The Subprime Crisis and Asia
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August 25, 2007

The subprime crisis appears, at least temporarily, to have entered a quiet period. No one knows whether the worst is over or this is the calm before the storm. Last Friday, for example, we learned both that U.S. home sales had been better than expected and that the losses on mortgage-backed securities of the big Chinese banks had been worse. The flow of contradictory news makes even more difficult than usual to forecast what comes next.

Asian central banks and governments, appropriately, have kept their powder dry. There have been no sharp interest rate reductions like the Fed's extraordinary intra-meeting cut in the discount rate. Nor have there been sharp increases to defend currencies like the Australian dollar and the New Zealand kiwi hammered down by the crisis. To be sure, the Bank of Japan has provided liquidity to ensure the smooth operation of the Tokyo market. And the Reserve Bank of Australia has intervened in the foreign exchange market in Sydney. But these interventions have been small by U.S. and European standards.

Looking before leaping makes sense, since the ultimate impact of the subprime crisis is yet to be seen. Personally, I have always been skeptical that the Asian economies will be unaffected if America slows. Asia's exports to the United States are simply too important. Proponents of the idea that Asia can keep growing even if the U.S. slows cite growing intra-Asian trade as evidence that the U.S. now matters less. But they overlook the fact that much of this intra-regional trade is in parts and components assembled into final goods in China and sold to the United States.

I also suspect that investor losses from the U.S. mortgage mess will be larger than currently forecast. Asian investors have been seeking alternatives to U.S. treasury bonds for some time. Almost certainly their alternative investments have not been limited to AAA-rated collateralized debt obligations but have included more speculative securities.

If the U.S. economy enters a recession and Asian growth slows, what should governments and central banks do? In particular, what is the role for the regional cooperation that Asian leaders have been working to encourage?

Efforts to stabilize intra-regional currencies would not be appropriate, because different Asian economies will be affected differently. Singapore, Taiwan and Malaysia depend most on the U.S. market, so they will need relatively large interest rate cuts and currency depreciations to make up for lost exports. In contrast, other economies that depend less on exports to the U.S. will want to see their interest rates and exchange rates adjust by less.

We see here why proposals to establish a system of pegged exchange rates in Asia are wrongheaded. Different Asian economies have different structures. They experience the same external shocks with different degrees of severity. Yoking them together in a common exchange rate system would be the height of lunacy.

But this does not mean that there is no scope for cooperation. If a U.S. recession causes Asian growth to slow, then Asian governments are also going to want to cut taxes in order to stimulate domestic demand. The Chinese government, for its part, will want to boost public spending. But each Asian government will hesitate to go first. They face a free-rider problem, since some of the benefits from increased demand will spill over to neighboring countries in the form of increased exports. And investors may look askance at any one Asian government that unilaterally raises its budget deficit.

This creates an argument for Asian governments to move together. Rather than any one of them increasing its budget deficit dramatically, together they can take a series of small steps in the same direction but still have the same positive impact on regional demand.

But moving together requires information sharing, consultation and coordinated action. This, of course, is what the ASEAN+3 surveillance process is designed to achieve. There may soon be a need to put that process into action.

In addition, cooperation is needed to prevent Asia from having its own subprime crisis. The crisis in the United States resulted from inadequate regulation of financial markets. U.S. regulation was loosened to win back business that had migrated to London. Singapore, Hong Kong, Shanghai, Tokyo and Seoul are now competing to see who will be the dominant Asian financial center. This creates a similar pressure for competitive deregulation. Asian governments and central banks need to cooperate to ensure that this does not result in a race to the bottom.

There has been much talk in recent years about the desirability of financial cooperation in Asia. Now is the time to put the principle into practice.

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