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

Cyn-Young Park
Director
Regional Cooperation and Integration Division
Economic Research and Regional Cooperation Department
Asian Development Bank

Peter Rosenkranz
Economist

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)

Exports deteriorate during COVID-19 in ASEAN+3 economies

y-o-y = year-on-year.
Source: ADB calculations using data from CEIC and Haver (accessed May 2020).
High and rising debt exposes ASEAN+3 vulnerability

Sectoral Indebtedness (% of GDP)

- **Global**: 305% ($187 tn)
- **Advanced economies**: 387% ($158 tn)
- **Emerging market economies**: 168% ($28 tn)
- **Emerging Asia**: 199% ($18 tn)
- **ASEAN+3**: 328% ($44 tn)
- **Global**: 322% ($184 tn)
- **Advanced economies**: 383% ($184 tn)
- **Emerging market economies**: 220% ($71 tn)
- **Emerging Asia**: 265% ($57 tn)
- **ASEAN+3**: 344% ($81 tn)

Notes: The percent values refer to total across all sectors. Economy grouping based on Institute of International Finance definition.

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.
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.


Cross-currency basis swap, 01 January 2008 – 27 May 2020 (in bps)
The Role of the Regional Financial Safety Net within the Global Financial Safety Net
The global financial safety net is multi-layered

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

IMF = International Monetary Fund, OCR = ordinary capital resources, RFA = regional financing arrangement. Source: ADB compilation based on Scheubel, Stracca, and Tille (2018).
**RFAs differ in terms of instruments, funding structures, availability of funds**

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

ADB Approved Policy-Based Lending, 1978–2017 ($ million)

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

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
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?
Thank you and download our report!
Overview of Approved CPRO

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Sector</th>
<th>Approved Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>Health; Public sector management</td>
<td>1500</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Health; Public sector management</td>
<td>1500</td>
</tr>
<tr>
<td>Philippines</td>
<td>Health; Public sector management</td>
<td>1500</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>Health; Public sector management</td>
<td>25</td>
</tr>
<tr>
<td>Bhutan</td>
<td>Public sector management</td>
<td>20</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>Public sector management</td>
<td>500</td>
</tr>
<tr>
<td>Mongolia</td>
<td>Health; Public sector management</td>
<td>100</td>
</tr>
<tr>
<td>Nepal</td>
<td>Health; Public sector management</td>
<td>250</td>
</tr>
<tr>
<td>Georgia</td>
<td>Health; Public sector management</td>
<td>100</td>
</tr>
</tbody>
</table>

Updated as of 04 June 2020.