THE WORLD BANK GROUP MACROECONOMICS, TRADE & INVESTMENT GLOBAL PRACTICE DECEMBER 2018 NOTE NUMBER 353

viewpoint

Global Financial Market Turmoil

Ndiamé Diop

Ndiamé Diop (Ndiop@worldbank.org) is Practice Manager for the East Asia and Pacific Region in the Macroeconomics, Trade & Investment (MTI) global practice of the World Bank Group.

Useful comments on this note were received from Frederico Sander, Rong Qian, Richard Record, Indira Hapsari, and Kiatipong Ariyapruchya (all MTI, East Asia and Pacific).

Why is South East Asia Exposed but Resilient?

South East Asia's largest middle-income economies are highly integrated into global financial markets. While this provides considerable benefits, it also exposes them to sudden retrenchments of portfolio flows from emerging market economies. This note shows that Indonesia, Malaysia, the Philippines, and Thailand are nevertheless resilient because they have learned and applied key lessons from the 1997 Asian financial crisis. One key lesson is that adoption of a flexible exchange rate should go hand in hand with keeping foreign currency exposure in the balance sheets of the public sector, the financial sector, and the corporate sector low or hedged.

South East Asia's (SEA's) large economies are under some stress from trade tensions and rising U.S. interest rates. This reflects these economies' sensitivity to the U.S. Federal Reserve monetary policy, their high degree of global trade integration, and their strong production network links with China. In sharp contrast to the situation in 2017, in Indonesia, Malaysia, the Philippines, and Thailand, the currencies depreciated against the U.S. dollar, bond yields rose, and stock markets have declined to date in 2018.

However, these countries have managed to hold up relatively well because they have learned and applied key lessons from the 1997 Asian financial crisis and have maintained strong fundamentals. One key lesson from the 1997 crisis is that adoption of a flexible exchange rate is crucial to amortize capital flow shocks, but it should go hand in hand with keeping foreign currency exposure in the balance sheets of the public sector, the financial sector, and the corporate sector low or hedged. Another lesson is the importance of large foreign reserve holdings to insure against sudden reversals in capital inflows.

Going forward, while contagion from Argentina and Turkey seems contained, sustaining resilience will not be automatic. It will hinge on macro-fiscal measures to reduce inflation (the Philippines), prevent the current account deficit from widening (Indonesia), and reduce external debt (Malaysia). Structural measures to encourage foreign direct investments and deepening the financial sector are also crucial to strengthen Indonesia's resilience.

This note: (i) discusses the contrasting states of equity, bond, and currency markets in SEA between 2017 and 2018; (ii) explains why some currencies in the sub-region are more sensitive to sudden changes in portfolio capital flows than others; (iii) discusses the sources of SEA's

WORLD BANK GROUP

resilience, and (iv) identifies priority policies to sustain the sub-region's resilience. The analysis focuses on Indonesia, Malaysia, the Philippines, and Thailand. These countries were chosen because they are the largest in SEA, have flexible exchange-rate regimes and are strongly integrated into global financial markets.

Asset markets in flux

The contrast in the state of asset markets in SEA between 2017 and 2018 is striking. In the first 10 months of 2017, SEA countries received a total net portfolio flow (equity and debt) of US$20.8 billion (Table 1). Reflecting these large inflows and high investor confidence, bond yields dropped sharply, and stock markets rose (Table 2). This is in sharp contrast with January–October 2018, during which net portfolio flows to SEA dropped by close to US$9 billion, leading to currency depreciations, rising bond yields, and depressed stock markets (Table 2). While capital outflows in the bond markets seem to have stabilized (thanks to debt issuances at higher yields), the pressure on stock markets continued through October 2018, explaining the continuous weakening of currencies in the sub-region.

Two key factors help explain the contrasting developments in SEA capital flows and asset markets between 2017 and 2018: (i) changes in U.S. monetary policy and (ii) trade tensions between the United States and its major trading partners—particularly China. Like other emerging market economies such as Argentina, Brazil, India, and Turkey, SEA is highly sensitive to changes in U.S. monetary policy because global portfolio investors constantly undertake "arbitrages" on the risks and returns on investments in SEA's liquid markets relative to markets in the United States. Typically, capital flows to emerging markets increase when U.S. interest rates are low, and the global financial markets are calm. Such a situation in 2017 led to large net portfolio capital inflows to SEA. Conversely, global investors tend to withdraw capital from emerging market economies when U.S. interest rates rise. In March 2018, the U.S. economy's tight labor market and rising inflation led the U.S. Federal Reserve to reaffirm its adherence to a tightening cycle. Since then the federal funds rate has been increased three times (in March, June, and September) with possible further hikes in December and in 2019 (Figures 1 and 2).

Thus, going forward, risks of further portfolio capital retrenchment from emerging markets remain. Based on the Federal Open Market Committee (FOMC) members' judgment about the path of federal funds rates during their September 28th meeting this year, it is possible that U.S. interest rates may rise higher and faster than initially expected by the market (Figure 2). If this occurs, portfolio capital retrenchment from

Table 1 Equity and debt portfolio flows to South East Asia

	Jan–Oct 2017	Jan–Oct 2018	October 2018
	Equity portfolio flows (US$, millions)		
Indonesia	–1,372	–4,059	–372
Philippines[a]	1,071	–1,752	–182
Malaysia[b]	2,205	–2,505	–375
Thailand	168	–8,386	–1,868
	Debt portfolio flows (US$, millions)		
Indonesia	10,501	1,918	809
Philippines	–	–	–
Malaysia[b]	n.a.	n.a.	n.a.
Thailand	8,237	7,909	899

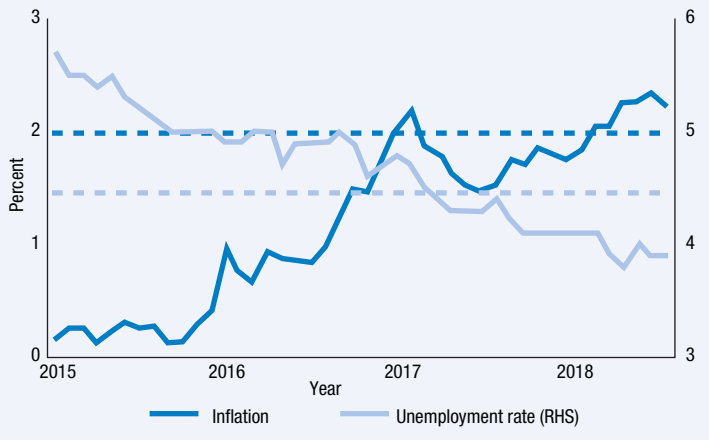
Source: CEIC Data (database), New York, NY (accessed November 5, 2018), www.ceicdata.com.
Note: — = not available; n.a. = not applicable.
a. equity only; b. equity and debt data not broken down; since equity flows are much greater, all flows are "assigned" in table to equity; portfolio flows through 9/15/18.

Table 2 Changes in bond yields, stock markets, and exchange rates in South East Asia

	Jan–Oct 2017	Jan–Oct 2018	October 2018
	Bond yield: change in basis points of the monthly average yields between the end and beginning of the period		
Indonesia	–113	198	16
Philippines[a]	–21	144	—
Malaysia	–29	18	2
Thailand	–38	27	4
	Stock market: change in monthly index average between the end and beginning of period		
Indonesia	13.9	–5.3	–1.2
Philippines	22.7	–15.0	–5.1
Malaysia	7.2	–0.5	–3.6
Thailand	12.2	–2.2	–2.1
	Currency: change in the LCY/USD exchange rate, monthly average, between the end and beginning on the period		
Indonesia	0.8	12.0	2.1
Philippines	3.1	7.2	0.1
Malaysia	–5.2	2.0	0.5
Thailand	–7.1	0.3	0.4

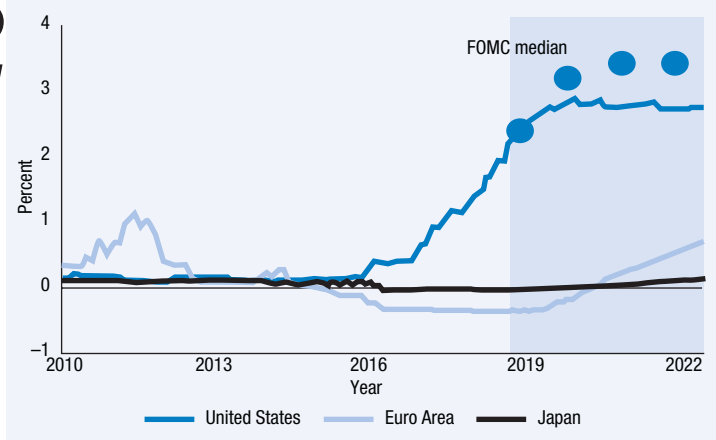
Source: CEIC Data (database), New York, NY (accessed November 5, 2018), www.ceicdata.com.
Note: — = not available; LCY = local currency.
a. Using September data; Philippines bond yield data is available only up to September.

Figure 1 **Inflation and unemployment rate in the United States (inflation: percent; year on year and unemployment: percent of labor force)**



Source: Global Economic Prospects (database), World Bank, Washington, DC, http://www.worldbank.org/en/publication/global-economic-prospects.
Note: Inflation is measured by year-on-year change in the personal consumption expenditures (PCE) price index. Both PCE price index and unemployment rate are seasonally adjusted. Dotted lines refer to projections over longer run in the latest Federal Open Market Committee (FOMC) meeting (in September 2018), based on the central tendency. Last observation is August 2018. RHS = righthand side.

Figure 2 **Policy rate and market expectations (percent)**



Source: Global Economic Prospects (database), World Bank, Washington, DC, http://www.worldbank.org/en/publication/global-economic-prospects.
Note: Policy rates are for the effective federal funds (United States), EONIA (Euro Area), and overnight call rate (Japan). Blue dots (FOMC median) are medians of individual FOMC participant's judgment of the appropriate target level for the federal funds rate at the end of 2018 to 2021, in the September 2018 FOMC meeting. Shaded area indicates market expectations derived from overnight swap rates (as of September 28, 2018).

emerging markets may increase, leading to sharp asset prices movement in emerging market developing economies. A similar scenario happened in mid-2013 when an announcement by then Federal Reserve Chairman Ben Bernanke that quantitative easing would be "tapered" later that year triggered capital outflows from emerging markets.

Global trade tensions constitute the second main factor behind the pressure on SEA markets. The sensitivity of SEA economies to trade tensions stems from the high degree of global trade integration and their strong trade links with China. The direct spillover impact of higher U.S. tariffs on China's goods (via lower Chinese demand for SEA's inputs) is difficult to estimate in the short term as business players are weighing whether the "shock" is temporary or permanent. However, threats of trade wars generate uncertainty in global markets and threaten to disrupt regional supply chains if they materialize—a risk enhanced by the tightening cycle of current U.S. monetary policy. There was a strong spike in SEA currencies (that is, depreciation) in July 2018 when the United States and China first raised their tariffs.[1]

While the situation in distressed emerging market economies may have adverse, indirect "sentiment" effect on SEA, direct contagion risks are likely to be contained. For instance, SEA's exposure to Turkey's financial sector is negligible, and Turkey's share in most SEA countries' exports is small, representing 0.7 percent, 0.8 percent, 0.1 percent, and 0.5 percent of Indonesian, Malaysian, Philippine, and Thai exports, respectively. A further slowdown in Turkey's gross domestic product (GDP) growth is therefore unlikely to have a significant direct impact on SEA. Markets in SEA would be affected only if events in Turkey disrupted the global financial markets, which seems unlikely.

When shifts in capital flows affect currencies

Three main factors explain the difference in the sensitivity of SEA currencies to volatility in capital flows. The first factor is the size of stable foreign financing inflows relative to the current account balance. Because foreign direct investments are the most stable capital inflows to developing countries, the "basic balance," that is, the difference between foreign direct investment (FDI) flows and the current account balance is often used to measure this gap. When the basic balance is negative (that is, FDI inflows are insufficient to fully cover a current account deficit), volatile portfolio flows are relied upon to fill external funding gaps, and this exposes countries to sudden changes in portfolio investor sentiment. If the negative basic balance is driven by a large current account deficit, a foreign financing gap opens, which needs to be closed through a currency depreciation and reduced domestic

demand (for example, lower GDP growth) or a sharp depletion of foreign reserves.

The second factor is the share of non-resident investors' holdings of domestic portfolio assets. When this share is large, the market is more sensitive to risks, and there is a higher chance of capital flight when global investor sentiment toward emerging markets suddenly changes. The third factor is the depth of the financial sector. There is empirical evidence that deep financial markets (proxied by the level of private credit extended by banks and other institutions as a share of GDP) serve as a shock absorber, mitigating the negative effects of external shocks on exchange rate volatility.[2] In the case of sudden portfolio outflows, financial sector depth enhances the ability of the domestic financial sector to purchase the assets sold by foreign investors without large swings in asset prices and exchange rates.

Table 3 and Figure 3 show how the four major SEA economies fare relative to these three factors. In Thailand, a large basic balance surplus (reflecting a large current account surplus) combined with a deep financial market significantly reduces the sensitivity of the Thai baht to portfolio reversals of moderate scale. For instance, with Thailand's basic balance of 8.5 percent of GDP, it would take portfolio capital outflows equivalent to more than this amount to weaken the baht (assuming all else are equal). In addition, Thailand's deep financial markets can help minimize the impact of sudden sell-offs by non-residents, as there are large domestic financial institutions to purchase the assets. Malaysia shows similar characteristics except that foreign investors hold a higher share of domestic bonds (32 percent) and the size of the basic balance surplus is about 50 percent lower than that of Thailand. Malaysia's deep financial sector is, however, a buffer that helps amortize the potential impact of sudden sell-offs on the currency. For both Thailand and Malaysia, capital outflows from residents (not captured by the basic balance) may be as important as non-resident flows in moving domestic currency markets.

At the end of the spectrum, Indonesia's rupiah is more sensitive to changes in portfolio capital flows. In Indonesia, this sensitivity is heightened by a combination of a low basic balance (near zero in 2017 and slightly negative in 2018), a high share in the foreign holding of domestic currency bonds (38 percent), and a shallow financial market (the shallowest in SEA). In the Philippines, equity flows and resident outflows are the main "mover" of the peso, as the bond market is small and largely domestic (non-residents hold only 5 percent of government bonds). The peso is less sensitive to sudden capital outflows because the scope of bond sell-offs is reduced by the small share of non-resident holding and a still positive basic balance (despite a widening current account deficit).

Table 3 **Basic balance, share of foreign holding, credit to GDP**

	Basic balance[a] (% of GDP)	Share of foreign holdings[b] (% of total government local currency debt issuance)	Credit-to-GDP[c] (% of GDP)
Indonesia	0.2	37.6	47.0
Thailand	8.5	14.1	164.7
Malaysia	4.2	32.2	145.3
Philippines	2.4	5	66.3

Sources: World Development Indicators (WDI, database), World Bank, Washington, DC, datatopics.worldbank.org/world-development-indicators/user-guide.html; AsianBondsOnline (database), Asian Bonds Market Initiative, Manila, Philippines (accessed November 5, 2018). www.asianbondsonine.adb.org

Note: a. WDI; b. As of end Q4, 2017(AsianBondsOnline); c. domestic credit provided by the financial sector (% of GDP); data for 2017 except Malaysia, 2016 (WDI).

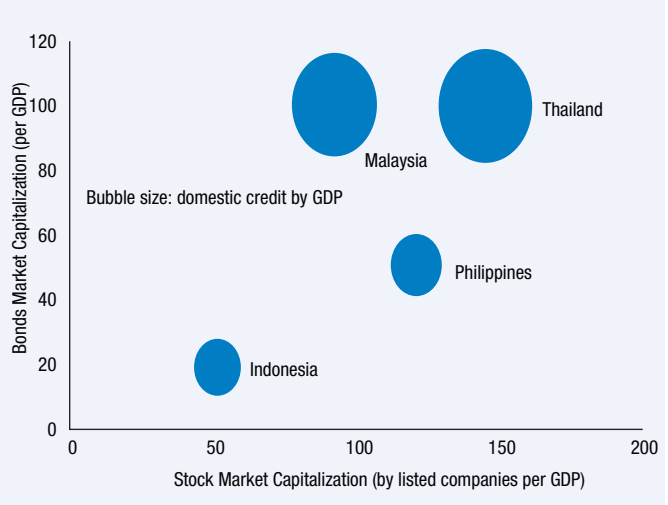
How resilient are SEA economies to capital outflows?

The initial impact and policy response to a retrenchment in capital flows depends on the degree of flexibility of the exchange rate. SEA economies have all adopted flexible exchange rate regimes since the 1997 crisis to avoid unsustainable misalignments and currency crashes and allow flexible adjustment to shocks. Thus, a depreciation of the exchange rate should be expected when portfolio flows retrench, especially where stable financing (for example, FDI) is low compared to the size of the current account deficit. This depreciation would help amortize the shock and minimize reserve depletion, but sharp depreciations may be a concern if foreign currency exposure in the balance sheets of the public sector, the financial sector, and the corporate sector is large, and household debt sizeable. Sharp depreciation may also fuel inflation, forcing the central bank to increase interest rates. Thus, the "vulnerability" of countries to sharp depreciation depends primarily on the following key factors:

- Public sector imbalances: such as high fiscal deficit, external public debt, and large contingent liabilities
- Financial sector imbalances: such as banks' high leverage and risk taking, liquidity, and currency mismatches
- Non-financial sector imbalances: such as excessive corporates and household debts
- Foreign reserves adequacy: foreign reserves compared to total imports, for example
- The initial level of inflation.

Against these factors, SEA displays a strong resilience base and fundamentals (Table 4). On the fiscal side, primary balances are in small deficit (Indonesia, Malaysia, and Thailand) or in surplus (the Philippines). In addition, the real GDP growth is higher than the real interest rate in all countries, auguring well for the trajectory of public debt, which remains relatively low across the region (except in Malaysia). In the financial sector, the leverage and risk taking by commercial banks is low: their capital adequacy ratios are all above Bank for International Settlement prudential requirements and non-performing loans are below 3 percent (except in Thailand). However, household and corporate debt remain high in Thailand and Malaysia, partly reflecting the depth and sophistication of the financial markets in these countries. All the countries in SEA have ample foreign exchange buffers relative to imports. Finally, inflation has remained low in 2018 for the region, except for the Philippines (5.1 percent on average in the January–October 2018 period, against 3.2 percent for Indonesia, 1.2 percent for Malaysia, and 1.1 percent for Thailand). Inflation in the Philippines accelerated over the past year due mainly to food supply bottlenecks and cost-push factors, and demand-pull factors.

Figure 3 **Depth of the financial sectors in South East Asia**



Source: World Development Indicators (database), World Bank, Washington, DC, datatopics.worldbank.org/world-development-indicators/user-guide.html

Table 4 **Selected indicators of resilience in key areas**

	Indonesia	Malaysia	Philippines	Thailand
Financial sector				
Net open position in foreign exchange to capital (%)	1.7	9.2	3.6	—
Non-performing loans to toal gross loans (%)	2.7	1.6	1.7	3.1
Regulatory tier 1 capital to risk-weighted assets (%)	22.2	14.0	12.7	14.9
Regulatory capital to risk-weighted assets (%)	22.5	17.5	14.5	17.8
Fiscal sector				
Real 10-year bond yield minus GDP growth (%)	–0.8	–1.0	–5.3	–3.2
Primary balance (% GDP)	–0.9	–1.1	1.4	–0.1
Government gross debt (% GDP)	28.9	54.2	37.8	41.9
External sector				
Reserves excluding gold as % of imports of goods, services, and income	45	45	52	74
Current account balance as a % of GDP	–2.7	3.3	–1.5	8.1
External debt as a % of GDP	34	56	24	32
Non-financial sector				
Household debt[a] (% GDP)	17.0	67.0	16.0	68.0

Sources: World Development Indicators (database), World Bank, Washington, DC. datatopics.worldbank.org/world-development-indicators/user-guide.html; CEIC Data (database), New York, NY (accessed November 5, 2018), www.ceicdata.com; Institute of International Finance (IIF, database), Washington, DC (accessed November 5, 2018), www.iif.com.
Note: Based on 2017 data; — = not available.
a. IIF.

SEA's strong macro-fiscal indicators reflect key reforms implemented following the East Asian financial crisis of 1997–98. Key lessons learned from the 1997–98 crisis include the importance of flexible exchange rates, the need to accumulate large foreign reserve holdings (to insure against sudden reversals in capital inflows), the advantages of low public debt (to sustainably conduct countercyclical fiscal policies as needed), and the importance of oversight institutions and prudential regulations (to keep bank, corporate, and household leverages in check). SEA has learned these lessons and has applied them in macroeconomic policies over the past two decades. Perhaps more importantly, SEA's governments have moved to a more flexible policy setting, using flexible exchange rates and prompt monetary and fiscal policy responses to shocks. This has generally helped SEA as a sub-region maintain resilience. However, to sustain resilience, each SEA country needs to pay attention to and act in a few specific policy areas.

Policy priorities for sustaining the economic resilience of SEA

Indonesia: Structural reforms needed to reduce vulnerability to episodic portfolio retrenchments

Indonesian authorities have long internalized the rupiah's sensitivity to sudden capital outflows by implementing prudent macroeconomic policies. Fiscal policy is prudent, with a strict adherence to the 3.0 percent of GDP legal deficit limit every year, leading to low levels of public debt (29 percent of GDP) and reasonable fiscal buffers. Typically, fiscal policy has had a strong impact on the current account deficit through capital goods imports. In response to recent global financial market volatility and weak FDI inflows, the government has postponed some large infrastructure projects to prevent the current account deficit from widening further.[3] Monetary policy has also prioritized macro stability in recent years, and a large real interest rate gap between the rupiah and the U.S. dollar has generally supported capital inflows. Between May and November 2018, the central bank has increased its policy rate by 225 basis points despite an inflation rate within the target range (3.5 percent).

Going forward however, good macro and macro-prudential policies may not be enough to guarantee resilience. Deep structural reforms are also needed. Indonesia's exposure to the vagaries of portfolio flows reflects the fact that the country exports less than it could and attracts less FDI than its good macro policies and large domestic market warrant. Structural reforms that aim to increase private investment including FDI, boost exports, and deepen the financial sector are crucial. Authorities could remove restrictions faced by investors to attract higher levels of FDI by reducing restrictions in the government's negative investment list. World Bank studies show that Indonesia's low level of FDI is linked to a high level of restrictiveness on foreign investment, including the limits to foreign ownership detailed in the negative investment list. Indonesia could also increase competition in financial services to develop its domestic banking sector. The sector is currently suffering from limited competition due to the dominance of state-owned banks and the presence of various barriers to increased product offerings (for example, long-term credit and hedging instruments). Capital markets, which do not currently offer sufficient funding to the private sector, are not yet a competitive alternative to the banking sector.[4]

The Philippines: Managing inflation and avoiding a fast widening of the current account deficit

In the short-term, reducing inflation is the Philippines' main policy challenge. Inflation rose to an average of 5.1 percent in the first 10 months of 2018, against 2.8 percent in the same period in 2017. This was driven in large part by food supply constraints (weak agricultural and fisheries production and rice import bottlenecks), cost-push factors (higher global oil prices and depreciation of the peso), and strong domestic demand (GDP growth has remained above 6 percent over the past three years). Indeed, core inflation rose to 4.9 percent in October 2018, from 2.6 percent in October 2017, breaching the central bank's 2018 target (2–4 percent). To contain inflation risks and anchor expectations, the central bank has raised the key policy rate by a cumulative 175 basis points to 4.75 percent (5 increases from May 2018 to mid-November). The central bank's forward-

looking statements of "strong commitment to price stability" and "readiness to act" augurs well. The government's decision to replace rice import quotas with a more open and transparent import tariff system is also important to fight inflation going forward.

Sustaining the Philippines' resilience will also hinge on preventing the current account balance from widening too much too fast, which requires calibrating the expansionary path of fiscal policy. The country's current account deficit increased rapidly in the first half of 2018 (1.9 percent of GDP), substantially higher than the 0.1 percent of GDP deficit in the first half of 2017. The rise in the current account deficit has gone together with fiscal expansion. The fiscal deficit has indeed gradually increased to 2.3 in the first half of 2018, from 2 percent in 2017. The fiscal expansion is driven partly by public capital spending on infrastructure, which increased by 41.6 percent growth in the first half of 2018 consistent with the government policy to improve roads, control flooding, and maintain bridges and school facilities. Going forward, a further fiscal expansion is likely to increase capital imports and the current account deficit as rising trade tensions reduce the likelihood of a compensatory rise in exports. Thus, for the Philippines, while closing the infrastructure gap is crucial for inclusive growth, calibrating and sequencing the fiscal expansion carefully will be important if the external environment remains difficult.

Malaysia: Fiscal reforms needed to bend the curve of external debt

While Malaysia's economic fundamentals remain sound, fiscal reforms will be crucial in sustaining the country's resilience. Malaysia's macro-fiscal indicators are solid, but at 54 percent, the level of public debt is high, and pursuing a fiscal consolidation trajectory is in order. The government repealed the goods and services tax on June 1, 2018 and unwound fuel subsidy rationalization. According to the Ministry of Finance, these changes will cost 1.7 percent of GDP in 2018, and they will be offset by spending cuts, bigger oil revenues, larger dividends from government-linked companies, and proceeds from the reinstatement on September 1, 2018 of a sales and services tax. Fiscal reform efforts should, however, be continued in the medium term to bring down the deficit and rebuild fiscal buffers. As part of the 2019 Budget publication, the new government announced that fiscal consolidation measures will help reduce the fiscal deficit to 3.4 percent of GDP in 2019 (from 3.7 percent in 2018), 3 percent by 2020, and 2.8 percent in 2021. Effective implementation of fiscal reforms will be crucial in sustaining the country's strong resilience to shocks.

Malaysia's current account surplus may also come under pressure from a possible global trade slowdown, but the cancellation of many government mega-projects could offset that. Malaysian exports represent 68 percent of the country's GDP. Trade protectionism and a slowdown in global demand are important downside risks to growth. While the robust growth of Malaysia's exports is expected to continue in 2018, it is projected to decelerate gradually in the coming years as the global environment becomes less supportive. However, the new government has cancelled many mega projects that could have led to significant capital imports and a rapid decline in the current account surplus, and this may help Malaysia keep its external financing needs from rising in the near term.

Thailand: reducing high household leverage

Thailand remains well placed to manage any potential volatility arising from cross-border capital flows due to the large scale of its buffers. Thanks to a large current account surplus (8.1 percent of GDP), Thailand displays a very large basic balance surplus and the largest foreign exchange buffer in the sub-region (74 percent of GDP). Moreover, at 42 percent of GDP, public debt remains low. Fiscal discipline and fiscal rules are now enshrined in law under the recently passed State Financial and Fiscal Discipline Act of 2018. External debt is also relatively low (32 percent of GDP) and mostly denominated in baht or hedged (Table 4). While the size of these buffers reflects Thailand's sluggish public investment and growth in recent years, there seems to also be a clear bias toward stability in policy making.

The government's past quasi-fiscal policies to stimulate consumption, such as the tax rebate for housing and car purchases, rice pledging scheme, and loose macro-prudential stance have

contributed to a rapid rise in household debt over the past 10 years. The latter stood at 52 percent of GDP in 2008, and it has risen to 68 percent in 2017 and 78 percent to date. Given the relatively high non-performance loan ratio (3.1 percent) and a possible rise in the central bank policy rate for the first time in three years, the high level of household debt represents a clear build-up of potential vulnerabilities. The Bank of Thailand has recently announced the issuance of loan to value caps for high-end housing to address pockets of risks and preempt the further build-up of vulnerabilities. In addition, the prudential supervision of "policy banks"[5] was transferred to the Bank of Thailand from the Ministry of Finance in 2017 to mitigate conflict of interest and increase transparency around the cost of directed lending to the taxpayer. These measures combined with the banking sector's high capital adequacy ratio (17 percent, well above Basel 3 requirements) further strengthen the health of Thailand's financial sector.

Conclusion

Going forward, the outlook for global growth, trade, and investment is likely to be less favorable for developing countries. Furthermore, rising trade tensions and interest rates will heighten policy uncertainty and elevate financing risks. In this context, continuous focus on macroeconomic stability will remain important for South East Asian economies. The application of the lessons from the 1997 crisis has served them well so far. An effective implementation of the recent "responses" to the global market volatility announced in the different countries over the past few months will however be crucial to sustain resilience.

Notes

1. Note that domestic country-specific factors also affected asset markets in Malaysia. For instance, the sharp one-time capital outflow in July was attributed to the surprise effect of the results of the May general elections. Net portfolio investment recovered rapidly in August as the new administration was established and its policy agenda announced.
2. See, for instance, Dabla-Norris and Srivisal 2013.
3. The mid-2013 "taper tantrum" of the United States caused the Indonesian financial markets to come under pressure. The stabilizing actions taken immediately—chiefly an increase in the price of fuel, which reduced the fiscal deficit, combined with a tightening of monetary policy—effectively brought the current-account deficits down and improved investor sentiment. Subsequent major fuel subsidy reform in late 2014 and early 2015 led *The Economist* magazine to "withdraw" Indonesia from the "Fragile Five" group of emerging market economies. Unfortunately, part of the fuel subsidy gain is lost due to a "pause" in adjustment of fuel prices over the past year.
4. See IMF-World Bank Indonesia Financial Sector Assessment Program (2018) for more details.
5. "Policy banks" are state-controlled specialized financial institutions (SFIs) set up under specific legislation to fulfil government policy objectives (for example, agriculture, housing, and SME development). SFIs are an important part of the Thai financial system, accounting for 25 percent of system deposits and providing 29 percent of household debt.

References

Dabla-Norris, Era, and Narapong Srivisal. 2013. "Revisiting the Link Between Finance and Macroeconomic Volatility." *IMF Working Paper,* WP/13/29.

International Monetary Fund. 2018. *Financial Sector Assessment Program Detailed Assessment of Observance—Insurance Core Principles.* March.

International Monetary Fund and World Bank. 2018. *Indonesia Financial Sector Assessment Program.*

Röhn, Oliver, Aida Caldera Sánchez, Mikkel Hermansen, and Morten Rasmussen. 2015. "Economic resilience: A new set of vulnerability indicators for OECD countries." *Economics Department Working Paper n. 1249.*

viewpoint

is a note series to encourage dissemination of public policy innovations. It is published by the Macroeconomics, Trade & Investment global practice of the World Bank Group. The views published are those of the authors and should not be attributed to the World Bank or any other affiliated organizations. Nor do any of the conclusions represent official policy of the World Bank or of its Executive Directors or the countries they represent.

To order additional copies contact Jenny Datoo, managing editor, Room F 5P-504, The World Bank, 1818 H Street, NW, Washington, DC 20433.

Telephone: 001 202 473 6649
Email: jdatoo@worldbank.org

Produced by Carol Siegel

Printed on recycled paper