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Author

Xuan Loc Doan
Xuan Loc Doan is Research Assistant on the Asia Progamme at the Global Policy Institute

Contact: x.l.doan@global-policy.com

Challenges Facing ASEAN and East Asia in a Turbulent Time

Introduction

On 17 April (2009), the second meeting of ASEAN (Association of Southeast Asian Nations) and AAF (Asia Forum) meeting took place in Singapore. This one-day conference was organised by the Singapore Institute of International Affairs (SIIA) and was attended by some 300 representatives of the region's governments, private sector and think-tanks. Given the timing of this meeting it is not surprising that one of the key issues raised by the forum was what Asian governments, multinational corporations and institutions should do in response to the current global financial crisis (GFC). This paper reviews the impact of the current crisis on the economies of ASEAN and East Asia, the policy responese, and their likely outcomes, in the context of the presentations made at the ASEAN-AAF meeting.

The impacts of the global financial crisis

First round: Asia spared

It was originally believed that the spillovers from the USA's subprime mortgage crisis on Asian financial and real economic activity would be relatively limited, and that the growth prospects of Asian economies would remain strong, with no significant downturn (Brooks and Hua 2009: 103; Sachs 2009: 4). There were good reasons to expect Asia to be relatively shielded from the crisis because, unlike the major financial institutions in the USA and in Europe, those in Asia had only limited exposure to subprime-related

Table 1: Capital write-downs and raised by major banks between 1 October 2007 and 3 April 2009 (US$ billon)

	Write-downs	Raised
World	1292.6	1109.4
America	869.6	646.0
Europe	387.2	393.6
Asia	35.8	69.7

Source: ADB 2009b

products (IMF 2009a: 71; IMF 2009b: 4). The fundamental factor explaining this limited exposure is that having experienced their own financial crisis 10 years ago, many Asian banks were cautious over investing in high-risk and high-return assets (see also Dixon 2009). According to the Asian Development Bank (Asian Development Bank), the region's banks reported only 0.09% direct exposure of subprime assets (ADB 2009b: 2). This report, notes that according to Bloomberg, of the US$1292.6 billion written off by major banks since 1 October 2007, Asian financial institutions accounted only for US$35.8 billion (see Table 1). In addition, the reforms implemented during and after the 1997 crisis had made Asian financial sectors relatively resilient to global shocks and well prepared for this crisis (ADB 2009b: 2). In short, Asian countries were relatively unscathed by subprime related-mortgage assets during the early stage of the crisis. Because of this, as the IMF Deputy Managing Director, Takatoshi Kato, remarked at the Harvard Asia Business Conference in February 2009: 'for a while, Asian economies took comfort from not being at the epicenter of the crisis, hoping that improved macroeconomic fundamentals and relatively sound bank and corporate balance sheets would insulate them from the financial turmoil.'

Second round: hit by capital flight

Yet, even though Asian financial institutions entered the global financial crisis with limited exposure to subprime-related assets, and had relatively healthy financial positions, the crisis and slowdown in the USA and Europe have had effects on Asia's financial markets through capital flow channels (IMF 2009b: 4). Indeed, the IMF concluded that the impact of the GFC on domestic financial markets in Asia have been substantial (IMF 2009a: 71). In other words, while being spared in the first round of the crisis, Asian countries were hit by the second round, when foreign capital and investments fled the region, causing currency depreciation and sharp falls in stock market prices. During 2008, stock markets tumbled by some 58% in Indonesia and India, 50% in Thailand and Singapore, and by over 65% in China. Overall, Southeast and East Asian stock markets fell more than the Dow Jones index, which fell by 31% during 2008. Thus, according to Kato (2009), the current crisis dismantled the myth that the Asian economies were insulated from the global financial turmoil. He maintains that because they dramatically increased their participation in international financial markets, this opened several channels of transmission of the global financial turmoil to the region (see also IMF 2009b: 4). Firstly, because foreign investors increased their holdings of Asian assets during the boom, the outflows during the crisis have been quite substantial. According to Kato (2009) outflows from equity markets alone in emerging Asia, amounted to some US$70 billion in 2008. Secondly, the increased dependence of Asian banks on international wholesale funding made them particularly exposed to the process of global deleveraging and the resulting shortage of dollar funding. Thirdly, since the region's corporations increased their reliance during the boom period on foreign funding, such as bond, equity and loan issuance, they were more exposed to refinancing risks when access to foreign borrowing was curtailed.

Third round: hit hard by export decline

Nevertheless, what struck ASEAN members and other Asian countries the hardest, though in an indirect way, was the third and final round, during which the GFC and recession in the West began to have serious effects on Asia's real economies through trade channels. As Dr. Noleen Heyzer, Under-Secretary-General of the United Nations and Executive Secretary, Economic and Social Commission for Asia and the Pacific said in her opening speech at the ASEAN-AAF, 'what started as a financial crisis in the West has become an economic crisis in the East'. Indeed, the impact of the global financial crisis on Asia's economies has been surprisingly heavy and dramatically affected the region's economies (IMF 2009a: 71). According to a study by the Asian Development Bank undertaken in April 2009, this crisis presents Asian countries 'with its most difficult economic challenges in recent times' being even broader, deeper and more complex than the one they experienced 10 years ago (Asian Development Bank 2009b: 2). This is because during the previous crisis, heathy growth and demand in the developed economies helped support Asia's recovery. However, this time the USA and Europe are in recession and their consumption, on which the region had long depended,

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is in decline. In other words, the fundamental factor lying behind this downturn is that the growth of Asian economies depends heavily on exports to developed markets, which have fallen dramatically since the outbreak of the financial crisis.

Prior to the GFC, Asian economies enjoyed impressive growth. Indeed, as Kato (2009) points out, 'it was only last summer that the region was enjoying double-digit expansion of its industrial production base'. However, it was the exports of the region to the outside world that played the

Table 2: Annual percentage growth rates of merchandise exports in Southeast and East Asian countries

	2007	2008	2009*
ASEAN**	**12.2**	**14.5**	**-17.7**
Indonesia	14.0	18.0	-25.0
Malaysia	9.6	12.8	-13.3
Singapore	10.5	13.1	-16.1
Thailand	17.3	16.8	-18.0
Vietnam	21.9	29.1	-31.8
East Asia***	**18.9**	**13.4**	**-6.2**
China	25.8	17.3	-4.3
South Korea	14.2	14.3	-15.0

* projection
** Ten ASEAN countries
*** China, Hong Kong, Taiwan, South Korea and Mongolia (excluding Japan)
Source: ADB 2009a

major part in this growth. Over the last three decades, the region had enjoyed a rapid growth of intra-regional trade (Brooks and Hua 2009: 125-6). Because of this, it was widely believed that Asia's dependence on external trading partners had decreased (IMF 2009b: 2). However, according to Kato (2009) this was a mistaken view, because in reality global demand still represented a major factor behind Asia's export growth (see also Brooks and Hua 2009: 125-6). Thus, the current crisis dismantled another widely held myth that 'emerging economies in Asia are decoupled from the business cycle of advanced economies' (Kato 2009). The growth of Asia's intraregional trade was largely driven by trade in parts and components within regional production networks, whose finished products were eventually exported to extra-regional markets. In other words, trade within Asia is part of a globalised supply chain, which is ultimately linked to demand in the external world. It is estimated that about half of the intra-regional exports, including both direct exports and indirect exports through a growing intra-Asian re-export trade, were destined for Westen markets. Thus, the crisis and the slowdown of the advanced countries cut a vital source of the Asia's economic growth (ADB 2009b: 3; IMF 2009: 2-4). During the final quarter of 2008 exports from East and Southeast Asia contracted by some 30% and significant overall declines were projected for 2009 (ADB 2008b: 39; Table 2). Electronics exports have been particularly hit, and badly weakening export performance in South Korea, Malaysia, Philippines and Singapore. Other Asian countries, such as Cambodia and Indonesia have also suffered as the consumption in advanced markets of their major, labor-intensive export goods, such as textiles, toys, and footwear has sharply contracted. In addition, falling commondity prices have badley affected Vietnam, Indonesia, Thailand, and Malaysia (ADB 2009b: 3).

As a result of the drastic fall of exports, Asian economic growth rates have fallen sharply and are projected to drop further. Growth in East Asia declined from 10.4% in 2007 to 6.6% in 2008, and is forecast to shrink to 3.6% in 2009, despite the relatively strong performance of China. Growth in Southeast Asia was only 4.3% in 2008, compared with 6.4% in 2007, and may fall to below 1% in 2009 (Table 3).

Worse than expected

Overall, the collapse of major financial institutions in the USA and then in Europe have had a very major impact on the Asian economies, far greater than many originally expected. Sachs (2009: 4) points out that 'Asia is experiencing a significant downturn right now, and one that is probably worse than in the official forecasts'. That is, while the banks in Southeast and East Asia largely avoided the credit crisis, the real economies of these countries have faced two indirect, but major, problems brought about by the current GFC. Firstly, the decline of foreign capital and investments. Second, which is much more severe, the fall of exports. In other words, the challenge that ASEAN and other Asian countries are facing is their heavy reliance on advanced countries, in terms of investment and trade. The critical question is how ASEAN and other Asian countries will addess these challenges.

Table 3: Annual percentage growth rates of GDP in Southeast and East Asian countries

	2007	2008	2009*
ASEAN**	**6.2**	**4.3**	**0.7**
Indonesia	6.3	6.1	3.8
Malaysia	6.3	4.6	-0.2
Singapore	7.8	1.1	-5.0
Thailand	4.9	2.6	-2.0
Vietnam	8.5	6.2	4.5
East Asia***	**10.4**	**6.6**	**3.6**
China	11.3	9.0	7.0
South Korea	5.0	2.5	-3.0

* projection
** Ten ASEAN countries
*** China, Hong Kong, Taiwan, South Korea and Mongolia (excluding Japan)
Source: ADB 2009a

The Responses

The experience of current crisis has brought home to the economies of Southeast and East Asia that in order to achieve healthy and long-term growth they must cut their dependence on the West. In order to do this a series of key measures have been implemented. These include creating a regional monetary fund, boosting domestic demand and investment, increasing intraregional trade, and increasing social protection. All of these have been in place or under discussion in the region's major economies since the late-1990s, largely as a response to the experience of the 1997-8 financial crisis (see also Dixon 2009). However, not only has the crisis given new urgency to these measures, but with around US$4 trillion in foreign exchange reserves, large current account surpluses and low inflation, Asia is well placed to engage in very high level of public expenditure (Sachs 2009: 4, 13).

Lesson one: Don't go to the IMF

The 1997/98 financial crisis taught Asian countries that they could not depend on the IMF or the USA in the event of another crisis. That is why, following the crisis, a proposal to create an Asian Monetary Fund (AMF) was put forward. However, due to strong opposition from the USA and the IMF, it did not materialise. However, in 2000, at a regional summit held in Chiang Mai, ASEAN countries and China, Japan and South Korea (ASEAN + 3), initiated a system of bilateral short-term financing facilities (see also Dixon 2009). Nevertheless, until the outbreak of the current crisis, this Chiang Mai Initiative (CMI) remained simply an arrangement to swap relatively small amounts of currency. The outburst of the GFC finally forced the region

> ‘Asian countries cannot achieve growth based on domestic demand unless the region’s governments make their citizens feel less insecure’

to take a much more robust step by creating a US$120 billion fund, which is aimed at supporting members hit with the type of capital flight which characterised the 1997-8 crisis and providing an alternative to the IMF. However, it remains to be seen how this $120bn regional fund will operate and whether it will eventually lead to the creation of the AMF. Another key issue, which has not yet been resolved, is what currency will the regional fund be based on, China’s yuan or Japan’s yen.

Lesson 2: Promote domestic demand and reduce export dependence

As has already been discussed the current crisis taught Asian countries that they must cut their dependence on exports. In order to do so they must boost domestic consumption. This has been given further urgency by evidence of declining domestic consumption in the wake of the contraction of exports (*Economist* on 29 January 2009). While all the major countries have sought to stimulate consumption through government expenditure, and fiscal measures, these are only short-term solutions. A longer-term impact could be achieved through spending their massive reserves on infrastructure, education, health or energy programmes. Sachs (2009: 13) points out that ‘Asia needs all of that desperately’, because Asia ‘is still the region of the world with the fastest urbanization, with the most dramatic need for pollution control, for cleaning up the energy sector, for cleaning up the rivers, for sustainable urban development’. By spending on infrastructures they also create jobs for people, which in return enables them to spend. However, the fundamental problem remains one of permanently increasing the propensity to spend and reducing the need to save. Engineering such a structural reform is not easy given the lack of social protection.

Improving social protection and stability

Asian countries cannot achieve growth based on domestic demand unless the region’s governments make their citizens feel less insecure about their healthcare, their children's education or their future and retirement. In other words, improving social protection is vital for Asian countries if they want to recover from the crisis and ensure long-term growth. Health and welfare expenditure is one of the most effective and fastest ways of injecting buying power into communities. As Dr. Noleen Heyzer, mentioned in her opening speech at the ASEAN-AAF meeting, if Asia wants to develop a robust regional economy with a low level of poverty, social protection must be the corner stone of the recovery plan, providing minimum wage, employment insurance and health insurance, and increased individual security. In addition, it is believed that reducing disparities and poverty, and maintaining social protection and individual security, will lead to national socio-political stability, which is vital not only for the region's economic recovery, but also for healthy and long-term development. In his closing speech of the ASEAN-AAF meeting, Malaysia's Deputy Prime Minister Tan Sri Muhyiddin Yassin underlined that: 'National socio-political stability is necessary for economic recovery to take place. We cannot benefit even if the world's economic engines somehow manage to re-start when our societies are in tatters'. He further stressed that to avoid this policies have to go beyond social security to ensure that legislatures, judiciaries and civil services are 'capable and robust, as well as broadly inclusive and democratically-based'.

Enhancing intra-regional trade

ASEAN and other Asian countries can reduce dependence on exports by accelerating the growth of intraregional trade. One way to achieve this is for the Asian countries, especially ASEAN members and China, to see each other as end markets rather than as primarily links in the global supply chain. Again, in order to do this, the region's governments must introduce major reforms to encourage their citizens to spend.

Another way to promote the interregional trade is to establish free trade agreements. However, this is proving very difficult. Even though ASEAN agreed to establish a FTA in 1992, progress has been very slow. Major barriers to regional integration included the lack of complementarity and, according to the panellists at the ASEAN-AAF meeting, the great divergence in political and economic conditions. In addition, the plans for closer regional economic have been further delayed by the undermining of ASEAN's credibility and relevance by the on-going Myanmar situation and destabilising domestic political events, most recently in Thailand.

Conclusion: from challenges to opportunities

In conclusion, there is no doubt that the global financial crisis and slowdown in the USA and Europe have brought many challenges to Southeast and East Asia. Even though the financial institutions in Southeast and East Asia have been relatively unharmed by the global crisis, the region's economies were hit hard by the financial crisis and recession in the advanced countries. However, while ASEAN and East Asia face serious problems, the crisis also provides opportunities to solve them, a point stressed by Dr Heyzer in the opening speech of the of the ASEAN-AAF meeting. Indeed, it was the global financial and economic turmoil that finally pushed the ten ASEAN members and three East Asian nations to establish the US$ 120 billion emergency fund. This illustrates the manner in which these countries are not only attempting to overcome the current crisis and avoid similar ones in the future, but also consider the crisis as an opportunity to decrease their reliance on foreign capital and such agencies as the IMF. The crisis also gives them a good chance to reduce their reliance on exports, increase interregional trade, improve infrastructure, healthcare, social protection, and educational provision. There are clearly great opportunities. Thus, it remains to be seen whether the countries of South-east and East Asia come out of the crisis stronger and more self-reliant.

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The Global Policy Institute
London Metropolitan University
31 Jewry Street
London EC3N 2EY
United Kingdom

Tel **+44 (0)20 7320 1355**
Fax **+44 (0)20 7320 3018**
Email **office@global-policy.com**
Web **www.global-policy.com**

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