1. Overview and summary

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The growth of financial markets has clearly outpaced the development of financial market regulations. With growing complexity in the world of finance and the resultant higher frequency of financial crises, all eyes have shifted toward the current inadequacy of financial regulation. With financial innovation and securitization becoming more popular, interconnectedness in the financial system is at its height, both for intra- and extra-sovereign jurisdictions. Geographical boundaries have less relevance for financial flows than they do for trade in goods. During good economic times in the past, supported by financial innovation, financial and non-financial institutions alike were eager to participate in the expanding financial sector with its promise of high returns. The risk compression was widespread. Seen from this perspective, the 2008–09 global financial crisis (GFC) that occurred in the US, and the subsequent crisis in the Eurozone, should not be too surprising. Meanwhile, the policy response has been unprecedented. And surely it affects Asia.

The book is about what this episode means for Asia's financial sector and its stability, and what will be the implications for the region's financial regulation.

Fluctuations in US and Eurozone interest rates since 2000 could not have been more pronounced. Responding to the 2000 recession and the events of 11 September 2001, the US Federal Funds rate fell precipitously from over 6 percent in 2001 to a mere 1 percent by summer of 2003. Over the same period, the European Central Bank (ECB) rate dropped from over 4 percent to 2 percent. Fears of asset bubbles subsequently led to interest rate increases in the US and Europe. By late 2007, on the eve of recession and the subprime crisis, rates had doubled in Europe and increased more than fivefold in the US. As the recession began in December 2007, the Federal Reserve drastically shifted gears again, lowering interest rates steadily from more than 5 percent to 2 percent by mid-2008. The subsequent collapse of Lehman Brothers in September forced the Federal Reserve to be even more aggressive in pushing down rates, with the Federal Funds rate reaching 0.25 percent by the end of 2008, which is where it remains at the time of writing. The fall of interest rates in the Eurozone was not much less dramatic, with a steady decline from over 4 percent in 2007 to 1 percent shortly after the Lehman crisis, to 0.5 percent in mid-2013, and 0.25 percent at the time of writing.

Amid financial globalization, such sharp swings in interest rates in developed economies have generated waves of capital flows to developing economies, including in Asia which has already held considerable excess savings since the aftermath of the 1997–98 Asian financial crisis. What are the impacts of such flows in terms of the risks of financial instability, and to what extent do the excess savings affect the investment decisions of agents? These fundamental questions are dealt with in Part II.

Much of the flow of capital into Asia has been intermediated by the banking sector as evidenced by the increasing share of banks' non-core liabilities, which also reflects changes in the wholesale funding market. This poses the risk of procyclicality and it also reduces the sensitivity of non-core liabilities to output changes and monetary policy. The resulting financial cycle is not in synchronization with the business cycle, making monetary policy alone insufficient to deal with the procyclicality and financial instability caused by such bank-led flows. This is the reason why macro-prudential policy needs to complement standard macroeconomic policy.

Given changes in global financial conditions, the importance of the non-core liability ratio as part of an early warning system cannot be overemphasized. The power of this ratio to predict financial and currency crises, under different levels of capital market openness, is shown in Chapter 3, which suggests that macro-prudential policy must take into account the complex relationship between banks' non-core liabilities and capital flows. Any efforts to further liberalize the financial sector also must account for such a relationship.

However, not all countries in Asia have a liberalized system of capital flows. Those economies that still control flows can insulate themselves from risk. At least that is what many would expect. Yet, even in a relatively closed banking system, non-financial firms can take up the role of financial intermediation by depositing external funds and their proceeds in the domestic banking system, which in effect influences domestic credit conditions. Thus, the risks of procyclicality remain in place even in a closed banking system. In such circumstances, decomposing M2 into core and non-core liabilities is more useful for the purpose of gauging financial stability. By using the case of the PRC and utilizing firm-level data, this issue is analyzed in detail in Chapter 4.

With the emergence of excess savings after the 1997–98 Asian financial crisis, massive inflows of capital also meant additional liquidity in the region's economy. The cost of capital fell markedly as a result. This environment has changed the investment decisions and behavior of banks, firms, and households, as they lean toward more risky spending and prefer investing in financial assets. The macro-financial implications and how they affect the real sector, including socioeconomic conditions, are discussed in the last chapter of Part II. It is shown that the composition of excess savings differs across countries in the region, and that the visible trends are also unequal. The rise of corporate savings is notable, largely caused by improved current accounts and growing per capita income across the region.

Prior to the GFC, a growing share of capital inflows was intermediated through the banking sector, and hence was labeled bank-led flows. After the GFC, the flows going through debt or bond markets became significant, and hence were labeled debt-led flows. In addition to the exchange rate pressure exerted by capital inflows, these two types of flows are particularly volatile. As bank-led flows lead to rapid growth in credit, especially in the property and consumer goods sectors, and also raise banks' preferences for risky financial assets, the risk of procyclicality can be high. The reaction to the Federal Reserve's announcement in mid-2013 that it was considering tapering its quantitative easing measures also shows that the reversals of debt-led flows can easily cause fluctuations in exchange rates and rattle bond markets. This can undermine long-term financing in capital markets. Clearly, policymakers and regulators are faced with a very serious challenge.

The rise of agents' preference for financial assets is largely driven by the lure of high returns in the fast-growing financial sector, the perception of low risk compared with investing in the real sector (owing to numerous difficulties associated with a less-than-favorable business climate), and the greater number of financial instruments created through financial liberalization and innovation. Yet, the fact that in most countries only a tiny share of the population has access to the financial sector may have exacerbated already skewed income and asset inequality. This phenomenon is highlighted in the last section of Part II by using an empirical case study based on an economy-wide model where a large portion of the increased income of financial asset holders (mostly the urban rich) is generated from asset returns, leaving those with no financial assets in a relatively disadvantaged position. The development impact of investing the excess savings in financial assets rather than in real sector investment is also apparent in the labor market. To the extent that the job-creating capacity of financial investment is smaller than that of real sector investment, this contributes to falling employment elasticities observed throughout Asia.

The analysis in Part II shows that the risks of procyclicality associated with increased non-core liabilities through bank-led flows and volatility in capital markets are not only manifest in macro-financial vulnerability, but also in development terms through rising income inequality and unemployment. Based on this premise, therefore, if appropriately designed and effectively enforced, the proposed macro-prudential policy may provide benefits beyond just ensuring financial stability.

The resulting effect of the procyclicality risks can also interrupt business and financial cycles, which may reduce the effectiveness of standard macroeconomic policy, as discussed in detail in Part III. More seriously, given the dominant role of banks, including their influence over capital markets in the region, the risks can be systemic. This is where the rules and standards play an essential function, especially in relation to systematically important financial institutions (SIFIs). The supervision of SIFIs – whether domestic (D-SIFIs), regional (R-SIFIs), or global (G-SIFIs) – is critical as their failing can result in severe financial instability impacting a nation's financial system and economy, and further spreading into regional and global financial systems. Although the economies of emerging Asia are typically characterized by relatively large D-SIFIs with only a handful of G-SIFIs, hence international financial regulatory standards may not currently be a priority, increasingly more D-SIFIs in the region have transformed into R-SIFIs. As this will increase the amount of cross-border operations, the regulatory design and standards must eventually address issues surrounding how to supervise the cross-border operations of SIFIs. This topic is discussed in Chapter 6. It is also argued in this section that a regulatory structure must vary according to the nature and size of its financial sector, its domestic and international importance, and the skills and resources of regulators and the particular government.

To the extent that financial liberalization offers benefits but also carries risks of financial crisis, the discussions in Chapter 7 put the whole concept of financial liberalization and innovation into a more balanced perspective, whereby all the potential risks are matched with the benefits and opportunities of liberalization, including opportunities associated with development-related matters (for example, mortgage markets, small and medium-sized enterprises – SMEs – finance, non-bank finance, trade finance, and mobile financial services). By focusing on legal and institutional frameworks, this section elaborates on various issues and challenges in terms of how financial liberalization can maximize the benefits and minimize the risks of crisis.

Understanding the importance of systemic risk is important, but measuring it is another issue. What elements and factors need to be incorporated in the measure of systemic risks? To the extent that banks' operations are becoming more interconnected, especially between large and medium-sized banks, Chapter 8 explores alternative measures of systemic risk by using the examples of some ASEAN+3 countries, as well as India, in comparison with the situations in Europe and the US.[1] It is argued that although only a handful of G-SIFIs are operating in Asia, some of the large regional banks could pose potential risks to overall financial stability in the region.

Integration and cooperation in support of financial stability is discussed in Part IV. The current dominance of D-SIFIs in Asia resembles the situation in the region's capital markets. In general, Asian investors have a strong home bias and, to a lesser extent, a global bias, while lacking a regional bias. Yet, as discussed in Chapter 9, home bias is inefficient as investors concentrate on domestic assets, reducing portfolio diversification, the efficient allocation of capital, and risk sharing. To the extent that increased integration and home bias are interlinked, the type and quality of financial reform to create greater transparency and lower information asymmetry to promote integration can also influence the degree of home bias. Whether they will result in increased cross-border flows within Asia more than increased flows between Asia and the rest of the world should not be a concern. To reduce the level of home bias, the focus should be on removing the unnecessary obstacles that remain.

While opening up financial markets offers benefits, as discussed in Chapter 10, the risks involved are not small. The bitter experience of the 1997–98 Asian financial crisis still lingers. The misplaced policy response advocated by the IMF had consequences that led ASEAN+3 countries to set-up a new regional financial arrangement. Known as the Chiang Mai Initiative (CMI), the arrangement started with a series of bilateral swaps that were subsequently combined and multilateralized (henceforth known as the CMIM). Efforts were also made in the area of crisis prevention. Learning from Europe's challenges in dealing with crisis in an environment where integrated supranational institutions are not supported by suitable institutions to absorb shocks, Chapter 10 reviews the nature of regional financial arrangement in ASEAN+3 and presents some suggestions for future development.

But the crisis management component in regional financial arrangements needs to go beyond financial swaps. To limit costs to taxpayers and minimize the political fallout when financial institutions fail, and to increase depositor confidence during a crisis, a well-designed deposit insurance scheme is also imperative. This is also an important part of financial safety nets. Chapter 11 makes the argument that the old system of insurance is flawed in that it relies on low coverage limits and systems funded by assessments of surviving institutions. While the trade-off between securing stability through a pre-funded system and efficiency through an unfunded system is at the core of designing a deposit insurance system, by using examples from the ASEAN+3, it is further argued that deposit insurance cannot be intended to absorb all the costs of a systemic crisis. However, government will always have to intervene if depositors are to be protected. Nonetheless, since it is part of the broader role of financial safety nets, the standard requirements for the system to be effective must be in place, such as macroeconomic stability, a sound banking system, governance, prudential regulation and supervision, a strong legal framework, and a sound accounting and disclosure regime.

More generally, an effective resolution regime is needed as part of crisis management. In this context, global policy development that is principles-based would be ideal, but what is more important is not the form of regulation rather than the practical function of the regulation. This is one of the arguments made in Chapter 12. The best practices and the post-GFC cases in Europe, the US, and the ASEAN+3 are discussed in detail, providing a wide range of resolution regimes. When special resolution does not exist, it is recommended that for bank-dominated ASEAN+3 countries the focus should be on banks as opposed to other financial institutions, as they have the most systemic significance.

Learning from the damaging effects of a double mismatch scenario that led to the 1997–98 Asian financial crisis, and the fact that Asia still needs a huge amount of long-term financing for investment in infrastructure (hard and soft), overreliance on the banking sector cannot be maintained. Financing from capital markets, especially bond markets, should play a greater role. Banks' ability to obtain long-term financing has been reduced and will be curtailed even further when Basel III rules are imposed. In Asia, bond markets have developed steadily, especially in ASEAN+3 countries, following the Asian financial crisis. The creation of the Asian Bond Market Initiative (ABMI) is expected to further strengthen the regional bond market. While government bonds have dominated the market, corporate bonds have grown faster during the last few years. It is in this context that the discussion in Chapter 13 focuses on factors that affect corporate bond issuance and the capital structure of corporations in emerging Asia. Using eight countries as the sample for the period 1995–2007, these factors are classified into firm and market characteristics. The results show that size, leverage, profitability, and growth prospects all influence the decision to issue for both seasoned and unseasoned issuers. Market and interest rate differentials also impact decisions. In the case of issuance of foreign currency bonds, the following factors have a positive impact: size of firm, availability of tangible and collateral assets, short-term interest rate differentials, and scale of foreign participation. Meanwhile, the following factors have a negative impact: profitability, debt-to-GDP ratio, and stock market turnover. Overall, since the depth and liquidity of the market matter, efforts to improve them are recommended, including lowering withholding taxes and liberalizing foreign exchange swap and derivatives markets that allow non-resident issuers to hedge against risks.

The recent phenomena of capital flows and excess savings in Asia that influence the region's financial sector and related financial regulations are important. Yet, focus should remain on their manifestation in the real sector and the welfare of the population in general. Seemingly unrelated issues such as inequality and the role of SMEs are in fact closely related with financial sector regulation. To the extent that the majority of participants in the financial sector are high-income and urban-based agents, when the sector grows the gains in wealth and financial returns also concentrate among these agents. As discussed in Chapter 5, this can exacerbate already rising inequality in Asia. In those countries where the financial sector is either newly established or less developed – for example, in Brunei Darussalam, Cambodia, Myanmar, the Lao People's Democratic Republic (Lao PDR), and Viet Nam, which are known collectively as the BCMLV countries – the degree of concentration can be even higher. Yet, these countries and others still need further financial sector development. This is where efforts to promulgate and implement financial inclusion become important, along with improvements in corporate governance.

Chapter 14 in Part V emphasizes corporate governance in the BCMLV countries by utilizing the results of a survey of monetary authorities, regulators, and stock exchanges. The discussion also emphasizes the importance of sequencing financial reforms and taking into consideration the different conditions in each country and the danger that the growth of the financial sector will outpace a country's regulatory capabilities. The approaches to promote financial inclusion are discussed in Chapter 15. Implicit in the discussion is the notion of striking a balance between expanding participation in the financial sector and ensuring financial stability. To promote financial inclusion the following should be ensured: (1) the regulatory architecture for financial inclusion is coherent with the current legal framework; (2) an additional layer of intra-agency and central and local government coordination to cope with the variety of institutions, products, and businesses; and (3) the governance of regulatory and supervisory bodies, particularly in preventing possible conflict of interests, is of paramount importance to safeguarding and leveling the playing field, and ensuring the efficiency and effectiveness of regulations.

Financing for SMEs is another important component of financial inclusion. Small and medium enterprises often suffer from unstable access to appropriate funding, yet such stable access is an important precondition for the sustainability of their operations. Chapter 16 identifies the limitations of traditional bank lending for SMEs from an empirical analysis and suggests possible regulatory responses to innovative financing modalities for them from a holistic point of view.

As capital markets become even more important, it is expected that a large pool of funds will shift toward capital markets. Two potential sources are pension funds and insurance companies. While the share of these sources has indeed been growing, the level is still limited. There is ample room for these sources to play a greater role in the coming years. Yet, from the regulatory framework perspective, a lot of improvements need to be made. Given the diversity in regulatory quality and enforcement across the region, and with some frameworks far from being harmonized with international standards, a wide range of reforms is clearly needed in the areas of solvency standards, risk assessment, and governance. As more jurisdictions begin to implement the Insurance Core Principles (ICP), assessing how best to accommodate multi-jurisdictional compliance and reporting requirements will become a growing strategic challenge. In Chapter 17, it is argued that regulators of banks, pensions funds, and insurance companies should analyze the interactions of new regulations, the associated trade-offs and risks, and their consistency to avoid creating the wrong incentives.

Striking the balance between maintaining stability and growth is always a primary challenge for policymakers and regulators. To the extent that growth in many Asian countries is dependent on trade (both exports and imports), the role of the financial sector and its regulation in affecting trade cannot be overlooked. One of the critical areas of support to trade is the provision of trade finance. During the GFC, as the interbank market practically ceased to function due to the reluctance of banks in advanced countries to lend dollars and provide guarantees, banks around the world, including in Asia, had difficulty acquiring funding for trade finance. This severely curtailed the region's capacity to conduct trade. Pricing for trade finance doubled and fluctuated wildly, irrespective of the health of the region's financial sector. This contributed to the dark days in 2009 when trade volumes fell drastically. Despite various interventions to mitigate this problem,[2] the last section of Part V suggests that there are a number of factors hampering efforts to close the trade finance gap. These include the regulatory environment and anti-money-laundering (AML) and know-your-client (KYC) requirements that are not uniform across jurisdictions while also being costly amid weak banking systems that lack transparency. Clearly, more systematic interventions and reforms are needed to secure the sustainability of trade financing. Regional cooperation in this area may also help minimize the impacts of a shock in trade financing like what happened in 2008–09.

Connecting all the narratives and the analysis above, the following storyline emerges. While the coexistence of excess savings and massive capital flows in Asia during the past decade may have contributed to strong growth, it also elevated the risks of financial instability. These risks can lead to a financial cycle not being in sync with the business cycle, making monetary policy insufficient to deal with procyclicality. The challenges faced by policymakers and regulators to strike a balance between financial development and stability, or between maximizing benefits and minimizing risks of financial liberalization, get increasingly more difficult. Facilitating cross-border flows to reduce home bias through harmonization, and supporting the development of corporate bonds are examples that can help to maximize the benefits. On the other hand, strengthening financial regulation and its enforcement with good monitoring and supervision, and at the same time providing an effective resolution mechanism, including a deposit insurance system and financial safety nets, can help reduce the potential risks and damaging impacts of financial instability and crisis. Yet, the bottom line should never be overlooked, that the purpose of financial development is to support the real sector without exacerbating already worsening income inequality throughout Asia, as the welfare of the majority is the ultimate development goal. Asia still requires financial development, but development of an inclusive nature with support for SMEs, long-term financing from capital markets to promote infrastructure development (hard and soft), and more stable trade financing to promote the region's exports and imports. Any proposed framework of financial regulation should take these factors into consideration.

NOTES

1. ASEAN+3 refers to the ten members of the Association of Southeast Asian Nations plus the PRC, Japan, and the Republic of Korea.
2. In response to Asia's widening trade finance gap, the Asian Development Bank (ADB) increased the amount of risk that its Trade Finance Program (TFP) could assume to US$1 billion at any one time from the original limit of US$150 million. The TFP seeks to: (1) close private sector market gaps by providing guarantees and loans within 24 hours at market rates through partner banks to support trade, and (2) leverage resources by bringing in co-financing partners. Between 2009 and the first half of 2013, the TFP had attracted US$8.4 billion in co-financing to support trade in the most challenging markets where gaps are proportionally the largest. The co-financing also drew private sector entities into challenging markets for the first time. In general, the TFP's due diligence and rigorous monitoring of bank risk provide comfort and bring the private sector into TFP transactions in the most challenging markets. The TFP also provides technical assistance to help Asian companies get more and better-priced access to trade finance.