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The purpose of this policy brief series is to provide an analysis on macroeconomic policy challenges facing the ESCAP region. Some of these challenges may appear suddenly and confront policymakers unexpectedly. Other challenges may be long term or recurrent ones that suffer from inaction, policy fatigue, or the benign neglect of policymakers. Analyses and reliable statistics may be lagging behind or may not be available at all. This series aims at generating a forward-looking discussion among policy planners, researchers and other stakeholders that will build a regional consensus and forge political will on the policy actions and pressing reforms that are needed.

The first volume of the series is dedicated to the financial crisis: a crisis that over the past decade was predicted many times, by many, including ESCAP and other international organizations, eminent scholars, economists, policymakers and futurists. Less than a handful predicted its exact timing. None averted it. Much remains to be understood and done before regulatory policies and systems can be reformed.

ADDRESSING THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON ASIA-PACIFIC ECONOMIES

INTRODUCTION

In the current global financial crisis, 15 September 2008 marked a decisive turning point. It was the day that the American investment bank Lehman Brothers Holdings, Inc. collapsed, exacerbating the financial turmoil and causing an extraordinary downward spiral in confidence. It was also the day on which the crisis truly hit Asia-Pacific shores, spreading beyond its equity markets and posing the greatest threat to development since the financial collapse of 1997. The impact on the region was seen most immediately in the financial sector, while the medium-term impact on growth will become evident in the coming months. Countries will be able to avoid the worst of the consequences by bolstering national policy actions with key concerted regional cooperation initiatives.

CONTAGION RETURNS

The region is once again the victim of contagion, although this time it is not between Asian economies but from abroad. Indeed, many of the policy failures blamed on the region in 1997 are evident once again in the United States of America and Europe, albeit to varying degrees — lax supervision of financial systems, excessive credit creation and build-up of asset bubbles. Asia-Pacific economies are better prepared for currency and balance of payments crises than they were a decade ago, having improved current account balances and built up a protective shield of foreign exchange reserves.

This resilience notwithstanding, the improvements have not been enough to prevent domestic financial repercussions. The global shocks and contagion effects triggered by the financial crisis have brought to the fore certain country-specific vulnerabilities in the region, with external financial vulnerabilities playing an important role, as is discussed below.

HOW HARD HAVE THE REGION'S FINANCIAL MARKETS BEEN HIT?

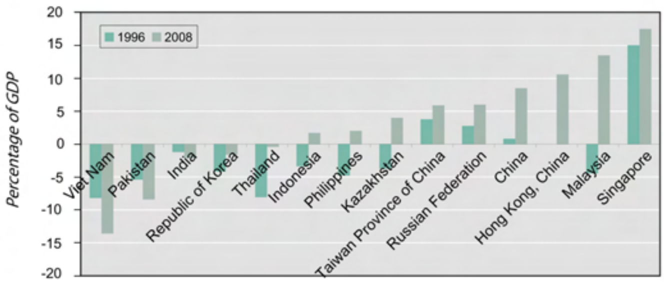
Global financial turmoil resulted in foreign investors withdrawing from equity markets across the region, with the result that equity and currency markets have tumbled, although the degree has varied highly across economies. Given the important role that foreign investors play in capital markets in some countries, capital outflows resulted in a sharp decline in exchange rates against the United States dollar. Since August 2008, the greatest equity market falls have taken place in the Russian Federation, Kazakhstan, Thailand and Indonesia, while the greatest currency depreciations against the United States dollar have taken place in the Republic of Korea, Indonesia, India, the Russian Federation and Pakistan. To varying degrees, countries have prevented a full pass-through of capital outflows to currency values by drawing down their foreign exchange reserves. Pakistan has faced the greatest difficulty in maintaining its currency value, requiring IMF support to bolster dwindling reserves as the currency fell to an all-time low in October. The Republic of Korea and Singapore have each agreed on a precautionary $30 billion currency swap facility with the United States Federal Reserve.

WHAT DID THE REGION LEARN FROM THE 1997 CRISIS?

Rising current account deficits were one of the major triggers of the 1997 Asian financial crisis. The magnitudes of the deficit in 1997 ranged from 3.5 per cent of GDP in Indonesia to 8 per cent in Thailand by the end of 1996.[1] In the ensuing period, countries hit by the 1997 crisis[2] have significantly improved their current account balances (see figure 1), even if current account balances in some of these countries have declined in recent years. Current account deficits in countries not hit by the 1997 crisis are also generally healthy, with the exception of Viet Nam and Pakistan.

[1] ESCAP, *Economic and Social Survey of Asia and the Pacific 1998* (ST/ESCAP/1844).
[2] The countries that suffered the worst effects of the 1997 Asian crisis were the Republic of Korea, Thailand, Indonesia, the Philippines and Malaysia.

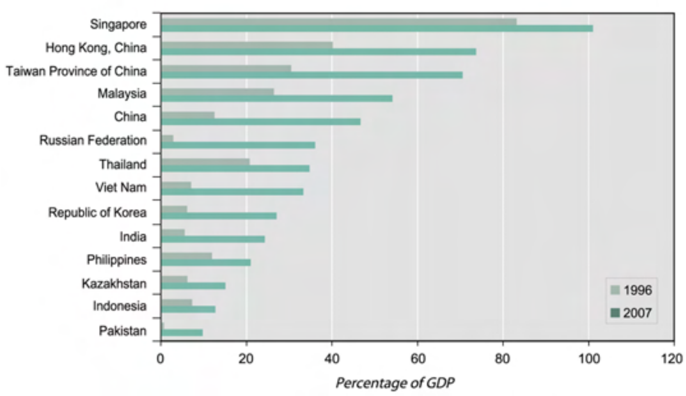
Figure 1. Current account balance as a percentage of GDP in selected developing ESCAP economies, 1996 and 2008



Sources: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2008) and *World Economic Outlook* database (Washington, D.C., October 2008); and national source for India.
Note: Data for 2008 are estimates.

It is important to recall that, in 1997, current account deficits went hand in hand with exchange rates pegged to the United States dollar, which were rising significantly. Eventually, those currency values, starting with the Thai baht, were attacked by speculators, spurring central banks to defend their currencies, but countries did not possess adequate foreign exchange reserves to signal that they could sustain their defence. While most economies in the region today have moved away from official currency pegs and a commitment to defend particular exchange rates, they have maintained a de facto regime of adjustable pegs. This time around, however, they have vast foreign reserves at their disposal (see figure 2), and they have shown their willingness to use those reserves to defend currency values and maintain stability. Nevertheless, it should once again be pointed out that there is significant variation across the region; in the event a currency comes under pressure, the size of the buffer will vary.

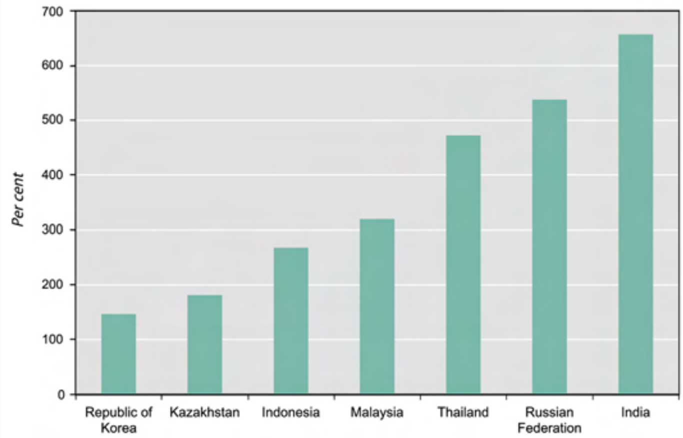
Figure 2. Foreign reserves (excluding gold) as a percentage of GDP of selected developing ESCAP economies, 1996 and 2007



Sources: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2008); and *World Economic Outlook* databases (Washington, D.C., October 2008).

A second major change in policy stance is that most countries have reduced their vulnerability to external short-term debt, which was a key factor in the 1997 financial crisis. Today, in the event of an inability to roll over such short-term debt due to global risk aversion and unwillingness to lend, the buying of foreign currency to finance repayments will exert pressure on currencies. However, this time around, the reserves cover for external short-term debt is healthy in most countries, though there are still concerns regarding the Republic of Korea (see figure 3).

Figure 3. Reserves to external short-term debt cover reserves as percentage of short-term debt repayments, Q2 2008



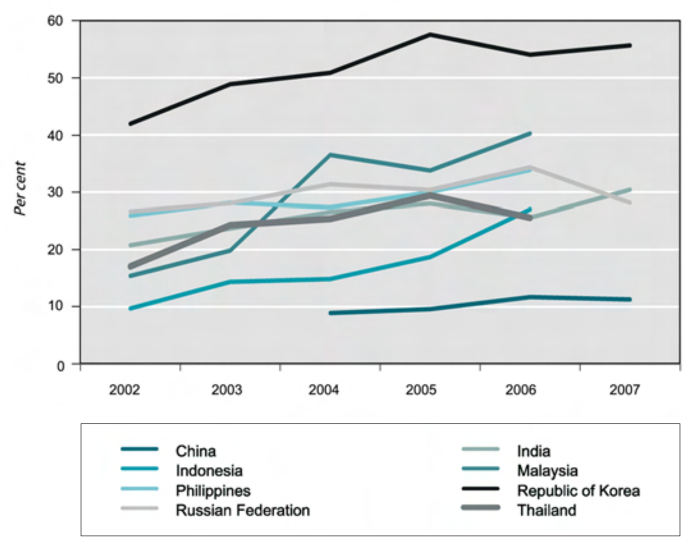
Source: World Bank, *Quarterly External Debts Statistics*.
Notes: Short-term debt comprises public and private debts. Data on short-term intercompany lending is not available. For Kazakhstan, figures related to GDP are as of Q4 2007.

WHERE ARE THE VULNERABILITIES AND PRESSURE POINTS?

HEIGHTENED EXPOSURE TO MOBILE CAPITAL FLOWS

The spark that has led to immediate macroeconomic difficulties for some economies of the region has been, once again, exposure to short-term portfolio capital. The significant and growing share of foreign portfolio capital in external financial liabilities has been a significant feature of many major developing economies across the region, including those most affected by recent equity and currency market declines (see figure 4). At a time of generalized international risk aversion, defending outflows of short-term portfolio capital to prevent excessive currency depreciation can reduce the amount of reserves available to cover external short-term debt repayments and current account deficits. This is an ongoing concern for many countries.

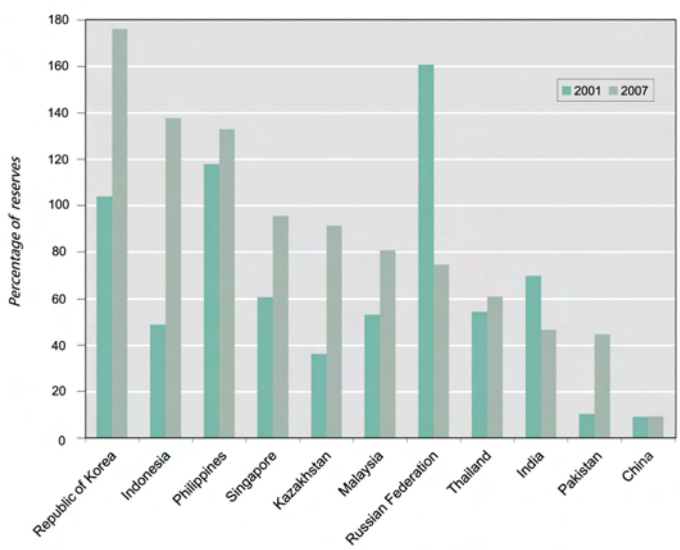
Figure 4. Stock of foreign portfolio investment as percentage of total external foreign liabilities in selected developing ESCAP economies, 2002-2007



Source: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2008).
Note: Derived from international investment position (IIP) of the respective economies.

An analysis of the stock of portfolio investment held by foreigners as a percentage of reserves (see figure 5) provides a snapshot of the possible vulnerabilities that currencies would face in the event of an outflow of short-term portfolio capital. The reserves cover for portfolio investments is seen to have decreased substantially across much of the region over the past decade, with reserves insufficient to fully cover the stock of portfolio investment for the Republic of Korea, Indonesia and the Philippines. At a time of unprecedented financial instability, in which flights to safety have low threshold triggers, or in which liquidity constraints for financial institutions can easily result in recalls for highly leveraged investors, reserves may easily come under strain in any bid to defend currency values. Such generalized outflows of foreign portfolio capital may be further compounded by a similar exit of capital initiated by domestic residents, to the extent that residents are free to make portfolio investments abroad. It is clear that access to a greater pool of reserves than is normally adequate assumes an even more important role in reassuring investors and can in turn serve to reduce the extent of net capital outflows.

Figure 5. Stock of foreign portfolio investments as a percentage of reserves for selected developing ESCAP economies, 2001 and 2007

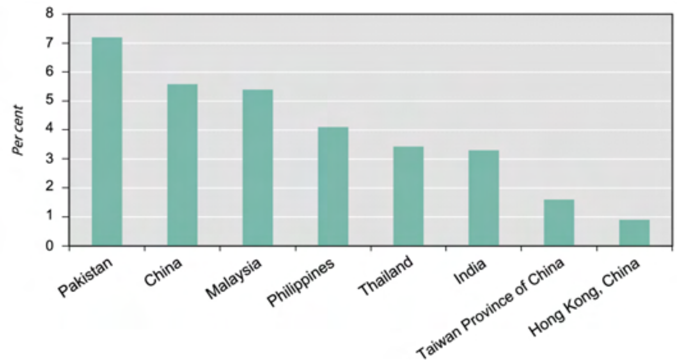


Source: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2008).
Notes: Financial investment comprised of portfolio and financial derivatives investments. Derived from the international investment position (IIP) of respective economies. Data for 2007 refer to 2007 or latest available.

BANKING SECTOR VULNERABILITIES ON THE RADAR

Apart from highlighting macroeconomic vulnerability, the current crisis has also highlighted banking sector concerns. Although most economies in the region possess adequate reserve cover for external short-term debt at the national level, banking sectors in some cases may run the risk of being overly dependent on foreign sources for their lending. It is important to ensure that the banking sector is healthy without need of government assistance, as such assistance can of itself create a generalized loss of confidence in the sector. Non-performing loans (NPLs) are currently below the international threshold of 8 per cent across major economies in the region (see figure 6), thus creating less immediate solvency risk and providing a buffer for possible increases in NPLs in coming months due to the economic slowdown.

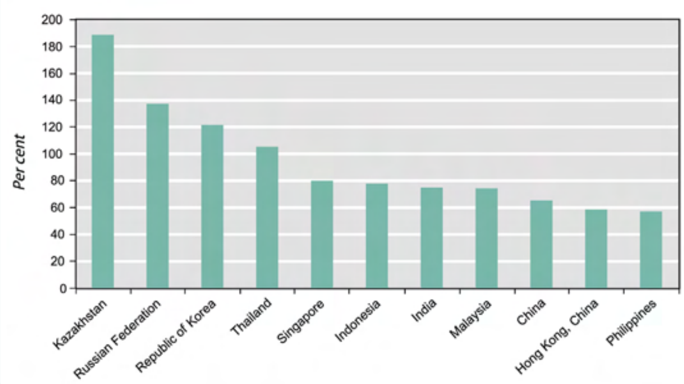
Figure 6. Non-performing loan rates in selected developing ESCAP economies, Q2 2008



Source: CEIC Data Company Limited.
Note: Data for India and Pakistan refer to 2006 and Q4 2007 respectively.

There are concerns, however, about liquidity shortages. Banking loans in some countries are notable for substantially exceeding domestic deposits (see figure 7) thus requiring banks to rely on significant wholesale funding. To the degree that such funding comes from external sources and is comprised of short-term loans, the global credit crunch may result in banks coming under stress in funding their activities. The banking sectors in Kazakhstan, the Russian Federation and the Republic of Korea have been highlighted due to their dependence on external short-term funding. Currency mismatches in such funding expose banks to exchange rate risks, while maturity mismatches can lead to roll-over and interest rate risks. In response to such concerns, the Republic of Korea recently unveiled a $130 billion package to guarantee short-term foreign bank loans.

Figure 7. Loan to deposit ratio of selected developing ESCAP economies, September 2008

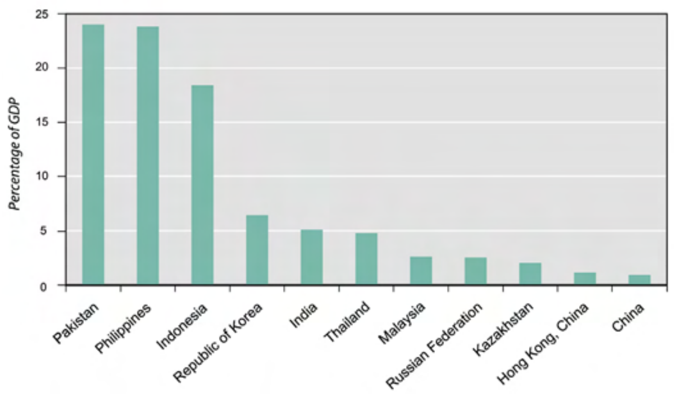


Sources: ESCAP staff estimation based on CEIC (for China; Hong Kong, China; India; Indonesia; Philippines; and Singapore); CEIC Data (for Malaysia and Thailand); ADB Central and West Asia Department Report No. 2 (for Kazakhstan); and ESCAP staff calculation based on statistics by the Central Bank of the Russian Federation (for Russian Federation).
Notes: Data for the Philippines, Kazakhstan and Indonesia refer to February 2008, March 2008 and August 2008 respectively.

EXTERNAL PUBLIC SECTOR REPAYMENT PRESSURES ALSO UNDER SCRUTINY

Another potential vulnerability for a few countries in the region is related to public external debt and repayment pressures. Pakistan, the Philippines and Indonesia (see figure 8) display particularly high levels of total external public debt. While short-term external public debt levels are generally low, high levels of total external public debt can create long-term pressure on currencies in these countries.

Figure 8. External public debt as a percentage of GDP in selected developing ESCAP economies, Q2 2008



Source: World Bank, *Quarterly External Debt Statistics*.
Notes: "Public debt" refers to debts of public sector (government and monetary authority) and publicly guaranteed private debts.
For Philippines, data source is CEIC. For Kazakhstan, figures related to GDP are as of Q4 2007. For China, data source is CEIC. Figures refer to foreign debts. Public debt refers to foreign debt held State Council.

WHAT NEXT? THE IMPORTANCE OF GREATER REGIONAL POLICY COORDINATION

Countries have already undertaken a host of domestic actions designed to ensure the liquidity of banking systems, guarantee bank deposits and support asset markets. However, experience shows that purely domestic actions can raise the risk of adverse consequences in neighbouring countries. This was seen in the early days of the current crisis when some European countries guaranteed bank deposits — leading to undesired cross-border movement of capital away from those countries that had not — before an agreement on a common regional approach was reached. The experience in Asia was similar. Announcements of government guarantees on bank deposits were made in quick succession — and in a largely uncoordinated manner — by Indonesia, Malaysia, the Republic of Korea, Singapore, Hong Kong, China, and Taiwan Province of China, among others. Governments were concerned that deposits would flow out to those countries/areas with guarantees in place.

The immediate crisis response to managing financial vulnerability in the region should be focused on regional policy measures. The ESCAP secretariat will be at the forefront of this policy debate. Through its strengthened analytical and normative role, it will promote consensus building on the policy actions needed, as highlighted below.

The region needs to establish comprehensive foreign exchange reserve support for all vulnerable economies. The recent ASEAN+3 agreement to accelerate the implementation of the foreign exchange reserve pool is an important first step. However, the membership of the scheme is still limited. Furthermore, the current size of the pool — $80 billion — is generally viewed as insufficient, given the size of short-term portfolio capital flows to economies as discussed above. Furthermore, the usefulness of the pool will be limited in the event of an episode of contagion, as multiple country requests for assistance would result. While the concept of a reserve pool is currently limited to balance of payments support, it is equally important to have available a regional contingency plan with sufficient funds to respond quickly to liquidity and capitalization problems encountered by domestic banks. The evolving regional approach to providing vulnerable economies with reserve support will crucially require surveillance and monitoring mechanisms to be strengthened. In this regard, drawing policy lessons from experiences with the Manila Framework Group, established in November 1997, as well as the ASEAN surveillance mechanism, under the Economic Review and Policy Dialogue of ASEAN+3, will be important.

Furthermore, countries should engage in consultations on exchange rate policies with a view to establishing more coordinated and durable regional currency arrangements. National exchange rate management policies operating in isolation have been a key cause of build-up in asset, credit and investment values in some economies of the region. The need to maintain export competitiveness by controlling currency appreciation in recent years resulted in increasing domestic liquidity through incomplete sterilization of capital inflows. Pressure to undertake currency devaluations in the current environment of export difficulty would result in beggar-thy-neighbour competitive relations, to the detriment of all in the region.

Beyond immediate measures to tackle the fallout of the financial crisis, the attention of the region will have to turn in short order to preventing future crises. While the long period of stability between 1998 and 2008 consigned the debate on the international financial architecture to the history books, the sheer magnitude of this crisis and the threat of systemic collapse clearly presents a critical opportunity to discuss and agree on a new multilateral financial system. In its design, this system should reflect the evolving balance of global economic influence, including the major economies of the Asia-Pacific region. The new multilateral system is likely to include a more inclusive framework of economic governance, which would be multipolar in character. A fresh approach to global market regulations is needed — one that balances medium-term stability with the role of financial markets as a potential support for economic growth. Proposals on this will be discussed in an upcoming policy brief of this series on the financial crisis. Anything less risks undoing decades of hard-won gains in poverty reduction and the hope it has given millions of living in economic security and dignity.

This issue of the *Macroeconomic Policy Brief* has been prepared by the Macroeconomic Policy and Analysis Section, Macroeconomic Policy and Development Division, ESCAP. Insightful comments from the following external reviewers are acknowledged with appreciation: Yilmaz Akyüz, former Chief Economist of the United Nations Conference on Trade and Development (UNCTAD), and Ramkishen Rajan, Associate Professor, George Mason University, United States.

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