Kiyohiko G Nishimura: Inter-regional financial cooperation – another layer of financial cooperation towards financial stability

Remarks by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at CEMLA's 60th Anniversary Commemorative Conference "Central Bank Cooperation at the Beginning of the 21st Century", Mexico City, 19 July 2012.

* * *

1. Introduction

First of all, I am grateful to the organizers for inviting me to the 60th Anniversary Commemorative Conference of CEMLA, a symbol of financial cooperation between central banks in Latin America. I am especially thrilled, because this is the ideal opportunity to discuss international monetary stability and central bank cooperation from the integrated perspective that spans Latin America and Asia. Latin America and Asia are among the most developed regions in terms of financial cooperation.[1] Today, I would like to take the concept of financial cooperation one step further by considering the topic of inter-regional financial cooperation. Although the theme of financial cooperation at the global, intra-regional, and bilateral level has been discussed at a variety of international forums such as G20, I believe inter-regional financial cooperation, especially between Latin America and Asia, represents another important layer between the global and the intra-regional or bilateral levels.

2. Latin America and Asia in the 21st Century: from low to high correlation

Let me begin by giving a brief summary of the linkage between Latin America and Asia with respect to real economic and financial activities, focusing particularly on the period since 2000.

Both regions have experienced several large-scale financial crises since the 1980s, namely the Mexican Debt Crisis in 1982, followed by the so-called Tequila Crisis in 1994, the Asian Financial Crisis in 1997 accompanied by the Russian Crisis, and the Argentine Crisis in 2000. However, roughly speaking, this period in our history also highlights the fact that, until the collapse of Lehman Brothers in 2008, we had never faced a large-scale financial crisis simultaneously. In fact, the cross-country correlation of real GDP growth between Latin America and Asia shows relatively small coefficients in the early 2000s (Slide 1). The reason could be that the regions are geographically distant, and thus relatively less influenced by each other, particularly in terms of trade activity.

However, this relationship had already begun to change during the era of the so-called Great Moderation, and has changed dramatically since the Lehman shock and the recent European sovereign debt crisis. In fact, the above-mentioned cross-country correlation shows a significant increase since 2008 in the correlation coefficients of all major Asian economies,

[1] This 60th anniversary event implies that CEMLA began its activities in 1952, merely seven years after the end of World War II. Asia and the Pacific (hereafter, referred to simply as Asia unless otherwise noted) also has a long and very active history of regional financial cooperation. The central bank leaders of seven South East Asian nations gathered in Bangkok, Thailand in 1966, and established the foundation of SEACEN, which plays an important role as a training and learning hub in the region. In 1982, the SEACEN Center was established to provide the secretariat function in Kuala Lumpur, Malaysia, and has since been hosting and co-hosting a number of valuable and timely seminars and conferences. Seminars and conferences were co-hosted with CEMLA, and the Bank of Japan contributed to them as a speaker and lecturer. In 1991, the Bank of Japan invited Asian counterparts to form EMEAP, consisting of eleven central banks and monetary authorities in the region. EMEAP has since then celebrated a number of concrete achievements in regional financial cooperation, including the establishment of the Asian Bond Fund.

following a gradual increase in China and Japan a few years earlier. Although geographical distance has not changed, our mutual dependency in trade has dramatically increased since the mid-2000s, driven largely by China, and owing to significant improvements in transportation technology and a decline in various trade-related costs (Slide 2).

The linkage of trade, and thus economic and financial activities, between Latin America and Asia is expected to be strengthened further in the future. Trade volume is determined by the size of population and the degree of complementariness of goods and services, if transaction costs are sufficiently small. The combined populations of Latin America and Asia are forecast to remain at more than 60 percent of the global population. As income levels increase, the two regions combined are expected to become one of the largest consumer markets in the world (Slide 3). Moreover, the two regions have a well-balanced supply-and-demand relationship, ranging from agricultural goods and raw materials to capital goods. This implies that future trade activity in a combined Latin America and Asia can be self-sustained without having to rely substantially on advanced countries. As mutual linkage of economy is enhanced through trade, eventually so is financial linkage between the two regions, including an increase in foreign exchange transactions for the purpose of real demand and hedging, as well as an increase in stock price correlation reflecting active cross-border corporate transactions.

This heightened inter-dependency of economy and financial markets implies that a financial crisis in one region has a direct impact on the other. Moreover, as the importance of a combined Latin America and Asia increases, so too does the chance that they happen to become the epicenter of a global financial crisis. In this regard, policy makers of the two regions are mutually responsible for the stability of the global economy and financial market. To fulfill such responsibility, financial cooperation should not be confined to one region.

Latin America and Asia have many issues in common. Addressing capital flows is one such issue. A variety of regulations and macroprudential measures has already been introduced, and has been to a certain extent effective in each of the jurisdictions or regions. However, more structural issues associated with financial stability should be discussed, not only at the intra-regional level, but also at the inter-regional level between Latin America and Asia. These structural issues include the development of liquid and deep capital markets, and improvements in financial infrastructure, including deregulation and harmonization of regulations. Moreover, from a longer-term perspective, issues related to population aging, and corresponding arrangements of social security and tax systems, also need to be considered comprehensively with an inter-regional view in mind.

3. Asian experience on financial cooperation

Let me now turn to the Asian experience on financial cooperation, anticipating similar discussion of the Latin American experience later from other participants.

(Vulnerabilities in Asia)

Although overall economic and financial stability has been improved remarkably in Asia since the Asian Financial Crisis, there are still vulnerabilities in the region. First, there remains the double-mismatch of currency and maturity in the banking sector. Such vulnerabilities materialized in some Asian economies when U.S. dollar liquidity dried up after the collapse of Lehman Brothers. We have seen similar impacts recently with the deleveraging by European banks. Second, in Asia, including Japan to some extent, the financial intermediation function has still been served largely by indirect financing, mostly through banks. Given this financing structure, a large negative shock hitting financial institutions makes it difficult for non-financial corporations to gain smooth access to debt financing from these institutions, almost regardless of their financial soundness. Third, there is still the issue of scant investment opportunities in Asian local currencies. Abundant savings in Asia have not been invested sufficiently within the region, and have thus eventually been invested outside the region, such as in bonds in the United States and developed Europe.

To put it in a different perspective, the Asian financial sector remains highly dependent on banks, indicating the underdevelopment of regional bond and other capital markets. Owing to such an unbalanced market structure, Asian economies are exposed to the risk that domestic asset prices become volatile because of rapid global capital flows, resulting in a sharp increase in the volatility of foreign exchange rates. Also, the immature local derivatives market makes appropriate risk-taking transactions difficult, as risk-hedging instruments are limited (Slide 4). Moreover, owing to their less-developed securitization markets, Asian economies do not sufficiently enjoy the merits of the securitization schemes that attract a variety of investors depending on their risk-taking capacities (Slide 5).

(Authorities' efforts to address vulnerabilities)

How have the Asian authorities responded to these vulnerabilities? I would like to explain their efforts in three aspects.

To develop local currency-denominated bond markets

The first is a project aimed at developing liquid bond markets to provide a bridge between abundant local savings and local investments: the ABF of EMEAP, and the ABMI of ASEAN+3.

The Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) established the Asian Bond Fund (ABF) investment trust in 2003, and became the initial buyers by investing in sovereign and quasi-sovereign bonds in the eight member jurisdictions. When it was launched, the Fund was limited to investment only in U.S. dollar-denominated bonds. However, since 2005, the Fund has begun to include those denominated in the local currencies of the eight members. In addition, EMEAP launched an exchange-traded fund (ETF) called the Pan Asian Index Fund (PAIF). The PAIF was first listed on the Hong Kong Stock Exchange in 2005, and later cross-listed on the Tokyo Stock Exchange in 2009.[2]

As part of the ASEAN+3 process, the authorities have launched the Asian Bond Markets Initiative (ABMI),[3] aimed at promoting bond markets. The most notable recent achievement is the establishment in November 2010 of a trust fund in the ADB called the Credit Guarantee and Investment Facility (CGIF). The CGIF plans to start its credit guarantee operations for local currency-denominated corporate bonds issued in the ASEAN+3 jurisdictions in the third quarter of 2012 at the earliest. At the Finance Ministers' and Central Bank Governors' Meeting in May this year, another new roadmap for the ABMI was proposed and endorsed to further promote resilient capital markets in the region, for example, by improving the regional credit rating system, developing small and medium-sized enterprises' finance and securitization markets, and raising the level of financial education.

To establish and enhance a currency swap network

The second response by Asian authorities to the region's vulnerabilities is a project to establish and develop a mutual framework of U.S. dollar liquidity provision, called the Chiang

---

[2] Each listed fund, as well as the PAIF, aimed at raising awareness among private investors, has steadily gained recognition among investors, although the extent of this recognition varies across the markets. Moreover, the project has been functioning as a catalyst for improving market infrastructure, such as deregulation and exemption of withholding taxes for non-resident investors, through its reviewing process among the EMEAP members.

[3] ABMI advocates four main issues, namely i) facilitation of demand for local currency-denominated bonds, ii) promotion of their issuance, iii) improvement of the regulatory framework, and iv) improvement of the relevant infrastructure for the bond market.

Mai Initiative (CMI). Aimed at improving the region's resilience against external shocks, the CMI started building a bilateral currency swap network in the region, which involves a contingent claim on foreign currency reserves held by each ASEAN+3 authority. The CMI has since enhanced its effectiveness by increasing its size and the number of participants. In fact, in March 2010, the authorities evolved the CMI framework from its original bilateral swap arrangements to the multilateral Chiang Mai Initiative Multilateralization (CMIM), which is a collective decision-making framework signed by all member jurisdictions in a single contract.[4]

To ensure the effective implementation of crisis prevention and actual U.S. dollar liquidity support, it is essential for the authorities to monitor closely the regional economy and financial markets, and exchange views on their respective macroeconomic policies. The ASEAN+3 authorities thus established their own but independent surveillance unit, called the ASEAN+3 Macroeconomic Research Office (AMRO), in Singapore in April 2011.

Recent efforts to enhance financial stability

In addition to the above-mentioned two projects, momentum is building among Asian central banks to make cross-border collateral arrangements (CBCAs), aimed at further enhancing financial stability in the region. CBCAs are arrangements whereby a central bank provides local currency liquidity by accepting foreign currency assets, such as sovereign bonds in foreign countries, as eligible collateral. Such arrangements already exist in some advanced countries. CBCAs are thought to be an effective framework particularly in times of short-term money market stress. Foreign financial institutions' branches and subsidiaries often lack stable local funding sources, such as retail deposits. However, under a CBCA, they can still continue to provide credit to their customers, who are in most cases branches and subsidiaries of non-financial corporations domiciled in their home countries.

In fact, a CBCA was established in November last year between the Bank of Japan and the Bank of Thailand, as there are many Japanese non-financial corporations operating in Thailand. At almost the same time, a CBCA was announced between Bank Negara Malaysia and the Monetary Authority of Singapore, and early this year between Bank Negara Malaysia and the Bank of Thailand. Meanwhile, EMEAP has formed an action group and made a CBCA reference template for their future expansion in the region. So far, they are bilateral negotiations between two jurisdictions, depending on their necessity.

Moreover, Japan and China are making efforts to enhance mutual cooperation towards the development of financial markets in the two largest Asian economies. Owing to cooperation between the authorities and private market participants, many tangible outcomes have already been achieved, including the purchase of Chinese government bonds by the Japan's Foreign Exchange Fund Special Account and the start of direct exchange between Japanese yen and Chinese renminbi on the Tokyo and Shanghai markets.

4. Towards inter-regional financial cooperation

As economic and financial linkages deepen, I believe that the above-mentioned efforts and issues addressed in Asia can be shared more or less with Latin America. Both regions also have common structural problems. I believe that it is fruitful for regions bearing similar problems to resolve them collaboratively.

First, let me raise the issue of demographic change and economic potential. Slides 6, 7, 8, and 9 show the ratio of working-age population to the rest, that is, how many people of

---

[4] At the same time, the authorities expanded the total borrowing amount from USD 90 billion to USD 120 billion, enabling prompt and effective U.S. dollar support in times of crisis. Moreover, at the above-mentioned Finance Ministers' and Central Bank Governors' Meeting, the authorities agreed to double the size of the CMIM to USD 240 billion, and expand its scope to also cover crisis prevention.

working age have to provide for one dependent person, for Japan, the United States, Asia, and Latin America, respectively. Low fertility rates and population aging have been the main cause of prolonged low economic growth in Japan since 1990. This is also likely to become a big issue even for Korea and China in the not-so-distant future. Some Latin American countries may also have similar concerns, although the degree varies across jurisdictions. Having this future vision well in mind, we have to be prepared even now to implement the necessary social reforms, including the restructuring of social security systems, tax reforms, and revision of employment systems.

Second, let us consider the development of asset prices and credit expansion. In Slides 10, 11, 12, and 13, the development of property prices and loans in real terms is added to the chart of the working-age population ratio (inverse dependency ratio) in the previous Slides 6, 7, 8, and 9, respectively. In Japan and the United States, we see a significant relationship between population dynamics and real asset prices. A similar tendency is also observed in China, as representative of Asia, and Brazil, as representative of Latin America. Whether this development leads to the generation and bursting of asset bubble depends largely on future policy implementation in the respective regions.

To address these structural problems, it might be more effective for both regions to collaborate, rather than to deal with them individually and independently. The following three points are also issues to be considered cooperatively.

First, as an economy develops and a middle-income class emerges, we need to implement measures to realize a more balanced growth between domestic and external demands. At the same time, the population eventually ages as the economy matures, and thus the key to success will be the promotion of domestic demand appropriately in line with the developmental stage of the economy.

Second, from the viewpoint of reducing asset price volatility, it is also important to further develop regional capital markets with the aim of enhancing resilience against external shocks. In this regard, we need to take into account market differences within the region.

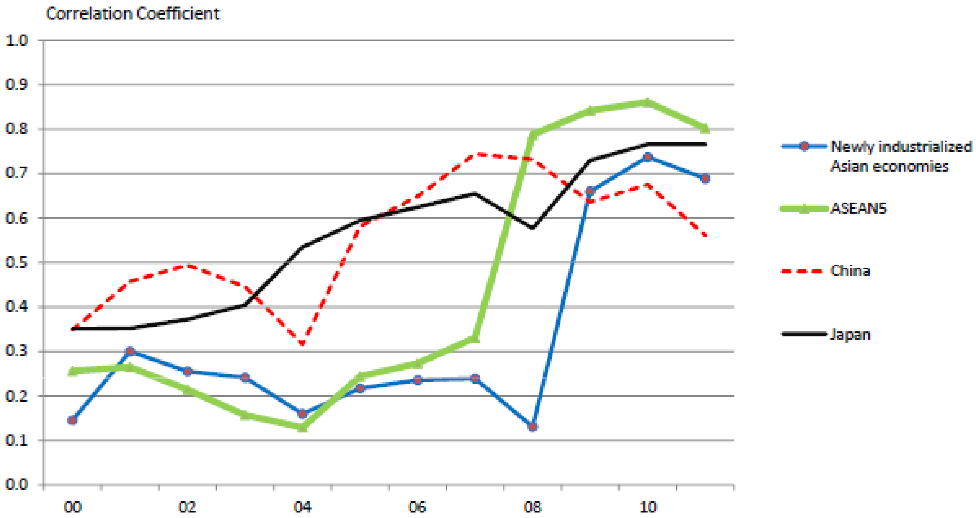
Third, it is essential for each jurisdiction to harmonize its market regulations and practices with the global standards in promoting cross-border transactions. However, unilateral effort by a single jurisdiction has its limitations, and thus collective effort is desirable to improve market infrastructures effectively in both regions. While respecting diversity across jurisdictions, we should not introduce arbitrary regulations or ignore global contractual practices.

Needless to say, even if we are successful in dealing with these issues, we cannot completely prevent financial crises. However, we can improve our resiliency in times of crisis by preparing multi-layered safety nets as backstops in the financial system. Such safety nets include the development of deep and liquid capital markets, the establishment of currency swap networks, and cross-border collateral arrangements. Moreover, it is also important to establish solid foundations for individual and regional economies by addressing at an early stage long-term social structural problems such as declining fertility rates and population aging. A resilient real economy is an indispensable factor in financial stability.

Last but not least, as you already know, the IMF-World Bank Annual Meetings will be held in Tokyo this coming October. The Bank of Japan plans to take advantage of this opportunity to co-host a seminar with CEMLA. I will participate in this wonderful event, representing the Bank of Japan, and I look forward to the enthusiastic proposals and discussions regarding financial stability in Latin America and Asia, and thus global financial stability, among a variety of participants, including senior officials of central banks in the two regions.

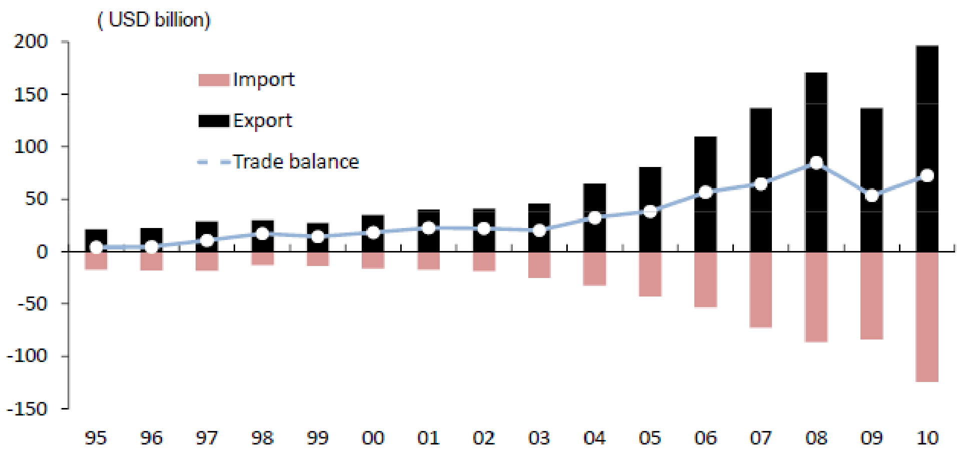
I will stop here. Thank you for your kind attention.

(Slide 1) Cross-Country Correlation of Real GDP Growth between Latin America and Asian Regions/Countries



(Note1) Newly industrialized Asian economies comprise Hong Kong SAR, Korea, Singapore, and Taiwan Province of China. ASEAN5 comprises Indonesia, Malaysia, Philippines, Thailand, and Vietnam. Latin America includes the Caribbean countries.
(Note2) Cross sectional data period is from 1990 to 2011.
(Source) IMF

(Slide 2) Deepening Trade Relationship between Latin America and Asia



(Note1) Latin America comprises Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.
(Note2) Asia comprises ASEAN (Brunei, Cambodia, Indonesia, Laos, Myanmar, Malaysia, Philippines, Singapore, Thailand, and Vietnam), China, Japan, and Korea.
(Source) UNCTAD

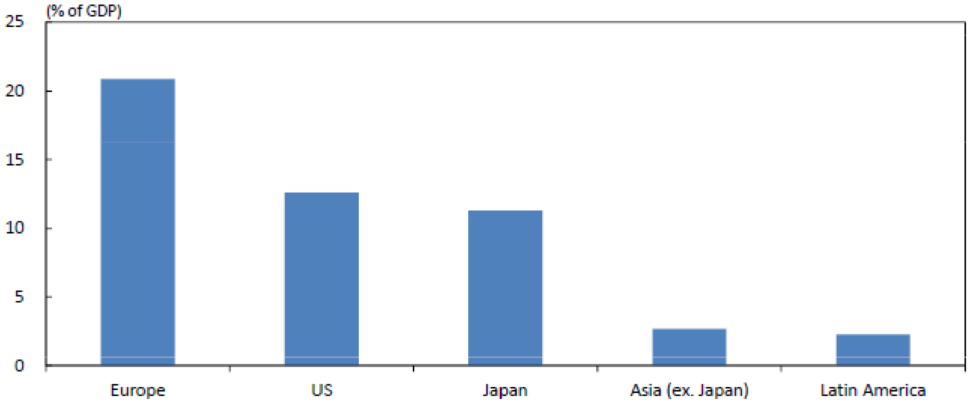
(Slide 3) Population Dynamics in Latin America and Asia

	1950	1970	1990	2010	2030	2050
World Population (billion)	2.5	3.7	5.3	6.9	8.3	9.3
Share of World Population (%)	61.4	64.8	68.0	68.3	66.4	62.8
Latin America	5.9	7.1	7.7	8.0	7.9	7.6
Asia	55.4	57.8	60.3	60.4	58.5	55.3

(Source) United Nations

(Slide 4) Asia's Vulnerabilities: Underdeveloped Derivatives Market

Notional Amounts Outstanding of
OTC Equity-Linked Derivatives (End-June 2010)



(Note) GDP data of Bolivia, Colombia, Guatemala, Suriname, Fiji, Laos, Maldives are estimates. GDP data of Latin America do not include the Falkland Islands (Islas Malvinas).
(Source) BIS; Bloomberg; IMF; United Nations

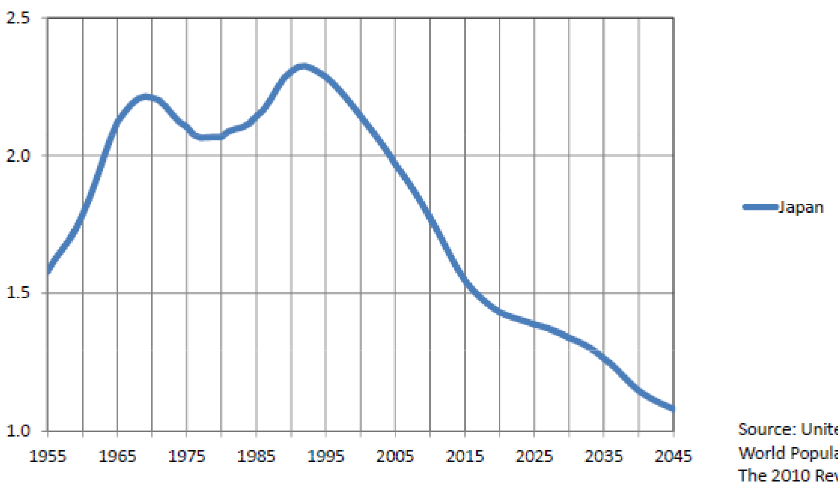
(Slide 5) Asia's Vulnerabilities: Underdeveloped Securitization Market

		Asia (ex. Japan)	Japan
% Change in Newly Issued Amount from 2006 to 2011			
	Corporate Bonds	377.4%	27.2%
	Securitized Products	-10.7%	10.6%
Securitized Products / Corporate Bonds (Newly Issued Amount in 2011)		3.5%	28.4%

（Source） Dealogic DCM Analytics

(Slide 6) Population Change: Japan

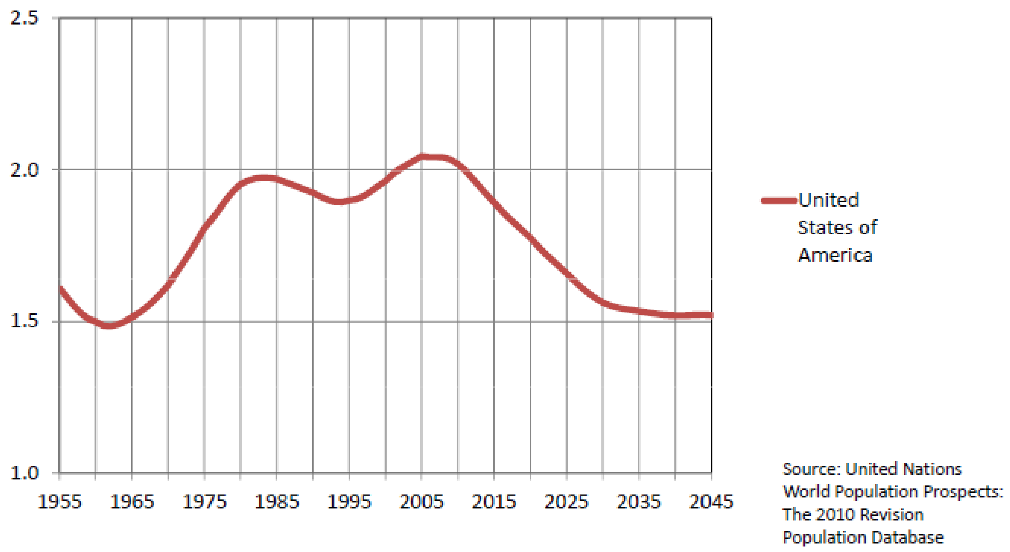
Inverse Dependency Ratio: Ratio of Working-Age Population to the Rest
= How many people of working age have to provide for one dependent person?



Source: United Nations
World Population Prospects:
The 2010 Revision
Population Database

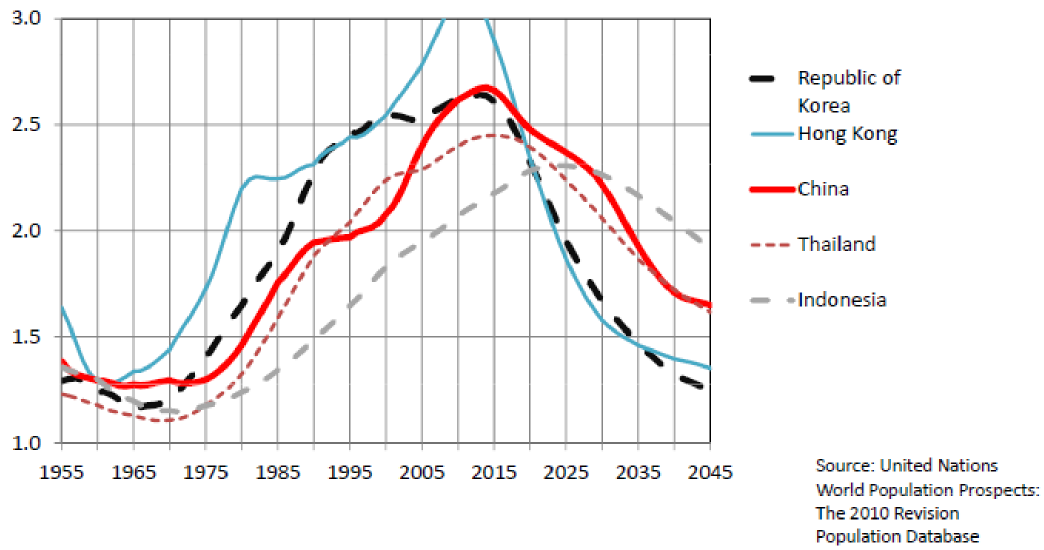
(Slide 7) Population Change: United States

Inverse Dependency Ratio: Ratio of Working-Age Population to the Rest
= How many people of working age have to provide for one dependent person?



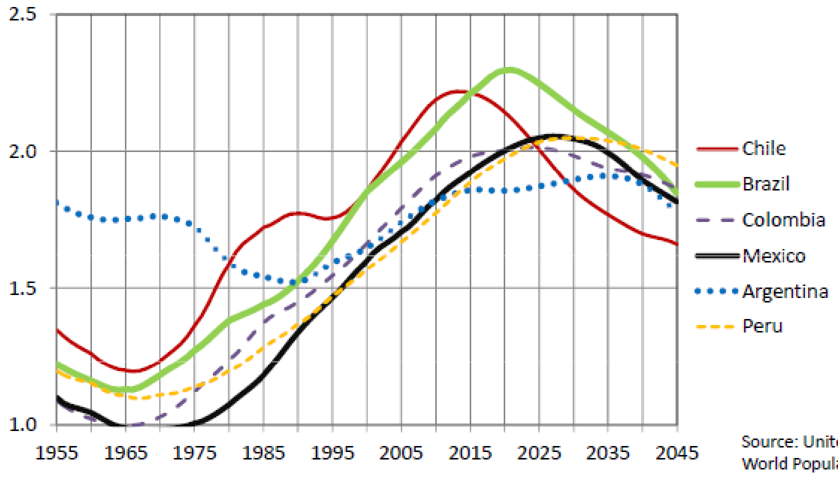
(Slide 8) Population Change: Asia

Inverse Dependency Ratio: Ratio of Working-Age Population to the Rest
= How many people of working age have to provide for one dependent person?



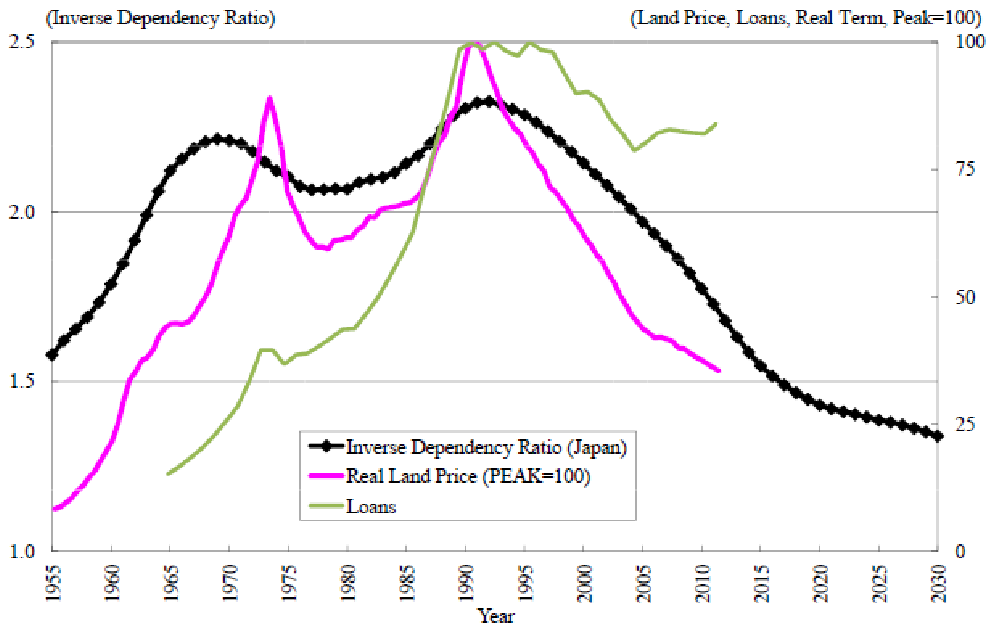
(Slide 9) Population Change: Latin America

Inverse Dependency Ratio: Ratio of Working-Age Population to the Rest
= How many people of working age have to provide for one dependent person?



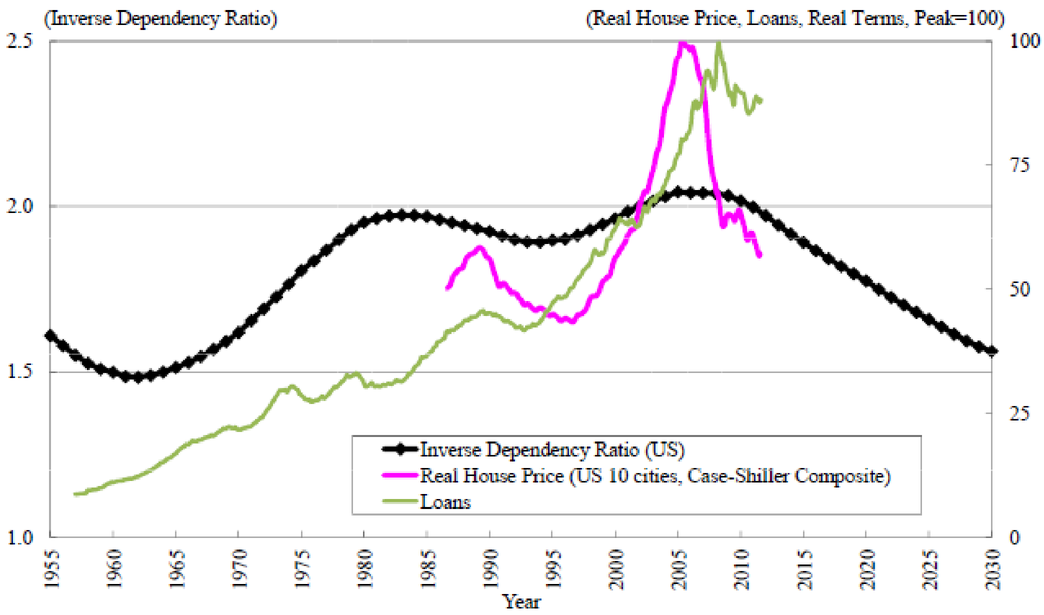
Source: United Nations
World Population Prospects:
The 2010 Revision
Population Database

(Slide 10) Population Change and Asset Price: Japan



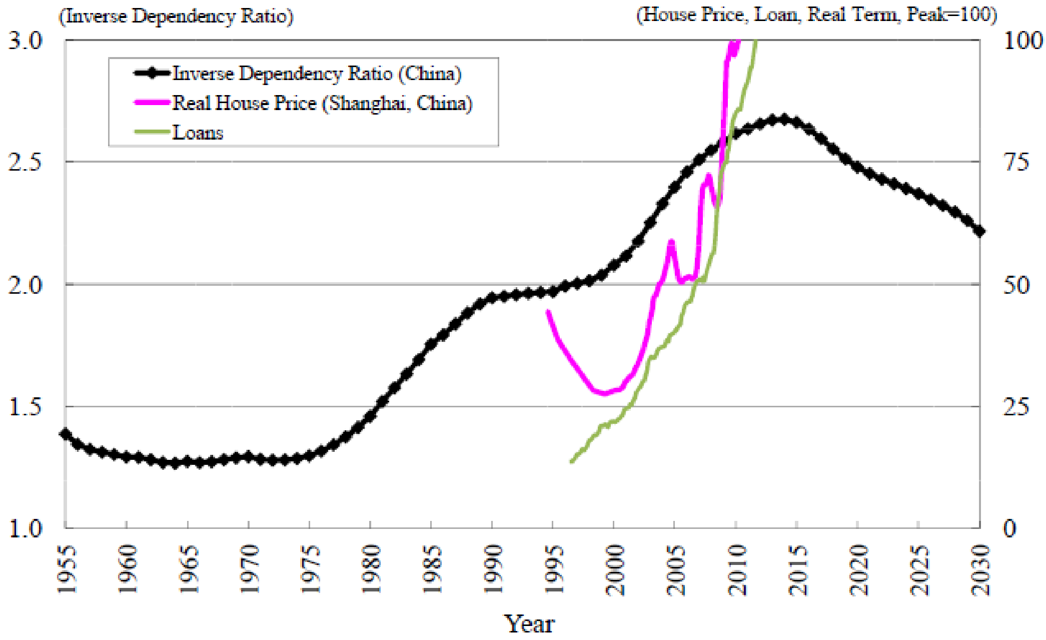
Source: United Nations; Japan Real Estate Institute; Japan Ministry of Internal Affairs and Communications; Bank of Japan

(Slide 11) Population Change and Asset Price: US



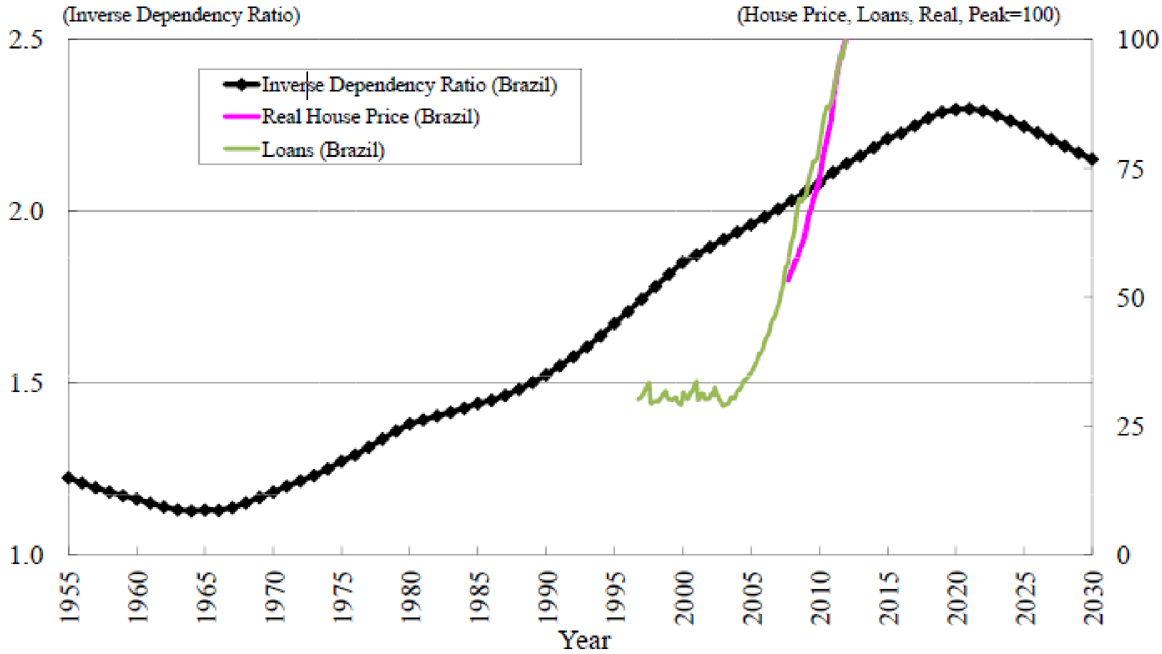
Source: United Nations; Standard and Poor's; U.S. Bureau of Labor Statistics; Federal Reserve

(Slide 12) Population Change and Asset Price: China



Source: United Nations; CEIC, etc

(Slide 13) Population Change and Asset Price: Brazil



Source: United Nations; FipeCap; CEIC