commodity items which had been driving revenue and output growth.

Perhaps the most important difference between this and past bust cycles is the prospect of the ExxonMobil LNG Project. In the event that this project comes on-stream, and this is looking increasingly likely, the nature and structure of the PNG economy will fundamentally change.

This has had an immediate impact on the Government's fiscal position with the 2009 Budget predicting a 25 per cent overall decline in domestic tax revenue.

In last year's PNG economic update, Bob Warner and Eric Omuru warned that PNG would one day face this situation, highlighting the need for commodity boom revenues to be invested in productivity enhancing sectors which can generate long term economic benefits for the country. The global financial crisis appears to have brought that day to the present. The question is, however, has PNG made the requisite reforms and investments in human and physical capital to withstand a global economic downturn? Or will this commodity boom follow the path of previous decades and be followed by an economic bust?

Unlike previous booms, the Government has a large supply of unspent windfall revenues which it will be able to use to maintain expenditure levels at commodity boom levels for a number of years. Indeed, this will be the case in 2009 with the Budget foreshadowing a K600 million drawdown from Trust. Perhaps the most important difference between this and past bust cycles is the prospect of the ExxonMobil LNG Project. In the event that this project comes on-stream, and this is looking increasingly likely, the nature and structure of the PNG economy will fundamentally change. Although weaknesses in these calculations exist, ExxonMobil modelling predicts that the size of the PNG economy will more than double over the medium term, rising in real terms from K8.65 billion in 2006 to K18.2 billion. Oil and gas exports would increase more than four-fold, with the LNG project contributing an additional K11.4 billion, compared to total PNG oil and gas exports of K2.6 billion in 2006.

Significant reforms have been made this year to the system of intergovernmental financing. Following reforms to the Organic Law on Provincial Governments and Local-level Governments in July, new measures were introduced in the 2009 Budget to reduce the difference between each provincial government's service delivery costs and the amount of revenue which they receive. This is a positive step forward as continued progress on this front, combined with improved accountability mechanisms, will bring provinces to a similar level of fiscal capacity to meet the costs of delivering a comparable set of basic services.

This optimism does mask some important challenges facing the country over coming years. The onset of the LNG project will create classic Dutch disease effects and put further pressure on the rural sector, which creates wealth and livelihoods for the vast majority of Papua New Guineans. The massive growth in output is also likely to spur on more growth in domestic liquidity and inflation. Again, this will disproportionately impact on the welfare of the poor.

More fundamentally, the LNG Project is likely to perpetuate what is already a highly commodity dependent economy. This has diverted, and is likely to continue to divert, much needed attention and focus away from more important economic challenges such as lowering the costs of the PNG's pervasively expensive business and investment environment. Some progress was made in the airlines sector this year with the entrance of a Virgin Blue/Airlines PNG partnership dramatically lowering the cost of international flights. Nevertheless, national investment policies continue to be dominated by subsidies, concessions and monopoly trading rights. As a result, PNG fell back another 9 places in the 2009 World Bank Cost of Doing Business survey, now ranking 91st out of 121 developing countries.

Further microeconomic reform is needed if PNG is to set itself on a long term sustainable growth path. EAFQ

2008: change and politics

PICTURE: PHOTOGRAPHER NAME

Japan needs to build a better democracy, rather than waiting for a leader.

TOBIAS HARRIS

As the kanji of the year suggested, 2008 was a year for change. Change, of course, was the message of U.S. President-Elect Barack Obama's campaign, but in Japan, change seemed to mostly refer to the teledrama *CHANGE*, starring male idol Kimura Takuya as Asakura Keita — a schoolteacher pressed into political service after his politician father's death (this is Japan, after all). The naïve and idealistic teacher is propelled to the premiership by the political fixers of the ruling party, who think his popularity can save their flailing organization. Naturally he rises above the murk of the political world and delivers change Japan can believe in.

The story could not be less connected to the reality of Japanese politics in 2008.

Japan started the year governed by Fukuda Yasuo, who spoke of the need for the ruling Liberal Democratic Party (LDP) to listen to the people. He, however, resigned as prime

Mr. Aso — best known outside Japan for his manga obsession and his all-too-frequent gaffes — was able to convince the party rank-and-file and the party's Diet members that he was in touch with the Japanese people.

minister in September, speaking of how he was "different" from the people (which prompted a Japanese internet meme). His replacement Aso Taro was elected LDP president — and with it, prime minister — by a landslide in the party's emergency election. Mr. Aso — best known outside Japan for his manga obsession and his all-too-frequent gaffes — was able to convince the party rank-and-file (who rewarded him 134 out of 141 LDP prefectural votes) and the party's Diet members that he was in touch with the Japanese people and that only he could restore public faith in Japan's long-time ruling party.

This has not quite happened. Far from being in touch with the concerns of the Japanese people, Mr. Aso may be the most insensitive yet. He has been dogged by reports that he frequently spends his evenings drinking in luxury bars. He spoke poorly of doctors and the elderly, important constituencies in a rapidly aging society. These miscues, while crude, will probably not make or break the LDP in the next general election, but Mr. Aso's inability to respond effectively to the gathering global crisis currently consuming Japan just may. As 2008 ends, Japan finds itself in recession once again, but the LDP has been hesitant in formulating a response. In large part this is because the Aso government is a prisoner of past decisions taken by LDP governments; namely, the government's hands are tied by a national debt totaling roughly 180 percent of GDP — by far the largest debt/GDP ratio in the OECD. Mr. Aso is also suffering from the mistakes of his immediate predecessors: Abe Shinzo's disastrous response to missing pensions records contributed to the LDP's defeat in the 2007 elections for the Japanese Diet's upper house. And Mr. Fukuda poorly managed the roll-out of a new health care system for citizens over seventy-five. Both have battered the LDP's support among broad swathes of the public. The opposition Democratic Party of Japan (DPJ), already in control of the upper house, is poised to perform well in the next election, even in regions that have long been LDP strongholds.

That being said, the prime minister who has most profoundly impacted today's LDP is none other than Koizumi Junichiro. Mr. Koizumi's term as prime minister ended in 2006, but his impact continues to the present. Mr. Koizumi waged open war on the "old" LDP — the party of public works pork, postal patronage, massive *koenkai* (politicians' personal support groups), and government-by-factions and *zoku giin*. He sought to reform the party and the cabinet to strength the position of the prime minister, while changing how Japan spent money on public works in order to undermine what he called the "opposition forces" — i.e., LDP politicians of the old school. The battle over postal privatization tied together all of these threads.

But Mr. Koizumi left before he could complete his project to remake the LDP and nation. And in doing so he may have dealt a death blow to the LDP, perhaps as he intended.

Mr. Koizumi left an LDP torn into pieces. His electoral coattails created a strong reformist bloc within the party: the so-called Koizumi children. At the same time, however, Mr. Koizumi's departure emboldened the opposition forces, who under Abe, Fukuda, and Aso have worked to reverse or stall further structural reforms and isolate the reformist bloc within the party. Divisions within the LDP are mirrored in the public at large. In urban districts, where Mr. Koizumi enjoyed great success — and where a number of the Koizumi children have their seats — voters are dismayed by the backsliding in the LDP and will likely turn back to the DPJ in the general election required to be held by September 2009. In less populated districts, however, voters are aggrieved over Mr. Koizumi's reforms, having watched influxes of money from Tokyo dwindle and waited for the government to do something to reverse the precipitous decline of Japan outside Kanto. (Given the demographic makeup of rural Japan, these voters

are undoubtedly also alarmed at government mismanagement of the health and pensions systems.) These dynamics contributed to the DPJ's 2007 victory — Ozawa Ichiro, the DPJ's president, is a product of the Tanaka Kakuei machine that fortified LDP rule in these areas, and he ably exploited the dissatisfaction of both urban and rural voters.

The civil war within the LDP may also finally be coming to a head. As 2008 reaches its denouement, the LDP's reformists — who have grown ever more discontent at their isolation within the party and fear for their electoral lives if they run under the banner of Mr. Aso — may finally be prepared to break with the LDP. Watanabe Yoshimi, a leading Koizumian and a crusading administrative reform minister under Abe and Fukuda, has openly criticized Mr. Aso's leadership and suggested that he may try to topple the government and form his own party. Other prominent reformists have criticized Mr. Aso, suggesting that Mr. Watanabe might be able to lead enough reformers out of the party to strip the government of its parliamentary super-majority and trigger a general election.

In short, while it appears that Japan experienced no change whatsoever, 2008 has indeed been a year of change. Not merely a change of prime ministers, but a change in the comparative standing of the LDP and the DPJ. Decay could be considered change as well. It is far from clear how the LDP's current crisis will resolve. 2009 may bring monumental change to the political system: the LDP breaking in half, a new reformist party's becoming the key to forming a government, the DPJ winning power in a landslide.

PICTURE: PHOTOGRAPHER NAME

Koizumi Junichiro, the Japanese prime minister who most profoundly impacted today's LDP.

One way or another, Japan needs political change. The latest economic downturn will only exacerbate the problems already facing Japan. It will make it all the more difficult for the government to provide pensions and other social services. It will delay the government's efforts to pay down Japan's national debt to more sustainable levels. It will swell the already swollen ranks of Japan's temporary workers, who now constitute nearly a third of the labor force. And it will do little to encourage younger Japanese to marry and start families. Contrary to the political philosophy of TV drama CHANGE, changing leaders — or ruling parties — will not make these problems go away. Even Mr. Koizumi, the closest Japan has come to a truly dynamic leader, was forced to compromise in his desire for reform. Change is difficult, and it will not emanate solely from Nagatacho.

Voting the LDP out of power, however, could still be an important first step in changing Japan by making its political parties more accountable to the public and stimulating new ideas for how to solve the growing list of problems that darken Japan's future. Rather than placing blind hope in the "Japanese Obama" — whoever that might be — or a particular party, the Japanese people should strive to build a more responsive, transparent, and accountable democracy. That would truly be change. EAFQ