



Recommendations of Policy Responses to the Global Financial and Economic Crisis for East Asian Leaders



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East Asian Leaders: Recommendations of Policy Responses to the Global Financial and Economic Crisis

To: East Asian Leaders

East Asian leaders urgently need to formulate and implement economic and financial policies to offset the impacts of the global financial and economic crisis, and to secure the basis for long-term broad-based and sustainable growth. The undersigned have developed and support the broad thrust of the policy recommendations presented in this document. In principle, the recommendations are intended for East Asian economies, although, in some cases, they may only be relevant to the ASEAN and ASEAN+3 economies. Under the Asian Policy Forum which the Asian Development Bank Institute (ADBI) supports, ADBI has facilitated the development and compilation of these recommendations, including organizing workshops and conferences on the subject, soliciting individual contributions, and updating on recent developments. However, this document reflects the individual opinions of the signatories, and should not be construed as the official position of either the Asian Development Bank or ADBI. Further, the individual authors retain some differences of view on the details, while joining to recommend decisive action by leaders.

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Recommendations of Policy Responses to the Global Financial and Economic Crisis for East Asian Leaders

We recommend the following policies for East Asian leaders to counter the current financial stress and economic downturn, and to set the stage for a normalization of financial market conditions and broad-based, sustainable economic growth driven mainly by domestic and regional demand, and consistent with environmental sustainability.

Monetary policy: More dramatic easing of monetary policy is needed in most East Asian economies. Central banks need to take strong steps to support liquidity in both domestic and US dollar markets, including using lender of last resort facilities, expanding the types of assets to be purchased, and promoting bilateral and multilateral currency swap measures. Central banks should review their monetary policymaking to strengthen macro-prudential frameworks so that asset price developments and systemic risks—in addition to goods price inflation—could be appropriately taken into account.

Financial market stabilization and augmentation: East Asian governments should set up an Asian Financial Stability Dialogue including regional finance ministry officials, central bankers, and financial market regulators and supervisors to facilitate policy coordination for financial sector stability and development. Avoiding a credit crunch for small and medium-sized enterprises (SMEs) and for trade related activities is particularly important. We recommend further development of Asian bond markets and a “road map” and timeframe for greater regional financial integration.

Fiscal policy: East Asian governments should accelerate investment in sectors with high growth potential, including infrastructure projects, especially those whose benefits are broad-based and consistent with energy conservation, environmental improvement, and climate change adaptation. We support the establishment of an Asian Infrastructure Investment Fund (AIIF), which could be facilitated by the Asian Development Bank (ADB). Government programs should also support employment expansion schemes, strengthen social safety nets, and improve income distribution to encourage consumer spending from longer-term perspectives.

Trade policy: East Asian governments must take strong action to reaffirm their commitment to free trade and regional economic cooperation, and refrain from undue export promotion or import restrictions. East Asian leaders should take concrete steps toward establishing an East Asia-wide free trade area.

Exchange rate policy: East Asian governments should avoid competitive exchange rate depreciation as a way to escape from of the crisis. The Chiang Mai Initiative (CMI) should be expanded in size, fully multilateralized, and de-linked from International Monetary Fund (IMF) programs. We support the recent agreement by ASEAN+3 finance ministers to establish a secretariat for regional economic surveillance. East Asian economies need to undertake greater exchange rate policy coordination.

International financial architecture: East Asian leaders should actively participate in global forums such as the G20 to put their imprint on reforms of the global financial system, and support regional initiatives. Their proposals need to focus on strengthening international support for emerging and developing economies through increased funding of the international financial institutions, including a general capital increase for ADB. Second, they should focus on the reform of the functions and the governance structure of the Bretton Woods institutions so that the voice of Asian economies is better reflected in their governance. Finally, they should focus on the reform of global supervision and regulation of systemically important institutions operating cross-border so that another global financial crisis is avoided.

Recommendations of Policy Responses to the Global Financial and Economic Crisis for East Asian Leaders

Executive Summary

Introduction: This paper summarizes our recommendations for policies of East Asian economies to counter the current financial stress and economic downturn, and to set the stage for broad-based, sustainable economic growth and a normalization of financial market conditions. It is important to implement a set of measures that will help reduce the vulnerability of East Asian economies to future shocks. In the medium-term, exports to developed economies are likely to prove to be less of an engine of growth for the region than previously. Therefore, Asia needs policies to facilitate a shift toward domestic led growth and greater reliance on regional demand.

Our recommendations include both short-term stabilization measures in monetary policy, financial market support, fiscal policy, trade policy, and currency management, and longer-term structural measures to strengthen the bases for financial stability and sustainable growth. A key priority in the short-term is to maintain the flows of international and domestic credit for viable business activities. Longer-term proposals have the broad aim of encouraging greater reliance on domestic and regional demand within East Asia and less reliance on exports to United States (US) and European markets, and promoting the adjustment of international imbalances that were key factors behind the current crisis. Moreover, the crisis should be seen as an opportunity to promote economic growth that is inclusive, energy efficient and consistent with a sustainable environment.

Monetary policy: With inflationary pressures broadly abating across the region, central banks have greater scope to shift their concerns to cutting interest rates and reserve requirements to support growth. The extent of appropriate easing will vary by country, but more dramatic easing is called for in most instances. Central banks also need to take strong steps to support liquidity in both domestic and US dollar markets, including using lender of last resort facilities, expanding the types of assets the central bank can purchase, and promoting bilateral currency cooperation measures.

Financial market stabilization and augmentation: The East Asia region so far has avoided a systemic financial crisis, and financial authorities need to increase vigilance and develop contingency plans to prevent one from developing. East Asian governments should set up an Asian Financial Stability Dialogue including regional finance ministry officials, central bankers, and financial market regulators and supervisors to facilitate financial sector policy coordination. Regulators need to step up their monitoring of bank solvency, have clear policies in place to deal with stressed institutions, encourage banks to increase transparency through more regular and timely reporting of key financial indicators, and strengthen regulatory standards for liquidity risk management. Extending and formalizing official guarantees of bank and other deposits might be considered as short-term measures. Regulators should encourage banks to immediately start raising capital to strengthen capital ratios well above prudential norms, and prepare schemes for public recapitalization and public purchases of non-performing assets where appropriate. In the extreme case of a credit crunch, authorities should take necessary steps to prevent a downward spiral from feeding into the real sector. Avoiding a credit crunch for SMEs and for trade-related activities is a particularly important task.

Further development of Asian local currency bond markets (through the Asian Bond Markets Initiative and the Asian Bond Funds) could provide important support for efforts to expand fiscal policy. Finally, Asian economies should agree on a broad “road map” and timeframe for achieving greater financial integration for the region.

Fiscal policy: With financial market stress, there is a greater than normal role for expanding fiscal policy to stabilize aggregate demand. East Asian governments should give priority to increasing domestic demand by accelerating investment in sectors with high growth potential, including high quality national and regional infrastructure projects, especially those whose benefits are broad-based and consistent with energy conservation, environmental improvement, and climate change adaptation. We support the establishment of an Asian Infrastructure Investment Fund (AIIF), a mechanism by which infrastructure projects in the region could be prioritized and funded, and this could be facilitated by the Asian Development Bank (ADB). Government programs to support employment expansion are also critical. In the longer-term, governments should aim to encourage consumer spending through policies to strengthen social safety nets and improve income distribution.

Trade policy: East Asian governments must take strong action to reaffirm their commitment to free trade and regional economic cooperation, and refrain from undue export promotion or import restrictions in order to recover from economic slowdown. East Asian leaders should take concrete steps toward establishing an East Asia-wide free trade area—be it among the ASEAN+3 or East Asia Summit (EAS) countries—that embraces many WTO-plus elements. This requires further deepening of ASEAN economic integration through building an ASEAN Economic Community as well as closer cooperation among People’s Republic of China (PRC), Japan, and Korea.

Exchange rate policy: East Asian economies should strengthen exchange rate policy dialogues, avoid competitive exchange rate depreciation, and avoid large misalignments among regional currencies. In this context, the Chiang Mai Initiative (CMI) should be expanded in size, fully multilateralized as quickly as possible, and de-linked from International Monetary Fund (IMF) programs. We strongly support the recent agreement by ASEAN+3 finance ministers to establish a secretariat for regional economic surveillance. East Asian economies need to be prepared for undertaking greater exchange rate policy coordination to respond to large scale exchange rate alignment that may come after the stabilization of the current financial crisis.

International financial architecture: East Asian leaders should actively participate in forums such as the G20 and an expanded Financial Stability Forum to put their imprint on reforms of the global financial system, and support regional cooperation and integration initiatives. First, the leaders need to contribute proposals for strengthening international support for emerging and developing economies through increased funding of the international financial institutions (IMF, World Bank and other multilateral development banks), including a general capital increase for ADB. Second, they should focus on the reform of global supervision and regulation of cross-border financial activities of both systemically important and less important institutions. Third, they should also propose reforms of both the function and the governance structure of the Bretton Woods institutions. The governance structure of these institutions needs to reflect the increased economic importance and voice of Asian economies.

Recommendations of Policy Responses to the Global Financial and Economic Crisis for East Asian Leaders

Introduction

The current financial crisis and global economic downturn did not originate in Asia, but Asian financial markets and economies have been severely affected, and the impact is likely to deepen substantially over the next several quarters. The most obvious areas of impact have been in equity, currency and credit markets, and, more recently, exports, which have declined sharply across the region. This sensitivity has been heightened by the export-led growth strategies followed by many economies. Export-related production and investment have been affected, and domestic demand has softened.

Nevertheless, Asian economies face the current downturn with many strengths. These include massive foreign exchange reserves; sound macroeconomic management, notably in the areas of fiscal and debt; healthy balance sheets in the private sector, both financial and non-financial; current account surpluses in most economies; and improving inflation fundamentals. Asian economies were less affected by exuberance based on credit, and bank losses have been small relative to those in North America and Europe. These cushions provide scope for proactive policy responses, including fiscal stimulus and interest rate cuts. In many cases, the lessons of the Asian financial crisis of 1997-1998 appear to have been well learnt, and most Asian economies possess a high degree of policy flexibility. Therefore, they can provide pillars of strength in the current global environment. Finally, Asian economies have strong strategic interests in policy initiatives to support global recovery

This paper summarizes our recommendations for policies of East Asian economies to counter the current financial stresses and economic downturn, and to set the stage for a normalization of financial market conditions and broad-based, sustainable economic growth. It is important to implement a set of measures that will help reduce the vulnerability of Asian economies to future shocks. The crisis should also be seen as an opportunity to promote growth that is energy efficient, and consistent with sustainable environmental impacts. Moreover, in the medium-term, exports to US and European markets are likely to be less of an engine of growth for the region than previously. This suggests that a new growth model will be needed, and Asian economies need to explore all avenues to facilitate high and sustainable growth of domestic and regional demand for finished products and services. This orientation should provide an important long-term guidepost for developing policies and institutions.

Our recommendations are divided into two parts. The first focuses on short-term stabilization (“fire fighting”) measures in monetary policy, financial market support, fiscal policy, trade policy, and currency management. Monetary policy and fiscal policy need to be mobilized, and measures to forestall systemic financial crises and a credit crunch must be put in place. The commitment of East Asian economies to avoid protectionism and unilateral currency devaluation must also be reaffirmed. These measures are aimed at forestalling, or at least minimizing, the direct impacts of the current crisis, so prompt implementation is critically important.

The second set of recommendations addresses longer-term issues of:

- (i) strengthening the policy framework for inclusive and sustainable economic growth in the region;
- (ii) transforming the Asian economy into a dynamic, integrated economy driven by domestic and regional demand rather than one excessively dependent on exports to US and European markets; and
- (iii) improving the effectiveness and stability of regional financial markets.

We believe that strengthening and developing institutions for regional coordination can make a significant contribution to achieving these goals, and are desirable to include the region's poorer economies in the broad-based growth process. For example, strengthening of institutions related to regional surveillance and reserve pooling can play an important role in macroeconomic stabilization efforts. An Asian Financial Stability Dialogue forum including regional finance ministry officials, central bankers, and financial market regulators and supervisors could facilitate financial sector policy coordination and stability. Moves to integrate regional financial markets, including more consistent regulation, can facilitate the development of intraregional financing of investment, and would enable the high savings in the region to be recycled to finance attractive investment projects.

East Asian finance ministers and central bank governors need to meet and enunciate a collective East Asian program for stabilizing the regional and global economies. The articulation of measures to promote early recovery of the East Asian economies will boost confidence and position the region as a leading centre of global recovery. East Asian leaders also need to present these policies effectively to the next G20 summit and other global forums and international financial institutions. This will require intensifying the process of economic and financial cooperation in East Asia.

I. Short-term policy recommendations

Monetary policy

Ease monetary policy: With inflationary pressures broadly abating across the region, central banks have greater scope to support growth. The extent of appropriate easing of monetary policy will vary by country, but more dramatic easing is called for in most instances. Some policy coordination may be required to avoid undesirable moves in cross exchange rates.

Support liquidity in domestic and US dollar markets: The foreign currency liquidity shortage has not fully abated and may intensify in the face of further problems in developed country financial institutions. Arranging bilateral currency swap lines with other central banks or multilateral currency swaps with a regional institution—like a multilateral CMI—could also help.

With the risk of rising stress on domestic liquidity conditions, national authorities need to be ready to provide liquidity support on a timely basis where needed. The region's central banks should have a number of tools—most importantly lender of last resort facility so liquidity can be provided directly to banks if necessary—ready to address any pressures that emerge in local currency funding markets. At the same time, central banks should ensure that liquidity support operations will not unnecessarily compromise monetary policy objectives. Clear policies on eligibility, type of collateral, interest rates charged, and maturity of lending are needed. In all cases where the lender of last resort function is used, authorities should ensure that adequate collateral is provided so as to avoid putting the central bank balance sheet at risk.

In the event that circumstances warrant liquidity provision to financial institutions that are not covered under standing facilities, specific conditions for support need to be made public. As part of contingency planning, authorities may also explore the modalities for providing support and whether any liquidity might best be made available directly to institutions in need, or indirectly through bank lending. Expansion of the types of assets a central bank can purchase should also be considered. Where legal restrictions limit the types of assets that central banks can buy, these restrictions should be reviewed and possibly eased.

Financial sector stabilization

Establish regional policy coordination framework: Communication and coordination at the regional level need to be strengthened. East Asian countries should set up an “Asian Financial Stability Dialogue”—an Asian version of the Financial Stability Forum—to help monitor the region’s financial markets and develop a plan of action in response to the immediate challenges of the global financial crisis. The forum would be created among finance ministries, central banks, and financial market regulators and supervisors. The forum could share more information, harmonize prudential indicators, increase coordination on conducting early warning system analysis, and discuss more openly national and regional policy interventions. This forum could also promote longer-term financial market development and integration, establish standards for governance and transparency, and improve investor confidence.

Increase monitoring and develop contingency frameworks for systemic financial crisis: So far, situations of major systemic financial risk have not developed in the region, but financial authorities need to increase vigilance and develop contingency plans in this area. Regulators need to step up their monitoring of bank solvency and have clear policies in place to deal with stressed institutions. National regulators should clearly signal that they are monitoring conditions closely and are ready to take necessary measures to maintain financial stability. Prompt corrective action frameworks may also need to be adjusted in the event of difficulties in systemically important institutions. Extending and formalizing official guarantees of bank and other deposits might also be considered as short-term measures—should lender of last resort facilities not be sufficient to prevent bank runs if confidence evaporates. At the same time, however, these measures raise concerns about moral hazards in the banking sector and should be applied judiciously.

Increase transparency and risk management: Regulators should encourage banks to increase transparency through more regular and timely reporting of key indicators of liquidity, profitability, and capital, and their exposure to developed country counterparties. Given the opaqueness of complex derivative products and a lack of clarity about who holds the risks, it is essential to strengthen financial system transparency. Accordingly, authorities should encourage greater disclosure of complex financial products and ensure “complete and accurate disclosure” by firms of their financial conditions. Regulatory standards for liquidity risk management need to be strengthened, particularly for banks that rely heavily on capital market funding. Authorities need to ensure that regulated financial institutions have in place proper liquidity risk management frameworks and formulate contingency plans to deal with a disruption in external financing. Close attention is needed to ensure that local banks are properly classifying loans, and adequately provisioning against problem loans.

Strengthen bank capitalization: Regulators should encourage banks to immediately start raising capital to strengthen capital ratios well above prudential norms. Such moves would also send clear signals to the market that banks are entering the downturn from a position of strength rather than weakness. In the current unsettled international conditions, regulators may signal that systemically important financial institutions will not be allowed to fail. Precautionary public recapitalization schemes should also be ready where appropriate. However, public recapitalization should be approached with the primary aim of strengthening the financial system and promoting needed adjustments, not protecting individual institutions or shareholders.

Prepare for public purchases of non-performing assets: Economic conditions may worsen and bank non-performing loans (NPLs) may rise. A framework should be in place for government funded asset management companies to buy non-performing assets from banks and other financial institutions, supplemented by public capital injection programs as needed.

For this purpose due diligence of bank assets will be indispensable to identify NPLs and determine prices for NPL purchases.

Alleviate a credit crunch: In the extreme case of a credit crunch, authorities should undertake measures to prevent a downward spiral from feeding into the real sector. Providing guarantees on new lending might be a first option, if bank balance sheets and liquidity positions remain sound and the pullback is the result of excessive risk aversion. In addition, credit can be supplied directly to the real economy either by the public sector buying financial instruments issued by firms or through central bank credit extensions.

Avoiding a credit crunch for SMEs, which typically have more difficulty accessing finance even in the best of times, is an important task. To address SMEs' funding constraints, it may be desirable to establish a regional loan facility to expedite funding for them. Providing support for trade credit is also critical to prevent further trade contractions.

Fiscal policy

Expand fiscal policy: With financial market distress, monetary policy effectiveness is often reduced. This suggests a need to focus on a greater than normal role for expanding fiscal policy to stabilize aggregate demand. As noted above, many Asian economies have considerable scope to do so. Short-term fiscal policy measures should be designed in a way consistent with the longer-term objective of facilitating East Asia's structural adjustment.

Increase infrastructure spending: Given that potential growth is still generally high across the region, and infrastructure in many cases inadequate, there is a presumption in favor of increased infrastructure investment to facilitate this growth. East Asian governments, especially large economies such as the PRC, India, and Indonesia, should give policy priority to increasing domestic demand through acceleration of high quality national and regional infrastructure projects. In particular, infrastructure investment with broad-based benefits (such as rural transport and communication facilities) and strong multiplier effects (such as mass housing) needs to be given preferential attention. Infrastructure investments that address concerns for sustainable energy, environmental improvement, and climate change adaptation (e.g., efficient mass transport systems, energy efficient structures, and facilities) must likewise be given due priority.

Expand employment support schemes: It is important to support employment in order to stabilize consumer sentiment and spending. Governments should consider employment creation schemes such as Singapore's policy to maintain employment through a public subsidy program for training.

Cut taxes and increase cash transfers: Where fiscal conditions permit, governments should also consider tax cuts for individuals and corporations to support consumer spending and investment. Tax cuts can be implemented more expeditiously than government spending programs. Governments also need to take into account the likely extent to which tax cuts will be spent. Increased cash transfers for other social safety nets to protect the socially vulnerable population also are also likely to be needed.

Ease financing bottlenecks: In some economies, financing is likely to be a bottleneck for fiscal expansion. We urge East Asian governments to consider ways to facilitate inter-country borrowing to finance such spending. Multilateral development banks, bilateral official institutions, and private international financial firms can become involved in issuance, underwriting, credit rating, legal service, among others.

Trade policy

Avoid beggar-thy-neighbor trade policies: East Asian governments must take strong action to reaffirm their commitment to free trade and regional economic cooperation, and refrain from undue export promotion or import restrictions in order to recover from economic slowdown. They should avoid the type of policy mistakes of trade protectionism made during the Great Depression in the 1930s. This message should be communicated to the rest of the world as well. East Asian economies should take steps to monitor any development of trade protection moves.

Initiate negotiations for a regional trade agreement: East Asian leaders should promote freer trade in East Asia by declaring their intention to commence negotiations for a region-wide free trade area—whether it is based on ASEAN+3 or EAS countries—which contains many WTO-plus elements such as facilitation, investment, intellectual properties, competition policy, procurement, labor, and other cooperation measures. This requires further deepening of ASEAN economic integration through building an ASEAN Economic Community as well as closer cooperation among the PRC, Japan, and Korea to establish a foundation for an East Asia-wide regional free trade area (FTA). This can help to promote rebalancing of growth away from excessive dependence on exports to US and European markets, as market integration can create new business opportunities, expand regional trade and investment, and new regional demand.

Exchange rate policy

Resist beggar-thy-neighbor currency devaluations: East Asian economies should strengthen policy dialogue and make clear their opposition to unilateral attempts at currency devaluation to try to boost exports. This could lead to a phase of competitive devaluations which will benefit no one, and will also make the shift to domestic demand led growth much more difficult. East Asian economies should also try to avoid significant currency misalignments within the region.

Enhance the Chiang Mai Initiative and its effectiveness: The eight members participating in the Chiang Mai Initiative (CMI) are currently sitting on a total of nearly US\$4 trillion in foreign exchange reserves. The lack of US dollar liquidity is therefore one area they can easily overcome if they enlarge the CMI and streamline the disbursement process. We support the recent agreement to multilateralize CMI and expand the size of a multilateral CMI to \$120 billion, and believe that the size of the fund could be further increased. The details of the multilateralization scheme—including how much each country should contribute to the fund and its decision-making process—should be agreed upon as soon as possible.

Given the special circumstances of the current crisis, CMI support during this period could be made more flexible by (i) delinking CMI from IMF programs; (ii) requiring no conditionality in a way comparable to the IMF's recently introduced Short-Term Liquidity Facility (SLF); and (iii) supplementing CMI by bilateral contributions from economies inside and outside the region to make the resources available sufficient for potential needs in the region.

International support for emerging and developing economies

International efforts to support emerging and developing economies, which require short-term liquidity for balance-of-payments purposes and medium- to long-term funding for development investment, should be strengthened. This includes increased funding for the international financial institutions (such as IMF, World Bank and other multilateral development banks). In this context, ADB can play a significant role in facilitating infrastructure investment in the region, especially for projects already in the pipeline, and for this purpose an increase in ADB's capital base is urgently needed.

Monitoring of impacts, by income group, sector, etc.

Increase monitoring: The impacts of the crisis could have disproportionate impacts on lower income groups and particular regions. There may be backsliding on commitments related to environmental improvement and sustainable development. These developments need to be monitored closely by individual economies, and corrective policies developed if necessary. Care must be taken to ensure that measures taken for short-term stabilization will not be at the expense of vulnerable sectors and of long-term sustainability.

II. Medium-term recommendations for cooperation, integration and reform

The most important medium-term task is to pursue structural adjustments that will enable East Asian economies to develop internal markets and rely less on US and European export markets. This needs to be accomplished by fiscal support, financial integration with safety nets, a region-wide FTA and other types of integration.

Monetary policy framework

Central banks' role in macro-prudential oversight. Frameworks for macro-prudential oversight need to be strengthened in each economy. These should both complement existing micro regulatory structures and ensure an appropriate focus on macro-prudential issues and systemic risks. In line with increased monitoring responsibilities for central banks, all East Asian economies need to strengthen economic and financial sector monitoring at national and regional levels. At the national level, significant coordination is required among central banks, financial sector regulators and supervisors, and finance ministries to ensure that macro-prudential oversight will be effective, by setting up a national financial stability forum or providing the central bank with the oversight mandate.

Review policy framework: As part of the macro-prudential exercise, East Asian central banks should review their monetary policy frameworks with a view to clarifying issues such as how asset price developments should be taken into account and how harmful bubbles can be avoided. The “two pillar” approach of the European Central Bank and the Bank of Japan, which considers longer-term risk factors as well as the short-term outlook for output and inflation, may provide guidance in situations where prices of goods and services are still stable, but asset prices show signs of unsustainable trends.

Financial sector development and regulatory reform

Develop a "road map" and timeframe for regional financial integration: East Asian economies should agree on a broad “road map” and timeframe for achieving greater financial integration for the region. Financial sector cooperation in East Asia should promote further development and reform of domestic financial markets and regional financial integration in order to facilitate the intermediation of Asian savings within the region and attract foreign investment in instruments denominated in domestic currencies. Regional cooperation for setting common regional standards and granting mutual recognition is essential. Greater attention needs to be paid to ensuring consistency in regulations across national markets, and improving the coordination and cooperation across financial market regulators. Dialogues need to be held about how to harmonize taxes on financial assets and income as differences in these across borders and investor classes can inhibit the demand for assets in individual markets as well as discouraging regional integration.

Improve monitoring, surveillance, and regulation: The region's authorities need to continue to improve regulatory oversight of domestic and cross-border financial systems to enhance their resilience. Weaknesses and gaps in financial sector regulation and supervision arguably allowed excessive leverage and risk taking in the US and Europe. Improving the

focus of regulation and oversight, and increasing them where necessary, can help address those features of regulatory regimes that may have contributed to the current turmoil. For example, monitoring activities of systemically important global financial institutions needs to be strengthened.

From this perspective, East Asian economies should consider consolidating—or at least strengthening coordination across—various financial regulatory agencies. This would make it easier to gain an overall and consistent picture of financial developments in their markets, and would also simplify the process of regional coordination, especially when a systemic financial crisis develops. This would help to avoid regulatory gaps in systems where regulation is divided along functional or institutional lines.

Further develop Asian local currency bond markets: Broadening and deepening local currency bond markets remain important goals for more efficient and resilient domestic and regional financial systems. Further development of Asian bond markets (through the Asian Bond Markets Initiative and the Asian Bond Funds) could provide important support to economies seeking to raise funds for infrastructure development, SME financing and other private sector investment. A broad range of reforms is required to develop well integrated and functioning Asian bond markets, such as (i) removing impediments to market entry and investment, particularly those on capital and exchange controls; (ii) broadening and diversifying the investor base; and (iii) improving market infrastructure, such as clearing and settlement, credit guarantee and data collection. With regard to the third point, ASEAN+3 authorities may accelerate the establishment of a credit guarantee and investment mechanism to provide credit guarantees for local currency denominated bond issuance to gain easier access to domestic and regional funding.

Reform misaligned incentives: Problems of misaligned incentives that contributed to excessive risk taking and leverage in the US and Europe also need to be addressed. The Financial Stability Forum and the IMF have noted numerous problems during the current crisis related to a misalignment of incentives between owners and managers of financial institutions; by credit rating agencies; and in the context of the “originate and distribute” model of securitized finance.

Mitigate pro-cyclicality of financial markets: Regulators may consider designing prudential regulation in a counter-cyclical fashion, including forward looking risk evaluation, adequate liquidity provisioning, and monitoring of maturity and currency mismatches to help avoid large financial swings and their destabilizing effects on the economy. Ways to reduce pro-cyclicality of financial regulations also need to be considered at the global level as part of international financial architecture reform.

Fiscal support for structural adjustment

Fiscal support toward a low carbon economy: Fiscal support should be provided to facilitate the development of newly growing industries and East Asia’s adjustment toward regional demand driven growth. In particular a significant volume of investment is needed to guide the East Asian economies toward a low carbon society, focusing on improving energy efficiency, developing clean energy, reducing environmental impacts, and addressing climate change mitigation and adaptation. Energy subsidies will have to be eliminated and a carbon tax may have to be introduced so that use of carbon based energy is reduced.

Establish Asian Infrastructure Investment Fund: One way for East Asian economies to jointly accelerate infrastructure development is to establish an infrastructure investment fund. This is particularly important in an environment where private capital inflows are shrinking because of global financial conditions, and some economies may be facing funding constraints. We support the establishment of an Asia Infrastructure Investment Fund (AIIF),

a mechanism by which infrastructure projects in the region could be prioritized and funded. ADB can play a significant role to facilitate this. The AIF would also contribute to narrowing the development gap in the region by assisting low income countries to have access to grant or low cost funding and strengthen greater infrastructure connectivity with other growing regional economies.

Strengthen social sector protection: Establishing effective social sector protection systems and social infrastructure for education, health, unemployment and old age pensions can encourage consumer spending by reducing the need for precautionary savings. Measures aimed at improving income distribution can further this aim as well. In addition, targeted cash transfer programs should be strengthened to protect the poor and the socially vulnerable from increases in carbon-based energy prices.

Regional trade and investment integration

Liberalize foreign direct investment and trade in services: While establishing an East Asia-wide FTA, regulations on foreign direct investment should be reviewed with an eye toward encouraging cross-border investment, both within the region and from outside. With exports of goods likely to produce less economic growth than before, East Asian economies need to focus on ways to encourage growth of services exports. Liberalizing services trade should be a priority for regional economic integration as its growth can further expand regional markets and demand.

Pursue open regionalism: East Asian leaders should maintain open regionalism rather than aim for a fortress East Asia. After the completion of an East Asia-wide FTA, East Asian economies should aim to connect themselves with North and South America, and with Europe. A nested approach may be useful by expanding various ties with the Americas and Europe.

Exchange rate policy coordination

Institutionalize management of a multilateral Chiang Mai Initiative: A proposed secretariat for regional economic surveillance as part of a multilateral Chiang Mai Initiative (MCMI) could become a permanent credit institution to deal with financial and currency crises as well as normal regional surveillance. Institutionalizing the management of MCMI is necessary as regional financial markets are increasingly integrated and financial globalization takes place at a faster pace. This is expected to give confidence to national policymakers embarking on further capital account liberalization.

Promote more consistent currency regimes: Looking beyond the current global financial crisis and economic difficulties and considering the rising degree of economic interdependence among East Asian economies through trade and investment, East Asian economies need to undertake greater exchange rate policy coordination with each other. Once global financial stability is restored, one can expect the resumption of large capital inflows into Asia. To manage such capital inflows and maintain macroeconomic and financial sector stability, it will be important to allow greater rate flexibility vis-à-vis outside currencies—such as the US dollar and the euro—while enhancing exchange rate stability vis-à-vis regional currencies. This requires a significantly coordinated approach to exchange rate regimes.

Reduce dependence of intraregional trade on US dollars: The vulnerability of the Asian financial and payments systems to dollar shortages needs to be reduced. One approach is to promote the use of international payments on a net settlement basis. Another approach is to encourage internationalization of regional currencies so that they can be used for trade invoicing and settlements.

More effective international financial architecture

In light of their increasingly important global role, East Asian economies should actively participate in reforming the global financial system as well as supporting regional cooperation and integration initiatives. Existing institutions such as the IMF, WTO, G-20, and the Financial Stability Forum need to be strongly supported, but East Asian economies need to promote their interests and propose reforms where needed. In this regard, it is important for the six members of EAS participating in the G-20 meetings—Australia, the PRC, India, Indonesia, Japan, and Korea—to work with other members to present a united front at the G-20 process. The regional financial cooperative arrangements in East Asia—such as the CMI and a proposed Asian Financial Stability Dialogue (AFSD)—may be considered as building blocks for an improved international financial architecture.

Establish global expenditure support fund: At the G-20 Summit in Washington D.C. in November 2008, Indonesian President Yudhoyono proposed the establishment of a global expenditure support fund (GESF) to enable emerging markets to take counter-cyclical measures to maintain reasonable levels of economic growth. The amount of resources required for this fund will not be large, but this type of fund could have a major positive impact for the region. It could help the region by providing more instruments to undertake more effective macroeconomic policy coordination and implementation.

Promote intraregional long-term loans for fiscal expansion: In addition to the AIIF, the role of bilateral assistance is also critical. Providing long maturity loans at concessionary rates for public investment or other needed fiscal stimulus by economies with large resources to economies with fewer resources could also be very helpful and could be increased over the next few years. One recent example is guarantees provided by Japan for samurai bonds issued by Indonesia.

Reform the supply side of financial flows: The current global financial turmoil has shifted attention back to the supply side of problems related to capital flows. The crisis has revived calls for fundamental reform of the IFA, revolving around proposals for international institutions designed to regulate and stabilize international capital flows. A starting point would be for East Asian economies to discuss measures to manage short-term capital inflows, particularly when markets become euphoric and inflows are excessive. Such measures will be more effective if coordinated at the regional level.

Reform functions and governance of Bretton Woods institutions: In light of their high levels of foreign exchange reserve holdings, East Asian countries need to contribute proposals for reforming the functions and governance structures of Bretton Woods institutions. In particular, East Asian leaders need to argue that their efforts to construct an efficient multilateral CMI can fill in as a regional liquidity supplier to complement the roles of global financial institutions. The governance structure of these institutions also needs to be reviewed and adjusted, taking into account the increased economic importance of East Asian economies.

Establish financial sector supervision and regulation at the global level: The rapid spread of global financial contagion partly reflects the failure of national level financial supervision and regulation to keep up with the globalization of finance. There is a need to establish supervision and regulation at the global level, and, to this end, we support the call of the G20 countries in November 2008 for intensified international cooperation among regulators, and the recent decision by EU leaders to create an EU-wide supervisory framework. There is a clear need to strengthen international standards for transparency and accountability, and implement them expeditiously to protect against adverse cross-border developments affecting international financial stability. This includes establishing “supervisory colleges” for all major systemically important financial institutions. Cross-border activities of less important

financial institutions, which nonetheless can have significant impacts on relatively small local markets, may also be regulated. East Asian governments need to participate in these efforts.

Reform rating agencies: The role of global rating agencies in contributing to the current financial crisis needs to be assessed, and recommendations for reform developed. In particular, the revenue source of rating agencies and the ways ratings are used need to be reviewed. East Asian leaders should encourage the sound development of, and coordination among, regional rating agencies so that regional and global investors can efficiently choose the best investment opportunities in the region.

The Asian Policy Forum, established in 1999, is a region-wide mechanism for enhancing intellectual and analytical leadership among Asian policymaking communities. ADB Institute is the secretariat. The Forum brings together leading members of Asian research communities to produce, through collaborative research activities and open-minded discussions, policy recommendations on the most challenging development issues confronting Asian policymakers. The Forum focuses on specific policy issues that reflect current problems with long-term development implications and pose the opportunity to search for a common Asian voice. The policy recommendations reflect the Asian situation in terms of each economy's institutions, history, and stage of development.