



Asia in the Post Sub-Prime World Order

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Thank you Jorge for the kind introduction. I would like to also thank CIGI for inviting me to address such a distinguished audience. I have had the privilege of taking part in two CIGI workshops in the past year, both on the subject of new international governance mechanisms. At the time, discussions of such grandiose themes might have seemed unrealistic to many observers, maybe even borderline delusional. In the wake of the global financial crisis, we know today that these ideas are very much being debated at the highest levels. Leaders from the G20 countries will meet in Washington, D.C. on November 15, in effect bringing to life the L20 – an idea which has its roots firmly in Canada and more specifically in the person of former Prime Minister Paul Martin. Let me therefore congratulate CIGI for the vision and foresight to have invested in research and discussion on these issues of global governance well before the crisis erupted.

In my speech this afternoon, I would like to offer some variations to the overarching theme of this conference – China in a Shifting World Order. In particular, I would like to do three things:

- i) To discuss the naming rights for the “shifting” world order
- ii) To direct the focus away from China and to Asia more broadly
- iii) To highlight the implications for Canada and Canada’s international policy

Events of the last few months suggest that the world is entering a new era. The conference theme describes it as a “shifting” world order. But shifting from what? Shifting to whom? What marks the turning point? You will see from my speech title that I have given provisional naming rights for this shift to the “sub-prime crisis”. There is a nice ring to the idea of a “post sub-prime era” in the sense that “sub-prime” means less than optimal, and hence “post” sub-prime would suggest moving closer to “prime” (but not necessarily so).

There are other candidates for the so-called naming rights to the turning point of a shifting world order:

- We could be more specific about the sub-prime crisis by describing its national origins, hence “Post *US* sub-prime crisis” or perhaps even “Post George Bush Sub Prime Crisis”. This would signal that there is a shift not merely from one set of global governance models to another, but that there may be a concomitant shift in power away from the United States to other countries. The Germans may have the best word for that sense of gloating that one feels at the misery of others, but I can assure you that “Schadenfreude” in being expressed in many languages around the world.
- Until the financial crisis erupted a few weeks ago, I think many of us would have identified the global turning point of 2008 as the Beijing Olympics. This was an extravaganza for the world to behold – not only in terms of Chinese organizational and athletic prowess, but also the national pride that was engendered by China’s hosting of the games and the way in which world leaders congregated in Beijing, including some who had initially sworn that they would boycott the event because of concerns over human rights violations in Tibet.
- Another candidate for the turning point of 2008 might well be the welcoming of India as a nuclear power. Whether you see the US-India civilian nuclear

cooperation agreement as a step back in nuclear Non-Proliferation Treaty regime or the natural outcome of a global power transition, it is a big deal in India and I think also for the world.

- Many commentators of a certain persuasion have been quick to label the turning point in 2008 as the end of “neo-liberalism”. Others prefer the term “Washington Consensus”. I don’t like the term “neo-liberalism” because it tends to be used as a catch-all description for all that is wrong with capitalism, and therefore -- by definition – undesirable. I believe there are many features of “neo-liberalism” that will in fact survive the current global economic soul-searching. And it may come as a surprise to many that in the years ahead, the staunchest defenders of economic liberalization and open markets will come from Asia.

Which brings me to the second part of my speech. While the focus in this conference on China is timely, we should not be misled into thinking that China alone holds the key to a shifting world order. China neither wants that role, nor can it live up to such a role – at least not in the near term. It is more useful to think about China in the broader context of Asia, and the collective influence that the region as a whole will have on changes in international economic and financial arrangements. There are a number of reasons why we should focus on Asia rather than on China narrowly:

- i. The reordering of the investment banking industry so far has been led by Japanese firms rather than Chinese investment banks. E.g. MUFG \$9b investment in Morgan Stanley; Mizuho \$1.2b in Merrill Lynch; Sumitomo Mitsui Financial Group \$1b in Barclays; Nomura’s acquisition of Lehman operations in Asia and Europe for a paltry \$227m. Chinese investment banks not as mature as Japanese investment banks and certainly not as successful in the recent acquisition of US investment industry assets. CITIC looked at stake in Bear Stearns in Oct 2007 but was not able to conclude; China Development Bank (with Barclays) also failed to pick up

ABN Amro assets in 2007. CIC investment of \$3b in Blackstone in early 2007 has resulted in large losses so far.

- ii. While the foreign reserves of China are substantial indeed, at around \$1.9 trillion; the total for Asia is even more impressive (>\$4trillion). Together with oil-producing Gulf states, these capital surplus countries will play a critical role in the recapitalization of western financial institutions.
- iii. So-called new international economic and financial architecture has been discussed in Asia for at least ten years, since 1997 Asian financial crisis. Asia is in a sense ahead of the world in thinking about reform of the international system. Twist is that Asian thinking has been about new regional institutions rather than the global system. E.g. Chiangmai agreement ++ which includes. reserve pooling, multilateral swap agreements, and macroeconomic surveillance. It is unlikely that Asian economies will jettison regional integration/cooperation in favour of a global approach. If anything, the current global crisis will spur a multi-track approach, with renewed commitment to deeper regional integration. Recent ADB study on “Emerging Asian Regionalism” includes recommendations for an Asian financial stability forum and a secretariat for macroeconomic and exchange rate policy coordination. Survey of opinion leaders in Asia: 83% believe that an “Asian economic community will produce large benefits”. ADB President Kuroda still bullish on Asian economic outlook and has encouraged more rapid development of Asian bond markets.
- iv. The issue of demand-switching (export-led to consumer-led) is not just a China issue. China is simply the export platform for final goods produced with intermediate inputs imported from East Asian suppliers. Managed floats have kept most Asian currencies relatively undervalued. China has to lead by allowing RMB to rise, and switching to domestic sources of demand, but other Asian economies have to follow. Intraregional trade has grown from 37% in 1986 to 52% in 2006. As share of GDP, trade among integrating Asia has risen from 10% in 1986 to nearly 30%. Parts and

components account for 30% of manufacturing trade in Asia (ASEAN = 42%; China = 25%).

- v. China is preoccupied with domestic issues of social stability and economic development. Hence China is not willing to lead in the construction of a post sub-prime world order. Emphasis for the time being is Asian regional integration and cooperation.

How will Asia contribute to and feature in a post sub-prime world order? For starters, the L20 meeting in mid November will include 6 Asian countries: Japan, India, China, Korea, Indonesia, and Australia.

Capital flows: The world will look to capital surplus countries in Asia to recapitalize the US and other economies hit hard by the financial crisis. At the very least, Asian investors must be persuaded to maintain their holdings of US dollars, even if they see the US economy heading into a sharp recession. As it turns out, the US dollar has strengthened significantly in the last few weeks, but this has been the result of a flight to quality rather than a vote of confidence in the health of the US economy. Many analysts believe that in the medium-term, the US dollar will depreciate sharply. There is a danger that foreign holders of US treasuries may be looking at the current strength of the US dollar as the “last chance” to get out of a debased currency. If this happens, the outflow of capital from the US would precipitate a sharp rise in interest rates and an even sharper slowdown in the economy.

Asian investment in the US and European countries will come in many forms. Sovereign wealth fund investment is needed more than ever, and the resistance to these government-owned sources of investment that we saw in the last two years will likely diminish (as western industrialized countries increase their own forms of state ownership of productive assets as a result of the financial crisis).

Financial architecture: We are unlikely to see wholesale reform of the Bretton Woods institutions. The IMF and World Bank will continue to decline in importance, not only

because emerging countries are not adequately represented in the governance of these institutions, but also because they are not as useful as they once were. Middle income countries generally are not going to the IMF/IBRD because they do not have the need to do so. The enhanced Chiangmai agreement has a multilateral swap facility for the ASEAN plus three countries which could potentially be decoupled from IMF-style conditionality.

Trade architecture: The WTO Doha Round is moribund, hence bilateral and regional FTAs will become even more important in the years ahead. As of the end of 2007, Asian economies are involved in 134 trade agreements (signed, in negotiation, or under study). 30 of these deals involve only Asian economies; 104 involve at least one economy outside of Asia.

Economic development paradigm: It is too early to declare the end of “neo-liberalism”. There will certainly be less emphasis on deregulation and privatization; more mixed economy; role of the developmental state; demand management will again be seen as an acceptable form of macroeconomic management (we are all Keynesians now). But trade liberalization will continue to be a priority in Asia, particularly through FTAs. Asia will push for open markets not just because of export-led strategies, but also for the broader benefits that openness brings for productivity and economic development. In China and India especially, economic reform continues to be a priority at the highest levels of government, albeit tempered by greater emphasis on “balanced development”. Perhaps we are moving to a “Beijing Consensus” on economic management, but we may find that many aspects of the new approach don’t look much different from the current “Washington Consensus”.

Implications for Canada

The good news is that we are a member of all the important clubs, including the G8 and G20. Hence we will be at the table when discussions on the reform of

international institutions take place. The bad news is that if there is a “reset” of global governance arrangements, it is not clear if Canada will still have a prominent place at the most important clubs. With respect to the role that Asia is likely to play in the remaking of the international order, there is also good news in that Canada is an Asia Pacific nation and therefore has the standing to be part of institutional developments in the region. However, we often seem to be a reluctant member of the Asia Pacific region. Neglect of relations with Asian countries over the years has diminished our credentials as a legitimate player in the region. The government has identified the Americas as its geographic priority and while China and India feature in various pronouncements about Canada’s commercial strategy, integrating Asia is not taken seriously.

We clearly need to build stronger relations with major Asia countries such as China, India and Japan, but we also need a better understanding of Asia as a regional power, and the role that is played by smaller countries such as Korea and the members of ASEAN. A foreign policy approach based on the idea that we can pick and choose our Asian friends on the basis of presumed common values will not work. Ottawa must take seriously the many variants of Asian regionalism and find ways of participating in the deeper economic integration that is taking place in the region. Free trade agreements with Asian partners can be part of this strategy, and we should look to conclude as soon as possible the FTA talks with South Korea and Singapore, as well as to consider joining other trade agreements such as the P4 or Trans-Pacific Strategic Economic Partnership. With the adoption of a ASEAN charter and the creation of a legal entity representing the 10 Southeast Asian countries, Ottawa should appoint an Ambassador to the regional grouping. This would signal our support for the role that ASEAN is playing not just on economic integration in Southeast Asia, but also its role in broader regional integration and cooperation through the ASEAN plus Three Forum and the East Asian Summit.

Conclusion

There is much breathless talk today about the need for a new Bretton Woods. This has come about because the countries that were “at the creation” of Bretton Woods are at the centre of the financial storm that has erupted. This is not to say that the crisis does not have global ramifications and that global solutions are required. But it is important to remember that talk about the reform of the international financial architecture has been going on for a long time, and that it has had particular resonance in Asia, especially since 1997.

If we are indeed entering a post sub-prime world order, Asia will play an important role in it. That role, I believe, will be based as much on regional initiatives that are underway as on global initiatives. Canada – a staunch defender of the multilateral system – will be faced with new questions about the balance between global and regional/preferential approaches in its international economic policy. If Canada is truly an Asia Pacific country, we are going to have to prove it to our regional partners.