Promoting Future Growth through Financial Sector Development and Reform

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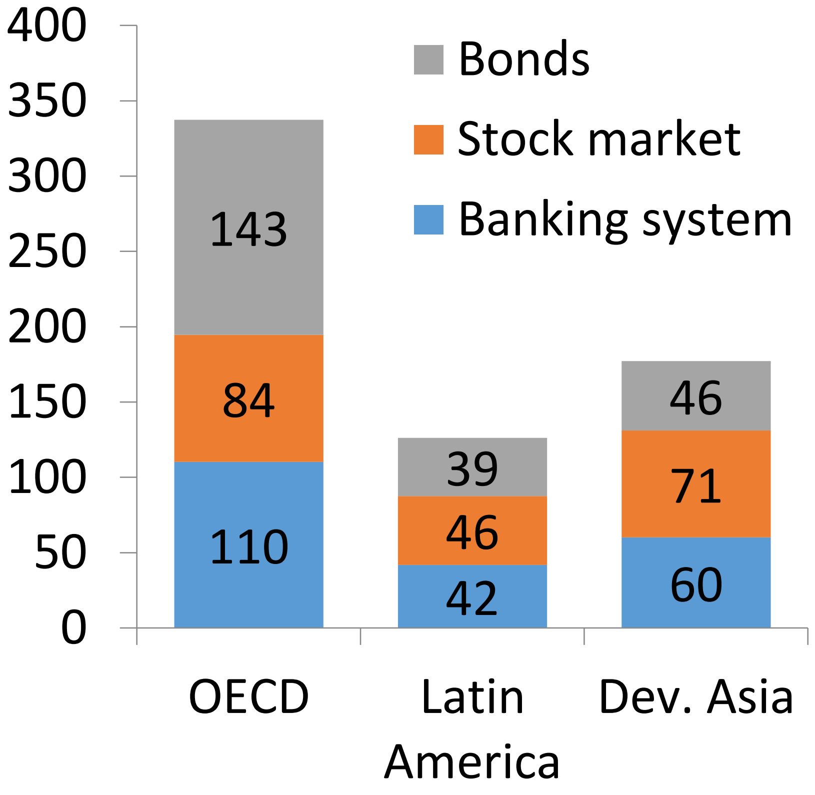
FINANCING ASIA'S FUTURE GROWTH

ADB

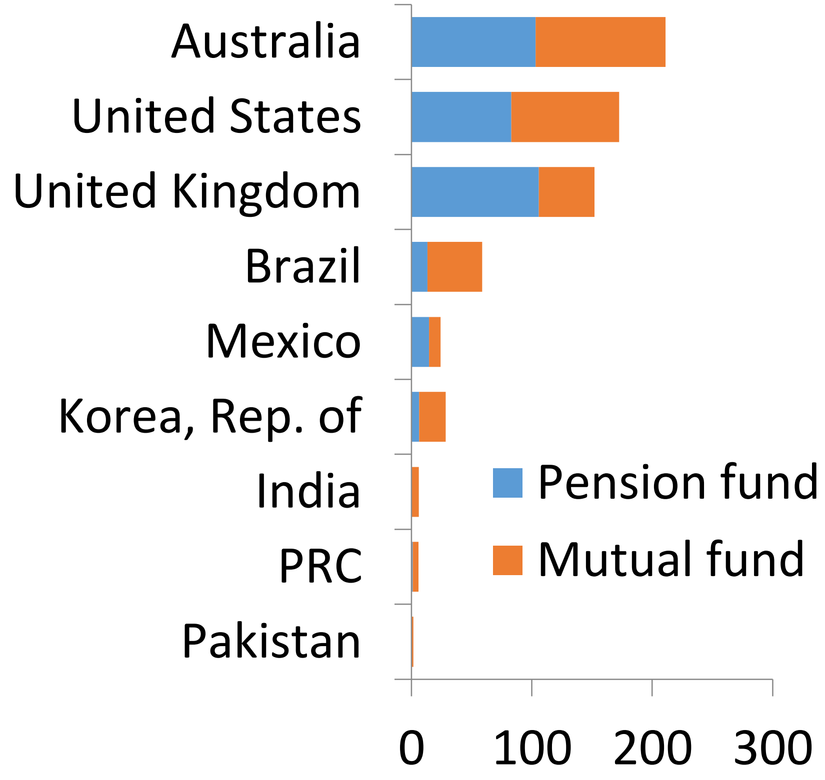
Asia's financial systems still lag advanced economies...

Financial structure around the world (% of GDP), 2011



Source: ADB estimates based on data from Beck et al. (2000, 2009) and Cihak et al. (2012).

Pension and mutual fund assets (% of GDP), 2013



Sources: OECD (2015), Pension funds' assets (indicator). doi: 10.1787/d66f4f9f-en (accessed on 13 February 2015); Worldwide Mutual Fund Assets, available: http://www.ici.org/research/stats/worldwide

Financial development affects economic growth…

- Empirical evidence points to growth benefits from closing the finance gap.
- Boosting developing Asia’s average ratio to GDP of liquid liabilities from about 65% to 75% , for example, adds about 0.4 percentage points to average annual GDP growth per capita.
- The evidence indicates that growth can come from developing either banks or capital markets.
- The actual level of financial openness also appears to have direct positive and significant effects on economic growth, but not the de jure measure of capital flows.
- This suggests that a commitment to open domestic financial sector does not necessarily foster economic growth until it actually facilitates flows of capital to the economy.

Do effects differ in developing countries and in Asia DMCs?

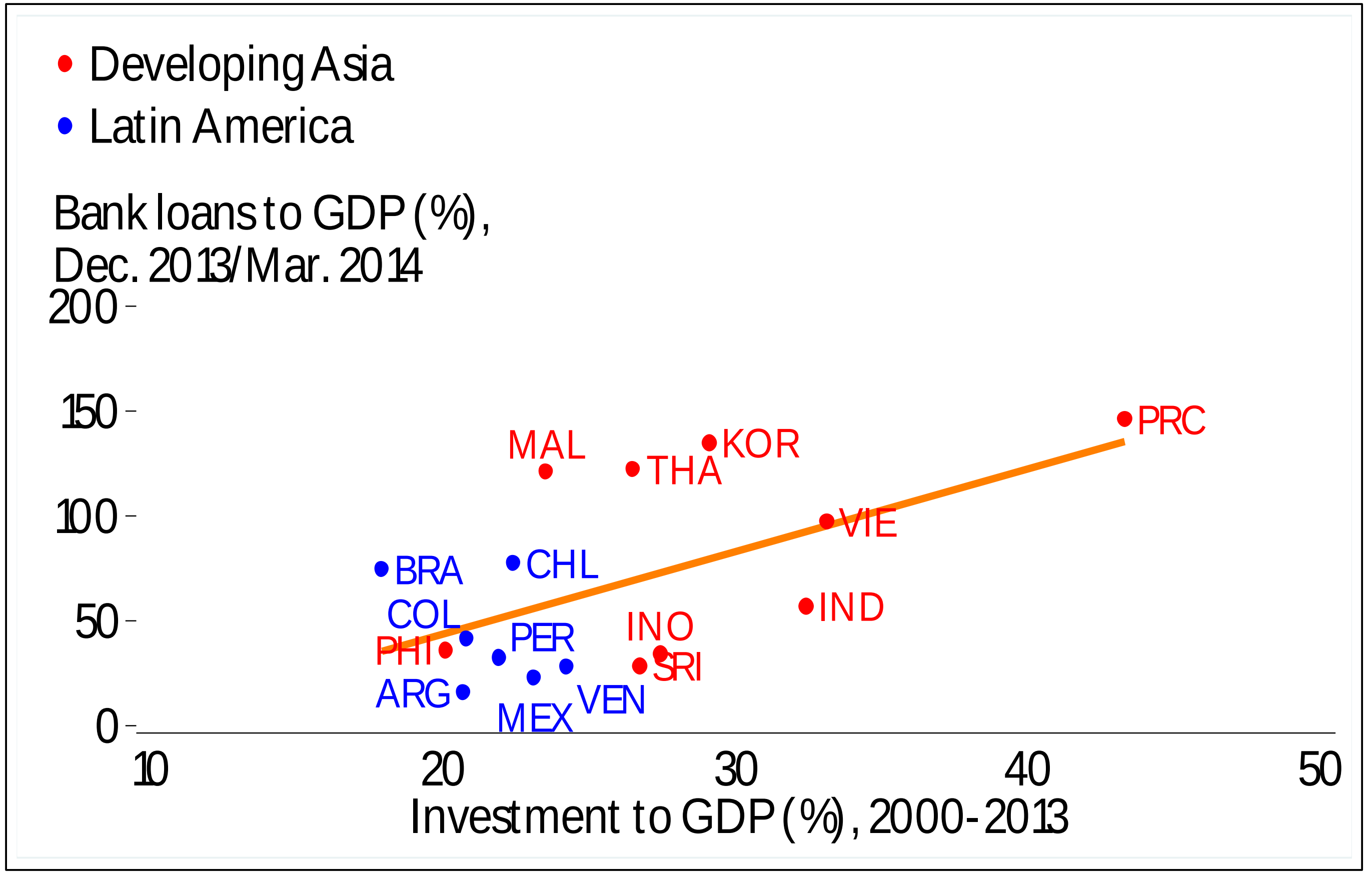
- Positive effects of financial sector development on growth are mainly true in the developing countries, with an even stronger effect in developing Asia.

  → Reinforces the need for promoting financial sector development in fostering economic growth in developing countries.

- The effect of financial openness on growth in developing countries in general tend to be lower than elsewhere, with some evidence of exception for the case of developing Asian countries.

  → Suggesting the potential financial instability implications of financial openness that may hamper growth.

Financial deepening associated with higher investment and faster growth…



Different Degrees of Financial Development and Openness…

- The effect of financial development on growth tends to be lower in countries with higher degree of financial openness; likewise, the effect of financial openness on growth is also lower when the level of financial development is higher.
  - →These complementary observations suggest that a combination of a high degree of financial sector development and financial openness could potentially limit growth potential, because they may expose countries to greater financial market volatility and higher risks for capital flow reversals.
  - →They reinforce the need for sound financial sector regulation that could reduce the sector’s volatility, particularly when the size of domestic financial sector grows and its connection to the global financial system is enhanced.

Should we favor for particular exchange rate regime?

- The effects of different exchange rate regimes on growth are not robust.
- There are some indications of a negative association between a flexible exchange rate regime and growth.
  - → These may reflect the fact that many of the lower growth developed countries in the sample adopt a flexible exchange rate. But, they may also suggest that exchange rate fluctuations in countries with flexible exchange rate regimes may create more uncertainty that reduced their growth potential.
- There are some evidence about milder effects of financial openness on growth when a more flexible exchange rate regime is adopted.
  - → This suggests that a more flexible exchange rate regime may reduce the effectiveness of financial openness in promoting economic growth.
- There are also some evidence about stronger effects of financial sector development on growth under a managed floating exchange rate regime.
  - → A credible less flexible ER regime may offer more certainty for investment decisions that could enhance growth.

FDI vs non-FDI…

- Both FDI and non-FDI components of capital flow tend to be positively associated with economic growth but that evidence of positive effects of non-FDI flows on growth is weak.
- The effect of FDI on growth tends to be stronger in Asian countries.
- FDI and diverse foreign funding can mitigate external financial shocks

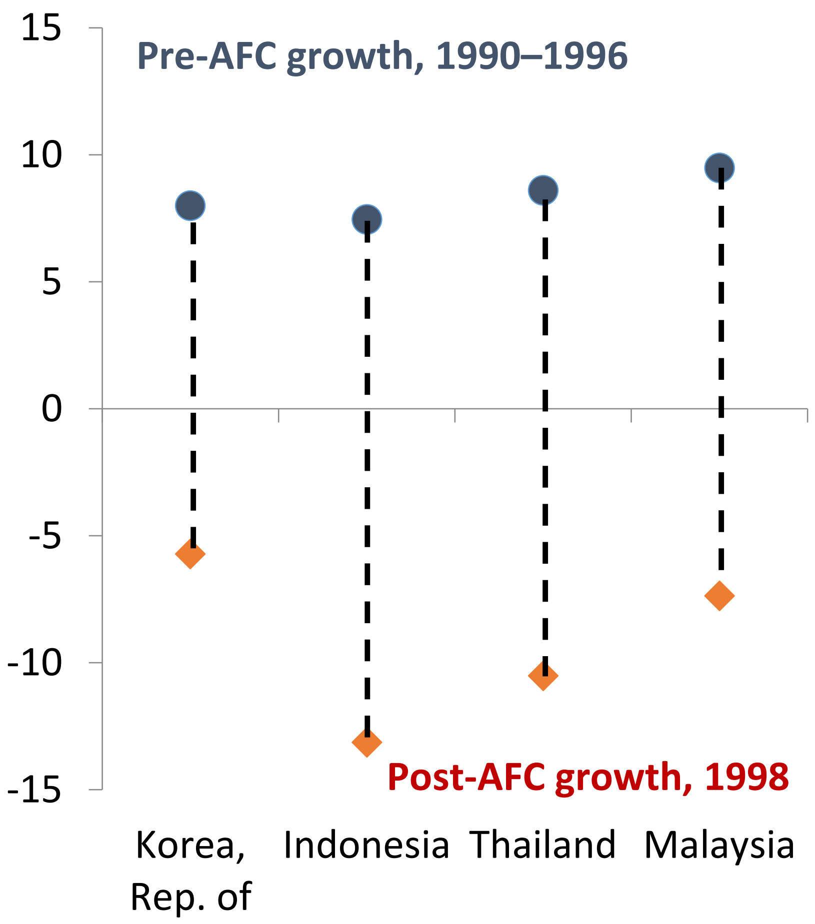
In sum…

- Asia's growth would benefit from further financial sector development.
- To be effective in promoting growth, the financial sector needs to be stable and sound.
- What to do to ensure soundness and stability of the financial sector?

Financial stability must be maintained …

- Financial development, innovation, and liberalization can be generally beneficial; however, they sometimes destabilize financial systems
- Therefore, financial stability must be maintained to enhance growth, equity, and inclusive growth
- The **inclusiveness of growth** depends on financial stability because the poor are disproportionately defenseless against financial crises.
- Financial instability can seriously undermine economic growth, when financial crises result

Financial instability disrupts growth and hurts the poor…



AFC=Asian financial crisis; GFC=global financial crisis

Outcomes of 134 Banking Crises: 1970-2011

Type of Economy	Output Loss (% of GDP)	Increase in Debt (% of GDP)	Fiscal Costs (% of GDP)	Fiscal Costs (% of financial system assets)	Duration (years)	Peak non-performing Loans (% of total loans)
All	23.0	12.1	6.8	12.7	2	25.0
Advanced	32.9	21.4	3.8	2.1	3	4.0
Emerging	26.0	9.1	10.0	21.4	2	30.0
Developing	1.6	10.9	10.0	18.3	1	37.5

Figures are medians.
Source: Laeven and Valencia, 2012

Bank regulation must be part of financial reform agenda …

- Developing Asia’s financial systems have become much healthier since reform following the AFC
- However, homegrown risks such as large **shadow banking** systems and unrestrained **household debt** expansion demand vigilant monitoring of financial stability
- A key priority is to ensure that regulatory and supervisory regimes support dynamic environment by controlling the related risks to **financial stability**
  - Assessments of the GFC invariably point to ineffective finance regulation and supervision as the main reasons for the onset of the crisis and its severity

Post-crisis analysis by IMF, FSB, & BCBS identified aspects of bank supervision …

- Adequately monitored and controlled **macroprudential** risk, not just individual microprudential bank risk, as a buildup of vulnerabilities could pose **systemic** risk (the risk of collapse of an entire financial system or entire market)
- Conducted comprehensive stress testing of the banking system, taking into account highly risky scenarios even if they seemed unlikely (tail risk)
- Paid attention to interdependencies, including cross-border risks
- Considered risks in the shadow banking industry or cross-sector risks posed by nonbank financial intermediaries

Post-crisis efforts to reform ...

- Post-crisis efforts to reform and enhance international bank regulatory and supervisory standards and practices were pursued by IMF, WP, BCBS/IBS, FSB
- Much progress has been made on the regulatory front—especially with Basel III tightening of the rules on the quantity and quality of bank capital (**Revision of 29 Basel Core Principles**, 2012)
- The BCBS is increasingly guided by the need for a **macroprudential perspective** on financial regulation, in addition to the microprudential perspective

Macroprudential Policies in Asia

Specific use of macroprudential policy instruments by economy, 2000-2013

MPP type	Country										Total	%
	SIN	HKG	INO	MAL	KOR	IND	TAP	THA	PHI	PRC		
Credit-related[a]	13	5	11	6	23	6	3	15	1	9	**92**	**49.2**
Liquidity-related[b]	0	0	7	3	3	18	6	1	10	31	**79**	**42.2**
Capital-related[c]	1	1	1	0	2	4	0	0	6	1	**16**	**8.6**
Total	**14**	**6**	**19**	**9**	**28**	**28**	**9**	**16**	**17**	**41**	**187**	**100.0**

SIN = Singapore; HKG = Hong Kong, China; INO = Indonesia; MAL = Malaysia; KOR = Republic of Korea; IND = India; TAP = Taipei,China; THA = Thailand; PHI = Philippines; PRC = People's Republic of China.

[a] Caps on LTV ratio, caps on DTI ratio, caps on foreign currency lending, and ceiling on credit/credit growth

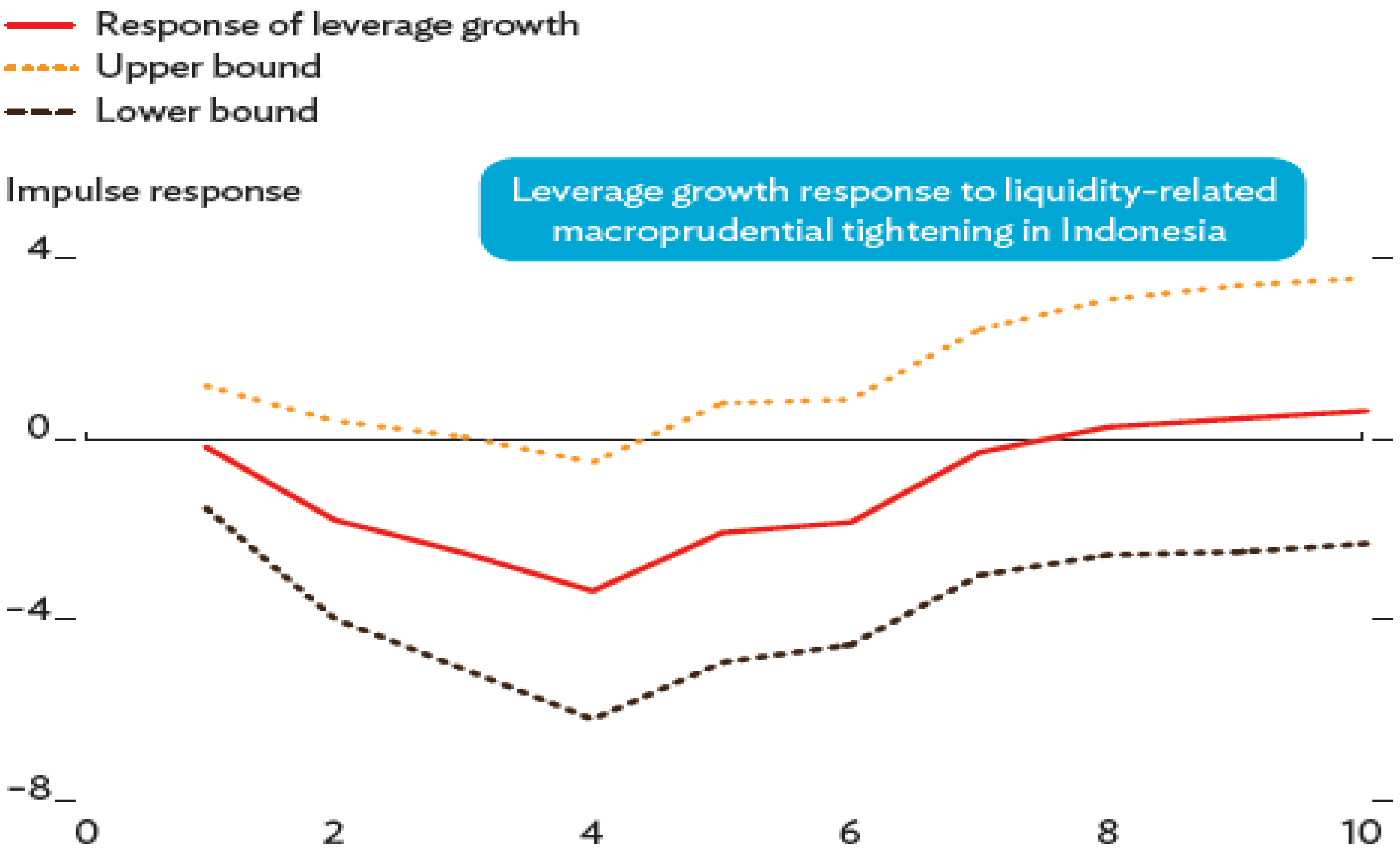
[b] Limits on net open currency positions/currency mismatch (NOP), limits on maturity mismatch, and reserve requirements

[c] Countercyclical/time-varying capital requirements, time-varying/dynamic provisioning, and restrictions on profit distribution

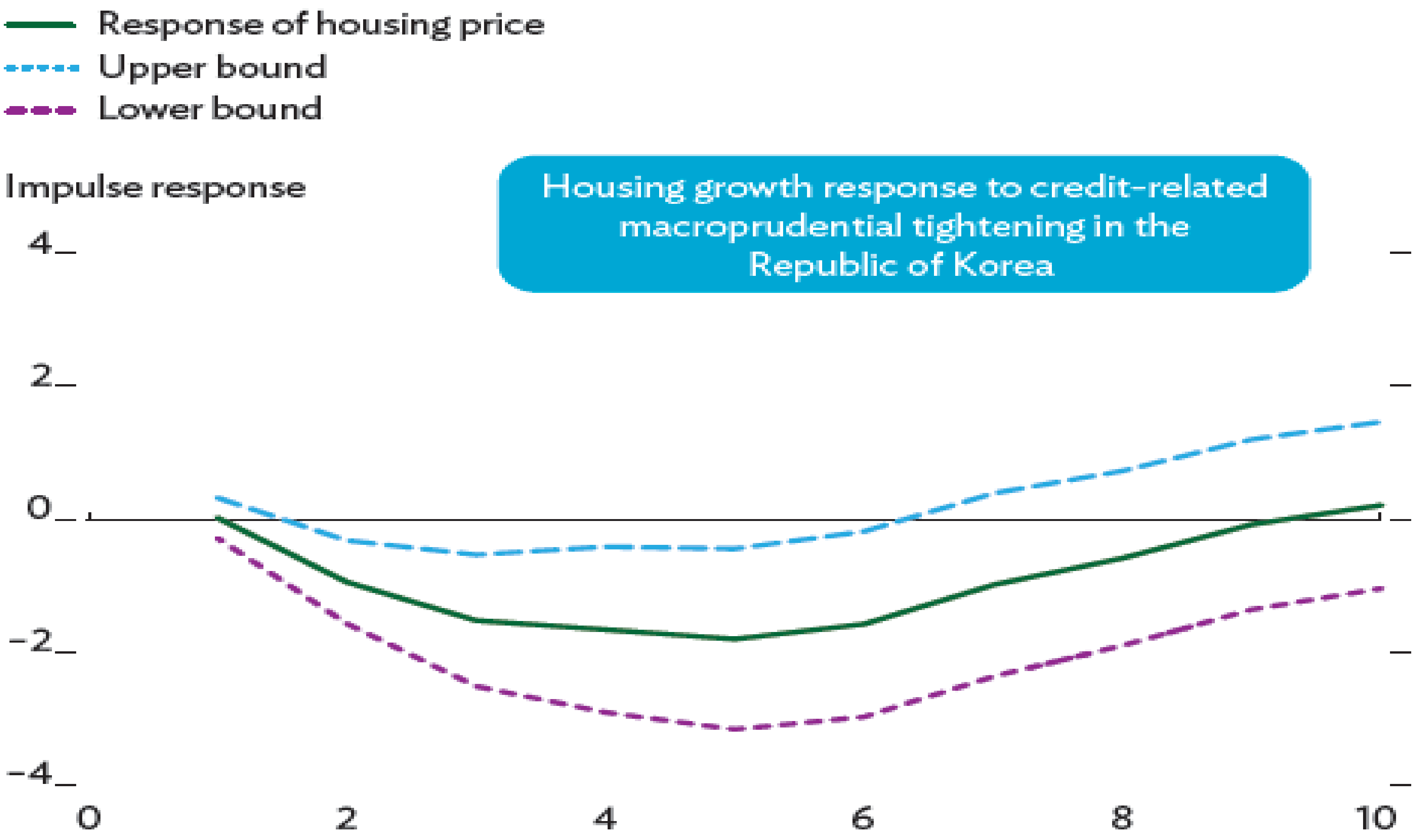
Source: Authors' calculations

Macroprudential policies can indeed promote financial stability in Asia. More specifically, different types of macroprudential policies are more effective against different types of macroeconomic risks

Indonesia: Leverage growth to liquidity-related MPP



Korea: Housing growth to credit-related MPP



Source: Lee, Asuncion, and Kim (forthcoming).

Policy reform recommendations: Macroprudential policy framework

1. The salient implication for Asian financial regulators is that, while they should explore the use of macroprudential policies, they should assess which exact policies are appropriate for the particular macroprudential risk they face (**Threshold Analysis**)
2. In detecting systemic risks and tackling them, policymakers should avoid any complacency in developing a legally operational sound **macroprudential policy framework**

Conclusion

- As developing Asia grapples today with the slowdown of growth momentum since the GFC, further financial sector development has never been stronger
- The GFC underlined the importance of sound and effective financial regulation to safeguard financial stability, which is vital for both growth and equity
- Bank regulation would be the first line of defense against financial shocks and it must be part of financial reform agenda
- Macroprudential policies have potential for shoring up financial stability in developing Asia