Discussant remarks: development of financial markets in Asia and the Pacific

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1. Introduction

Your Excellencies, Governors and Governor-in-waiting, Mr. Jaime Caruana, Colleagues from the BIS and regional central banks. I have no slides to show you and will therefore, with your Excellencies' permission, make my remarks from where I am sitting. My remarks will touch on some of the issues raised in the presentations this morning, and I will also use this opportunity to elaborate my own thoughts on some of those issues

2. Exchange rates and financial systems

In the paper on "Private information, stock markets and exchange rates", the authors conclude that FX flows related to the stock market have a more lasting impact on exchange rates than do other types of flows. This is attributed to private information about the stock market, whereas other types of flows presumably do not contain similar information. It is an empirical paper, and the authors openly admit the limitations of the results. I encourage the authors to explore the extensions – in terms of both the length of the sample as well as the number of countries included in the study. In my own mind, the impact of such portfolio flows on the exchange rate depends on a number of factors, including the intensity and persistence of central bank intervention and the depth and sophistication of the financial system.

On this particular point, reading this paper reminded me of another one that I read a few weeks ago. It is a paper published this year in the Journal of Monetary Economics and co-authored among others by Philippe Bacchetta and Kenneth Rogoff. It was interesting because it provided some counter evidence to the commonly accepted view that exchange rate volatility does not have a significant effect on real activity. The authors tested whether a country's level of financial development matters in choosing how flexible an exchange rate system should be if the objective is to maximise long-run productivity growth. They find that exchange rate volatility has a negative impact on long-run growth when countries are less developed financially. Conversely, the more financially developed an economy is, the less adversely it is affected by exchange rate volatility. If these findings are validated they would complement earlier work by researchers such as Sebastian Edwards which suggested that, for countries to benefit from capital account liberalization, they must have achieved a certain level of institutional and financial development. Premature liberalisation can lead to more risks than benefits for the economy and financial system.

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3. Capital flows and financial systems

In the paper on the "Internationalisation of Asia-Pacific bond Markets," the authors explore the issue of the motivations of borrowers in raising foreign currency debt and swapping the proceeds into local currency, rather than borrowing the local currency directly. My take from the paper is that much of the motivation has to do with the imperfections or underdevelopment of the domestic markets. While this may provide a cheaper source of financing for economic agents, there are also associated risks. Many of these risks are noted in the paper. From the perspective of policymakers, there are two main risks. First, it could potentially weaken monetary policy. For example, in a period of high interest rates, residents may resort to cheaper foreign borrowing – potentially undermining the central bank's efforts to cool the economy. Secondly, such external borrowing could also create a drain on the central bank's foreign exchange reserves. This is especially so if the borrowers have no source of foreign exchange earnings. As amply shown during the Asian Financial Crisis, the central bank could become caught between the pressures on the exchange rate and the demands on its reserves. Therefore, it is crucial that central banks monitor the size of such borrowings. These risks should also create incentives for regional authorities to further develop and deepen their financial markets. While regional financial markets have certainly become deeper, especially after the Asian financial crisis, progress has not been uniform. In many countries, the financial systems continue to be dominated by banking institutions, with banks still playing a dominant role in financing the economy.

4. What type of financial system will we build in Asia?

I concur with the keynote speaker that the current crisis is an opportunity for us to think about the future development of our financial systems. In particular we need to ask what will be the nature of financial systems in Asia. Given the wealth and economic potential of this region there is plenty of opportunity for robust financial systems to develop in the region. However, as highlighted in the keynote address, we need to think carefully about the link between the development of the financial markets and their role in economic development. I do not believe this link would happen if we merely reproduce in the region replicas of the existing global financial centres. We do not want to create financial systems that end up becoming originating centres for speculative forces that promote instability in other regional countries. Essentially, "beggar-thy-neighbour" financial systems that create national prosperity at the expense of regional neighbours. We should avoid creating systems which have a tendency to create financial bubbles that rise like hot air balloons to stratospheric heights before bursting. More fundamentally, we need to think about what the economies and diseconomies of scale for our financial systems would be. How big can a financial system become while remaining anchored in real economic activity, without getting involved in the "walking on water" type of activities that ultimately have submerged the advanced financial systems below a sea of risks? Are our financial systems being built to serve our economies, or are our economies being made subservient to the needs of the financial system?

I have noticed that there is growing interest in the region in having financial centres. The attraction of such centres is fairly obvious. They contribute to diversifying the sources of growth. Financial centres create various positive spillovers to other industries, ie tourism, legal, accounting, communications. They are a source of high-paying jobs and higher tax revenues. Some may even see them as a source of economic power and influence.

However, financial centres also come with some costs. I will briefly mention a few that relate directly to macroeconomic policy: a steep rise in asset prices; the influx of financial firms and rich financiers results in an increase in the prices of housing and office space; an appreciating exchange rate can make the non-financial sectors of the economy less competitive; increase in social inequality and income gaps; increased cost of living (eg having to commuting from further away due to high cost of accommodation closer to the centre of activity); a reduction in quality of life (eg traffic congestion and pollution); the relatively high pay in the financial sector will attract the best talent to that sector, potentially to the detriment of other sectors of the economy; and large financial centres within national borders could also potentially affect the efficacy of monetary policy.

It is important for national policymakers to internalise some of these externalities as they consider the benefits of these financial centres. Also, as regional countries compete for the advantage of their national financial centres, there is the risk that they could become vulnerable to the risk of regulatory arbitrage. Only a couple of days ago, the same copy of the Financial Times newspaper carried two stories that are relevant to this topic. One was about the Chairman of the US Congress financial services committee proposing to exclude financial groups based in countries that have more lax regulatory regimes than the US. This was due to concerns that tighter regulation in the US may put its financial system at a competitive disadvantage relative to other countries. The other piece discussed the concern that, as the Commodity Futures Trading Commission in the US imposes tougher speculative limits, it may push traders to migrate to London, where apparently the Financial Services Authority is less convinced about such restrictions. There is no reason to believe that regional policymakers would not be affected by similar concerns as they focus on developing their national financial systems. With so many countries wanting to create financial centres, large global financial institutions could essentially play national regulatory authorities against each other to gain the best concessions. This must be avoided. It would not be in the regional interest and may not even be in the national interest of the countries involved. Therefore, it may be beneficial to recognise the potential for regulatory arbitrage, and possibly, try to develop a regional consensus on how to deal with it. It is an area where cooperation could be highly beneficial in creating well regulated and stable regional financial systems.

5. Lesson of vigilance from current crisis

In the current crisis, there are plenty of reasons for Asian policymakers to feel vindicated given the preaching that the region received during the Asian financial crisis and the years since. However, the main lesson that all should take away from the current crisis is that, as policymakers responsible for regulating and supervising financial systems, we have no room for complacency and we have to be careful about putting too much weight on conventional wisdom. We do not really know when conventional wisdom is going to be turned on its head – and that includes conventional wisdom about regulatory and supervisory best practices. A healthy dose of scepticism should be part of the DNA of every financial system regulator.

It is indeed a credit to regional authorities that the regional financial systems have withstood the current crisis in the manner that they have, but the crisis is not over yet. New risks could emerge. With economic growth expected to be low for some time, there would be pressure on bank profits and we have to ensure that it does not lead to short-sighted behaviours. Also, with the current low interest rate environment, we must be vigilant that the combination of a search for yield and the availability of cheap credit do not lead to the build-up of risk within the financial system. The markets are also vulnerable to episodes of euphoria about emerging markets. We must be vigilant that the large inflows that accompany such episodes are properly managed. There is potential for this to happen given the prevailing market belief that emerging markets (especially in Asia) would lead in the recovery from the current global recession.

If we look at the sources of the current crisis, whether it be home mortgages, and, increasingly now, commercial mortgages, a key contributory factor was the availability of ample cheap credit. It may be the case that, in the crisis-affected countries, despite the large injections of central bank liquidity, the credit spigots continue to remain tightly shut. However, in Asia, the fact that our financial systems have not been significantly affected and are still functioning well should not only be a source of justifiable pride, but also concern. Concern, because interest rates in Asia have also fallen to very low levels and our functioning banking institutions – unless mitigated by appropriate risk management practices and regulations – could very well feel pressured into what may later turn out to be less than prudent lending. A sustained period of low interest rates could also put pressure on other financial market players, such as the life insurance companies. The risk of asset price bubbles developing is also real.

6. Monetary policy and asset prices

Which leads me to my final point on the role of central banks in managing asset prices. Central banks should relook at the paradigm that we can focus on price stability and that, when it comes asset prices, our role is to go in and clean the mess once it all blows up. As is obvious now, the cleaning up comes with a hefty bill – not just in terms of financial cost, but also the economic and social costs. Within the context of regional countries, the experience of the Asian financial crisis should also carry lessons about the role that large capital inflows play in creating such bubbles.

Dealing with asset prices certainly leads to issues of public and political acceptance of actions undertaken by central banks to manage them. But we should ask ourselves how a consensus developed around the issue that a key task of central banks is to manage inflation. As the inflationary episodes in the 1970s and 1980s were crucial in creating a consensus around managing inflation, it may be that the current crisis has created a similar opportunity to develop a consensus around the role of central banks in managing asset prices.

However, for that to happen, a consensus must first develop within the central banking community itself. And we must put serious effort into designing mechanisms to identify and address developing asset price bubbles. Professor Sundaresan has alluded to certain possibilities in this respect. Apart from the RBI, I know of other regional central banks that have taken a proactive role in managing asset price bubbles. At the very least we should take this as an opportunity to re-examine the monetary paradigms and frameworks that we have come to accept as conventional wisdom. Without such efforts, it is unlikely that we would be able to influence the views of key stakeholders on this issue. For regional policymakers, it presents an opportunity to show thought leadership – looking at the issue from the perspective of emerging markets, rather than leaving the issue to be decided solely by institutions in the more developed countries.

Thank you.