# Glenn Stevens: Financing the Asian century

Remarks by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Asia-Pacific Financial Market Development Symposium, Sydney, 10 April 2013.

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Welcome to Sydney.

We are here this evening at the Royal Sydney Yacht Squadron, founded in 1862 for the enjoyment of sailing by its members.

I am not a sailor; aviation is more my hobby. But one can see that in sailing, key elements to a successful voyage would be similar to those in aviation. These would include:

- an adequate amount of training and proficiency on the part of the skipper and crew
- a realistic assessment of the capabilities and limitations of your craft
- a clear destination and a route to get there, though with some flexibility in amending the route should circumstances change
- a realistic assessment of the risks involved, including a respect for the weather[1]
- compliance with the rules
- a plan B in case something goes wrong
- in the worst case scenario, the availability of rescue to protect human life – though not the financial interests of the boat's owner.

All these are important.

Without wanting to push the analogy too far, many elements of policy making and financial development could be said to share many of these attributes.

We need to understand how systems work, and their limitations. We want the participants, regulators and supervisors to have appropriate training and skill. We need to keep in mind our desired destination and retain some flexibility of choice in the route depending on circumstances. We need to think about how to respond in the event problems occur and to have a clear idea of whose interests need to be protected. We need a realistic assessment of how much we can't know. And so on.

Meetings such as this one are good opportunities to learn about how the system is developing, to improve our understanding of how it works, and to have a conversation about desired destinations and routes to get there. And I think after the events of the past five years, we are all conscious of the limits of our knowledge.

It would be apparent from your deliberations today that Asia's financial markets are continuing to develop rapidly. To take the market for fixed interest securities, the total size of the bond market in Asia, excluding the very large Japanese market (which has been highly developed for a long time), now amounts to about US$7 trillion, having increased substantially over the past five years. This is an amount equivalent to around 60 per cent of the area's GDP. While in absolute terms a lot of this growth has been in China, in many of these countries debt markets are equivalent to at least 50 per cent, and in some cases well over 100 per cent, of national GDP. Issuance of corporate debt in 2012 was about

[1] In aviation and, I imagine, in sailing, a good weather forecast is invaluable. My observation is that those weather forecasts are actually pretty good. Unfortunately, the same cannot be said for forecasts in economics and finance. This doesn't mean we don't set out on the journey – we have no choice – but it means we should do so with due care.

US$700 billion, which is not far short of the amount in the euro area, though still a long way below the pace of issuance in the United States. Metrics of liquidity suggest an improving trend, with reasonable turnover and in most cases bid-ask spreads on sovereign debt coming down to a handful of basis points.

Equity markets are likewise of substantial size. For several Asian countries, and leaving aside markets like Singapore and Hong Kong, market capitalisation relative to GDP is broadly similar to or even larger than in the United States. The Chinese equity market is considerably smaller in relative terms, but that is not surprising given the history of being a centrally planned economy.

Banks in Asia continue to play a central role in providing finance, which is reflected in the relatively large size of banking systems in the region. A number of countries in the region, including China and Japan, have banking system assets exceeding 200 per cent of GDP – although some other countries, where financial deepening and liberalisation still has some way to run, have relatively smaller banking systems. After being severely affected by the Asian financial crisis in the late 1990s, the region's banking systems were fairly resilient to the more recent (global financial) crisis and are today well capitalised with sound asset performance.

So the size of Asia's financial system has grown substantially.

Some have said that Asia's financial development and integration lags behind the progress being made on the trade and economic fronts. The striking growth of intra-Asian trade reflects the general trade orientation of the Asian growth strategy but also, in recent years, the growing organisation of production processes across borders. Where it is possible to adopt a set of agreed technical standards – global standards for IT components, or communications protocols might be examples – and impediments are removed, it seems that economic networks spanning national borders can quickly emerge. If it is true that this has outpaced financial integration, perhaps that is because it may be harder to align and streamline legal and regulatory processes insofar as they bear on financial activity than it is for trade.

Having said that, I'm not sure that growth in Asian finance is lagging all that far behind. The statistics on growth of markets seem a bit too compelling to push that argument too far.

Moreover, further growth in Asia's capital markets is surely likely. The region continues to have, in the main, high rates of saving and investment. So its real "wealth" is growing. (So is its human capital, which will improve the productivity of its physical capital stock.) In addition, many countries continue to see the normal pattern in which the markets that intermediate the flows of saving and investment, and that develop the tradeable financial claims over the stock of real wealth, grow faster than income. The experience of the advanced countries suggests that this process of "financial deepening", while it may ultimately have some limit, has a long way to go in the emerging world.

So the task for policy might be not so much to promote growth per se, as to shape the growth. What sort of financial system do we want to see develop in the region? What, in other words, is our destination?

Three desirable descriptors come to mind. We want a financial system that is sound, efficient and integrated.

"Sound" does not mean refusing to take any risk. The yachts outside are probably safest when tied up to the mooring. If that's all that ever happens, though, they are not fulfilling their purpose. Similarly we want some prudent risk-taking in the financial sector – that is its job. It could be argued that the world's financiers swung in 2008 from insufficient regard for risk to excessive risk aversion.

But as is the case when the yachts move off from their moorings to catch the winds in the open water and perform as they were designed, a degree of risk is involved. And, like sailing, the context for that risk-taking has to give due weight to safety. In years past, excessive leverage, inadequate attention to liquidity and funding risk, and poor lending standards all played a part in a serious erosion of confidence in banks and various “shadow banks” in the United States and Europe. We would have to say as well that supervision was found wanting. Once the crisis hit, the complexity of operations across borders then greatly complicated efforts by policymakers to address the resulting problems.

The financial system in this time zone, in contrast, has come through this episode in much better shape. Thanks partly to the painful lessons of the Asian crisis and other episodes, banks had generally stronger capital positions and higher lending standards, while supervisors had also done their job in the years prior to 2007. Moreover, several banking systems in the region are among the earliest adopters of the new, tougher, Basel standards.

It goes without saying that we want this prudence to continue. But unlike the case in some other countries, the financial sector in the region is well placed to play its role in supporting the sustainable growth of economic activity and trade. It is noteworthy that as European banks sought to pull back from some activities in the region, including trade finance, banks from within the region have stepped up. So this is a point for confidence.

This is not to say that there are no sources of vulnerability. In particular, concern has been expressed about the risks that may be growing in the “shadow banking” system in China. In recent years, an increasing share of financing in China has been provided by non-bank entities and through banks’ off-balance sheet activities. In no small part, this growth in shadow banking reflects restrictions on both the quantity of bank credit, and controls on loan and deposit rates. Such restrictions lead to demand for credit exceeding the formal banking sector’s ability to supply it, and also provide an incentive for savers to seek alternatives to low-yielding bank deposits. The Chinese authorities have introduced a number of measures to mitigate the risks, and many types of shadow banking activities in China are now subject to some regulatory oversight. Hopefully, this will lead to a stable outcome. But China’s experience is one that others have had at various times: as long as there are incentives to by-pass the formal banking sector, the shadow banking system may keep on growing together with the risks. More generally the risks associated with prolonged low interest rates globally are very much on the minds of policymakers right around the region, and will be for a while, I would think.

Turning to the second and third on the list of desirable attributes for finance, namely efficiency and integration, it may be that these will naturally go together. An efficient financial system intermediates savings at a low cost, and directs them to the uses that are expected to produce the highest risk-adjusted return. As in most industries, a degree of competition in the system is helpful in producing this efficiency. Competition from foreign firms can be a powerful force in this regard. So openness to cross-border investment flows will remain important, as will openness to the innovative new domestic entrants.

Of course, as in any industry, and perhaps more so in finance, there have to be boundaries to competition. We don’t want lending standards to be competed down too far, for example, any more than we would want competition between airlines to lead to lower maintenance standards in pursuit of lower costs. That is where the regulatory framework and the supervisors come in.

Moreover, greater integration in the region, insofar as that is possible and remains consistent with legitimate national sovereign objectives, offers efficiency gains as well. A large regional capital market would be expected to offer a greater field of choice for savers and borrowers and lower intermediation costs. Progress towards this is being made through efforts to make regulatory frameworks more consistent and improving infrastructure across regional markets, even as demand increases for locally issued debt securities. These developments have been aided, in part, through regional cooperation on initiatives such as the Asian Bond Fund and the Asian Bond Markets Initiative. Ongoing cooperation will help to continue the development of regional capital markets.[2] I would simply observe that it may take a degree of commitment to keep progress occurring, not least because some responses to the financial crisis around the world may work towards a lessening of the degree of globalisation of finance.

## End-piece

To these observations about safety, efficiency and integration, I would add two further thoughts. The first is that Asia will in all likelihood continue to have multiple currencies for a long time yet. A decade ago it was becoming fashionable for Asia to look at Europe and wonder whether that was a model for an Asian currency area in due course. But we can now see all too clearly how demanding it is to be in a currency union, and how much supporting financial and political structure is needed for it to work. This may one day be built in Asia, but it takes a long time: Europe's prodigious efforts over 50 years or more did not, as it turns out, produce fully the conditions for currency union.

It follows from this that Asian markets for foreign exchange in Asian currency may need to continue developing. It probably means as well that unless something serious goes wrong in China, the RMB will eventually become the dominant currency in the region. That may be stating the obvious, but there could be a profound adjustment for many countries in the region from membership of what is, at present, a de facto US dollar zone, to membership of an RMB zone. To some extent this has begun with the use of RMB for trade settlement, which is growing quickly. Full development will require liberalisation of the Chinese capital account. This will presumably continue to occur, but on a timetable decided – as it should be – by the Chinese authorities.

The second and final observation is related to exchange rates in some ways. It is that Asia surely will want to see its own financial sector doing more of the intermediation of its own saving. That is, Asia will want to send less of its saving abroad to hold supposedly "low risk" – and certainly low return – obligations issued by the "old" world, and do less re-importing of that saving, in the form of risk capital intermediated by the major financial centres at higher cost. Why not deploy the region's own saving at home, for higher return? It is not as though there are no productive opportunities in the region. By most accounts Asia's infrastructure needs over the next couple of decades are very large. Moreover, as the region's own financial sophistication and strength grows, and as its capacity to accept risk grows commensurately, the need for costly self-insurance against capital flow disruptions surely lessens. That does not deny the logic for what Asia did for many years in building foreign reserves, but the cost benefit analysis is surely looking different today from 15 years ago. So to use the language from the beginning of my remarks, perhaps there are now more direct routes to the destination of development and prosperity for Asia than there were a decade or two ago.

All of this is tied up with the debate about "global imbalances", the reorienting of Asia's growth towards domestic sources, the role and governance of the international institutions, and so on. These are issues worthy of discussion, including in the G20 process as well as in regional fora. But that is a discussion for another day.

Once again, welcome to Sydney and I hope your deliberations will be a great success.

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[2] For example, market depth and liquidity would likely benefit from increased access for non-resident investors as well as the growth in complementary market segments such as repo markets.