Future strategies for regional financial development

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Issues

- Implications of the global financial crisis for the Asian markets and the main policy challenges to be addressed to prevent, or minimize the impacts of regularly occurring international financial market turbulence.
  - What are the appropriate responses from Asia to this crisis?
  - To what extent can regional financial cooperation ameliorate some of the effects?
  - Should Asia accelerate financial integration as a response?
  - Issues on regional regulatory harmonization in the context of market integration.
  - What should Asia recommend for changes to Global Financial Architecture?

Direct impacts in Asia

- Eastern and smaller European economies are hit hard. But Asia's direct exposure to the US subprime loan or troubling major financial institutions was limited.
- Why?
  - Lessons of 1997 crisis: strengthened prudential rules and risk management; limited exposure to unhedged/ illiquid FX assets; enhanced transparency; good CAR; etc.
  - Less sophisticated banks and small non-banks, securities companies and institutional investors unable to have a large exposure to those;
  - Some capital control on outward investments.
  - Many Asian economies do not have a well developed securitization/ ABS market of their own.

➔ More indirect impacts from strong contraction of the global demand are felt and foreseen.

Indirect impacts

- Many export-dependent Asian economies suffer export earnings losses. Some exporters go bankrupt.
  - ➔ *Unemployment*.
  - – Business sector is suffering first before the financial sector gets hit. The level of *NPL* may surge in coming time.
- Prices of oil and other *commodities* crashed.
  - ➔ Resource-rich, commodity-based economies are hit hard. But the region as a whole should be a gainer.
- Many Asian economies also depend on imports and *FDIs* while some carry large trade deficits.
  - ➔ Depressed FDI inflows also cause unemployment.
  - – Pressure may gradually come to currencies of economies with large trade deficits unless they manage to rebalance the trade quickly.

Indirect impacts – continued

- Local stock and property markets are depressed, causing a *negative asset effect* and *under-collateralization* of credits.
  - ➔ The negative asset effect as well as the unemployment *depress the consumption*.
- Banks are cautious in lending to SMEs and new business ventures while established businesses became cautious in borrowing.
  - – Market interest rate declined with monetary relaxation. Asia has good room to further relax M-policy.
  - – But the money is not necessarily reaching out to those who can make productive use of it and generate employment.
  - ➔ More than just expansionary monetary policy is necessary.

Coping with weak external demand and foreign investment

- Fiscal policy to fill shortfalls in the aggregate demand.
  - *Employment* needs to be sustained with targeted fiscal policy (e.g., tax holidays, interest subsidies for labor-intensive industries).
  - *Investment* in infrastructure needs to continue.
  - Some banks may need *capital injection* or nationalization.
  - ➔ Needs to develop the domestic *government bond* market.
- Need to address the corporate distress.
  - Enforcement of *bankruptcy* to liquidate and avail assets and resources for productive use. But it takes time and is costly.
  - Bankruptcy regime in some economies is inefficient. But it takes time to improve.
  - ➔ *Regulatory forbearance* or bankruptcy enforcement? Difficult choice in a reality of crisis, and good balance needs to be hit.

Coping with weak external demand and foreign investment – continued

- Need arrangements to promote credit flows to the corporate sector and households in addition to the expansionary monetary policy.
  - e.g., credit guarantee, trade bill rediscounting, etc. but with a care to avoid creating undesirable side effects and stress to the banking system.
- Temptation to restrict imports (protectionism) and outward investments (capital control) to contain the pressure on the international reserves and exchange rate.
  - May be individually rational but collectively dangerous behavior.
  - Reduced FDIs reduces the import of machinery/ equipment.
  - ➔ Regional cooperation on currency swaps/ sovereign credit guarantee should be useful in preempting or fending off speculative attacks on currencies.

Longer-term issues

- Asian economies are diverse in the level of income, savings, population, industrialization, and resource endowment.
  - Developmental needs of the financial sector differ across countries.
  - ➔ Intra-regional trade and finance/investments should be beneficial.
- Large population and growing income mean the engine of growth is shifting from exports to domestic demand not just now but into the future.
  - Need to reduce the import dependence by strengthening supporting industries (for production of high quality parts/ components) and integration into regional supply chains.
  - Housing and consumer finance
  - ➔ Need enhanced access to finance for *SMEs* and *households*.
- Need to continue to invest in *infrastructure*.
  - ➔ Need domestic long-term finances (equity/ bond markets, securitization, institutional investors/ contractual savings).
- Need to address issues of urbanization and income disparity.
  - ➔ Enhanced access to *microfinance* for the poor.

Future strategies for regional financial development

- The region needs a full-fledged financial system that can respond to increasingly diverse needs of the domestic economy i.e., businesses, households, the public sector and the society.
  - *Bank-dominant* financial sector with differing levels of development. Middle income countries are building a stronger non-banking sector, but in low income countries, even the banking sector is small.
  - Still high *loan to deposit ratio* due to shortage of bank-investable assets particularly in low income countries where domestic money/ bond market is under-developed.

- SMEs and households including the poor need better access to finance.
  - Enhanced *credit information system* and *secured lending regime* to improve the access to credits for SMEs and households.
  - *Leasing* and finance companies to serve for SMEs and households.
  - *Risk capital* mobilization with small cap market (for SMEs) and venture capital / private equity funds.
  - Efficient *trade finance*.

Future strategies for regional financial development – continued

- Need domestic *bond market* and *institutional investors*.
  - To mobilize domestic long-term savings to finance investments in infrastructure as well as current fiscal stimulus programs.
  - Also useful in reducing the pressure on the term mismatch in banks' balance sheet.
  - Focus on the *government bonds* as a core, but building a corporate bond market including ABSs is an ultimate goal.
- Need to build *contractual savings* institutions and diversify the investor base.
  - Small insurance companies and pension funds in low income countries.
- *Consolidated supervision* is needed for *financial conglomerates*.
- *Securitization* should be beneficial for financing real estate, consumer credits and infrastructure development if used prudently.

Future strategies for regional financial development – continued

- The region aims to promote intra-regional financial and investment flows and integrate the regional market.
  - To recycle savings of net saving economies to net borrowing ones.
  - Can this be done without the aid of the third/ common currency?
  - Regional cooperation in currency swaps, sovereign credit guarantee to ensure the resiliency against external shocks.
- In particular, build a regional bond market.
  - Cross border settlement network is needed. But currency matters.
  - Regional regulatory harmonization for corporate bond market (e.g., standards for public issues, eligibility for investment by pension funds and insurance companies, credit rating requirements, etc.)
- Intra-regional role sharing?
  - Does every country need a stock exchange?
  - How to support the cross-border settlement network?
  - Is it possible at all to develop and use a currency basket unit or adopt a common currency in the foreseeable future?

Balance of payments and exchange rate management

- Sound regulation, supervision and risk management alone are not sufficient to ensure the financial stability when there is large and persistent excess liquidity or lack thereof due to structural imbalances in BOP or aggregate investment and savings.
- Persisting large trade surpluses/ deficits or capital flows brought challenges to some Asian economies with rigid exchange rate management (i.e., Mundell-Fleming Impossible Trinity).
  - Monetary policy failed to control domestic money supply, resulting in rapid credit growth, asset bubbles and subsequent crashes.
  - Manageable balance in fiscal finance and public debt is an important ingredient.

➔ Need consistency between the BOP (or I-S) structure, the exchange rate management and the monetary policy framework.
  - In particular, need to move toward more flexible and market-based management of exchange rate.

Global financial architecture

- Is there a need of a regional/ global financial supervisor?
  - Basel Committee, IOSCO, IAIS and their Joint Forum on international standards for financial regulation and supervision and cross border supervisory cooperation.
  - Home country supervision. Is it not enough?
- Should USD continue to be the currency for international/ intra-regional trade and investment?
  - USD strengthened against most other currencies despite the fact that the crisis started in the US.
  - Is there room to consider other alternative (e.g., SDR)?
  - Should Asia aim to adopt a common currency?

Thank you.