Discussant remarks: financial stability issues in Asia and the Pacific

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The first paper entitled "Contagion and Risk Premia in the Amplification of Crisis: Evidence from Asian Names in the CDS Market" is a very interesting one. It reminds me of Mervyn King's latest speech before the Worshipful Company of International Bankers at the Mansion House on the role of risk aversion in the aggravation of the global financial crisis. Don, Miko and Eli's paper is more specific, focusing as it does on credit default swaps (CDS) and expected default frequencies (EDF) as an amplification mechanism for the recent financial crisis. They also argue that shifts in risk aversion, more than the reassessment of risk, are what drives valuation of credit instruments. This has significant implications for both monetary and prudential policy. This is what we saw last October, when CDS spreads jumped as a result of the sudden shift in risk aversion following the closure of Lehman Brothers. In the case of the Philippines, sovereign CDS spreads tripled in the month of October, although macroeconomic fundamentals remained sound.

I have a few comments on the first paper.

Understanding and managing risk aversion is indeed very critical. To be able to do this, it would be useful to bear in mind three things:

One, the true nature of risk is very hard to perceive. That is why it was useful for this paper to focus on the CDS and EDF. As their results show, funding became very difficult to come by not because the risk per se increased but because the repricing of risks made it so. Valuation losses, as distinguished from actual losses, drove the whole process.

In more general terms, the sudden reversal of investors' appetite away from the risky assets of emerging economies is often cited as a factor explaining crises in financial markets in this region. The alternation between periods of bullishness prompting investors to make risky investments, and periods of bearishness, when they retreat to the safest forms of investments, could indeed be at the root of sharp fluctuations in asset prices.

Thus, it is imperative that we delve deeper on how better to address risk aversion. While the so-called conventional judgment finds it hard to take an independent view of the future, the contrarians are in no better a position. This will suggest that the market could always be subject to sudden and violent changes. The picture becomes more complicated when we argue that speculative mania takes place not only because of financial engineering, but also because of gullible investors.

From the regulatory perspective, as Mervyn King of the Bank of England would propose, financial regulation should be simple and robust. Complex measures of risk and capital adequacy are rarely sufficient to capture developments that are "easy neither to anticipate nor calibrate". I agree that efforts should be taken to address both the cross-section and time series aspects of bank dynamics. Bank interconnectedness should be established, particularly the abetting effects of complex transactions such as derivatives. The procyclical behaviour of risk-taking should also be studied. The challenge is to translate these general principles into some form of constrained discretion very much akin to its application to monetary policy so that excessive risk-taking can be monitored and appropriately dealt with.

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The paper is very useful in that it argues that risk premia may be used to calibrate capital standards over the cycle and help mitigate procyclicality. This is the practical value of the paper and this is very significant.

Two, given that this is an issue of market confidence, communication may be strategic. Communication is a crucial part of the job of everyone charged with management of the economy. Perceptions held by domestic and international audiences of the state of our economies are too important to be left unmanaged. Experience has shown that, in times of crisis, better economic fundamentals are not properly appreciated by the market. Thus, there is a need to proactively and aggressively communicate the strength of one's economy to restore investor confidence.

And three, on a broader scale, we also have to pause and assess the direction we want to take in further propagating financial globalization. The question is: if contagion seems to strengthen with globalization, what does that make of globalization? Without a doubt, globalization has had a deep impact on the way modern economies function. The benefits of globalization have accrued to diverse communities and regions but it has also brought with it significant risks. Economic and financial globalization thus not only calls for policy responses at the national level but also at the international level. It also calls for the consideration that such policy responses may have implications that extend beyond the domestic borders. I share the view of Joseph Stiglitz who once remarked, "I am a great cheer for globalization when it is managed well." This is something that is being done now in various forums and we hope good progress is made in this direction.

Let me say a few words on the second paper "Determinants of House Prices in Nine Asia-Pacific Economies"

This second paper is a very good example of collaborative study, in this case by economists from the central banks of the Philippines, Thailand and Hong Kong together with the BIS.

The first idea is that, in identifying the determinants of house prices in nine Asia-Pacific economies, the paper showed the absence of a significant bubble episode, considering that the period after the Asian crisis has generally been a period of economic growth as well as financial reform and consolidation in the region.

The result also shows that the detection of a housing bubble could be very challenging. The methodology that they used is very sensitive to their ability to list macro-financial variables or institutional factors. If the list is incomplete, one can argue that what may be considered a bubble actually includes factors that are acceptably fundamental. This is very tricky.

Thus, what can we say at this point?

Let me start from the most basic. Statistics: I share the view that the challenge for emerging markets is to develop and improve their house price series. This call assumes greater urgency considering that house prices have become more relevant as an asset price in monitoring and forecasting domestic inflation.

The results also support the observation that the resiliency of the Asia-Pacific region in the current crisis may be explained by the fact that we learned from the 1997 Asian crisis which largely emanated from the real estate bubble. Moreover, substantial support was also provided by the government housing finance systems, which makes up for the constrained access to housing credit from banks. In the Philippines, for example, government agencies account for 75% of cumulative housing loan releases for the period 2001-06. In addition, remittances from overseas Filipino workers (OFW), a main driver of the current account surplus, play an important role in the growth story and in the reinvigoration of the housing market. The seeming bubble detected for Manila luxury housing market during the period under review may be indicative more of a transition towards a new equilibrium – as 2006 was marked by renewed economic confidence with the fiscal house finally put in order.

My third point is that, even if house price statistics are available, one key issue is the determination of the long-run equilibrium level of house prices, their direction and the extent to which one can say there is an emerging misalignment or bubble.

Finally, given these difficulties, we can only sympathise with monetary authorities who may have to increase their policy rates enough to have some perceptible impact on a surging housing market. This could inflict collateral harm on, for example, the foreign exchange market and real sector activity. I therefore agree that we need to give due attention to house price dynamics in financial stability deliberations. For instance, a run-up in house prices reflecting better fundamentals may result in tighter monetary and regulatory policies. Similarly, a cyclical run-up due to market imperfections may need actions which differ from those needed to deflate asset price bubbles.

Having said that, let me cross the t's and dot the i's.

I call for better housing price series because determining whether housing price inflation represents a bubble or a cyclical development could be tricky. We can only imagine the serious policy implications if the central bank fouls up on this.

At this point, let me stress that the issues raised in the two papers are just some of the challenges facing us, monetary and regulatory authorities, today as we continue to try to preserve financial stability in our respective jurisdictions. The current global financial crisis has highlighted several issues and challenges and some of them have already been touched upon by our keynote speaker, Mr Goodhart.

Let me just highlight a few of these challenges.

Policy mix to preserve monetary and financial stability.

It is clear that restoring financial stability during the global market turmoil would not have been possible without combining traditional regulatory and prudential measures with exchange rate and monetary policies, of which interest rates have been only one important instrument. Moreover, it would not have been possible without the close coordination of monetary, fiscal and regulatory authorities.

Procyclicality of the financial system.

The first paper is especially useful in raising the issue of valuation losses and, therefore, research on the dynamics of risk premia, default probabilities and systemic banking health will be most instructive. Mr Goodhart mentioned today that the adoption of Basel II, combined with the simultaneous application of mark to market fair value accounting had the unintended effect of making the official regulatory system much more procyclical and unstable than previously. Given this, should we dispense with these international standards? Easing the mark to market rule, for one, does allow markets that have broken down to adjust and correct themselves in the midst of a crisis. On the other hand, a blanket suspension of mark to market accounting may not create a positive long-term solution as it leaves market players without indicators to guide them, which could lead to a prolonged illiquidity of the market. To which we can say that even if one were to assume that the market is liquid and one were to use mark to market, market values are far from market-based. They are driven by panic, uncertainty, even speculation – both in good times, ie to a lesser degree, and in bad times, ie to a higher degree.

The reason is quite obvious. Both accounting and regulatory capital requirements are based on estimated probabilities of default and estimates of losses given the possibility of default.

These two parameters move in sympathy with the economic cycle. In some jurisdictions, in the UK, for instance, some have proposed to relate the capital requirements to average loss rates through the cycle rather than on estimates of loss which differ across the cycle. A similar approach seems to be evolving in Basel.

Macroprudential framework for addressing risks at the system-wide level.

Certain realities pose some challenges to the implementation of a macroprudential approach to regulation. Closer coordination between monetary and supervisory authorities is required. There is no question that monetary authorities should be responsible for conducting the macro risk analysis. However, more thought should go into identifying what should be enforced in terms of appropriate macroprudential tools. This is especially a concern if supervisory authorities are saddled with mandates that are inconsistent with the macroprudential objectives. Given that the recent global financial crisis was in more ways than one an informational failure, making the judgment on the state of the business cycle and whether and when to change the rules, monetary authorities should play a leading role but in close consultation with the supervisory authorities.

The second paper on housing prices will be most useful in the following areas:

1. It raises the issue of whether greater weight should be assigned to housing price dynamics in policy deliberations to avoid inappropriate adjustment of regulation or the policy rates.
2. It highlights the role of liquidity and risk-taking in generating asset bubbles and the implications for the transmission of monetary policy and the design of macroprudential frameworks.

The fourth issue is the preservation of financial stability while fostering financial innovation to achieve greater productivity and efficiency.

I do not want to think that we should postpone the implementation of important financial innovation in a period of financial instability. We need to strike a balance here.

Over-reliance on private self-regulation may expose financial systems to risks of the type we have seen over the past few years. There was a clear failure of banks and investors to identify, price and manage risks. But too much public sector regulation may stifle innovation, affect the financial system and slow economic growth. The challenges that policymakers face in this regard are therefore big. I believe that the prerequisite to embracing financial innovation is appropriate prudential regulation, including appropriate disclosure and transparency standards. These would ensure that all stakeholders are fully aware of the risks that they are taking on.

Indeed, preserving financial stability is not an easy task. We have to continually put our heads together to come up with the best solutions. In the EMEAP region, we have established the Monetary and Financial Stability Committee which has been tasked with the responsibilities of doing both surveillance and examination of key economic and financial issues in the region. We are also drafting a medium-term work programme to be able to address emerging issues within the next two years. There are three working groups working on issues in monetary policy, financial markets, banking supervision and the payments and settlements system. We are designing a weekly template of high-frequency data to be given

to member countries if only to alert everyone to any irregular movement of any of the monitored indicators.

In the ASEAN and ASEAN+3, we have realised that we need a more concrete form of regional cooperation and mutual support. Thus, we have decided to pool our resources to form a $120 billion fund that will be made available to any member country experiencing a balance of payments need. An integral component of this facility is the mechanism of enhanced surveillance.

We also realise that institution building should be pursued. Hence, efforts continue in the area of capital markets development, as well as liberalisation of financial services and the capital account, with due consideration for each individual country's level of development.

Finally, some words on the Asian Research Programme. We are pleased to know that the programme will continue. There will be better synergy and more productive results if we can continue leveraging on these collaborative efforts as we have striven to do in the first three years of the programme.

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