U.S. DEPARTMENT OF THE TREASURY

Press Center

Under Secretary for International Affairs David H. McCormick Remarks

12/16/2008

HP-1329

On U.S.-Asia Economic Relations at the Asia Society in New York

New York– This is an unprecedented time for the global economy. The downturn has been swift and severe, and the turmoil has spread quickly around the world. Countries across the globe have taken action to minimize the impact of the crisis and to reform the global financial system to guard against such challenges in the future. While the outlook for 2009 is exceptionally challenging, the coordinated actions of U.S. policymakers, and many of their international counterparts, have decreased the chances of systemic collapse that appeared all-too-possible several months ago.

We have witnessed a unique degree of coordination as policymakers across the global economy have taken steps to stabilize the system. In early October, the Group of Seven industrialized countries announced and are now implementing a coordinated action plan to provide liquidity to markets, protect depositors, and to strengthen confidence in financial institutions. In early November, the President hosted a Summit with the Heads of State of the Group of Twenty countries during which they committed to a comprehensive plan for the reform of the international financial system. And we have also seen a number of countries throughout Europe, Asia, and Latin America take significant fiscal actions as well as coordinated monetary policy. While financial markets have responded favorably to these efforts, there is no doubt that enormous uncertainty and challenging policy choices lie ahead.

In this context, I would like to take a step back today and consider how we got here and offer some lessons from our recent experience in combating the crisis. I will conclude with some thoughts on how the current turmoil will shape, and in some ways constrain, policy choices for the next chapter of economic challenges facing the United States and Asia.

Global Economic Climate

How did we get to this point? Benign economic conditions marked by low interest rates, low inflation, and less volatile asset markets, led many in the decade prior to this crisis to ignore the "risk" half of the risk-reward equation at the heart of financial markets. Investors around the world, who in preceding years had enjoyed above-historical returns on most assets, continued reaching for higher gains. In response, the financial-services industry created a variety of complicated new financial products to meet this demand, and regulators and investors alike showed a growing complacency toward risk. These factors, blended together, created underlying conditions that were ripe for instability.

The imbalance between risk and reward was most evident in the U.S. housing market where lenders significantly loosened credit standards, particularly for a new generation of adjustable-rate mortgages. In the summer of 2007, these vulnerabilities in our financial system became clear as looser credit standards in the housing market, combined with an abrupt halt to rapid home-price appreciation, led to a significant rise in delinquent mortgages. This in turn contributed to immediate and unexpected losses for investors and a reconsideration of the risk-reward relationship − first in housing, and soon after, across all asset classes. Shaken investor confidence in housing assets had a domino effect throughout world markets, ratcheting up demand for cash and liquidity, and curtailing the pace of new lending and investment necessary for continued growth.

These concerns grew as several large important financial institutions failed, or were rescued from failure. Credit markets began to freeze, and consumers and businesses around the world found it more difficult and expensive to get the credit necessary for the smooth functioning of the global financial system. The consequences of this credit crunch are still developing, but there is no doubt that economies around the world are slowing dramatically as consumer demand weakens, investments are delayed, and unemployment rises.

According to IMF projections, world growth is expected to slow from 5 percent in 2007 to 3.75 percent in 2008, and to just over 2 percent in 2009. Advanced economies, which are expected to contract by a quarter of a percent in 2009, have led the downturn. Emerging market countries in recent years, including those in Asia, have made impressive strides in strengthening their fundamentals, accelerating their economic growth and cushioning themselves against external shocks. Nevertheless, as the events of the past months have shown, emerging markets are not immune from the global financial stress. Emerging markets as a whole are still expected to grow, but more slowly as the IMF has revised its 2009 growth projections for emerging economies from 5.1 percent to 4.1 percent.

Slowing global economic demand poses daunting challenges for many Asian economies, especially those more dependent on export-led growth. While most Asian countries have had relatively limited direct exposure to mortgage-related assets, deleveraging by foreign investors and slowing external demand have simultaneously created tighter credit conditions and lower expectations for growth. This has led to heightened volatility in equity, money, and debt markets.

These developments put to rest the notion of "decoupling," which is the idea that the economic growth of emerging markets in Asia, or other parts of the world, is independent from that of the developed world. As the current crisis makes painfully clear, in this era of global trade and investment, our economies − and our prosperity − on both sides of the Pacific are inextricably linked. In order to maintain strong economic growth in America, we need a strong, growing Asia, just as Asia's success depends on a thriving United States. This reality puts a premium on our ability to cooperate fully to restore confidence to global financial markets and return our economies to robust growth.

Lessons for U.S. - Asia Economic Engagement

The U.S.-Asia economic partnership can be strengthened if we heed the lessons we have already learned from the ongoing turmoil. Undoubtedly, much of the current situation will be best understood with the benefit of time, but today I would like to discuss five lessons that are already coming into focus and consider their implications for the choices policymakers will make in the future.

First, openness to international trade and investment has been and will continue to be the linchpin of economic growth for the global economy. The United States and Asia are more dependent upon one another for our economic growth and prosperity than at any time in our respective histories. I n the current climate of anxiety and uncertainty, policymakers must ensure strong communication and coordination, avoid beggar-thy-neighbor policies, and guard against protectionism.

Fortunately, as the crisis has worsened, global policymakers have responded with coordinated policy action. The Group of Seven action plan I mentioned earlier aims to restore the flow of credit by securing interbank lending, and coordinated central bank actions have provided unprecedented levels of liquidity to the market. Bilaterally, the Strategic Economic Dialogue (SED), which has been an invaluable forum for building U.S.-China economic relations, has been especially important in strengthening our lines of communication and cooperation during the crisis. Earlier this month at the 5 th SED meeting in Beijing this collaboration was apparent in a number of ways. For example, to address the acute decrease in available trade finance that has occurred as the crisis has developed, the U.S. Export-Import Bank and the Export-Import Bank of China announced that they will provide funding to support over $38 billion of finance for exports for emerging market countries. To combat short-sighted appeals for protectionism, many policymakers throughout the world have also reaffirmed their commitment to completing a successful Doha trade round and refraining from raising new barriers to trade and investment.

As a second lesson, it is also clear that as the crisis has spread to emerging markets, developed countries must act rapidly and in concert to minimize the impact on the still vulnerable populations in these countries. As is always the case, however, resources alone cannot solve problems rooted in weak policies. Therefore, before we provide financial assistance bilaterally or through the International Financial Institutions (IFIs), we must determine the underlying cause of economic vulnerability and ensure necessary corrective action to address the weakness. Lending large sums of money before assessing root causes and the appropriate policy responses can also damage the IFIs themselves, by reducing the capital available to assist other countries in need and by undermining the institutions' credibility. At a time of competing fiscal demands, we need to make sure that the finite taxpayer resources are spent wisely to enhance financial stability and spur economic growth in these important economies .

When resources are needed, however, the IFIs are a logical place to turn, and these institutions must show flexibility and adaptability to help their member countries. The IFIs must review their existing programs and resources to determine if they are adequate to meet these challenges. T he IMF currently has $150 billion in available lending capacity, for example, while the World Bank has the capacity to nearly triple current lending to $35 billion per year for the next three years. Both institutions have taken encouraging steps to develop new programs and approaches and quickly increase their commitments. The IMF recently announced the establishment of the Short-Term Liquidity Facility, which is designed to help strong-performing members facing temporary liquidity problems. The World Bank and the multilateral development banks are also developing innovative ways to strengthen country financial sectors and address potential shortfalls in trade finance. While these institutions must act quickly, we must take care not to demand that they engage in ways that go beyond their mandates or financial capacity.

Third, as the IFIs play an even more crucial role, their ambitious reform should be embraced. Further delay will only harm the effectiveness and legitimacy of the intuitions. The United States has been a leading voice on governance, making clear that these institutions must reform to remain relevant. And, as highlighted by the Leaders at the G-20 Summit, there is a growing recognition that governance issues are central to institutional legitimacy. While the recent IMF quota reform was an important step, it should have been more ambitious in ensuring emerging markets have a seat at the table that better reflects their growing economic influence in the world economy.

The United States has also strongly advocated a smaller and more focused IMF Board and called on other nations to work with us to reduce the number of chairs from 24 to 20 by 2012, with no loss in the number of emerging market or developing country chairs. In addition, the United States fully supports expanding membership in the Financial Stability Forum (FSF) to include major emerging market economies, and I am happy to report that the FSF is working at record speed on a proposal for expanded membership. Greater representation is not a one-way street, however, with greater voice and influence, emerging market countries must assume greater leadership responsibilities and act as constructive partners in these institutions.

Fourth, in developing a crisis response we must remember that the private sector must be a critical part of the solution. Government and the IFIs cannot solve this crisis alone, and they cannot and should not crowd out the private sector. To successfully navigate this crisis, the private sector must also play an active role, especially in those industries that have benefited from public sector support. In situations where government intervention is necessary, we must consider specific ways in which the private sector can assist in the recovery. For example, in the United States we have helped promote financial sector stability with direct capital injections, but ultimately it is the banks that must take these funds and resume responsible lending to consumers and businesses. Likewise, in countries with capital account pressures, banks must work responsibly to avoid exacerbating the rollover risk of a crisis-affected country. In this period of unprecedented government intervention, we must think carefully about its long-term implications and how the government can best exit over time. With this in mind, Treasury has structured its Capital Purchase Program with disincentives for long-term government ownership.

Finally, both Asia and the United States must stay focused on addressing the fundamental macroeconomic policy challenges that contributed to the crisis. Some of these challenges have been discussed for many years, with policymakers voicing concern about the buildup of global imbalances. As a result of the turmoil, we are seeing a gradual rebalancing, as the U.S. current account deficit begins to contract, and emerging markets take steps to boost domestic demand. But we must guard against the re-emergence of significant imbalances as the world economy recovers. For many in Asia, the crisis highlights the need for export driven economies to encourage robust growth of domestic demand. For Japan and many parts of Europe, it means regulatory reform to increase competition, entrepreneurial activity and investment to bring about stronger domestic-led growth. For the United States, it means boosting domestic saving and reducing government deficits over the long-run. In addition to these policy actions, steps to assure exchange rate flexibility play a critical role in allowing needed economic adjustments to occur.

Conclusion

The next year is going to be an extraordinary one as policymakers around the world continue to act to stabilize the global financial system and economy while implementing the necessary reforms to address the root causes of this crisis. Many of these important steps will be achieved through the G-20 Leaders process, but we must also take care to include and work collaboratively with countries not represented in this forum. It is clear that the G-20 Leaders take their charge of comprehensive change seriously, and they are committed to significant reforms in the months leading up to the next Summit hosted by the United Kingdom in April. At the center of any effective multilateral policy action will be the United States and Asia. We must look for ways to enhance our cooperation and leverage our regional, multilateral, and bilateral dialogues and relationships to ensure the integrity and efficacy of these efforts. The road ahead will not be an easy one, but the US-Asia economic partnership will be at the heart of our recovery. And our economic relationship will no doubt emerge even stronger as a consequence of weathering this storm together.

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