

Financial Development in Asia:

The Role of Policy and Institutions,
with Special Reference to China

Barry Eichengreen

Singapore

May 29, 2015

The Asian financial crisis framed current views (and policies) toward financial development in the region

- The problem as seen through that lens was that Asia didn't have better developed securities markets.
- Banks, the Asian crisis showed, are a problem when they grow so large that they become too big to save and too big to fail.
- They can be a hotbed of insider dealing or, in then popular parlance, "crony capitalism."
- They can be unstable when they rely excessively on the interbank market for short-term, offshore, foreign-currency-denominated borrowing.



- Asian countries would be better off, according to the then conventional wisdom, if they developed better-diversified financial systems
- This would allow them to reduce their dependence on bank intermediation and offshore funding.
- Deep and liquid securities markets that supplemented these traditional sources of finance could serve as a valuable “spare tire,” in the widely-cited words of Alan Greenspan.

Subsequent experience has underscored the importance of some elements of this conventional wisdom

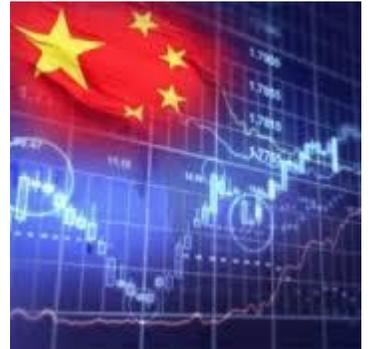
- Certainly experience has underscored the problems of moral hazard and opportunism that arise in connection with the operation of large, complex financial institutions.
- It has provided more evidence of the prevalence of “crony capitalism” while highlighting that such problems are by no means peculiar to emerging markets or Asia.
- It has pointed up the dangers of too big to fail.
- We have Iceland and others as reminders of the risks of allowing banks to rely excessively on short-term, offshore, foreign-currency funding.
- And we have the 2008-9 crisis and subsequent contrasts in the development of the U.S. and European economies as object lessons in the advantages of well-diversified financial systems.

However,

- The global credit crisis is also a reminder that agency problems exist not just in banks but also in securities markets.
- Moreover, the crisis challenged the presumption that deeper, more sophisticated financial markets are necessarily better.

Another thing that has visibly changed in the last ten years is the greater prominence of China

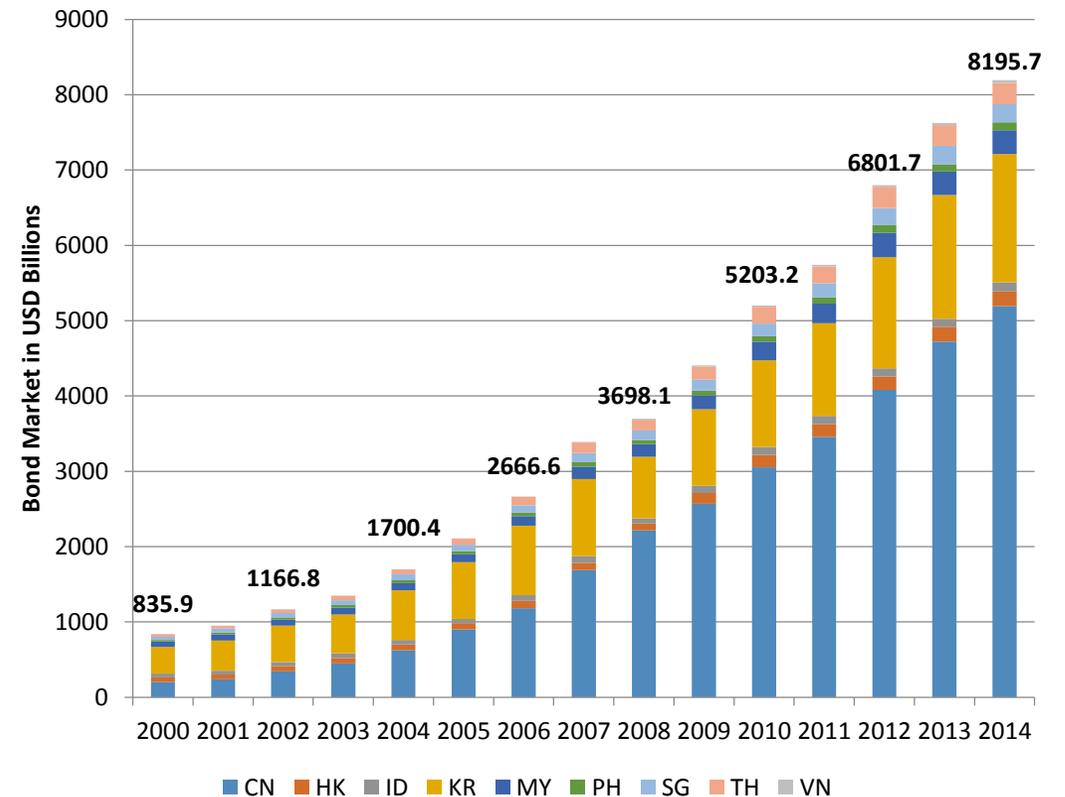
- China figures prominently by virtue of its size and the fact that its economy grew at high single-digit rates for the better part of the last decade.
- Developments and policy challenges in China necessarily command more attention than ten years ago, when I first visited these issues, since what happens in China doesn't stay in China, financially or otherwise.



Where Asia now stands

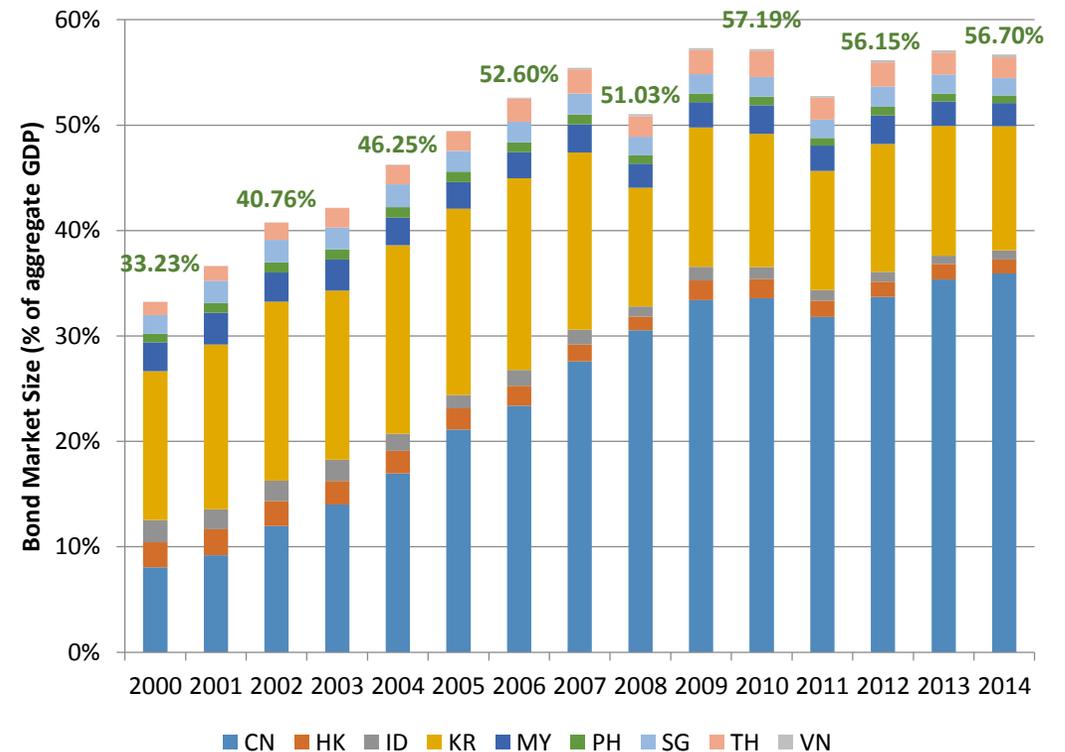
- The stock of outstanding domestic debt securities issued in East Asian countries ex Japan has expanded enormously since the turn of the century.

Figure 1. Local Bond Market in Asia (ex. Japan)



- This expansion is less impressive when measured against GDP.
- In addition, the period was one of enormous increase in reliance on debt securities not just in Asia but in countries around the world.
 - Pointing against the idea of any exceptional Asian achievement.
- And finally, the majority of the increase in the issuance is accounted for by just one country, China (as seen in the baby blue bars here).

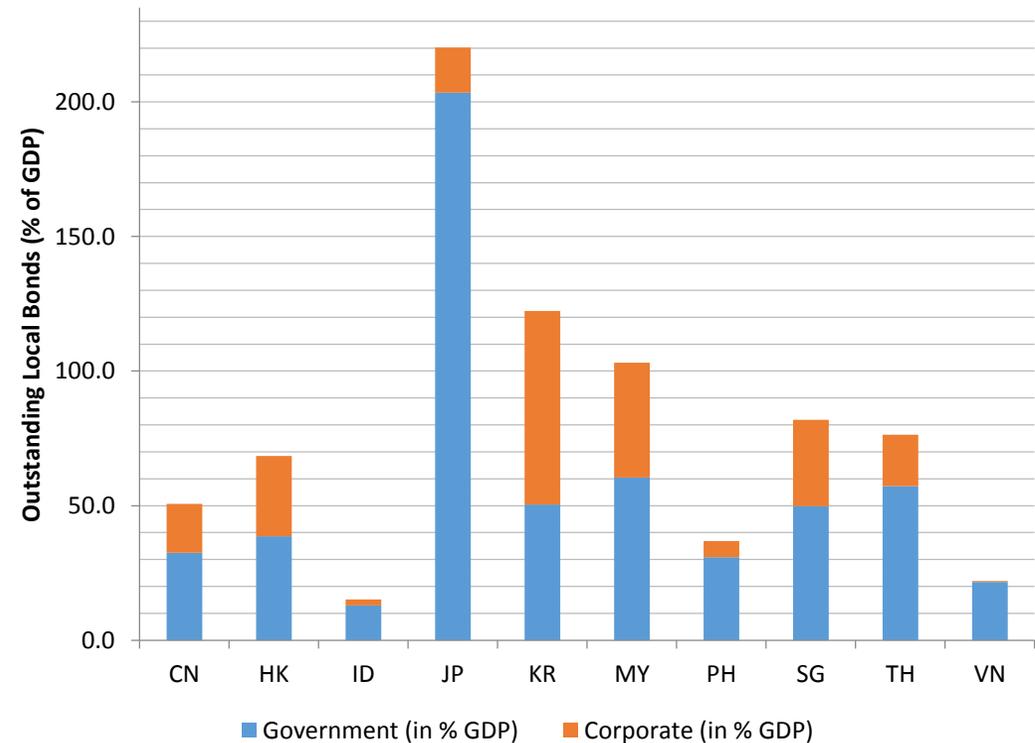
Figure 2. Local Bond Markets in Asia (% GDP, aggregate)



The resulting picture is uneven

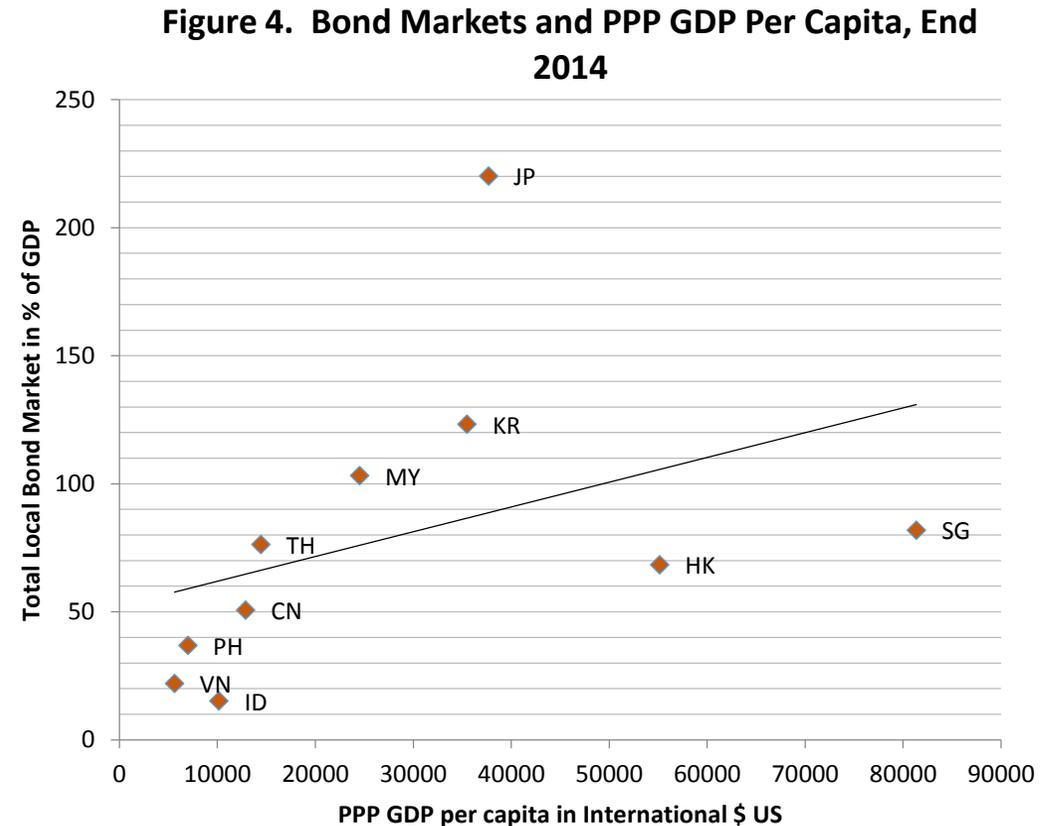
- Leaving aside Japan, whose history is different and whose situation is unique, it shows that Korea and Malaysia have the deepest bond markets, so measured, with ratios of debt securities to GDP on the order of 100 per cent.
- China's ratio, at roughly half this, is notably lower.

Figure 3. Size of Local Bond Market as % of GDP, End 2014



Not everything else, of course, is equal

- Levels of development vary enormously within the region.
- In terms of the average relationship between per capita GDP and bond market capitalization, Indonesia and Vietnam underperform, while Korea and Malaysia overperform, at least slightly.



One can do the same thing for a larger sample of countries, including controls

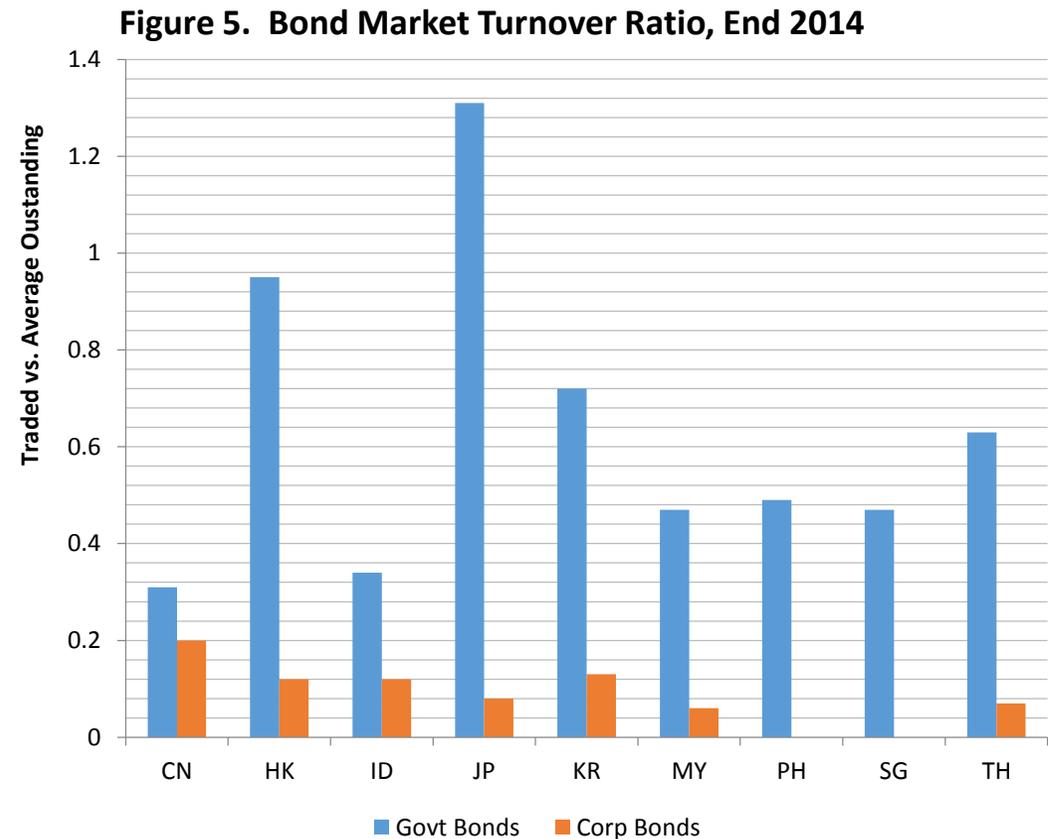
- When I did this in 2004, together with my coauthor, Pipat Leungnarimitchai, we found that Asian countries were negative outliers in the period 1996-2002.
- Using revised BIS data, we find the same thing for the pre-2002 period but not the subsequent (post-2002) period.
- If anything, Asian countries have larger bond markets than predicted by their observed characteristics, providing some support for the fruitfulness of efforts to develop markets in debt securities in the interim.
- Levinger and Li (2014) put the conclusion enthusiastically as follows: Asia's bond markets have moved from being the region's financial weak link to becoming "a role model for other emerging market countries trying to build resilience..."

This may be a bit strong

- The statistical result for the second subperiod depends heavily on the inclusion of Japan.
- When we instead create an AXJ dummy, the negative coefficient for the earlier period remains, but for the recent period the coefficient in question goes to zero.
 - When private and public debt are distinguished, we now see that for private debt the variable in question enters positively (Asia-ex-Japan corporates and banks now issue even more debt domestically than their other observable characteristics would lead one to expect).
 - In contrast, for public debt it enters negatively (unlike Japan, Asian governments issue less debt than those characteristics would lead one to expect).
- On balance, this suggests that the problem of Asia's stunted bond markets if not solved has been at least considerably ameliorated.

There is also wide variation in other measures of bond market development

- Figure 5 shows the bond market turnover ratio (average daily trading as a share of amount outstanding) for both the corporate and government segments.
 - Where available.
- The liquidity of the government segment, so measured, exceeds that of the corporate segment across the region, although the difference, interestingly, is least pronounced in China.



When turnover is related to income per capita, China is a negative outlier. Looks better in terms of spreads

Figure 6. Bond Market Turnover and PPP GDP Per Capita, End 2014

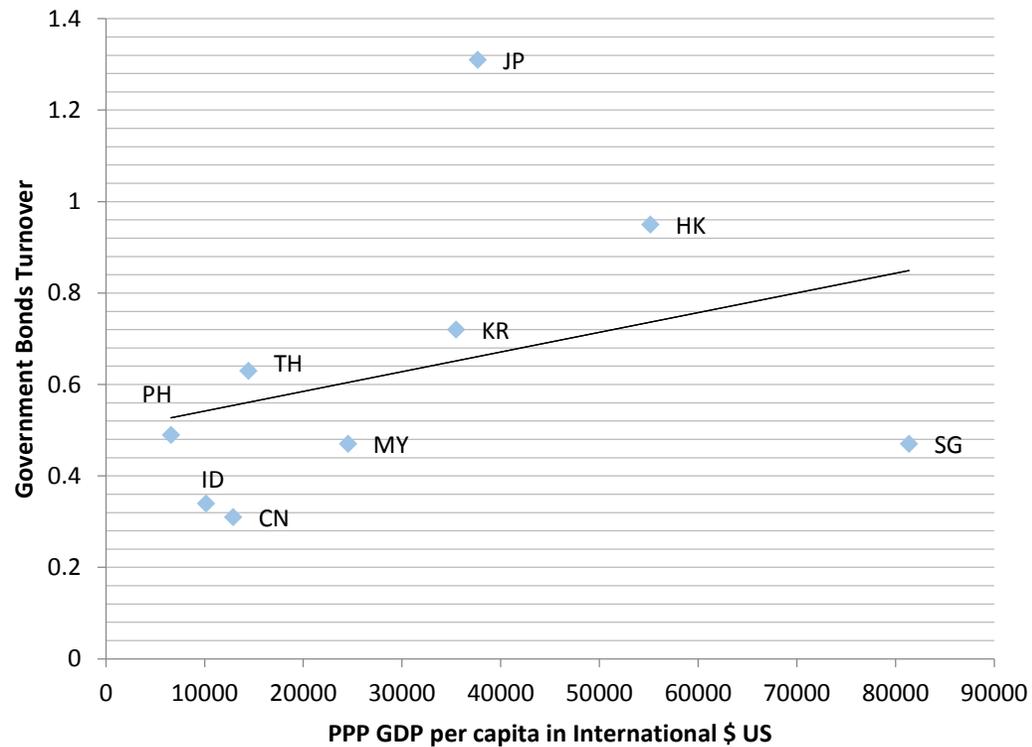
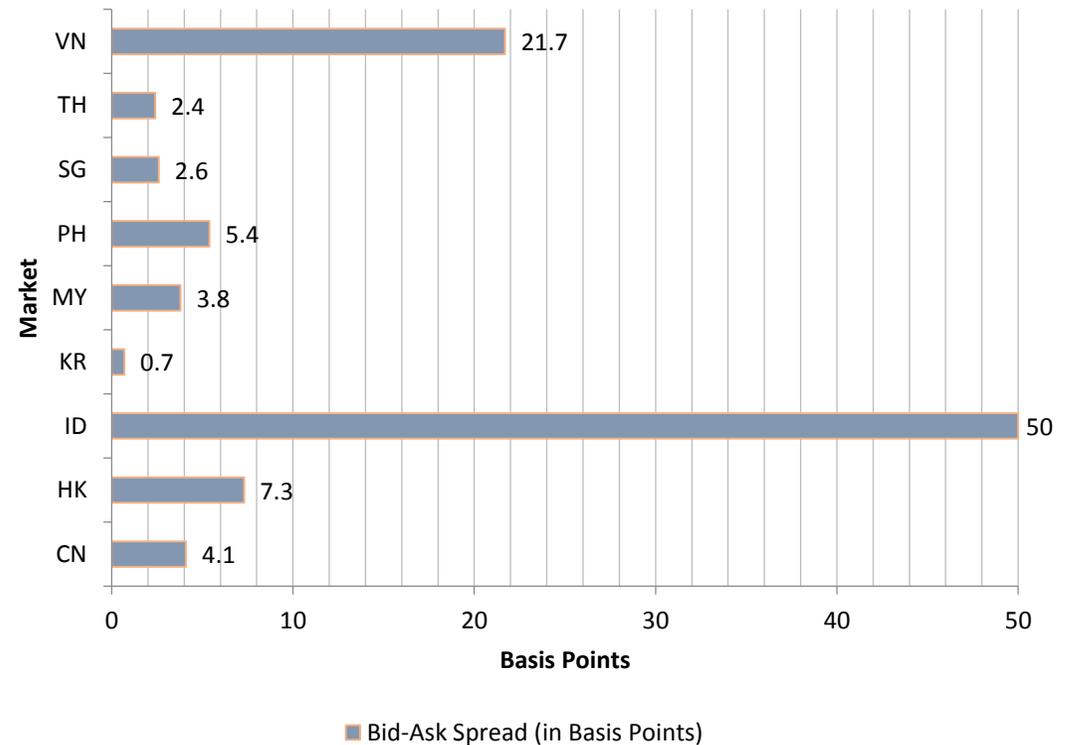


Figure 7. Local Currency Government Bond Bid-Ask Spreads, 2013



And in terms of equity markets

China is slightly below the level of market capitalization “predicted” by the average relationship in the region, but displays a slightly higher than predicted rate of turnover

Figure 8. Equity Market Capitalization and GDP per capita

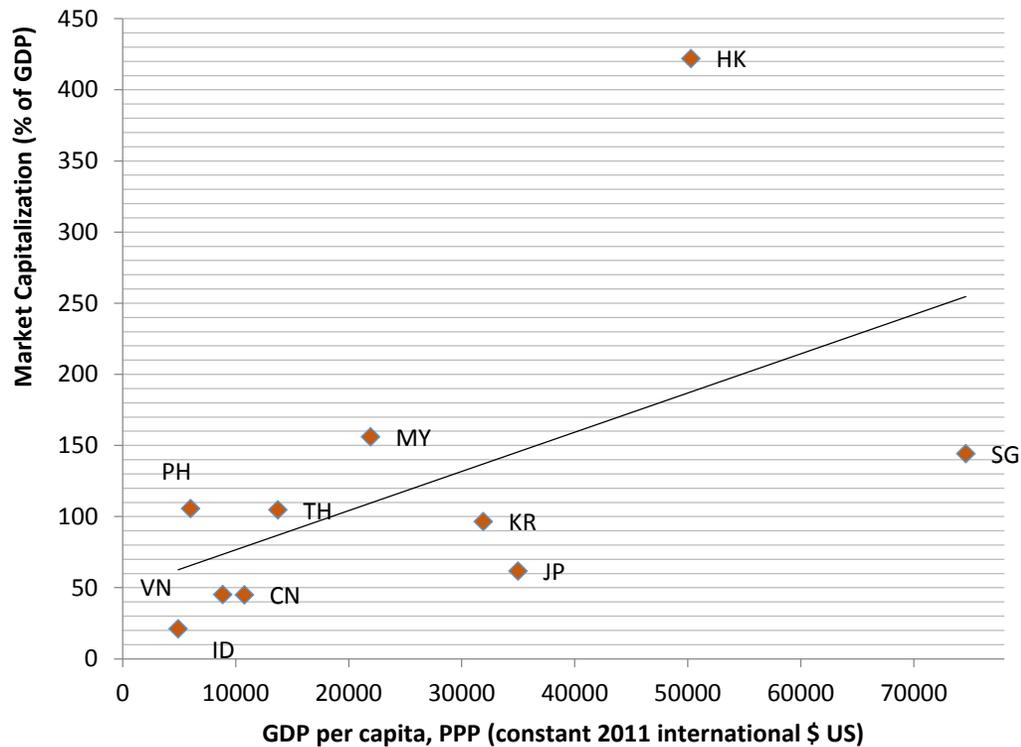
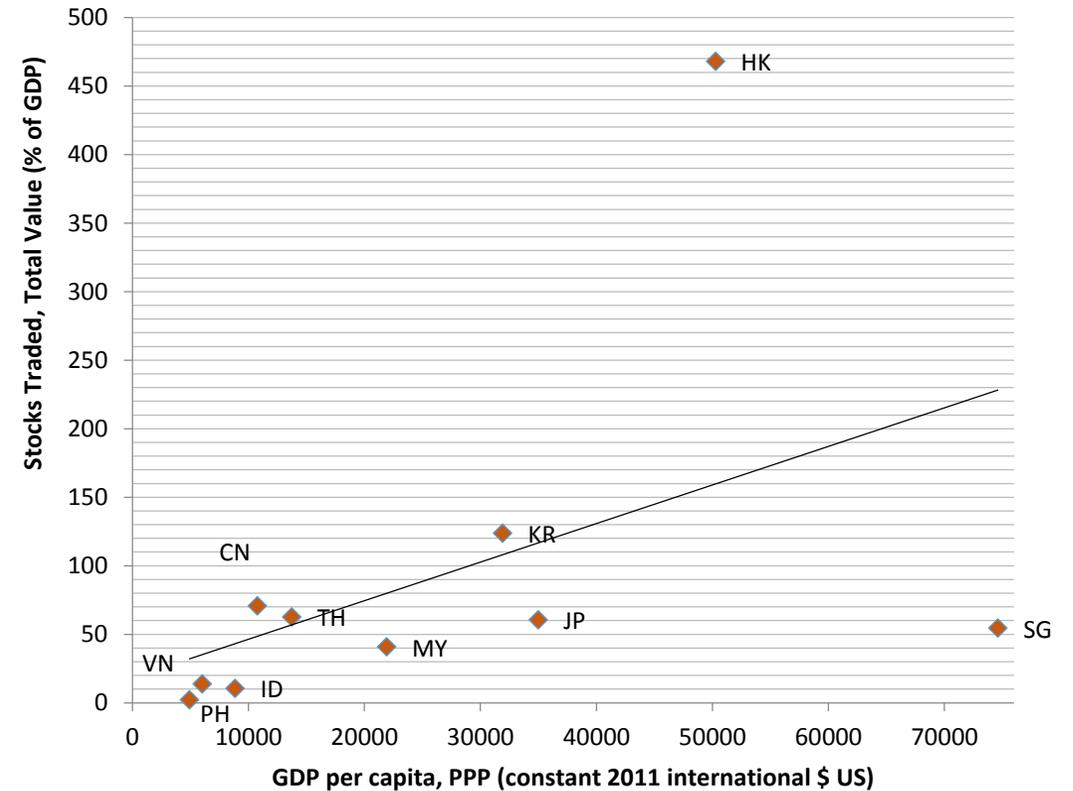


Figure 9. Equity Market Turnover and GDP per Capita



The empirics show an open capital acct as having a positive association with financial depth

- The arguments for a causal connection are enticing:
 - On the one hand, opening the capital account is a way of introducing the chill winds of competition into the financial sector.
 - Access to offshore markets offers additional funding opportunities.
 - It limits the ability of policy makers to maintain ceilings on deposit rates below international levels (as in China up until now).
 - It permits intermediaries to diversify their portfolios internationally and offer a better mix of risk and return.
 - It allows for a more diverse investor base, making for higher levels of turnover and market liquidity.

But there are also compelling arguments against using CAL as a lever for forcing the pace of financial development

- Capital account opening heightens exposure to financial disturbances originating abroad.
- Access to foreign funding can amplify the adverse effects of existing financial distortions, rendering the removal of restrictions on the capital account welfare reducing.
 - Recall Korea in the 1990s, for example.
- If that offshore funding is denominated in foreign currency or the country lacks an autonomous monetary policy owing to the nature of its exchange rate regime, the resulting currency mismatch can be destabilizing.
- When bad news arrives, and even when it doesn't, capital inflows can give way to sudden stops and capital outflows, with devastating consequences for financial stability.
 - And nothing is more damaging to financial deepening and development than financial instability.

I then consider the evidence on this question

- Which is mixed.
- Some support for the threshold view.
- Some support for the view that CAL does more to stimulate growth and financial development in countries with strong institutions.
- Some evidence that CAL can encourage institutional development.
 - But this response may occur slowly.
 - That makes using CAL to force the issue a risky strategy.

Bringing us to the case of China

- China's financial system is fourth largest in the world, behind only those of the United States, the Euro Area and Japan.
- China's financial depth scaled by GDP is commensurate to that of other countries with comparable per capita incomes, either now or (in the case of the now-advanced countries) historically.
- China has financial issues, of course. I will argue that they are in fact quite similar to those of the Asian crisis countries of the late 1990s, and understanding how that crisis was resolved also points to a way forward for China.

If there is a problem, it is not with the size of China's markets but with their structure.

- As in other countries at China's stage of economic development, the country's financial system remains heavily bank based.
 - As in the Asian crisis countries of the late 1990s.
 - Banks account for 60 per cent of the sum of bank lending and stock and bond market capitalization; even higher than in many other EMs owing to China's historically bank-directed system.
- Those banks are encouraged to take risks because of the perception of an implicit guarantee.
 - As in the Asian crisis countries of the late 1990s.

So, financial development starts with banking-sector reform

- The big Chinese banks, which account for the bulk of bank intermediation, are still majority state owned.
- Fully commercializing and privatizing them will produce positive results only if their implicit guarantee is removed.
- Implementation of deposit insurance is a start, but not sufficient.
- Decontrolling lending rates but not deposit rates threatens to squeeze profits and encourage risk taking.
- It encourages business to be diverted into the shadow banking system as households seek higher returns.
- Fortunately, it now appears that deposit rate decontrol is imminent.

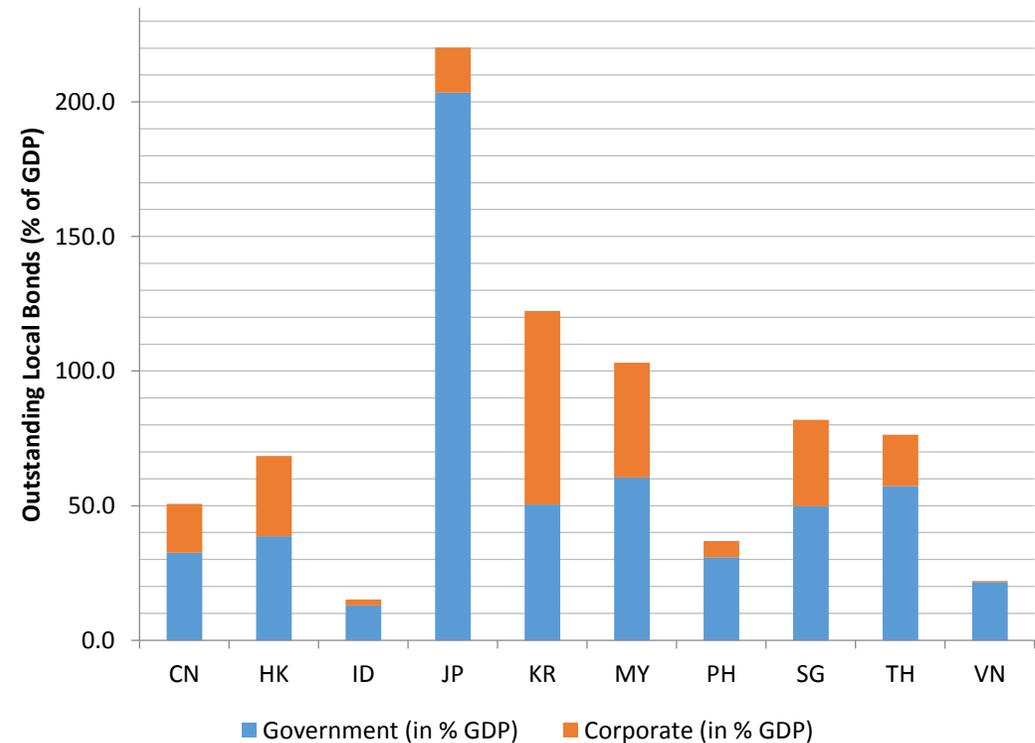
And strengthening the banks requires widening the regulatory perimeter

- Bringing the shadow banks into the light.
- Some steps in this direction have been taken.
- For example requiring wealth management products to be registered with the China Bank Regulatory Commission before banks sell them to the public.
- But more remains to be done.

In terms of bond markets, my focus this morning, expansion has been rapid

- But the bond market has weaknesses.
- It is small relative to scale of the economy, smaller than in other emerging markets such as Brazil, Malaysia, Thailand and South Africa.

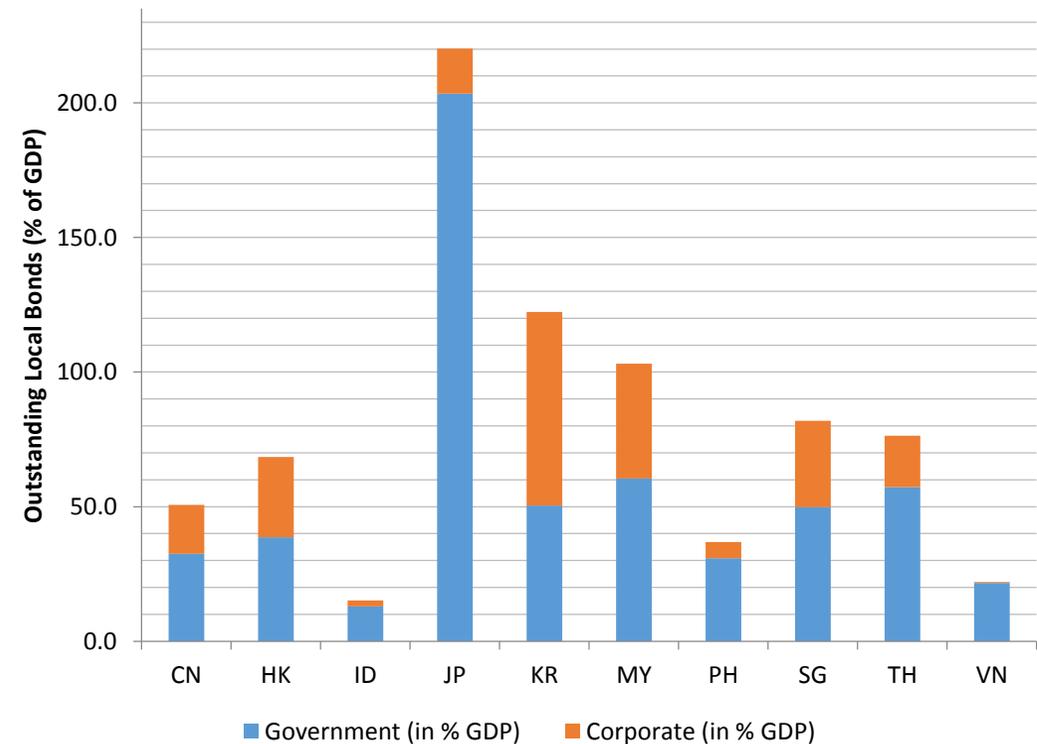
Figure 3. Size of Local Bond Market as % of GDP, End 2014



In terms of bond markets, my focus this morning, expansion has been rapid

- It is dominated by short-term issuance.
 - In March the Finance Ministry announced a plan for provincial governments to refinance RMB 1 tr. in debt (most bank loans and trust loans) as bonds so as to lower rollover risk and (hopefully) reduce funding costs. When the first tranche of this debt was marketed in April, demand from the banks and investors generally was underwhelming
- Banks still buy many of the longer-term issues, as if much bond issuance is effectively bank lending in disguise.
- Corporate issuance is dominated by majority-state-owned companies.
 - Given that much corporate bond issuance is by state-owned companies, whose bonds are then purchased by state-owned banks, one wonders how many of these transactions are policy directed as opposed to arm's length.

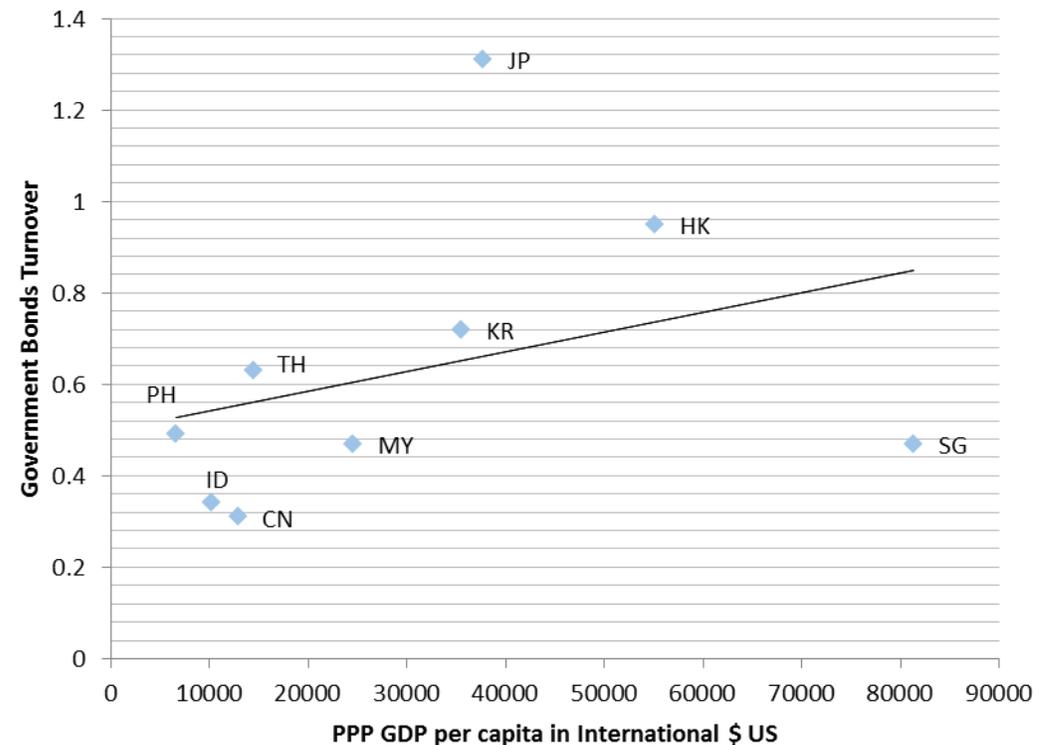
Figure 3. Size of Local Bond Market as % of GDP, End 2014



Nor is this the diverse investor base to which the architects of liquid bond markets aspire

- Banks are not active traders.
- The dominance of banks on the buy side may thus account for the relatively limited liquidity of the secondary market (as measured by turnover, or amount traded as a share of the value of bonds outstanding), in government bonds in particular.

Figure 6. Bond Market Turnover and PPP GDP Per Capita, End 2014



The authorities are taking steps to address these weaknesses

- Guidelines to enhance transparency
 - As in the Asian crisis countries after 1998.
- Issuance of hedging instruments to encourage wider participation.
 - As in Asian crisis countries after 1998.
- Allowing for defaults by bond issuers for the first time.
 - As in Asian crisis countries after 1998.
- Liberalizing access of foreigners to the market.
 - As in Asian countries after 1998, which also comes with risks (viz. above).
 - I close this section with that question, recommending that the Chinese authorities should go slow (and worrying that they aren't).

Finally, excessive financialization?

- Experience of the financial crisis has raised this possibility, and concern.
- A series of studies using cross-section and panel data suggest that returns to financial development diminish at some point.
- These studies suggest, from a statistical point of view, that the effect can actually turn negative in the relevant range.
- Taken literally, they suggest that Singapore, Malaysia, South Korea, Thailand and Hong Kong and China are all at or above the level where the contribution of credit to economic growth turns negative.
 - We can debate how seriously to take the statistical result.
 - We should have learned to be sceptical about “magic numbers.”
 - But this is a reminder that what matters is the quality, and not just the quantity, of financial development
 - The real question being whether there is a quantity/quality tradeoff at some point.

Conclusion

- The Asian crisis of 1997-8 was attributed, in part, to the failure of economies in the region to build deep, liquid and diversified financial systems.
- Comparing the situation today with that back at the turn of the century suggests that economies in the region have made progress in the desired direction.
- Asian countries no longer stand out as having stunted bond markets.
- The conclusion holds most strongly for corporate bond markets, which many observers would argue matter most.
- Evidently, Asian policy makers have succeeded in advancing their objective of building better diversified financial systems.

But problems and challenges remain

- Currency mismatches on bank balance sheets are more closely scrutinized by supervisors and regulators, but nonfinancial corporations continue to borrow heavily offshore, incurring unhedged foreign-currency obligations.
 - Why do we see this if corporate bond markets in the region are so efficient?
- Domestic bond markets still lack liquidity by the standards of the leading international financial centers.
- Lack of liquidity, as manifested in low turnover and high bid-ask spreads, reflects the uneven development of the relevant trading platforms and technologies but also the absence of a more diverse investor base.

This creates a temptation to rely on capital account liberalization

- To throw open domestic markets to foreign investors – as a way of jump-starting the financial-development process.
- But, as I argue in the paper, this strategy is risky.
- Instead, policy makers should focus less on headline measures of financial depth and liquidity and more on the efficiency of the financial system in meeting the needs of households and firms.
- Asian policy makers drew an analogous conclusion about fixed investment from the 1997-8 financial crisis: that they needed to focus less on the volume of investment and more on its efficiency. They should now apply the same lesson to the development of the financial system, both in China and more generally.

- Thank you.