Financial Development in Asia: Work in Progress

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The 1997-98 Asian financial crisis exposed weaknesses in the region's national financial systems but since then East Asia has become the world's most dynamic economic region. Domestic financial systems have developed. Cross-border financial flows within the region are growing apace as demand grows from governments and large firms and as the capabilities of financial institutions develop. Governments have initiated regional cooperation aimed to prevent future crises and manage them if they occur.

Has financial development been sufficient to meet the demands of the dynamic real economies? Have lessons been learned from the 2008-09 global financial crisis? Where once it seemed wise to vow "never again" will there be a regional financial crisis, today it is broadly recognized that by their very nature financial systems are crisis prone. Just as financial reforms can promote economic growth and development, the boom and bust behavior of insufficiently-regulated financial markets can seriously damage the real economy.

This book finds financial development in the Asia-Pacific region to be work in progress. It focuses on such questions in four parts by examining, first, the future implications of historical studies of the relationships between financial development and growth. Second, it turns to financial development including banks, non-bank financial institutions and capital markets. Third, it examines how financial stability is being sought in the region in the context of global financial regulation, national monetary policy conduct, and regional cooperation. Finally it examines China's plans for capital account opening and renminbi (RMB) internationalization and the policy implications for China's neighbors.

Modern financial systems provide significant services: they mobilize the resources of an economy; facilitate transactions necessary to carry on economic exchange; assist the management of risk by pooling and diversifying risks faced by investors and savers and the users of those funds; collect and evaluate information required for investment decisions; and monitor and evaluate the behavior of corporate managers (Levine 1996). By channeling funds to uses that offer the highest available rates of return financial services play potentially crucial roles in financing growth and facilitating entrepreneurship and risk taking.

Asian financial systems have evolved from those with high levels of government ownership of the mainly bank-dominated systems to more diverse systems with growing reliance on market competition. A large financial literature supports the merits of such reform, mainly through benefits of faster economic growth as savers receive higher rates of return and entrepreneurs and

innovators access funding more readily. Long ago Schumpeter (1911) assigned a central role to credit as an engine of innovation and entrepreneurship. Studies of financial sector reform and economic growth during the past half century, particularly McKinnon (1973) and Shaw (1973) identified a strong positive relationship between financial intermediaries' roles and economic growth – and a negative relationship between financial repression (government-imposed nominal interest rate ceilings) and real economic growth and the real size of the financial system. More recent empirical studies by King and Levine (1993 a, b and c), among others, on large samples of developing countries find positive relationships between growth and such financial indicators as bank assets to total financial assets, private sector credit relative to both total domestic credit and GDP.

Financial development also has risks and costs. Policy changes that promote a more efficient financial sector imply the closure of inefficient firms. New policies and practices such as modern supervision and regulation mean abandoning special relationships and poor lending practices. Like trade in goods, competition brings net benefits, but at a cost to those whose interests were well served by legacy systems.

One of the alleged risks of reform is increased probabilities of crisis. While there is evidence that domestic deregulation and opening up and the sequencing of reforms can expose or exacerbate problems in the presence of macroeconomic or regulatory weakness which may lead to crisis (Mckinnon 1991), it is not the reforms that cause difficulties, rather they expose the weaknesses. The answer is to address them, such as weak risk evaluation and management capabilities in banks, connected lending, insolvent banks—and in the macroeconomy-- so that capital account liberalization can proceed without precipitating a major financial disruption. A broad commitment to financial reform can help to create the incentives to address financial and supervisory weaknesses.

The Asian financial crisis exposed the weaknesses in Asian financial systems from heavy reliance on banks, both government- and family-owned, the region's dependence on private capital flows and modern capital market institutions based in international financial centers such as New York, London, Hong Kong and Singapore (Eichengreen and Park 2005). The crisis also revealed the inadequacy of the Bretton Woods system in managing today's cross-border capital flows (Chen 2000), prompting countries in the region to rely on themselves by developing their own equity markets and by cooperating to develop a regional bond market with assistance from the Asian Development Bank. More recently, the region's economic dynamism has stimulated demand for the capabilities and longer view of capital markets and secondary markets, particularly in China and South Korea. Governments' resolve to prevent another crisis has created incentives to extend cooperation to create the Chiang Mai Initiative, an emergency financing mechanism for use if a crisis occurs, and to work to prevent future crises through regular surveillance of their economic performance and policies.

Study of the triggers in the United States of the 2008-09 global financial crisis has renewed concerns about the potential for the boom and bust behavior in modern financial markets seriously to undermine real economic growth. Not only did financial innovation produce new instruments but these were instruments, such as the securitization of sub-prime mortgages, which concentrated risk in ways that neither banks nor regulators understood. In other words, sophisticated innovations got ahead of the regulators. In the wake of the crisis, governments (in convening the G-20 leaders' summits) and regulators (at the Bank for International Settlements and Financial Stability Board) have created new standards for assessing bank risks as well as new institutions to monitoring macroprudential or systemic risks in increasingly linked banks and capital markets that operate around the globe.

Finance and Growth

The large contemporary and historical literature on relationships between financial development and economic growth has overlooked more recent work on the historical evidence that uses modern methods and disaggregated data. **Barry Eichengreen's** survey of this modern literature based on historical evidence is therefore a timely study which reminds us of the diverse approaches taken by four OECD economies (Great Britain, the United States, Germany and Japan) to develop their financial sectors. Banks were the dominant institutions long before capital markets were developed (the latter in some cases responded to urgent demands for capital to finance wars). But the distinction between bank-based and market-based financial systems has been over-emphasized. He points out that "history casts long shadows": legacy systems take time to change, and that financial systems are networks and ecosystems in which banks and security markets are complements, based on differing comparative advantages – banks in information and securities markets in financing real and more risky and uncertain technologies. The role of government is central in that it creates the institutional and incentive frameworks; but regulation and enforcement of regulations should be viewed as potential growth facilitators or obstacles, and governments must be aware of this.

Eichengreen also includes South Korea and China where he notes that both financial systems were originally bank-based. By watching how financial systems developed in the OECD, they moved to deregulate and liberalize their financial markets and then found they had to respond to growing demand from dynamic firms and firms investing in risky technology. In both South Korea and Japan it took crises to create policy climates in which resistance by vested interests to reforms could be overcome. Will China's experience be different?

Financial Development

Many economies in the Asia and Pacific Region which have experienced fast economic growth and abundant domestic and foreign funds have undertaken financial reforms and implemented macro-prudential policies in the past two decades. Yet, financial systems in general and capital

markets in particular in the region have not been as developed as might have been expected. The two papers in this section shed some light on this subject.

Tatiana Didier and Sergio Schmukler's detailed statistical analysis of financial development in Asia shows the evolution of bank and capital market institutions by size, their shares of domestic financial systems, as well as such measures as composition of bank credit and banking system concentration, and comparable indicators of bond and equity markets. But Asia's financial systems remain less developed than aggregate measures suggest. In comparisons with advanced and other emerging market economies, Asians are ranked between the more diverse and liquid markets of advanced countries but more developed than Eastern Europe and Latin America. Bond and equity markets and institutional investors are evident, but capital is channelled mainly to large companies; public sector issuers account for most bond market activity. Their evidence implies that Asian governments still have a long way to go in developing capital markets and diversifying their financial systems. In particular, it reveals the relative absence of SME finance and informal finance, sources on which a number of Asian economies continue to rely relatively heavily for job creation and other economic activity. Didier and Schmukler believe that part of the problem seems to lie in the financial intermediation process which has not been able to mobilize and allocate funds effectively. In particular, non-bank financial intermediaries can play larger roles and take greater risks. But in this, the challenge is how to balance stability and development.

Andrew Sheng deepens the focus on capital markets. As he notes, historically national governments had little need for bond markets because of the importance they attached to prudent fiscal policies and balanced budgets. At the same time equity markets existed but were dominated by family- and state-owned enterprises. Insurance and pension funds were state-sponsored or dominated by state firms, while asset and wealth management is a relatively new industry. In the wake of the global financial crisis the pattern of emerging markets funding advanced economies has highlighted the desirability of the former relying less on exporting and more on domestic demand and investments as engines of growth.

In other words, Asian finance should in future serve better the real economy. Sheng sets several conditions by which this can happen: through appropriate resource allocation, market-determined prices, better risk management and appropriate governance objectives and enforcement. The challenges of capital market development will vary among different economies but a common feature is bank dominance and 'short termism'. He proposes a detailed (and daunting) agenda for developing capital markets which includes developing the necessary market infrastructure including information and trading platforms; creating payments and settlement systems, legal, regulatory and exit frameworks; use of public-private partnerships and deeper regional cooperation to identify and address bottlenecks and barriers to free trade and financial integration. Like Didier and Schmukler, Sheng points out that the Asia and Pacific region has potentials to deepen capital markets, but the challenge is how to improve the intermediation process, a subject the APFSM Report specifically addresses

Financial Stability

While financial deepening and catch-up with developed countries' financial systems are important goals for emerging economies, balance is necessary between financial development and financial stability, particularly in view of the recent regional and global financial crises. Maintaining financial stability is obviously the responsibility of international financial regulators, national governments and regional institutions**.**

Robert McCauley examines the implications for Asian financial systems of global financial regulators' new priority accorded identification and management of macro-prudential, or system-wide, risks. The first implication is Basel III's implementation for the cost and efficiency of financial intermediation in the region through standard setting and monitoring capital quality and quantity requirements, leverage and liquidity standards. McCauley argues that available evidence suggests that banks have managed to raise their capital ratios without raising the overall cost of credit or restricting its availability. Basel III also coincides with a retrenchment of European banks from Asia but Asian and non-Asian banks have filled the gaps, causing little impact on trade finance, forex derivatives, project finance and home-host issues. The second implication is Basel III's macro-prudential regulations with a built-in countercyclical capital buffer. Should national or international regulation go beyond Basel III? McCauley can only envisage national polices applying to capital assets or liabilities across the board or to particular categories. He recognizes that macro-prudential policies taken in isolation can be very difficult to enact and sustain. As a consequence he counsels the use of rules over discretion and points out that, in countries with different regulators for banks, capital markets, insurance, and pension funds, the importance of close cooperation *within* countries in implementing macro-prudential policies.

Hiro Ito focuses on the conduct of monetary policies in the Asian economies since the global financial crisis, reflecting concerns about the volatility of capital flows which arrived in massive volumes after the crisis as nominal US interest rates moved towards zero – and the risk of large capital outflows as the extraordinary easing of US monetary policy through quantitative easing begins to reverse. Comparing to the pre-Asian crisis period, Ito finds most Asian emerging economies have more flexible exchange rates, greater monetary independence, slightly less financial openness and an increased level of international reserve holding, providing some protection against such volatility. However, it has been suggested recently that as a result of financial globalization, it is now harder for monetary policy to determine longer-term interest rates through manipulating the shorter end of the yield curve, implying that it is more difficult to achieve both macroeconomic and financial stability. It has also been suggested that as a result of the close financial linkages between the United States and other countries, the importance of exchange regimes in monetary policy has reduced. The monetary trilemma is reduced to a dilemma or an 'irreconcilable duo' between monetary independence and capital mobility. However, the empirical evidence is divided on this issue of whether exchange rates matter. Ito then estimates the extent to which long-term interest rates respond to short-term interest rates

(the pass-through) in 71 developed and developing countries during 1970 to 2011. He finds that cross-border capital flows do weaken the link between long- and short-term interest rates, thereby undermining macroeconomic and financial stability. He further examines trends and correlations in long- and short-term interest rates taking into consideration the determinants of capital flows and finds support in emerging economies which are highly open to capital flows and receive a great amount of flows for net capital inflows to weaken the link and reduce authorities' grip on the longer end of the yield curve. But as he points out, what this finding suggests is that the institutional structures handle mainly short-term debt financing; further financial reform to encourage long-term finance, particularly by developing bond markets, could lengthen the term of cross-border flows. This concern creates a dilemma, however, since authorities are likely to have a stronger grip on if financial systems retain their current short-term bias. The link between financial globalization and interest pass-through should therefore be considered as an additional factor to incorporate into macroprudential monitoring.

Reza Siregar and Keita Miyaki continue the focus on regulation and international cooperation for macroeconomic and financial stability by examining the origins and record of the Chiang Mai Initiative (CMI), the key regional institution for financial crisis prevention and management, created in 2000 in the wake of the Asian financial crisis. Just as the crisis exposed weaknesses in domestic financial institutions, lack of regional institutional capabilities were also evident. CMI was originally created as a pool of central bank swaps. It was formalized as the CMI Multilateralization (CMIM) in 2009 and its financial resources were doubled by member governments in 2012. Throughout its life, CMIM has faced uncertainty about whether governments are willing to surrender sovereignty sufficient to participate effectively in peer surveillance – which is also a potential channel to gain some leverage over the objectives and performance of their partners. The ASEAN+3 Macroeconomic Research Office (AMRO) was created in 2011 to provide the technical support for this surveillance. Siregar and Miyaki survey the main indicators of regional integration, cross-border trade and financial flows; they also document the significant growth in cross-border capital flows among domestic banks which raises the question of whether the focus of surveillance should be expanded to financial sectors. Another evolving challenge they identify is the potential for 'forum shopping' as regional central banks continue to engage in bilateral swaps among themselves at the same time as they contribute to CMIM's resources for emergency finance. Siregar and Miyaki believe that bilateral and CMIM swap arrangements can complement each other if they are well coordinated and put under one general framework.

China's Financial Opening

China's economy has developed and expanded but development of its financial markets has not kept pace, as is evident in the statistical analyses in preceding chapters. China's new leaders who assumed power in 2012-13 have begun to change that, at a measured pace. China is already the world's leading exporting nation and will sometime before 2030 become the world's largest economy. Restricted capital account transactions ensured stability of key domestic prices and insulated China from external shocks during its three-decades growth sprint. As the industrial economy becomes more complex and the urban middle class grows, market forces will play a "decisive" role, not least in the financial sector. Opening the capital account has become a narrative for necessary monetary and financial reforms and RMB internationalization is considered congruent with China's rising global importance. Both developments will have repercussions far beyond China's borders.

Yu Yongding examines the case for capital account opening with a review of the arguments for and against. He notes that empirical studies are unable to establish conclusively whether or not such liberalization is growth-enhancing. Indeed, historical evidence shows that opening the capital account opens an economy to the risks of volatile capital movements. The advanced countries that eliminated capital controls many years ago are still vulnerable to external shocks but they use a variety of means to buffer the effects on the real economy through flexible exchange rate regimes that act as shock absorbers. As Yu points out, an integrated approach to capital account liberalization should be part of a program of integrated and comprehensive macroeconomic and structural reforms. He discusses the evolving policy debate in China since the early 1980s and recommends China undertake a carefully-timed gradual sequence of reform that includes adopting a flexible exchange rate (the managed exchange rate creates substantial opportunities for interest rate arbitrage) and clear definition and enforcement of property rights. He argues that China's capital account is already quite open as the result of liberalization since 1996 and that RMB internationalization has "opened a large hole in China's wall of capital controls". The remaining controls aim at short-term capital flows. There should be no haste to remove these, especially when timing of the US Federal Reserve Board's exit from quantitative easing is uncertain and emerging markets face elevated risks of capital flight if US interest rates rise.

Il Huong Lee and Yung Chul Park focus on currency internationalization in Asia and the Pacific region. They propose a multilateral currency scheme for trade settlement for certain members of ASEAN + 3. Since 2009, RMB internationalization has first promoted its use in trade settlement with China's neighbors; at the same time the capital account has been gradually liberalized (but not opened). The response has been rapid in trade settlement and inter-bank markets for the RMB have followed; in addition the RMB is being used as an investment and reserve currency. In other words the region is ready for greater financial cooperation and Lee and Park see the RMB sequenced 'model' of internationalization as applicable to the region. Their proposed currency scheme for East Asia would use some of the regional currencies, including non-convertible ones, for trade settlement. It would be built on a set of multilateral

agreements among participating countries which would include convertibility of national currencies for trade, a clearing mechanism built on a network of clearing banks, interbank foreign exchange markets for direct trading, investment vehicles for non-national currencies received, and an adjustment mechanism for imbalances in currency flows between trade surplus and deficit countries. It is important initially for China, Japan and Korea to join the scheme with ASEAN 5 members joining later.

Lee and Park argue that such a scheme will make the region less dependent on the US dollar and less subject to financial spillovers from advanced countries. At the country level, Japan would gain as it is expected that Yen would increase in use as a currency for trade settlement in the region. The scheme would also aid China in broadening its regional base as a launching pad for the RMB globalization and speeding the capital account liberalization process. They argue the scheme would also help to overcome domestic opposition in South Korea to further financial liberalization. For other countries, the scheme would boost confidence in their currencies and allow them to hold less foreign exchange reserves. Lee and Park recognize such negotiations will be difficult and protracted but maintain that by reducing the costs and risks this route of multilateral currency internationalization is superior to ad hoc deregulations and liberalization.

Conclusion

In conclusion, the chapters in this volume document both work in progress and unfinished business in East Asia's financial development and cooperation. Several authors emphasize the short-term bias to finance supplied traditionally by banks, but counsel the importance of diligent attention by policy makers and regulators to ensure the financial system as reformed still serves primarily the real economy. Banks and capital markets are complementary parts of the financial ecosystem for real growth only if regulators maintain a level playing field. Capital market development is a critical ingredient for financing the region's extensive infrastructure requirements. Yet, using China as an example, the corporate bond market includes mainly state enterprises because of a lack of transparency required to monitor non-state issuers. A related issue is the lack of SME finance when financial systems are designed to serve large connected borrowers like state enterprises.

Several discussants emphasized the importance of innovation to broaden the range of services, modernize allocation and increase efficiency. Yet this is not always the case; financial institutions have found innovative ways to escape the full impact of their decisions on the rest of the economy. Collateralized debt obligations (CDOs), for example, were cited as an innovation that encouraged more leverage within the system and increased the risks of default. Shadow banks were also cited as examples of institutions benefiting from regulatory arbitrage. Regulators' responses, therefore, have to be to force financial institutions to internalize the full impacts of their decisions.

Governments also have other lessons to learn. Lessons from the Asian financial crisis include the importance of sequencing domestic financial reforms that lead to development of capital markets; another is that ways should be found to encourage SME finance through technologies, new institutions other than banks and a role for government perhaps in providing partial credit guarantees in certain cases. Lessons from the global financial crisis include the emerging importance of macroprudential policy. A whole-of-system approach is needed, for example, to pricking asset bubbles rather than relying primarily on monetary policy which has a larger objective. Rules are needed, but what rules?

Another area of work in progress is regional financial cooperation. The question was asked, 'why has no country drawn upon the resources of CMIM?' Is it because of the governance structure and fears of a slow decision making process? Complacency about the likelihood of another crisis? Some participants observed that a future objective for inter-governmental cooperation should be to align the trade and financial architectures. One (trade) includes ASEAN member countries plus six others, while the other (finance) includes only the ASEAN members plus three others.

Finally, it should be noted that there is intense interest by its neighbors in China's handling of capital account opening and RMB internationalization, particularly in light of the evolving rules for the experimental opening taking place in the Shanghai Pilot Free Trade Zone. While most agree that capital account liberalization should be gradual, in recognition of the major institutional reforms required, some argue against over-determination of RMB internationalization, advising China to 'lay the pipes and let the water decide'. More generally, consideration of multilateral currency internationalization might use the RMB 'model' of sequencing the use of national currencies, beginning with trade settlement.

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