Danger of Financial Collapse and Risk Management in Asia - Pacific Region

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Recent changes in finance markets of Asia-Pacific countries have led questions of stability of regional economies. Although the regional finance market enjoyed the stability in the past few years but emerging risks could cause instability in the coming years. This article will discuss factors that cause recent fluctuations and examine how regional economies are protected from domino effects. Finally, it suggests four solutions to the risk management.

1. Increased demand

International investors have regularly bought stocks from Asian countries since 2004 and caused prices to rise (see Figure 1). This region attracted US$39 billion worth of investment in 2005 – equaling 63% of the net equity capital of developing countries. The hottest stock exchanges of the region are in China, Thailand and India. International investors also bought other assets, including bonds and commodities from both developed and emerging markets.

Purchase of stocks is stimulated by both internal and external factors:

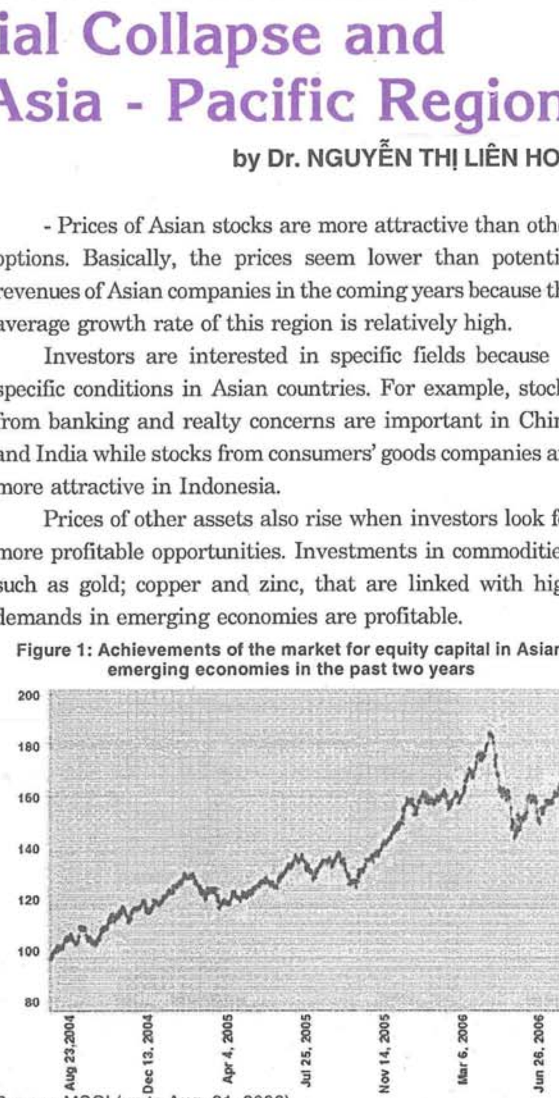
- In developed countries, especially Japan and the U.S., the interest rate is usually low. The American interest rate fell from 6.5% in 2001 to 1% in 2003. Japan has maintained an interest rate of 0% since 2001. Flow of indirect investment to Asian economies has increased quickly when loans in cheap foreign exchange, such as the yen and the dollar, were used for buying stocks and other assets.

- Prices of Asian stocks are more attractive than other options. Basically, the prices seem lower than potential revenues of Asian companies in the coming years because the average growth rate of this region is relatively high.

Investors are interested in specific fields because of specific conditions in Asian countries. For example, stocks from banking and realty concerns are important in China and India while stocks from consumers' goods companies are more attractive in Indonesia.

Prices of other assets also rise when investors look for more profitable opportunities. Investments in commodities, such as gold; copper and zinc, that are linked with high demands in emerging economies are profitable.

Figure 1: Achievements of the market for equity capital in Asian emerging economies in the past two years



Source: MSCI (up to Aug. 21, 2006)

2. What have made a difference in recent years

The situation changed suddenly on May 10, 2006 when the stock prices fell globally. Stock prices in the Asia-Pacific fell in May and June experiencing the biggest monthly fall since September 2002. After a short period of stability in late June, the stock market fluctuated again in July. All countries in the region were affected by the record fall of the year. Commodity exchanges also experienced remarkable falls. In mid-June, price of copper fell by 25% and gold by 23% in comparison with ones in May.

The first noteworthy was the fact that the FED increased the interest rate by 5% on May 10, 2006. Investors couldn't anticipate it when they thought that the interest rate would stay at 4.75%. Although the FED has 15 times increased the interest rate since 2004, they were all predictable. Changes in the direction of a tight monetary policy in May by the American government (and by the Japanese in March) reduced the liquidity. Those two facts made the international investment in Asian assets fall considerably.

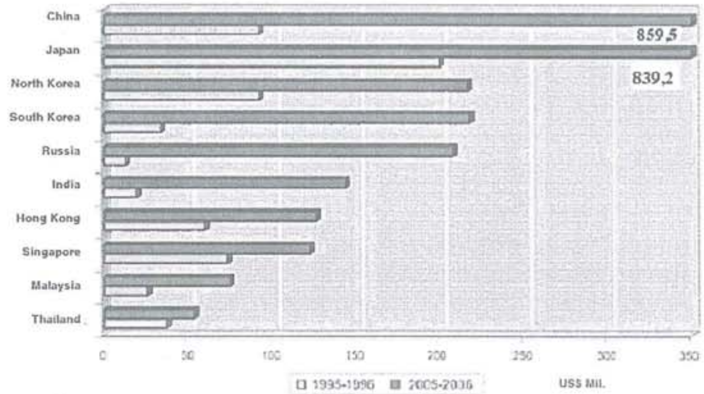
The latest signs of instability from the market for equity capital came from worries about political situation in Middle West and its effects on the oil price. Rises in the American interest rate also caused long-term concerns about its economic growth in future. High interest rates could lead to low growth rate because it reduces spending, investment and value of individual assets due to lower value of real estates. Integrated effects of these factors on American spending cause impacts on Asian export. Exporters in this region could meet depression in future, which affects badly their stocks' prices.

3. Need to prepare better conditions right now

Instability of the Asian finance markets causes worries because bitter memories of the 1997 crisis are still fresh but present changes don't produce signs of a crisis because Asian countries are much stronger now.

Regional countries are in stronger position to keep changes under control. In 1997, the sale of Asian assets came from worries about unstable macroeconomic foundation of these countries because of high foreign debt and fixed exchange rate system. These countries have adopted more flexible exchange rate systems and ensured bigger foreign exchange reserves (see Figure 2). Moreover, these countries enjoy the world's best prospects for economic growth. For example, official statistics from India in May show that its export and industrial production reached their peaks in the first half of 2006. The Chinese growth rate in the second quarter of the year rose to a record level of 11.3% - the highest in the past decade.

Figure 2: Biggest foreign exchange reserves in Asia- Pacific (US$ million)



Source: IMF, June 2006 (including gold reserve)

At present, assets are sold at the same prices all over the world after the oil price and American interest rate rose. Particularly, the Asian market for equity capital is not considered as a target as in 1997. Stock exchanges in many emerging economies in South America and Eastern Europe, such as Mexico, Brazil, Turkey and Russia, are suffering recession.

Asian countries are less dependent on the foreign indirect investment, so any outflow of capital produces a smaller impact. Foreign direct investment increases remarkably as compared with the last decade. The inflow of indirect investment is also smaller in absolute terms. There is a common fall in the movement of capital and asymmetry of loan terms. Proportion of short-term financing from external debt has decreased remarkably.

Banking systems in Asian countries have been beefed up and their profitability has increased in recent years. The capital adequacy ratio in Asian banks have risen and most of them topped the internationally- agreed mark of 8%. Doubtful debt has decreased in most countries.

4. Is a healthy adjustment needed?

According to current expectation of the Asian dynamics, the fall in the market for equity capital could be seen as a healthy, reasonable and necessary adjustment. The P/E ratio of a company has relations with its future income and this ratio is important to investors when valuating the prices of stock. Ratio analysis shows that stocks in certain Asian exchange have been overestimated in comparison with the average level of emerging markets. Recent adjustments, however, seem to make the stock prices move to an acceptable level.

In some other markets, such as ones in Thailand, Hong Kong, China and Singapore, the P/E ratio fell in the past two years, cuts in selling prices have nothing to do with the worry about overestimation.

In short, the revaluation of the market for equity capital could be seen as an adjustment process in which the stock price becomes more appropriate to performance and prospects of the company and the whole market after a period of low profitability ratio for markets for assets in developed countries.

At present, the economic foundation of Asia is still healthy. Some remarkable risks, however, come from external events:

- The increased and high price of oil is a serious threat to the prospects of oil-importing economies in the region. High price of oil leads to high inflation rate and damage to the balance of payments on current accounts of oil-importing countries. Moreover, the high price of oil also requires unfavorable adjustments, such as reducing the supply of fuel and increasing the interest rate.

- Increases in the interest rates in developed countries, especially in the U.S., Japan and Europe, may come from the fact that the inflation in these countries shows an upward tendency. This situation could lower the world's growth rate. Asian economies will be affected by falls in the demand for exports and through the need to increase the interest rate in these economies.

- Some Asian countries have seen increases in prices of real estates in recent years. A considerable rise in the interest rate may affect mortgagors and owners of real estates, which leads to lower spending. Governments in these countries have realized this danger and some of them have started controlling the price of real estates.

- Although these reasons are main factors that reduce interest of foreign investors in regional countries, the outflow of capital may increase too much because of their excessive reactions and effects from the outflow from other countries. This behavior is common in economic crises, in 1997 for example, and it's hard to prevent once it has occurred. Risks also become bigger because of increases in contingency funds and investment financed by debts in the region in recent years. A greater decrease in the price of assets may highlight unfavorable domino effects among countries through these channels.

5. A 4-solution approach to a strong and flexible economy

When Asian economies integrate into the global economy, they will face high degrees of risks caused by frequent changes in the global environment. Building a strong and flexible economy to overcome global shocks and adjust to new conditions is a matter of great importance. Establishing firm macroeconomic and microeconomic bases, a healthy financial sector and regional cooperation in finance markets are essential to this effort:

(1) Asian countries should ensure firm macroeconomic bases in order to win confidence of investors and maintain their economic growth. Key elements in inflation control and stabilization are: right fiscal policy to keep budget deficit low and debt burden at a bearable level; and a flexible exchange rate system that can absorb external shocks and reduce asymmetry of loan terms.

(2) Countries should develop healthy financial sectors to generate trust in and benefits from the inflow of capital. This requires a well-built law system to prevent bad debts. Independence and fair competition for banks to ensure effective distribution of credits and revaluation are also necessary factors. Authorities must diversify by degrees new and complicated products that are in use in regional finance markets. The most noteworthy is sectors that develop fast credit and structured credit derivatives. Knowledge of and system for risk management should be updated in order to ensure early warnings of any reverse of flows of capital.

(3) Countries should establish healthy microeconomic bases in order to ensure efficiency for the economic system. A basic requirement is the right to get clear information about assets, supervised by powerful administrative machinery for companies and institutions to operate effectively and transparently. The labor market should be flexible enough to regulate economic recessions. Social security net must be more developed in order to protect the public from difficulties in such periods. Emphasis must be put on retirement and unemployment insurance.

(4) Countries should beef up regional cooperation in order to reduce effects caused by instability of the finance markets. Positive changes in this direction have made their appearance. Asian+3 economies are sharing information about the flow of indirect investment, cooperating with one another in legal activities, establishing a financial support mechanism to deal with dangerous movements of capital through the Chiang Mai Initiative about monetary transactions. Funds for financial support are short because base assets can only meet the demand to a necessary extent. Efficiency of the regional supervision on domestic policies must be improved. What id important is to expand the cooperation in these matters with other countries in the region.

Vietnam is in Asia and integrating into the world economy, therefore it can't be immune to global shocks and systematic effects from the international financial environment. That is why we should soon realize problems in order to make timely adjustments to policies and beef up the cooperation with regional countries to limit bad effects of external shocks on the domestic finance market and the whole economy as well ■

Reference:
- MSCI, Emerging Market Asia Index (data as of Aug. 21, 2006)
- IMF, International Financial Statistics (CD-ROM, July 2006)
- Global Finance Development 2006.