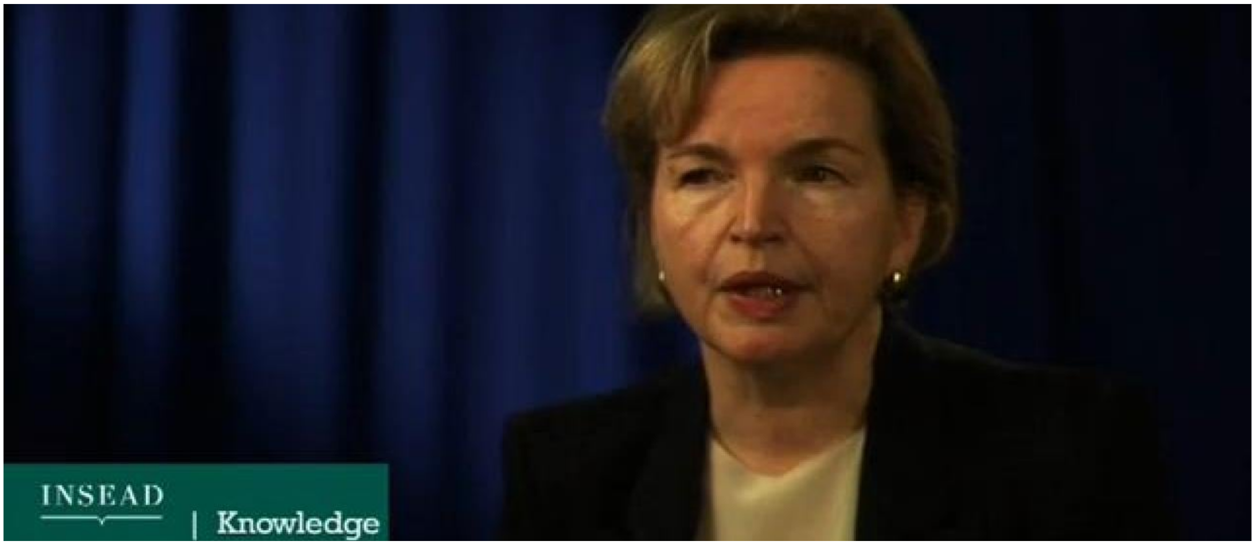
The big picture from West to East

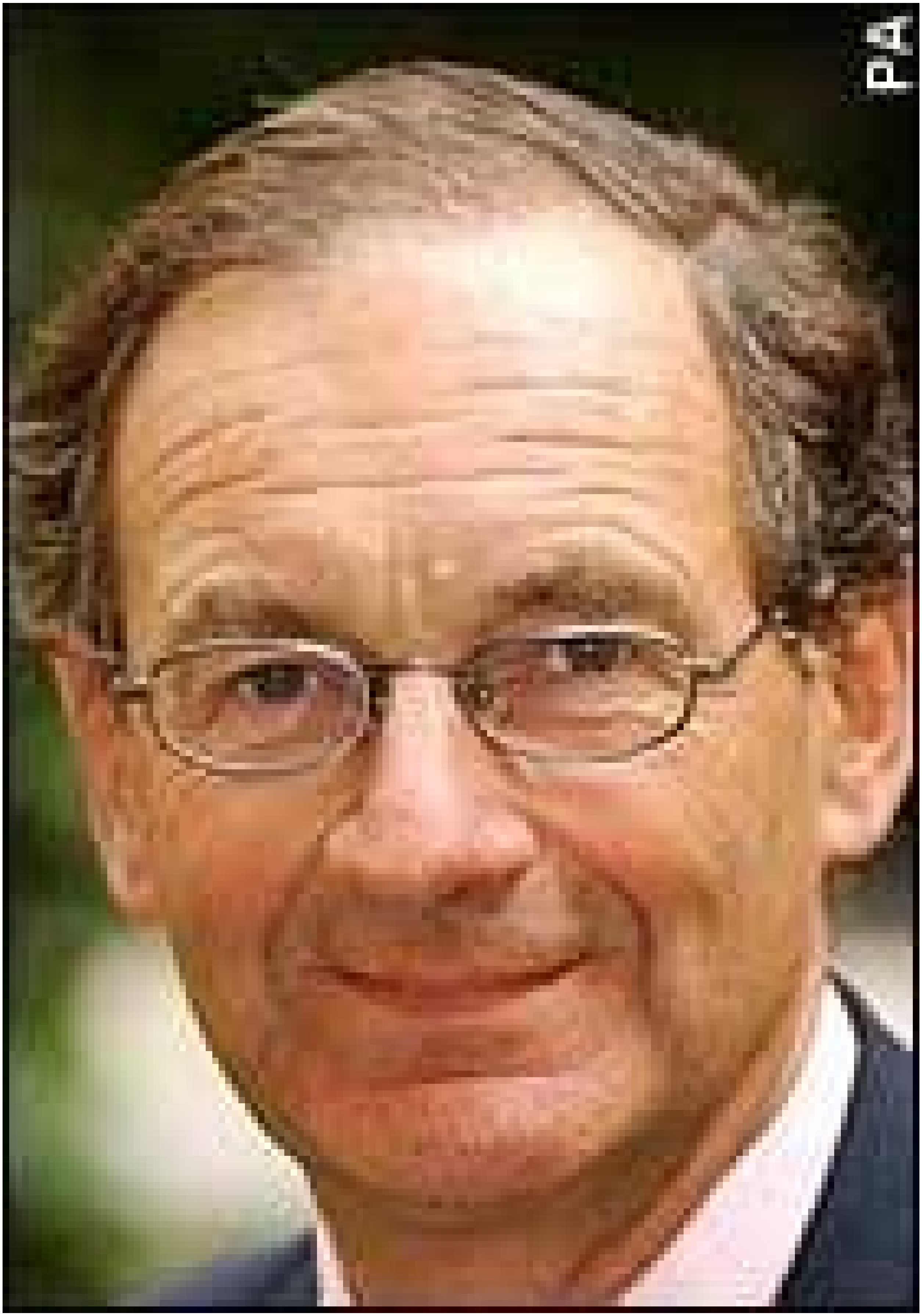


By Kevin Tan

Continuing debt issues have put central banks and governments the world over into uncharted waters. What lies ahead for the US, Europe and Asia? Sir Andrew Large, a former Deputy Governor of the Bank of England, Gertrude Tumpel-Guggerell, an ECB executive board member and Zhuang Juzhong, Deputy Chief Economist of the Asian Development Bank, share their outlook.

The continuing economic crisis has put central banks and governments the world over into uncharted waters. For the industrialised West, the question seems to be a choice between economic stimulus and jobs, in the hopes of creating a softer landing, or a swift shock at the hands of the free markets in the hopes of getting through the downturn more quickly. In emerging markets, the question is how to deal with being the focal point for investors looking to maximise returns.

Specifically, for the Federal Reserve in the US, that means pumping hundreds of billions of dollars into the markets – buying Treasury bills to increase liquidity - while in Europe, the concern is that monetary union may be at risk due to the strains posed by eurozone countries which are mired in debt. Meanwhile, in Asia, economies are surging, but the prospect of 'hot' money flowing into the region could potentially spell trouble through overheating. INSEAD Knowledge has been looking into the prospects for economies both in the West and Asia.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Fears that the Fed’s second round of quantitative easing (dubbed QE2) may lead to a faster pace of inflation may be overdone. Sir **Andrew Large**, a former Deputy Governor of the Bank of England, says although QE2 could be inflationary, the Fed is capable of managing price stability.

“Will quantitative easing lead to inflation? The answer is ‘maybe’”, says Large, an INSEAD alumnus (MBA ’70). “On the other hand I don’t think one should overlook the fact that the Fed can easily reverse the policy stance, if they think that inflationary expectations are rising too quickly. So I don’t think that just because they have done this it means that inflation’s an inevitability.”

Over the next eight months, the Fed will be buying $600 billion in longer-term Treasuries in the open market, as it strives to fulfill its mandates of achieving maximum sustainable employment and its informal ‘price stability’ inflation target of between 1.75 and 2.00 per cent.

US unemployment remains persistently high at around 10 per cent, while inflation remains astoundingly low at one per cent or less, the slowest on record. That’s despite the Fed’s earlier injection of $1.7 trillion into the financial system to avert an economic depression in the wake of the global financial crisis. Furthermore, US banks remain unwilling to lend despite sitting on reserves of over one trillion dollars, capitalised by the Fed’s purchases of Treasuries and mortgage-backed securities between December 2008 and March 2010.

Speaking to INSEAD Knowledge, Large says that while he has “some reservations” about QE2, he concedes the Fed’s primary mandates necessitate its quantitative easing actions, adding that the idea that a little bit of inflation would reduce the US debt burden “might well be a twinkle in a few policymakers’ eyes”.

But he reckons there is “a certain amount of uncertainty” about whether QE2 will succeed in jump-starting economic growth, and he is also concerned that QE2 will instead result in significant monetary outflows to emerging markets, which have already seen “very big increases in (foreign exchange) reserves”.

Criticisms of QE2

Separately, the Fed’s critics, including officials in China and Germany, have argued that QE2 will give the US an unfair trade advantage by weakening the greenback and provoking a global currency war. QE2, they say, may also spark inflation and create price bubbles in equities, commodities and other asset classes globally.

Recalling the hyperinflation experienced in the Weimar Republic following the first world war, Large believes Germany is right to “point out the dangers” of printing money and pumping it into the economy. “It’s seared in the German consciousness and I think one respects that,” says Large. “I do think that the dangers are perhaps slightly overstated, given the possibility the Americans have to withdraw the stance they are taking.”

In contrast to the Fed's quantitative easing, the European Central Bank has been reducing liquidity in the European banking system by some 350 billion euros over the past five months, says **Gertrude Tumpel-Guggerell**, an ECB executive board member. She says this reflects the central bank's confidence in the improved stability of the banking system and easier access to capital.

"We are confident we are in a phase where the recovery makes it also easier for the banks to continue their lending," Tumpel-Guggerell told INSEAD Knowledge on the sidelines of the Bloomberg BusinessWeek European Leadership Forum in London at the end of November. "The risks have gone down and therefore we are in a period where we don't think that we would need additional measures."

When asked for her view of QE2, Tumpel-Guggerell pointedly sidestepped the question, saying that "each central bank has to take the measures it thinks adequate for each region and area of responsibility". But she noted that the ECB has taken "unconventional steps", cutting interest rates and encouraging banks to lend during the global financial crisis – much like the Fed did.

The euro crisis?

The ECB official was also guarded in her response to a question about whether the euro is in trouble. Europe's current economic turmoil, replies Tumpel-Guggerell, stems from the aftermath of the global financial crisis, which requires financially beleaguered European countries to reduce their debts and resolve their budget deficits.

For instance Ireland, which has agreed to a 67.6 billion euro bailout package from the European Union and the International Monetary Fund, aims to reduce its budget deficit to three per cent of GDP by 2014 by employing a raft of measures including cutting public spending, raising taxes, and using its available financial reserves, says Tumpel-Guggerell.

Notwithstanding growing fears that Spain, Portugal, Italy and Belgium might be next in line to seek financial bailouts, Tumpel-Guggerell expressed optimism about the economic outlook for the eurozone, noting that it is "doing much better" than was expected a few months ago.

“Our surveys show more optimism than before, not only consumers but also corporates are confident,” she says. “The Purchasing Managers’ Index is positive, all the books are very positive, so therefore I think there is more confidence in the system than we had seen before and we should put this into perspective.”

Indeed, Europe’s macroeconomic risks for the next three to five years are well-balanced in her view. “We are pursuing a policy of preventing inflation from going up,” she says. “We are in a much more balanced situation than we were two years ago. We don’t see this inflation risk at the moment.”

“We also don’t see the deflation risk. Therefore, we are confident that the remaining difficult issues will be addressed.”

As for concerns that economic and monetary union may fall apart in Europe, the ECB official argues that most Europeans support and believe in EMU.

“Go to people who live in the eurozone, ask them if they would go back to their old currencies,” she says.

“I think the majority of people are confident that the euro has served them well, is very useful in intensifying our trade relations, is also useful in preserving wealth for the future.”

“For many people it’s an important issue. So there is confidence in the euro. Talk to the people who have the euro and don’t overestimate what are the concerns of the day. They are not relevant in the long term.”

While central banks in the West are trying to boost liquidity, in Asia the fear is that flows of ‘hot’ money from the US and Europe in search of higher yields could be inflationary and create asset bubbles, says **Zhuang Juzhong**, Deputy Chief Economist of the Asian Development Bank, who spoke to INSEAD Knowledge on the sidelines of the school’s Leadership Summit Asia in November.

These capital inflows could inflate the value of Asian currencies and harm Asian exports, says Zhuang. And being volatile and short term in nature, the capital inflows could destabilise the region. As a result, Asian countries are taking “well-targeted” capital controls to counter economic distortions, he adds.

Asked whether he is concerned about the devaluation of the US dollar due to the Fed’s quantitative easing, Zhuang says the international community needs to cooperate in managing “this recovery process”.

Renminbi revaluation

On Beijing’s part, it is beginning to understand that a more flexible renminbi exchange rate is good for China and for the world, says Zhuang, noting that this issue should be looked at from the short-term and long-term perspectives.

Although the international community – in arenas such as the G-20 meetings - is clamouring for China to allow a faster appreciation of the renminbi to address global trade imbalances, Beijing points out that allowing the renminbi to appreciate too quickly could hurt Chinese exports, resulting in job losses and social unrest, says Zhuang.

Furthermore, resolving the undervaluation of the reminbi alone won’t solve the problem of global trade imbalances, Zhuang adds, pointing out that the renminbi has already risen by 45 per cent in real terms since 2005. He says that he believes that China will gradually allow greater flexibility in the renminbi exchange rate.

Indeed, China has taken “a fairly pragmatic view” on the issue of the renminbi, says **Edward Tse**, Chairman for Greater China at management consultancy Booz & Company, who participated in a panel discussion on China at the INSEAD Leadership Summit Asia in November.

“Over time, the Chinese government would like to make the renminbi a real internationalised currency,” says Tse. “In other words, it can be used for exchange of money transactions, not only within China but also outside of China.”

“So in order to make that happen, the Chinese government will inevitably need to begin to reform the currency system for the renminbi over time. The Chinese government has in fact already started doing that.”

China, says Tse, is committed to the appreciation of the renminbi against a basket of major currencies based on an incremental approach.

China’s economic outlook

As for China’s economic outlook, Tse believes the economy will continue to grow at around eight or nine per cent annually for the “foreseeable future”, as Chinese companies have become “bona fide world-class competitors”.

“In my view, China still has a lot of room for fast economic growth but, at the same time, some of these issues like inflation will need to be carefully observed and managed,” says Tse.

However, China needs to address the issue of its shrinking labour force due to the effect of the one-child policy instituted two decades ago, he says. Unless this demographic shift is resolved, China’s population will get older and its workforce will shrink. Tse adds that Beijing is rethinking its one-child policy and will institute reforms to avoid hurting the country’s future economic growth.

A resurgent Asia

As a whole, developing Asia (excluding Japan) has been well-served by the region’s economic stimulus measures, enabling the region to make a V-shaped recovery in the wake of the global financial crisis, says ADB’s Zhuang. But it could yet be affected by the economic climate in the US and Europe.

“I think the risk for developing Asia now is this slower pace of recovery, what we call fragile recovery in industrialised countries, in the US and parts of Europe”, says Zhuang.

The ADB has provided approximately eight billion dollars in financing to some 39 infrastructure, health and education projects in Asia so far this year. “Out of this eight billion, three billion is from a so-called counter-cyclical support facility. It's a fast-disbursing additional support,” says Zhuang. “So we provide this support to fund countries like Bangladesh, Kazakhstan, Indonesia, Philippines and Vietnam. So we have responded very effectively I would say. And, of course, if there are needs, then we stand ready to respond.”

The winds of economic growth are undeniably gusting towards Asia, as capital flows from the debt-battered West in search of more robust havens. Indeed, the World Bank expects economic growth in Asia Pacific to outpace the US and Europe significantly in 2011. But Asia’s role as a locus for investment is not without its risks, as asset prices in the region are being inflated by the flood of ‘hot’ money liquidity. That could result in financial instability, the IMF warns, pointing out that unless world governments work together to unwind the global economic imbalances, another major worldwide recession may not be too far off.

This article was written by Kevin Tan based on a series of interviews for INSEAD Knowledge in November.

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