Managing Economic Crisis in Southeast Asia

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Preface

In January 2010, the Institute of Southeast Asian Studies (ISEAS) and the Saw Centre for Quantitative Finance, NUS Business School, jointly organized the International Conference on Managing Economic Crisis in Southeast Asia. The seven papers included in this book consist of a selection of the papers presented in the conference, and subsequently revised for publication. Chapter 1 was specifically written by the volume editor to highlight the more salient features of the similar as well as different approaches adopted by the countries to combat the global financial crisis that impacted the region.

I would like to thank the chapter writers for their excellent cooperation for presenting the papers in the conference and, more importantly, for revising the papers for publication. My thanks also go to Mrs Triena Ong of ISEAS Publications Unit for overseeing the expeditious publication of the book.

Saw Swee-Hock

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1
The Global Financial Crisis: Impact and Response in Southeast Asia

Saw Swee-Hock

Introduction

The global financial crisis, started in the summer of 2007 in the United States, triggered the greatest post-World War II economic recession that spread rapidly to all parts of the world. The ensuing shocks to the international financial system severely disrupted credit plans and dislocated economic activity everywhere. Though the financial sector in Southeast Asia was spared the more serious repercussions of the sub-prime crisis, the resultant economic recession was experienced in the region as exports of raw materials and manufactured products took a sharp downturn as external demand shrank. The countries in the region had experienced considerable damage during the Asian financial crisis in 2008–09, and have implemented many important and necessary reforms which have placed the countries in a good position to overcome the latest global economic crisis.

Economic growth had been moving on a satisfactory path throughout the region in recent years, but was severely disrupted by the economic recession. Some countries experienced a marked slowdown in their economic growth in 2008 and 2009, while the others even recorded a contraction as the impact of the recession became more serious. Businesses were affected by shrinking demand and unemployment rose to record levels in most countries. The governments in the region acted swiftly by putting in place significant stimulus packages designed to prop up the damaged sectors and to stem the rise in unemployment. By and large, the bold policy responses have enabled the countries to prevent the economic downturn from worsening and to permit the normal trajectory of economic growth to resume expeditiously. With the economic recovery well on track, the countries might have to move on to the next stage of how and when to start unwinding the stimulus packages.

Origin of Financial Crisis

The root of the financial crisis that started in the United States can be traced to the method of mortgage loans offered by financial institutions to home buyers. The normal procedure is for the lenders to go through a standard process of due diligence by verifying the status of the borrowers' income and assets to ensure that they are in a good position to pay the regular mortgage payments. During the period of housing boom engendered by prolonged low interest rates and easily-available loans, the lenders became extremely lenient in extending loans even to borrowers who did not satisfy the prime credit requirements. Some mortgage loans were recklessly provided to so-called "NINJA" borrowers known to have no job, no income, and no asset at all. More importantly, the explosion of sub-prime loans due to lax lending occurred at a time when the U.S. Government, for mainly political reasons, was actively encouraging home ownership.

The beginning of the sub-prime crisis seemed to have emerged sometime in 2006 when the Federal Reserve Bank (the Fed) began to up interest rates to combat the growing inflationary pressure. This rising cost of servicing mortgage loans led to many home owners encountering great difficulty in making their regular mortgage payments. When home value appreciates due to rising prices, the borrowers could circumvent the unfriendly interest rate environment by refinancing the original loans on more favourable terms. On the other hand, when the home value started to tumble during the market slump, refinancing was almost impossible. This led to increased defaults in mortgage payments, and eventually to foreclosures becoming rather common. In fact, 1.3 million homes were foreclosed in 2007 in the United States as compared to about 0.65 million during the period 2001–05.

There was another phenomenon that had contributed to the emergence of the sub-prime crisis, and this refers to the common practice of securitization of the mortgage loans. To make more funds available to home buyers, the banks bundled the loans together and repackaged them as new securities known as Collaterized Debt Obligations (CDOs). These derivative products based on mortgage-backed loans were then sold to investors, mostly investment banks, at very attractive terms. The investors were attracted by the better returns of the securitized CDOs and the relatively higher ratings accorded by rating agencies. There is also the perception that the CDOs were quite safe since they were secured by properties pledged as collateral by the borrowers. The additional funds raised from the sale of CDOs enabled the banks to provide more mortgage loans to primarily sub-prime borrowers.

When the sub-prime borrowers could not make their regular mortgage payments, banks had no choice but to foreclose the properties at values much lower than at the time of purchase by the borrowers. The losses incurred by the borrowers and the lenders contributed to a further downward spiral in the housing market. The value of the CDOs collaterized on the mortgage loans tumbled swiftly, or even became worthless, and the investors ceased to receive payment from the banks. In fact, it was the sub-prime mortgages that eventually led to the massive losses incurred by the holders of CDOs, and even to bankruptcy in cases where the investment banks have devoted an enormous proportion of their business to CDOs.

The final step in the sequence of events starting with the original sub-prime loans refers to the practice of Credit Default Swap (CDS). The investment banks were not unaware of the risk involved in buying CDOs upon which they used to issue derivative bonds. To deal with the possibility of these bonds defaulting, the investment banks bought insurance cover from insurance companies by making fixed periodic payments or premiums. Under this Credit Default Swap (CDS) arrangement, the insurance companies would guarantee to reimburse the investment banks any losses when the bond issuer defaulted. There are instances when the insurance companies were unable to make good these losses because they had insufficient funds to defray the huge losses arising from their massive holding of CDSs. To these insurance companies, bankruptcy became a real option.

Impact on Financial Institutions

The sub-prime problem has weighed heavily on the U.S. financial markets, resulting in permanent declines in valuation across many asset classes amidst rapid deterioration of the financial environment. Among the insurance companies that suffered massive loans by participating in the CDS arrangement was the giant American International Group (AIG). While the core insurance business of AIG was essentially sound and profitable, the same cannot be said of one of its subsidiaries which had been issuing voluminous amounts of CDSs to offer protection against losses from CDOs based on mortgage loans.

The rapid fall in home values resulting from a collapse of the property market had triggered a chain reaction that inflicted huge losses on AIG. In the last quarter of 2008 alone, it suffered a loss of US$62 billion, the biggest quarterly loss in U.S. corporate history. To limit the potential damage to the financial system, the U.S. Government came to the rescue with an infusion of US$30 billion into AIG, aside from the earlier bailout funds of US$150 billion, to prevent the company from going bankrupt. In the end, the U.S. Government was left owning some 79.9 per cent of the company's equity. Undoubtedly, the global insurance industry would have faced a great catastrophe if AIG were to be allowed to go bust. This is a good example of too big to be allowed to fail.

It was inevitable for the sub-prime mortgages to exert such a great impact on Freddie Mac and Fannie Mae, the government-sponsored enterprises entrusted with providing the much-needed finance to home buyers. They bought the mortgage loans from lenders and repackaged the mortgages and sold them as mortgage-backed loans to investors. The sharp rise in loan defaults by home owners during the property slum led to enormous losses and imminent bankruptcy. To restore some semblance of financial stability and confidence in the market, the U.S. Government nationalized these two companies. About US$1 million preferred shares in each company was acquired by the U.S. Treasury. In addition, more stringent controls were introduced governing capital requirements, portfolio holdings, and acquisition of exotic loan products. In an attempt to provide more businesses to these two ailing companies, they were permitted to extend loans to buyers of more expensive houses and to hold less cash in treasury.

The sub-prime housing bubble had inflicted tremendous strain on investment banks, particularly those which had been purchasing vast amount of CDOs and CDSs. One of them was Bear Stearns which was holding a large quantity of these financial products. As expected, it posted big losses, and by March 2008 did not have sufficient funds to open for business. It had to approach J.P. Morgan for a big loan, and it was eventually agreed that the latter would undertake to guarantee US$29 billion for potential losses. The U.S. Government was also forced to come in with an exposure limited to US$29 billion. With the infusion of new capital, Bear Stearns was able to resume normal business.

The other venerable investment bank, Lehman Brothers, was not so lucky when it suffered massive losses during the sub-prime crisis. Without the injection of additional working capital from other financial institutions and/or the U.S. Government, it came as no surprise that Lehman Brothers should file for bankruptcy on 15 September 2008. The collapse of such an important institution disrupted the smooth functioning of the entire financial market in the United States and other countries where Lehman Brothers had a significant presence. For sure, the financial environment in Singapore was rocked by the collapse of Lehman Brothers, with the Lehman Minibond Notes and other structured products becoming worthless to many individual investors.

A somewhat different path was undertaken by the two investment banks, Morgan Stanley and Goldman Sachs, which have taken a serious beating by the sub-prime crisis. In an attempt to save themselves, they have chosen to convert into commercial banks to enable them to accept deposits to boost their capitalization. In adopting this survival strategy, the two newly converted banks had to accept the prohibition of dealing in unfamiliar derivative products and credit instruments that caused them to get into trouble in the first place. Like other commercial banks, they were subjected to stricter level of control and surveillance and by a lower leverage ratio of assets-to-borrowing.

Aside from insurance companies and investment banks, some commercial banks were exposed to the financial disruption, with smaller unknown banks declaring bankruptcy. The big banks, exerting a pre-eminent influence in the U.S. economy, were just not allowed to go bust, and even encouraged to receive financial aid from the U.S. Government. Among the nineteen banks that secured government aid was the Bank of America which received US$25 billiion in late 2008 and a further US$20 billion in the following year. The infusion of capital came from the U.S. Government bailout fund known as Troubled Asset Relief Program (TARP).

TARP was a special plan established by the U.S. Government to curb the financial turmoil by taking over troubled mortgages held by financial institutions. Armed with an initial sum of US$250 billion, the U.S. Treasury was authorized to buy and sell the mortgages, and to use the profits to purchase more assets. This enabled the initial function to be enlarged to US$350 billion. Financial institutions that took advantage of the facilities offered by TARP were able to lower their debt-to-capital ratio, and were therefore more willing to resume lending to consumers, businesses, and other banks. This rescue plan succeeded in injecting greater liquidity into the financial system, although the government loans were expected to be paid back in due course. What has also happened is that the U.S. Government has become a major shareholder of the participating institutions.

Not surprisingly, the negative impact of the sub-prime loans was quickly felt in Europe because of the close links among the major financial institutions across the Atlantic. Many financial institutions in Europe had to be bailed out by their respective governments, while others had to file for bankruptcy. In Britain, Northern Rock was the first to suffer a bank run in the autumn of 2007 when some £1 billion, or 5 per cent of its deposits, was withdrawn in one day on 14 September. The Bank of England stepped in to provide an emergency funding of about £26 billion, which in reality meant that the bank was being nationalized by the British Government. This was followed by a comprehensive bailout plan designed to provide extra capital, greater deposit insurance, more loan guarantees, and repurchase of securities. The British plan, with some modifications, was adopted by many European countries to weather the financial tsunami that was deepening and spreading relentlessly. Clearly, the governments would have to continue to improve and streamline their regulatory and supervisory regimes.

Economic Recession in Southeast Asia

The turmoil engendered by the sub-prime loans was felt in almost every sector of the economy, and swiftly developed into the worst global economic recession since the Great Depression in the 1930s. In the United States, particularly affected were the housing market, the car industry, manufacturing and retail trade, resulting in a drastic reduction in demand for imported goods. As the U.S. economy deteriorated and shrank, unemployment rose to unprecedented level. In an interdependent globalized world, the economic recession originating in the United States quickly spilled over into almost every part of the world. Countries that have built their economic system with great emphasis on export-orientated activities have been affected more severely as the demand for their products in the West collapsed.

Although Southeast Asia escaped the initial shock as its financial institutions did not hold much toxic assets, the region was pummelled by the sharp drop in external demand from the developed countries. Suddenly, the economies of some countries grew at a slower rate, while the others even contracted as the global demand for their raw materials and/or manufactured goods fell dramatically. Many businesses barely survived and others went into receivership. Unemployment rose sharply as workers lost their jobs when companies began to downsize their workforce or went bankrupt. New jobs were of course scarce during recessionary period. As expected, there was considerable differences in the severity of the economic recession among the ten countries in the region.

At the height of the recession in 2009, negative growth was indeed experienced by Thailand (–2.2 per cent), Cambodia (–2.0 per cent), Malaysia (–1.7 per cent), Singapore (–1.3 per cent) and Brunei (–1.2 per cent). The prolonged political unrest in Thailand, accompanied by a steep decline in tourist arrivals, has undoubtedly contributed to the worst recession recorded in the region. As for the oil-state of Brunei, the economic contraction can be attributed mainly to the fall in the value of exports due to the drop in the price of oil. The economies of the other five countries managed to expand in 2009, but at a much reduced pace. Fortunately, for the region, the Indonesian economy, anchored essentially by domestic demand, fared quite well with 4.5 per cent growth. So did the relatively closed economy of Myanmar with 4.4 per cent, and Vietnam with 5.3 per cent. Due to the sharp reduction in remittances from its overseas workers, the Philippines did not do so well, registering only a small growth of 0.9 per cent.

The immediate response to the economic recession from the countries in the region took the form of significant monetary and fiscal stimulus aimed at supporting domestic demand and paving the way for an early recovery. Fortunately, the past reforms undertaken during the Asian financial crisis of 1997–98 have provided many ASEAN nations the monetary and fiscal space to ease liquidity and pump-prime the local economy. The various stimulus programmes could therefore be more effective in allowing the economy to weather the recession and to perform better than one can possibly expect in 2009. The continuation of the economic expansion in early 2010 seems to suggest that a V-shaped recovery is a distinct possibility, with however some variation in the exact timing of the recovery among the countries in the region.

One should not forget that the economic recovery was, to some extent, made possible by the improving external environment in the developed countries most affected by the sub-prime loans. Indeed, the various stimulus measures implemented in the developed countries have stabilized the financial markets, and thus permitting the recovery to be sustained and widespread. China and Japan, the region's biggest trading partners, have registered satisfactory growth in the last quarter of 2009, and poised for stronger growth in 2010. The brighter outlook for the global economy, coupled with the effective local stimulus, will see all the countries in ASEAN experiencing better growth in 2010 and beyond, albeit at a slower pace as compared to the pre-crisis period.

In examining the experience of the individual countries in the region, we have decided to focus on those important countries more influenced by the global financial crisis. These countries have responded decisively by implementing diverse but significant stimulus packages to revive their battered economies. The more important objectives of the stimulus were to help the suffering businessmen, reduce unemployment, and minimising individual hardships among citizens most affected by the economic slump. The countries that are not covered in this book are Myanmar, Cambodia and Laos, which are the least developed economies primary dependent on domestic demand. Also excluded is the tiny nation of Brunei whose economy is dominated by the oil industry.

Country Experience

We will begin with the city-state of Singapore which has the most open economy with a significant financial sector and a high-end manufacturing industry churning out products for the world market. Against the backdrop of the global economic recession, the economy of Singapore started to contract in late 2008 on account of its manufacturing, transport, logistic and external trade closely linked to global and regional trade flows. It is not surprising that the impact of the crisis on the real economy proved to be quite damaging culminating in a slow growth of 1.8 per cent in 2008 and a negative growth of 1.3 per cent in 2009.

The collapse of Lehman Brothers devalued all the Lehman related structured products marketed in Singapore, with huge losses incurred by retail investors. There is apparently some mis-selling of these products such as Lehman Minibond Notes, DBS High Notes, Jubilee Notes and Pinnacle Notes. The Monetary Authority of Singapore (MAS) intervened and investigated the sale of these products by ten financial institutions. The outcome was a ban imposed on the sale of the products by the institutions for periods ranging from six to twenty-four months, the length of which depended on the extent of mis-selling. Furthermore, the institutions were encouraged to compensate their clients saddled with troubled loans, and investors were given the opportunity to channel their grievances to the newly-established Financial Industry Dispute Resolution Centre.

As for the wider issue of tackling the economic recession, the Singapore Government responded swiftly by implementing a wide range of stimulus measures. By far the most significant programme was the S$20.5 billion Resilience Package presented in the 2009 Budget in February of the year. The key aims of the stimulus were to assist badly damaged companies to stay afloat and to save jobs in the midst of deteriorating employment condition. On the whole, the stimulus has succeeded in preventing a further worsening of recession and in engendering a quick and robust recovery. The financial crisis in Singapore, as in other countries, was influenced not only by the sub-prime mortgages, but also by the failure of some proper supervision and regulation of the financial system. In this respect, some remedial measures were introduced in Singapore.

The chapter on Malaysia presents a detailed account of the performance of the economy during the period 2007–09. The Malaysian economy expanded by a healthy 6.2 per cent in 2007, but by a lower pace of 4.6 per cent in 2008. In fact, the quarterly figures for the latter year has already pointed to a clear downturn of the economy, progressive lower rates of 7.4, 6.6, 4.8 and 0.1 per cent in the respective four quarters. This downtrend continued into 2009 when the economic recession first emerged with the economy contracting by 6.2 per cent in the first quarter. This was followed by better figures of –3.9 per cent and –1.2 per cent in the next two quarters. Other aspects of the economy such as industrial production, tourism, international trade, domestic and foreign investments, inflation and external reserves were also examined in the chapter.

The quick response of the Malaysian Government to the economic recession took the form of monetary and fiscal stimulus programmes. A RM700 million stimulus package was implemented to create some 163,000 training and job placement opportunities in the public and private sectors. One component of the package was a RM50 million worth of modular training for workers wishing to upgrade their skills. All these measures served as a useful buffer to the depressed labour market.

Another component of the stimulus package was the liberalization of twenty-seven services sub-sectors in April 2009 for foreign investors to make up the shortage of local capital and expertise. Among the sub-sectors opened up were computer and related services, health services, tourism, transport and shipping. To reinforce this measure, the 30 per cent Bumiputra equity requirement for newly-listed companies was abolished with effect from June 2009 to create a less oppressive environment for investors. In regard to taxation, the personal income tax was reduced from 27.0 per cent to 26.0 per cent in 2010. Individual relief and deduction were also increased for the same year.

The financial sector of Thailand has escaped the more serious negative impact of the sub-prime loans. This is because the Asian financial crisis of 1997–98 has forced the Thai Government to introduce many important reforms.

Consequently, the Thai banks have adopted a conservative strategy by not exposing themselves to risky foreign assets and non-performing loans. Their capitalization and liquidity remained essentially intact during the current global financial crisis. However, the real economy could not escape being damaged by the economic recession that inflicted the whole world. In the first place, the steep fall in external demand led to a massive contraction of total trade, by 19.7 per cent in 2009. The detailed quarterly figures for the year revealed a steep decline of 28.7, 29.7 and 22.9 per cent in the first three quarters respectively, with a small rise of 6.1 per cent in the fourth quarter. Mainly because of this unfavourable trend, the economy contracted by 2.3 per cent in 2009 as compared with a positive growth of 2.5 per cent in the previous year. Unlike the other countries in the region, there was the extensive political unrest that inflicted considerable damage to the Thai economy.

Two stimulus packages were implemented by the Thai Government. Stimulus Package I, amounting to 117 billion baht, was introduced in March 2009 to encourage more consumption and to mitigate the hardships of the people. They, especially the low income earners and senior citizens, were given special allowances, free utilities, and free travel on bus and train. With the aim of assisting home buyers, real estate developers, building material producers, and construction workers, the income tax deduction for home buyers was raised from 100,000 billion baht to 300,000 billion baht and the tax rate on property transfer and registration was also lowered. Pump-primary infrastructure projects such as road building, canal development and water projects were started, particularly in the rural areas.

In mid-2009, the Abhisit Vejjajiva Government decided to introduce Stimulus Package 2 with the specific objective of promoting long-term economic development. This second package consisted of a 1.43 trillion baht for the three-year period 2010–12 to be utilized to fund important infrastructure projects. The total sum was divided into 1.11 trillion baht meant for government projects and 321 trillion baht for state-owned enterprise investment projects. In a way, the objective of the second package was intended to remedy the inadequate funding for infrastructure development in the past. The lack of good infrastructures has been a major bottleneck in the economic development of the country.

Vietnam did not dip into recession during the current global economic crisis. What happened was that its predominantly agricultural economy continued to expand, though at a slower rate. The annual growth rate was lowered from 8.5 per cent in 2007 to 6.2 per cent in 2008 and 5.3 per cent in 2009. In the main, the growth of the economy has been driven by domestic consumption rather than external demand. In responding to the economic slowdown, the Vietnamese Government has therefore placed greater emphasis on encouraging domestic activities and consumption. First, there was the easing of the monetary policy. The required reserve ratio was lowered significantly from 10 per cent to 3 per cent in March 2009. The base interest rate was slashed from 13 per cent to 7 per cent in February 2009, remaining unchanged until November 2009 when it was raised to 8 per cent. The exchange rate policy was implemented in a more flexible manner. Consequently, the official interbank exchange rate was gradually adjusted upward, and the band for exchange rate was widened from