Session 2, Parallel Group 2B

# Financial Vulnerability in Asia

**Stephany Griffith-Jones and Ricardo Gottschalk[1]**

## Summary

The rate of economic growth across much of Asia has been a key factor in reducing poverty. But ongoing efforts to reduce poverty could be undermined by a financial crisis or economic slowdown. This paper looks at how to make financial stability the platform for a sustained reduction in poverty across the region. Besides providing stability, the financial sector should also support pro-poor growth in 'normal times'.

The Asian financial crisis of 1997 cost the region over US$900 billion in lost output. In Indonesia, the number of people living in poverty doubled as a result of the crisis. So it is essential to minimise the risks of another financial crisis in Asia, especially at a time when the opening up (liberalisation) of economies means they are more vulnerable.

This paper looks at the strengths and weaknesses of Asian economies, focusing to some extent on China. Strengths include rapid growth, a dynamic export sector, large trade surpluses and high domestic savings rates. Some countries also hold high levels of foreign exchange reserves, as a kind of insurance policy against a currency crisis. But they could consider other 'insurance' options, based on a regional, collective approach, with the support of the international community.

In China as in other countries, the main weakness is the banking sector. Efforts are now being made to make this more robust. But other weaknesses still need to be tackled, including high fiscal deficits (e.g. India) and unsustainable debt service ratios (e.g. the Philippines). Financial markets (including the stock market and bond market) remain relatively undeveloped. This situation will change, as China is to fully open up its banking sector by the end of 2006. But the involvement of foreign banks should be gradual and well regulated, so as to avoid weakening Chinese banks further. Financial liberalisation should proceed with care until the banking sector is strengthened.

The report identifies priorities for policymakers in Asia:

- where something works well, build on it.
- where change is needed, it should be a gradual process. In the context of liberalisation, the benefits of attracting foreign capital need to be weighed against the increased costs and risks.
- as countries open up and liberalise their financial systems, care should be taken to avoid unplanned negative consequences.
- take measures to address problem areas (e.g. reduce large fiscal deficits or debt service ratios where necessary).
- regional and international systems for crisis prevention and management should be strengthened.
- as a precaution, social 'safety nets' should be put in place to protect poor people from the impact of any crisis or economic slowdown.

The overall priority is to minimise the risks of a financial or currency crisis, as this would seriously undermine ongoing efforts to reduce poverty in the region.

[1] Stephany Griffith-Jones and Ricardo Gottschalk are both Research Fellows at the Institute of Development Studies.

The views and opinions of authors expressed in this paper do not necessarily state or reflect those of DFID or the Asia 2015 organisers.
© Institute of Development Studies and Overseas Development Institute.