Choongsoo Kim: Strengthening the resilience of the financial system in Asia and the Pacific

Welcome remarks by Dr Choongsoo Kim, Governor of the Bank of Korea, at the BOK-BIS Roundtable on "Strengthening the resilience of the financial system in Asia and the Pacific", Hong Kong SAR, 10–11 December 2012.

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Greetings

On behalf of the Bank of Korea I bid a warm welcome to all participating in the BOK-BIS Roundtable on Financial Markets. Our gratitude goes in particular to those giving presentations and the BIS as the co-host.

Currently, the world economy has not yet gained traction amid the prevailing high degree of uncertainty, not having completely broken free from the aftershocks of the Global Financial Crisis and it is now facing the euro area sovereign debt crisis and the risks of the U.S. fiscal cliff. When we turn our eyes to the Asia-Pacific, economies closely linked with China in a supply chain are on the alert for the spillovers to them depending upon the direction the Chinese economy takes,[1] and some economies are keen to see a soft-landing of their household debt and real estate prices. In addition, emerging market economies in Asia and the Pacific are making various efforts to prevent advanced countries' crisis response measures including QE and international financial market unrest from causing excessive capital flows and consequential commodity price increases and the exchange rate volatility.

At this critical juncture, I think it is most timely that this meeting is being held as it sets out to examine financial system resilience in Asia and the Pacific and to find measures to strengthen it.

Seizing this opportunity, I would like to give you my thoughts on the need to strengthen regional financial integration and other policy tasks such as maintaining financial stability in order to boost the resilience of the financial system in Asia and the Pacific.

Regional financial integration in Asia and the Pacific and financial system resilience

Countries in Asia and the Pacific and, above all, financial markets in emerging economies show very high beta, namely sensitivity, to global shocks taking place in systemically important economies such as the U.S. and Germany.[2] The real economy's resilience in emerging market economies including those in Asia, in contrast, is analyzed as having increased greatly over the past ten years[3] and, unlike advanced economies, emerging market economies have kept up relatively high growth rates since the Global Financial Crisis.

The fact that the resilience of the financial markets in Asia and the Pacific does not match that of the real economy seems to be because the degree of regional financial integration is relatively low compared to that of trade integration, in other words, real integration. While the share of regional trade in total trades in Asia and the Pacific, by the way, in my speech this morning, Asia and the Pacific refer to 12 ACC members of the region, has generally maintained a high level of around 49% for the past ten years, the degree of capital integration is low, with the share of regional portfolio investment running at only around 10%.

[1] Ahuja and Nabar (2012).

[2] Elekdag et al. (2012).

[3] IMF (2012b).

Consequently, at a time of shocks external to the region like the Global Financial Crisis, the real sector showed relatively high resilience thanks to its high regional dependence, but the financial sector even became an innocent bystander due to its heavy extra-regional dependence. More specifically, when the Global Financial Crisis broke out, financial institutions in the US and the euro area embarked on massive deleveraging. Hence Asia and the Pacific experienced large scale capital outflows, which were unrelated to pull factors, and consequent financial market unrest.

In this regard, one step toward enhancing the resilience of the Asia-Pacific financial system is to further strengthen regional financial integration in such a way as to relieve the asymmetry between the degrees of financial and real integration. The initial target level for strengthening financial integration can be taken as that of regional trade integration. If so, risk sharing with offshore regions including the U.S. and the euro area will decrease, while risk sharing through the Asia-Pacific financial system will increase.[4] Besides the risk diversification effect in moderating offshore shocks, closer regional financial integration will lead to consumption smoothing in regional economies, a typical effect of financial integration, and will also contribute to the easing of global imbalances and the development of regional financial markets.

In the course of the euro area crisis, the Asia-Pacific is actually enjoying certain positive effects — its financial system has become more stable along with a rise in regional financial transaction. This appears attributable to the fact that, while European banks have deleveraged out of Asian emerging market economies, regional banks, such as those of Japan and Australia, have stepped up their lending to regional emerging market economies, which has helped ease the shocks.[5]

Meanwhile, the Asia-Pacific seems to be well placed to a double harvest in terms of the positive effects from the progress of regional financial integration. First, since regional economies show large differences, for example in terms of economic development status, population aging and the degree of financial market development, the wide diversity within the region makes for possible complementary financial transactions within the region. For instance, if an aged country with a high degree of capital accumulation and a low growth rate invests in a country with a younger demographic structure and showing relatively strong growth, benefits accrue to both parties,[6] such as improving profitability and the raising of required funds.

We need to set the methods and appropriate degree of financial integration in the Asia-Pacific, bearing in mind the lessons from the Global Financial Crisis and the latest ones from the euro area. The Global Financial Crisis highlighted the danger of the excessive financial integration of advanced economies, including the U.S. and European countries,[7] and the euro area crisis was attributable to the serious internal imbalances accumulated by financial integration[8] that was blind to the differences in industrial competitiveness within the region. The degree of regional financial integration should therefore be set within a level at which the positive effects, such as risk diversification and sharing, are not offset by the negative effects from spillovers. Furthermore, just as a variety of species helps reduce the possibility of the collapse of an ecosystem,[9] financial integration in the Asia-Pacific that

4 Rungcharoenkitkul (2011).

5 McGuire and Rixtel (2012).

6 Jin and Jokish (2011).

7 Aizenman et al. (2011).

8 Carton and Herve (2012).

9 Haldane (2009).

recognizes and makes the most of the diversity of regional economies will further strengthen financial system stability.

Moreover, since the Asia-Pacific accounts for 30 percent of total global GDP and 46 percent of total global population in 2012, respectively, and includes economies with developed financial markets such as Japan, Australia, Singapore and Hong Kong SAR, the region is fully capable of developing its own regional financial markets.

Policy tasks for financial stability in the Asian and Pacific region

After undergoing the Asian Financial Crisis from 1997 to 1998, Asian emerging economies, while proceeding with capital account liberalization, improved the resilience of their economies by individually achieving moderate inflation, a sound fiscal policy, and a current account surplus and building up foreign currency reserves as a first line of defense against crisis.[10] Despite such efforts, the Global Financial Crisis brought home to us all the danger of surges and sudden stops. It also taught us a lesson that the interconnectedness of the global economy has made the Asian-Pacific financial system subject to external shocks and that the capacity of an isolated response by a single country has hit its limit. As I noted earlier, even in advancing regional financial integration to strengthen its buffer against external shocks, the Asian-Pacific may also have to shoulder a cost burden as there would be heightened contagion effects from internal shocks.

Therefore, to ensure the stability of the financial system it is vital to build up organically functioning multi-layered financial safety nets including bilateral currency swaps, regional liquidity arrangements, and IMF loans as global liquidity arrangements, and not just foreign currency reserves if situational needs are to be met.[11] These are all necessary, since we cannot foretell where and in what form the next crisis will emerge regionally and globally. Although advanced economies take a rather more reserved position on building multi-layered financial safety nets, citing moral hazard and such like, I believe we need to focus on the benefits that this safety net would bring about not only for emerging economies but also advanced economies. Having financial safety nets would indeed lower the need for emerging economies to accumulate foreign currency reserves due to the original sin hung around their necks that their local currencies are not used for international settlement. Thus in due course it would lead to global re-balancing.

Meanwhile, the Asia-Pacific accounts for 55% of world foreign currency reserves, providing an environment conducive to strengthening crisis response capacity within the region through bilateral currency swaps or regional liquidity arrangements. One such regional financial safety net, the CMIM(Chiang Mai Initiative Multilateralization) has made much progress but it is still judged in need of further improvements to serve as an effective crisis response.[12] The scale and membership of regional financial safety nets should be enlarged in keeping with regional trade volumes and the degree of regional financial integration. However, the euro area has had to wrestle with difficulties in seeking to expand such of safety nets since the outbreak of its crisis, serving as a saltatory warning over which we should ponder. Also, too much focus on a timely crisis response can increase moral hazard on the part of recipient economies and investors, on the other hand, too strict bailout conditions can bring about a stigma effect, undermining the bailout’s usefulness. Thus, a balanced design and effective surveillance mechanisms are crucial.

Having said that, what is most important is that every individual economy should be committed to making every effort for the stability of its own financial system. First of all,

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[10] IMF (2012b).

[11] Kim (2012a).

[12] Hill and Menon (2012).

whether financial stability is explicitly included in a central bank's mandate or not, in view of the macro-finance linkage, as the central bank, it needs to prevent the build-up of excessive imbalances in the financial system while not detracting from price stability. Additionally, policy makers should measure misalignments in asset prices with alternative indicators, notably economic agent's financial leverage, taking the view that they are one source of systemic risks rather than they should simply be stabilized. Based on the results, they need to seek steps such as the use of macroprudential policy to curb the misalignments. Furthermore, in coping with highly volatile capital flows, an economy needs to consider capital flow managements[13] which can help lower the proportion of unstable capital flows such as short-term debt and mitigate the boom-bust cycles of capital flows.

In today's open global economy, however, the policy effects taken by an individual economy alone can be limited because the effects always spill over to other economies. Thus, policy coordination among economies concerned is necessary to ensure the intended policy effect. In this regard, regional cooperative organizations such as the ADB, ASEAN+3, SEACEN, EMEAP and indeed this meeting are very important for policy coordination in the Asia-Pacific region. While we live in a global economy, we know that there is no global jurisdiction. Under such circumstances, it is likely that a state of multiple equilibria prevails. Good and bad equilibrium can coexist for some time. We may need to remember that an intra-local equilibrium is no more than a "knife-edge equilibrium", which is vulnerable to external shocks and falls short of stability and resilience.[14] In the ongoing Eurozone crisis, there has been injection of massive capital in pursuit of intra-regional equilibrium. From the perspective of global equilibrium, however, for the faster recovery of world economy, capital should, by all the principles of economic structural adjustment, flow into economies with faster growth and higher productivity. As pointed out earlier, multiple local equilibria may be suboptimal rather than optimal given the external effects. Thus, policy coordination striving for having a global-dimension equilibrium through the IMF, BIS, and the G20 is called for.

Conclusions

The Global Financial Crisis revealed that under excessive financial integration without appropriate regulations and financial safety nets, crises could spread around the world with amazing rapidity. Currently, the Asia-Pacific is in the somewhat paradoxical situation, where it needs to deepen regional financial integration in order to heighten financial system resilience against shocks occurring outside the region. Nevertheless, the costs of that greater financial integration in terms of crisis contagion can be reduced by the appropriate execution of macroprudential policies by individual countries and the strengthening of multi-layered financial safety nets. I am therefore sanguine that our objective of bolstering Asia-Pacific financial resilience can be achieved.

Past experience shows that one region's economic crisis can be overcome easily when another region can lead the world economy. In the Asian Financial Crisis, the United States and Europe took that role, which helped Asian economies overcome the crisis. In the resolution of the current crises in advanced economies, emerging economies whose potential economic growth is much higher than advanced economies similarly need to take the role of leading the world economy on the basis of domestic demand rather than exports. To put it more specifically, the size of the domestic markets of the emerging economies as compared to the magnitude of GDP is, however, relatively small so they cannot take up the slack sufficiently to lead the world economy. To overcome this limit, free trade agreements could be a good solution in that they can expand market size through boosting both trade

[13] IMF (2012a).

[14] Kim (2012c).

and domestic demand. In this regard, the Korea-China-Japan FTA, the negotiation of which just started, could be a benchmark example if it is signed in the near future.[15]

In addition, in the current global financial system which is decentralized without a global jurisdiction, policy coordination and information sharing through international institutions and cooperative organizations are of the utmost importance. For example, we should be looking closely at plans for the pursuit of joint research on indicators for measuring financial system resilience in Asia-Pacific and on ways in which it can be strengthened. In this regard I look forward to this meeting serving as productive forum for wide-ranging discussions on all aspects of the resilience of the Asia-Pacific financial system, the presentation of possible options and the pooling of members' experiences.

Thank you.

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[15] Kim (2012a).