Tarisa Watanagase: Global financial crisis and economic integration in Asia

Address by Dr Tarisa Watanagase, Governor, Bank of Thailand, at the TU-JBIC International Conference on "The Future of Economic Integration in Asia", Bangkok, 21 November 2008.

*   *   *

Distinguished Speakers and Guests,

Ladies and Gentlemen,

It is my honor and pleasure to accept the invitation from the Faculty of Economics, Thammasat University and Japan Bank for International Cooperation to speak at this congregation of prominent researchers and policy makers in the International Conference on "The Future of Economic Integration in Asia". I would also like to congratulate the organizers for putting together a concrete and thorough program covering all core aspects of Asian economic integration that need better understandings and brainstorming efforts from academics, as well as the public and private sectors. I believe that the knowledge and views from this avenue will certainly provide important inputs for shaping the future direction and pace of economic integration in our region.

Ladies and Gentlemen,

While trade and financial integration in Asia has been gathering significant momentum for the past decade, the current global financial crisis has manifested an extraordinary case and timing for us to reassess and rethink carefully about the future course of further integration among our regional economies and beyond. Therefore, it is very timely to talk about the global financial crisis and its implications for economic integration in Asia.

In doing so, first, let me start with the current financial crisis and its relation with global financial imbalances and economic integration. Then I will briefly discuss the stage of Asian economic integration and highlight the benefits it rendered in cushioning a number of regional economies from the adverse effects from the crisis. After that, I will draw the lessons from the current crisis that should further help gear our integration towards the path that reaps the most benefits and minimizes potential risks along the way.

Ladies and Gentlemen,

During 2004-2006, one of the main potential threats to the world economy centred around the global financial imbalances arising from the chronic and rising US current account and fiscal deficits. Although most economists believed that the situation was not sustainable, no one could predict the timing and extent of the unwinding process, nor whether the US would face a hard on soft landing. The current crisis, unfortunately, manifests an abrupt unwinding of the imbalances. The trigger point of the crisis is clearly the subprime lending problem in the US, a new phenomenon. However, most economists would agree that the root cause of the crisis lies beneath excessively accommodative monetary policy that led to excessive credits, and in turn, to asset price bubbles, a repeating cause of past crises. Other important driving factors behind rising credit expansion and bubbles included rising financial innovation and its complexity and lax supervision.

The global financial imbalances could not have heightened rapidly since the early 2000s without fast rising global economic integration. Both global trade and financial integration aided the growing US domestic consumption as well as the twin deficits of the current and fiscal accounts. Trade integration facilitated exports especially from Asia to meet the US demand. On the other hand, increasing financial integration allowed emerging economies with fast rising export revenues to invest the money in the US market where there is a wide variety of financial assets and instruments. At the same time, financial institutions in most advanced economies and a number of emerging economies have invested in opaque financial products, which originated in the US and spread globally through financial integration. Therefore, with economic integration at the global level, the large global saving-investment mismatches between the US, who is a net spender, and emerging market Asia and others, who are net savers, were allowed to persist for a continued period. In addition, with global financial integration, what was originally expected to be a US problem once imbalances unwind, has turned into a global crisis.

Ladies and Gentlemen,

One common and frequently asked question is whether further integration at both the global and regional levels, especially financial integration, should be deterred as it has created channels that allow a financial crisis in one country to spread to various parts of the world. I believe that, like all economic matters, integration offers benefits and comes with costs. While we see significant adverse impacts of global integration, Asian economic integration, in fact, has a crucial role in helping a number of our regional economies withstand this enormous external destabilizing shock. Hence, our essential tasks are about determining an appropriate pace of further integration and making us increasingly resilient in response to the fast changing environment.

To elaborate the above points, allow me to briefly talk about the developments of Asian economic integration with the world and within the region. On the trade side, there are two important on-going forces. First, international trade with the economies outside the region has risen significantly especially due to the emergence of China and India in the world trade arena, as well as policies to lower trade barriers and establish trade agreements. Second, within East Asia, intra-regional trade has grown rapidly and surpassed trade with the outsiders since 2004. The driver is vertical integration of the production networks of multinational corporations across regional economies.

On the financial side, since the Asian financial crisis, East Asian economies have taken various efforts to deregulate and deepen the financial markets and liberalize their capital account. We have witnessed significantly rising financial linkages within East Asia. We have also seen rising FDI activities both within the regional economies and with other regions. Increasing regional FDI is largely a result of the aforementioned regional production networks. Portfolio investment has also increased significantly prior to the period of the subprime problem due to increasing demand of international investors for emerging market assets. Meanwhile, the lessons from the Asian crisis are still kept in mind as international borrowing, especially short-term borrowing, has continued to be below the pre-crisis levels in most regional economies.

Overall, economic integration in our region has proceeded quite rapidly. However, the degree of regional financial integration still lags that of trade integration. It is also important to mention that the financial markets in East Asia are integrated relatively more with the global markets than with each other. One important evidence is that the regional stock markets have moved more closely with the US market.

Ladies and Gentlemen,

Now I would like to get back to the earlier point to explain why I think that regional economic integration has played a role in helping the regional economies deal with this current financial crisis.

It is evident that regional trade integration has provided a better buffer against declining export demand from the G3 economies. Even though the main final demand for East Asian products through intra-regional trade is still in the G3 economies, the strong and growing domestic demand in regional economies especially China and India over the years gives a significant additional cushion for our exports compared with the past crises. Export revenues that the Asian economies have accumulated over the years largely through the regional production network have been a major contributor to the build up of foreign reserves at a comfortable level.

Furthermore, efforts to increase regional financial integration have come hand-in-hand with financial sector reforms and fostered regional cooperation, particularly in terms of crisis prevention and management. Regional surveillance through enhanced channels of communications and platforms of information sharing has been a main focus across different fora of economic ministers and central banks in Asia and the Pacific. The main regional crisis management tool, reserves pooling arrangement under the Chiang Mai Initiative, has been enlarged and its activation process has also been streamlined to better serve the needs of its members.

Surely, Asian economies cannot decouple from the global economy as we still depend considerably on other economies outside the region. However, I believe that post Asian crisis regional integration and cooperation have helped most of our regional economies to stand by each other amid the turbulent environment.

Ladies and Gentlemen,

Although the regional economies have become increasingly more resilient and have focused on fostering effective regional crisis prevention and management mechanisms, we still need to be vigilant about the on-going risks. Moreover, there are important lessons from this crisis that we need to take into consideration in choosing the direction and pace of further economic integration in the new environment.

First, while innovations and the removal of barriers to cross-border activity have expedited global capital market integration, they could also bring about complexities, less transparency, and therefore greater possibility and magnitude of systemic risks. Sophistication of financial products has led to inadequate understandings of market players as well as lack of transparency in certain securities markets and intermediaries. One notable example is the unregulated and non-standardized markets for structured products where a fair evaluation of the instruments as well as of the counterparty risk has been very difficult, not only for market players but also for supervisors.

Second, the current financial crisis demonstrates the amplifier role of the financial sector in a boom-bust economic cycle. In the environment of fast credit expansion, rising capital inflows, and lack of proper regulation, the inherent procyclical nature of the financial sector has contributed to one of the unprecedented build-up of financial imbalances in the US during the boom and a disorderly unwinding of these imbalances during the bust.

Third, the crisis also raises a crucial question about the role of monetary policy in maintaining macroeconomic and financial stability. The important question is whether monetary policy should be employed to help deter the build-up of asset price bubbles apart from the macroeconomic stability objective.

And fourth, Asian financial markets have been more susceptible to negative events in the major financial markets. Volatilities in the regional financial markets have increased, driven increasingly more by actions of international investors. We have witnessed large capital reversals during the periods of risk aversion as their investment positions were unwound both in the stock and bond markets.

Ladies and Gentlemen,

These four important lessons will be important inputs for us while we cautiously proceed with further integration. This crisis experience clearly shows that a financial crisis can happen in any markets regardless of the level of market development, size, and region. To date, the economies that have been hard hit by the crisis originated in the US through financial spillover effects include the Euro zone, UK, and some economies in Eastern Europe, Asia, and Latin America. It is confirmed again that, whenever financial imbalances arise, financial distress can easily occur and become rampant due to the increasing linkages across the globe.

So I believe that the key to our endeavor is to 1) take a careful step of further integration, 2) increase economic and financial resiliency, and 3) be ready to deal with unforeseen risks ahead.

We can compare this important decision of embarking on further integration to the situation where we are already in a sea expedition. If we are already in the middle of the ocean, sailing back to the origin or resisting further integration seems likely a bad idea. However, to reach the destination safely and be able to weather the likely stormy sea along the way, we need to plan ahead in navigating the boat and be ready to adjust the speed. Moreover, we need to make sure that the boat is in a good condition. We must therefore be alert and well prepared to deal with the storms and other dangers.

Ladies and Gentlemen,

The next important question is “how to carefully set the appropriate path and pace of further integration in the new economic and financial landscape?” With the principle of market-led integration in our region, the role of the authorities is in terms of promoting integration and establishing infrastructures that may be too costly at the initial stage for the private sector. In this spirit, the direction and speed of integration will be largely determined by market forces. The private sector will therefore, all the more important, need to spearhead with their ingenuity, creativity, and determination and also work closely with authorities.

However, the authorities still have a main role in determining the degree of capital account openness which is a necessary condition for greater financial integration with external markets. It is true that resisting further capital account liberalization over an extended period is likely ineffective and counterproductive. Yet, as recent events have demonstrated, large and volatile capital flows can become a destabilizing effect on an economy, and, with limited monetary policy tools, it may be necessary to “throw sand in the wheel” when circumstances warrant to preserve the overall economic and financial stability. This is still a topic for open debate, but I think I would like to move on to other important points.

Ladies and Gentlemen,

To facilitate greater integration both at the global and regional levels, increased economic and financial resiliency is unquestionably a prerequisite for success. In our region, much has been achieved since the Asian financial crisis recovery period.

Overall, East Asian economies have become more resilient. The managed float exchange rate and Inflation Targeting monetary policy frameworks that a number of regional economies have adopted after the Asian crisis have proven to be effective tools in maintaining economic stability and have had a role in helping spur economic growth. They have also had a role in helping dent financial imbalances especially excessive external borrowings and their maturity mismatches. The latest numbers of external debt to GDP in East Asia (except for the case of South Korea) stood below 30 percent in 2007, declining from the range of 62 to 168 percent from the peak during 1998 whereas the ratio of foreign reserves to short-term debt in most regional economies jumped from approximately 1-3 times in 1998 to 4-8 times in 2007.

Nevertheless, as mentioned earlier, the direct role of monetary policy in curbing financial imbalances apart from price stability will need to be revisited. It may be very well be the case that some tightening monetary policy is needed along side prudential measures in curbing financial imbalances.

On the financial sector side, reforms that have been put in place to foster transparency and governance as well as to strengthen regulation and supervision have also resulted in significantly healthier financial institutions across the region in terms of solvency, liquidity, and profitability. These reforms aiming to ascend to the international best practice such as the IMF’s Financial Sector Assessment Program (FSAP), the Basel II capital standard, the fair value accounting rules or IAS 39, will help ensure financial sector stability in the long-term as well as escalate the level of competitiveness and resiliency of the regional financial institutions. However, research studies are needed in finding ways to mitigate the procylicality problem associated with the adoption of Basel II standard and the IAS39 rules.

Nevertheless, much more still needs to be tackled further. More emphasis will be needed on improving and enhancing risk assessment and management of bank and non-bank corporations as well as strengthening authorities' responsiveness to risks. Deepening and broadening capital markets, particularly the relatively infantile corporate bond markets will continue to be one of the top priorities as liquid and well functioning local capital markets would help the domestic financial markets withstand risks in the increasingly more volatile world capital market better. The important tasks in this area include improving the legal and regulatory frameworks to ensure investor protection and increase transparency, enlarging and diversifying the investor base, and finding ways to improve the quality of international and local credit rating agencies' over-the-cycle risk assessment.

In addition to the above crucial works, I would like to stress the challenge in human resource development as the world becomes more complex. This crisis has notably demonstrated the lack of financial experts who are well-versed in financial innovation and risk management both in the public and private sectors. We need experts who can deal with problems through creative thinking as unforeseen risks likely lie ahead along the future path of integration. The sharing of knowledge and information will crucially help fill the gap among our regional experts.

As for regional cooperation, it is essential to further enhance regional surveillance especially in the areas of financial markets. Crisis management increasingly needs close regional coordination to strengthen effectiveness of the chosen measures and avoid beggar-thy-neighbor actions. And in terms of the scope, we also need to reach out more to our neighbors in South Asia and the Middle East so that they become the more important partners in both trade and investment spheres.

Ladies and Gentlemen,

To conclude, Asian economies have come a long way in this sea expedition of economic integration. Throughout the journey, our boats have survived many storms. We know that we can lend a hand to one another if our fleet of boats moves together as a group. During this current heavy storm, we learn that we need to be wise in steering the boats to go forward. There is no turning back. After all, we know from experience that all storms will end one day and the more resilient fleets will recover faster and have a better chance of reaching the destination.

Thank you very much for your attention.