Ravi Menon: Harnessing capital for Asia's growth

Opening address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Deutsche Bank Access Asia Conference "Harnessing Capital for Asia's Growth", Singapore, 25 May 2011.

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The Asian Century: what can go wrong?

Mr Rob Rankin, distinguished speakers, ladies and gentlemen, good morning.

1. According to Deutsche Bank's forecasts, China's economy will become the largest in the world in 2022. India is projected to become the world's third largest economy by 2015. Pundits have dubbed the 21st century the "Asian Century", much as the 20th century has been described as the "American Century", and the 19th century the "British Century".

2. But Asia's rise is not a pre-ordained outcome. History has shown that straight-line extrapolations of growth do not always hold; more recent history suggests that they are the exception rather than the norm.

3. Two thousand years ago, at the height of the Roman Empire, Asia ex Japan accounted for more than half of global GDP, while Western Europe accounted for less than 10 per cent. The picture was not very different for the next 1500 years or so: Asia ex Japan was typically three times larger than Western Europe.

4. Then came the Renaissance and the Industrial Revolution in Europe. By the start of the First World War, it was the turn of America and Europe to account for more than half of global GDP. Asia less Japan was less than 15 per cent. And as recently as 1970, that share was just under 10 per cent. But today, in the space of just 40 years, developing Asia's share of world GDP has nearly tripled to 27 per cent. Projections are that developing Asia will again account for half of world GDP by 2050.

Will it happen?

5. There are many things that can potentially stop the Asian juggernaut. International conflicts, domestic upheavals, wrong economic policies, even climate change, have been cited as wild cards that can throw these projections off course. Top of my list is old-fashioned misallocation of resources. Asia's strength – its high savings and investment rates – can become its weakness.

6. The Asian growth story is essentially an investment story, fuelled by high rates of domestic savings and relative openness to foreign capital. Gross fixed capital formation in emerging Asia during 1980–2000 was about 35 per cent of GDP, compared to 21 per cent in Latin America and 25 per cent in Eastern Europe. High rates of investment and high rates of economic growth created a virtuous cycle of development in emerging Asia during the last 40 years, unmatched in history.

7. But there are growing concerns whether this is too much of a good thing. The investment-to-GDP ratio in developing Asia has gone up further, from 30 per cent in 2000 to 38 per cent last year. The ratio of gross capital inflows to GDP has doubled over the same period, from 8 per cent to 17 per cent. These numbers, in themselves, are not cause for concern. Indeed, some would argue that emerging Asia's investment on a per capita basis is not very high. The real question is whether these investments are going into the right places. Asia's periodic bouts of asset market bubbles – especially in real estate – are a case in point. Michael Pettis of Beijing University, for instance, warns that Asia's extraordinarily successful development model will eventually run into the constraints of "massive over-investment and misallocated capital".

8. The key challenge that faces Asia therefore boils down to this: “how can Asia harness its sizeable domestic savings and large inflows of foreign capital to realise its economic potential?’

There are three things emerging Asia needs to do right.

First, Asia needs to price capital correctly.

Second, Asia needs to strengthen its infrastructure for allocating capital.

Third, Asia needs to build up expertise in investing capital.

Price capital correctly

9. Let me begin with the pricing of capital. History is replete with examples of how mispricing capital leads to serious misallocation of resources, which in turn leads to excessive risk-taking and a build-up of debt that eventually ends in a financial crisis.

10. Take Latin America in the 1970s. Global interest rates were low and capital sought higher returns in a booming region. International creditors lent huge sums for industrial development. External debt quadrupuled between 1975 and 1983, rising to 50% of the region’s GDP. But when interest rates soared from 1980 onwards, the payments to service this debt began to cripple the economy. At the same time, the projects these investments went into failed to deliver the expected returns. It all ended in a severe debt crisis that set back Latin America by at least a decade. Essentially, a mispricing of capital resulted in cheap funding and overinvestment.

11. Developed economies are equally prone to the risks of mispriced capital. The subprime mortgage crisis, which precipitated the global financial crisis less than three years ago, is another example of mispriced capital leading to excessive risk taking and leverage. Low interest rates in the US fuelled both a housing and a credit bubble that eventually burst, dragging down investors and intermediaries alike.

12. In emerging Asia, today, high levels of domestic savings coupled with large capital inflows pose the risk of unproductive investments and asset bubbles. When capital inflows slow down, as they inevitably must, the consequent unwinding will be rapid and possibly unpleasant.

Asian policymakers have been responding to the situation in various ways

13. First, they have allowed the price of capital to rise – either through exchange rates or interest rates or both. Second, they have regulated the demand for capital through fiscal tools, such as transaction taxes and stamp duties. Third, they have regulated the supply of capital through administrative tools, ranging from restrictions on bank lending to selective capital controls.

14. The most effective way is to price capital correctly. Several Asian economies have been raising policy interest rates, though real interest rates still remain rather low. There has also been a fair amount of exchange rate appreciation. Since mid-2009, most regional currencies have appreciated by about 5 to 6 per cent in real effective terms. Monetary policy in Asia is likely to remain tight in the months ahead. This should help to get the price of capital right, tame asset price inflation, and reduce the risk of misallocated resources.

15. Indeed, as emerging Asia continues to grow, allowing the exchange rate to steadily appreciate over the medium term is vital to ensuring that capital inflows are moderated and capital is allocated to productive investments.

16. But interest rates and exchange rates cannot take the burden of adjustment entirely, especially over the short term, given the scale and pace of capital inflows. Therefore,

macroeconomic policy adjustments have been complemented in some Asian countries by macroprudential measures, like reductions in banks' loan-to-value ratios and debt-to-income ratios. In exceptional cases, resort to capital flow management measures may be necessary to bring the situation under control.

Strengthen infrastructure for allocating capital

17. Next, emerging Asia must strengthen its infrastructure for allocating capital. Banks are still the principal channel for allocating capital in Asia, and post-Asian financial crisis, many Asian authorities have taken steps to strengthen their banks. Banking systems were cleaned up of their non-performing loans, recapitalised, and strengthened. Capital adequacy ratios were raised and a more risk-differentiated view was taken of bank assets. Risk management systems were made more robust. It was in large part because of these changes, that Asia was better able to withstand the global financial crisis in 2008 and 2009.

18. But much work remains to be done in one important area. Developing Asia needs to continue to develop its capital markets. The Asian financial crisis was essentially due to a double-mismatch in bank financing – currency mismatches and maturity mismatches. This is where strong capital markets can play a useful role in allocating capital in a more balanced and efficient manner. They also help to deepen financial intermediation, so as to facilitate the deployment of the region's high savings for investment within the region.

19. This was why, nearly ten years ago, the ASEAN+3 countries (namely the ten nations of ASEAN together with China, Japan and South Korea) introduced the "Asian Bond Markets Initiative (ABMI)". The ABMI has had a good start – the Asian corporate bond market has grown by more than 2.5 times during 2002 to 2010. But it is still too small relative to the size of Asia's investment needs. It needs to be more liquid and diverse. Access to capital market funding is still mostly restricted to large conglomerates and government-linked companies.

20. Emerging Asia is also under-represented in the equity universe. The region's 45 countries in the MSCI AC World Index account for less than 10 per cent of the Index although their share of world GDP is 19 per cent.

21. We need to make emerging Asia's capital markets deep enough to effectively intermediate its considerable savings pool and broad enough to provide a range of suitable instruments for risk mitigation.

22. The crying investment need in Asia is for infrastructure. A report released by the Asian Development Bank Institute estimates that the total investment needs for national infrastructure development in Asia will average close to US$750 billion per year from 2010 to 2020. But private participation in infrastructure investments in Asia amounted to just US$15 billion in 2009, less than half the US$39 billion that went into real estate investment. It will be a shame if Asia's considerable savings pool, not to mention the inflows of capital from abroad, goes into speculative real estate instead of productive infrastructure investments that enhance long-term economic growth. Having well-developed capital markets is a good way of ensuring that capital is allocated to productive uses.

23. A promising experiment in developing better mechanisms for allocating capital is the World Bank-Singapore Urban Hub. Established in 2009, it brings together Singapore's public agencies, research institutes, and private sector players to share their experiences with developing countries, in areas ranging from water and waste management, land use planning, and urban development. As a financial centre, Singapore provides a suitable platform for public-private-partnership financing frameworks to help channel private capital into infrastructure development in Asia.

Build expertise for investing capital

24. While pricing capital correctly and improving the channels to distribute it more efficiently are necessary, they will be insufficient if the human expertise to manage and allocate the capital is not well developed. Building a successful team of financial intermediaries hinges on identifying the right talent and building the right competencies.

25. In Singapore, MAS and the industry have worked together to develop the Financial Industry Competency Standards (or "FICS"), aimed at enhancing the professionalism of the financial sector workforce. The accredited programmes of FICS are readily accessible, with funding support of up to 90 per cent of the programme fees. MAS supports relevant training programmes under the Financial Training Scheme, which co-funds training costs for training courses.

26. Substantial investment has also been made in the area of financial research. The work of researchers here helps to increase the body of knowledge and understanding of risks unique to Asian markets. Many research institutes have been set up in Singapore to support these efforts.

26. Singapore has put much effort into attracting asset managers to bolster the buy-side of the investment equation. As at end-2010, assets managed out of Singapore stood at S$1.4 trillion, with a rolling 5-year average growth rate of 16 per cent per annum. The Asia Pacific region continues to be the key investment destination for Singapore-based asset managers, accounting for just over 60 per cent of total assets under management. Private equity, venture capital, and other alternative investors have found Singapore a conducive centre to access regional and international investment opportunities. Such concentrations of investment talent and expertise in the major financial centres of Asia augur well for sound investment allocation.

Conclusion

27. Let me sum up. The prognosis for Asia is good. An increasingly educated population, sound and prudent governance, and open markets set the stage for Asia to return to its historical role as the centre of gravity in the global economy.

28. But this is not an assured outcome. With high domestic savings and excess liquidity flooding the international system, the risk is that capital in Asia could potentially be mispriced and misallocated. This can in turn lead to asset bubbles and inflation. But if Asia is vigilant in ensuring that capital is priced correctly, that the infrastructure for allocating it is strong, and that the human expertise for investing it wisely is built up, Asia will be better placed to realise its potential.

29. Conferences like these, that bring together investors, intermediaries, and policymakers, can play a useful role in the effort to realise Asia's promise. I applaud Deutsche Bank for lining up a strong programme of lectures and presentations, examining in greater depth the promises and pitfalls of the Asian century.

30. I wish you a fruitful time, not only exploring new ideas and identifying new opportunities at this conference, but also discovering new delights during your stay here in Singapore.

Thank you.