

## **Tarisa Watanagase: Emerging markets in financial globalization – striking the right balance for liberalization**

Luncheon address by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the conference “Asian Banking – Challenges and Opportunities”, San Francisco, 6 September 2007.

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Madam President and CEO of the Federal Reserve Bank of San Francisco,  
Distinguished Participants,  
Ladies and Gentlemen,

I am delighted to be here, among this distinguished gathering of policymakers, financial experts, and keen watchers of Asian banking developments, to deliver a message on the prospects for economic growth and stability in Asia. Given Asia’s diversity, I would like to focus my talk today on Asian emerging markets’ experience and challenges going forward. In particular, I would like to highlight to you the near-term challenges of coping with rapid exchange rate appreciation and volatile capital flows and the need for a more flexible economy for better financial resiliency over the medium to long term. I will also touch on the implications for the banking sector, which is the predominant financial sector in most emerging markets.

One decade after the crisis, emerging Asia is vibrant. They also look less vulnerable to financial disturbances. Asian emerging markets are learning to live with heightened uncertainty in the world where the extent and the whereabouts of the risks are unclear, and which necessitates that every player manages his own risk better. In this highly integrated world, small open Asian economies want to take advantage of financial globalization to promote sustained increase in living standards. Over time, they wish to move from incomplete financial market to a better world of risk-sharing, risk absorption, and diversification. But there is tension to be managed in the short run. Under Bretton Woods II, in which much of Asia is still tightly linked to the fortune of the US dollar, and in the context of ongoing “global imbalances,” emerging markets need to strike a balance between financial stability and financial development. In particular, when our markets and institutions are still developing, the struggle between financial integration and financial stability, enterprise and prudence, requires from us a deft balancing act.

Ladies and Gentlemen,

From a historical perspective, today’s emerging markets are unique in their common experience. This uniqueness is twofold. On the one hand, it is quite apparent that our openness has gained us immense benefit from global economic integration, the phenomenon denied to advanced economies when they started off. At the same time, and as a result of our openness, small developing economies face risks and volatilities that accompany financial globalization, the scale of which advanced economies never had to face in their early stages.

In fact, sustained increase in living standards is a relatively new economic phenomenon to emerging markets. Having experienced modern economic growth after 1950, we are late comers. And having much to benefit from being late, it took us a much shorter time to treble our per-capita income than today’s advanced economies did between 1800 and 1950.<sup>1</sup> Indeed, international difference in living standards has declined over the latter half of the

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<sup>1</sup> Parente and Prescott (1999) documents the evolution of international income and growth differences and gives a list of growth facts before and after the industrial revolution.

twentieth century as a result of emerging markets' fast-pace and sustained growth. During the past 20 years, the world's income gap has narrowed even faster. It cannot be by sheer coincidence that this period has also witnessed growing international trade and financial integration and the entrance of China, and subsequently India, into the comity of trading nations.

Along these high growth trajectories, emerging markets' aggregate real income and consumption are an order of magnitude more volatile than advanced economies (both in terms of levels and growth rates). Not only is consumption more volatile in emerging markets, but it is also more volatile in relation to income. In fact, over the business cycle, consumption is around 40 percent more volatile than income for emerging markets, while it is less volatile than income for advanced economies. The unique volatility outcomes can be attributed to a distinct set of macroeconomic shocks which are specific to emerging markets or their propagation mechanism, or both.<sup>2</sup> I think that the extraordinary volatility in real aggregate consumption and income can be partially attributed to episodes of financial instability that occur not infrequently in emerging markets. In fact, these bouts of extreme instability have disrupted the potential growth trends, which in some cases have taken years to recover. On the whole, these episodes may be associated with too much financial liberalization too soon.

The unique global backdrop, as well as the economic outcomes in terms of growth and volatility that I have just shared with you, presents a real dilemma and at times tension in emerging Asia. And nowhere is this tension more palpable than it is in the realm of exchange rate and capital account regimes. While benefits from trade integration are appreciated and shared by billions the world over, net benefits from international financial integration have not been so apparent in Asia and emerging economies in general. This is consistent with an observation that Asian emerging markets rely increasingly more on trade integration because it is judged to be a safer mode of risk-sharing with the world. As a result, while the pace of financial integration has far outstripped trade integration in advanced economies, it has only managed to keep pace with trade integration in emerging markets.<sup>3</sup>

Ladies and Gentlemen,

Asian economies and policymakers have come a long way in their attitude toward macroeconomic risk management since 1997. Countries have taken unilateral actions to promote economic and financial resiliency.

Having appreciated the evidence that macroeconomic stability provides an environment that is conducive for sustained growth, Asian emerging markets have continued to pursue fiscal discipline and more flexible exchange rates on the whole.

The result is improved fiscal balances and better public debt structure, which is heavy toward longer maturities and domestic-currency denominated. Monetary policy's first priority is to achieve long-term price stability, and in certain countries, Thailand included, central banks actively pursue explicit inflation targets.

To be sure, countries have made efforts to ensure stronger prudential regulation and supervision of banks. The evidence is mixed on this front, but increasingly, more countries are adopting risk-based supervision and international accounting standards, including Basel II and IAS 39. A number of Asian emerging economies have also achieved significant

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<sup>2</sup> The same is true when comparing relative volatility in growth rates of consumption and income (Kose, Prasad, and Terrones, 2005). While this is a broad characterization of emerging markets, some countries, for example Thailand, have experienced a much less volatile consumption to income ratio. (Aguilar and Gopinath, 2007).

<sup>3</sup> From the new External Wealth of Nations Mark II (EWN II) dataset, compiled by Lane and Milesi-Ferretti (2006). The extent of financial integration is measured by the total international assets and liabilities as a percentage of GDP and the degree of trade integration is measured by exports plus imports over GDP.

consolidation and modernization of their financial institutions. They have built up new legal and information infrastructure to strengthen the foundation for financial system capacity for crisis prevention and resolution. In some countries, new foreclosure laws, bankruptcy laws, debt restructuring mechanisms, and credit bureaus, which were absent before 1997, are now in place. Public and private efforts have stepped up significantly to expand the capital markets domestically as well as regionally. Across the region, policymakers are sharing knowledge and expertise to ensure efficiency and pragmatism in the implementation of policy.

Most obviously, Asian countries have also built up international reserves to a multiple of short-term external debt or other traditional measures of potential claims on reserves. They have also relied less on foreign debt financing and shifted more toward equity securities and direct investment.<sup>4</sup> This shift in the pattern of capital flows demonstrates to some extent advances in equity market development and corporate governance in the region.

For a few countries, reserve accumulation partly constitutes a deterrent to the repeat of the last extreme episode of instability in 1997. As an added benefit, a relatively well-developed system of prudential banking regulation has also helped these countries avoid speculative pressures on their exchange rates.

As far as financial integration is concerned, there have been selective and timely capital account restrictions and liberalization on both inflows and outflows over the years. Much of this caution derives from the bitter lessons from the 1990s. But, even so, it is worth mentioning that, measured by total foreign assets and liabilities as a percentage of GDP, the trend from Bangkok to Seoul is that of more financial integration over the past 20 years.<sup>5</sup>

Ladies and Gentlemen,

These changes in policies and risk awareness make it less likely that financial market disturbances will trigger a sharp and broad-based dent to real economic outcomes.

But, it may be a slight overstatement to declare that Asia as a whole has become resilient to shocks and disturbances today. In a sense, the impressive heights of Asian international reserves may be construed less as an indication of fundamental strength than as an indication for needed progress toward modern monetary policy framework. In addition to that, the size of accumulated global financial vulnerabilities that may unwind in the near future is by most measures unprecedented; the extent and the whereabouts of the risk concentration are unclear. And as a result, circumstances of greater macroeconomic adversity may yet again put to test emerging markets' ability to adjust.

The pressing and practical challenges emerging Asia faces in the near term are three-fold. Indeed, the three challenges are inter-related. They are "hot money" inflows and large inflows in general, pressure for rapid domestic currency appreciation, and finally, the potential loss of monetary autonomy in the sense of independent interest rate policy.

Having done the right thing over the past 10 years, Asian emerging markets have become darlings of international investors and have had ample access to funds at favorable cost – although the more powerful underlying reason may ironically be a medium-term flight from US dollar assets since 2002. With large capital inflow comes pressure for these currencies to appreciate. In this experience, some currencies appreciate faster than others. In fact, those that surrender most of their monetary autonomy or maintain restrictions on cross-border capital flows need not feel immediate pressure to appreciate. But those that have come further along the liberalization road have to face a different music.

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<sup>4</sup> From the new External Wealth of Nations Mark II (EWN II) dataset, compiled by Lane and Milesi-Ferretti (2006).

<sup>5</sup> Ibid.

Rapid appreciation in the exchange value of the currency renders part of the domestic industries less competitive in the global markets. It is true that with this appreciation, commodity imports such as fuel and energy as well as metal and raw materials have become more affordable despite rising world price trends. But these benefits are spread-out while the cost is centered on labor-intensive, high domestic-content primary sectors, such as agriculture and low-end manufacturing. As a result, even for net primary commodity importing economies, the nature of the problem is as much political economy as it is economic. There are strong and vocal constituencies in emerging markets that are averse to currency appreciation and part of them averse to variability in the exchange rate itself.

Meanwhile, hot money, or indeed large inflows in general, can fuel asset prices and encourage excessive risk-taking behavior. Central banks may wish to counter that excess in the interest of financial stability. If the central bank chooses to maintain a high interest rate stance, the pressure on the currency to appreciate will likely mount.

Not unlike today's political economy in advanced countries, emerging market politics also risks being less favorable to openness, but more partial to protection of selected industries or protectionism in general.

As such, I hope you appreciate that, when it comes to policy, there is risk in change as well as in inertia. This is the fundamental challenge we face.

Since the challenge going forward requires significant ability for emerging economies to adjust flexibly, what has brought us here may not deliver us safely to prosperity.

Beyond getting the fundamentals right and strengthening them, the solution package we seek must help reduce the distortions perpetuated on our economies. These distortions impose real costs and hinder our chances to become more resilient going forward. This solution package must by default and by design be broad-based.

Allowing the competitive pressure and incentive to operate is undoubtedly the best way to foster investment in physical and human capital, as well as innovation and risk-taking, all of which are crucial to long-term productivity growth. They are also crucial for a flexible and resilient economy. But policy and regulations still have a role to play. The imperative here is to improve on policy and regulation design that can help deal with market excesses.

On an appropriate degree of financial openness through time, there is little consensus today, even among leading academic economists. The key here is prioritizing liberalization and reforms. But the right pacing and sequencing of capital account liberalization in one country may not be solution for the next.

In order to outline capital account policy priority, I think policymakers in emerging economies should underline the fact that big market events that pose systemic risks tend to reflect collective mistakes in which most market participants are offside in the same direction. So, to reduce the chance of prolonged financial misalignment with economic fundamentals, the priority for emerging markets may lie in improving the flows and quality of financial information, corporate and public governance, as well as legal infrastructure to allow in different players and views.<sup>6</sup> With players of different views and risk appetites in the market, we have a better chance that the financial system will undergo constant self-correction. Crashes in asset price will also likely be less prolonged and the ensuing economic cost less devastating.

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<sup>6</sup> See Bannier (2005) for an articulation that large players need not make market responses more aggressive if the market does *not* uniformly believe that fundamentals are weak. And see Abreu and Brunnermeier (2003) for argument that the resilience of financial bubbles can stem from the inability of arbitrageurs to temporarily coordinate their selling strategies.

Emerging markets not only require stronger financial intermediaries and better supervisors, but also access to deeper and more liquid capital markets. Our own financial markets may not be deep enough soon enough, but those who are ready for it should not be encumbered from having access to the world financial markets. Emerging economies that can manage the risks have benefited from liberalized inflows in the past, but some of these economies may benefit more if their citizens can unload domestic systematic risk abroad.<sup>7</sup> Timely outflow liberalization may help smooth emerging market's consumption and income, a significant welfare improvement.

Set in this light, the immediate implications for Asian banks from the challenges that I have outlined earlier may initially be the deterioration in the quality of their loan portfolios, including potentially higher non-performing loans. But over time, in response to structural changes undertaken by other economic sectors as well as increasing disintermediation and competition from both domestic and foreign players, we should observe stronger and more competitive banks in emerging markets. This transformed well-supervised, prudent and enterprising banking sector will remain crucial to the dynamism of Asia.

Ladies and Gentlemen,

Extraordinary emerging market income and consumption volatility may be the result of macroeconomic shocks, their propagation mechanism as well as policy and institutional setup, but it can be ameliorated by better risk sharing with the world. In this welfare-enhancing endeavor, international financial integration on top of ongoing trade integration can play an important role.

To end my talk today, let me share with you briefly the approach taken by Thailand. The Bank of Thailand has sought a balanced approach to managing capital flows under flexible exchange rate. We also undertake concomitant reforms in the area of financial system and market development. These initiatives are closely related and progress in one requires progress in the others.

In building a resilient economy, prudent fiscal and monetary policy does help. As an automatic stabilizer, flexible exchange rate also helps. But, prudent macroeconomic management alone will not raise people's living standard in the long run. We need a balance between prudence and enterprise or the ability to take risky action and make sound decisions on the part of the business sector. Otherwise, we risk either having a stagnant, inefficient economy or building a fast-growing one on a bubble; neither of which we can afford.

Hence, the priority is the need to design a system that allows for constant self-correction – one that also lets the economy regain its strength quickly after a severe negative shock. That system should be underpinned by a strong link to the world economy, which will encourage innovation and efficiency. The competitive markets should operate under a clear rule of law with good governance. In support of them, we need an effective and honest government and supporting institutions that focus on improving resiliency of the economy and sustainable long-term economic growth.

Ladies and Gentlemen,

Advanced economies do have economic, if not also strategic, interests in the success of Asian emerging markets. An Asia that is well-adjusted and integrated into the world markets will add prosperity and stability to the world economy for years to come.

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<sup>7</sup> See Henry (2006) for a critical review of the literature on theory and evidence of capital account liberalization.

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