Ten Years after the Asian Crisis:
Toward Economic Sustainability in Southeast Asia[*]

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1. Background

Southeast Asia has come a long way since the financial crisis of 1997-1998. Ten years after, the region's accomplishments in grappling with and overcoming the crisis and in returning to sustained growth are varied and impressive. Growth in several low-income countries like Vietnam, Cambodia and Lao PDR has accelerated to rates above pre-crisis performance (see Table 1). The crisis affected economies returned to positive growth quite quickly after the severe recessions: Malaysia and the Philippines regained and exceeded the pre-crisis level of per capita income in 1999, while this took longer, till 2003, in Indonesia and Thailand (World Bank 2007: 26).

But even as the region celebrates recovery, recent growth in most of the post-crisis economies is still running at around 2 percentage points less than in the two decades before the crisis, taking 2002-2006 as the period of sustained post-crisis expansion. Ten years after confronting the reforms needed to rebound from the financial crisis, the crisis-affected economies are still confronting complex reform challenges. In addition, Southeast Asia still remains exposed to downside risks from the global environment, especially pronounced balance-of-payment disequilibria, high crude oil prices, signs of inflationary pressures in developed countries, and sharp rises in financial market volatility.

This paper does not attempt to survey all of the challenges facing Southeast Asia in overcoming all kinds of reforms in order to moving towards solid growth. Instead, it

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looks at the region's causes and consequences of the crisis, the policy responses, especially the role of international institutions like the IMF, the search for protection and alternatives and some lessons learnt since the crisis. Of course, the challenge is different for each country, but it is still important for each country to share experiences on how to recover from the crisis and to search for a way to boost growth to higher rates, which still remains a strong agenda for countries in the region.

2. About the Crisis

Integration with the global financial markets has not been an unmitigated blessing for the emerging market economies. Up until the Asian crisis, emerging East Asia attracted almost half of total capital inflows to developing countries. Buoyant with the experiences of strong growth in the late 1980s and early 1990s, the regional economies of Indonesia, Malaysia, Philippines, Singapore, South Korea and Thailand received large capital inflows and experienced a dramatic surge in asset prices, with an excessive build-up of short-term debt (Chirathivat 1999; Chirathivat and Murshed 2002).

At that time, Thailand, Indonesia and South Korea had large current account deficits and the maintenance of pegged exchange rates to the US dollar encouraged more external borrowing, which finally led to excessive exposure to foreign exchange risks in the financial and corporate sectors. In the mid 1990s, changes in the economic environment began to emerge. On the one hand, the US economy recovered from a recession in the early 1990s, thus allowing the Fed to raise interest rates to head off inflations. As a result, the US attracted capital flows and raised the value of the US dollar to which many Southeast Asian countries' currencies were pegged, thus making their exports less competitive. On the other hand, the impact of China started to emerge, and the Chinese currency depreciation in 1994 caused the exports growth of ASEAN countries to further slow down.

Causes

In essence, the crises that have occurred in the region can be characterised by a combination of currency crisis with a sudden and sharp depreciation of the exchange rate, banking crisis with solvency problems for a number of banks and financial institutions, and an external debt crisis with large ratios of short-term foreign debt to international reserves. But it was a capital account crisis that caused the troubles in the region, rather than a conventional current account crisis that is often caused by poor macroeconomic performances (Yashitomi and Shirai 2000).

The Asian crisis erupted in the volatile financial environment of the 1990s, where international capital – mainly private short-term capital, moved from developed countries to emerging market economies in a significant and increasingly large scale. These capital inflows were driven by strong macroeconomic fundamentals, interest differentials, and a belief that a quasi-fixed exchange rate regime would be sustainable.[1] Following partly the IMF prescriptions, substantial capital inflows occurred, in particular, after governments had liberalised the domestic financial sector and the capital account without a well-designed sequence.[2]

The reasons behind the Asian financial crisis are explained in the following points:

- Financial liberalisation deepened the impact of domestic financial weaknesses. Financial institutions were given access to foreign financing, yielding new opportunities for risk-taking activities
- Excessive risk-taking activities took place under inadequate risk management by banks, and improper regulations and supervision for banks
- Structural weaknesses of financial institutions were further aggravated by weak corporate governance of both firms and financial institutions, and close relations with government which have become a source of moral hazard in the private sector

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[1] The famous unholy Trinity by Mundell-Fleming: Fixed exchange rate, capital mobility and independent monetary policy. One can have only two at the same time.

[2] Thailand is a case in point. The country started capital account liberalisation early in 1997 after the IMF annual meeting in Bangkok in 1993.

- Overt credit expansion increased domestic absorption, thereby widening the current account deficit. Thus, large account deficit was driven by a capital account surplus and not by the poor macroeconomic performance such as high inflation and large fiscal deficits
- Massive short-term and foreign-currency borrowing aggravated the so-called double mismatches; maturity and currency mismatches
- Triggered by the initial deterioration of the balance sheets of financial institutions and firms, capital inflows dropped sharply, causing a severe balance of payments deficit and a drain in foreign reserves. Then, subsequent sudden and massive reversal of international capital flows occurred due to the mutually enforcing currency and banking crisis (Yoshitomi and Shinai 2000)

Among economists, there is a common agreement that an excessive build up of short-term debt was a proximate cause of the recent crises particularly in East Asia (Rodrik and Valesco 1999). For other economists, including Stiglitz and Sachs, they believed that “capital account liberalization was the single most important factor leading to the crisis” (Stiglitz 2002: 99). Even an economist like Bhagwati argues “the chief underlying cause of the Asian crisis (…) was to be found in the hasty opening to freer capital flows under pressures from what I have christened the Wall Street-Treasury complex” (Bhagwati 2002: 59). The above mentioned authors blame the IMF and the World Bank for pressuring countries into premature financial liberalisation.

Other economists like Miskin point to the role of asymmetric information in the global financial markets that led to a “herd mentality” among investors that magnified a relatively small risk in the real economy[3] and provoked contagion effects that followed. Caramazza, Ricci and Salgado (2000) categorised possible reasons for contagion of financial crisis: fundamentals (common shocks) trade linkage, financial linkage and a shift in investors’ sentiment.[4]

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[3] For this batter part, the crisis has thus attracted microeconomic interests from behavioural economists and financial experts who are interested in financial market psychology.

[4] This is what the economists called the third generation currency crisis models with balance sheet effects (see the works of Goldstein and Turner).

Consequences

The crisis hit Thailand first, then Indonesia and South Korea; all these three countries figured among the hardest crisis-hit economies, and all received financial bailouts from the IMF. Malaysia was equally hit by the crisis but refused the IMF assistance. At one point, contagion effects of the turmoil also hit other ASEAN countries – Singapore and the Philippines in particular, and Cambodia, Lao PDR, Myanmar and Vietnam, to a certain extent.

All these countries had been exposed to a varying degree of macroeconomic effects, including sharp reductions in GDP, exchange rates, stock value and other asset prices, as well as steep increases in unemployment. As a result, many businesses collapsed, in addition to other social and political issues that exploded due to the crisis. The resignations of Suharto in Indonesia and Chavalit Yongchaiyudh in Thailand were a part of the political upheavals that followed the crisis. There was also a general rise in anti-Western sentiment, with George Soros and the IMF singled out as targets of criticism, especially by the continuously vocal Malaysian prime minister, Mahathir[5].

More long-term consequences included a loss of opportunities that were created in the boom years up until the crisis hit. The crisis-affected economies experienced a deep recession, then a sluggish growth following the years of 1997 and 1998 (see Table 1). Some economists suggested the impact on countries like Indonesia and Thailand between 1997 and 2001, as similar to the great depression in the 1930s. Even after the recovery, taking 2002-2006 as the period of sustained post-crisis expansion,[6] the economies of Indonesia, Malaysia and the Philippines have achieved real per capita

[5] Of course, sectoral-level and crowding out effects were also enormous. For example, the crisis allowed European business to move in at the expense of US business in Thailand, or Islamic and separatist movements intensified in Indonesia as the central government lost its control (http://en.wikipedia.org/wiki/Asian_financial_crisis).
[6] It is not a straightforward assessment for underlying growth performance of the crisis affected countries in the period after the crisis, because, for one thing, these economies were also soon hit by a second shock, the severe recession in the global high tech industry in 2001, which led sharp downturns in exports and output growth in much of East Asia.

income growth of 3 to 3.5 percent, with per capita growth in South Korea and Thailand averaging 4 to 4.5 percent.[7]

As these trends suggest, it will actually take much longer for the Asian post-crisis economies to close the gap with the developed world. In fact, a rise in East Asia per capita income, relative to the developed economies, has tended to flatten out among post-crisis economies in recent years compared to previous decades. But overall, real per capita incomes in the crisis-affected economies have significantly exceeded the pre-crisis levels. The question that remains is how many ASEAN countries, considered as middle income economies, can struggle to climb towards higher income levels, like Japan, Hong Kong, Korea, Singapore and Taiwan, which have already escaped the "middle income trap". These examples show that it is possible; but the task will not be simple. The crisis consequences are part of these challenges for the Southeast Asian region as a whole.

Evidently, there is not one but several sets of challenges facing economies in the region today.[8] But one particular area, which relates to a slower pace of growth in several crisis-hit economies, is pronounced differences in investment spending across economies. The recovery of investment after the 1997-1998 crises and the 2001 slowdown has often been weak and erratic,[9] and a consensus has not been reached about the causes of slower growth in investment among East Asian economies in the post-crisis period.

To a certain extent, cyclical "boom and bust" aspects of investment performance in the region can provide a useful explanation for the weakness of investments (World Bank 2007: 30). In particular, parts of the answer are high levels of spare capacity that were built up before the crisis, huge negative demand shock released by the crisis, and further negative demand shock from the Information Technology stock recession in 2001. In that conjunction, corporate sector debt, bad debt in the financial system and

[7] Per capita growth rates in the 3-4.5 percent range are above the world's per capita growth rates of 1.8 percent over the last quarter century. However these growth rates are still lower than aggregate per capita growth of 5-6 percent range in 2002-2006 for Eastern Europe, Central Asia and South Asia, for example (World Bank 2007: 27).
[8] This paper, by far, will not be able to balance out all of the crisis effects on these countries.
[9] With the exception of China, investment spending growth has continued running at double digit rates.

the need for painful corporate and financial restructuring, especially in Indonesia, South Korea and Thailand, also worsened the economic shock[10] (see Table 2 and Chart 1).

In the end, those cyclical explanations became less plausible as the time elapsed since the crisis occurred. For many cases, one can learn that:

- Capacity utilisation has been rising in most countries
- Corporate indebtedness has now fallen to levels similar to industrialized economies
- Banks in crisis-affected countries have achieved substantial improvements in capital adequacy, asset quality, profitability and more competition with the entry of foreign banks
- Bank lending has remained sluggish, not because of bank capacity to supply credit, but rather due to the sluggishness in corporate demand for loans.

Other analysts have emphasised the importance of new investment uncertainty. Such a structural adjustment process, as compared to rapid intensification of competition from China, may generate uncertainty, which may lead to new investment being delayed during an interim adjustment period during which firms try to adjust to the new environment. For example, the quality of the investment climate is likely to play an important role, as firms are concerned about macroeconomic instability and economic policy uncertainty. The investment climate surveys of the World Bank (World Bank 2007: 31) cite the following examples:

> "Even though macroeconomic conditions have greatly improved since the 1997-98 financial crisis, some 42 per cent of Indonesian firms in 2005 still cite concerns about macroeconomic instability as a major concern, although this proportion is down from 50 per cent in 2003. These continued concerns may relate to firms' long memories of the crisis and also to occasional episodes of renewed volatility in exchange

[10] More broadly, heavy debt burdens are making Asia's financial systems vulnerable to volatility in global markets. However, financial systems across much of Asia are sounder than in 1997 and transparency has improved.

> rates, interest rates and inflation in the post crisis period, in particular in 2000/01 and in 2005."
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> "Firms concerns have also been high in the Philippines, where the government's efforts to reduce a large fiscal deficit and huge public debt have been at the centre of attention."
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> "Firms were concerned about this sort of policy uncertainty in Indonesia (…) the Philippines and Thailand."
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> "IMF (2006) also notes some deterioration in the World Bank's indicators of governance for East Asia over the last decade (Kaufman, Kraay and Mastruzzi 2006), which may also suggest an increase in policy uncertainty."

2. Policy Responses

Most crisis-affected economies experienced negative growth rates in 1998, with a set-in recovery in 1999 and started to perform better in 2000. For most countries, the crisis was over in 2001, but there are still formidable challenges for reform in crisis-hit economies. The recovery process has revealed the strength behind these economies – the East Asian model – with all the virtues pointed out in the East Asian Miracle reports;[11] industrial competitiveness, strong exports, foreign direct investment, and high savings and investment. However, when these economies were thrown into the crisis, their responses were almost immediate, with countries like Thailand, Indonesia and South Korea accepting the bailouts package from the IMF. Malaysia and the Philippines were also hit hard but preferred not to opt for the IMF support.

When the crisis-hit economies were still in the recession, they needed to map out a growth recovery strategy. In particular, it was pointed out that structural reform, a safety net for the poor, and restoring international capital flows were immediate keys to recovery.[12] As a result, the actual pace of recovery took place clearly in 1999, even exceeding what the World Bank (1998) had predicted. Many factors behind the

[11] Including the IMF and the World Bank in the early 1990s.
[12] See: Ito, Takatoshi. 2001. Growth, Crisis, and the Future of Economic Recovery in East Asia. In Rethinking the East Asian Miracle, ed. Stiglith and Yusuf, 82, The World Bank.

recovery include strong exports, partly due to depreciated exchange rate levels; rebuilding of foreign reserves, partly because of collapsing imports of 1998; fiscal deficits and low interest rates stimulating aggregate demands; various structural reforms to strengthen the financial system; and sustained foreign direct investment inflows.

IMF and the World Bank

Early critics questioned the controversial role of international institutions like the IMF and the World Bank, with some even openly charging the overall Washington Consensus. As pointed out by Ito (2001: 82-83), factors that caused the Asian miracle in the World Bank report (World Bank 1993) and factors that are responsible for the Asian financial crisis are somewhat different:

> "Most development models (in the World Bank report (1993), quoted by the author) emphasize "real factors". Financial variables have not been much emphasized in the literature."
>
> "Most factors that are believed to have caused the Asian currency crises are "financial". (…) Development obviously needs both real and financial factors."

The crucial question is why the World Bank and the IMF failed to see that Asian economies grew despite the primitive state of their financial sectors and that this growth was temporarily arrested when financial institutions collapsed, either in advance of or as a result of the crisis. Of course, there were also some other incidents like when the IMF called for East Asian countries to liberalise their capital account in the early 1990s to which these countries responded, but ultimately did not take any real financial reforms, which would later become the cause for their economies to collapse.

When the crisis settled in, the role of the IMF became controversial, especially in the bailout countries of Indonesia, South Korea and Thailand, causing many locals to name the crisis, the “IMF crisis”. As said earlier, the IMF was criticised for encouraging emerging Asian economies to liberalise the financial sector, to maintain high domestic interest rates in order to suck in portfolio investment and bank capital and also to peg their currencies to the dollar to reassure foreign investors against currency risk. However, the strongest criticism of the IMF role in the crisis was targeted towards its response.

The IMF offered each country a multi-billion dollar “rescue package” to enable these countries to avoid debt default. However, the IMF support was conditional with a series of drastic economic and financial reforms also known as structural adjustment package (SAP). This SAP required the ‘rescued’ countries to allow the IMF a role in domestic policy responses.

> “To cut government spending to reduce deficits, allow insolvent banks and financial institutions to fail and aggressively raise interest rates… The reasoning was that these steps would restore confidence in the nation’s fiscal solvency, penalize insolvent companies and protect currency values” (http://en.wikipedia.org/wiki/Asian_financial_crisis).

Critics noted, however, that this shock therapy had done more harm than good. The austerity programme set these countries back deeper into the crisis than otherwise believed. In fact, many economists argued that with the contractionary nature of these policies that put these countries on the verge of economic collapse, there should be room for the traditional Keynesian response.[12] This includes ways to increase government spending, financing good companies to stay in business and lower interest rates as needed. This reasoning is based on the following arguments:

> “That by stimulating the economy and starving off recession, governments could restore confidence while preventing economic pain (…) the US government pursued expansionary policies. Such as lower interest rates, increasing government spending and cutting taxes when the US itself entered recession in 2001” (http://en.wikipedia.org/wiki/Asian_financial_crisis).

[12] In the case of Thailand, only the fourth LOI (May 1998) moved to a more expansionary fiscal policy.

3. Managing Policy Framework

The major issue of the crisis-affected economies is how to manage vulnerability and reduce risk of further crisis. Two broad strategies have been pursued. First, because of exchange rate depreciation, these economies have generally been able to run current account surpluses and build up foreign exchange reserves as a buffer and insurance policy against future crises (see Table 3). Second, they have sought to strengthen fundamentals. For example, by maintaining a prudent macroeconomic policy and by strengthening the financial sector.[13]

As the Asian crisis resulted from massive capital inflows, which caused these countries to be excessively exposed to massive short-term foreign liabilities, one can point to the need for a prudent macroeconomic policy with reliable policy instruments in place.

Rethinking Capital Controls

Many emerging economies face greater risk of sudden capital inflows and outflows, the consequent pressure on exchange rates and undesirable effects on domestic financial institutions. The best protection against capital account crises and contagion would be to strengthen the international financial institutions and the domestic policy frameworks. However, these improvements at the international and domestic front may not be able to be achieved overnight, thus rendering domestic financial markets vulnerable to external shocks.

The Malaysian experience on capital controls appears to have had a salutary effect, mainly because controls were supported by a sound macroeconomic policy

[13] Among these kinds of risks that might persist or new risks that might emerge are potential unwanted side-effects from the mix of policies used to support recovery after the crisis, or risks associated with only incomplete implementation of reforms (World Bank 2007: 34)

framework, bank and corporate restructuring, an undervalued currency, credit supervision and time-bound measures. Favourable external environments have also undoubtedly helped Malaysia to recover from the crisis. Also, Malaysian controls on short-term capitals had been justified in the transition period as financial safeguards, and these measures had been introduced just in time before the crisis fully erupted.

The Malaysian case suggests that deployment of capital outflow controls should not be rejected categorically. However, capital outflow controls are temporary measures and can have a negative impact on future capital inflows. This might hamper future economic growth, especially when there is a negative impact on FDI.

Appropriate Exchange Rate Regime

Debate over exchange rate regime, after the Asian crisis, is not about fixed versus flexible exchange rates. Rather, it has been reformulated with respect to the "new" question of which monetary system or which exchange rate system would be the best one to achieve price stability. However, as one could easily imagine, economists are still having opposing views. This is because a large number of monetary authorities face an impossible trilemma of simultaneously achieving exchange rate stability, full financial integration and monetary policy independence – otherwise known as the unholy trinity, by Mundell-Fleming.

For Asian crisis affected economies, Eichengreen (2002) argues that capital mobility in the face of volatile global financial markets makes it difficult to sustain even the slightest inconsistency between monetary and fiscal policy and the exchange rate policy. Under these circumstances, "soft" pegs (fixed but adjustable exchange rates) are unsustainable, as the market will expect that the government will eventually subordinate the exchange rate peg to domestic policy objectives and thus will speculate against the peg. To avoid this, countries have to choose between a "hard" peg[14] and a free float of the exchange rate.

[14] The "hard" peg is a credible commitment to the fixed exchange rate, such as the currency board of Hong Kong or in the extreme, a full dollarisation of the economy as in Ecuador. Under these conditions, monetary policy becomes passive.

For these reasons, it has been argued that if a country attempts to achieve exchange rate stability and monetary policy independence, it needs to introduce capital controls (Yoshitomi and Shirai 2000: 17). If a country attempts to promote full financial integration and monetary policy independence, it needs to adopt a flexible exchange rate regime. If a country attempts to achieve exchange rate stability and full financial integration, a very rigid exchange rate such as the currency bound or a currency union can only be achieved by abandoning monetary policy independence. As a result, it has become more difficult for the Asian emerging economies to single out the most appropriate exchange rate regime under capital account liberalisation (see Table 4).

Strengthening the Financial Sector

A lesson learnt from the Asian crisis is that financial institutions should be supervised and regulated adequately, since financial openness deepens the impact of domestic weaknesses because international and domestic investors can take their money out. Financial globalization exposes crisis-hit countries to the irrationality of international markets, which invite twin crises and serious contagion. Also, the existence of weak domestic financial institutions reduces the central bank's ability to use the domestic interest rate as a macroeconomic tool and is likely to amplify the twin crises.

In general, it has become clear that transparency in the financial sector, in particular its financial operations, is important to build confidence and reduce the possibility of speculative attacks driven by asymmetric information among investors. The fact that financial market participants do not have equally good information about their customers means that banks have no choice but to raise funds even in a crisis thus causing further damage to their balance sheets. Since banks conduct transactions with each other, problems in one bank create problems in others. This induces a situation in which a sudden loss of depositors' confidence produces a system-wide panic or systemic risk.

For these reasons, it is crucial for Asian emerging economies to have their financial markets regulated and supervised. If their financial institutions are well managed and regulated, an expansion of their balance sheets would be limited by the size of their capital, not by the availability of funds. At present, most countries have strengthened prudential supervision and regulations as well as global standards for the capital adequacy requirement, accounting, auditing, disclosure and so on. They have gone to strengthen the corporate governance of the banking sector by internationalising the banking system, allowing foreign banks to establish branches domestically or acquiring existing financial institutions. These are the necessary steps that emerging market economies should take to develop equity and bond markets, in addition to having an explicit deposit insurance system that provides assurances to savers, which may spur capital mobilisation and be a source of financial sector stability.

4. Search for Financial Cooperation

The actual progress in financial reform at the global level has always been slow. Proposals to regulate and stabilise global financial flows or to come to orderly debt workouts when a financial crisis hits are being discussed, but prospects of implementation are poor. The recent failure of reforming the IMF is another example of inertia at the global level.

The disappointment with the progress at the global level has led to initiatives for financial stability and cooperation at the regional level. A first attempt was the Japanese proposal, highlighted during the crisis by Malaysia to establish an Asian Monetary Fund (AMF), but it did not go very far. More progress has been achieved under the Chiangmai Initiative (CMI), where the ASEAN countries, together with Japan, Korea and China agreed to cooperate on financial matters.

In general, the idea for regional financial cooperation in East Asia covers many aspects.[16] The first aspect is to stabilise intra-Asian bilateral exchange rates by adopting a unified peg to a common basket system for serving exchange rates. This is particularly important for countries with relatively diversified export destinations that provide no obvious single major global currencies to peg against. The second aspect of the cooperation is to establish a set of bilateral swap arrangements between regional central banks to supplement the existing financial facility made available by the IMF. The third aspect of regional monetary cooperation is to strengthen economic and financial surveillance and exchange of information.[15] The fourth aspect of monetary cooperation in East Asia is to establish a regional bond market. This allows countries in the region to make use of the large amount of domestic saving by floating bonds, denominated either in the US dollar or domestic currency, in the regional market.[16]

AMF Proposal

The Asian crisis showed that Asia cannot depend on the IMF. With this lesson in mind, Japan proposed in 1997 to establish the AMF to supplement the IMF role for macroeconomic and financial surveillance and for providing policy dialogue as well as for pooling resources at the regional level.[17] The idea is that the AMF would act more quickly and appropriately than the IMF. However, the timing for submitting such a project was not right. The US, Europe, the PRC and the IMF strongly opposed it and forced Japan to drop the proposal.[18]

As often pointed out by economists, it is necessary for creditors to speak with one voice during the crisis. The AMF would provide different conditions of assistance

[16] See: Nasution, Anwar. 2005. Regional Financial Arrangements in East Asia, Paper presented at the 2005 AEA-ACAES Joint Meetings, Philadelpia, P.A. 7-9 January (mimeograph).
[15] It is hopeful that bilateral swap arrangements and regional surveillances could become embryo of the formation of the AMF to supplement the IMF in helping crisis countries in East Asia.
[16] Evidently, bonds denominated in domestic currency diminish foreign exchange risks.
[17] By creating an original fund of USD 100 billion to provide liquidity to support members.
[18] As it did not happen, Japan later proposed its Miyazawa plan in a different context to help crisis-hit countries to economic and social recovery.

from the IMF conditionality. Such a different opinion among creditors creates incentives for debtors to play one against the other. As consolation for the withdrawal of the AMF proposal, a number of leading emerging countries in East and Southeast Asia were invited in 1999, to join world fora such as BIS and G-20 as well as several committees of the IMF. Their participation in these activities might help them to learn the "rules of the game" for globalization as well as to inject the "Asian input" to the fora.

Regional Surveillance

After the Asian crisis, the case for regional surveillance mechanisms grew strong in Southeast and East Asia. The purpose of such surveillance is to improve transparency and exchange information as well as to allow participating countries to share and discuss reports on their economic conditions. Through the mechanism, it could also provide a venue for policy dialogue and discussions for mutual interests and economic challenges facing the region. At the core, surveillance is also a pre-requisite for economic policy coordination, mutual liquidity support and cooperation on exchange rate management.

Following in the footsteps of APEC, the Manila Framework Group (MFG) was established in November 1997. The MFG is a forum for regional surveillance economic and technical cooperation, strengthening the IMF capacity to respond to a financial crisis, and developing a cooperative financial arrangement to supplement the IMF resources. The MFG however, failed to provide what was badly needed by the crisis-affected countries. This prompted ASEAN to establish its own regional surveillance mechanism in October 1998. Following the Manila Summit, it became the ASEAN+3 Finance Ministers Forum in November 1999.[19] Subsequently, the

[19] In between, the ASEAN Secretariat prepared the surveillance report with inputs provided by REMU (Regional Economic Monitoring Unit) of the ADB.

ASEAN regional surveillance has expanded to an Economic Review and Policy dialogue of ASEAN+3 to include Japan, Korea and the PRC.[20]

Chiangmai Initiative

With the failure to establish the AMF, the ASEAN+3 Summit meeting in Manila in November 1990 had proposed a "Joint Statement on East Asian Cooperation" that would cover a wide range of regional cooperation issues, including monetary cooperation. Leaders agreed on "enhancing self-help support mechanism in East Asia through the ASEAN+3 framework". To provide additional resources available in this region, the finance ministers of ASEAN+3 agreed to establish a regional financial arrangement by adopting the Chiangmai Initiative (CMI) at their meeting in Chiangmai on 6 May 2000.

The CMI framework has two components, namely: a network of bilateral swaps and repurchases arrangements among the ASEAN+3 countries, and an expansion of the existing ASEAN Swap Arrangement (ASA). Basically, the bilateral swap arrangement (BSA) is a two-swap arrangement where each party can request the other party to enter into the swap transaction. This is to provide short-term liquidity support when necessary, to overcome balance of payments difficulties in the specific countries, up to the agreed amount. The CMI was approved at the meeting of the Deputies on 7 November 2000 in Beijing, and now consists of several BSA with a total value of around USD 80 billion.

In the end, the purpose of BSA is to create an additional regional facility to cope with volatile capital flows, speculative attacks, and to economise on foreign reserve holding. Under BSA, countries can swap their domestic currency for US dollars for a period up to 90 days, which can be renewed seven times, at an increasing cost each

[20] The REMU of the ADB is in charge of the preparation of the report. Since 2002, this surveillance mechanism has been conducted twice per year among the Deputies of the Ministers of Finance and Governors of the Central Banks. It is also important to note that all these fora are on a voluntary basis. The meetings have no power to impose policy measures or sanctions.

time. Only ten percent of the maximum agreed sum in the BSA can be withdrawn automatically. The remaining 90 percent depends on an IMF program being in place.

Asian Bond Markets

The impact of the Asian crisis might have been less if these countries had better developed bond markets. Several studies show that Asian bond financing is underdeveloped and that the region is characterised by bank-dominated financial systems. A well-developed bond market allows corporations to source for their finance from equity, bonds and bank loans in a way that gives an optimal capital structure and would allow investors to achieve a better risk-return balance in their portfolios. In the absence of bond markets,[21] firms and investors are forced into risky short-term financing and sudden and sharp reversals of short-term financing will exacerbate any crisis that occurs.

Countries of ASEAN+3 had taken initiatives to develop the Asian bond market (Ma and Remolona 2005). In December 2002, government officials discussed the Asian Bond Market Initiative (ABMI) in recognition of the need to develop Asian bond markets. In August 2003, the ASEAN+3 Finance Ministers Meeting (AFMM+3) put forward the establishment of the working groups under the ABMI. The working groups have since embarked on efforts to further develop the region's bond markets. More recently, a number of countries have started to issue local currency bonds for investors, but the overall amount is still small.

Exchange Rate Arrangements

Presently, East and Southeast Asian nations adopt a variety of exchange rate management systems. However, in reality, most countries in the region still peg their exchange rates to the US dollar. Prior to the crisis of 1997, Indonesia and South Korea

[21] Total outstanding regional bond markets in 2003 are USD 120 billion, as compared to more than USD 9 trillion on the global international bond markets.

had adopted a managed floating exchange rate management, but still restricted their currency movement to the US dollar, whereas Thailand maintained a strict pegging. Under the IMF programme, exchange rate policies in Indonesia, South Korea and Thailand shifted to independent floating, supported by inflation targeting as a monetary policy strategy. Along with the control of short-term capital movements, Malaysia moved from managed floating to a strict pegging. Cambodia and Singapore maintain the managed floating system; Myanmar, Vietnam and China preserve strict pegging while Brunei and Hong Kong have adopted the currency board system (see Table 4).

Since then, new proposals to achieve the exchange rate stability includes pegging regional currencies to the yen, establishing a basket system for setting currencies and cooperation to help one another defending the exchange rate regime of its choice by creating Asian exchange rate mechanisms. In the long run, Asia might adopt a single Asian currency. Other argue that it is difficult to go in that direction as the world is largely a US dollar standard. Therefore, formalising East Asia to become part of the US dollar standard promotes exchange rate stability and therefore solves the problem of crisis-prone economies, which was the root of the Asian crisis in 1997 (Chirathivat, Claassens and Schroeder 2004).

5. Outlook

Southeast Asia, like the rest of the Asian region, will continue its economic transformation in large parts based on integrating into the global economy. As a result, an acceleration of financial sector integration is part of the benefits the countries could gain in financial growth, but it is not without risks. As learnt during the ten years after the crisis, the capital market integration via associated capital flows also brings risks, including the possibility that large inflows might entail sudden shocks of capital outflows and could cause currency and financial collapses.

The question that remains is whether the region is still vulnerable to capital markets and financial crises. In many respects, it is fair to say (World Bank 2007) that these countries are less vulnerable to the specific kind of crises that hit their economies in the second half of 1997 and in 1998. However, this does not mean that they are not subject to risks.

The Asian region remains exposed to risks from the global environment, especially the current configuration of global imbalances, the sharp rise in financial market volatility and the possible economic fallout that may occur. Nevertheless, a decade of sound macroeconomic policies and continuous structural reforms leaves the region well placed to weather the shocks. As a matter of fact, the structure of policy responses will differ for each country because of the different degree of linkages to the global economy and the evolvement of their domestic institutions.

There is currently a distinctive evolution of East Asia's overall balance of payments in the recent post crisis period, with large current account surpluses being joined by significant capital account inflows, especially in 2002-2004 (see Table 5 and Chart 2). However, most countries in the region that were subject to upward pressure on the exchange rate (caused by large balance of payments surpluses and the rapid build-up of foreign reserves in recent years)[22] have started to intervene in the foreign exchange market (see Table 6). On another note, inflow surges in cases like South Korea and Thailand have made it more difficult to deal with strong pressures in exchange rates or asset prices.

Critics say that global imbalances are likely to remain in the medium term, and the volatility in the financial markets looks set to pressure countries with proper policy responses. In such a case, ASEAN finance ministers compared recent challenges in market volatility and pressure on exchange rates as similar to those which hit the region during the Asian crisis of 1997.[23] Apart from learning about each country's own experiences on crisis and recovery, regional financial arrangements are also now building up to defend against future risks.

[22] Especially the PRC.
[23] Global imbalances, particularly, the weaknesses of the US economy, are having strong effects on capital flows pouring in Asia in search of higher returns, thus putting pressure on currencies across the region.

There are no ready-made recipes for dealing with the challenges of more volatile capital inflows. It is up to each country to determine a fuller policy mix that best fits their needs. More flexibility on exchange rate movements, a strong monetary policy framework that can keep inflation expectations in check, strengthening risk management and developing financial markets, including the context of regional financial integration, are some of the most important policy measures which can help domestic and regional financial systems to cope with the risks in capital flows.

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Table1 : East Asia and the Pacific: GDP Growth Projections

Country	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005e	2006f	2007f	2008f
Brunei Darussalam	2.2	1.1	3.1	4.8	0.3	3.1	4.5	2.9	-1.5	-0.6	3.1	2.9	2.7	3.9	2.9	0.5	0.4	3.8	2.6	3.0
Cambodia	3.3	1.1	7.6	7.1	4.0	8.0	6.5	5.3	5.7	5.0	12.6	8.4	7.7	6.2	8.6	10.0	13.4	9.5	7.0	6.0
Indonesia	7.5	7.2	7.0	6.5	6.8	7.5	8.2	7.8	4.7	-13.1	0.8	5.4	3.6	4.5	4.8	5.0	5.7	5.5	6.0	6.3
Lao PDR	9.9	6.7	4.0	7.0	5.9	8.2	7.0	6.9	6.9	4.0	7.3	5.8	5.7	5.9	6.1	6.4	7.0	7.5	7.1	9.0
Malaysia	9.1	9.0	9.5	8.9	9.9	9.2	9.8	10.0	7.3	-7.4	6.1	8.9	0.3	4.4	5.5	7.2	5.2	5.9	5.5	5.8
Myanmar	3.7	2.8	-0.7	9.7	5.9	6.8	7.2	6.4	5.7	5.8	10.9	13.7	11.3	12.0	13.8	13.6	13.2	7.0	5.5	4.0
Philippines	6.2	3.0	-0.6	0.3	2.1	4.4	4.7	5.8	5.2	-0.6	3.4	6.0	1.8	4.4	4.9	6.2	5.0	5.4	5.8	5.8
Singapore	10.0	9.2	6.6	6.3	11.7	11.6	8.2	7.8	8.3	-1.4	7.2	10.1	-2.4	4.2	3.1	8.8	6.6	7.9	5.5	5.7
Thailand	12.2	11.6	8.1	8.1	8.3	9.0	9.2	5.9	-1.4	-10.5	4.4	4.8	2.2	5.3	7.1	6.3	4.5	5.0	4.5	4.8
Vietnam	7.8	5.0	5.8	8.7	8.1	8.8	9.5	9.3	8.2	5.8	4.8	6.8	6.9	7.1	7.3	7.8	8.4	8.2	8.0	7.8
China	4.1	3.8	9.2	14.2	14.0	13.1	10.9	10.0	9.3	7.8	7.6	8.4	8.3	9.1	10.0	10.1	10.4	10.7	10.0	9.5
Japan	5.3	5.2	3.4	1.0	0.2	1.1	2.0	2.7	1.6	-2.0	-0.1	2.9	0.2	0.3	1.4	2.7	1.9	2.2	2.3	1.9
Hong Kong SAR	2.7	4.0	5.7	6.5	6.3	5.6	3.9	4.2	5.1	-5.5	4.0	10.0	0.6	1.8	3.2	8.6	7.5	6.8	5.5	5.0
Korea	6.7	9.2	9.4	5.9	6.1	8.5	9.2	7.0	4.7	-6.9	9.5	8.5	3.8	7.0	3.1	4.7	4.2	5.0	4.4	4.4
Taiwan, China	8.5	5.7	7.6	7.8	6.9	7.4	6.5	6.3	6.6	4.5	5.7	5.8	-2.2	4.2	3.4	6.1	4.0	4.6	4.2	4.3

Note: e means estimates and f means forecast

Source: IMF (2007), World Economic Outlook Database for April 2007

Table 2: NPLs of Commercial Banks

(% of total loans)

	2000 Dec	2001 Dec	2002 Dec	2003 Dec	2004 Dec	2005 Dec	2006 Dec
Indonesia a/	18.8	12.1	7.5	6.8	4.5	7.6	6.1
Korea b/	8.8	3.3	2.4	2.2	2.0	1.3	0.9
Malaysia c/	9.7	11.5	10.2	9.0	7.5	5.8	4.8
Philippines d/	15.1	17.3	15.0	14.1	12.7	8.5	6.0
Thailand e/	19.5	11.5	18.1	13.9	11.6	8.3	8.1

Note: (a) Excludes IBRA's AMC; end-3Q 2006 data is as of Aug.

(b) Excludes KAMCO/KDIC. The NPL ratio increased in1999 due to the introduction of stricter asset classification criteria (forward looking criteria).

(c) Excludes Danaharta. NPL series used by Bank Negara Malaysia, which is net of provisions and excludes interest in suspense.

(d) From September 2002 onwards, the NPLs ratios are based on the new definition of NPLs (as per BSP Circular 351) which allows banks to deduct bad loans with 100 percent provisioning from the NPL computations.

(e) Excludes transfers to AMCs. (Note that the jump in headline NPLs in December 2002 was a one-off increase, reflecting a change in definition and did not affect provisioning requirements).

Source: World Bank (2007)

Table 3: East Asia: Foreign Reserves Minus Gold (US$ Billion)

	China	Indonesia	Malaysia	Philippines	Thailand	Hong Kong (SAR)	Korea	Singapore	Taiwan, China	Total
Dec-96	107.039	19.281	27.009	9.905	37.810	63.808	33.201	76.847	88.038	462.938
Dec-97	142.762	17.396	20.788	7.178	26.254	92.804	20.369	71.289	83.502	482.341
Dec-98	149.188	23.516	25.559	9.273	28.825	89.650	51.975	74.928	90.341	543.255
Dec-99	157.728	27.257	30.588	13.282	34.063	96.236	73.987	76.843	106.200	616.185
Dec-00	168.278	29.394	29.523	13.090	32.016	107.542	96.131	80.132	106.742	662.848
Dec-01	215.605	28.016	30.474	13.476	32.363	111.155	102.753	75.375	122.211	731.428
Dec-02	291.128	32.039	34.222	13.329	38.055	111.896	121.343	82.021	161.656	885.689
Dec-03	408.151	36.296	44.607	13.655	41.077	118.360	155.282	95.746	206.632	1,119.806
Dec-04	614.500	36.320	66.418	13.116	48.665	123.540	198.994	112.232	241.738	1,455.523
Dec-05	821.514	34.724	70.203	15.926	50.692	124.244	210.317	115.794	253.290	1,696.704
Oct-06	1,012.008	39.895	79.345	19.440	60.685	131.181	229.387	131.553	261.820	1,965.314
Nov-06	1,040.926	41.579	79.500	19.658	62.756	132.661	234.183	134.308	265.140	2,010.711
Dec-06	1,068.489	42.586	82.164	20.025	65.292	133.168	238.882	136.717	266.148	2,053.471

Source: World Bank (2007)

Table 4: Elements of Monetary Arrangements in East Asia and Australia following the crisis in 1997

Country	Exchange Rate Arrangement	Year of adoption of inflation targeting	Bank Restructuring
Australia	Independent floating	June 1993	-
Brunei Darussalam	Currency board arrangement	-	-
Cambodia	Managed floating	-	yes
China, People Republic	Pegged	-	yes
Hong Kong	Currency board arrangement	-	-
Indonesia	Independent floating	January 2000	yes
Japan	Independent floating		yes
Korea	Independent floating	April 1998	yes
Laos	Managed floating	-	yes
Malaysia	Pegged	-	yes
Myanmar	Pegged	-	yes
New Zealand	Independent floating	December 1989	-
Philippines	Independent floating	January 2002	-
Singapore	Managed floating	-	-
Thailand	Independent floating	May 2000	yes
Vietnam	Pegged		yes

Source: Nasution, A (2005)

Table 5: East Asia - Balance of Payments 2003-06 - Percent of GDP

	Overall Balance				Current Account				Capital Account			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
East Asia	7.0	8.8	5.5	7.0	4.6	4.5	5.8	7.1	2.4	4.2	-0.3	-0.1
China	7.1	10.7	9.1	9.2	2.8	3.5	7.1	8.6	4.3	7.1	2.0	0.6
S.E. Asia	3.2	4.7	1.0	4.6	4.9	3.4	2.1	5.3	-1.7	1.2	-1.1	-0.7
Indonesia	1.8	0.0	-0.6	2.2	3.4	0.6	0.1	2.6	-1.6	-0.6	-0.7	-0.5
Malaysia	10.0	18.4	2.9	8.0	12.8	12.6	15.3	17.3	-2.8	5.9	-12.4	-9.3
Philippines	0.4	-0.6	2.9	3.5	1.6	2.4	2.0	4.7	-1.2	-3.0	0.9	-1.2
Thailand	2.1	4.7	1.2	7.1	3.3	1.7	-4.5	1.6	-1.2	3.0	5.6	5.5
NIEs	8.5	7.9	1.9	4.5	6.9	6.6	5.6	5.6	1.6	1.3	-3.7	-1.1
Hong Kong	4.1	3.1	0.4	4.7	10.4	9.5	11.4	10.7	-6.3	-6.4	-11.0	-6.0
Korea	5.6	6.4	1.4	3.2	1.8	4.1	1.9	0.6	3.8	2.3	-0.5	2.6
Singapore	14.9	15.3	3.1	15.8	24.2	20.1	24.5	27.5	-9.3 -	4.7	-21.4	-11.7
Taiwan, China	15.0	10.9	3.3	3.6	9.7	5.8	4.6	7.0	5.2	5.1	-1.3	-3.4

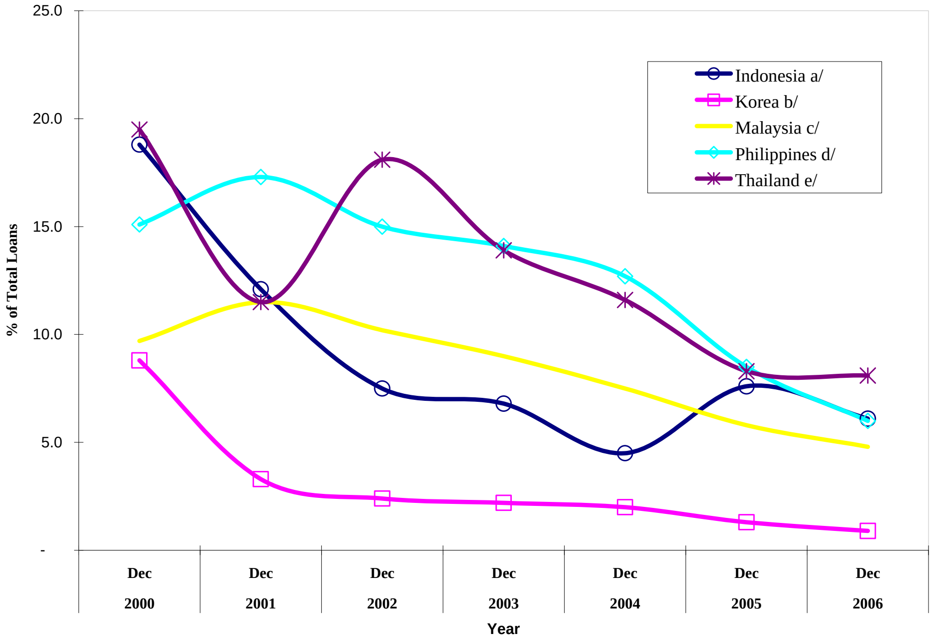
Source: World Bank (2007)

Table 6: East Asia: Exchange Rates (LCU/$)

	China	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan, China	Thailand	Yen
Apr-06	8.02	8,775.00	945.70	3.63	51.83	1.58	31.91	37.52	114.30
May-06	8.02	9,220.00	947.40	3.63	52.65	1.58	32.02	38.13	112.24
Jun-06	8.00	9,300.00	960.30	3.68	53.59	1.59	32.40	38.22	114.95
Jul-06	7.97	9,070.00	953.10	3.65	51.62	1.58	32.76	37.85	114.80
Aug-06	7.96	9,100.00	959.60	3.68	50.94	1.57	32.91	37.58	117.32
Sep-06	7.91	9,235.00	945.20	3.68	50.39	1.59	33.10	37.54	117.80
Oct-06	7.88	9,110.00	944.20	3.65	49.81	1.56	33.26	36.75	117.65
Nov-06	7.84	9,165.00	929.90	3.62	49.76	1.54	32.43	36.02	116.40
Dec-06	7.81	9,020.00	929.60	3.53	49.13	1.53	32.60	36.04	118.95
Jan-07	7.78	9,090.00	940.90	3.50	49.03	1.54	32.95	35.80	121.68
Feb-07	7.74	9,160.00	938.30	3.51	48.29	1.53	32.95	35.45	118.54
Mar 28-07	7.73	9,150.00	940.78	3.46	48.12	1.52	44.30	32.11	116.92

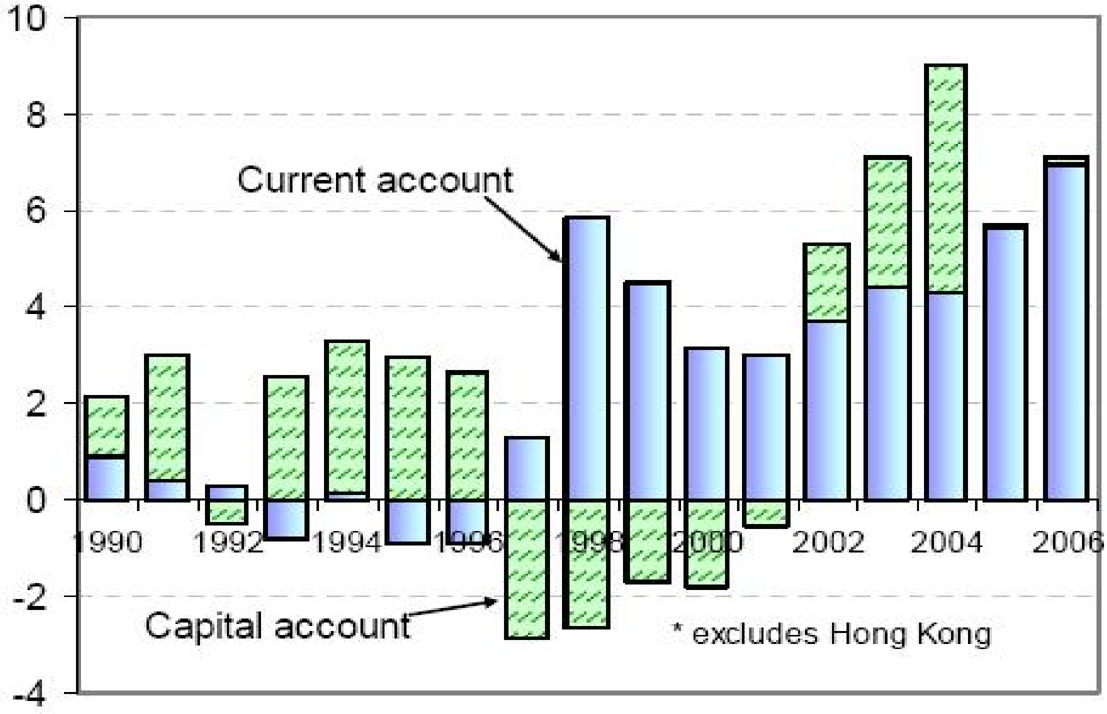
Source: World Bank (2007)

Chart 1: NPLs of Commercial Banks



Source: World Bank (2007)

Chart 2: East Asia Balance of Payments: Overall Balance (% of GDP)



Source: World Bank (2007)