Summaries

Introduction: Sources of Strengths, Remaining Vulnerabilities and New Policy Challenges for Asia
Stephany Griffith-Jones and Ricardo Gottschalk
Currently much of Asia is growing at an impressive rate, thus allowing for a very significant reduction in poverty and contribution to meeting the MDGs. One of the potential risks that could undermine continued rapid growth and poverty reduction in Asia is a financial crisis, especially if it spread through contagion from one country to another and/or if it occurred in a major country. This article summarises the strengths and potential financial vulnerabilities in Asia, which are the focus of this *IDS Bulletin*. One potential vulnerability is linked to a source of strength: the region's high levels of international reserves. This has contributed to excessive liquidity, which has been a major factor behind bubbles in the stock markets of several Asian countries. The article also highlights new policy challenges, such as the risk of an abrupt unravelling of global imbalances, which may drastically change the prospect for developing countries and Asia in particular. Another challenge is the explosive growth of derivatives worldwide, and increasingly in Asia; this can pose new risks for the stability of the whole financial system and may have destabilising and pro-cyclical effects on key macroeconomic variables and thereby economic growth.

Emerging Economies in East Asia: Are They Safe From Future Crises?
Yung Chul Park and Charles Wyplosz
This article offers an overview of recent developments among East Asia's emerging market economies (EMs), including China. It shows that most East Asian countries have made considerable progress in making their financial systems more resilient, having prudent macroeconomic policies, and having accumulated large amounts of foreign exchange reserves. But it argues that although risks have been reduced, they have not been totally eliminated. Among the potential sources of vulnerability common to nearly all countries analysed are their high dependence on exports as a driver for growth, which makes them vulnerable to trade shocks; and asset inflation – for example via real estate market bubble – in the latter case already in the making in China and Korea; also, progress has been somewhat uneven across countries, with Indonesia and the Philippines lagging behind other countries in reducing financial vulnerability.

Ten Years After the Asian Financial Crisis: The Fragility and Strength of China's Financial System
Yu Yongding
Over the past ten years since the Asian financial crisis, the Chinese economy has been performing extremely well. While emphasising the extremely positive growth performance China has had so far, this article also identifies key threats to the country's economic stability in the future. Among the sources of vulnerability are: a still somewhat fragile financial system, in particular banks, despite recent reforms in the system and improvements in some of its key indicators; the excessive liquidity in the economy, which is a major factor behind bubbles and inflation, and a new challenge facing Chinese economic authorities. The article also discusses how China may prevent a crisis from happening, highlighting the role capital controls can play in crisis prevention, and draws lessons on this from the Asian crisis.

Thailand: The Financial System Ten Years After the Crisis
Ammar Siamwalla
Thailand faced a major currency crisis starting in early July 1997, with the Baht falling by more than half in eight months. But it was the massive failure of the financial system that had a more profound impact and wrought significant institutional changes to the economic system of the country. This article therefore focuses on the changes that occurred in the Thai financial system since 1997, and evaluates the performance of the economy that emerged. With regard to the ability of the new financial system to support the economy, the article argues that Thai

private banks are now extremely wary about lending to large business, turning to consumer lending and mortgages and thus following the trend of banking worldwide. As banks have withdrawn from supplying capital to large companies, the capital market has expanded and become an important source of funding to such companies.

Indonesia: Ten Years After the Economic Crisis
Sri Adiningsih
This article discusses the country's recovery from the crisis and reforms that were undertaken to support the recovery process. It argues that thanks to sound macroeconomic policies and reforms in the financial sector and the economy more broadly, recovery eventually came to fruition, even though it took longer than in other crisis-affected countries in the region. But the article also argues that it is not always the case that major reforms necessarily guarantee continued macroeconomic stability and sustainable economic growth. It shows that the Indonesian economy remains very vulnerable, and that there is not a better symptom of this than the mini crisis that hit the country in 2005, just a year after recovery from the 1997 crisis had been fully achieved. The article points out that, in addition to the remaining weaknesses Indonesia still faces – fiscal deficit, government debt and relatively low foreign reserves, two drawbacks characterise the economy nowadays: the relatively slow growth performance of the productive sectors and the increased dependence on short-term capital flows.

The Malaysian Economy: Vulnerability to Crises
Azidin Wan Abdul Kadir
The recovery in the Malaysia economy since 1998 has been due mainly to exports, private consumption, and a boost in public investment, even though there is a lower investment level than in the past. The article argues that Malaysia is unlikely to return to the rapid growth of the pre-crisis period due to the changing and more challenging global economic environment. Like many other Asian countries, Malaysia has accumulated high levels of foreign reserves, thereby protecting the country from speculative behaviour by international investors. But an important source of vulnerability remains on the trade side, as Malaysia's exports are still fairly concentrated on electronic goods. In terms of trade partners, Malaysia has grown less sensitive to the US and more to East Asia, especially China. But given its high dependency on trade and the large trade flows between the US and China, significant slowdown in the US economy could hit Malaysia in a major way, despite recent diversification in its main export markets.

The Philippines – Ten Years After the Crisis
Margarita Debuque-Gonzales and Maria Socorro Gochoco-Bautista
Unlike the other crisis-afflicted countries where financial fragility is a main concern, the Philippines' largest worry is instead how to effectively leverage for long-term growth. As this article emphasises, economic growth in the post-crisis period, although respectable, has not been fast or strong enough for the country to catch-up with the rest of East Asia. In regard to sources of vulnerabilities, as in Indonesia, the article highlights the fact that foreign reserves have not been as large as in other countries in the region, and that fiscal deficit and debt levels remain higher than in neighbouring countries as a proportion to national income.

How Have the CLV Economies been Exposed to Financial Vulnerabilities?
Vo Tri Thanh, Serey Chea, Sarat Ouk and Le Xuan Sang
The article on Cambodia, Laos and Vietnam (CLV) sheds light on possible risks associated with developments in key macroeconomic fundamentals, the financial system and foreign exchange policies following the market-oriented reforms undertaken since the late 1980s. It shows that the market reforms have led to major changes in the CLV economies and contributed to fast economic growth and development in the 1990s and early 2000s. However, informed by the events related to the Asian crisis, they argue that the liberalisation process, if implemented improperly, could involve risks. Key issues face the CLV countries: to different degrees they still rely significantly on external resources to finance their investment-saving gaps; external trade has become a major driver of growth, but the downside is vulnerability to international trade shocks and disputes and global recession. Domestically, these countries have been financially supported by weak banking systems that need further strengthening despite recent progress. They also face high levels of dollarisation, especially Cambodia and Laos, which can imply greater vulnerability to shocks.

Policy Suggestions for Greater Financial Stability
Stephany Griffith-Jones and Ricardo Gottschalk
This article offers policy suggestions for greater financial stability. It focuses on initiatives that can be

pursued by national governments to deal with new sources of potential vulnerability that have arisen within the global and national financial sectors, such as derivatives. While these new financial instruments help corporates and other actors to transfer risks to others better able and willing to bear them, they can also pose new risks for financial stability and have destabilising and pro-cyclical effects on key macroeconomic variables, such as capital flows and the exchange rate. To help reduce such vulnerabilities, the article proposes the design and issuance of new instruments, such as GDP-linked bonds, that can better diversify risks that countries face due to their increasing integration in the world economy. It also discusses the adoption of Basel II and its possible unintended effects such as increased pro-cyclicality. It therefore recommends measures to try to compensate increased procyclicality, as well as a gradual approach to its adoption, especially in low-income countries where capacity implementation is a major constraint.