The global financial and economic crisis has been frightening and severe, but it provides an opportunity for many policymakers worldwide. Responding to the current crisis and beyond, Asia can fundamentally redesign its approach to development and bring about more sustainable, balanced growth. There is a huge potential for Asia to become not only a major source of manufactured products, but also a major source of demand for goods and services. For this to happen, it will take the creation of new institutions and forums, such as an Asian Monetary Fund and an Asian Financial Stability Dialogue, and a firm policy commitment by Asian leaders.

In order to craft a road map to get there, an analysis of the current financial crisis — how it happened and how the affected-economies have responded — is necessary.

Most importantly, the crisis was the product of built-up systemic financial risks in both the US and Europe. The US crisis, of course, followed the bursting of a housing price bubble created by excess liquidity and undue risk taking. Three key factors were: loose monetary policy; inadequate financial supervision and regulation; and large, persistent current account deficits. The failure
While the negative effects of the current global financial crisis are severe and obvious, one possible benefit is that it affords Asia a unique opportunity to step forward and take a more decisive role in shaping the global financial architecture of the future. Masahiro Kawai, Dean of the Asian Development Bank Institute, argues that Asian policymakers should seize this opportunity to reshape their economies and regional relationships in order to give Asia its rightful place at the global table.

Of US monetary policy to contain excess liquidity in the face of the emerging housing bubble was a major factor behind a build up of financial risks. It is now well known that the US Federal Reserve did not aggressively address the housing bubble, but rather responded to its bursting with monetary policy easing. Wide gaps in financial supervision and regulation — a result of a highly fragmented regulatory structure and weak oversight of investment banks, insurance firms, rating agencies, and derivatives — allowed a shadow banking system to expand enormously and pose grave systemic risks. In addition, large, persistent current account deficits enabled over-spending and artificially prolonged the housing bubble.

In Europe, financial institutions were not innocent bystanders. Major European financial institutions not only invested in toxic US assets, but also had exposure to inflated domestic real estate and volatile Eastern European economies. They financed these risky investments largely by wholesale funding through international and domestic capital markets. In the Eurozone, a single monetary policy allowed for divergences among countries in real interest rates and real effective exchange rates due to differential inflation rates. As a result, countries with higher inflation faced lower real interest rates and stronger real exchange rates, thereby fueling active housing markets, property development and foreign borrowing. These contributed to the build up of macroeconomic and financial risks in a number of countries, especially in the UK, Ireland, Spain, and Greece. Vulnerabilities were even more apparent, with larger current account deficits, in some of the peripheral, non-Eurozone countries in Europe, including Iceland, Hungary, and the Baltic states. Many European financial institutions had large exposures to these financially vulnerable countries.

A second major factor was a weak international financial architecture that was unable to cope with the pace and complexity of financial globalization and rapid innovation. What began as the US sub-prime mortgage crisis rapidly spread to a general crisis in US and global capital markets and then to the real economy as manufacturing output and trade declined worldwide. All developed economies experienced financial turmoil and recession; most emerging economies were also affected, particularly those which borrowed excessively in foreign currency or depended heavily on US (and European) markets for exports.

The spillover impacts of US and European vulnerabilities on global finance and economic activity were clearly underestimated. The International Monetary Fund (IMF) failed to discern the depth and severity of the macroeconomic and financial risks and implications of the US sub-prime crisis and the European risks for global finance, trade and capital flows. It was not able to compel the US and Europe to take necessary policy steps to reduce economic and financial risks.

Furthermore, there was no international framework capable of regulating, monitoring and supervising the cross-border activities of systemically important financial institutions, their products; and, more generally, global financial markets. Ideally, a global financial body should have been in place to supervise, regulate and ultimately prevent a global financial crisis as well as resolve internationally active, insolvent financial institutions. Such a body could have provided rapid analysis and a timely warning of a crisis...
and helped further global financial integration in a stable manner.

PREVENTING FUTURE CRISES

Developed economies, particularly those at the center of the global economy—the US and Europe—have a clear responsibility to maintain sound macroeconomic and financial conditions because crises in these economies have severe ramifications for the global economy. Three steps are needed.

First, the major central banks in the world—the US Federal Reserve and the European Central Bank—must aim to ensure both price stability and financial stability; the loss of such stability can affect not only one’s own region but also the rest of the world. Essentially, these central banks need to run prudent monetary policies that prevent both goods price inflation and financial excesses. In the Eurozone, stronger policy coordination is needed among national fiscal authorities and financial regulatory agencies for financial stability. With a single central bank, Eurozone monetary policy cannot adequately address the problem of low real interest rates in countries with high inflation rates, a situation that can over-stimulate economic activity in real estate and other asset markets. Fiscal policy restraint and tight financial supervisory and prudential measures will be needed to prevent excessive booms in these countries.

Second, the world’s leading economies need to significantly strengthen financial supervision and regulation. In the US, given the increasingly interconnected nature of financial activities and the rise of financial conglomerates, it makes sense to create a consolidated regulatory structure to oversee a wide range of financial services. However, this possibility does not seem likely to happen. At least banking supervision and regulation should be consolidated, oversight of derivatives transactions should be strengthened, and large regulatory gaps should be eliminated. According to the Obama administration’s proposal, the Federal Reserve will be in charge of supervising and regulating systemically important financial firms and is likely to conduct macro-prudential oversight. A clear resolution regime for nonviable financial institutions will also have to be introduced. The Fed will have to work closely with other regulators and the Treasury for effective crisis prevention, management and resolution. The European Union’s decision to establish a European financial supervision system—including a European Systemic Risk Board to oversee the stability of the financial system as a whole and a European System of Financial Supervisors as the region’s micro-prudential coordinator—is highly welcome. Europe also needs a region-wide resolution framework.

Third, the world’s leading economies should not run unsustainable current account deficits, which are sources of global financial instability. As a result of the global financial crisis, the US is now undergoing a rapid adjustment by reducing household consumption, which is contributing to a more sustainable current account. But this adjustment is quite disruptive because it is accompanied by sharp declines in demand, output and employment, forcing current account surplus economies in Asia to go through corresponding adjustments due to their shrinking export markets. With more balanced current accounts globally, the financial crisis would not have had such a negative impact on the global economy, particularly the Asian economy.

NEEDED: STRONGER FINANCIAL ARCHITECTURE AND A REFORMED IMF

One of the factors behind the global financial crisis was the lack of a strong international financial architecture. To correct this, the IMF must reestablish itself as an effective, credible, and trustworthy institution. It must focus on strengthening macro-financial surveillance of systemically important economies (like the US and the EU) to assess their impact on the world economy and improve multilateral consultation on issues, such as global payment imbalances, to promote global macroeconomic and financial stability. The IMF should be in a position to compel these leading economies to correct policies if necessary.

I welcome the decision by the G-20 leaders to establish the Financial Stability Board (FSB) as a
successor to the Financial Stability Forum (FSF) with expanded membership from 12 to 25 members\(^1\). The FSB aims to address financial vulnerabilities and to develop and implement regulatory, supervisory, and other policies. It is mandated to collaborate with the IMF to provide early warnings of macroeconomic and financial risks and to take action to address them. For the FSB to perform its functions, it is essential that the US and the UK—the site of the two most dominant global financial centers—fully commit to the substantial upgrading of regulatory and supervisory policies.

For the IMF and FSB to be successful, they need to work with regional organizations with similar mandates. A regional counterpart of the IMF is found in the EU’s support for Iceland, Eastern European countries, and the Baltic states that were affected by the global financial crisis. A regional financial stability organization is currently under construction in Europe and a similar structure is needed in Asia.

A stronger international financial architecture requires fundamental governance reform in key international institutions, particularly the IMF. Even though it has now acquired extraordinarily large resources—tripling from $250 billion to $750 billion—prompted by the global financial crisis, the IMF will not become credible or gain trust without significant reforms. Currently the IMF is de facto monopolized by Europe and the US; Asia does not have a sense of ownership or influence. Europe is over-represented with more than one third of the voting power and with eight seats on the board of twenty-four executive directors. The US has the only veto power and the managing director of the IMF has always been a European.

To become credible and trusted, at least by Asians, the IMF needs to implement three major changes: 1) Europe’s voting power needs to be reduced by 10 percentage points; 2) no country, including the US, should have veto power; and (3) the next managing director should be chosen from Asia. Without such fundamental changes, Asian members will never have the sense of ownership and influence needed to regard the IMF as a trustworthy partner.

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**ASIA’S POLICY AGENDA**

Asian economies benefited tremendously from export-led growth centered on US and European markets in recent decades. But this growth model can no longer be relied upon to sustain the region’s economic growth beyond the crisis. Asian economies need to adapt to a new global environment where the world’s leading economies—the US and EU—will no longer be the growth engines of the world economy. The challenge will be to develop a greater emphasis on domestic and regional demand.

Asian policymakers need to rebalance and diversify sources of economic growth through implementing four essential measures, listed in order of priority:

- **Demand-side policies to strengthen household consumption**, particularly by strengthening social protection systems—including those for health, education, unemployment, and pensions—to reduce precautionary savings.
- **Supply-side measures to stimulate non-traded sectors**—such as services—and facilitate better alignment of domestic production with domestic demand. This can be done by promoting not only...
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traditional services, but also IT-based, knowledge services, and “green” sectors focusing on renewable energy development, energy conservation and environmental improvement. Small and medium-sized enterprises often play a significant role in these areas.

• Regional market integration to encourage regional trade in goods and services and cross-border investment, thereby enhancing the potential for long-term growth. Integration of financial markets is also crucial to mobilize the high level of savings within the region and promote investment in infrastructure.

• A stronger regional financial architecture to support the rebalancing of Asian economies. Asian policymakers will have to be convinced that a reduction of current account surpluses will be met by a credible regional reserve pooling arrangement, like an Asian Monetary Fund; otherwise their desire to continue to accumulate foreign exchange reserves will persist.

The challenges are substantial, but the current crisis affords an opportunity for Asia to fundamentally redesign its approach to development and bring about more sustainable, balanced growth. There is a huge potential for Asia to become not only a major source of manufactured products, but also a major source of demand for goods and services. But in order to achieve this, an unprecedented level of policy cooperation will be required.

REGIONAL MARKET INTEGRATION

Asians should promote Asia—particularly the rising middle-class in emerging Asia—as the primary growth market for their products, inputs and outsourcing. The creation of an Asia-wide free trade and investment area beyond the ASEAN Free Trade and Investment Area can contribute to this goal. Such an initiative would expand markets and create greater business opportunities within the region. Currently, there are many overlapping bilateral and plurilateral free trade agreements in the region, posing the Asian “noodle bowl” challenge. Consolidation of the noodle bowl into a single agreement would enable more Asian firms to enjoy the benefits of freer trade and investment. Trade liberalization in both goods and services is critical to further expand regional markets and demand.

One of the factors behind the global financial crisis was the lack of a strong international financial architecture. To correct this, the IMF must reestablish itself as an effective, credible, and trustworthy institution.

Asian governments should take concrete steps toward establishing an Asia-wide economic partnership agreement (EPA) starting with the ASEAN+3 or ASEAN+6 members. For this to be possible, both a Japan-China EPA and a Japan-Korea EPA need to be concluded as soon as possible.

Such market integration should also cover finance because further integration of financial markets can facilitate the recycling of Asia’s high savings for regional investment, particularly when capital inflows from other regions are shrinking. Further development of Asian bond markets—through the establishment of a credit guarantee and investment mechanism to allow greater local-currency bond issuance—is key to the acceleration of domestic currency investment financing. A recent study by the Asian Development Bank and its Institute, Infrastructure for a Seamless Asia, recommends the creation of an Asian Investment Infrastructure Fund as a mechanism by which infrastructure projects in the region can be prioritized and funded.

ESTABLISHING AN ASIAN MONETARY FUND

Asia should establish new regional institutions and forums to complement the global financial architecture provided by the IMF and the FSB. This implies that global institutions should also clarify their roles and expertise in relation to regional institutions. Global institutions have a role to ensure global consistency, but this does not mean that they set all the key agendas and that regional institutions simply follow their lead.
Mutual feedback and interactions between the two will be highly desirable.

The ongoing multilateral expansion of the Chiang Mai Initiative (CMI)—with financial resources of $120 billion—could eventually lead to the creation of an Asian Monetary Fund (AMF) once a strong, independent professional secretariat is set up, and the CMI’s linkage to the IMF is removed. The decision by ASEAN+3 finance ministers to create both a surveillance unit (a de facto secretariat) and an advisory panel of experts (a de facto board of executive directors) supports this development. A new AMF should be able to handle regional financial crises given the region’s large foreign exchange reserves.

The AMF would encourage many Asian economies to rebalance growth toward domestic and regional demand while correcting payment imbalances. After the Asian financial crisis of 1997-1998, many economies in the region saw building massive foreign exchange reserves as effective self-insurance against currency crises. For them, the alternative of going to the IMF would be political suicide because of lingering bad memories of what was widely called the “IMF crisis” by the public at large. These economies had every incentive to accumulate reserves by running large current account surpluses or intervening in currency markets. The region’s emerging economies would welcome rebalancing if an AMF, free of the stigma attached to the IMF, could reduce financial turbulence and act as the region’s lender of last resort. Under the current crisis situation, policymakers also should consider greater flexibility in using the CMI, in line with the IMF’s recently introduced Flexible Credit Line.

Setting up an Asian Financial Stability Dialogue (AFSD) among the region’s financial authorities would facilitate financial sector stability and development and would complement the FSB’s global effort to strengthen cross-border financial supervision and regulation. Its mandate would be to detect and address financial sector vulnerabilities in the region by monitoring key financial products, institutions and markets and encouraging the region’s policymakers to take policy actions to reduce financial risks. It would help harmonize financial market infrastructure and allow regional members to respond to financial crises once they occur. Since membership in the FSB does not include all Asian economies, the AFSD would play an important role in bringing global policy directions to the region and, in turn, bring a regional perspective to the global FSB process. The AFSD would have to work closely with an AMF to ensure macroeconomic and financial system stability, just as the FSB and the IMF will have to collaborate at the global level.

IN CONCLUSION
In global forums such as the G-20, Asian policymakers should communicate their views, experiences and interests and be firm about what is needed:

- Asia’s macroeconomic policy responses have been swift, properly scaled and effective and it will be the first region to recover from the current global recession.
- Asia will do everything possible to rebalance growth, but this requires similar policy measures on the part of the US.
- To maintain a stable global financial system, the world’s leading economies (the US and EU) need to strengthen financial supervision and regulation.
- The IMF needs to reestablish its credibility and trust by focusing on effective surveillance of systematically important economies such as the US and EU and by implementing substantial—not marginal or merely symbolic—governance reform.
- Developed economies (particularly the US and the UK) should give the Financial Stability Board their full political support and the resources and expertise needed to enable it to carry out its new mandate effectively.
- Finally, a regional financial architecture—including the broader multilateral Chiang Mai Initiative and an eventual Asian Monetary Fund as well as an Asian Financial Stability Dialogue—should be an integral component of a new global financial architecture.

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