Ten Years after the Crisis: Is Asia Prepared for Future Financial Shocks?

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"Ten Years After: Learning from the Asian Financial Crisis
Are Prevention Mechanisms Sufficient to Avoid Another Crisis?"
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Outline

I. Introduction

II. Crisis, Recovery and Reforms

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V. National and Collective Management of Economic and Financial Risks

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VII. Way Forward

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II. Crisis, Recovery and Reforms

1. Crisis

- The crisis was a result of interactions between the forces of financial globalization and domestic structural weaknesses
- Forces of financial globalization—financial market opening (double mismatches) & volatile capital flows
- Domestic structural weaknesses—financial sector, corporate sector, and supervisory and regulatory frameworks
- Lessons—(1) adopt sound macroeconomic policy, (2) strengthen domestic financial and corporate sectors, (3) avoid double mismatches, and (4) develop self-help mechanisms
- Crisis prevention is better than cure

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II. Crisis, Recovery and Reforms

2. Recovery

- V-shaped economic recovery from 1999 was solid, facilitated by intra-regional trade linkages, although at lower growth rates than in the pre-crisis period
- Investment rates declined sharply and stayed low in the post-crisis period, thereby creating current account surpluses
- Some economy, like Indonesia, was semi-permanently damaged by the crisis
- Rise of China as an explosive exporter and FDI recipient has exerted competitive pressure on crisis-affected ASEAN and Korea

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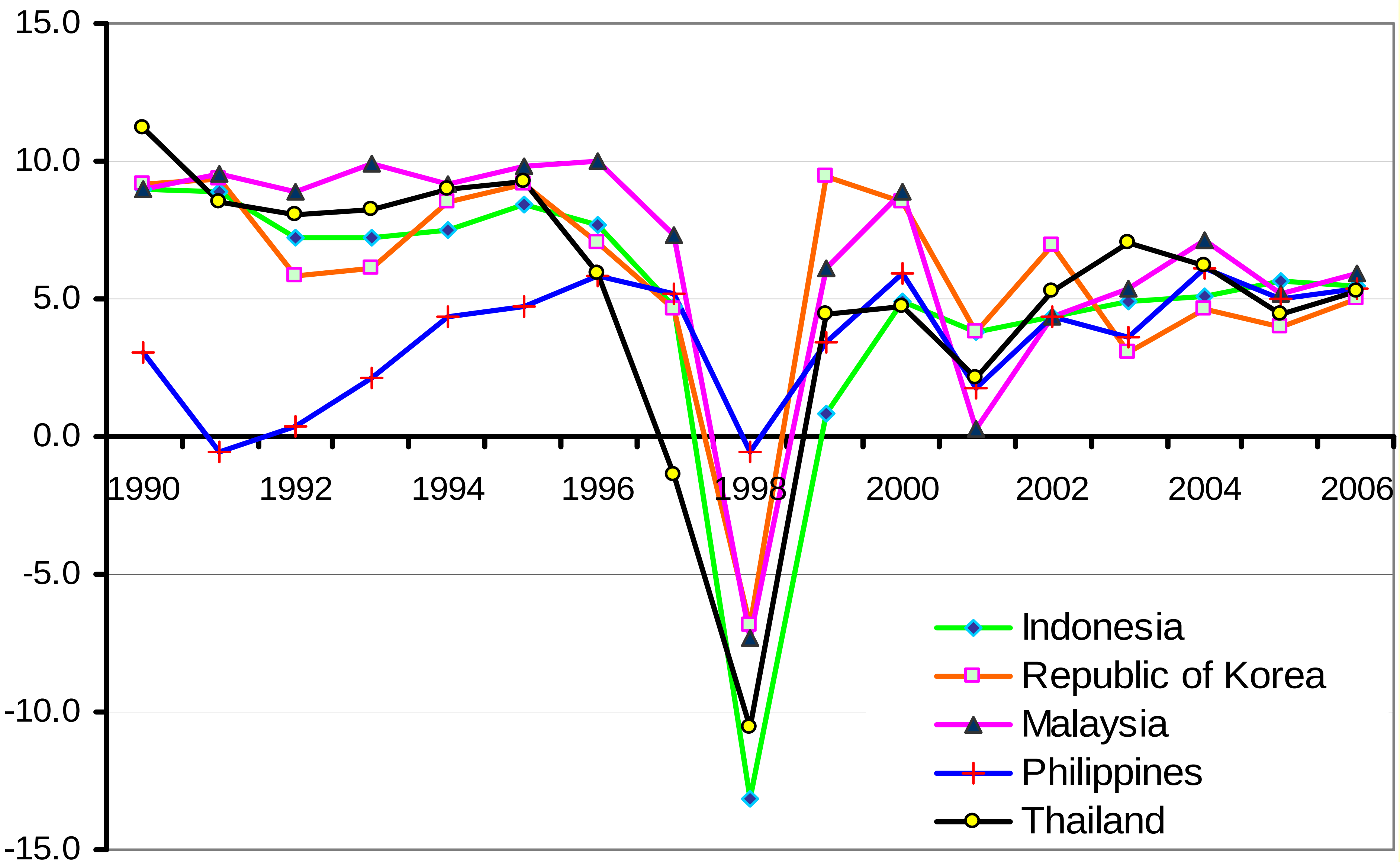
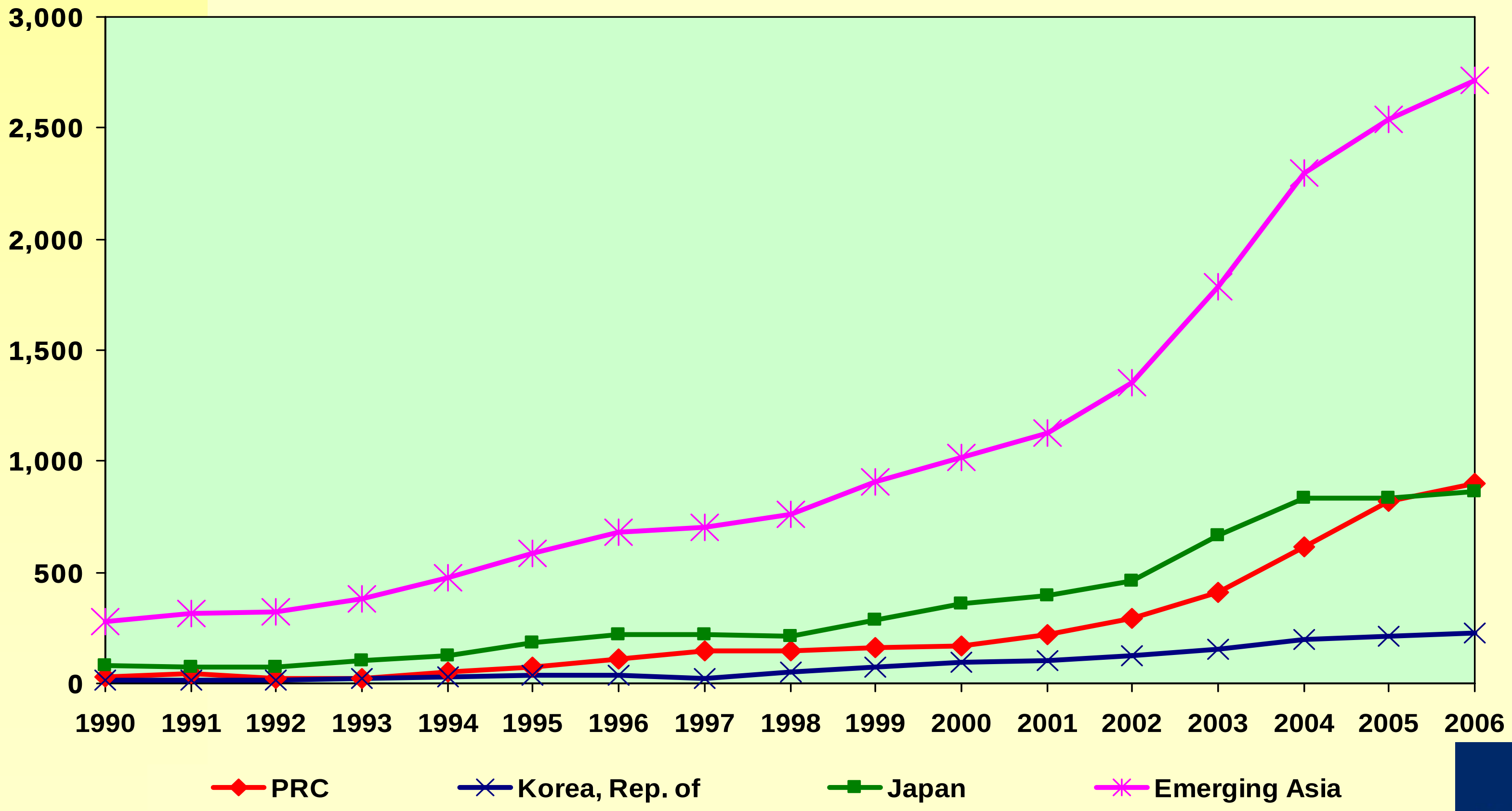
Chart: Real GDP Growth (Annual, %) in Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand (1990-2006)



Data source: World Development Indicators (2006), International Financial Statistics (2007), and Statistic Bureaus of each country

Foreign Reserves, 1990-2006 ($ billion)



II. Crisis, Recovery and Reforms

3. Post-crisis Restructuring and Reforms

- Improved financial conditions through reductions of non-performing loans and short-term external debt and accumulation of foreign exchange reserves
- General shift toward greater exchange rate flexibility
- Financial and corporate sector restructuring, reforms and reconstruction

  - Banking sector restructuring and reforms
  - Capital market development and opening
  - Reform of insolvency procedures
  - Corporate governance reforms
  - Reform of regulatory and supervisory systems

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III. Lessons from the Crisis

1. Crisis Prevention (National, Global and Regional Measures)

Crisis prevention is better than cure

- Adopt sound macroeconomic management (monetary, fiscal, debt management)
- Avoid “double mismatches” in the balance sheets of public and private sectors
- Adopt sustainable exchange rate regime
- Errect a robust and resilient financial system and corporate sector for sound risk management

III. Lessons from the Crisis

2. Crisis Management (National, Global and Regional Measures)

Ensure the crisis does not magnify or prolong

- Mobilize timely external liquidity of sufficient magnitude (IMF liquidity, regional liquidity)
- Adopt appropriate macroeconomic and structural policies to reflect the specific counditions and reality of the economy (IMF conditionality, regional capacity to formulate appropriate adjustment policy)
- Bail-in private international investors (stand-stills, volunatary or involuntary PSI)

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III. Lessons from the Crisis

3. Crisis Resolution (National, Global and Regional Measures)

Resolve the sisytemic consequences of the crisis as quickly as possible

- Establish domestic mechanisms for resolving impaired bank assets and corproate liabilities (regional liquidity)
- Introduce interantional mechanisms for resolving public and private external debt (CACs, SDRM, other international debt insolvency procedures)
- Cushon the effects of crises on low-income groups through social sector policies (national social safety nets, interantional assistance)

IV. Implementation of Lessons

Score Card

- National measures:

  - Most progress: avoiding double mismatches

  - Least progress: social sector protection

- Global measures

  - Most progress: ROSCs

  - Least progress: PSI, HLIs, international insolvency procedures

- Regional measures:

  - Most progress: regional bond market development

  - Least progress: regional adjustment policy, regional exchange rate poilcy coordination

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IV. Implementation: National Policy Reforms

1. Prudent Macroeconomic Management

- Sound macroeconomic policies (non-inflationary monetary policy and disciplined fiscal policy) to avoid boom and bust cycles, or current account deficit and surplus swings
- Avoid double mismatches (currency & maturity) and balance sheet risks
- Choice of exchange rate regime and pace of foreign exchange reserve accumulation must be consistent with the overall macroeconomic objective
- Sequencing of capital account liberalization

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IV. Implementation: National Policy Reforms

1. Prudent Macroeconomic Management: Capital Account Liberalization (China etc)

- Capital account liberalization needs to be well-sequenced and well-spaced as part of an integrated, comprehensive reform package, including reforms of the macroeconomic management framework, the financial system and exchange rate regime
- It is critical to quickly but prudently establish the preconditions for a successful reform package
- Most important is the establishment of core institutional infrastructure—well-defined property and creditor rights; stringent prudential & regulatory regimes; better accounting standards; and strong corporate governance

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IV. Implementation: National Policy Reforms

2. Sound, Resilient Financial Systems

- Establishing resilient national financial systems
- Stronger risk management by commercial banks—through better bank regulation and supervision and greater competition at the national level—is essential to crisis prevention and coping with financial shocks
- Preparation for early implementation of Basle-2 desirable
- Capital market development, particularly for local currency-denominated bonds, and capital market supervision
- Corporate governance and insolvency reforms

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IV. Implementation: National Policy Reforms

3. Competitiveness and Productivity

- Improvement of the investment climate to encourage greater private-sector investment
- Promotion of the knowledge economy—the role of human capital, innovation, labor productivity, total factor productivity (TFP)
- Trade, FDI, industrial clusters and agglomeration
- Infrastructure and physical and digital connectivity
- Energy efficiency and environmental improvements as a new source of competitiveness

IV. Implementation: National Policy Reforms

4. Social Sector Protection and Governance

- Poverty and human development challenges
- Income disparities and inequality
- Economic inclusiveness—health, education and access
- Economic reforms and adjustment through social sector protection

Governance reforms are needed to ensure that economic growth does not exclude the most vulnerable sectors of society from development.

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IV. Implementation: Regional Financial Cooperation

- Reforms of the international financial system have been inadequate (CCL, PSI, SDRM), and national efforts to strengthen domestic economic systems take time to be effective

Three Pillars of Financial Cooperation:

- Economic and financial surveillance mechanism (ASEAN+3 ERPD)
- Liquidity support facility (CMI)
- Asian bond market development (ABMI and ABF)
- *Exchange rate policy coordination has yet to be developed*

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IV. Implementation: Regional Financial Cooperation

1. Regional Economic Surveillance

- ASEAN Surveillance Process, EMEAP Process and ASEAN+3 Finance Ministers' Economic Review and Policy Dialogue (ERPD) process—April 2002 first meeting—for information sharing, economic monitoring, policy dialogue, and peer pressure
- Analysis of macroeconomic and financial conditions, at the global, regional & national levels, and assessment of sources of financial vulnerabilities and policy responses
- Decision to integrate ERPD & CMI in May 2005

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IV. Implementation: Regional Financial Cooperation

2. Reserve Pooling—Chiang Mai Initiative

- Liquidity support to contain and/or manage the risk of currency attacks against liquidity crises and contagion
- Bilateral swap agreements (BSA) among ASEAN+3 countries (16 BSAs signed for a total USD 80 billion)
- Expansion of the ASEAN Swap Arrangement (ASA) to USD 2 billion in April 2005
- 20% of CMI BSA can be disbursed immediately for short-term financial assistance without IMF liquidity support (conditionality)
- Multilateralization of CMI

  - Collective decision-making of BSAs (May 2006)

  - Self-managed reserve pooling (May 2007)

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Progress of BSAs and ASA under CMI

(as of 30 April 2007)

BSAs	Currencies	Effective Date	Expiration Date	Size/Direction	TOTAL
Japan-Indonesia	Rupiah-USD	August 31, 2005	August 30, 2008	USD 6 billion (1-way)	6
Japan-Korea	USD-Won, USD-Yen	February 24, 2006	February 23, 2009	USD 10 billion, 5 billion (2-way)	15
Japan-Korea	Yen-Won, Won-Yen	May 27, 2005	July 3, 2007	USD 3 billion, 3 billion (2-way)	6
Japan-Malaysia	USD-Ringgit	October 5, 2001	October 4, 2007	USD 1 billion (1-way)	1
Japan-Philippines	USD-Peso, USD-Yen	May 04, 2006	May 03, 2009	USD 6 billion, 0.5 billion (2-way)	6.5
Japan-Singapore	USD-Singapore dollar, USD-Yen	November 8, 2005	November 7, 2008	USD 3 billion, USD 1 billion (2-way)	4
Japan-Thailand	USD-Baht, US-Yen	March 7, 2005	March 6, 2007	USD 3 billion, 3 billion (2-way)	6
PRC-Indonesia	USD-Rupiah	October 17, 2006	October 16, 2009	USD 4 billion (1-way)	4
PRC-Japan	Renminbi-Yen, Yen-Renminbi	March 28, 2002	March 27, 2006	USD 3 billion, 3 billion (2-way)	6
PRC-Korea	Renminbi-Won, Won-Renminbi	May 27, 2005	June 23, 2007	USD 4 billion, 4 billion (2-way)	8
PRC-Malaysia	USD-Ringgit	October 9, 2002	October 8, 2005	USD 1.5 billion (1-way)	1.5
PRC-Philippines	Renminbi-Peso	April 30, 2007	April 29, 2010	USD 2 billion (1-way)	2
PRC-Thailand	USD-Baht	December 6, 2001	December 5, 2004	USD 2 billion (1-way)	2
Korea-Indonesia	USD-Rupiah, USD-Won	December 27, 2006	December 26, 2009	USD 2 billion, 2 billion (2-way)	4
Korea-Malaysia	USD-Ringgit, USD-Won	October 14, 2005	October 13, 2008	USD 1.5 billion, 1.5 billion (2-way)	3
Korea-Philippines	USD-Peso, USD-Won	October 17, 2005	October 16, 2007	USD 1.5 billion, 1.5 billion (2-way)	3
Korea-Thailand	USD-Baht, USD-Won	December 12, 2005	December 11, 2007	USD 1 billion, 1 billion (2-way)	2
				Subtotal	80.0
ASA	ASEAN Countries	As of April 2007		USD 2 billion multilateral	2.0
				TOTAL	82.0

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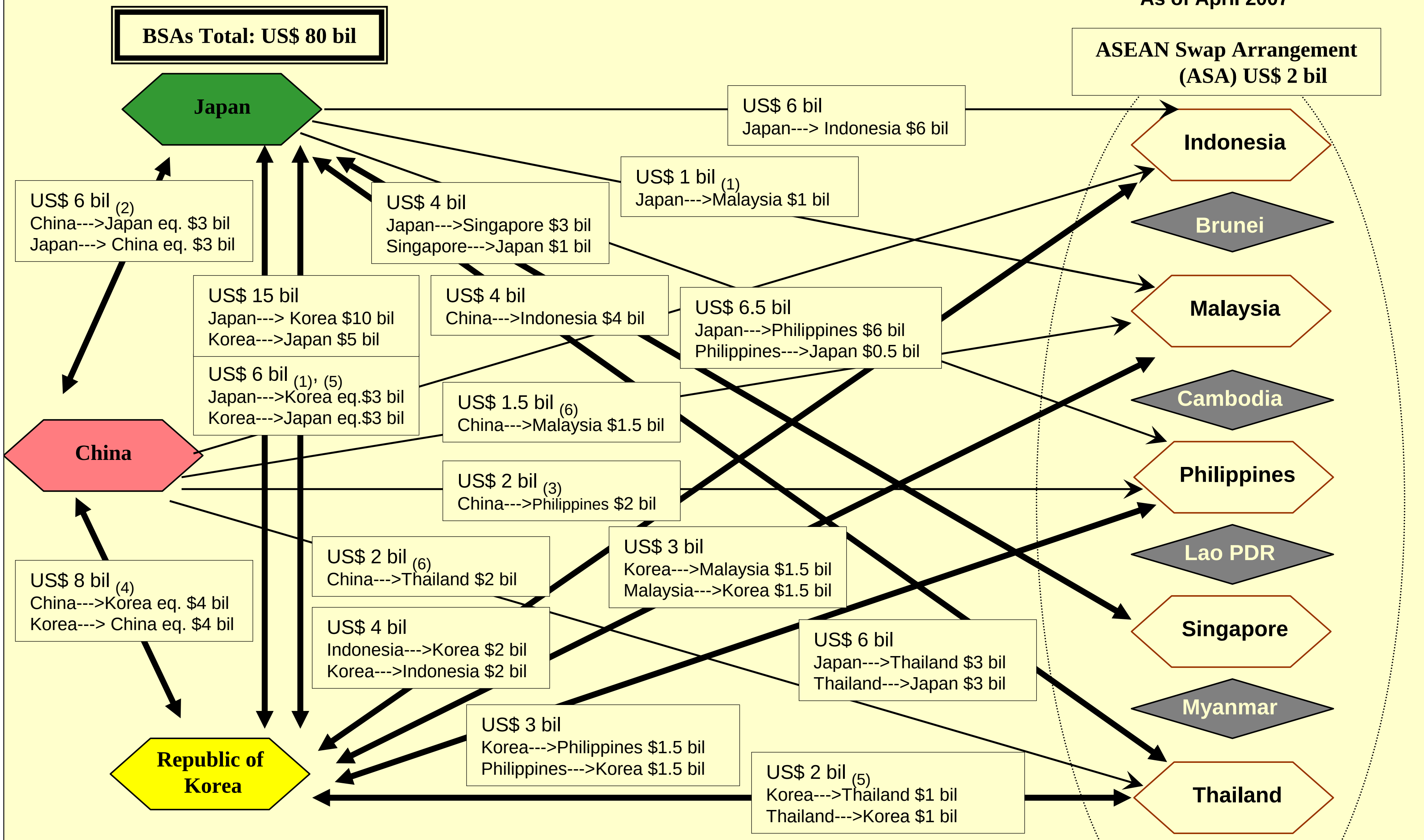
Network of Bilateral Swap Arrangements under CMI

As of April 2007



(1) In addition to the BSAs under the CMI, there exists another BSA under the New Miyazawa Initiative between Japan and Malaysia (US$2.5 bil).
(2) Local currency swap between Japanese YEN and Chinese YUAN.
(3) Local currency swap between Chinese YUAN and Philippine PESO.
(4) Local currency swap between Chinese YUAN and Korean WON.
(5) Local currency swap between Japanese YEN and Korean WON.
(6) The sum of US$ 77.0 billion includes the BSAs between (a) China and Thailand, (b) Korea and Thailand, and (c) China and Malaysia, those of which are currently under negotiation for renewal, but does not include the BSAs under New Miyazawa Initiative and the ASEAN Swap Agreement (ASA).

IV. Implementation: Regional Financial Cooperation

3. Asian Bond Market Development

- Need to build well-functioning local-currency-denominated bond markets
- Better resource allocation to reduce bank dominance and help allocate financial resources more efficiently
- *Asian Bond Markets Initiative (ABMI)* by ASEAN+3 Finance Ministers to develop the supply side of bond markets with focus on market infrastructure

  - Current Working Groups: (i) New securitized debt instruments; (ii) Credit guarantee and investment mechanisms; (iii) Foreign exchange transactions and settlement issues; (iv) Rating systems
- *Asian Bond Fund (ABF)* by EMEAP (Executive Meetings of East Asia Pacific Central Banks) to strengthen the demand side of bond markets

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Issuance of Local-currency Denominated Bonds in Emerging ASEAN+3 Countries by Multinational and Bilateral Institutions

Date	Country	Issuer	Amount	Tenor
Nov-04	Malaysia	ADB	MYR400 million	5-year bond
Dec-04	Malaysia	IFC	MYR500 million	3-year Islamic bond
May-05	Malaysia	WB	MYR760 million	5-year Islamic bond
May-05	Thailand	ADB	THB 4 billion	5-year bond
Sep-05	Thailand	JBIC	THB 3 billion	5-year bond
Oct-05	PRC	ADB	CNY 1 billion	10-year Panda bond
Oct-05	PRC	IFC	CNY1.13 billion	10-year Panda bond
Oct-05	Philippines	ADB	PHP 2.5 billion	5-year bond
Apr-06	Malaysia	ADB	MYR500 million	5 year bond*
May-06	Malaysia	KfW**	MYR500 million	7-year bond
Sep-06	HK, MY, SG & TH	ADB	USD 10 billion (with LCY equivalent)	Medium term note program

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V. National & Collective Management of Economic & Financial Risks

1. Medium-term Risks to Asia

- Disorderly unwinding of global payments imbalances
- Surges of capital inflows to Asia, creating economic overheating
- Rise in protectionism in North America
- Hard-landing of the US economy
- Hard-landing of the Chinese economy
- Rises in global long-term interest rates
- Further increases in oil prices
- Geopolitical risks in Asia

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V. National & Collective Management of Economic & Financial Risks

2-1. China's Macroeconomic Management

- Continuous accumulation of foreign exchange reserves at an under-valued RMB exchange rate, due to current and capital account surpluses
- Limited sterilization means a continuous injection of base money (liquidity) into the economy, posing the risk of over-lending by banks, overheating, inflation, and asset price bubbles
- With a leaky capital account, prudent macroeconomic and financial-sector management requires greater flexibility of RMB. RMB revaluation in July 2005 and its shift to a managed float suggest the beginning of a better arrangement

V. National & Collective Management of Economic & Financial Risks

2-2. Capital Account Liberalization

- Capital account liberalization needs to be well-sequenced and well-spaced as part of an integrated, comprehensive reform package, including reforms of the macroeconomic management framework, the financial system and exchange rate regime
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V. National & Collective Management of Economic & Financial Risks

3. Global Payments Imbalances and Surges in Capital Inflows

- Asia needs to consider its best response policy in the event of disorderly unwinding of global payments imbalances and/or surges in capital inflows
- Recent surges in capital inflows are a source of macroeconomic and financial sector vulnerabilities (Thailand, Korea, Vietnam, China, etc)
- Difficult to cope with these problems by national policies alone as the emerging Asian economies' choice of exchange rate regime is constrained by that of China, a competitive investor

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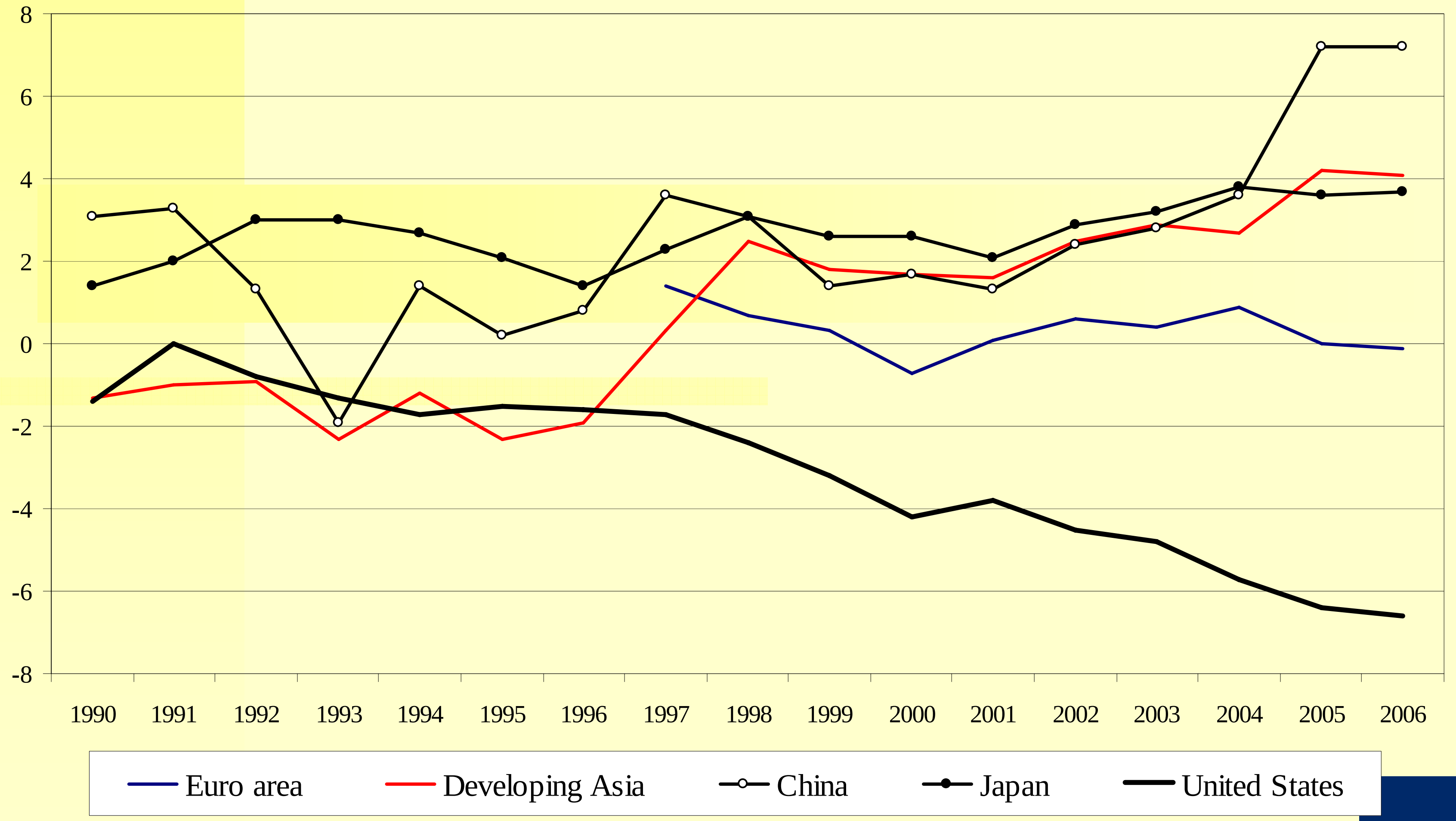
Current Account Balances, 1990-2006
(as a percentage of GDP)



Source : International Monetary Fund, World Economic Outlook Database, September 2006.

V. National & Collective Management of Economic & Financial Risks

4. Exchange Rate Policy Coordination

- Close interdependence of East Asian economies through trade, investment and finance requires exchange rate stability within the region
- But Asia’s exchange rate regimes are in serious disarray and are in need of coordination
- Resolution of the global payments imbalance and rapid inflows of capital to East Asia may require collective appreciation of the East Asian currencies vis-à-vis the US dollar
- Creation of an ACU as an exchange rate index can facilitate closer surveillance of currency market developments and coordination of exchange rate policies

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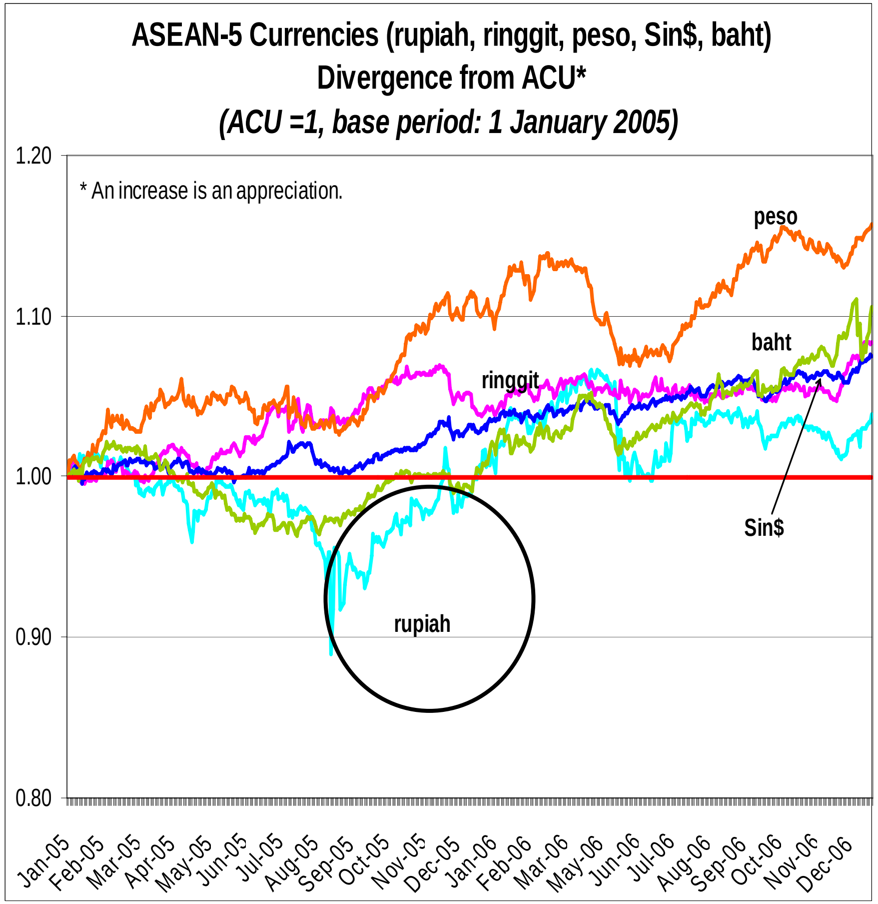
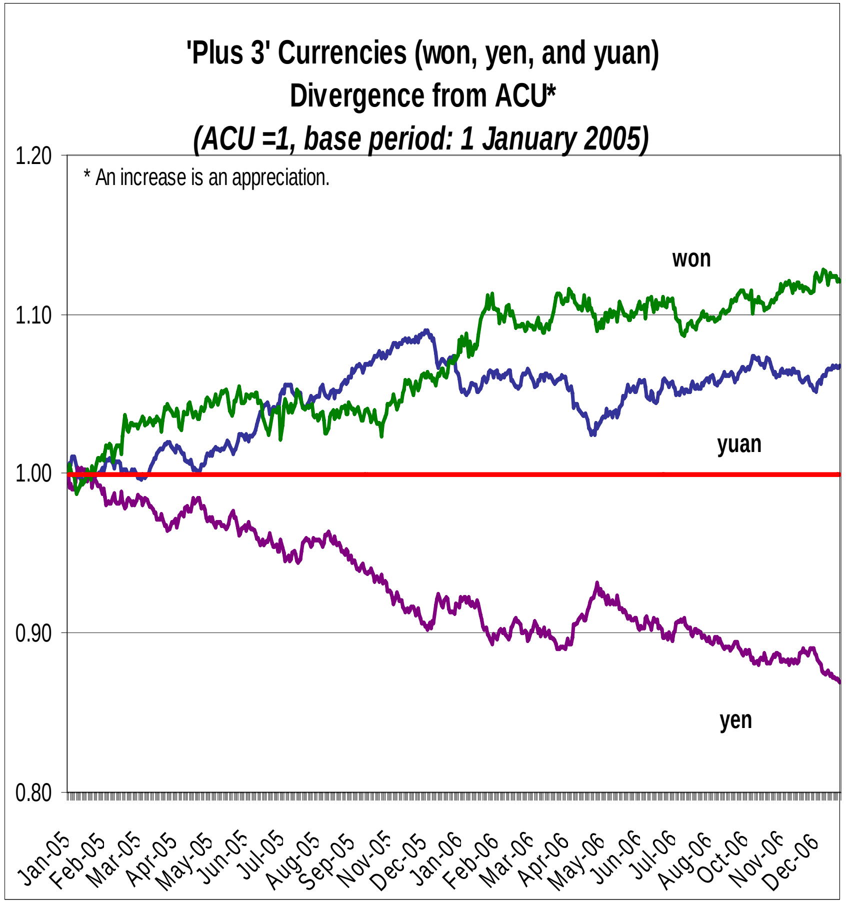
Trend of Main Asian Currencies vis-à-vis the ACU: 1/2005 - 12/2006





V. National & Collective Management of Economic & Financial Risks

5. Consolidation of FTAs into a Single FTA

- To reduce the Asian “noodle bowls,” coordination and cumulation of rules of origin, and harmonization of standards need to be pursued
- Building on ASEAN+1 FTAs, multiple, overlapping FTAs may be consolidated into an ASEAN+3 FTA (China’s proposal) or ASEAN+6 FTA (Japan’s proposal)
- This ASEAN-centered approach requires deeper integration of AFTA towards the ASEAN Economic Community
- Afterwards, East Asia should work with NAFTA and EU to foster inter-regional FTAs

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VI. Way Forward

- Recovering from the 1997-98 crisis, Asia is again the most dynamic growth center of the world economy
- Crisis-affected East Asia is more resilient to financial shocks as a result of improved external financial conditions (reductions in short-term external debt and accumulation of foreign exchange reserves), greater exchange rate flexibility, restoration of financial health of commercial banks, and financial and corporate sector reforms
- Asia (including China, India, ASEAN, and others) continues to face significant challenges in macroeconomic management (including choice of exchange rate regime), financial sector reform, real sector competitiveness and social sector protection

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VI. Way Forward (cont'd)

- Asia needs to adjust when growth prospects are strong—(1) strengthen national financial systems, (2) improve investment climates, and (3) improve social sector protection
- Asia needs to consolidate FTAs into ASEAN+3 (or ASEAN+6) FTA to benefit from freer trade & FDI
- Asia needs to strengthen financial cooperation in ERPD, CMI and bond market development
- Uncoordinated exchange rate regimes can be a source of problem
- In order to reduce its vulnerabilities to the disorderly unwinding of global payments imbalances or the surges of capital inflows, Asia needs to initiate exchange rate policy coordination: ACU may be a useful tool to facilitate this process

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Thank you
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