

Structural Reforms in ASEAN-5 Economies: Past Successes and Future Challenges

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Introduction

The Asian Financial Crisis (AFC) in 1997 - 1998 marked a significant turning point for several Asian economies. From the viewpoint of the ASEAN-5 economies¹, the experiences from the AFC brought to light the importance of comprehensive reforms to address the underlying weaknesses and structural deficiencies of an economy (Park et. al., 2013). These structural reforms² include an array of policies to support the banking systems, address spillovers into the real economy and strengthen the dynamism and resilience of the crisis-affected economies. While the macroeconomic resilience of the regional economies have been sustained for about two decades, the current global economic and financial environment, especially in the aftermath of the Global Financial Crisis (GFC), increasingly poses significant challenges and downside risks to the sustainability of growth in the ASEAN-5 economies going forward. Furthermore, the rise of Industry 4.0³, rapid urbanisation and the growing importance of climate change also call for proactive structural reforms that help to keep pace with global issues and trends. This article serves to highlight the importance of structural reforms in Malaysia and its ASEAN neighbours against this backdrop.

Critical reforms in the post-AFC period

The AFC brought into view the region's vulnerability associated mainly with financial and economic fragility. On the financial side, an over-reliance on the banking sector, under-supervised and under-regulated financial systems and a deep mismatch between foreign liabilities and foreign assets were key vulnerabilities. The crisis also revealed several structural challenges such as debt-driven investment booms, rigid exchange rate regimes and current account deficits in the 1990s. In the aftermath of the crisis, the crisis-affected economies underwent deep transformation, recovered and thrived by embracing pertinent structural reforms. In the financial sector, policy measures successfully strengthened the supervision and regulation of the banking system, diversified sources of financing and enhanced domestic financial infrastructure. Measures in the real sector focused largely on improving macroeconomic management, strengthening public institutions and building up buffers to manage external shocks. As a result, ASEAN-5 economies today have diversified sources of growth, developed financial sectors, flexible exchange rates and healthier external positions (Chart 1).

Chart 1

Current Account Balance and Foreign Reserves in ASEAN-5*



* Refers to Indonesia, Philippines, Malaysia, Thailand and Singapore

Source: IMF October 2016 WEO, Haver, Bloomberg

¹ ASEAN-5 refers to Indonesia, Malaysia, Philippines, Singapore and Thailand.

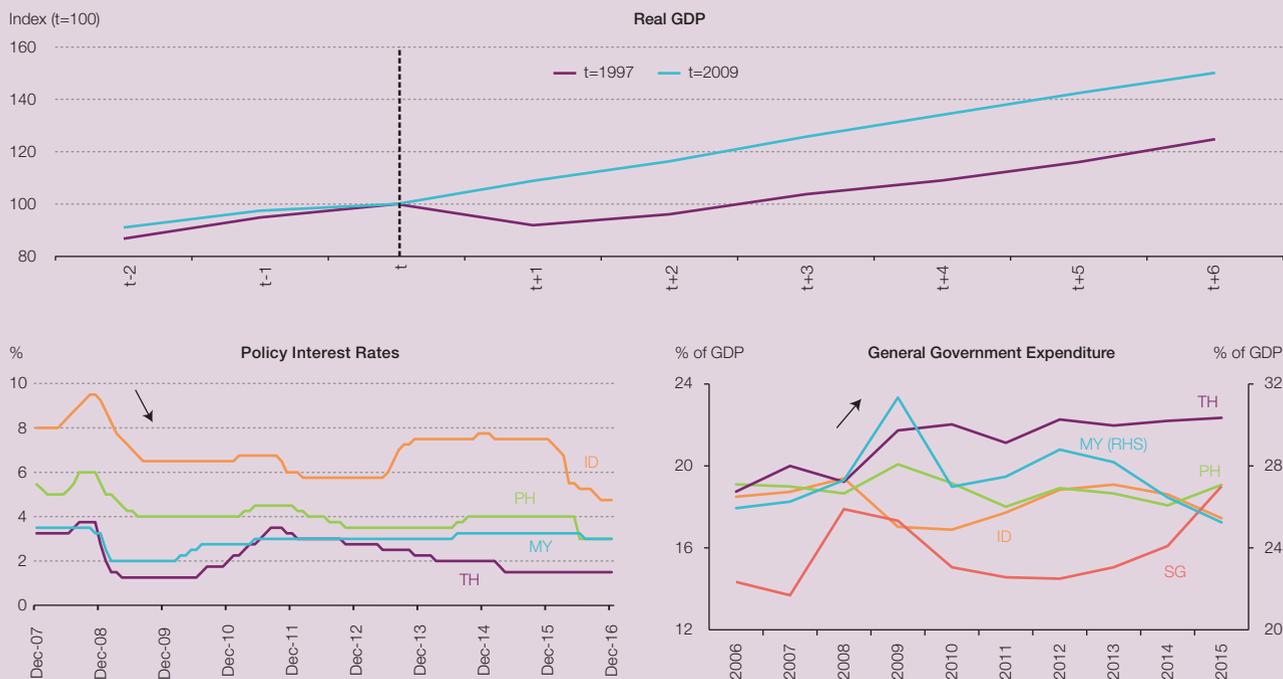
² Refer to policies that improve the productive capacity of an economy by removing impediments to the efficient functioning of markets.

³ Refers to the combination of several major innovations in digital technology, including the Internet of Things, cloud computing, digital fabrication, advanced robotics and artificial intelligence.

ASEAN-5 demonstrated considerable resilience in 2009 during the GFC, much of which could be attributable to the strength in the region's economic fundamentals. While GDP and export growth declined significantly in 2009, the region's financial systems were largely unaffected with continued functioning of financial intermediation. Households and corporates also entered the crisis with generally stronger balance sheets. Of great significance, the more flexible exchange rates and more institutionalised and transparent monetary policy making have allowed the region to pursue more effective monetary policies, thereby cushioning the severity of the crisis. Central banks across ASEAN-5 reduced their key policy rates by an average of 290 basis points from peak to trough between 2007 and 2009. Additionally, fiscal support took place with stimulus packages, including tax cuts and subsidies in several economies. As a result, growth rebounded swiftly, from 2.6% in 2009 to 8.9% in 2010.

Chart 2

Real GDP, Policy Interest Rates and General Government Expenditure in ASEAN-5



Source: IMF October 2016 WEO, Haver

Structural reforms continue to be relevant for ASEAN-5 in the post-GFC period

While the ASEAN-5 economies have experienced success in executing structural reforms post-AFC, **the GFC has unleashed new challenges** for the region that render further structural reforms critical in the current period. These challenges include, but are not limited to:

a) Prolonged weakness in global trade

Against the backdrop of persistent weakness in several of the major advanced economies, global trade has remained sluggish post-GFC. Of significance, the weak recovery in investment growth, which generally has higher import content, contributed to slower growth of trade relative to overall GDP growth. Beyond this cyclical weakness, other structural forces have also weighed on trade activity, including the diminishing impact from past impetuses on trade such as the proliferation of global value chains in the 1990s and early 2000s and PR China's ongoing transformation towards a more consumption-based growth model⁴. Therefore, the external

⁴ For more details, please refer to Box Article on 'Recent Slowdown in Global Trade: Cyclical Bane or Structural Shift?' in Bank Negara Malaysia's Annual Report 2015.

demand that has been a key source of growth for the regional economies prior to the GFC has now become a source of decelerating momentum for ASEAN-5 given the region's trade openness. The trend of lower global trade growth is expected to persist given the lack of new impetus to growth in the major economies amid rising anti-globalisation sentiments. The IMF forecasted that world trade will average 4.1% in the next five years compared to 8.4% from 2003 to 2007⁵. Therefore, the region needs to focus on its competitiveness in this more challenging global environment, if it is to continue experiencing relatively healthy growth rates going forward.

b) Limitations of fiscal space

While the ASEAN-5 economies generally have more macroeconomic policy space to manoeuvre domestically compared to most major advanced economies, headline fiscal balances in a few economies have yet to return to pre-crisis (2003 - 2007) levels. General government gross debt has also risen in several economies amid an environment of low and accommodative interest rates. This highlights the concerns over the need to restore fiscal space to allow for counter-cyclical responses to future shocks. Additionally, fiscal space needs to be generated to address developmental challenges, including greater investments in infrastructure to reduce supply bottlenecks and human capital development. In this respect, encouraging greater private sector participation in the development of physical infrastructure and the provision of financial, education and healthcare services could help to lower the fiscal burden of the government, while also increasing productivity gains and improving the quality of services.

c) A new global financial landscape

Following the GFC, the global financial landscape has been shaped by new regulatory standards such as the Basel III, which has been introduced to strengthen prudential and regulatory standards for the banking sector. In this regard, policy makers in the region have maintained prudent financial positions by building capital and liquidity buffers of regional financial institutions after the AFC (Yao, 2016). This has allowed the region to be well-positioned to meet the requirements of this new global standard. Nonetheless, the financial landscape continues to evolve, providing both opportunities and challenges for the region. Technological advancements have spurred growth in Financial Technology, otherwise known as FinTech, which has the potential to reshape the way financial services are provided. New ways of financing, new products and new participants have emerged, challenging the role and relevance of traditional business models. These include FinTech developments that have expanded the frontiers of banking in areas such as peer-to-peer lending, merchant and e-commerce finance and online trade finance⁶. It is therefore critical for policymakers in the region to provide a supportive legal and regulatory environment that would support innovation, but at the same time ensure consumer protection and the orderly functioning of financial markets.

ASEAN-5's policy focus on structural reforms

Recognising the increasing urgency of implementing comprehensive reforms in this challenging environment, policy makers in the region continue to undertake proactive measures, not only to address potential risks and spillovers from the external environment in the short term, but also to further strengthen the region's growth prospects and competitiveness over the medium term. While the specific mix of reforms to address the challenges unleashed following the GFC may differ across countries, the general reform priorities for ASEAN-5 encompass the following:

a) Enhancing economic productivity

Growth in the region has been achieved through the vibrant external and domestic sectors. Amid prolonged weakness in global trade, it is highly important for the region to undertake reforms to ensure continued balanced growth going forward. This can be done through raising the productive capacity of an economy by improving connectivity, competitiveness and human capital competency. In light of this, the ASEAN-5 economies have been forward-looking reformers that have prioritised investments in both hard infrastructure such as upgrading transportation networks and increasing broadband penetration, and soft infrastructure like improving governance

⁵ Source: IMF October 2016 World Economic Outlook.

⁶ Source: World Economic Forum (2015).

mechanisms and developing human capital. Recognising the need for greater private sector involvement in financing the scaling-up of infrastructure development, regional economies have also taken proactive measures to enhance existing public-private partnership (PPP) frameworks, thus reducing the reliance on government fiscal resources. Efforts to foster productivity through infrastructure development have been complemented by the development of a competent workforce, not only in promoting sustainable growth over the longer term, but also in ensuring an equitable distribution of economic gains. For example, several countries in the region, particularly Malaysia and Singapore, have been steadfast in undertaking instituted labour market reforms such as the implementation of minimum wage, improving accessibility to higher education, and deepening labour skills to enhance competitiveness.

b) Maintaining macroeconomic stability

To further strengthen underlying fundamentals, policy makers in the ASEAN-5 countries, particularly the Philippines, Indonesia and Malaysia have been embarking on reforms to improve fiscal space and public institutional frameworks. In particular, the introduction of tax reforms and subsidy rationalisation, and the diversification and expansion of public income sources have played a vital role in re-building policy space since the GFC period. Economies such as Singapore and Malaysia have also undertaken pre-emptive policies such as macro-prudential measures to manage imbalances in the property market and curb concerns over elevated household indebtedness. A prudent fiscal position and forward-looking policies to reduce vulnerabilities can therefore lay the foundation for better macroeconomic stability.

c) Enhancing flexibility and efficiency of financial systems

With the rapidly evolving global financial landscape, authorities in the region recognise that regulations should not stifle innovation and new approaches to financial development (Arner and Park, 2010). Instead, in keeping abreast with the development of FinTech, continuous efforts have been undertaken to encourage greater experimentation. ASEAN-5 economies such as Singapore and Malaysia, for example, have begun to embrace the emergence of FinTech by introducing regulatory sandboxes. This has enabled financial institutions and FinTech participants to test their innovations in the market within a well-defined environment, with appropriate financial safeguards in place, thereby stimulating competition and promoting innovation while preserving financial stability.

Keeping pace with global trends

Beyond addressing the challenges that have emerged following the GFC, it is equally important for the region to be proactive in carrying out reform efforts to both harness the benefits and minimise the risks from shifting global trends. Policy imperatives include keeping in stride with the rise of Industry 4.0 and promoting an inclusive and green economy. Industry 4.0 has created new growth areas, such as sharing economy and e-commerce. While much has been done in ASEAN-5 to ride on the wave of Industry 4.0, the e-commerce adoption remains fairly nascent, suggesting that there is still considerable room for improvement⁷.

Amid rapid development and urbanisation, the urgency to safeguard against negative social cost has risen. In light of this, regional economies have been implementing reforms to promote inclusive growth by enhancing the access to opportunities for all segments of society. This includes introducing a more comprehensive social protection mechanism such as providing financial services to the unserved and underserved at the individual and business levels. In Malaysia, myriad efforts have been undertaken to improve the access and usage of quality and affordable financial services through innovative channels, products and infrastructure.

In creating an environmentally sustainable growth, efforts to expand and scale up the usage of energy-efficient technologies have also been gradually gaining traction in the region. For example, in 2015, investment in solar projects within the South East Asian region, particularly Thailand, Indonesia and the Philippines, rose to a record high of USD1.7 billion (2010-2014 average: USD0.9 billion)⁸. A few regional economies have also increasingly supported green building adoption,

⁷ Source: A. T. Kearney (2015).

⁸ Source: Clean Energy Pipeline (2016).

by using ecologically-friendly construction materials and conserving energy and space. Singapore, in particular, has taken the lead in Asia by ranking first on the Economist Intelligence Unit's Asian Green City Index⁹.

Regional cooperation beyond national initiatives

The regional economies recognise that policy strategies need to be two-fold, because the deepening of structural reforms at the national level needs to be complemented by initiatives to increase regional cooperation. Of importance, the ASEAN Economic Community (AEC) Blueprint 2025 draws attention to the fact that greater integration allows regional economies to harness the benefits arising from the diversity and complementarities that exist across the economies¹⁰. As such, ASEAN's information sharing and capacity building initiatives play an important role in enhancing the technical capacity of policy makers in undertaking reforms. Taking into account the different development levels and needs of its member states, ASEAN also continues to make progressive efforts in intensifying regional financial integration, promoting financial inclusion and ensuring financial stability. Of note, the ASEAN Banking Integration Framework (ABIF) highlights ASEAN's commitment to strengthen intra-regional trade and investments while preserving regional financial stability.

Conclusion

ASEAN-5's transformation through economic and financial reforms have accorded the region with stronger fundamentals and policy flexibility to withstand external shocks, as illustrated in the region's swift rebound during the GFC. Today, headwinds in the global economic environment, including persistent weakness in international trade activity, prolonged macroeconomic and policy uncertainties, and increased volatility in exchange rates and capital flows necessitate these economies to continue prioritising reforms. Additionally, shifting megatrends such as technological disruptions, rapid urbanisation and climate change offer both challenges and opportunities for the region. By promoting sustainable growth and economic dynamism, the region can raise resilience amid these cyclical and structural shocks. Advancing collaboration amongst economies in the ASEAN region also allows countries to leverage on each other's strengths to reap greater economic and social benefits of reforms.

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⁹ Source: Economist Intelligence Unit (2011).

¹⁰ Source: ASEAN Secretariat (2015).