Choongsoo Kim: Financial integration, financial stability and central banking

Speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the International Conference on "Financial integration, financial stability and central banking", organized by Japan Financial Services Agency, Tokyo, 10 February 2012.

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Good morning, ladies and gentlemen.

It is a true pleasure and privilege for me to be here this morning. I am very grateful to Commissioner Hatanaka of the Financial Services Agency, Chairman Mae of Japan Securities Dealers Association, and President Saito of Tokyo Stock Exchange Group, for inviting me to this conference as a keynote speaker.

As we all know, the global crisis has demonstrated how financial disruption in a major economy can quickly spill over to affect the entire world, through a complex web of interconnected markets and cross-border exposures. And while causing global recession, these spillovers also manifested themselves in diverse forms, depending upon where the weakest points in the vulnerability chain lay–for example, leading to fiscal crises in advanced economies and to abrupt capital flow reversals in emerging economies. The crisis also revealed a number of shortcomings in our financial regulation and supervision, as shown for instance by our failure to detect the systemic risk arising from pro-cyclicality and nonlinearity in asset prices.

Given its far reaching impact on the financial sector and the broader economy as well, the global crisis has and will continue to cast a long shadow on financial and real activities over the coming years if not decades. But it has also brought us important lessons and new thinking about central banking, financial regulation and fiscal prudence. And we have made substantial progress, ranging from formulating a strengthened regulatory framework to laying the foundation for better international policy coordination through bodies such as the G20.

And now, as we enter our fourth year since the crisis, I would argue that it is time to pay greater attention to reviving economic growth and the related policy agenda. The ensuring of financial stability–or more broadly macroeconomic stability–is of course a prerequisite for reviving growth, but the converse is also true. The real and financial sector linkages in other words involve two-way traffic. And indeed, it is hard to imagine that the highly indebted countries in Europe will be able to succeed in putting their public finances on sustainable footings if their growths remain stagnant.

In this respect, global financial resources may have in recent years been directed too much toward financing of unsustainable fiscal deficits in debt-ridden countries and too little toward growth and job creation. I believe that redirecting of financial resources more toward growth–more specifically, toward countries with high productivity–could yield substantial stability benefits to all in the long run.

This is why I see a greater role for Asia going forward. Asia weathered the global crisis well, and has thus far remained resilient to negative spillovers from the on-going fiscal crisis in Europe. Moreover, many expect Asia to develop even more into the engine of global economic growth. But Asia also faces many challenges. Its source of growth is skewed to external demand, and there is limited scope for domestic demand to play a major role. Intra-regional trade has been on the rise, true, but it remains only secondary to trade with other advanced regions. Our regional financial markets are meanwhile underdeveloped, less satisfactorily integrated, and vulnerable to shocks of external origin. While Asia accounts for over one-third of world GDP, its share in world finance is less than one quarter.

That said, I find the theme of this conference to be highly topical. Asian Market Integration and Financial Innovation should, I believe, be our path to prosperity and stability. In what follows, I would like to set out my views on this theme, with a particular emphasis on the role of the central bank.

Asian market integration: a way forward to financial deepening and stability

Let me begin by addressing the benefits and the risks of financial integration in Asia.

Asian economies grew rapidly over the past several decades, by integrating themselves to the world economy through trade. During the catch-up process, Asia was able to upgrade and boost the scale of its productive capacity and, through learning-by-doing, significantly reduce its productivity gap vis-à-vis its advanced trading partners.

I believe that financial integration can and should bring the same benefits for Asia as trade integration. In principle, financial integration facilitates domestic financial development, improves resource allocation within and across countries, and ultimately promotes growth. The diverse stages of development and demographics of Asian countries offer fertile ground for such efficiency gains from financial integration. These benefits are relatively well understood.

Another important but less known benefit is a stronger market base for financial stability. Financial integration tends to bring about greater market liquidity, improved risk allocation and enhanced competition, all of which contribute to financial stability by allowing market participants to better absorb and trade risks among themselves (IMF, 2011)[1].

I think these stability gains are particularly relevant for Asia, where the brunt of regional trade and finance is denominated and settled in the dollar and other reserve currencies. Heavy dependence on the dollar has nurtured currency and maturity mismatches here, and the associated liquidity risks of individual banks have often translated into sovereign risks as our domestic financial markets have offered little scope for liquidity trade. And while Asia has been relatively free from financial crises since 1997, this has been aided by capital controls or large holdings of low-yield foreign reserves or both.

If better integrated Asian markets can produce more safe assets of our own, offer greater risk hedging, and help to reduce financial mismatches, the financial stability gains to us could be quite large. Korea’s recent experience offers some anecdotal evidence of the potential benefits of bond market integration. Specifically, increased investment in Korean treasuries by Asian official investors helped very much last year to offset capital outflows from our country driven by Eurozone investors.

Despite efforts devoted for more than a decade, however, Asian market integration is still far less than satisfactory. For instance, intra-regional bond investment accounts only for 7 percent of total bond investment in Asia, compared to figures of 59 percent for the EU and 19 percent for North America. In this light, the Asian Bond Markets Initiative (ABMI) should remain a high priority on Asia’s financial reform agenda.

We should keep in mind as well that financial integration is a market process that takes a very long time and evolves only gradually. Policies and institutions implemented to promote financial integration may–and perhaps should–also differ across time and place. But I do not think Asian markets are intrinsically different, in terms of their modus operandi, from other advanced markets. Therefore, I believe Asian market integration should be guided by the same principles adopted by advanced markets–such as greater exchange rate flexibility,

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freer capital mobility, transparent rules and regulations, and fair competition based upon reciprocity. In addition, a clear roadmap should be in place to enable the private sector to prepare itself well in advance for the changes that are coming.

Financial stability and central banking

The efficiency and stability benefits of Asian market integration are not things that can be taken for granted. Instead, reaping these benefits requires the meeting at all times of an important precondition–namely, adequate risk control.

As noted earlier, financial integration and deepening can lead to a stronger market base for financial stability. Nevertheless, financial integration will in all likelihood lead to increased systemic risk, as countries and markets become more interconnected. The fact that the global crisis started in the most advanced and financially integrated regions suggests that the systemic risk can be far larger than the sum of the risks of the individual financial institutions or markets involved.

Systemic risk is a complex function of all sorts of linkages, arising from cross-correlated and pro-cyclical asset prices, market frictions, and interconnectedness, among other factors. This is what makes the role of the central bank in managing systemic risk pivotal. At the most basic level, of course, control of systemic risk will require strong prudential oversight of individual financial institutions and markets.

But that is not enough. A shock in an isolated financial market or in the real sector can quickly spill over into another, and in the process be dramatically amplified. After all, subprime mortgage-related assets accounted for only a small portion of the total financial assets of the United States and Europe leading up to the global crisis, but they nevertheless triggered the global crisis when the housing bubbles in these economies burst.

For this reason, systemic risk control should be approached from a macro-prudential perspective in which the real and financial sector linkages take center stage. And given their mandates and financial resources, central banks are arguably well positioned to develop macro-prudential judgment of systemic risk and to take actions if warranted. To be specific, the existence of real and financial linkages implies that price stability and financial stability cannot be considered in isolation, and that monetary and macro-prudential policies, despite being so distinct in many respects, should be closely coordinated. In addition, we should note that the central bank's exercise of its lender of last resort function during times of liquidity disruption is in fact also a macro-prudential policy (BIS, 2011)[2].

We have recently witnessed sea changes in the governance structures of macro-prudential policy in major financial center countries, where central banks have now become responsible for–or at least involved in–both monetary and macro-prudential policies. Such departure from the so-called Tinbergen Principle reflects the new thinking on central banking and financial stability since the global crisis. I believe there is no one-size-fits-all solution, however, and that governance structure should rather be tailored to individual country circumstances. It should nevertheless be made clear that the central bank needs to play a role in macro-prudential oversight on systemic risk, and that close dialogue and policy coordination between the central bank and the supervisory authority, if they are not the same, is crucial for financial stability.

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[2] Central Bank Governance and Financial Stability, BIS Report.

Korea's take on stronger financial stability

Before concluding, let me touch briefly on Korea's take on the strengthening of financial stability since the global crisis.

Korea has learned from the crisis that the combination of good macroeconomic fundamentals and a large reserve buffer is not sufficient to guard against adverse external shocks, particularly if the economy's underlying financial vulnerabilities are large. At the center of our acute policy concern since the crisis has been excessive capital flow volatility, stemming from currency and maturity mismatches in our foreign liabilities. Another priority has been institutional reform to strengthen the role of the Bank of Korea in ensuring financial stability, with a greater focus on crisis prevention and management.

Macro-prudential measures have recently been implemented to limit the excessive FX risks on our banks' balance sheets. First, ceilings on the forward FX positions of domestic banks and foreign bank branches were imposed in October 2010, and are currently set at 40 percent and 200 percent of equity capital, respectively. Second, a macro-prudential stability levy (a bank levy) on the non-core liabilities of banks was put into effect from August 2011, with the levy rate varying depending on maturity–in a range from 20 basis points for short-term liabilities with maturities of one year or less to 2 basis points for longer-term liabilities with maturities five years or longer.

These two measures are not capital controls as they are applied equally to domestic and foreign banks. And although it may be premature to judge, they do appear to have influenced banks' risk taking in foreign currencies. Finally, for precautionary purposes, Korea renewed and expanded its central bank currency swap arrangements with Japan and China late last year, a move which increased the amount of foreign currency liquidity available to us by about 90 billion dollars.

In parallel, a major governance reform was also implemented in 2011 by revision of the Bank of Korea Act. Through this revision, the Bank of Korea is now mandated with the responsibility not only for maintaining price stability, but also for paying due attention to financial stability as well. The Bank is in addition required to prepare an official financial stability report semi-annually, and submit it to our National Assembly. The revision has also endowed us with expanded scope for providing emergency liquidity support, and with greater access to information from financial institutions including non-banks.

Concluding remarks

Let me conclude now with a few final remarks.

Asia can open a new chapter in its economic development by turning to take advantage of relatively unexplored opportunities in financial trade. If the trading of goods has enabled Asia to grow rapidly thus far, financial integration and innovation can and should do the same. This is because it is in the area of finance where Asia has yet to catch up with the forerunners, and where the productivity gap hence remains substantial. The first step toward Asian market integration and financial innovation should be financial liberalization at the national level, guided by the same principles that guided our advanced peers in the past.

But the risks attendant to financial integration and innovation are by no means small. Economic growth and financial prowess will prove elusive if systemic risk is not brought under adequate control. And the recipe for success in this regard is well known–stable monetary policy, fiscal prudence, and enhanced financial regulation with a greater focus on macro-prudential oversight.

I hope my address today will serve as a reminder of why the central bank and the supervisory authority should work together to ensure financial stability, an important precondition for success in the process of Asia's future financial take-off.

I look forward to productive discussion during this conference, hoping that it will guide us to solutions to the challenges that Asia faces.

Thank you for your attention.