Heng Swee Keat: The impact of the global financial crisis on Asia

Keynote speech by Mr Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, at the International Institute of Finance (IIF) Asia Regional Economic Forum, Singapore, 4 March 2009.

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Introduction

Ladies and Gentlemen,

Good afternoon.

I welcome the International Institute for Finance (IIF) for holding its Asia Regional Economic Forum in Singapore. It is good to see such a diverse group gathered here for this Forum.

An unprecedented crisis

The most commonly used adjective to describe the current financial crisis is "unprecedented". Indeed, many aspects have been exceptional –

- the speed at which events unfolded and triggered a series of domino effects;
- the scale of the impact, which has become global; the range of financial institutions and investors affected;
- the near-perfect correlations of markets and asset classes that had been uncorrelated when conditions were benign;
- and the range of unconventional measures taken by financial authorities globally to try and arrest the unfolding crisis.

These features of the crisis are exceptional. But perhaps the most crucial aspect that has had a profound effect on the dynamics of this crisis and its impact on emerging economies, is that unlike various past crises, this current crisis originated in the US.

This is unlike various financial crises in the past 25 years or so – which tended to have certain recurring themes, and which tended to begin in emerging economies before their knock-on impact was felt internationally. The analytical tools and policy prescriptions for dealing with such crises became more tried and tested over time, even if applied in too dogmatic a fashion at times. Global institutions, whether it was the IMF, developed nations, or a consortium of strong international banks, had the wherewithal to bring sufficient resources to bear on the problem. Crisis resolution was never easy but did not quite look insurmountable.

Not so this time.

The epicenter of this crisis is the US – it is the world's largest economy, holder of the international reserve currency, and home to the largest and most sophisticated financial system. So we are talking about the core of the global financial and economic system where severe problems arose and have since spread across borders.

In the US, the "shadow" banking system grew rapidly but was quite opaque in the way it operated. Before long, problems built up and spread to engulf the "traditional" banking sector. Within a short time, commercial banking operations were severely impaired. Right now, we are dealing with the bursting of multiple, overlapping bubbles – the housing bubble, the household credit bubble and the consumption bubble. Cutting across all three bubbles was leverage – households overstretched themselves; the financial institutions which were extending this credit to households were themselves taking on excessive leverage. The combined effect now is a painful deleveraging process that drives down asset prices, shrinks balance sheets, and feeds straight into the real economy in the form of credit contraction. Adverse feedback loops between the financial system and real economy have become entrenched.

The Eurozone, which accounts for the second largest share of global GDP, has deep financial linkages with the US. Through these linkages, financial stresses were transmitted across the Atlantic rapidly. Many banks in Europe, as well as other financial institutions such as insurance companies and asset managers had large exposures to US assets. Many were over-leveraged and dependent on benign conditions for liquidity to continue flowing. So they got sucked into this vortex. We have a similar story of credit evaporating and strains being felt in the real economy.

Over in Japan, recovery from a decade of economic growth stagnation has been derailed by the collapse of external demand with serious knock-on effects on domestic activity. Japan's capacity to support the growth of other advanced and emerging economies is now diminished.

So a global recession is now upon us. The three economic giants – the US, Europe and Japan – together accounted for just over 50% of global GDP in 2007. All three cylinders are sputtering. The impact has already been felt worldwide. How long and how deep this recession will be is still an unknown, though many economists are predicting a long L-shaped trajectory. What has become clear is that US households can no longer function as the engine for the entire world economy. Unfortunately, there is no clear alternative growth driver in sight yet.

On the financial front, American and European banks that have been at the core of intermediating global capital flows are severely weakened. Global capital flows, not least flows into emerging markets, are likely to significantly retract in 2009 – as IIF projections show. Foreign direct investment is set to ease substantially. Cross-border banking flows as well.

On the surface, this is not unlike previous financial crises originating in emerging economies. But there is a critical difference. In those cases, external credit typically dries up due to some domestic factor triggering a loss of confidence in the host country. Foreign financial institutions become risk averse, and withdraw. This time, large banks in the developed countries have certainly also become risk averse. But there is also the important factor that their own balance sheets have been severely impaired, and so, risk aversion aside, they have little capacity to lend. In other words, a key factor for capital withdrawal this time is banks in the developed source countries pulling back to hunker down for their survival. Emerging economies, many with sound fundamentals, are suffering the collateral damage. This comes after years of rapid growth fuelled by yield-hungry foreign capital.

For these reasons, the transmission of the shocks in the US and Europe to the rest of the world has been swift and sharp. Indeed there have been many comparisons to the Great Depression. Yet, compared to the 1930s, an importance difference today is that news spread across the globe far more rapidly. Even rural households in China and India can now access this stream of bad news, real-time, through satellite televisions and the internet. The hyper-efficiency of information flows has in itself introduced new uncertainties as sentiment shifts rapidly and abrupt loss of confidence becomes self-reinforcing.

Crisis response: decisive action needed

How do we deal with this crisis? Despite its scale and unprecedented nature, it may be instructive to study the pattern of responses in previous crises. In past crises, the responses typically go through several overlapping phases. Initially, there is a lack of appreciation of the scale and severity of the problem. This then gives way to fear and panic as the problem becomes stark. Next, anger sets in, and a hunt for culprits begins. As the financial and economic stresses take root, pessimism sets in. If remedial actions are seen to be tentative and lacking in conviction, recovery is delayed and interrupted by bouts of renewed panic. It may take some time before the hard realities are accepted, and a level-headed search for viable solutions sets the path for recovery.

Elements of these have been played out in the current crisis. Initially, the "subprime" issue was regarded as a manageable problem, confined to a small segment of the US housing market. Then it triggered seizure in the wider credit markets. After months of turbulence, the hope was that markets would unclog and financial institutions would be quite unscathed by the credit losses and liquidity strains. When it became clear that this script was wrong, the new hope was that the real economy would be largely unaffected, and de-coupling would spare Asia. All these hopes have been dashed. Confidence is at an all-time low, uncertainties at an all-time high.

The key lesson here is that we cannot base our actions on sequential responses that under-estimate the severity of the situation. Policy actions have to be decisive and coordinated. Policymakers, financial institutions, businesses and the general public, especially in those economies most severely affected, will have to make significant adjustments. Those better able and faster to adopt the right mindset to confront the new environment will fare better for it, and reduce the prospect of a long period of malaise.

Even with the right mindset, there is no simple solution to resolve these enormous challenges. But let me suggest three dimensions that need to be tackled: first, take decisive action to arrest the negative spiral; second, in doing these, keep an eye on medium term sustainability; third, consider the global dimension and impact on others. Let me touch on each of these in turn.

Overcoming present difficulties

First, political consensus has to emerge quickly, so that authorities can take decisive action to arrest the negative spiral between the financial system and the real economy. Injections of capital into distressed financial institutions and the removal of toxic assets are crucial. Capital injections thus far have only matched write-downs recorded to date, leaving insufficient buffers for estimated future write-downs. The clean-up must be thorough. Only then can the financial system resume its critical role in credit intermediation. In the US, given the role of the shadow banking system and credit markets which continue to be impaired, alternatives need to be found to replace these. Bank balance sheets need not only to be maintained, but expanded to replace capital withdrawn from credit markets. Viable businesses need to get enough support to ride out extraordinary pressures. We need to rebuild confidence which is a key foundation for sustained recovery.

Second, while it is important for us to focus on the "here and now", we also need to look ahead. While "in the long run, we're all dead", quick fixes can return to haunt us faster than we expect. After the urgent issues are resolved, financial markets will quickly turn their attention to other weaknesses. Many of the measures today can lay the seeds for structural difficulties, if these are not withdrawn as soon as practicable.

For instance, the unprecedented easing of monetary conditions, including quantitative easing, has been necessary to ensure sufficient liquidity in the system as weak bank balance sheets suppress intermediation. But excess liquidity remaining in the system longer than necessary is in turn a recipe for inflation into the medium term. The mechanisms for mopping up the excess liquidity need to be put in place early. Meanwhile, the scale of fiscal stimulus, and funding needed to support this, has raised the spectre of destabilised sovereign bond markets and the crowding out of private borrowings. This does not bode well for private capital formation, and could create stresses downstream for corporations which do not have the advantage of sovereign backing. Further, if deficits are seen to be structural, market reaction could negate much of the effect of fiscal stimulus. There is also the issue of how to restore private-sector driven intermediation of credit in due course. While government support for businesses' access to credit is necessary now, it cannot continue indefinitely.

In other words, even as we take unconventional measures, we need to have an eye on medium-term sustainability, and make clear our "exit" strategy and timing. Just as we must not be behind the curve in taking action to stabilise markets, we need to anticipate what lies ahead and plan accordingly. This is crucial because that later-stage "exit" action represents not just the end of this phase but a crucial transition into another set of conditions with totally different policy demands.

Third, we need to consider the global dimension of our responses, and the impact on other economies. For instance, the bank deposit guarantee scheme that first started in Ireland triggered a domino effect and made its way to this region. To minimise uncertainty, some degree of coordination to remove these guarantee would be necessary. As governments in the developed economies inject huge sums of public funds to shore up banks, the instinct is to place demands on these banks to lend domestically. This may seem sensible individually. But collectively, this 'abandon-thy-neighbour' policy can trigger a big reduction of credit, and undermine economic recovery that eventually hurts the developed economies. Protectionist measures hurt emerging economies most, and they can trigger a backlash that sets the world back. We must resist such regression.

Asia's responses

Let me now turn to the impact of the crisis on Asia, and responses to that.

Asian economies will slow considerably. Those that are more highly dependent on external demand will contract more sharply than the rest. But unlike during the Asian Financial Crisis, the fundamentals in Asian financial systems and economies are generally sound. Banks are well-capitalised and have limited direct exposures to toxic assets. Corporate and household balance sheets are stronger. Current account positions are healthier and external liabilities manageable. The policy responses in several countries have been decisive and robust. Central banks in the region have appropriately eased monetary policy, and governments have put in place a range of fiscal and other measures to support lending and to cushion the impact of the global crisis.

Nevertheless, considerable risks remain for Asian economies. The extent of demand contraction for Asia depends on how long and deep the recession is in the US and Europe. That remains an unknown. Credit flows to corporations have been affected by the heightened risk aversion of domestic banks as well as by some pull-back by global banks. A few economies have experienced considerable capital outflows. The economic contraction will certainly affect the loan books of banks. Should the downturn be deep and prolonged, the resilience of banks with weaker risk management systems will be severely tested. It is necessary to remain vigilant.

However, Asia's economic performance and policy responses so far provide assurance that the medium-term growth story remains compelling. FDI and domestic investments have increased over the years, and intra-region production networks have deepened. Both the hard and soft infrastructures have improved significantly in the last decade. Domestic consumption's contribution to growth has grown steadily, and will play a bigger role in future. The drive towards deeper regional integration remains unabated. Just days ago, ASEAN signed the Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area, and re-affirmed its commitment to implement the ASEAN Economic Community.

One important question for many participants here today is the policy direction of Asian governments towards the financial sector. I believe that authorities in the region will continue with the twin track of developing the banking system and capital markets. The importance of a well-functioning financial system in supporting economic growth and wealth creation is well recognised in this region. The need for funding to promote investment, develop infrastructure and facilitate urbanisation will return. Once growth resumes, the wealth that is generated has to be properly deployed. In this regard, global financial institutions, whose commitment and capacity are being tested by this crisis, need to take a medium-term view of their businesses in this region.

Singapore's response and commitment

Let me now briefly say a few words on Singapore's responses. Like everywhere else, Singapore has experienced tightening credit conditions. We have taken action to address both the inter-bank money markets, as well as the flow of credit from banks to corporations.

In the inter-bank money markets, MAS remains focused on ensuring that both the Singapore Dollar and the US Dollar markets continue to function smoothly. For the Singapore Dollar market, we have and will continue to ensure sufficient liquidity, through our monetary operations and standing facility. For the US Dollar market, we established a US$30 billion swap line with the US Federal Reserve. This line is alongside other swap lines that the Fed has with 13 other central banks, including several in Europe and Asia.

As a major funding centre, we took precautionary measures to ensure that global financial institutions operating here continue to have access to US dollar liquidity. The Federal Reserve on its part recognised the importance of providing US dollar liquidity to financial institutions through central banks in sound, well managed and systemically important financial centres, so as to improve global US dollar liquidity conditions as necessary. We have not had to use the swap line, nor do we see any impending need. But the precautionary measure has served us well. We will continue to be vigilant in anticipating issues, and in taking proactive measures to strengthen the resilience of our system.

With regards to the flow of credit from banks to corporations, we believe this is best facilitated through government schemes to co-share some of the risks with banks. In February, the Government announced the Special Risk-Sharing Initiative (SRI). Under this Initiative, the Government will absorb 75% of the risk for insurance covering working capital and trade-financing loan facilities. The Government will also absorb 80% of the risk for bridging loans which go towards meeting firms' working-capital needs. We also have schemes for SMEs and micro-loans.

Apart from ensuring that the financial system continues to function effectively, the Government has, as in past periods of downturns, used fiscal measures to minimise the impact of the crisis. This involves targeted help for families and companies, while continuing to build capabilities to prepare for the upturn. This time, a creative Jobs Credit Scheme has been added to help companies keep their workers.

Conclusion

Ladies and Gentlemen, these are very challenging times. The global economy is in recession, and the financial system remains fragile. We need tough, decisive and forward-looking actions in the core economies that are deeply affected.

Asian economies have also been severely affected, and policy adjustments are necessary. However, the medium-term prospects for growth remain strong. The secular trend in the growth of Asian enterprises and corporations, growing intra-regional trade, and the demands for infrastructure financing will generate new opportunities for corporate and institutional businesses. Wealth creation and the rise of the Asian middle class, coupled with the low penetration of financial services will drive the growth of personal financial services.

I am confident that when the dust settles, global financial institutions which rebuild their resilience and stay engaged in our region will increase the value of their Asian franchises. Asia will continue to provide strong growth opportunities and geographical diversification benefits. Some Asian financial institutions will also develop strong operations, brand names and a regional footprint. They will play their role in driving Asia's continued growth.

In Singapore, while we are working to cushion the impact of the crisis, we are also building capabilities in the economy and the financial sector for the upturn.

I wish you all a fruitful two days of deliberations and interaction.

Thank you.