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"The Asian Financial Crisis 10 years on:

What has changed and what have we learnt?"

The Next Ten Years

Is Asia Likely to Fall Into Another Financial Crisis?

(4232 words)

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Abstract

The IMF-World Bank annual meeting was held in Singapore in September 2006. The previous time the annual meeting was held in Asia, the region was in the middle of a massive slump - with Thailand, Indonesia and South Korea among the worst hit. Almost a decade after the Asian financial crisis, the region has moved ahead. Financially, the region is in far sounder shape than ten years ago.

On hindsight, the crisis was a watershed for the region, forcing closer integration through schemes such as the Chiang Mai Initiative and kick-starting important banking and financial reforms. In many crisis-affected countries, complex political changes were also set into motion. While the Asian crisis is now past, Asia is not back to the status quo ante. Much has changed in the global economic and financial architecture since 1997. The growing pace of integration and innovation in global financial markets has brought opportunities to Asia, but the associated risks and volatilities also mean that Asia is not immune from another crisis. Since a productive concern about the future involves an understanding of the past, the present conjuncture is a useful opportunity for Asia to reflect on the causes of the Asian financial crisis, as well as the lessons inherited from that experience.

The painful lessons drawn by Asia are important in reducing the incidence and severity of future financial crises. But in some cases, they have also introduced additional challenges for Asia. Hence, Asia's future lies in the constant evolution of policies to keep pace with the changing financial landscape, maintaining regional economic and political stability, as well as staying plugged into the global economy, despite all the risks it entails.

(278 words)

Miracle, Crisis and Renaissance

"*What's going on in East Asia is something quite new – a renaissance*." [1]

Those were the words of Dr. Homi Kharas, Work Bank Chief Economist for East Asia and the Pacific, who recently published a report with fellow World Bank economist, Dr. Indermit Gill, identifying the forces and challenges at work in East Asia's new economic landscape, which has undergone a period of transformation since the financial crisis of the 1990s.

Indeed, much has changed since the financial crisis struck Asia a decade ago. In the intervening ten years, Asia has recovered from the crisis and re-established itself as one of the most dynamic and important driving forces in the region. Along with China, an emerging powerhouse of growth, economies in East Asia have grown to reach US$4 trillion in current dollars in 2005 and collective foreign exchange reserves in the region have also reached a staggering amount of US$1.6 trillion.[2] Such growth figures are definitely reminiscent of what East Asian economies achieved in the pre-crisis period. From 1965 to the 1990s, per capita income levels increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia.[3] The high and sustained economic growth attained by the high-performing East Asian economies impressed the World Bank so much that the term 'Asian miracle' was coined to describe what was going on in the region. However,

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[1] The World Bank. "An East Asian Renaissance: Ideas for Economic Growth." 18th September 2006. http://web.worldbank.org/wbsite/external/countries/eastasiapacificext/0,,contentmdk:21056110~pagepk:146736~pipk:146830~thesitepk:226301,00.html.

[2] The economies of Japan and India have not been included into the figures. Asia Today. "What Asia has really learned from 1997." 26th Oct 2006.

[3] Per capita income levels in Hong Kong and Singapore even exceeded those in some industrial countries. Stanley Fischer. "The Asian Crisis: A View from the IMF." Midwinter Conference of the Bankers' Association for Foreign Trade. 22nd Jan 1998.

as dramatic as the growth of the East Asia miracle was, so too was the financial crisis which struck the region in 1997. In the span of a few months, many of Asia's 'miracle' economies spiraled down into financial crises or near-crisis situations; and as an indicator of the gravity of the situation, the World Bank dubbed the crisis "the biggest setback for poverty reduction in East Asia for several decades."[4]

As we turn our view back to Asia today, it may seem almost churlish for us to question whether Asia may experience another financial crisis in the next decade. After all, Asia is currently enjoying an era of unprecedented prosperity and even looks set to take on the role of a global economic leader in the near future. However, we must not forget that financial crises have always been a chronic feature of the financial landscape, and the 1997 crisis also struck Asia at a time when it was most unexpected. Furthermore, the accelerating pace of globalization has brought new risks to the international financial landscape, which makes Asia, with its large reliance on global liquidity, all the more vulnerable to the vagaries of the international market. IMF economist Anne Krueger highlighted that "a productive concern for the future involves an understanding of the past."[5] Hence, it is pertinent that we examine the 1997 financial crisis and the lessons inherited from it in close detail. This would give us a better understanding of whether Asia today is well placed to deal with any challenges that abound on the horizon of the global financial economy.

[4] Frank Ching. "The Asian Economic Crisis: Policy Choices, Social Consequences and the Philippine Case - Social Impact of the Regional Financial Crisis." Asia Society. Feb 1999.

[5] Anne O. Krueger. "Lessons from the Asian Crisis." SEACEN Meeting. 12th Feb, 2004.

Causes of the Crisis

The crisis affected mainly the Asia-5 economies[6]. In short, what started out as an exchange rate crisis quickly deteriorated into a banking and financial crisis. The immediate trigger was a sudden and sharp reversal of capital flows.[7] However, numerous structural weaknesses plagued the crisis-affected Asian countries, which made them vulnerable to external shocks.

<u>'Punishment for Asian Sins'</u>

Professor Krugman developed a school of thought which viewed the crisis in relatively moralistic terms. He believed 'crony capitalism' and controversial 'Asian values' (which manifested into a patriarchal political structure) were responsible for some of the structural weaknesses in Asia.[8] The lack of accountability of political actors and a government-business relationship pervaded with corruption resulted in a lack of transparency in financial institutions, inefficient resource allocation and imprudent public spending. These unsustainable trends were brought to a crashing end with the onset of the financial crisis. Krugman's blaming of excessive state intervention may prove useful in understanding the post-crisis political reactions in Thailand and Indonesia.[9] However, a

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[6] The Asia-5 countries include Indonesia, Korea, Malaysia, the Philippines and Thailand. Japan and China did not experience a severe financial downturn because they had accumulated substantial foreign exchange reserves. Hence, they were less vulnerable to a speculative panic than other economies in the region.

[7] Net capital flows to Asian crisis countries swung from an inflow of over 6 percent of GDP in 1995 to an outflow of 2 percent of GDP in 1997. David Burton, Wanda Tseng, and Kenneth Kang. "Asia's Winds of Change." Finance and Development. June 2006, Volume 43, Number 2.

[8] Pablo Bustelo. "The East Asian Financial Crises: An Analytical Survey." University of Madrid, Spain. Oct 1998.

[9] In Thailand, the crisis brought a change of rule from the crony politics of the Banharn and Chavalit administrations to the more reformist Democrat Party, which emphasized a reduced role for the state. In Indonesia, cronyism was brought to an end with the downfall of President Suharto and this turning point marked the start of Indonesia's transition towards democracy.

cooperative and reciprocal long-term relationship between firms, banks and the government is nonetheless essential in coordinating investments and borrowing in an economy, and this may not necessarily imply corruption or favoritism.[10] In fact, in South Korea, despite the close working relationship between the government and the *chaebol,* the crisis was also largely attributable to the lack of state regulation, due to the government's pursuit of an excessively rapid financial deregulation and domestic liberalization policy in the 1990s, which reduced the government's ability to prevent financial market failures.[11]

<u>Vulnerability to Clean Air Turbulences</u>

A World Bank working paper further described the shocks that hit Asia as 'clean air turbulences' – these shocks, such as deteriorating terms of trade and capital outflows were invisible and an unprepared Asia did not have good flight plans for dealing with them.[12] Thailand, Korea and Indonesia were particularly vulnerable to these external shocks due to lax macroeconomic policies that allowed large inflows of unhedged short-term capital to fuel domestic credit booms in the corporate sector[13] and a general lack of prudential supervision and regulation for newly liberalized financial markets.[14] The policy of having a rigidly-managed exchange rate regime in countries such as Korea and

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[10] Robert Wade and Frank Veneroso. "The Asian Crisis: The High Debt Model Versus the Wall Street-Treasury-IMF Complex." New Left Review, Mar-Apr 1998.

[11] H.-J Chang. "Perspective on Korea: A Crisis from Underregulation", Los Angeles Times, 31st Dec 1997.

[12] Will Martin and Warwick J. McKibbin. "The East Asian Crisis: Investigating Causes and Policy Responses." World Bank Policy Research Working Paper No. 2172. Aug 1999.

[13] Sergio L Schmukler, Richard Newfarmer and Kawai Masahiro, "Crisis and Contagion in East Asia: Nine Lessons." World Bank Policy Research Working Paper No. 2610. 1st June 2001.

[14] For example, unhedged and unsupervised offshore borrowing by the private sector in Indonesia more than doubled from US$28.2 billion in 1992 to US$78.1 billion in 1997. This short-term foreign indebtedness increased the vulnerability of the corporate sector to capital outflows and potential declines in the country's exchange rate. Sukarela Batunanggar. "Indonesia's Banking Crisis Resolution. Lessons and the Way Forward." Banking Crisis Resolution Conference, CCBS, Bank of England, London, 9th Dec 2002.

Thailand also made their currencies prone to misalignment and speculative attacks. These structural weaknesses in the corporate and financial sectors contributed to an increasing financial fragility among East Asian countries; and when there was an abrupt reversal of capital flows in 1997, the Asian economies were unable to sustain their short term foreign indebtedness. Financial panic erupted, which exacerbated currency depreciations and declines in stock market indexes, finally plunging Asia into a period of financial turmoil.

Disruptive Forces in the International Financial System

However, there are also arguments that structural weaknesses are not all to blame. One reason is that the magnitude of the crisis far exceeded the possible faults of individual countries. Even Krugman himself conceded that 'the punishment (for Asian sins) was disproportionate to the crimes.' In fact, almost all ASEAN countries were running budgetary surpluses throughout the 1990s.[15] Hence, macroeconomic evidence gave very little evidence of an oncoming crisis.[16] Former World Bank Chief Economist Joseph Stiglitz likened the financial turmoil to the experience of rowing a boat on an open sea. A huge storm can tip the boat over, no matter how seaworthy it was made. In the global financial architecture, there are inherent disruptive forces such as financial bubbles, investor herd instinct (which often encompasses irrational exuberance) and speculative activities, and they can create global tidal waves that can overwhelm reasonably sound financial markets and trigger financial collapse.

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[15] Suthad Setboonsarng. "ASEAN Economic Cooperation: Adjusting to the Crisis" Southeast Asian Affairs. 1998.

[16] However, it is important to realize that weaknesses in macroeconomic fundamentals could have been concealed by overinvestment into the region during the period leading up to the crisis.

For example, at the height of the market mania from 1994-1996, capital flows into Asia led to real asset speculation which created a bubble in the property market. When the bubble collapsed in 1997, fears of worsening credit worthiness in the region induced foreign investors to start withdrawing their funds.[17] The withdrawal of short-term credit placed considerable pressures on the reserves of East Asian economies and Thailand lost virtually all its reserves trying to defend the baht from speculative attacks. As a result, it was forced to float the currency on 2 July 1997 and appeal to the IMF for a bailout from the crisis.

While irrational exuberance might be responsible for creating the asset bubble, disconsolate melancholia among investors was also partly responsible for the contagious character of the financial crisis.[18] Pure contagion can arise when investors, in making their investment decisions, lump countries in emerging markets together and do not discriminate between sub-regions regardless of their economic soundness. For example, during a crisis, decline in market sentiments may lead investors to reassess the fundamentals of other countries in their risk profiles, even if they have not changed. Singapore and to an extent, South Korea, are examples of countries which have suffered from the contagion effect brought about by a fall in investor confidence in the economies of Thailand and the Philippines during the 1997 crisis.[19]

The IMF has also not escaped blame for the crisis. For example, the contractionary policies pursued by the IMF in the crisis-affected countries have been

[17] This herd reaction was exacerbated by expectations of a Japanese recovery in May 1997, which led to a rise in Japanese short-term interest rates and induced investors to transfer their funds from emerging Asian economies into Japan to take advantage of the higher interest rates. Ibid.

[18] The crisis started from Thailand and spread to the Philippines, Indonesia, Malaysia, Taiwan and finally South Korea

[19] "The East Asian Financial Crises: An Analytical Survey."

described as ‘beggar-thyself’[20] policies which exported the economic downturn and exacerbated the contagion effects around the region. However, no matter how misguided the IMF prescriptions might be, it is undeniable that IMF endorsement of the economic programmes of the distressed Asian countries was essential in restoring investor confidence to the region.

A Sober Response to the Crisis

In short, at the root of the financial crisis was a complex web of structural weaknesses in Asia’s financial sectors and a heavily indebted corporate sector, which made the region vulnerable to external shocks. Whether region-specific weaknesses or flaws in the global financial architecture play the role of the main culprit is not of prior importance. What is important is that a good and sober response to the crisis must require individual countries to consider all plausible explanations for the crisis and not prematurely discount any factor. As ex-deputy Secretary-General of ASEAN, Dr. Suthad Setboonsarng once remarked, “Each of these explanations is likely to contain kernels of truth that would help the region ultimately break free of the consequences of the turmoil.”[21]

National Reforms

At the national level, reforms were carried out to address the weaknesses in the financial and corporate sectors, which were presumed to lie at the heart of the crisis. A

[20] Under a ‘beggar-thyself’ policy, countries were told to build up a trade surplus. This resulted in each country cutting back on imports, which led to other trading partners’ export level falling. Hence, there was a reduction of sales and an inducement of recessions abroad. Joseph E. Stiglitz. “Globalization and its Discontents.” W.W.Norton & Company. New York, London. 2002.p.107.

[21] Ibid.

key step taken in Korea, Thailand and Indonesia was the closure of insolvent financial institutions to minimize depositor panic. For example, Indonesia was forced to shut down sixteen banks while Thailand eventually closed fifty-four.[22] Following this was an injection of public capital to recapitalize the financial institutions. Desperately-needed reforms to improve corporate governance and enhance financial supervision and regulation[23] were also taken to strengthen the base of the financial sectors.

There was also a shift away from exchange rate targeting towards inflation targeting in four of the crisis-hit countries. For example, South Korea, Indonesia, Thailand and the Philippines all moved to institute monetary policy arrangements anchored on an inflation objective. Deviating from monetary policy anchored on exchange rates allows greater domestic flexibility in responding to external shocks, hence mitigating the possibility of future currency mismatches in the crisis-hit Asian countries.

Since 1999, the Asian economies have been recovering well from the crisis. For example, all of Indonesia's macroeconomic indicators improved from mid-2001 to early 2004 and the rupiah was even regarded as the best performing East Asian currency in 2002, appreciating by about 17 percent.[24] Progress in banking reforms has brought down regional levels of non performing loans[25], and corporate restructuring has also strengthened business groupings. The financial sector reforms implemented in Korea also

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[22] "ASEAN Economic Cooperation: Adjusting to the Crisis."

[23] Examples of policies implemented are tighter loan provisioning rules and higher minimum capital requirements.

[24] Tubagus Feridhanusetyawan and Mari Pangestu. "Indonesia in Crisis: A Macroeconomic Perspective." CSIS Working Paper Series. WPE 074. Feb 2004.

[25] Non-performing loans among ASEAN 5 (Indonesia, Malaysia, the Philippines, Singapore. and Thailand) banks have fallen from double-digit highs in 2000 to single-digits in 2005. Heng Swee Keat. "Unity And Integration In ASEAN: The Role of The Financial Sector." 16th ASEAN Banking Conference. 16th Nov 2006.

saw a rebound in growth in 2002, although annual growth rates in the past few years have still been regarded as below the nation's potential.[26]

Regional Integration

Contrary to popular prognosis, the crisis did not lead Asian countries to retreat into their nationalistic shells and build protectionistic walls around themselves. In fact, ASEAN's strongest response to the crisis was to reaffirm its abiding commitment to regional economic integration. In the ASEAN Vision 2020 issued in December 1997, ASEAN leaders resolved to advance economic integration and called for the acceleration of AFTA's[27] implementation. Another collective response to the crisis was the agreement to set up a mutual surveillance system to monitor economic and financial trends in the region. The ASEAN Surveillance Process would allow ASEAN leaders to keep track of Asia's recovery process and jointly consider policy measures to counter potential threats to any member economy.

However, financial cooperation in Asia was not restricted within ASEAN. In recognition of the financial interdependence within Asia and the inadequacy of contingency plans in the region in times of economic crises[28], the pre-existing ASEAN Currency Swap Arrangement was expanded to cover China, Japan and South Korea through a regional financial arrangement known as the 'Chiang Mai Initiative'. This pact was symbolic as some Asian countries regard the arrangement as a necessary first stage

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[26] Kim Kihwan. "The 1997-98 Korean Financial Crisis: Causes, Policy Response, and Lessons Presentation" High-Level Seminar on Crisis Prevention in Emerging Markets. 10-11th Jul 2006.

[27] ASEAN Free Trade Area.

[28] The IMF quotas for determining the maximum allocation of loans to Asian members have historically been low relative to the size of their economies, thus making the magnitude of possible IMF loans insufficiently large to provide necessary liquidity in times of crises. Saori N. Katada. Constructing Regional Interests in Japan and China. The Japanese Economy, vol. 31, nos. 3–4, Fall 2003/Winter 2003–4, pp. 126–150.

towards the creation of an Asian Monetary Fund to pool and allocate official reserves within the region. Much progress has been made in this arrangement, as the size of the currency swap agreements has doubled from US$39.5 billion in 2005 to S$71.5 billion in 2006.[29] To reduce their over-reliance on short term loans, Asian economies have also set out to expand their regional bond and securities markets as alternative sources of funding. For example, equity markets in East Asia have tripled in size to US$2.8 trillion from 1997 to 2005 while bond markets have grown to reach US$1.5 trillion in 2005.[30]

Global Stand

Regional collaboration programmes are expected to complement efforts at the national level in reforming corporate and financial sectors to promote macroeconomic and financial stability in the region. However, the crisis has also opened new fissures among members of the international community[31] and in light of the inherent flaws in the international financial architecture, ASEAN countries have responded by calling for information sharing among international regulators and a global agreement on the disclosure requirements of short-term capital flows in order to monitor them more effectively.[32] In the ASEAN Vision 2020, ASEAN leaders also expressed beliefs in "an

[29] The Chiang Mai Initiative allowed ASEAN+3 members (ASEAN, Japan, China and South Korea) whose currencies were under speculative attacks to borrow from one another through short-term swaps of foreign currency reserves to stabilize their currency. Abdullah Badawi. "Challenges on the Way to an East Asian Community." The Future of Asia 2006. 25th May 2006.

[30] Audrey Tan & Grace Ng. "Good job, East Asia, but more needed; To improve resilience, countries should further develop bond markets and regional financing." The Straits Times (Singapore).15th Sept 2006.

[31] For example, disappointment with the international community's failure to anticipate the Asian crisis has led to demands from some countries for the abolition of the IMF.

[32] With regards to the controversial role of the IMF, ASEAN has also collectively urged the review of the roles of international regulatory bodies, in order to enhance their capacity and capability to contain and resolve crises. ASEAN Secretariat 2000. "ASEAN Response to the Financial Crisis." http://www.aseansec.org/7660.htm

outward-looking ASEAN playing a pivotal role in the international fora." They advocated their position that the reform of the international financial architecture must involve the participation of all countries, including the emerging economies. These statements made by ASEAN were not just mere contributions to the global effort to resolve the financial turmoil. Instead, they reflected an increasing desire on the part of the recovering Asian countries to play a greater role in the international financial community. SM Goh Chok Tong encapsulated this point well when he said, "In the aftermath of the 1997 Asian financial crisis, Asian countries will want to have a bigger say on how their economies should be run should a similar crisis recur."[33]

The threat of another crisis came during the NASDAQ crash in 2001, which again highlighted Asia's vulnerability to global trends. The US slowdown, coupled with a fitful recovery in Japan, translated almost instantaneously into a regional export slowdown and threatened to retard Asia's recovery process. However, although growth rates for Asia decreased to 5.3%, it remained one of the world's fastest growing regions.[34] Also, a calamity like the 1997 meltdown did not occur. In the words of Asian Development Bank's Chief Economist Arvind Panagariya, "Compared with 1997, East Asia's 'crisis' economies have stronger external situations, better capital flow structures, more flexible exchange rates, greater transparency, and improved financial systems, so they are in a better position to avoid any renewed loss of confidence."

[33] Erica Tay. 'Asia deserves a bigger role in IMF, says SM Goh'. The Straits Times (Singapore) 13th Sept 2006.

[34] ADB. "Asian Growth to Slow to 5.3% in 2001, but Region Remains Among World's Fastest Growing." ADB News Release 029/01. 19th Apr 2001.

Economic Crises and Political Change

Our discussion of the Asian financial crisis is inextricably tied up to politics in the region because it can be cogently argued that 'bad politics' by a political party can decide how vulnerable a country is to a potential loss of confidence among international investors.[35] Furthermore, political parties are often necessary conduits if economic and political reforms are to be implemented in the aftermath of a crisis.[36] Renowned political scientist Stephan Haggard claimed that the link between economic crises and political change begins with the evident fact that severe economic distress is likely to decrease political support for incumbents.[37] This was true for many Asian countries in the wake of the crisis. In South Korea, the crisis brought Kim Dae Jung, a strongly reformist President to office and he pushed through wide-ranging institutional reforms aimed at surmounting the power of the entrenched corporate tycoons whose economic power gave them great political leverage.[38] At the end of his presidential term in 2003, he had significantly altered the political and economic landscape of South Korea by consolidating a democratic government and by ensuring 'fairer market play' uninhibited by the dominance of large corporations.

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[35] On the other hand, in Singapore, a disciplined and well-organized ruling party has led to a competent regulatory structure which supports a sound and transparent financial system, hence alleviating the damaging effects of contagion on the Singapore economy. Natasha and Hamilton Hart. "States and Capital Mobility: Indonesia, Malaysia and Singapore in the Asian Region." Cornell University, New York. 1999.

[36] Gregory W.Noble and John Ravenhill. "The Asian Financial Crisis and the Architecture of Global Finance". Cambridge University Press. 2000.".p.12.

[37] Stephan Haggard. "The Political Economy of the Asian Financial Crisis." Washington, D.C.: Institute for International Economics, 2000.p.87.

[38] For example, Kim Dae Jung created a new supervisory agency, the Financial Supervisory Commission, which was an independent regulatory agency that had substantial powers over the *chaebol* (conglomerate) owners with respects to the management of the financial crisis.

In Thailand, the crisis also brought a reformist party to office. The Democrat Party under Chuan Leekpai emphasized market reforms, liberalization and a reduced role for the state. However, the party's neo-liberal policies brought little economic relief (especially at the grassroots) and this led to a political backlash in 2001, which saw Thaksin Shinawatra leading a coalition of domestic capitalists to a seizure of power under the Thai Rak Thai Party. Thaksin's electoral victory showed that pure efficient market operation was not enough to deal with the aftermath of an economic crisis. Instead, strong national governments and domestic economic actors still play significant political roles in controlling economic policy-making and guiding the economy on the road to recovery in the wake of a crisis.

Unlike Malaysia which had a well-organized party machine that remained robust in the face of the financial crisis, Suharto's Golkar was a much weaker political institution which proved extremely fragile during the crisis.[39] When Suharto announced the elimination of fuel subsidies in response to IMF demands in May 1998, student riots erupted in Jakarta which eventually resulted in Suharto's downfall. After his successor Jusuf Habibie took over, Indonesia began to make the transition from an authoritarian regime towards a democratic state.[40]. However, Indonesia's transition to democracy, catalyzed by the crisis, has been fraught with difficulties. In the past decade, the country's fragile democracy had been threatened by political turmoil and internal

[39] Weak governments tend to fall during times of economic difficulty whereas strong political parties tend to be more resilient. As illustrated by the North Korean example,, a very strong political party can survive the worst economic crises, even if at extraordinary costs. Marcus Noland. "Avoiding the Apocalypse: The Future of the Two Koreas." Institute for International Economics. 2000.

[40] For example, Habibie passed a Political Parties Law to alleviate restrictions on the number of political parties and a Regional Autonomy Law as a first step towards decentralization of the country. Nadirsyah Hosen. "Indonesian Political Laws in Habibie Era: Between Political Struggle and Law Reform." Nordic Journal of International Law. Volume 72, (4) Nov 2003.

violence, which had also retarded the economy's recovery from the crisis. However, Indonesia has consolidated meaningful democratic gains since 1998. Current President, Susilo Bambang Yudhoyono, was elected to power by the people in the country's first-ever presidential election. Indonesia has also taken up a new democratic leadership role within ASEAN, as exemplified in President Yudhoyono's envoy visit to Myanmar last year[41]

Will Asia Face Another Financial Crisis in the Next Decade?

The Asian financial crisis set into motion complex economic and political changes in many of the crisis-affected countries. In the long run, the crisis may turn out to be a blessing in disguise for Asian countries by providing them with the opportunity to learn to adapt to the new rules governing the dynamic global financial economy, which will stand the countries in good stead in the future. Despite the success of reforms, Asia, with its financial openness, is not immune to the possibility of another crisis striking in the next decade, especially if external shocks strike the region. Hence, it is important for Asia to draw useful lessons from the past in order to reduce the incidence and severity of such crises. As famous Spanish historian, George Santayana, once warned: "Those who cannot remember the past are condemned to repeat it."

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[41] In his visit to Myanmar, President Yudhoyono raised the issue of democratization to leaders of the military junta. The Jakarta Post. "Yudhoyono arrives in Myanmar amid pressure for reforms." 1st Mar 2006.

Good and Bad Lessons

Increasingly, it has been realized that there is no good way to deal with the consequences of a financial crisis – only more or less bad ways.[42] Hence, while Asia may not be invulnerable to crises, every country should still strive to strengthen their own resistance to financial shocks. An important lesson learnt from the previous crisis was that a country's domestic economic policies remain the primary line of defence against external shocks. As financial liberalization takes place, a sound macroeconomic framework with appropriate fiscal and monetary policies serves as the core in crisis prevention. Asia has learnt this lesson well and macroeconomic conditions have improved greatly in Asia since the crisis. Most Asian countries maintain current-account surpluses and have also more than doubled their stockpiles of foreign exchange reserves since 1997 to serve as safeguards against external shocks to their currencies.

Besides macroeconomic stability, sound financial institutions and prudential banking regulation and supervision can also reduce the likelihood of a currency crisis deteriorating into a banking crisis. In the past decade, the strength of Asian banks has improved. Non-performing loans have fallen to a moderate level and debt-equity ratios in East Asia, which reached ninety percent in the years before the financial crisis, also fell to around fifty percent in 2005.[43] In Singapore, the liberalization of the financial sector has also been accompanied by the strengthening of financial institutions through a process of merger among the local banks. The increased resilience in the financial sector

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[42] Jack Boorman , Timothy Lane, Marianne Schulze- Ghattas, Ales Bulir, Atish R.Ghosh, A.Javier Hamann, Alexandros Mourmouras and Steven Phillips. "Managing Financial Crises The Experience in East Asia." IMF Working Paper No. 00/107. Jun 2000.

[43] "What Asia has really learned from 1997."

has made Asia less susceptible to changing external conditions, and allowed Asia to 'ride out nicely' when volatilities hit the global and Asian sharemarkets in June 2006.[44]

Turning our view to China, although the Chinese economy had avoided falling into an economic crisis in 1997, the plight of its Asian neighbors had driven home the pressing need for financial reforms in China, since many of the problems at the root of the crisis in Thailand and Indonesia (e.g. political lending and accumulation of bad loans) were present in China as well.[45] Financial stability in China is important as given China's economic clout, any financial shock in China is likely to threaten the economic and financial security of other Asian countries in the region.

There is also a need to pay heed to the wrong lessons that may be drawn as the countries recover from the crisis. For example, Korea has rightly strengthened prudential supervision since the crisis; but in a country that has had a long tradition of running the economy on government initiative, further strengthening of prudential supervision can bring about more regulations that can stifle the development of a dynamic financial system.[46] Hence, while there is a need to regulate and supervise financial systems to restore investor confidence, bureaucratic red tape must also be minimized to boost a healthy investment climate. More importantly, while Asian countries have dealt well with structural weaknesses which plagued them before the financial crisis, this should not signify the end of the process of reforms as economic conditions are always changing in the world. As IMF Chief

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[44] "Asia's Winds of Change."

[45] Wang Hongying. "The Asian Financial Crisis as Impetus for Financial Reforms in China. EAI Working Paper No.27." 18 June 1999.

[46] "The 1997-98 Korean Financial Crisis: Causes, Policy Response, and Lessons Presentation"

Economist Raghuram Rajan pointed out, "There is never an end to reforms…[Asia] can do more and probably should do more."[47]

Implications and Challenges for the Future

It is important to stress again that the painful lessons Asia inherited from the previous crisis are important in reducing the incidence of financial crises and ameliorating future crises. However, they do not eliminate crises totally, and in some cases, they may even introduce additional challenges for Asia. For example, the crisis made Southeast Asia aware of the need to reach out to its northern neighbors (through the ASEAN+3 framework) and while Japan's recovery after a decade of stagnation bodes well for Asia, the biggest new variable in the equation today is China. As China continues to open up its capital account, there is an urgent need for China to improve the quality of its institutional infrastructure.[48] Morgan Stanley economist Robert Feldman foresees a problem in 2009 when the investments leading up to the 2008 Beijing Olympics come to a sudden stop.[49] This sudden drop in demand can lead to a dislocation of economic activities. With poor corporate governance and a lack of proper legal and regulatory financial institutions, China could spiral into a period of economic turmoil. This would imply contagion effects for other Asian countries, with their close trade and financial links with China. However, Asian countries can help by sharing their post-crisis reforming and restructuring experiences with China. For example, to boost the health of

[47] "What Asia has really learned from 1997."

[48] An important priority is the resolution of the huge non-performing loans in China, which can be tackled by e.g. injections to state-owned banks. Masaru Yoshitomi. "Applying Key Lessons from the Asian Crisis to China in an Era of Asian Integration and Global Imbalances." UNU-WIDER Jubilee Conference WIDER Thinking Ahead: The Future of Development Economics. 17-18th Jun 2005.

[49] "What Asia has really learned from 1997."

China's financial institutions, Thailand recently signed a MOU with China to join hands in cross-border banking supervision and regulation matters.[50]

Secondly, the rising global imbalance comprising of a large U.S. current account deficit and a counterpart surplus in Asia also poses additional risks for Asia. In emerging Asia, the surplus largely reflects low inflation-adjusted interest rates in developed countries as well as an accumulation of foreign reserves by Asian leaders in a bid to reduce their vulnerability to future crises. Instead of going into productive investments, the flood of excess liquidity within Asia may be stoking inflation and creating asset bubbles; and as can be seen from the 1997 experience, a sudden loss of investor confidence can lead to an outflow of hot money which will destabilize Asia's financial markets. Thailand's recent adoption of unconventional capital controls to slow the inflow of short-term funds is a prescient indicator of the mounting risks facing the entire region. To put growth in the region on a more sustainable footing, Asia is currently implementing structural reforms to boost its domestic demand and to allow for more flexible exchange rates.[51] Furthermore, the high savings rate in Asia has also been blamed for militating against the further development of bond markets in Asia.[52] In absolute value, the combined size of bond markets in Asia ex-Japan is only ten percent of the US bond market.[53] The banking sector, which holds US$5.5 trillion in assets, still

[50] Comtex News Network. "China, Thailand to Join Hands in Banking Regulation." SinoCast. 11th Oct 2006.

[51] Elsewhere in the region, countries are also trying to address the problem of excess money flowing into their economies. For example, South Korea eased rules to allow individuals and companies to invest more outside the country in order to curb the won's rise while Chinese Premier Wen Jiabao called on Asian countries to intensify their monitoring of hot money. William Pesek. 'A Wake-up Call from Bangkok'. Bloomberg News. 17th Jan 2007.

[52] Andy Mukherjee. "Savings Glut keeps Asia's bond markets tiny." Bloomberg News. 10th May 2006.

[53] "Asia's Financial Markets - The Challenges Ahead."

dominates the financial sector. Hence, Asia does not have much of a 'spare tyre' to cushion its economies in the event of a crisis unless it diversifies its sources of finance by further developing its regional bond and equity markets.

Finally, it is important to note that despite the success of reforms in reducing the risk of recurrence of a financial crisis, many of the technical improvements in Asian countries are not matched by fundamental structural revisions. Entrenched ideologies and interests in the IMF, the UK and the US may continue to play down the need to redesign the global financial architecture as some Anglo-American financial players still interpret the Asian crisis as proof of Asian governments' corruption and incompetence.[54] For example, Asian countries have repeatedly called for an increase in voting rights in the IMF commensurate with their rising economic strength; but changes agreed on have been modest at most. Proposals to create an Asian Monetary Fund were also effectively killed in the face of strong opposition from the US and the IMF. However, more worrying is that the unifying impulse of the Asian financial crisis may be losing momentum with the euphoria of economic prosperity overshadowing the threat of economic downfall, and along with it, the incentives for economic cooperation. Hence, it is important for Asian countries to unite at this critical juncture and build up a common endeavor to develop a regional cooperative enterprise that can complement the existing international financial community and better protect Asia's interests in the global environment.

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[54] "The Asian Financial Crisis and the Architecture of Global Finance".p.35.

Conclusion

In summing up, the risks and volatilities associated with Asia's integration into the global financial system mean that the threat of financial crises is ever-present. However, there is no turning back now. As economist Frederic Mishkin revealed, "The issue is not whether financial globalization is inherently good or bad, but whether it can be done right."[55] Within Asia, financial fundamentals have improved over the past decade, and Asian economies, having inherited lessons from the past financial crisis, are certainly able to weather a crisis better than in the past. The strengthened institutional framework in Asia has also placed the region in a good position to harness opportunities in the global economy[56] to propel its next lap of growth. However, besides Avian flu, terrorism, and the other challenges identified above, as well as the looming threat of a housing-led slump in the US economy, domestic political instability can also threaten to derail Asia's promising future. For example, the recent Thai coup and the series of policy flip-flops under the new military government have raised questions about the new government's economic stewardship.[57] Sudden resignations of key technocrats have also severely reduced the government's credibility. Hence, the Thai example serves as a good reminder of how the region's fragile political maturity can affect its convalescing investment climate. Furthermore, with the increasing pace of innovation, new financial instruments such as derivatives have also increasingly come into use. Thus, there is a

[55] Frederic S. Mishkin "Financial Stability and Globalization: Getting It Right." Bank of Spain Conference, Central Banks in the 21st Century, 8-9th June 2006.

[56] For example, the rapid growth of Islamic finance in the Middle Eastern region allows Asia to tap into a previously unexplored customer segment.

[57] For example, following controversial capital controls imposed by the Thailand government in Dec 2006 and its partial reversal within 24 hours; in the following month, the government again proposed restrictive rules on foreign ownership of Thai companies, only to make selective and unclear exemptions the following day. Such policy ineptitude is extremely damaging for the country's investment climate.

need for Asia's regulatory knowledge and policies to evolve to keep pace with the developments of these innovative products in order to reduce the risk of potential shocks to their economies. Hence, Asia's future lies in constant reforming to strengthen its financial base, maintaining regional economic and political stability, as well as staying plugged into the global economy, despite all the risks it entails.

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