# THE ROLE OF ASIA'S FINANCIAL SAFETY NET DURING COVID-19

**Cyn-Young Park**
Director

**Peter Rosenkranz**
Economist

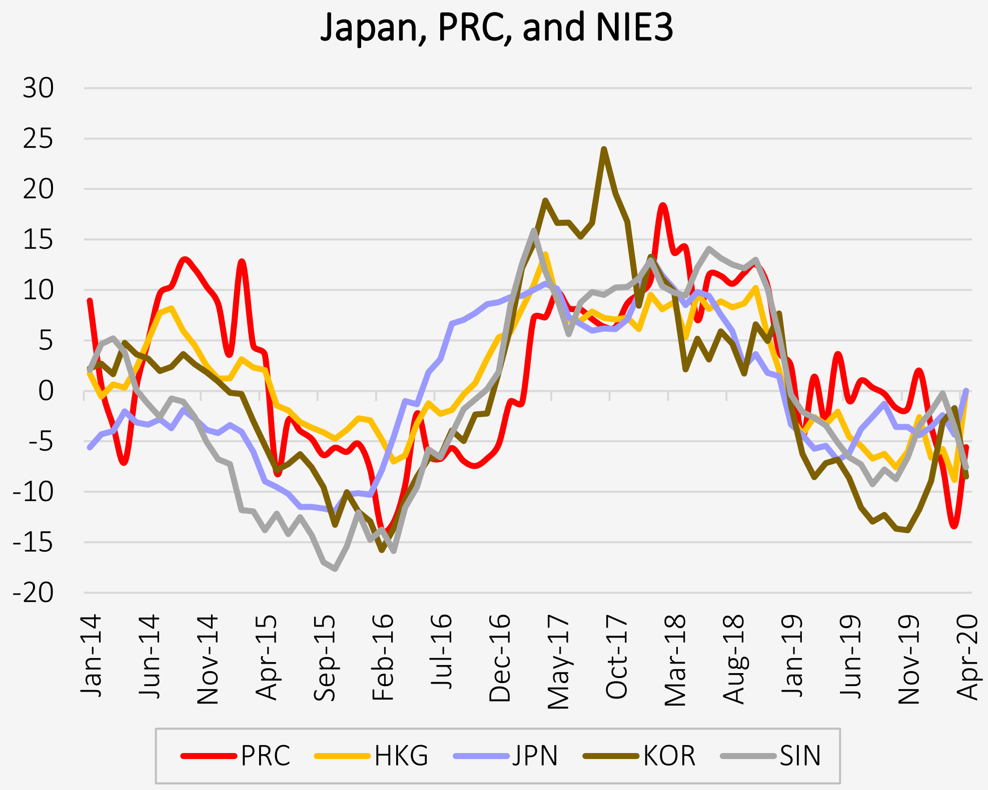
Regional Cooperation and Integration Division
Economic Research and Regional Cooperation Department
Asian Development Bank

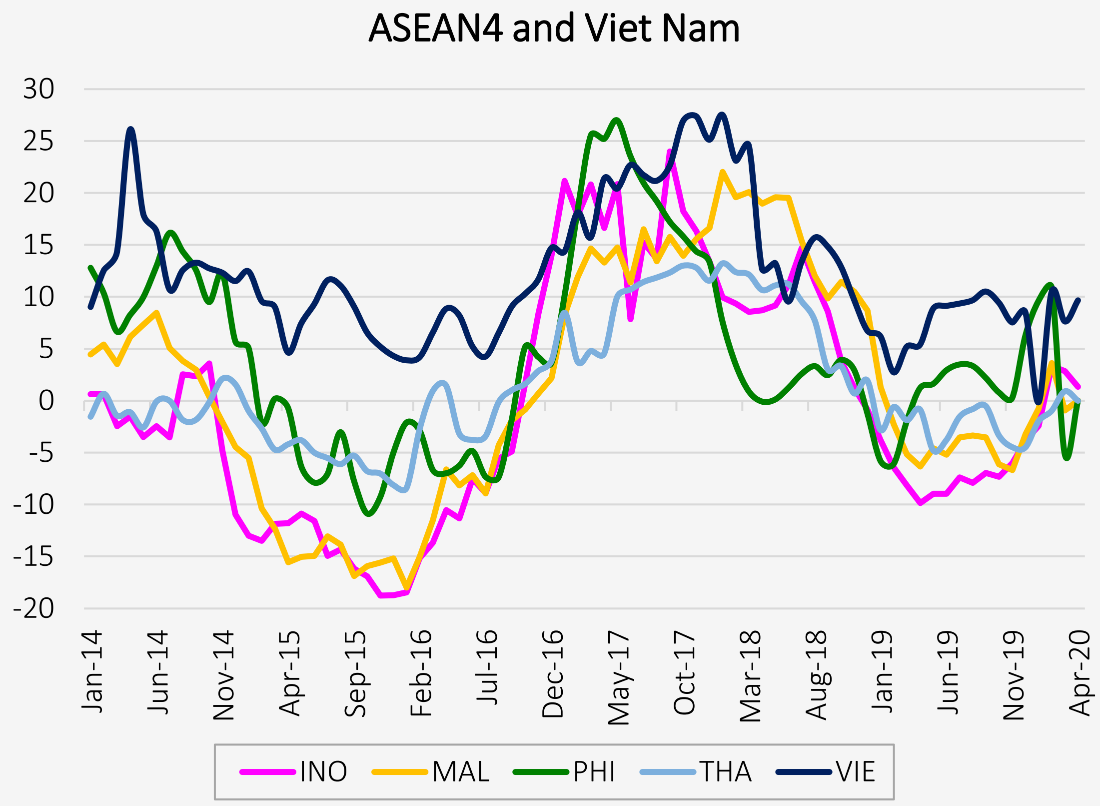
09 June 2020 | Regional Cooperation and Integration Policy Open Dialogue (RCI-POD) Webinar Series

# Economic and Financial Risks in Asia During COVID-19

# Exports deteriorate during COVID-19 in ASEAN+3 economies

**Monthly Export Growth** (%, y-o-y, 3-month moving average)

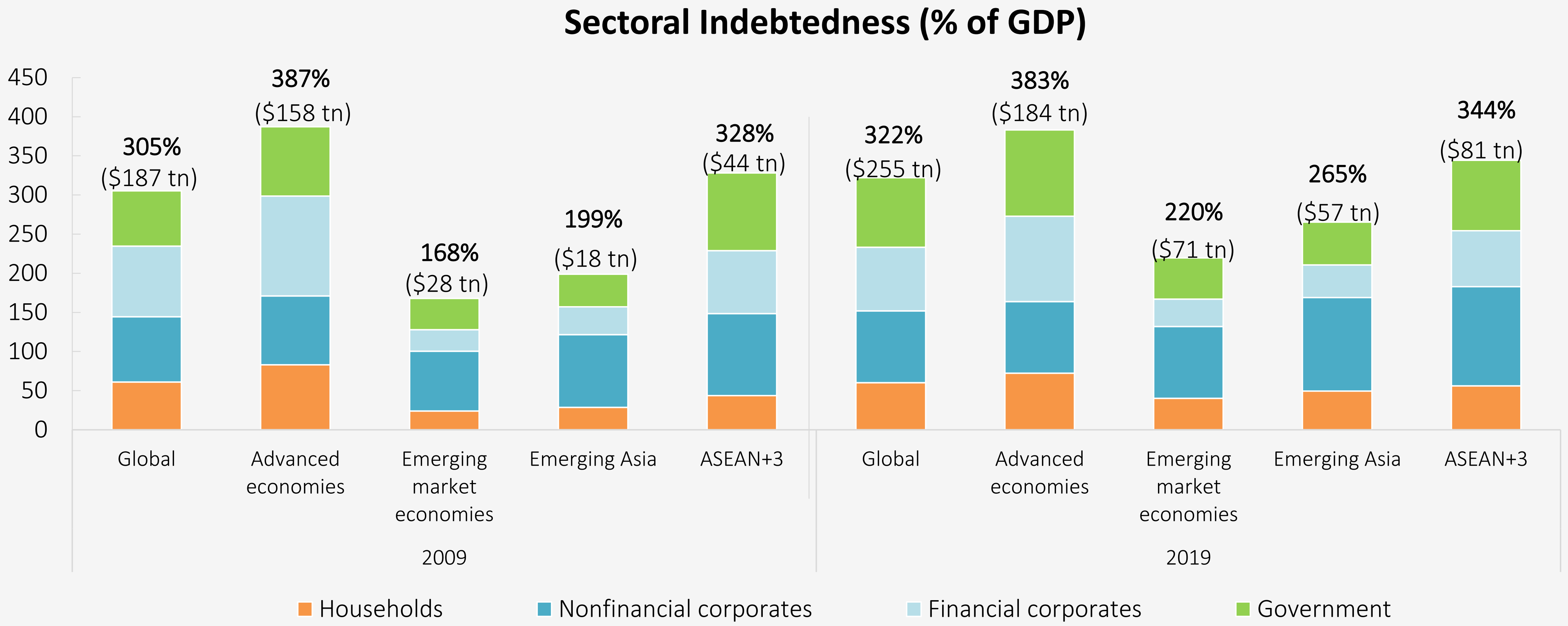



y-o-y = year-on-year.
Source: ADB calculations using data from CEIC and Haver (accessed May2020).

ADB

# High and rising debt exposes ASEAN+3 vulnerability




gross domestic product = GDP, tn = trillion.
Notes: The percent values refer to total across all sectors. Economy grouping based on Institute of International Finance definition.
Source: Institute of International Finance. Global Debt Monitor Database. https://www.iif.com/ (accessed 4 May 2020).

## Risk of a Vicious Cycle: High Debt, NPLs, Tight Credit, and Slow Growth

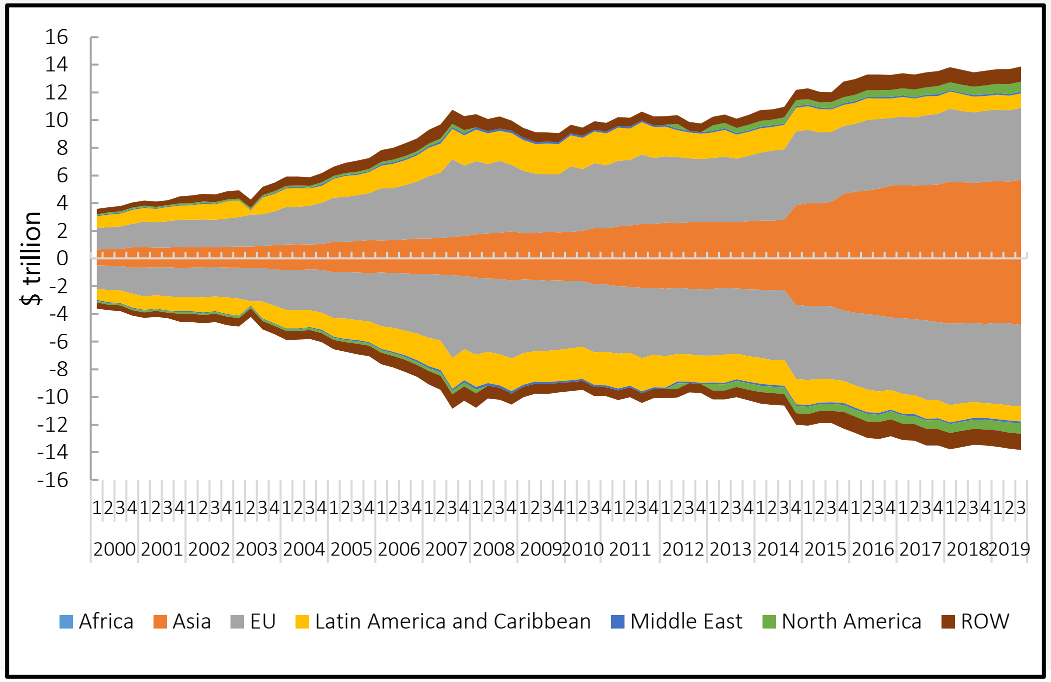
- The pandemic-induced economic downturn implies lower corporate earnings and household incomes, raising risks of defaults in the post-COVID-19 period
- Nonperforming loans have already increased in a number of Asian economies in recent years
- Studies show high NPLs and a banking crisis delay post-crisis economic recovery
- With globalized banking networks, NPL problems in advanced economies can also spill over to emerging market economies

ADB

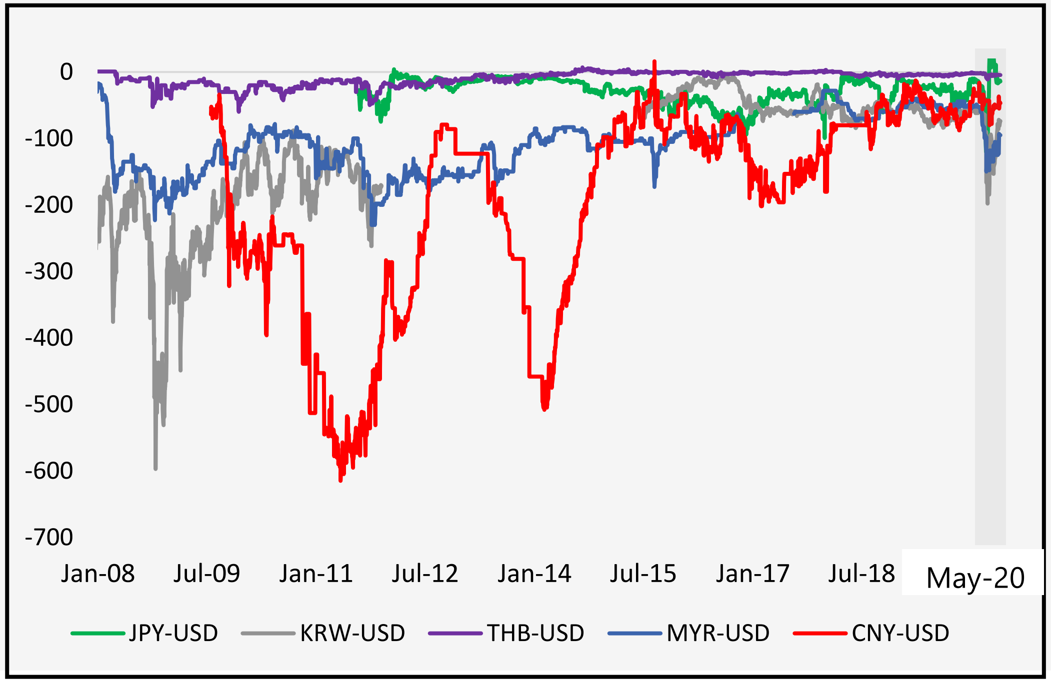
# COVID-19 pandemic exposes Asian banks' vulnerability to US dollar funding

- Emerging Asia remains heavily exposed to USD funding, while the landscape of non-US global banks has changed post-GFC
- Strains of dollar liquidity during the ongoing COVID-19 crisis reveal a similar pattern as during the GFC, with non-US global banks relying more on foreign exchange swap markets for USD funding
- Emerging Asian economies with weak external positions are particularly vulnerable to global dollar funding conditions as a stronger dollar increases the debt servicing costs of emerging market borrowers.

**US dollar-denominated cross-border bank holdings by non-US banks (2000Q1 – 2019Q3)**




**Cross-currency basis swap, 01 January 2008 – 27 May 2020 (in bps)**




ADB

# The Role of the Regional Financial Safety Net within the Global Financial Safety Net

# The global financial safety net is multi-layered

| Scope | Element | Conditionality | Availability and key factors determining access |
|---|---|---|---|
| **National** | Foreign exchange reserves | No | Past reserve accumulation, exchange rate regime |
| **Bilateral** | Central bank swap lines | Yes | Economic and political links with the reserve currency issuing country |
| **Regional** | RFA financing | For many RFAs | RFA forward commitment capacity; sometimes limited to a multiple of paid-in capital |
| | Asia and Pacific: ADB's crisis response and lending facilities | Yes | OCR-eligible and graduated DMCs, capped at $500 million per exogenous shock or crisis episode (CSF) |
| **Global** | IMF financing | For most instruments | IMF forward commitment capacity, IMF quota, political factors |

IMF = International Monetary Fund, OCR = ordinary capital resources, RFA = regional financing arrangement.
Source: ADB compilation based on Scheubel, Stracca, and Tille (2018).

ADB

# RFAs differ in terms of instruments, funding structures, availability of funds

| Features | CMIM | ESM | FLAR |
|---|---|---|---|
| Establishment | Established in March 2010, replacing the Chiang Mai Initiative, which was established in May 2000 | Inaugurated in October 2012, following the European Financial Stability Facility, established in June 2010 as a temporary backstop in response to European debt crisis | Created in 1991 following the accession of countries to the Andean Reserve Fund, which was created in 1978 |
| Members | All 13 ASEAN+3 economies | All 19 euro area member states | 8 Latin American economies |
| Objectives | (i) Address BOP and short-term liquidity difficulties in the ASEAN+3 region; (ii) supplement international financing arrangements | Help euro area countries undergoing severe financial distress | (i) Support the member countries' BOPs; (ii) improve conditions of reserve investments; and (iii) help harmonize exchange rates and monetary and financial policies |
| Type | Multilateral currency swap arrangement | Fund | Fund |
| Capital stock | $240 billion callable capital | €700 billion (€80 billion paid-in, €620 billion callable capital) | $3.9 billion subscribed capital (of which $3.1 billion is paid-in) (as of 2019) |
| Lending capacity | $240 billion (€194 billion) | €500 billion ($618 billion) | $4.8 billion (€4 billion) (as of 2017) |
| Lending instruments | (i) Crisis prevention facility<br>(ii) Crisis resolution facility | (i) Loans within macroeconomic adjustment program<br>(ii) Primary and secondary market purchases<br>(iii) Precautionary credit line<br>(iv) Loans for indirect and direct recapitalization of financial institutions | (i) BOP credit<br>(ii) Liquidity credit<br>(iii) External debt restructuring of central banks<br>(iv) Contingency credit<br>(v) Treasury operations |
| Surveillance | Yes, through AMRO | Only countries with financial assistance | Yes |
| Usage | Never been used | Yes | Yes |

ADB

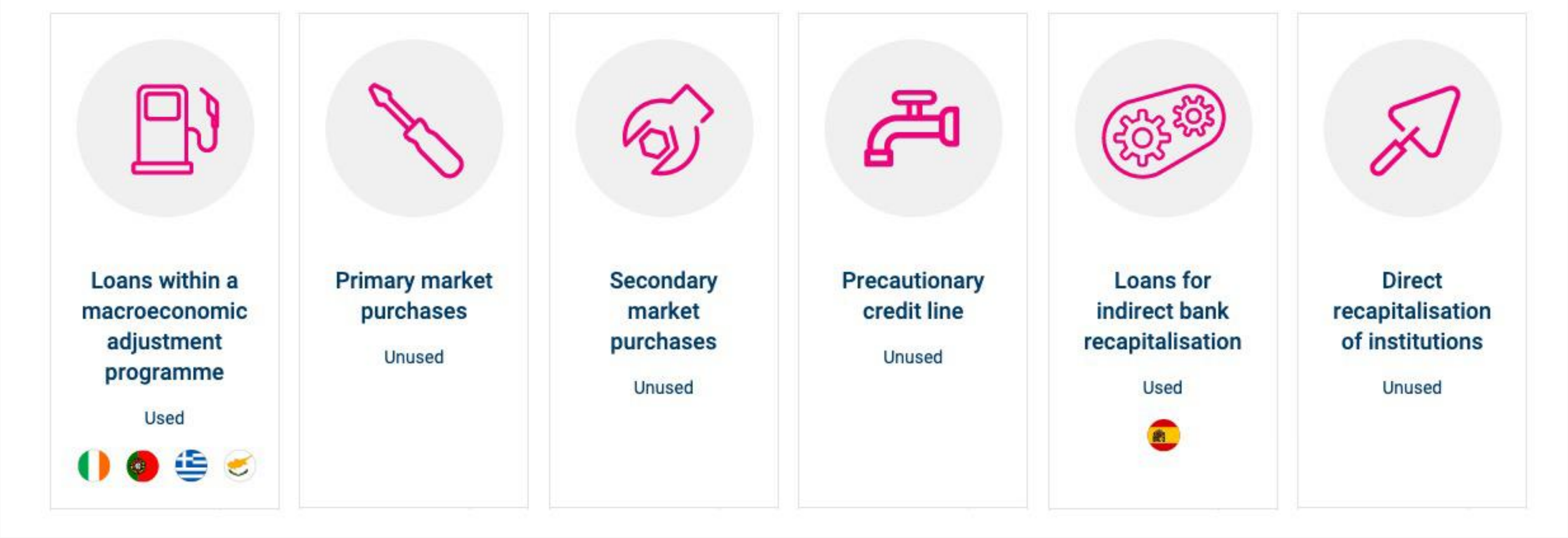
# European Stability Mechanism: An Overview

- **History:** The global financial crisis and European sovereign debt crisis triggered the creation of the **European Financial Stability Facility (EFSF)** as a temporary crisis mechanism. The **ESM** was later established in October 2010 as a permanent crisis resolution mechanism to safeguard financial stability in the region
- **Funding structure:** funds raised by issuing capital market instruments and engaging in money market transactions
- **Surveillance:** limited to countries granted financial assistance
- **Capital stock:** €700 billion (€80 billion paid-in, €620 billion callable capital)
- **Maximum lending capacity**: €500 billion ($618 billion)
- **Program decisions:** Mutual agreement by the **ESM board of governors** (19 finance ministers, and European Commission and European Central Bank may participate as observers)
- **Conditionalities:** Financial assistance is linked to policy conditions specified in a MoU between beneficiary member state and the European Commission, European Central Bank, and the IMF (where applicable).

ADB

# EFSF/ESM financial assistance has been extended to Ireland, Spain, Cyprus, Portugal, and Greece

**Lending Instruments**




- New temporary facility: **Pandemic Crisis Support** based on the Enhanced Conditions Credit Line

# ESM’s Response to COVID-19

- On 15 May 2020, the **Pandemic Crisis Support** based on the Enhanced Conditions Credit Line
  - ➢ Access granted will be 2% of the respective member states’ GDP, which would amount to a combined maximum volume of around €240 billion
  - ➢ Conditionality: Requested support would need to be committed to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID-19 crisis
  - ➢ Cost: Margin of 10 bps annually, a one-off up-front service fee of 25 bps, and an annual service fee of 0.5 bps, on top of ESM’s funding costs
  - ➢ Maturity 10 years, the credit line will be available until the end of 2022

- Part of a wider **EU COVID-19 aid package**, which also includes two other safety nets:
  - ➢ Up to 100 billion loans by the **EC** for **temporary support to mitigate unemployment risks in an emergency (SURE)**
  - ➢ €200 billion additional **SME loans** by the EIB

ADB

# ESM Treaty Reform

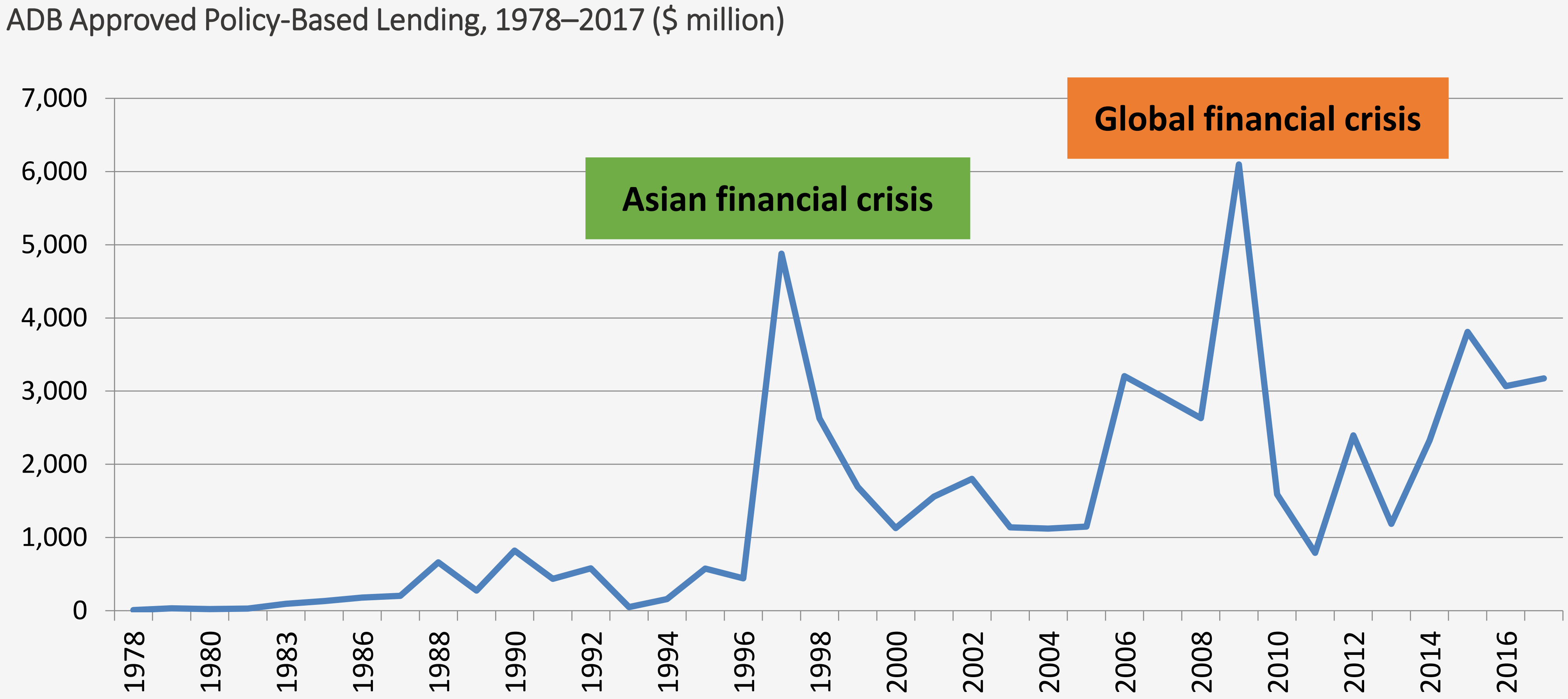
- Elements of the European Banking Union:
  - ✓ **Single Supervisory Mechanism (SSM)** supervises the significant banks in the euro area
  - ✓ **Single Resolution Mechanism (SRM)** resolves failing banks in an orderly manner with minimal costs for taxpayers and for the real economy

  (Pending) **European Deposit Insurance Scheme (EDIS)** (under discussion)

- On 4 December 2019, the Eurogroup agreed in principle on an ESM reform, subject to ratification of the 19 euro area member states:
  - It includes a common backstop for the **Single Resolution Fund (SRF)**, to support the SRM as last resort, in the event of a depletion of the SRF
  - After the establishment of the common backstop, the direct recapitalization instrument for banks will be removed from the ESM's toolkit of financial assistance instruments
  - Peace time surveillance: EC, in agreement with a member state concerned, may also invite ESM staff to join its missions related to economic policy coordination and budgetary monitoring for non-program countries

ADB

# ADB support has helped economies bridge financing gaps during financial crises

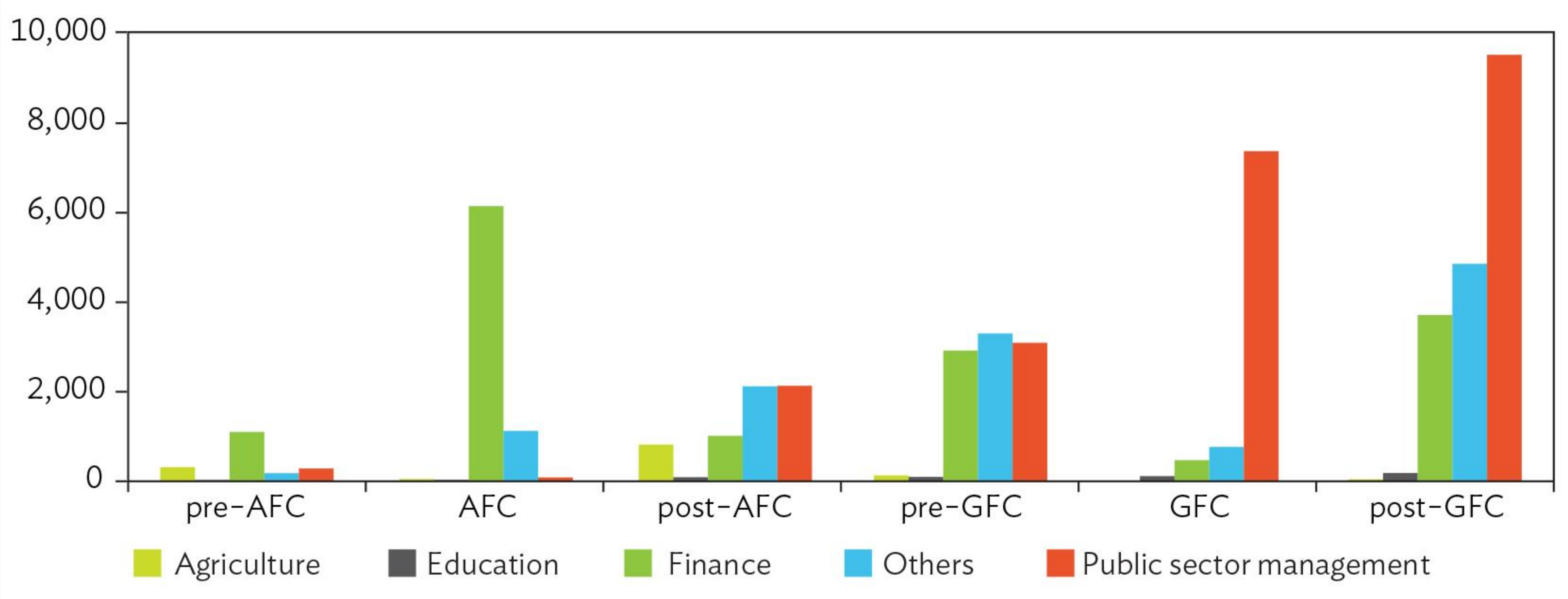



Source: Asian Development Bank Independent Evaluation Policy-based Lending Approvals Database (accessed September 2018).

# ADB PBL has shifted from support for financial sector development to public sector management

- In response to the Asian financial crisis, PBL support was concentrated in financial sector and capital market development
- Following the global financial crisis, support primarily shifted to public sector management

ADB Approved Policy-Based Lending by Sector, Pre-Asian Financial Crisis to end-2017




Source: Asian Development Bank.

# Policy Considerations

# Coordinated, multilateral efforts critical to COVID-19 response

- G-20 debt moratorium for low income countries
- The IMF and world's RFAs have reiterated support for a combined, coordinated response to mitigate impacts of COVID-19 pandemic
- The **IMF** has doubled access to its emergency facilities, approved debt service relief for 25 low-income economies, and introduced the **Short-Term Liquidity Line** to facilitate fast-disbursing finance for countries with strong economic policies
- The **ESM** announced to establish a **Pandemic Crisis Support**, amounting to a combined volume of €240 billion, based on its Enhanced Conditions Credit Line available to all euro area countries

# Policy considerations for safeguarding financial stability

- **Macro-financial policies to support the economy and markets**
- **Preemptive responses to address NPL problems**. Together with banks, national authorities should prepare clear action plans to resolve NPLs swiftly and effectively, incl. preventive debt restructuring/rescheduling schemes
- **Strengthen the regional financial safety net to bolster market confidence,** including CMIM and additional currency swap lines
- **Smooth coordination among IMF, MDBs, and RFAs** can mitigate the risks of moral hazard and ensure that crisis support and funding are most effective

ADB

# Policy considerations for safeguarding financial stability

- **Prepare "Exit Strategies" from crisis interventions:** restoring fiscal sustainability and proper unwinding of unconventional measures need careful maneuvering

- **Strong regulation and macroprudential policies** should be in place to prevent a buildup in financial excesses

- COVID-19 crisis provides an opportunity for regional financial cooperation to **regain reform momentum**

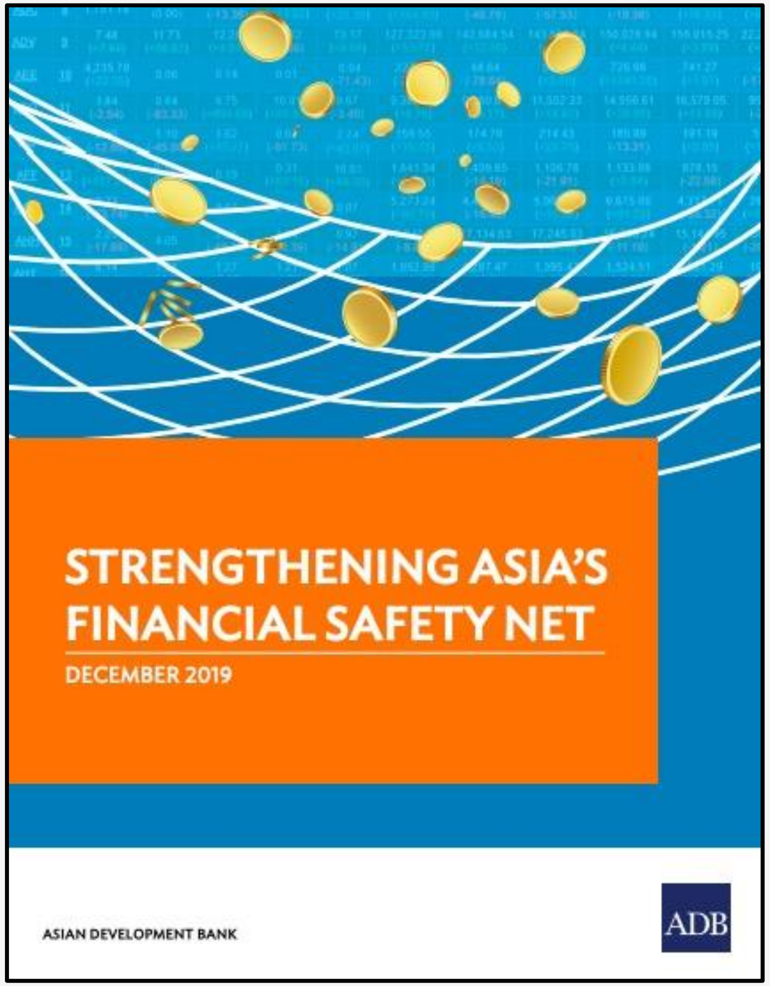
  - ➢ How can Asia reduce its financial vulnerability?

  - ➢ What can be done to further strengthen current arrangements of regional financial safety nets?

  - ➢ What is the remaining reform agenda in global financial architecture?

ADB

# Thank you and download our report!



# Overview of Approved CPRO

**ADB Approved COVID-19 Pandemic Response Option Loans**

| Country | Sector | Approved Amount ($, million) |
|---|---|---|
| India | Health; Public sector management | 1500 |
| Indonesia | Health; Public sector management | 1500 |
| Philippines | Health; Public sector management | 1500 |
| Kyrgyz Republic | Health; Public sector management | 25 |
| Bhutan | Public sector management | 20 |
| Bangladesh | Public sector management | 500 |
| Mongolia | Health; Public sector management | 100 |
| Nepal | Health; Public sector management | 250 |
| Georgia | Health; Public sector management | 100 |

Source: Asian Development Bank.
**Updated as of 04 June 2020.**