Finding The Right Exit From The Financial Crisis

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Developing Asia's rebound from the global economic crisis has taken firm hold. The Asian Development Bank predicts growth of 7.5% this year, up from 5.2% expected in 2009 and exceeding 2008 growth. Such robust expansion suggests authorities will 'exit' accommodative policies adopted during the crisis earlier than the rest of the world. Indeed, monetary authorities in countries such as India and Malaysia have already pushed policy rates up a quarter point, while many governments plan to reduce fiscal deficit targets this year.

But, the important question is: *exit to where?* As Asia exits this crisis it must ensure it is not entering another. Authorities around the world have so far failed to deal meaningfully with its underlying causes. Structural problems remain - such as inadequate financial market regulation and excessive liquidity - despite constructive proposals on global macro-policy coordination and financial regulatory reform. And in developing Asia, large current account surpluses and reserve accumulation will continue to exacerbate the global imbalances that underpinned the current global crisis. Current account surpluses in the region, particularly in the People's Republic of China (PRC), declined only marginally during the crisis and are expected to reach even higher levels over the next few years.

The uneven pace of recovery between developing Asia and the advanced economies suggests that capital inflows to Asia will surge once more. Even disregarding any major disruptions here, the region will remain vulnerable to large and potentially volatile capital movements, which could fuel inflation and asset price bubbles. As the 1997/98 Asian financial crisis demonstrated, rapid reversal of capital flows can have catastrophic economic effects. Excessive openness in international trade and financial transactions leave Asia most susceptible to global financial turmoil.

The 1997/98 Asian crisis and the current global crisis exposed weaknesses in developing Asia's financial and real sectors. To avert the next crisis - that is, to choose the right exit - policy makers must learn the right lessons and follow a more balanced and sustainable growth path.

That requires consistent adjustments on the demand and supply sides of the economy over the long-term. It means a broader monetary policy framework, more flexible exchange rates, continued fiscal discipline, greater domestic and regional demand, and better social protection.

First, implement a monetary policy framework that takes into account asset prices and financial market stability, and adopt a judicious mix of policies, including regulatory and direct capital control measures to manage volatile capital flows effectively. This also involves strengthening surveillance and regulatory regimes, including establishing an institutional framework for macro- and micro-prudential surveillance and regulation, ideally managed by a systemic stability regulator empowered with adequate enforcement tools and mandates.

Second, allow greater exchange rate flexibility, and develop an institutional framework that accommodates a concerted appreciation of regional currencies, as well as increased intra-regional exchange rate stability. It is clear that developing Asian economies, especially the PRC, cannot keep exchange rates stable against the US dollar and continue to amass international reserves. Regional cooperation in foreign exchange reserve management - such as the multilateralized Chiang Mai Initiative (CMIM), a regional reserve pool of $120 billion - should also be strengthened to defend against future financial crises.

Third, maintain fiscal discipline. Authorities should avoid political pressure to spend more (when not needed), and give more weight to rules rather than discretion in determining fiscal policy. Sufficient fiscal space should be ensured during high-growth periods by keeping public debt levels low enough to leave room to adjust during crisis periods. Over the medium-term, stronger institutional capacity and governance are needed to ensure effective fiscal policy and sustainability.

Fourth, encourage greater domestic and regional demand and the reorientation of the supply side of the economy more toward domestic demand. Export-led growth served Asian nations well. But it also raised the cost of economic vulnerability and introduced substantial economic distortions; its benefits now look much diminished, especially amid sluggish global demand. Asian authorities should also deregulate and encourage investment in growth areas of the service sector, including health, education, information, and telecommunications. Small- and medium-sized enterprises can, additionally, play an important role in supporting industrial clusters and creating domestic value-added.

Fifth, strengthen social protection in the areas of health insurance, unemployment insurance, and pensions to bolster social resilience. Effective social programs can encourage consumers to spend more, stimulating domestic demand and contributing to a post-crisis rebalancing. Governments also need to increase public spending on education and health to support productivity growth. Targeted social assistance programs to address extreme poverty and basic nutrition and health needs are also needed.

Alongside these policy prescriptions, regional and global efforts must be enhanced to pursue policy cooperation and coordination. Key elements of regional efforts include: setting up an Independent Surveillance Unit for CMIM which can grow to be an Asian Monetary Fund; and establishing a region-wide economic partnership agreement to encourage intra-regional trade in goods and services and investment. On the global stage, developing Asia must actively participate in major international forums and policy dialogue to support strong and sustainable global growth.

This is the way out, and a stronger, balanced, and more resilient Asian economy can help lead the way.

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