Economic Research Institute for ASEAN and East Asia

Policy Brief

Global Financial Crisis and Policy Responses in Southeast Asia : Towards Prudent Macroeconomic Policies

By Friska Parulian

The global financial crisis hit the Southeast Asian economies through financial and real sectors by the combination of lower global demand and tighter credit demand effect. The challenge for policymakers in this region is not just to prevent the escalation of the crisis and to mitigate the downturn, but also to ensure a good starting position once the rebound sets in. Policymakers should avoid taking on an excessive level of debt or creating the conditions for an inflationary bubble by the current reaction to the global slowdown. A prudent counter-cyclical policy is necessary, and we should not ignore the medium and long-term sustainability.

1. Global Financial Crisis: Implication for Southeast Asia

Economies around the world have been severely affected by the current financial turmoil, as a vicious circle between the real and financial sectors has been intensified. The global economic prospects have been marked down further; it is now projected to decline to 1.3% in year 2009 even with the assumption of vigorous macroeconomic policy supports (IMF, 2009).

The impact has come to Southeast Asia through both the financial sector and the real sector, with the key channel for transmissions as follows: 1) pressure on domestic investment through massive reversal of private capital flow and shrinking of official aid, 2) liquidity constraint and greater volatility in the capital and foreign exchange markets, 3) declining trade volume through lower export demand, and 4) pressure on private consumption through reduction in remittances, decline in commodities prices, and worsening job market condition.

For the group as a whole, growth is expected to decline for more than 6% in 2007 to less than 1% in 2009; while measuring in terms of growth of GDP per capita it is expected to decline from 4.6% in 2007 to -0.8% in 2009. Figures 1 and 2 present the development of countries' growth and current account balance in the region. Countries that relied most on manufacturing exports to industrial countries, including Singapore, the Philippines, and Cambodia,

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were affected by the slowdown (ESCAP 2009).[1] Singapore is the hardest hit because of its role as a trade hub that supports trade-related services from transportation to trade finance; its export fell year-on-year by 40% in January 2009 and experienced the deepest cut of growth rate in the region.

On the other hand, domestic demand in these countries is not sufficient to compensate the falls in exports in 2008; since in open economies, domestic demand - especially private consumption and investment - is highly dependent on export demand and export commodities' prices. Private investment started to contract at the end of 2008. The global liquidity crunch made access to project financing more difficult, especially for those funded by foreign direct investment. These two components may worsen the current account balance especially for countries experiencing deficit.

The crisis also contributes to a decline in foreign portfolio investment inflows and stock prices as well as adding volatility in the currency exchange rate. In Vietnam the VN index fell about two thirds in 2008, while in Indonesia the JSX index in the closing transaction of year 2008 was recorded at less than half of 2007's index value. Some currencies of economies in this region also depreciated starting in the second half of 2008, which put more pressure on countries with large external liabilities.

The risk for the region remains tilted to the downside. The key concern is that a deeper or longer recession in advanced economies outside Asia will dampen external demand leading to a negative impact for exports, investment, and growth. In addition, further deterioration in global financial conditions may additionally tighten financing constraints, hurting financial and corporate sectors in the region.

2. Monetary Policy Response

Facing with a rapidly deteriorating condition from the end of 2008, most economies have aggresively loosened the monetary conditions. Figure 3 shows the monetary policy easing conducted in the region since January 2008. Central banks in Indonesia, Malaysia, the Philippines, Thailand, and Vietnam have cut policy rates and/or reduced the reserve requirements. In addition, liquidity injection into strained money markets, drawn on reserves, and boost on available liquidity buffers have also been implemented in some economies. Singapore monetary authority loosened its monetary policy and allowed a modest and gradual appreciation of Singapore dollar against a trade-weighted basket of foreign currencies to a target of zero appreciation; while Vietnam central bank (SBV) devalued the dong and widened the dong-US$ trading band from 0.75% to 3%. Table 1 presents monetary policy responses in Southeast Asia at the time of writing.

For countries that operate an independent monetary policy, a monetary expansion would be a sensible step to boost the domestic demand, where conditions allow it. As a widely known rule of thumb, there is probably room when reserves are above a target of 3 to 4 months of imports or equal to the amount of short term debt. While taking price stability into consideration, the monetary stance should be relaxed if inflation is under control. Due to heightened inflationary pressure in the first half of 2008, monetary policy options for many Southeast Asian economies were limited. However, the reversal of commodities price trend in the second half of 2008 has dropped the inflation rate; giving room for easing the monetary policy to support

Figure 1. GDP Growth (%)

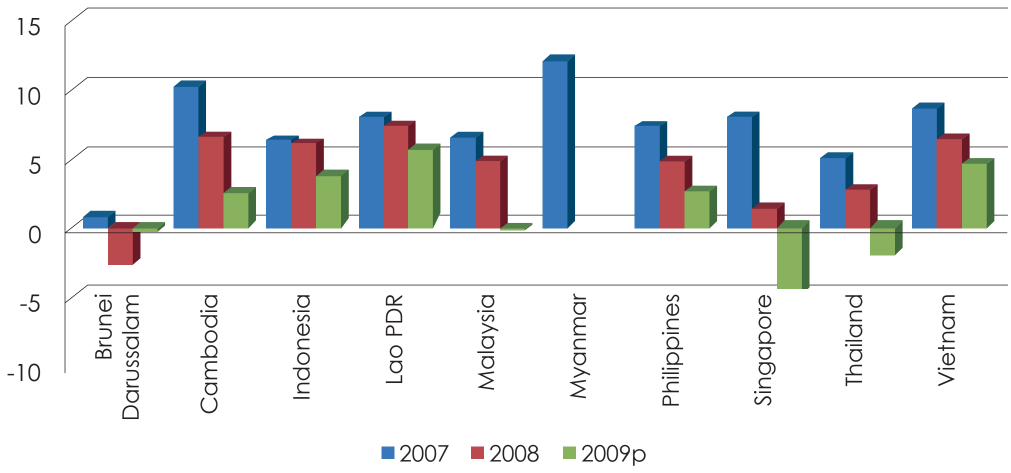
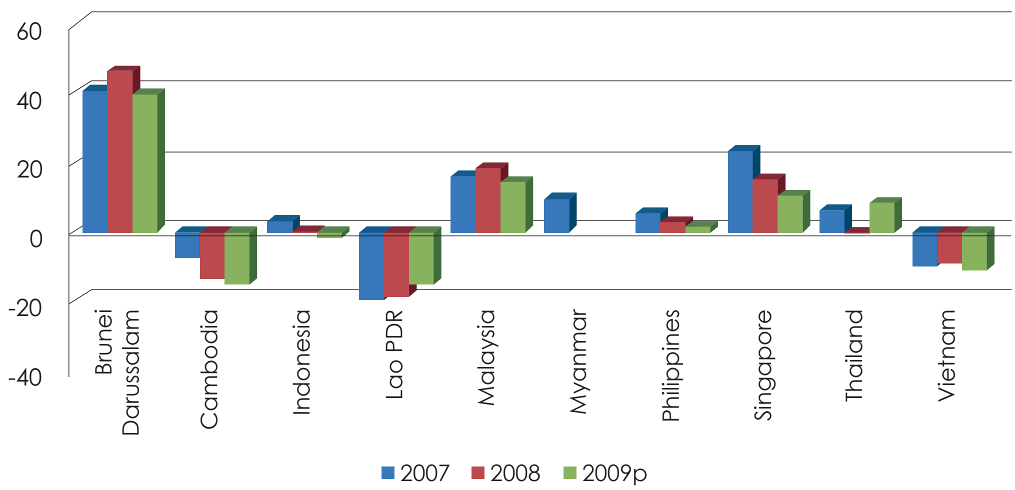
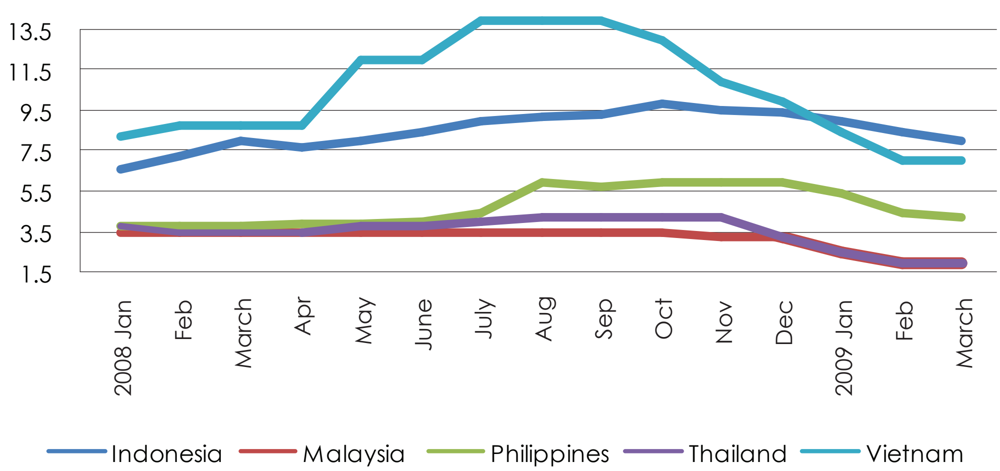


Figure 2. Current Account Balance (% of GDP)



Source for Figures 1 and 2: ADB (2009a).

Figure 3. Monetary Policy Easing (Policy Rate in %)



Source: Website of respective central bank.

growth. These trends are expected to continue in 2009, with the average projected inflation rate in the region being 3.3%.

Consistent with the deterioration of current account balance and monetary easing, nominal exchange rates depreciated across Southeast Asia. Figure 4 shows that currencies in this region started depreciating in the second half of 2008. To some degree, maintaining an adequate international reserve has provided ammunition to counter exchange rate volatility and to sustain foreign currency availability. However, authorities in this region may need to ensure the room for further monetary easing and determine possible risk in the future. Post-recovery inflation risk, availability of credit channel/intermediation, and exposure to exchange rate volatility should be put into the policy's analysis to ensure the maximal value of the money.

Table 2 presents several monetary indicators to observe the room for monetary easing. As pointed out in the table, countries like Cambodia, Laos, and Vietnam have smaller room compared to other economies, due to its low official foreign reserves, large current account deficit, and inflation risk in the near future.

Monetary easing and policy coordination in the region are important. However, some countries should put more attention before implementing further monetary expansion. Countries with high exposure to high inflation and facing particularly difficult external conditions - like large current account deficits, large rollover requirements, a reliance on fragile interbank flows, and dwindling reserves - may have to tighten monetary policy to preserve external stability, despite adverse consequences for domestic activity.

3. Fiscal Policy Response: Is There Enough Space to Conduct Fiscal Stimulus?

The extent of the downturn and the limits to monetary policy's effectiveness has increased calls for fiscal stimulus. Governments are faced with a difficult balancing act; delivering short-term expansionary policies but also providing reassurance for medium term prospects. The key policy issues then are whether there are room and capacity for effective counter-cyclical policies and whether responding to the global crisis is a policy priority for a specific country.

Two options of fiscal response could be considered to manage the current fiscal shock. The first is delivering fiscal stimulus consisting expenditure-related measures and/or revenue-related measures. Second, it may be possible to cope with the fiscal shock by making better use of existing resources, e.g, by trimming low priority expenditure, suggesting an immediate need to review the composition of public expenditure and to reprioritize less productive or wasteful expenditures. This is largely attributable to the fact that during recession constraints on the financing of government budget and debt are usually tighter in emerging economies.

A short-lived fiscal stimulus may be suitable for Southeast Asian economies, as long as the primary role is to lift internal demand and to protect the vulnerable that are worse off even with the effort to lift aggregate demand. However, whether a fiscal stimulus will offer value-for-money can only be assessed on a case-by-case basis, depending on the individual country's circumstances.

Fiscal stimulus has been implemented starting in year 2008 which varies both in

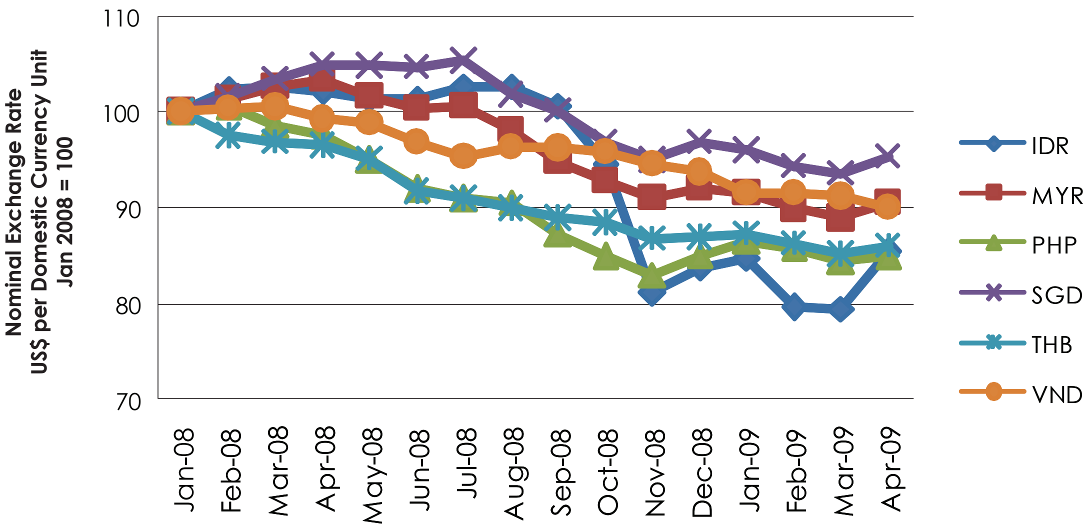
Table 1. Monetary Policy Responses in Southeast Asia

Components / Country	Cambodia	Indonesia	Lao PDR	Malaysia	Philippines	Singapore	Thailand	Vietnam
Policy rate	X	O	X	O	O	X	O	O
Reserve ratio	O	O	X	O	O	X	X	O
Liquidity injection	X	O	X	X	X	O	X	X
Exchange rate arrangement	O	O	X	X	O	O	X	O

O = with policy response, X = no policy response

Source: ADB (2009b).

Figure 4. Exchange Rate Movement



Source : Website of respective central bank.

Table 2. Several Monetary Indicators

	Official Foreign Reserves (Months of Imports)		Current Account Balance (% of GDP)		Inflation (Annual Average %)		
	End 2007	End 2008	2007	2008	2007	2008	2009*
Brunei Darussalam	2.1	2.3	40.5	46.1	0.3	2.7	1.5
Cambodia	5.0	3.5	-7.8	-14.0	5.9	19.7	7.0
Indonesia	8.0	5.3	2.4	0.1	6.4	10.3	6.3
Lao PDR	6.0	3.7	-19.7	-18.9	4.5	7.6	5.0
Malaysia	9.0	8.3	15.6	17.9	2.0	5.4	1.5
Philippines	7.0	5.7	4.9	2.5	2.8	9.3	4.5
Singapore	8.0	5.1	23.5	14.8	2.1	6.5	0.5
Thailand	8.0	6.7	5.7	-0.1	2.3	5.5	0.5
Vietnam	5.0	4.1	-9.9	-9.3	8.3	23.0	4.0

Source: ADB (2009a) and IMF, "International Financial Statistics" (IMF Website).

the type of instruments used and the size. Table 3 summarizes fiscal policy responses conducted or plan to be conducted in Southeast Asian economies during 2008-2010.

It might be too early to assess the total impact and effectiveness of currently announced fiscal stimulus, but there are some issues that should be addressed with regard to its effectiveness. First, it should be noted that stimulus may make fiscal positions of these economies deteriorate over time with consequences on interest rate, exchange rate, and inflation. The anticipation of future risk is necessary. Second, the observation of one economy's capacity and fiscal space to conduct a stimulus is also necessary. Efforts to boost demand through short-lived stimulus should not ignore concern about medium term sustainability. The initial fiscal condition before implementing any stimulus is a key to see the fiscal space. Figures 5 and 6 present indicators of fiscal space in the Southeast Asian economies.

From the previous three years data, it is shown that only Singapore and Brunei Darussalam have a fiscal surplus, though Singapore has a high total public debt to GDP ratio (102.6% in 2008). In contrast, Vietnam, Laos, and Cambodia have both large fiscal deficit and high total public debt to GDP ratio, indicating less room for conducting a fiscal stimulus. Malaysia, Indonesia, Thailand, and the Philippines have a smaller fiscal deficit, but their total public debt to GDP ratios are considerably high.

Conducting a large fiscal stimulus in economies characterized by large deficit and high public debt ratio may put pressure on long term sustainability. The World Economic Outlook (IMF, 2009) shows that the degree of public indebtness reduces the effectiveness of fiscal policy, and the impact becomes negative when the debt level exceeds 60% of GDP. These findings point to the need for a commitment to medium and long term fiscal sustainability to accompany any fiscal stimulus.

In short, the initial fiscal condition, the source of stimulus financing, and the contents of stimulus program are three interrelated factors that need to be considered before delivering any stimulus. Countries with relatively high public debt and large fiscal deficit should not consider delivering stimulus by creating new debt; only domestic financing or grant should be considered if stimulus needs to be delivered. For these countries, the second policy options, making better use of existing resources, may give more benefit to the economy rather than delivering a stimulus. Extra care is needed to ensure that it provides value-for-money. Fiscal management needs to be clearly prioritized, targeted, and consistent with overall fiscal prudence and avoid excessive build-up in public debt and pressure on the balance of payments.

4. The Importance of Policy Coordination and Cooperation

Different from the previous Asian financial crisis, the current crisis has a world-wide scope. Policy makers in emerging economies are likely to face dilemmas whose solution will be highly dependent on how they behaved during the boom period, as well as how the global shocks affect their individual economies. Several countries have delivered fiscal stimulus,

Table 3. Fiscal Policy Responses in Southeast Asia

Components / Country	Cambodia	Indonesia	Lao PDR	Malaysia	Philippines	Singapore	Thailand	Vietnam
Expenditure:								
Infrastructure investment	O	O	O	O	O	O	O	O
Support to SMEs and/or farmers	X	O	X	O	O	O	O	O
Safety net	O	O	X	O	O	O	O	O
Housing/construction support	X	O	X	O	X	O	X	X
Strategic industries support	O	O	X	O	O	X	O	X
Increase/subsidy in wage	O	O	O	O	X	O	O	O
Employment generation	X	O	X	O	O	O	O	O
Other	X	X	X	O	X	O	O	O
Revenue:								
Corporate income tax incentives	O	O	O	O	O	O	O	O
Personal income tax incentives	X	O	X	O	O	O	O	O
Indirect tax exemptions	O	O	X	O	X	O	O	O
Other	X	O	O	O	X	X	X	X
Stimulus Size (billion US$)	n.a	6.1	n.a	18.1	6.5	13.7	3.3*	18.6
Stimulus Size (% of GDP)	n.a	1.2%	n.a	10.0%	4.6%	11.5%	1.2%	22.1%

O = with policy response, X = no policy response

*excluded US$ 44.3 billion for infrastructure investment during 2010-2012

Sources: Asian Development Bank, International Monetary Fund, release of ministries of finance and news releases.

Figure 5. Fiscal Balance on Central Government (% of GDP)

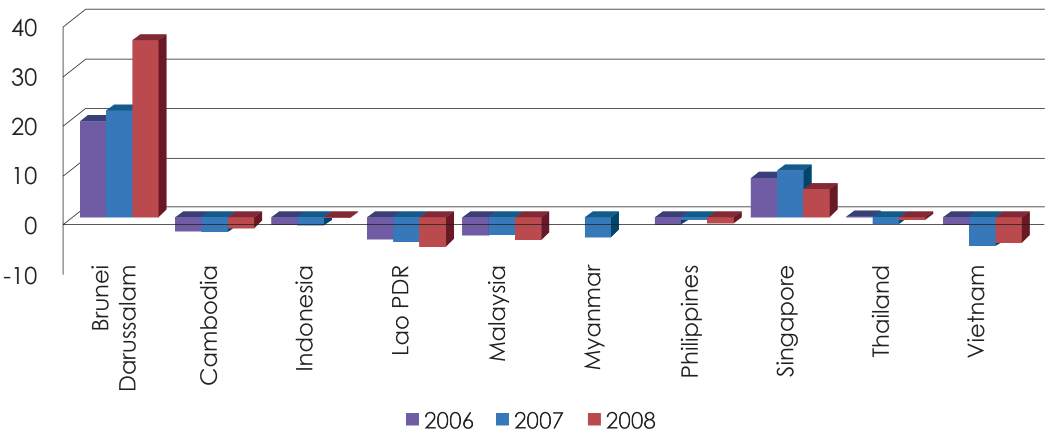
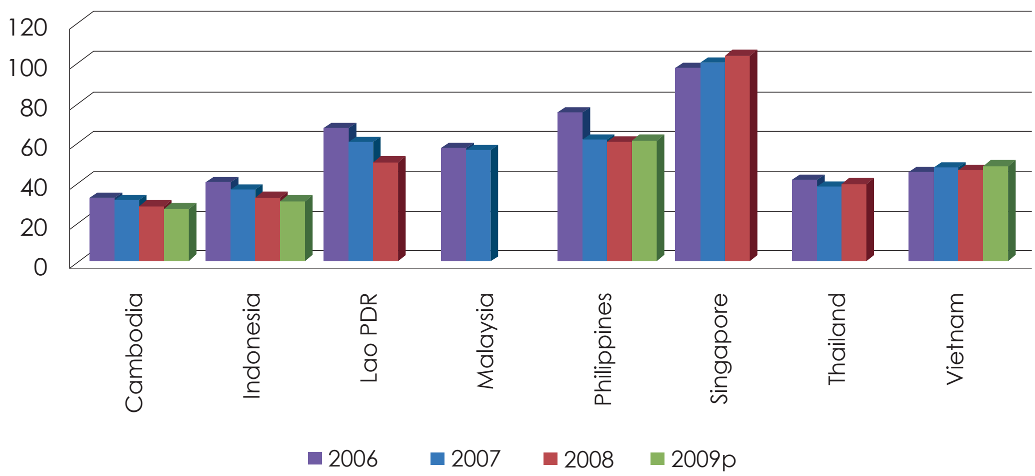


Figure 6. Total Public Debt (% of GDP)



Source for Figures 5 and 6: ADB (2009a).

though it has been relatively small (except Singapore, Vietnam, and the Philippines) to induce domestic demand, and thus regional demand. However, concern on strong macro fundamentals and medium term sustainability in the region should not be sacrificed for the short-lived demand-boost. Countries with fragile fiscal and monetary stance should consider prudently the cost of delivering fiscal stimulus and monetary easing, while countries with large space could contribute more.

Since the ideal objective of stimulus is to induce the demand during the slowdown, the capacity and the space of countries that implementing are very crucial. An ambitious stimulus that ignores the medium term sustainability and future risk should be avoided. It would worsen not only the economy performance but also regional stability since the high degree of trade openness and financial sector linkage might transfer any volatility faster than before.

Though the effectiveness of current policy easing is still in long lasting debate,[2] it is crucial to strengthen policy cooperation to provide a well-timed, targeted, and sizeable policy. A one-for-all solution policy should be avoided, and the characteristics of each economy should be given more consideration. A practice of prudent macroeconomic policy and regional cooperation are needed to anticipate post-recovery inflation risk and maintain long term sustainability in the region.

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[1] For several episodes of the crisis impact over specific countries see Chandarot, *et al.* (2009), Djaja (2009), and ESCAP (2009).

[2] See Eskesen (2009), Hemming, *et al.* (2002), and Muhleisen (2000).

About the author

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