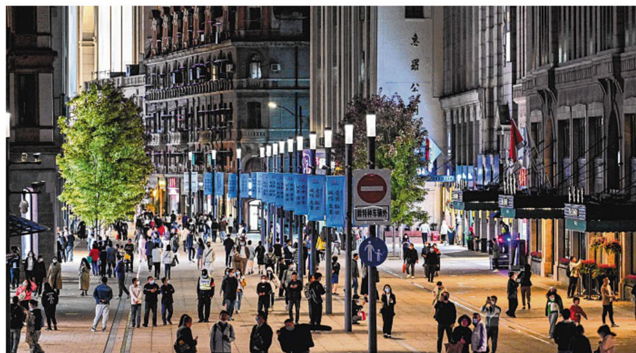

Shanghai street scene, October 2022; China's strict zero-Covid policy was a factor in the IMF's downgrade of Asia's economic growth prospects in the near term. PHOTO: AFP

Global headwinds: What lies ahead for Asia?

The region is on a much stronger footing now in terms of macroeconomic and external sector resilience, but some vulnerabilities remain. BY RAMKISHEN S RAJAN AND BHAVYA GUPTA

IN THE International Monetary Fund's recently released *Regional Economic Outlook for Asia and the Pacific*, growth prospects for the region were downgraded for the next two years. Following a robust 6.5 per cent post-Covid recovery in 2021, the IMF now forecasts the region to grow at a slower pace of 4 per cent in 2022 and 4.3 per cent in 2023, which is a fair bit lower than the average 5.5 per cent growth experienced over the last two decades.

The growth downgrade is attributable to several headwinds facing the global economy, including the strict dynamic zero-Covid policy and slow-motion real estate crisis in China, the economic impact of the prolonged geopolitical tensions due to the Ukraine war, and the aggressive rate hikes by the US Federal Reserve and consequent reversal of capital flows from emerging markets in Asia and elsewhere.

As most Asian currencies have tumbled against the US dollar this year, central banks have intervened to stabilise their currencies. The sizeable foreign exchange interventions and corresponding rapid depletion of reserves have even prompted comparisons to the Asian financial crisis (AFC) some 25 years ago.

Fears of AFC 2.0 largely unfounded

While some countries in South Asia, most notably Sri Lanka and Pakistan, have been crippled by acute economic mismanagement and unsustainable debt burdens, as has Laos in South-east Asia, the rest of emerging Asia is far more resilient and less prone to a repeat of the 1997 train of events. Here, we offer 10 reasons why.

1) The external sectors of East Asian economies are much stronger today, with many regional economies running current account surpluses, although there are some notable exceptions such as the Philippines and Cambodia.

2) There is much less dependence on foreign short-term bank debt today, which was widely regarded to be the primary source of financial vulnerability for the region in 1997 as it contributed to the sharp capital flows reversals from the region back then.

3) Most countries have abandoned the soft US dollar-pegged regimes which handicapped the regional central banks in managing external shocks. Currencies have generally become more flexible nowadays and this has helped to somewhat cushion the region from external shocks. Companies and financial markets have also become acclimatised to operating in an environment where exchange rates fluctuate.

4) Along with greater exchange rate flexibility, monetary policy frameworks in the region have become more transparent, institutionalised, and credible. This has made financial markets more confident about the ability of regional monetary authorities to maintain sound macroeconomic management in the face of domestic and global headwinds.

5) The banking sector has been comprehensively restructured after the crisis and major regional banks are far more resilient – in terms of being well-capitalised and having adequate liquidity buffers – and are better regulated today to withstand shocks to their balance sheets.

6) Capital markets are deeper and more diversified, with a lower reliance on US dollar financing in the case of sovereign debt. With the ability to borrow in local currency, governments are no longer that exposed to outsized currency mismatches and exchange rate risks.

7) The corporate balance sheets across various sectors in the region are generally in much better shape than before, reflecting in part the progress made on corporate governance standards and enhancements in regulatory oversight (though China may be a notable exception here).

8) Even though several countries in the region have experienced declines in their foreign exchange reserve holdings, this should be placed in perspective. Many Asian economies had been quietly accumulating reserves earlier, especially between the second half of 2020 and early 2021. Hence reserves are effectively back to pre-Covid levels and remain adequate based on most generally accepted measures.

9) Tangible efforts have been undertaken after the 1997 crisis to fortify external liquidity frameworks at the regional and bilateral levels for dealing with acute periods of balance of payments stress, making the region more prepared to manage crisis situations relatively swiftly when needed. This has been accompanied by an expansion of liquidity facilities provided by the IMF, creating a semblance of a layered financial safety net for the region.

10) The macroeconomic policy management toolkit for emerging economies has expanded and gained analytical backing by the IMF's integrated policy framework over the last few years, and now features a wider and more eclectic variety of instruments, including capital flow measures (CFMs) and macroprudential policies (MPMs).

Pockets of vulnerabilities

Overall, thanks to extensive and painful reforms, much of Asia is on a much stronger footing now in terms of macroeconomic and external sector resilience compared to a quarter century ago. However, some vulnerabilities remain that require resolution.

First, even though local currency bond markets have deepened within the region, the relatively high foreign ownership of these bonds in some South-east Asian countries makes them susceptible to sudden shifts in the global risk appetite. Consequently, steps need to be taken to develop a bigger local investor base within the region that is less prone to sudden and sharp capital flight.

Second, the IMF report has flagged concerns about an increasing accumulation of dollar-denominated debt in the corporate non-financial sector since 2007, which is a source of external vulnerability in the current context owing to large exchange rate movements and rising interest rates. Additionally, the increasing sophistication of regional corporates' international financial activities has made it more difficult to identify and monitor these external vulnerabilities.

Finally, while the rapid pace of financial innovation has spurred financial inclusion and efficiency, it has also created a large non-banking sector – including the fast-growing crypto universe of decentralised finance (DeFi) – which remains outside the regulatory perimeter in many countries. This non-bank sector could pose financial stability risks if not properly managed, especially in a period of tightening financial conditions and a fragile global environment.

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