Time of Upheaval: Where is Global Finance Heading? A View from East Asia

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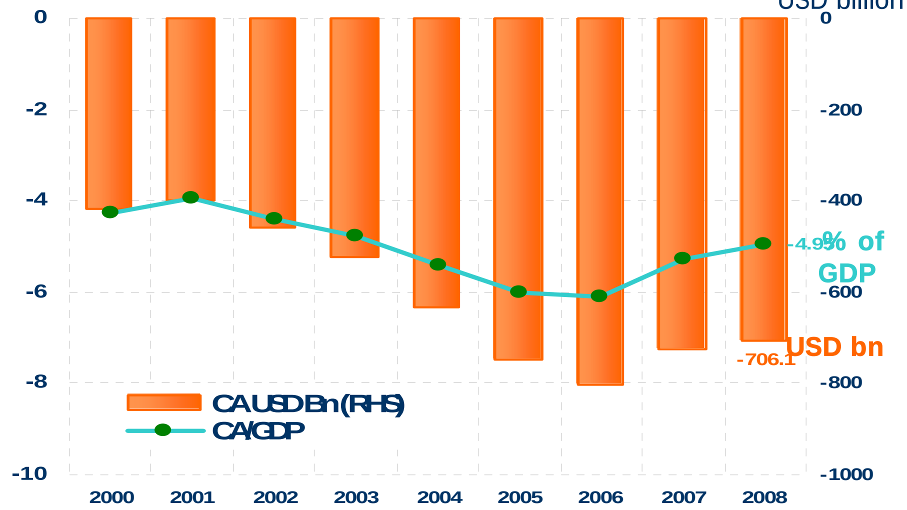
I. An Asian view on the current global financial crisis

- This is the first crisis of globalization, which shows crisis can happen in any economies, big or small, developed or emerging.
- Not too surprised, given the protracted build-up of the global imbalance. Dynamic of macroeconomic adjustment looks similar to the 1997-1998 Asian crisis, though the trigger point is more bank-led than currency-led.

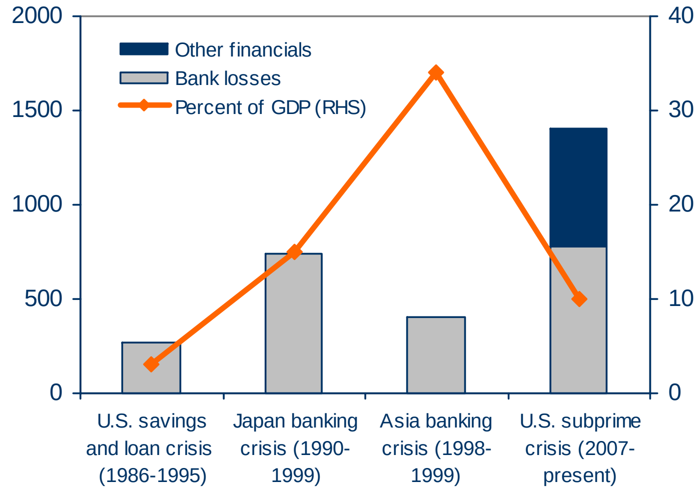
  But is surprised by the scale and speed of the deterioration.
- Policy efforts have been successful in stabilizing the financial markets.
- Many important questions remain: (1) roles of market and regulation in finance; (2) managing risk in the process of international financial intermediation; (3) global macro consequences of the policy responses.

Losses and impacts on financial markets

US current account (2000-2008)

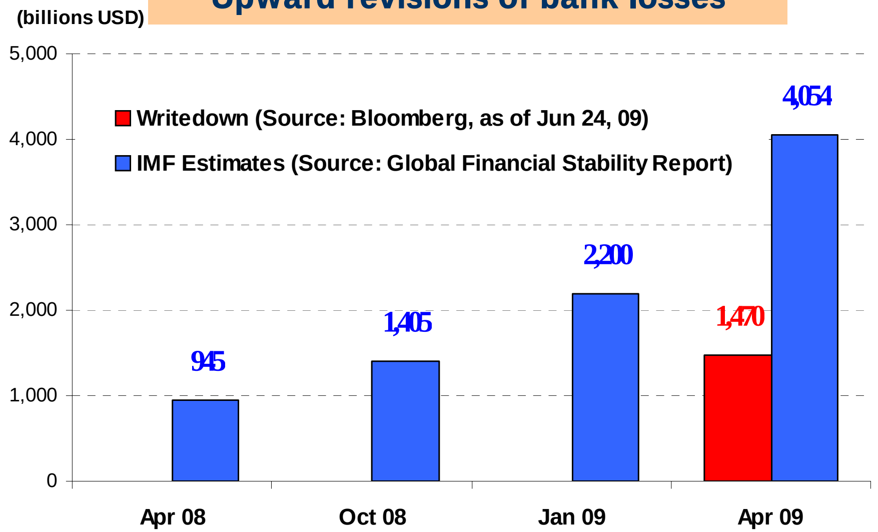


Comparison of financial crises

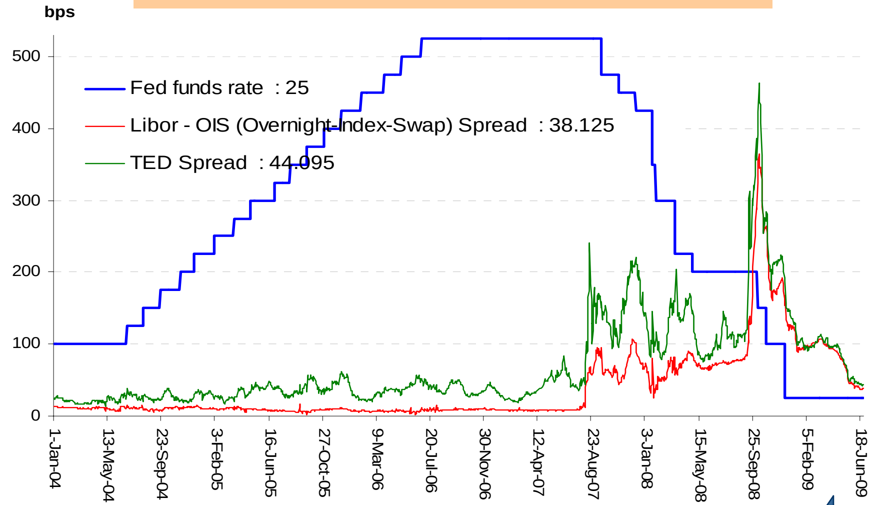


Source: GFSR, October 2008

Upward revisions of bank losses



3 Month US market spread



II. How emerging markets in Asia have managed so far in this crisis?

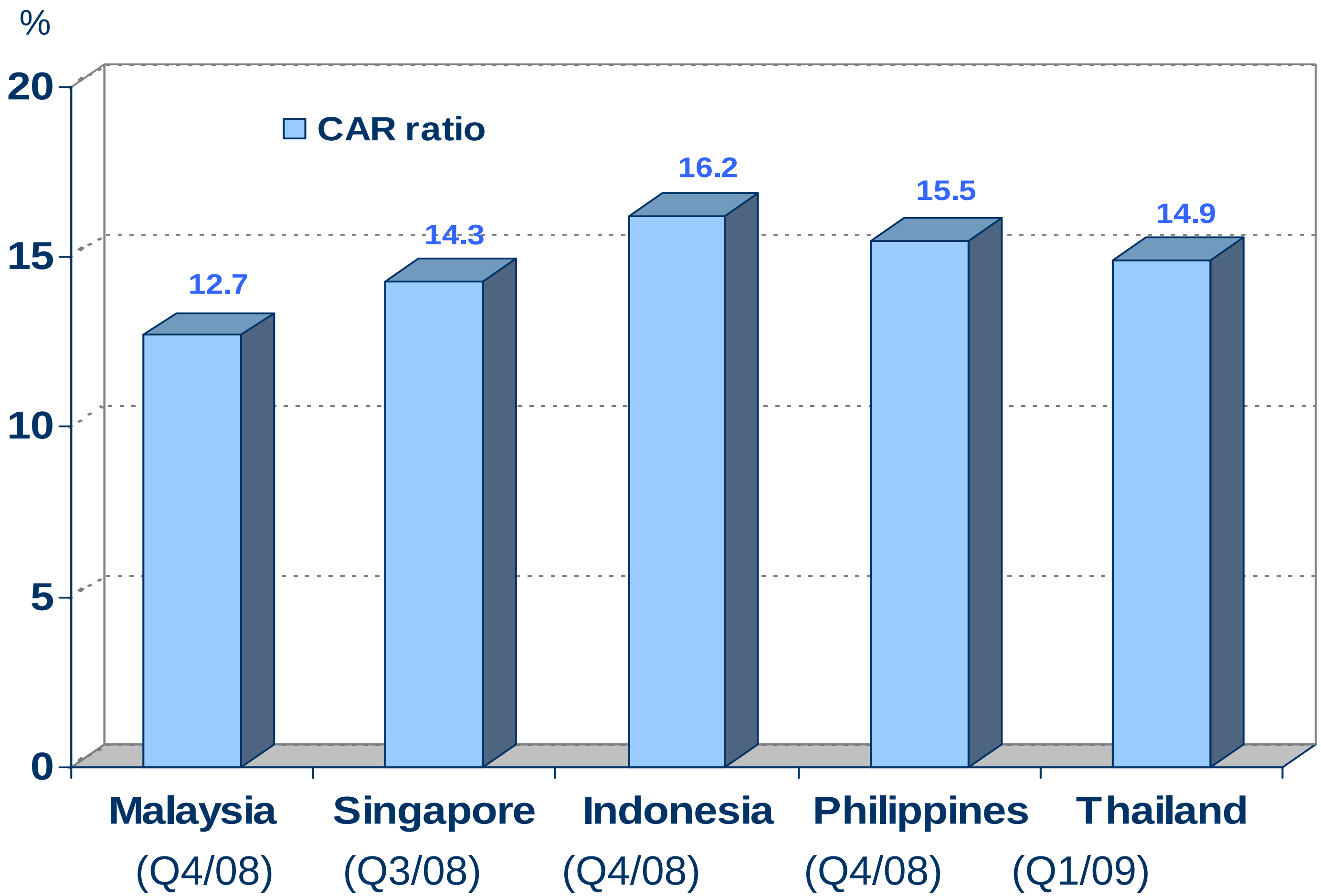
- Asian emerging markets were able to weather the impact of the crisis with a relatively strong initial position.

  – The region's banking sector is resilient due to (1) limited exposure to toxic assets, (2) relatively strong capital base, (3) less reliance on external funding, and (4) strengthened supervision.

  – External vulnerabilities are low : (1) current account surpluses,
  (2) high levels of international reserves, and (3) low external debt.

  – Economic fundamentals have improved : (1) no major imbalances, (2) corporate and household balance sheets are relatively sound, (3) capacity to adjust to shocks has improved due to greater flexibility in prices, and (4) adequate room for policy.

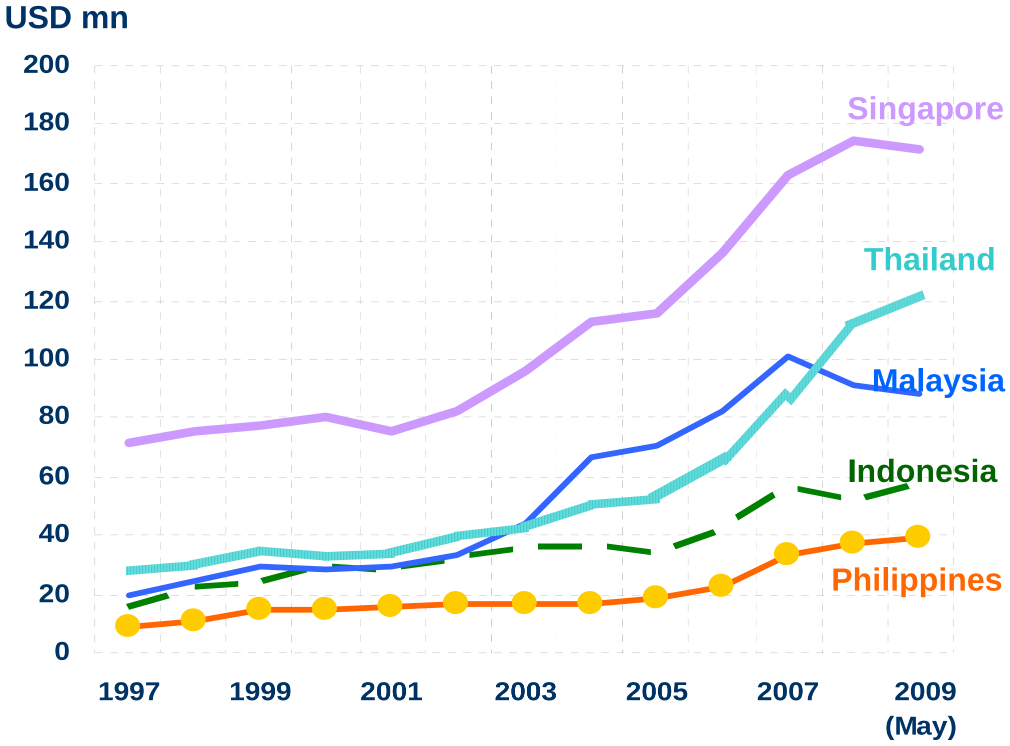
BIS Capital Ratio of ASEAN 5 Economies



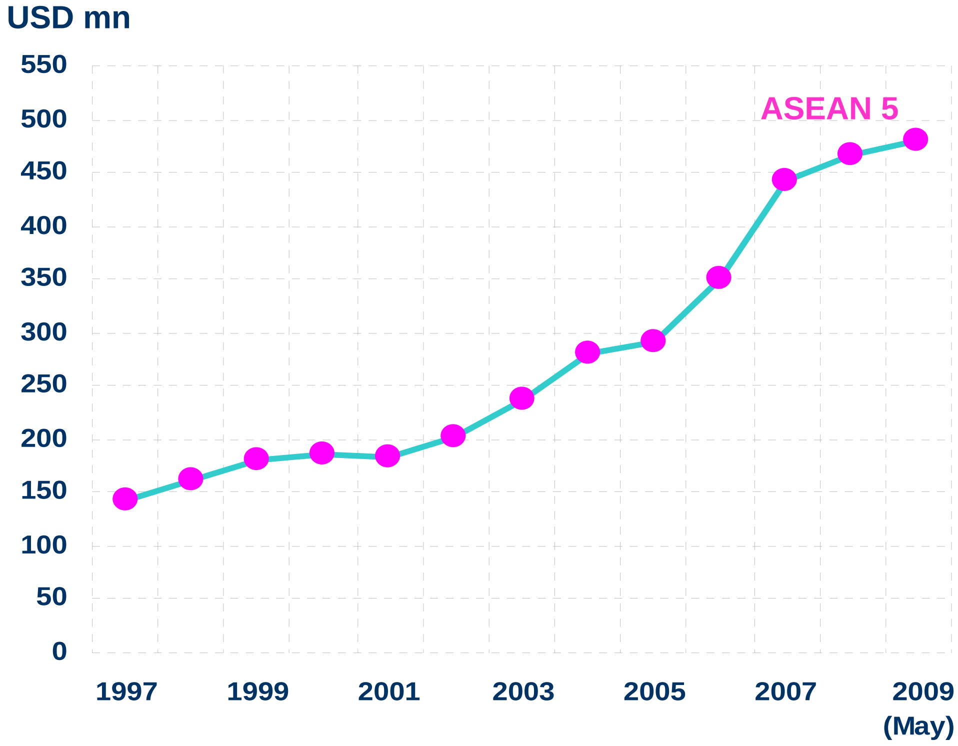
Source: central bank websites

International Reserves of ASEAN 5 Economies

ASEAN 5 International Reserves by Country (USD mn)
1997 – May 2009

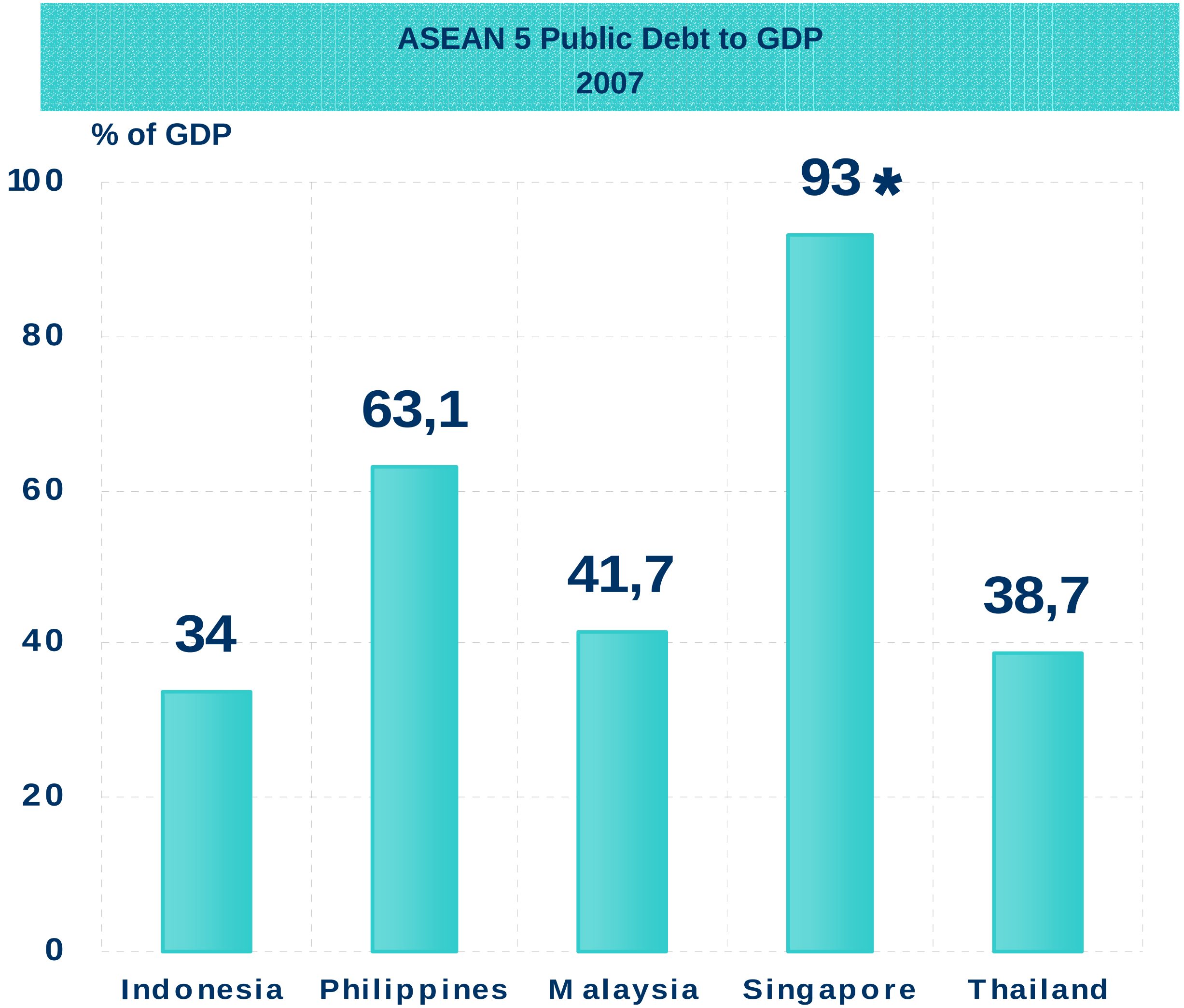


ASEAN 5 Total International Reserves (USD mn)
1997 – May 2009



Source: CEIC

Public debt to GDP of ASEAN 5 Economies



* Fiscal position is in surplus. Public debt comes largely from deliberate overfunding that aims to replace central bank debt by claims on Government.

Source: CEIC

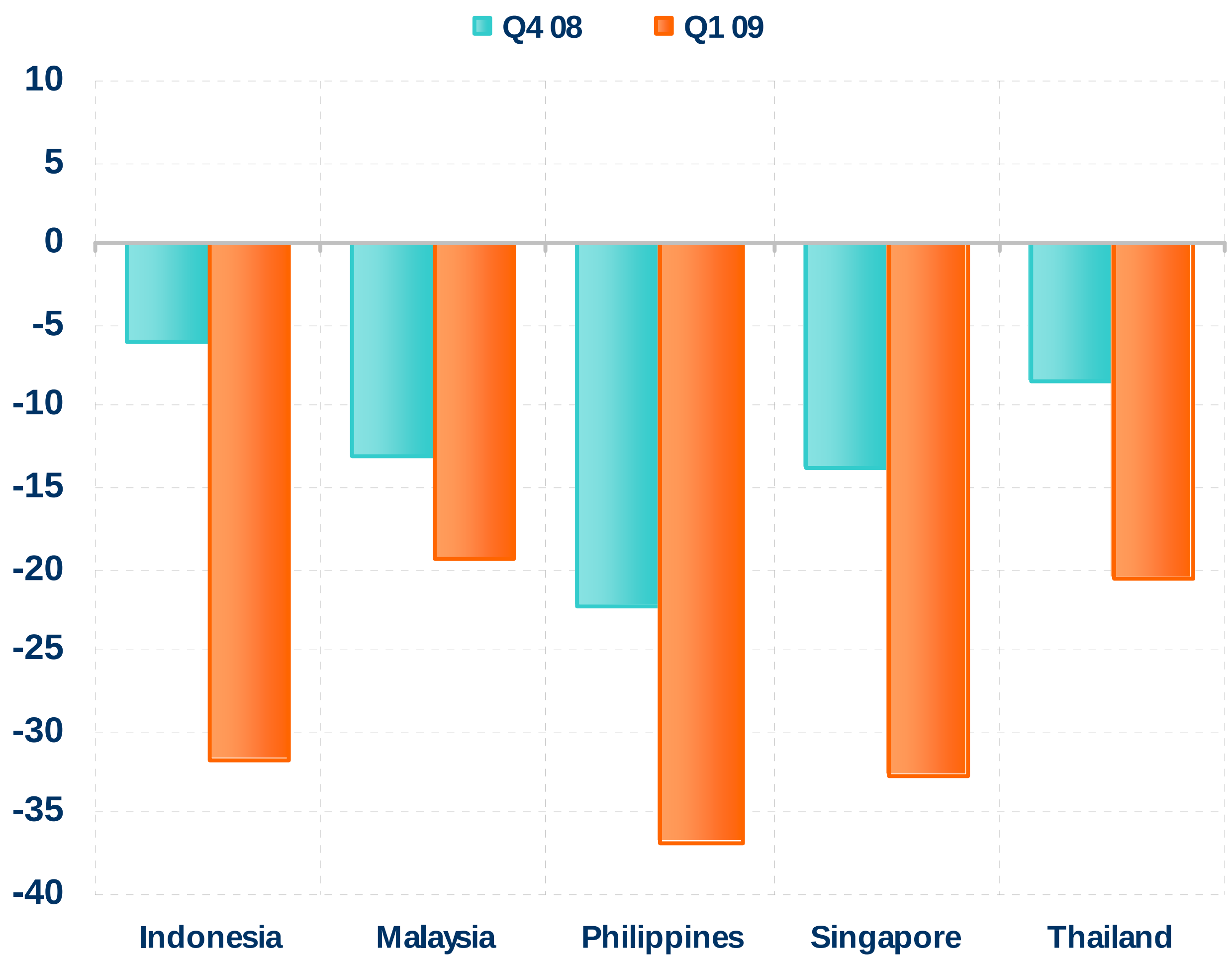
II. How emerging markets in Asia have managed the crisis

- Impacts on Asian emerging markets have been through (1) tightened access to international capital market as a result of global credit crunch; (2) capital flow reversals linked to deleveraging; and (3) real income decline due to the collapse in exports.
- Trade impact has been most severe.

  Policy response focuses on helping the economy to adjust to the impact of the shock through aggressive fiscal and monetary policies.
- With no banking sector impairments, the transmission mechanism of monetary policy has not been compromised to the extent observed in the developed economies. But increased credit risk have limited effectiveness of policies. On GDP growth, more positive signs are emerging, and conditions for recovery look promising in Asia.

Exports Growth of ASEAN 5 Economies

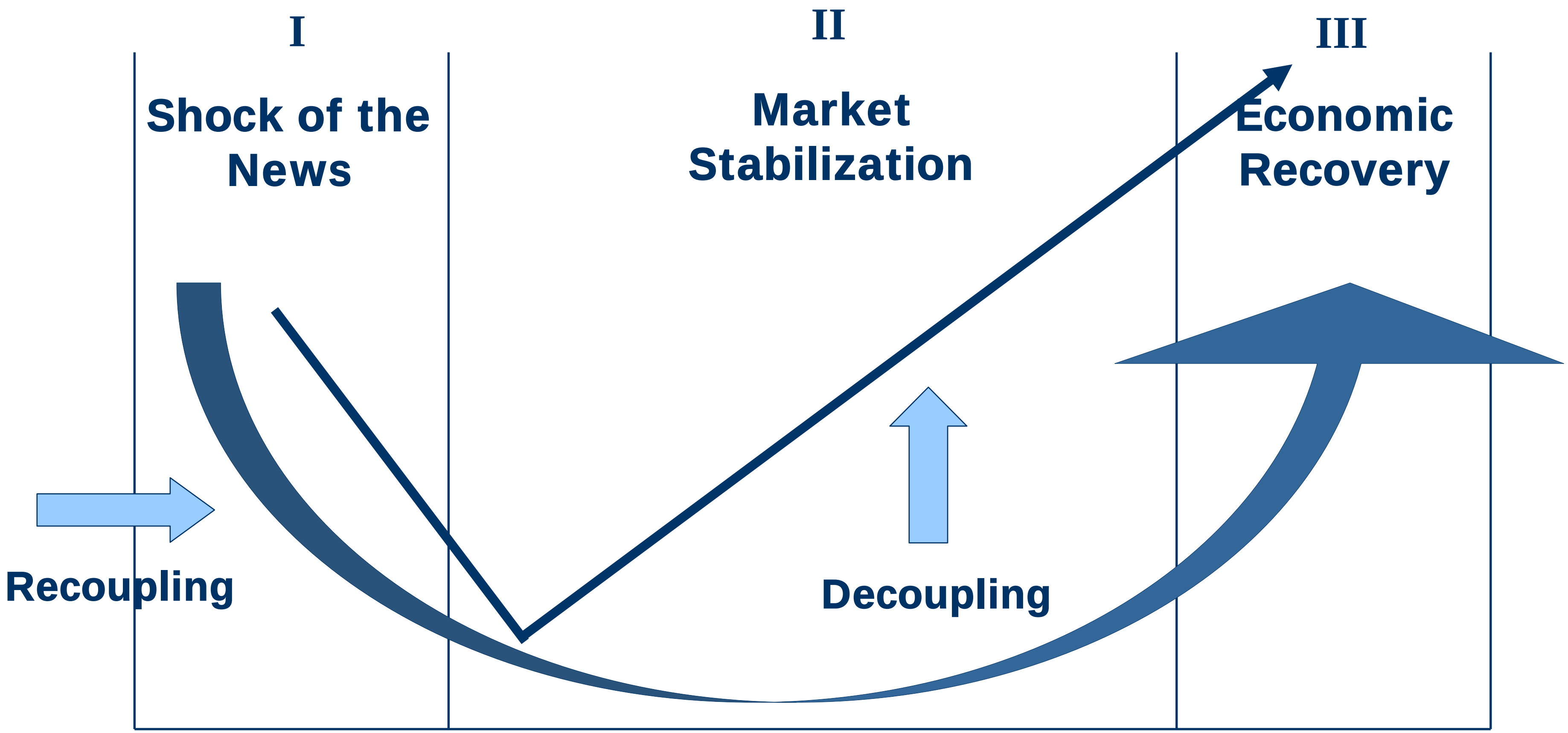
ASEAN 5 Exports Growth (% YoY)
Q4 2008 – Q1 2009



III. Decoupling or Recoupling?

- Evidence from the Asian financial crisis shows that economies affected by contagion were able to recover faster than the core-crisis economies because of the lesser damage on economic fundamentals and banks.
- So far, given substantial export declines and the impact of deleveraging, the story is one of recoupling, both for economic and financial.
- Economic decoupling is possible only at the initial stage of recovery. But beyond that will require major restructuring in the sources of growth. The shift in the source of growth is vital for sustaining a balanced long-term growth, and this calls for policies to shift incentives from exports to demand.
- Making this transition safely will be the next important challenge for emerging markets.
- A key enabler for this is the development of robust financial systems in emerging markets to translate local savings into productive investment.

Three stages of the dynamic of financial crisis



IV. Some observations on where Global finance is heading : A world of two halves

- This is also a crisis of globalized finance. Lessons learned from this crisis will lead to change in the structure of global finance, risk management and the approach to regulation.
- In parallel, adjustment to the crisis will continue, resulting in a world of two halves.
- The first half is the core-crisis economies that need to rebuild financial fundamentals and resume growth. The other half is the less-affected economies that will face a challenge of sustaining growth while avoiding financial instability.
- Differences in the growth prospects will spark a new financial cycle, driven by resumption of large capital flows into emerging markets. The challenge and the stake for emerging markets is to grow safely by managing the attendant risk to instability from the persistent and large capital inflows.

Key trends in the emerging financial landscape

Consumers

- Risk aversion
- Preference for local institutions
- Simplicity of transactions and products
- Demand greater transparency and accountability

Banks

- More conservative business models
- Less reliance on wholesale funding and the use of leverage
- More focus on risk management and higher liquidity buffer

Regulation

- Public surveillance
- Macroprudential oversight with focus on systemic stability
- Closer supervision of the systemically important financial institutions including the non-banks
- Procedure for an orderly unwinding of systemically important global players