ASIAN PERSPECTIVES ON FINANCIAL SECTOR REFORMS AND REGULATION

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Editors

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Preface

The financial systems of most Asian emerging markets proved relatively resilient to the global financial crisis. Still, as they attempt to maintain high and stable growth, these economies face substantial challenges in terms of developing their financial markets and strengthening regulatory frameworks. New paradigms for financial development and regulation will have to be suitably reframed for Asian emerging markets, many of which have institutional and capacity constraints.

This book presents selected papers from the proceedings of three conferences held in Asia during 2010 to discuss these issues. Each of these conferences brought together leading academics as well as senior policymakers and practitioners. Those papers, now chapters in this volume, set the basis for the discussions, which were frank and wide-ranging. They attempt to link together various aspects of financial market development, including broadening financial access and improving regulatory frameworks to enhance financial stability. This volume also highlights the tensions among some of these objectives and provides theoretical and practical approaches for resolving them.

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Introduction

ESWAR S. PRASAD

The global financial crisis that ravaged financial systems in the advanced economies and many emerging markets as well has necessitated the reconsideration of even the basic principles of financial regulation. Remarkably, emerging market financial systems in Asia have in general proved to be more robust and less affected by the global turmoil than their advanced economy counterparts. In light of that, it is important to carefully filter out the right lessons from this outcome. Moreover, the imperative of financial development remains as strong as ever in Asian emerging markets, although the focus is more on basic elements, such as strengthening the banking systems and widening the scope of the formal financial system, rather than on sophisticated instruments and innovations.

The crisis highlights the need for strengthening financial systems to make them more resilient to shocks. Asian emerging markets face particular challenges in stabilizing their nascent financial systems in the face of shocks, both domestic and external, and financial reforms are critical to these economies as they pursue sustainable high-growth paths.

Policymakers in Asian emerging markets are grappling with a distinct set of issues, including the lessons the crisis can offer for the establishment of efficient and flexible regulatory structures, the avenues that should be pursued to enable

This book adopts the Asian Development Bank naming convention of referring to its member economies. The Brookings Institution takes no position on the legal status of Taipei,China.

effective regulation of financial institutions with large operations in multiple countries, and the ways to achieve greater financial inclusion. A broad reconsideration of the optimal structure and appropriate regulatory and supervisory frameworks of financial institutions is needed for these economies.

The chapters in this volume provide different perspectives on designing effective strategies for maintaining the momentum of financial development and inclusion in Asian emerging markets, while strengthening macroeconomic and regulatory frameworks to promote financial stability.

Macroeconomic Frameworks for Financial Stability

Because of the financial crisis, attention has been drawn to the intricate interplay between macroeconomic and financial policies, both national and global. The absence of stable macroeconomic policies can hinder financial development. In addition, weakly supervised and inefficient financial systems can hamper the effectiveness of policy transmission mechanisms and make it harder to manage stable policies. Capital accounts that are becoming more open in both de jure and de facto terms add a further layer of complications in determining the right structure of macroeconomic frameworks.

In the aftermath of the financial crisis, policymakers in emerging markets are again being confronted by conditions that are creating risks to monetary and financial stability. In chapter 1, "Monetary Policy Challenges for Emerging Markets in a Globalized Environment," Sukudhew Singh explores three of these policy issues. One of them is easy monetary policies in the advanced economies, specifically unconventional monetary policies. The chapter argues that these policies are fostering volatility and distortions in the financial markets and creating risks for emerging markets. The second policy issue is management of asset price bubbles. Asian central banks will have to adopt a proactive approach and overcome the current intellectual paralysis regarding the role of central banks in managing asset price bubbles. The third policy issue is that, in a period of low global interest rates and ample liquidity, commodity prices are again on the rise, which could have dire consequences for emerging markets. Central bank vigilance to guard against spillovers into broader inflationary consequences is essential.

In mid-September 2008, following the bankruptcy of Lehman, international interbank markets froze, and interbank lending beyond very short maturities virtually evaporated. Despite massive central bank support and purchases of key assets, many financial markets remained impaired. Why was this funding crisis so much worse than other past major bank failures, and why has it proved so hard to cure? In chapter 2, "The Great Liquidity Freeze: What Does It Mean for International Banking?" Dietrich Domanski and Philip Turner suggest that much of the answer lies in the balance sheet between banks and their customers. It outlines the basic building blocks of liquidity management for a bank that operates in many currencies; it then discusses how the massive development of the foreign exchange market (forex) and interest rate derivatives markets transformed banks' strategies in this area. It explains how the pervasive interconnectedness between major banks and markets magnified contagion effects. Finally, it provides some recommendations for how strategic borrowing choices by international banks could make them more stable and how regulators could assist in this process.

Chapter 3, "Macroeconomic Policy and the International Financial Crisis through an Indian Prism," by Alok Sheel, provides a specific set of perspectives from one of the key Asian emerging markets. This chapter includes a critical analysis of the literature and traces the recent evolution of thinking about the macroeconomic policy response to the international financial crisis through both global and Indian perspectives. The chapter analyzes both monetary and fiscal policy responses to the crisis and discusses the relationship between them, particularly about how they worked in tandem and were often indistinguishable from each other. The chapter argues that, in the recent financial crisis, monetary policy proved impotent beyond a point and that effective fiscal policy was essential to counteract the crisis. In terms of monetary policy, the chapter argues that central banks should have a dual objective—targeting liquidity through short-term rates and targeting financial stability through legislation.

Macroprudential Regulation

Combining the bottom-up regulation of individual financial institutions with a top-down systemic perspective on financial regulation is one of the key challenges facing regulatory authorities around the world. While this sounds like a sensible and desirable approach to financial stability, there is no clear framework for integrating these two strands of regulation into a coherent and unified approach. Consequently, a patchwork of pragmatic approaches has been adopted by regulatory authorities in each country. The chapters in this section deal with some of these conceptual challenges and also describe how some countries have dealt with them.

New lessons, challenges, and debates have emerged from the recent subprime crisis. While the macroeconomic orientation of regulatory policies is in fact not new, and has always been among the classic tool kits of central banks in ensuring financial stability, the current explicit articulation and specification of such tools as a global standard is new. Chapter 4, "Macroprudential Approaches to Banking Regulation: Perspectives of Selected Asian Central Banks," by Reza Siregar, presents a broad review and analysis of the measures adopted by the central banks and monetary authorities of selected Asian countries to strengthen their prudential regulations, particularly the macroprudential component.

Chapter 5, "The Role of Macroprudential Policy for Financial Stability in Asia's Emerging Economies," by Yung Chul Park, provides an additional set of perspectives from Asia. This chapter analyzes the role and scope of macroprudential policy in preventing financial instability in the context of East Asian economies. It looks at the behavior of the housing market in a dynamic setting to identify some of the factors responsible for the volatility of housing markets and their susceptibility to boom-bust cycles, which it identifies as a key source of financial imbalances in these economies. It then discusses the causal nexus between price and financial stability and the roles and complementary nature of macroprudential and monetary policies in addressing aggregate risk in the financial system. The chapter identifies currency and maturity mismatches, which contributed to the 1997–98 Asian financial crisis, as ongoing concerns in these economies—although the high levels of reserves in the region now act as a buffer.

The next two chapters provide the views of two front-line practitioners who have dealt with these challenges in their own economies. Chapter 6, "Macroprudential Approach to Regulation: Scope and Issues," by Shyamala Gopinath, provides an overview of the Reserve Bank of India's approach to macroprudential regulation and systemic risk management and reviews lessons drawn from the Indian experience. The chapter emphasizes the need for the harmonization of monetary policy and prudential objectives, which may not be possible if banking supervision is separated from central banks. It also notes that supervisors need to have the necessary independence and flexibility to act in a timely manner on the basis of available information. Macroprudential regulation is an inexact science with limitations, and it needs to be used in conjunction with other policies to be effective.

In chapter 7, "Macroprudential Lessons from the Financial Crises: A Practitioner's View," Kiyohiko Nishimura provides a stylized account of the financial imbalance buildup in the late 1980s in Japan from a macroprudential perspective. It draws lessons in comparing the similarity of the recent U.S. experience to that of Japan in the 1980s. First, when excessive optimism prevails in the market, macroprudential measures alone may be insufficient; monetary policy may be needed in addition to macroprudential measures to rein in excessive optimism. Second, when excessive optimism prevails in financial markets, the central bank should be careful to avoid nourishing an expectation of prolonged low interest rates relative to their long-run, sustainable levels. The chapter argues that it is desirable to develop and operationalize early-warning indicators to detect signs of financial imbalance buildups and to rein them in early, before it becomes quite costly to do so.

Financial Development

Financial market development remains a key priority for Asian emerging markets. The global financial crisis has shifted the emphasis of the financial development agenda toward the basics of strengthening banking systems, developing basic derivative markets such as currency and commodity derivatives, and increasing the depth and liquidity of corporate and government debt markets. The chapters in this section review progress in these efforts and then hone in on a particular case—that of India—to evaluate the role of regulatory, institutional, and other barriers to financial development.

In chapter 8, "Financial Deepening and Financial Integration in Asia: What Have We Learned?" Raymond Atje reviews lessons learned from the Asian financial crisis and seeks to explain why the more recent financial turmoil had a milder impact on financial systems in East Asia. According to Atje, in the aftermath of the 1997–98 East Asian financial crisis, countries in the region attempted to promote regional financial integration as a way to address the mismatches (maturity and currency) in debtor balance sheets. Regional governments, with assistance from the Asian Development Bank, have been trying to foster the development of local currency debt markets. While the exact nature of the link between financial development and growth remains unclear, what is clear is that a sound and sophisticated financial system promotes the efficiency of investment and, hence, economic growth and that a poorly functioning financial system can inhibit economic growth and increase vulnerability to crises.

In chapter 9, "The Development of Local Debt Markets in Asia: An Assessment," Mangal Goswami and Sunil Sharma provide an assessment of the progress made in developing local debt markets in emerging Asia. The development of these markets has been limited by hurdles confronting players and institutions that are or could be the borrowers and lenders, by issues faced by current and potential liquidity providers, and by the absence of supportive government policies and regulations. The key challenge in Asia is to generate financial assets, in line with its economic growth, that can provide the underlying collateral for expanding fixed-income markets and hence domestic investment opportunities. Emerging Asia also needs to foster a credit culture to further deepen its local debt markets. The issue of critical size could be addressed through an integrated regional market for local currency bonds that provides greater scale, efficiency, and access.

The next two chapters discuss in depth the challenges of financial market development and regulation in India. Chapter 10, "Indian Financial Market Development and Regulation: What Worked and Why?" by Jayanth Varma, examines the regulation and development of financial markets in India over the last two decades and attempts to identify the strategies and approaches that have worked and contrast them with approaches that have not worked. The author argues that technology, competition, and regulatory reform have been the key drivers of market development in India, as many success stories are characterized by regulatory reform that unleashed competition and actively pushed rapid adoption of new technology. The chapter makes the case that the growing power of domestic and institutional investors, rather than direct state intervention, brought about a number of changes. The chapter also examines some of the regulatory challenges that lie ahead for the Indian financial markets and discusses lessons for Indian policymakers from the global financial crisis.

In chapter 11, "Financial Development in India: Status and Challenges," Rajesh Chakrabarti presents an overview of financial development patterns in the country. The chapter argues that financial markets in India have come a long way in the past decade and a half in terms of economic reforms, making India a leader in Asia in terms of financial deepening. However, challenges remain, especially in the areas of institutional and business environments, elements outside the direct control of financial policymakers. In light of the financial crisis, increasing attention is being paid to systemic risks and to the interconnectedness of markets. These issues have led to new regulatory priorities, like a more extensive overview of large financial conglomerates and the creation of a macroprudential regulator. Coordination, if not unification, of regulators appears essential to enable such macroprudential monitoring of the system. The chapter makes the case for a shift to principles-based regulation in India but notes that such an approach has its own challenges in terms of regulatory sophistication and capacity.

Contents

PART I

Macroeconomic Frameworks for Financial Stability

1

Monetary Policy Challenges for Emerging Markets in a Globalized Environment

SUKUDHEW SINGH

In the period before the financial crisis, the prolonged period of low real interest rates in advanced economies led to financial imbalances in these economies. The outcome was a search for yield that resulted in carry trades and the increased financialization of commodity markets, which led to volatility in capital flows and exchange rates as well as to escalating commodity prices. These developments had a bigger impact on emerging market economies (EMEs) than they did on advanced economies. However, low interest rates and the search for yield, combined with dubious financial innovations, also led to an excessive and substantially misdirected expansion of credit and asset price bubbles in a number of advanced economies.

In response to the crisis, unconventional policies adopted by the advanced economies have again pushed interest rates to very low levels, even lower than before the crisis. No doubt these interest rates were appropriate when the economies were looking into the abyss of depression, but the longer they are maintained in the current circumstances the greater the potential that they will once again lead to imbalances similar to those seen before the crisis. Only this time they are likely to affect the EMEs more than the advanced economies.

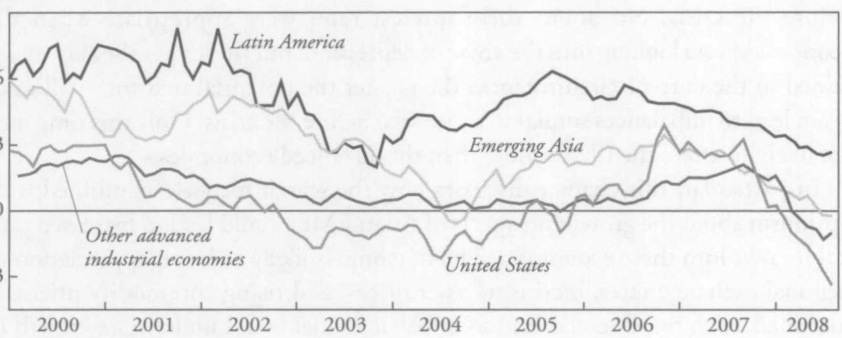
In particular, this chapter discusses how the search for yield combined with optimism about the growth prospects of Asian EMEs could lead to increased capital inflows into these economies. The outcome is likely to be an appreciation of regional exchange rates, increasing asset prices, and rising commodity prices. If sustained, such trends could lead to imbalances that could undermine growth in some of these economies at a time when the world is looking at EMEs to lead the global economy out of the recession. This chapter looks at the issues from the perspective of EME policymakers. It discusses the policy measures already undertaken by policymakers in Asia as well as those that could potentially be undertaken.

Introduction

Following the bursting of the Internet bubble in 2000, real policy rates trended downward globally (figure 1-1). What is even more striking, though, is that the real policy rate in the United States was below 1 percent from about the second quarter of 2001 right through to the second quarter of 2006, or a period of five years. It was in fact persistently negative for four of those years—that is, from about the fourth quarter of 2002 to the fourth quarter of 2005. Real interest rates in other industrial countries, while never turning negative, were also very low, falling below 1 percent around the end of 2002 and remaining below that level until the third quarter of 2006. In contrast, policy rates in Asian EMEs were considerably higher, being at the level of those in advanced economies only briefly in 2004. In Latin America real policy rates were even higher than those for other economies for almost the entire period. Therefore, there was a sustained period of very low interest rates in the advanced economies during the last decade and also a significant divergence in interest rates between the advanced economies and the EMEs.

While these interest rates were possibly appropriate for these countries given the monetary policy frameworks adopted by them, the sustained period of low real interest rates in the advanced economies and the divergence in interest rates relative to those in EMEs set off a chain reaction of developments that culminated in the current crisis. As we emerge from the current crisis, EME policymakers are

Figure 1-1. *Real Policy Rates, by Country or Region, 2000–08*



Source: Cecchetti, Mohanty, and Zampolli (2010).

again confronted by conditions that are creating risks to monetary and financial stability in their economies. In this chapter I explore three of these policy issues.

The first has to do with the implications for EMEs of the easy monetary policy conditions in advanced economies, specifically the unconventional monetary policies adopted. The volatility and distortions in the financial markets are creating risks for EMEs in a number of areas. Most important, the potentially large capital flows into EMEs can lead to volatility of exchange rates, which could create difficulties for open, trade-dependent, economies. They can also lead to significant volatility in bond and equity markets, as large volumes of foreign funds move in and out of these markets.

The second policy issue is the potential impact of capital flows driven by carry trades and the search for yield on the valuation of EME assets. Asset price bubbles have affected a number of the economies at the epicenter of the current crisis. In the period since the crisis, asset prices are likely to be again stoked; only this time there is a high risk that those bubbles will be in the EMEs. Large capital inflows will amplify such distortions. In managing these bubbles, central banks will have to overcome the current intellectual stalemate regarding the role of central banks in managing asset price bubbles. Asian central banks may need to adopt a proactive approach, even if many central banks in the developed countries have preferred not to play an active role.

The third and final policy issue has to do with the growing role of commodities as an asset class for investors. In a period of low global interest rates and ample liquidity, commodity prices are again on the rise, and this could potentially have more dire consequences for the EMEs than for the more advanced economies.

Effect on Emerging Market Economies of Unconventional Monetary Policies in Advanced Economies

The rapid growth in capital flows between advanced and EMEs has been significantly influenced by the monetary policies of the advanced economies. Research by the Institute of International Finance notes that since the 1970s there have been three major upswings in net private capital flows to EMEs.[1] As a percent of GDP, each peak in the up cycle has been higher than the previous one. It also notes that, based on the resumption of flows in 2009, the fourth upswing could be just beginning. There are compelling reasons to believe that EMEs could once again see a surge of capital inflows.

There is the expectation that economic and financial conditions in EMEs would be better than in the advanced economies. It has also been noted that, following the crisis, many EMEs are in better fiscal positions than a number of large advanced economies and are, therefore, better able to support growth. Further-

1. Institute of International Finance (2010).