

10th OECD-ADBI Roundtable on Capital Market Reform in Asia
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Summary of Proceedings

I. Introduction

1. The 10th OECD-ADBI Roundtable brought together more than 100 representatives from government, the business and financial sectors, and academia, from Asia, the Americas, and Europe to discuss the causes and recent development of the global financial crisis, its impact on and implications for capital market development in Asia.

2. The Roundtable was born ten years ago in the wake of the East Asian financial crisis. The idea at the time was that the mature OECD countries could help the East Asian economies in their post-crisis reform. On its tenth anniversary, the Roundtable met in the midst of another crisis, this time a crisis emanating from the developed world.

3. The international community—G20, G8/G7, IMF, World Bank, OECD, Asian Development Bank and other regional development banks—is responding aggressively to put out the fire of the crisis, return the world economy to sustainable growth path, and redesign national and international systems of financial governance to minimize the risk of crises like this occurring again.

4. The crisis has potentially significant development implications for Asia. Thus, the ADBI is conducting a series of conferences related to major aspects of the impacts of the crisis and their policy implications for ADB's developing member countries. The conferences are being organized in five broad thematic areas: macroeconomic impacts and policy; real economy impacts; social and environmental aspects; financial regulation and reform; and regional cooperation and architecture.

5. As a contribution to the global effort, the OECD has recently published its Strategic Response to the Financial and Economic Crisis. This focuses on two priority areas: finance, competition and governance; and restoring sustainable long-term growth. In the short term, there will be product deliverables in the areas of competition policy, corporate governance, financial education, tax havens, and trade and investment openness. Many of the OECD policy instruments are relevant to the G7 Finance Ministers' February 2009 request for a report on developing an agreed set of common principles and standards on propriety, integrity and transparency of international economic and financial activity.

6. Although the OECD's present membership covers only 30 (mainly developed) countries, it now has an "enhanced engagement program" which includes the People's Republic of China (PRC), India, and Indonesia (along with Brazil and South Africa), and it is developing a program of cooperation and dialogue with South East Asia.

II. Causes of the financial crisis

7. The causes of the crisis can be analyzed at different levels. Also, there were factors, like low levels of financial literacy, which exacerbated the crisis. And the chronology of the crisis played a role, as certain events acted as triggers. Ultimately, the lines of defense that could and should have prevented the crisis failed to do so.

8. As the IMF has noted, the root cause of the crisis was optimism bred by a long period of high growth, low real interest rates and volatility, and policy failures in financial regulation.

There are some parallels with the 1997/98 Asian financial crisis which followed a period of strong growth, rapid credit expansion and rising energy prices, and which originated from imprudent lending practices and excessive risk taking that resulted in the formation of asset bubbles.

9. It has been argued that over the past decade there was a global savings glut emanating from Asia and oil exporters which underpinned low interest rates and enabled countries like the US and some European countries to borrow large amounts of foreign capital, thereby fuelling the reckless lending that led to the crisis. This was, however, not considered to be a direct cause of the crisis.

10. Inadequate supervision of the financial sector was an important contributor to the creation of the housing price bubble, which eventually collapsed in mid-2006. The US financial sector has been neither regulated nor supervised in a way that is conducive to financial stability in a world of rapidly advancing financial innovation and rapidly evolving business models. The US has a highly fragmented system of rule making which is based upon federal law, regulation by agencies such as the Federal Reserve and SEC, and self regulatory organizations (like stock and option exchanges) each with its own rule. Overall, there are more than ten federal, state and industry regulatory bodies in the US.

11. Further, over recent years there was a relaxation of residential underwriting standards. Investment banks were not subject to the stringent capital adequacy requirements that commercial banks were subjected to and the over-leveraging of the balance sheets of these financial institutions became the norm. Financial derivatives were not regulated or monitored adequately by any financial authority. Rating agencies were not subject to any authority's supervision.

12. Looking into the crisis in more detail, we can see that four elements of financial innovation and deregulation came together to create the toxic products that were at the root of the current crisis. First, there was the securitization of plain vanilla residential mortgages into mortgage backed papers by government mortgage institutions such as Fannie Mae and Freddie Mac. Securitization meant that assets could be moved off the balance sheet into unregulated special investment vehicles (SIVs) that did not require capital. Second, accounting and regulatory standards permitted such potential liabilities to be moved off the balance sheet so that the banks benefited from "capital efficiency", allowing them to incur higher leverage with the same level of capital. Third was the use of insurance companies and the newly evolved credit default swap (CDS) markets to enhance credit quality of the underlying paper. If the underlying assets looked weak, the purchase of credit default swaps sold by AAA insurers such as AIG enhanced their credit quality.

13. Though not a causal factor, the low general level of citizens' financial literacy (even in developed countries) was clearly an exacerbating factor. Financial risks and responsibilities are transferred more and more to individuals. This is true for both credit decisions and retirement savings.

14. The market for adjustable, variable, interest-only mortgage loans (sometimes also in foreign currency) has exploded in several countries and transfers interest rate risk onto households. It is clear that many consumers were ignorant of the financial risks they were undertaking, and were vulnerable to predatory lending. It also meant that they were often not financially prepared for the falling housing prices which triggered the chain of events which became the crisis.

15. To better understand the current crisis, it is necessary to look at the chronology of events that unfolded over time with certain triggers. The first phase was a crisis of confidence from fall 2007 to spring 2008 when uncertainty and de-leveraging caused values

to plummet and counterparties to pull back. Following that was the second phase as the financial meltdown spread, a seminal event of which was the failure of the IndyMac Bank for which a buyer could not be found. This led to a run on the bank, and public concerns about which bank might be next.

16. The trigger that set off the systemic crisis worldwide was the Lehman's failure. Although it had only US\$620 billion in assets at the time of failure, Lehman's had a total of US\$1.6 trillion worth of counterparty positions that became frozen. Since Lehman accounted for nearly 14% of trading in equities in the London Stock Exchange and 12% of fixed income in New York and it also managed client assets for hedge funds and investor clients, the liquidity of its counterparties were immediately impaired on default. The default of Lehman's also triggered huge increases in CDS premia, which meant that those who sold protection had to offer immediately greater collateral. AIG, which had US\$441 billion of CDS positions, had to provide US\$14.5 billion to bring total collateral posted to US\$31 billion in a matter of days. AIG had eventually been nationalized by the US Fed who provided an US\$85 billion loan in exchange for 79.9% of its equity.

17. Notwithstanding the above causes, financial sector governance has checks and balances, "lines of defense" against financial crises. But all four lines of defense failed to stop the crisis. The boards and management of the banks who are directly accountable to the depositors and shareholders did not prevent these banks from taking on excessive risks. The second defense line of auditors, lawyers, advisers and credit rating agencies also did not stop the greed. Some of them clearly aided and abetted in the complex derivative trades. Thirdly, the regulators trusted that Wall Street knew what it was doing but did not verify. Finally, market discipline also broke down since the crisis happened in full transparency.

III. Impact of crisis on developing Asia

18. The global financial crisis has provoked a rapid deterioration in the world economy. It is now affecting Asia more severely than expected. While the IMF's latest projections suggest a short-lived recession -- they have the advanced economies growing again in 2010 after a GDP decline of 2.0% in 2009 -- all the signs are that the economic outlook will be worse. The IMF has been progressively scaling down its projections over past months, and has already suggested that a further scaling down is on the cards. Further, based on the experience of the Japanese crisis, a long (rather than short) period of economic downturn could be possible.

19. Asia has been mainly affected by indirect impacts of the crisis. Direct effects have been small as Asian banks are generally in good shape and have limited exposure to subprime losses. Following the 1997/98 financial crisis, reforms undertaken at both the national and regional level have strengthened market infrastructures and restored financial market integrity. Developing Asia has also been somewhat insulated by virtue of its less sophisticated banks and capital markets. But still financial markets have been hit. Most exchange rates (except the yen) depreciated and volatilities increased. Equity prices plunged and volatilities also rose markedly. Interbank and money markets came under stress. Credit market conditions tightened.

20. The major impact of the crisis on Asia is through cross-border trade and investment. Asia spent the last 30 years building up a supply chain to feed western consumption. As a result, the final demand for Asian exports comes largely from these advanced economies. The most export-oriented countries—like Taipei, China, Japan, Korea, and Singapore—are, therefore, the most affected by sharp declines in exports to the US and Europe. Resource-rich, commodity-based economies are adversely affected by declining prices of oil and other commodities.

21. There is also a risk of declines in migrants' remittance inflows to countries like the Philippines, India, Indonesia and Viet Nam. Tighter access to international liquidity has hit countries like Korea and Indonesia, while all countries have been affected by more limited access to trade credit.

22. The IMF is projecting that economic growth in developing Asia will fall to 5.5% in 2009 (from 7.8% in 2008) before kicking up to 6.9% in 2010. But for a healthy Asian recovery, a global recovery starting from the US is crucial. The current views on US recovery were however mixed from a quick v-shape recovery starting in 2010 to a U or even L-shape recovery that may take more than half a decade.

23. In the short- and medium-term, East Asia will therefore have to generate more home-grown growth. In the longer-term, Asia needs to undergo structural adjustment to a semi-permanent decline in US consumption by shifting away from an external (US and EU) demand-dependent economy towards a regional (Asian) demand-driven economy.

IV. Policy implications for developing Asia

24. To date, national responses to the crisis have been faster than regional or global responses. In addition to contributing to the global effort, Asia needs to develop a stronger regional response.

Policies to revive economic growth and financial stability

25. The crisis requires vigorous action in the short term to counter the negative effects on the economy. Most Asian countries have eased monetary policy and implemented fiscal stimulation measures. Banking sector support has been provided in the form of precautionary bank capitalization programs (Hong Kong, China; Japan; and Korea) and deposit guarantees (Hong Kong, China; Singapore; and Malaysia). And there have been liquidity injections in Japan and Korea.

26. Such policy responses are quite useful and necessary but they have been largely national, independent and uncoordinated. It is critical for Asian countries to co-ordinate their policies more closely in light of the interdependence among their economies and the positive spillover effects of fiscal policy stimulus, and to avoid beggar-thy-neighbor policies.

27. As some developing countries in the region have suffered international liquidity shortages, there have been a number of international liquidity arrangements: Korea and Singapore with the US Fed (\$30 billion each); Korea with Japan (central bank swap expanded to \$20 billion until 30 April 2009) and with the PRC (central bank swap expanded to \$30 billion); and standby facilities for Indonesia with the World bank, ADB, JBIC and AusAID.

Policies to rebalance growth away from export dependence

28. Exports to the G3 (US, EU and Japan) have been a key element of the strategy of East Asian developing countries. Over the medium term, this strategy will have to be adapted as the G3 may be facing a period of slow growth. The US in particular will have increased its savings, which means lower consumption and demand for imports of consumer goods.

29. Thus, East Asian developing countries will need to rebalance growth away from its dependence on exports to the G3. Growth avenues to be explored are increasing domestic demand, both investment and consumption, and increasing intra-regional trade of final demand goods.

30. The results of a CGE simulation study by Kawai and Zhai (2009) of the impact of a declining US demand on the adjustment of production and trade in Asia (which assumes a reduction in the US current account deficit by 4½ % of GDP) are instructive. This simulation finds that there would be a switch away from export-led growth to domestic demand-led growth in non-US (particularly East Asian) economies. East Asia's manufacturing sectors – such as vehicles, electronics and machinery – are major losers in the adjustment process, while its agricultural and services sectors are likely to gain from the expanded domestic demand.

31. Asian countries need to use fiscal policy to support this medium- to long-term structural adjustment: (i) in Japan, the focus should be on increasing productivity, strengthening the social security system, and stimulating the shift to a low-carbon economy; (ii) in the PRC, the focus should be on consumption, through reforms of social sectors (education, health and pensions) and reduction in income inequality (rural sector development); environmental improvement and energy efficiency; and (iii) in India and ASEAN, the focus should be on investment in infrastructure and a better investment climate. Indeed, infrastructure investment is crucial for making Asia's growth more domestic demand-driven, and for achieving long term sustainable economic development more generally.

32. There are a number of other factors which are relevant to rebalancing Asia's growth such as further financial sector development which would encourage Asians to invest their savings in the region, and strengthening the conditions for private sector development. Further, SMEs and households, including the poor, need better access to finance.

Policies to strengthen financial system

33. In the financial markets area, strenuous reforms have indeed been undertaken at both the national and regional level over the past decade. Financial deepening has increased rapidly and bank dependence has declined somewhat. Banking systems have become more resilient, though vulnerabilities remain. Countries have made significant progress in developing capital markets. Corporate governance and transparency have improved. Regulatory and supervisory frameworks have been strengthened.

34. Under the framework of the Asian Bond Markets Initiative (ABMI), ASEAN+3 and ADB have agreed to fast-track the establishment of a Credit Guarantee and Investment Mechanism (CGIM). It could be used to provide credit guarantee for bonds issued by the corporate sector and selected ADB member countries seeking external funding for fiscal purposes.

35. The contribution of lightly regulated and highly leveraged financial institutions such as hedge funds and private equity funds, together with innovative financial products such as derivatives and asset-backed securities, to the development and worsening of the crisis suggests that they may need to be monitored and regulated more closely. There is no consensus yet on whether to regulate hedge funds and private equity funds, although most recommendations focus on stepping up monitoring and communication rather than increasing regulation.

36. Innovative financial products played a key role both in the development of the current financial crisis and in the difficulty of unraveling it. The main categories of innovative financial products relevant to the current financial crisis are credit default swaps (CDS) and asset-backed securities (ABS). The areas of monitoring and regulation that need to be analyzed and reformed include regulations for origination, distribution and trading of derivatives and asset-backed securities, gaps in regulatory coverage, the Basel II capital adequacy rules, rules regarding government takeover of systemically important financial institutions that are

failing, the scope for international cooperation and surveillance, and the role of rating agencies and regulators themselves. Greater efforts to educate directors, market participants, regulators and credit agencies are also needed. As a consumer protection measure, financial education needs to be strengthened in order to help investors better analyze and fully understand the risk/return profile of these structured products.

37. Since the Asian crisis, there have been major improvements to corporate governance frameworks. Regulators have been strengthened, and there have been widespread introduction of codes (based on the OECD's corporate governance principles), major improvements in auditing and accounting, greater use of independent directors, and the duties of boards are more clearly defined.

Strengthening regional co-operation

38. From a longer-run perspective, reform of the international financial architecture (especially the IMF) is necessary to reflect the growing economic importance of Asia. It is also important to strengthen cross-border supervision and regulation of systemically important financial institutions and hedge funds. Asia needs to play a more pro-active role in the context of the IMF, G20 etc to ensure that international financial governance is sound. But it also needs to explore regional solutions to the crisis.

39. In the short term, Asia is unlikely to get a bigger weight in global organizations like the G7/G8 or IMF/World Bank, and therefore needs to develop stronger regional institutions as a complement to these global institutions.

40. In particular, Asia needs to create its own regional Financial Stability Forum to help strengthen financial sectors and supervision. Regional Financial Stability Forums (FSFs) can be building blocks for stronger global architecture. Regional FSFs are important institutional arrangements to increase implementation capacity, technical assistance and dialogue.

41. Further financial market opening and integration would help develop and integrate local currency bond markets to mobilize regional savings for regional investment. To strengthen intra-regional trade and attract foreign direct investment, it is essential to integrate the regional market through a region-wide free trade agreement. This could start from ASEAN+3 and then expand to ASEAN+6. Consistent with the simulation results cited above, the focus should be more on services liberalization.

42. Asia needs to consider closer exchange rate coordination. Once the US financial system stabilizes, Asia will likely re-attract large capital inflows, given the region's robust economic prospects. Asia will then need to manage capital flows in order to ensure financial and macroeconomic stability. With closer regional integration, Asia will need to manage its intraregional currency stability to support its intra-regional trade.

43. To further promote financial stability, Asia needs to enhance its reserve pooling arrangement by completing the multilateralization of the Chang Mai Initiative (CMI) as soon as possible, with greater flexibility and less conditionality (such as the linkage to the IMF) in its activation. Regional surveillance should be enhanced by: involving central bank governors in the ASEAN+3 finance ministers' process; establishing an independent, professional secretariat; taking up the exchange rate issue; and discussing fiscal policy and public debt issues.