

THE CALM BEFORE THE STORM? MANAGING THE RISKS OF AN ASIA-PACIFIC FINANCIAL DOWNTURN

Recent volatility in the Asia-Pacific financial markets has raised questions about the stability of economies in the region. Though the markets have been quiet in the last few days, there are new risks emerging which may lead to more stormy weather ahead. How well is the region prepared to handle financial shocks? Can they lead to another economic crisis? This policy brief examines what factors drive the current market volatility, and whether regional economies are protected against an economic meltdown. UNESCAP recommends a four-track approach for Asia-Pacific economies to manage the risks present in the global environment.

BUYING FRENZY

International portfolio investors have been steadily buying shares in Asia since 2004 and driving up prices in the process (see figure 1). The region saw US\$ 39 billion in inflows - or 63 per cent of developing country net portfolio equity investment - in 2005. The most popular equity markets were China, India and Thailand. Investors also bought a wide range of other assets - both developed and emerging market bonds and commodities.

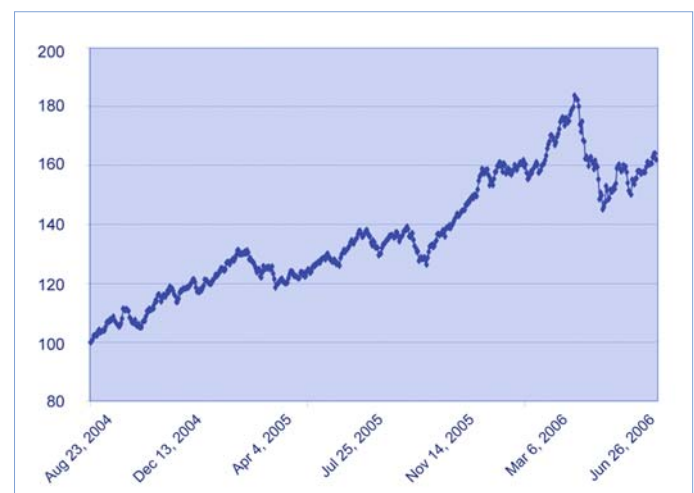
Buying was fuelled by both external and internal factors:

- The external push was low interest rates in developed countries, especially in Japan and the United States. The United States interest rate fell steadily from 6.50 per cent in 2001 to 1 per cent by mid-2003. Japan maintained a zero per cent interest rate since 2001. The booming portfolio flows to Asia were encouraged by borrowing in cheap foreign currencies, especially the yen and the dollar, to fund the buying of equities and other assets.
- The internal pull was the attractiveness of Asian equity prices compared with other investment options.

Essentially, these prices looked cheap compared with earnings prospects of Asian companies in coming years, driven by strong economic growth across the region.

- ▶ Investors have preferred particular sectors depending on country conditions. For example, consumption-related equities such as banks and real estate were important in India and China, whereas commodity stocks have been important in commodity producing economies such as Indonesia.
- ▶ Diverse non-equity asset prices also soared as investors looked for other ways to earn higher returns. Commodity prices especially benefited, partly because of their perceived link to strong demand from growing Asian economies, particularly metals such as gold, copper and zinc.

Figure 1
*Asian emerging markets equities performance
Past 2 years*



Source: MSCI Emerging Markets Asia Index.
Note: Data as of 21 August 2006

WHAT A DIFFERENCE A FEW WEEKS MAKE ...

The panorama abruptly altered on 10 May 2006 when global equity prices tumbled across the world. Asia-Pacific share markets fell throughout May and June, experiencing their biggest monthly decline since September 2002. After a brief respite at the end of June, equity markets were volatile again in July. All countries in the region have been affected, suffering record falls for the year. Commodity markets also moved significantly downwards. By mid-June the copper price had declined 25 per cent and the price of gold by 23 per cent from their peaks in May.

The initial trigger was the interest rate hike by the U.S. Federal Reserve in its monthly meeting on 10 May 2006 to 5 per cent. This was unforeseen by investors as they had expected the interest rate to remain unchanged at 4.75 per cent. Although the United States had already raised interest rates 16 times since 2004, earlier increases had been generally factored in by investors. The United States move to tighten monetary policy in May was preceded by large reduction by Japan of its liquidity from March onwards. The effect of these two developments was to reduce the international money available to invest in Asian assets.

The latest round of equity market instability has been caused by concerns about the recent political situation in the Middle East and its impact on oil prices. The rise in United States interest rates has also caused more long-term worries about future United States growth. Higher interest rates can dampen growth through reducing consumption and investment directly and also through lowering people's wealth by reducing house prices. The combined effect of these knocks to United States consumption would impact Asian exports. Exporting companies in the region may have decreased future earnings growth and this concern is impacting their share prices.

BETTER PREPARED THIS TIME

Instability in Asian financial markets causes worry in the region because the bitter memories of the 1997 crisis are still fresh. Current events do not signal a crisis and countries are much stronger now:

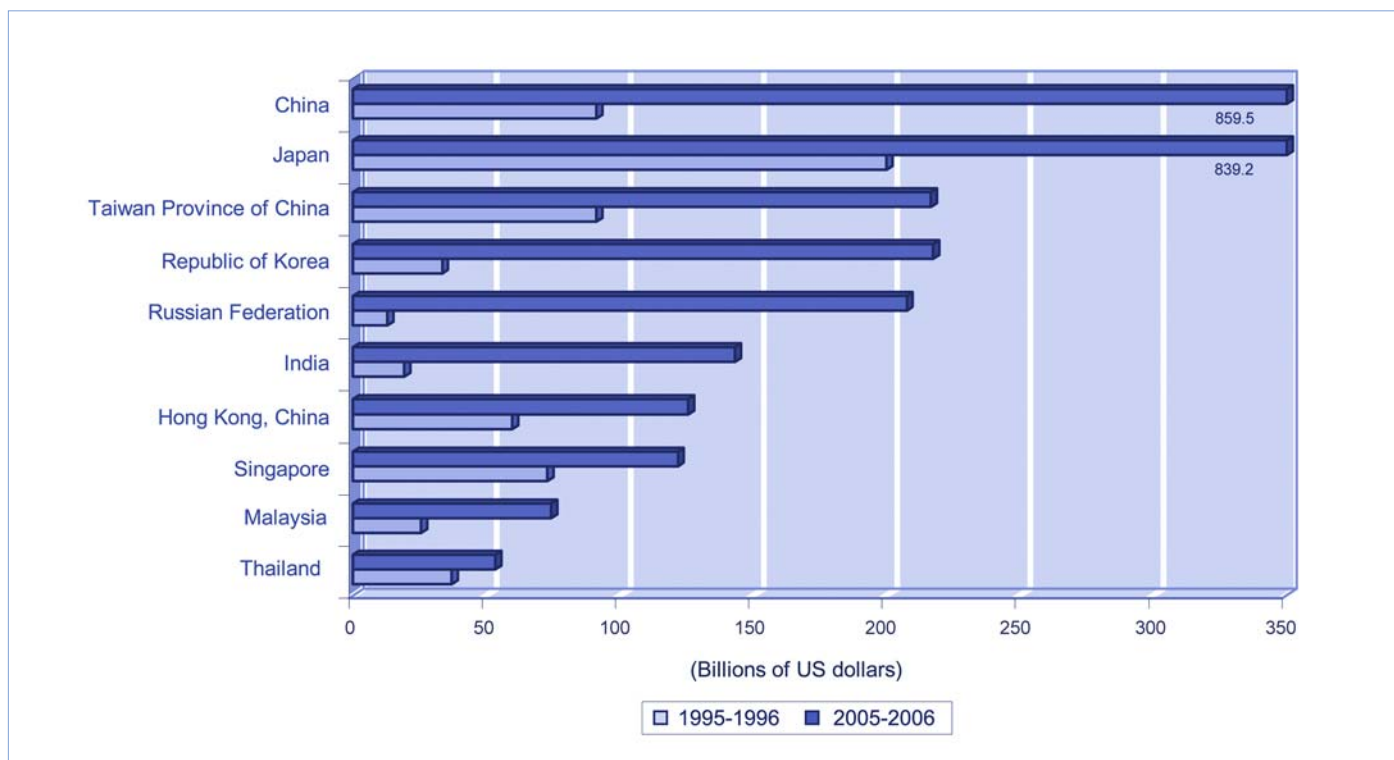
- Countries in the region are now in a stronger position to handle turbulence. In 1997, the selling of Asian assets was based on fears about the countries' macroeconomic fundamentals due to their high external debt and untenable fixed exchange rate systems. Countries now have more flexible exchange rate regimes and high foreign exchange reserves (see figure 2). The region also has the world's best growth prospects. For example, India released data in May showing that exports and industrial production were at their highest levels in the past six months. China's GDP growth in the second quarter of 2006 was at a record 11.3 per cent, the fastest rate in more than a decade.
- This time around assets across the world were sold in unison after the current oil price and United States interest rate rises. Asian equities were not especially targeted as in 1997. Latin American and emerging European country stock markets, including Mexico, Brazil, Turkey and the Russian Federation, suffered large declines.
- Asian countries depend less on portfolio inflows as an investment source. Therefore any outflows would have a smaller impact. The contribution of foreign direct investment has risen as compared to a decade ago. Portfolio inflows are also smaller in absolute terms. There is a reduced prevalence of currency and maturity mismatches in borrowing. The proportion of financing through foreign debt is lower, as is its short-term component.
- Countries have better banking systems. Profitability of banks has been increasing over recent years. Capital adequacy ratios are generally rising across Asia and are mostly well above the 8 per cent recommended international minimum. Non-performing loans have been reduced in most countries.

A HEALTHY CORRECTION?

According to current expectations of Asian dynamism, the equity market decline could be viewed as a healthy, necessary, and relatively moderate correction. The price/earnings (P/E) ratio - price of a company's shares relative to the company's future earnings - a main method for investors to value share prices, shows that shares in

Figure 2

Top Asia-Pacific holders of foreign reserves^a



Source: IMF, International Financial Statistics (CD-ROM), July 2006.

^a Defined as foreign reserves (excluding gold).

some Asian markets had become overvalued as compared to the emerging market average. However, the recent correction seems to be moving share prices back closer to more sustainable levels.

Some other equity markets, such as Thailand, Hong Kong, China and Singapore, had already been seeing declining P/E ratios over the last two years and therefore the selloff was not linked to fears of overvaluation.

Overall, the equity market revaluation serves to align share values more reasonably with companies' and countries' future performance, after a period of over exuberance driven by the lack of returns in developed country asset markets.

ALL IS NOT WELL-SEVERAL DOWNSIDE RISKS EXIST

At the moment Asian economic fundamentals remain robust. There are however several downside risks largely coming from developments outside the region:

- High and rising oil prices are the main threat to the prospects of net oil importing economies in the

region. High oil prices have already pushed up inflation in the region and hurt the current accounts balances of oil-importers. Further price rises would also require painful adjustment including further reduction of fuel subsidies and raising of interest rates.

- Further rises in developed country interest rates, in particular in the United States, the Eurozone and Japan, are possible if inflation shows signs of momentum in these economies. The result may be a global economic slowdown. Asian economies would be affected by a drop in the demand for their exports, and through pressure to increase their own interest rates.
- Some Asian countries have seen large housing price rises over recent years. A significant increase in interest rates may impact mortgage borrowers and owners of housing assets, leading to decreased consumption. Governments in the region are increasingly aware of the issue and some have taken steps to gradually control real estate prices.
- While the above reasons are possible triggers for a loss of investor interest in countries in the region, capital outflows may be exaggerated by overreaction

and also by contagion from outflows in other countries. This behaviour is commonly observed in financial crises, such as in 1997, and is difficult to stop once it is in motion. The risk has been heightened by the increase in hedge funds and credit-financed investment in this region in recent years. A further sharp drop in asset prices can set off a negative cross-country chain reaction through these channels.

TOWARDS A STRONG AND FLEXIBLE ECONOMY-A FOUR-TRACK APPROACH

As Asian economies are becoming more integrated into the global economy, they also face a higher risk from the constantly shifting global environment. It is increasingly important to build strong and flexible economies that can weather global shocks and adapt to new realities. Establishing solid macroeconomic and microeconomic fundamentals, healthy financial sectors, and regional cooperation in financial markets are crucial in this endeavour:

1. Countries must ensure solid macroeconomic fundamentals to maintain investor confidence and sustain economic growth. Key elements are moderate and stable inflation; sound fiscal policies that ensure low budget deficits and sustainable debt burdens; and flexible exchange rates regimes that can absorb external shocks and reduce currency mismatches in borrowing.
2. Countries must develop healthy financial sectors to build confidence and benefit from capital inflows. This requires well-developed regulatory structures to be in place to prevent bad debt. Independence and
3. Countries must have robust microeconomic foundations to ensure the efficiency of the economic system. A basic requirement is clear property rights, overseen by a strong judiciary, that allow companies and institutions to operate effectively and transparently. The labour market should be flexible enough to adjust to economic downturns. Social safety nets have to be developed further to prevent people falling into hardship during such periods. Key areas to address are unemployment insurance, and pensions.
4. Countries must improve regional cooperation to lessen the impact of financial market volatility. There have already been positive moves in this direction. The ASEAN+3 economies are sharing information about portfolio flows, collaborating in regulatory activities, and have established a financial support mechanism against disruptive capital movements through the Chiang Mai Initiative for currency swaps. The funds available for financial support are not sufficient as a primary means of response compared to the scale of possible need. The effectiveness of regional surveillance on country domestic policies needs to be improved. It is important to extend cooperation in these issues to other countries in the region.

This issue of the Socio-Economic Policy Brief has been prepared with substantive contribution from Mr. Shuvojit Banerjee, Poverty and Development Division, ESCAP.

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