Preface

The 1997–1998 Asian financial crisis highlighted several shortcomings in Asian financial markets, most notably the underdevelopment of domestic bond markets and deficiencies in corporate governance, transparency and financial regulation. Since then, Asian financial markets have made considerable progress in both development and regulation. Asian markets have now reached levels of development common in other economies with similar income levels. Markets are also becoming more integrated regionally, although not near the levels prevailing in Europe. Some of these changes have been the result of important initiatives undertaken to remedy deficiencies brought to the fore by the 1997–1998 crisis, including the Asian Bond Markets Initiative and the Asian Bond Fund project.

The global financial crisis of 2007–2009 posed a new set of challenges for Asian economies, while highlighting a lack of progress in some areas since the Asian financial crisis. This time the crisis originated in the developed economies – primarily the United States – that had large and sophisticated financial systems, but nonetheless allowed the build-up of systemic financial risks. Asian economies, for the most part, were not directly involved in the crisis, and were hit mainly by falls in exports and a loss of liquidity. Their economic and financial fundamentals had improved substantially since the time of the Asian financial crisis. Their financial systems were still relatively underdeveloped in terms of their reliance on sophisticated financial products such as collateralized debt obligations and credit default swaps, while their financial regulators were much less influenced by notions of self-regulating markets, and hence much more willing to impose prudential norms on lending behavior. Asian financial firms held relatively few toxic assets compared with their American and European counterparts. Asian economies also had much less exposure to short-term foreign currency debt than in the period before the Asian financial crisis, and had built up substantial foreign exchange reserves.

The purpose of this book is to identify the challenges imposed by the global financial crisis and suggest policy recommendations for addressing them. These challenges fall into four major areas: (1) preventing financial crises; (2) responding to financial crises if they do occur; (3) managing international capital flows; and (4) deepening and integrating...
financial markets to provide an alternative source of funding to foreign capital flows. Improving regional economic and financial surveillance and strengthening regional liquidity safety net mechanisms against future financial shocks can significantly contribute to achieving financial stability and supporting domestic demand growth. The global financial crisis illustrates the importance of implementing a framework for macroprudential financial supervision and regulation – through the creation of a powerful systemic stability regulator – that includes effective mandates and prudential tools. Steps to improve microprudential regulation and reduce the procyclicality of financial regulation are also important. Frameworks for monitoring innovative financial products and systemically important financial institutions need to be developed. Crisis response can be improved by: (1) having a coordinated set of financial authorities that, between them, cover all phases of the crisis; (2) ensuring there are credible \textit{ex ante} means of handling failures in all financial firms, particularly those that operate across borders; (3) implementing an effective deposit insurance system; and (4) improving resilience against shocks by substantially enhancing regional mechanisms, among others, through an Asian financial stability dialogue.

Managing volatile international capital flows remains a key problem for most emerging Asian economies. Judicious use of capital controls can contribute to stabilizing such flows. A further deepening and integration of its financial markets, especially bond markets, could help support the region’s long-term growth by helping to recycle Asia’s high savings for investment in worthy projects in the region, particularly when capital flows from other regions are volatile. Deeper and more integrated financial markets can also provide an extra layer of protection against the withdrawal of foreign capital from the region during economic downturns.

Regional institutions can contribute to financial stability as well. The completion of the Chiang Mai Initiative Multilateralization agreement and the establishment of an Association of Southeast Asian Nations (ASEAN) Macroeconomic Research Office could significantly contribute to creating an Asian monetary fund to monitor international risks and provide hard currency liquidity when needed. The creation of an Asian financial stability dialogue could also further the cooperation of fiscal, monetary and financial authorities in the region. Further development of Asian bond markets (through the Asian Bond Markets Initiative and Asian Bond Funds) and a newly created Credit Guarantee and Investment Facility could provide important support to countries seeking to increase investment for growth, whether for infrastructure or other types of private investment. Development of a market for bonds denominated in an Asian currency unit could also contribute to widening the regional bond market.
An Asian infrastructure investment fund could facilitate regional infrastructure investment.

Meeting these challenges will help to put Asian economies on a path of sustainable growth that relies more than previously on domestic sources of savings and final demand. By contributing to smaller global imbalances, such policies can also promote stable growth and less systemic risk in the world as whole, not just in Asia. Finally, they will enable Asian economies to have a greater role in the reform of the global financial architecture.

Early versions of the chapters in this book were presented at the conference on Global Financial Crisis: Financial Sector Reform and Regulation, held on 21–23 July 2009, and organized by the Asian Development Bank Institute (ADBI). The chapters benefited from comments made by discussants and other conference participants. I greatly appreciate the efforts of the excellent team of authors and participants. Professor David Mayes of Auckland University, Dr Peter Morgan of ADBI and I provided overall guidance as co-editors of the book.

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