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Enhancing Financial Stability in Developing Asia

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Abstract

Given no generally accepted framework for financial stability, policymakers in developing Asia need to manage, not avoid, financial deepening. This paper supports Asian policymakers' judgment through analysis of the recent events in the United States and Europe and of earlier crisis episodes, including Asia during the 1990s. There is no simple linear relationship between financial repression and stability—financial repression not only has costs but, so doing can itself undermine stability. Bank-centric financial systems are not inherently safer than systems that include meaningful roles for securities and capital markets. Domestic financial systems should be steadily diversified in terms of both number of domestic competitors and types of savings and lending instruments available (and thus probably types of institutions). Financial repression should be focused on regulating the activities of financial intermediaries, not on compressing interest rates for domestic savers. Cross-border lending should primarily involve creation of multinational banks' subsidiaries in the local economy—and local currency lending and bond issuance should be encouraged. Macroprudential tools can be useful, and, if anything, are more effective in less open or less financially deep economies than in more advanced financial centers.

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Developing Asia faces a much greater intellectual and policy challenge on the financial side of the economy than on the real side (i.e., the side concerned with producing goods and services). There is pretty clear consensus and even a roadmap for the trade and investment side of the spectacular East Asian development stories over the last 60 years. These were largely based on integration with global markets and value chains under rules that have been framed mostly by the United States and Western Europe. In the financial area, however, there is no such clear consensus.

A number of Asian countries, including Japan, the Republic of Korea, and Singapore, succeeded while pursuing a different path than the United States and United Kingdom on the treatment of household savings and maintaining limits on financial development. The excesses of Anglo-American financial liberalization being the apparent cause of the North Atlantic financial crisis of 2008–11 only deepened their caution. Major failures in risk management were identified in the rich Western countries, in both the public and private sectors. The understanding of financial linkages and of the system as a whole by relevant public authorities was inadequate (Gorton 2009), as was their prudential supervision of many individual financial firms. Financial innovation was associated with opacity, instability, and a potentially nefarious "shadow banking system" (Pozsar et al. 2010). These failures were an echo of those that caused the Asian financial crisis of 1997–98, though in both crises the message was exaggerated and oversimplified (Rhee and Posen 2013).

Yet, a number of Asian countries have wanted to create internationally competitive financial centers within their borders, which also require high levels of liberalization and financial innovation. Key elements of this effort included the development of market-based finance in the form of tradable equities, bonds, and even instruments of risk transfer such as derivatives and securitization; a deepening of international financial integration, associated with the elimination of cross-border capital controls and the adoption of common financial standards; and the creation of strong, competent, and independent institutions for financial sector oversight, within existing central banks or as autonomous agencies. Furthermore, the recent crisis notwithstanding, there is substantial evidence that financial repression imposes direct costs, if not outright limits, on broader economic development (Cline 2010), and, as demonstrated by the summer 2015 equity market developments in the People's Republic of China (PRC), can itself contribute to financial instability.[1]

Simultaneously, the elevation of the Group of Twenty (G-20) to its new status as "premier forum for international economic cooperation" among its member constituencies,[2] with an initial strong emphasis on financial regulatory matters (Rottier and Véron 2010), was intended to send a message that a new

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1. Mikitani and Posen (2001) sets out how financial repression and partial protection of certain banking sectors in the United States and Japan led to the savings and loan crisis of the 1980s and the Japanese banking crisis of the 1990s, respectively.

2. Group of Twenty, Pittsburgh Summit Declaration, September 2009.

policy consensus was being defined. This new policy consensus, like the G-20 itself, was supposed to involve developing and emerging-market economies on an equal footing with advanced ones. The G-20 reform program has recorded a few successes, notably the rapid finalization of the Basel III accord on capital, leverage, and liquidity for traditional banks, whose key elements were agreed by the end of 2010. The message, however, promised more than the G-20 could realistically deliver. As a result, the policy guidance for enhancing financial stability remains unsettled—and arguably deficient in terms of addressing the specific needs of emerging markets and nonbank activities.

In particular, the new G-20-centered framework's goal of providing more balance among developing, emerging-market, and advanced economies in shaping common global financial policies has not yet been fully realized. On the positive side, the membership of key bodies such as the Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS), or Committee on the Global Financial System (CGFS) has been significantly rebalanced to better represent Asian jurisdictions (as described below in the section on Cross-Border Integration). For reasons that involve both emerging-market and incumbent advanced economies, though, the influence of non-Western members of such bodies in their workings and outcomes is often less than the weight of those members' formal representation—and that is the case at the FSB (Véron 2014, Walter 2015).

In the absence of a generally accepted framework for financial stability, policymakers in developing Asia need to exercise judgment while determining which choices are best suited to their specific situation. The most important point is that there is no simple linear relationship between financial repression and stability—postponing or avoiding financial liberalization not only has costs but so doing can itself undermine systemic stability in developing economies. That fact holds, even though it is undeniable that Anglo-American light-touch financial regulation and supervision were destabilizing and warn us to avoid extreme deregulation. We offer the following guidelines for policymakers pursuing financial stability in developing Asia:

- Bank-based or bank-centric financial systems are not inherently safer than systems that include meaningful roles for securities and capital markets.
- Domestic financial systems should be steadily diversified in terms of both number of domestic competitors and types of saving and lending instruments available (and thus probably types of institutions).
- Financial repression should be focused on regulating the activities of financial intermediaries and investment managers/funds, not on compressing interest rates and returns for domestic savers.

- Cross-border lending from regional financial centers in foreign currency should be in limited quantities only for top companies, but creation of multinational banks' subsidiaries in the local economy—and local currency lending and bond issuance—should be encouraged.
- Macroprudential tools can be useful and, if anything, are more effective in less open or less financially deep economies than in more advanced financial entrepots, but they must be used aggressively when needed and are particularly suited for dealing with real estate booms/busts.

The next four sections develop these ideas in more detail for banking, nonbank finance, macroprudential policy, and cross-border issues. This paper aims at supporting Asian policymakers' judgment by providing policy views and recommendations that are based on our analysis of the recent sequence of events in the United States and Europe and of earlier crisis episodes, including those in Asia (including Japan) during the 1990s. The last section synthesizes the commonalities between developing Asia and some of these advanced-economy crises.

BANKING POLICY

Banks are the backbone of the financial system in most developing Asian countries and will remain so for the foreseeable future. Thus, banking policy will remain fundamental to shaping the financial system and ensuring financial stability.

In almost all cases, this policy should aim at fostering market mechanisms in the functioning of the banking system, especially the setting of interest rates for saving and borrowing and competition among banks. It is natural for governments everywhere to be tempted to distort the functioning of the financial system to facilitate the financing of their own operations or of specific economic activities or agents that they favor, a stance that the economic jargon loosely refers to as "financial repression." But this temptation of financial repression should be resisted in most circumstances, except during wars or other acute and temporary national emergencies. Specifically, the compression of interest rates offered to savers through a combination of capital controls and constraints on domestic banks—a common form of financial repression—is typically destabilizing, because it encourages savers to find their way around the interest rate caps with harmful unintended consequences. The PRC over the past decade offers a relevant illustration of this mechanism, in which the repression of savings has encouraged both unproductive overinvestment and the buildup of financial risk in the "shadow banking" sector (Lardy 2014).

Financial repression also exists under different forms in advanced countries, and its track record there is no more compelling than in less wealthy countries. The experience of the European Union offers a cautionary tale. Many EU member states entered the crisis of the late 2000s with a legacy of policies that included

- significant levels of public ownership of banks (at the national or local government level);
- other levers of government influence to direct lending, such as tax loopholes and tweaks in regulatory requirements, e.g., the now notorious practice of assigning a zero risk-weight to all EU sovereign debt;
- sector-specific accounting, auditing, and disclosure frameworks and practices;
- curbs on nonbank finance, e.g., the prohibition of activities such as leasing and factoring without a banking license, which enhanced the dominance of banking intermediation; and
- selective or complacent enforcement of competition policy in the banking sector.

The detail of these cases of "financial repression with European characteristics" varied across EU countries. Overall, they significantly contributed to the systemic banking fragility that has been plaguing European growth since the initial shock of 2007–08.

The need for competition and market-based price setting and credit allocation, however, should not offset the equally important need for proper bank regulation. Banks are inherently leveraged institutions, and, because they collect deposits, are repositories of trust in society. In addition, the services they provide are rife with asymmetries of information, which no amount of public financial education can adequately check. As a consequence, the regulation and supervision of banks by public authorities is a vital condition for financial stability and efficient financing of the economy.

The public-interest nature of depository institutions is one of the reasons why many countries have brought significant swaths of their banking system under public ownership. This is by no means unique to Asia. As mentioned above, Europe is a case in point. To give only a few examples among advanced economies, Italy nationalized many banks in the 1930s, and France in the 1940s, even though most of these were privatized in the 1990s. At present, more than a third of Germany's banking system is still in public hands. Even in the United States, the federal government guaranteed the two large US mortgage companies, Fannie Mae and Freddie Mac, before the crisis and now owns them as well. More often than not, however, the benefits of public bank ownership in terms of anchoring trust are offset by the challenges it creates in terms of poor corporate governance, politicized lending, interference of trade unions in management (in some countries), and other flaws that typically result in inferior risk management. Thus, those developing Asian countries that have reached a level of development that supports functioning large-scale private sector organizations should favor private over public ownership of their banking system (figure 1).

Nevertheless, again because of the same public-interest aspect of deposit taking and other features of banking, the operations of private sector banks should be ring-fenced from other forms of private sector activity. The principle known in the United States as "separation of banking and commerce," according to which banking and nonfinancial activities should not coexist within the same commercial entity, has gradually emerged as a response to the frequent abuses of bank-industry links, typically in the form of preferential financing by banks of related business operations against the interest of their other claimants, including depositors.

In developing and emerging-market economies, however, the separation between banking and commerce is often porous to nonexistent. In many such countries, established families or groups with multiple business interests are the only nonstate stakeholders that can provide the necessary financial and reputational capital to establish successful banks. This arguably justifies the recent initiatives in both the PRC and India to grant new bank licenses to existing corporate groups to check state-owned banking behemoths.

Even in advanced economies, the separation is seldom absolute. For example, several European automotive manufacturers have large credit-financing arms that are considered banks under EU legislation (even though they do not collect deposits), and in the United States, automakers and industrial equipment suppliers like GE had long maintained a sizeable quasi-bank financial arm. Policymakers in developing Asia, however, should remain acutely aware of the vast potential for conflicts of interest that exists when a bank is part of a broader commercial or industrial group. This is also true in the context of new internet-based financial services, which are often "bundled" with nonfinancial commercial offerings. While such bundling may represent an attractive and efficient proposition for consumers, it should be subject to adequate supervision.

A separate policy debate refers to the possible separation, within financial groups, of different types of financial activities and particularly of commercial and investment banking. In the United States, the Glass-Steagall Act of 1934 introduced such a stark separation, which was repealed in 1999, arguably to ill effect. Similarly in the United Kingdom, merchant banks were kept separate from commercial banks until the deregulation of the 1980s and 1990s. Similar provisions have existed or still exist in several Asian countries such as the PRC, India, Japan, and the Republic of Korea. For example, in the PRC, banks are prohibited from equities brokerage, which is the sole preserve of securities firms under a separate regulator. Following the recent financial crisis, the public anger against bailouts of large banks has led to the introduction or reintroduction of legal constraints on the structure of banking groups in the United States and Europe. These include the Volcker rule, which aims at prohibiting proprietary trading by banks in the United States; the Vickers reform in the United Kingdom, which mandates the ring-fencing of retail and commercial banking operations from other financial services; and EU legislation on banking structural reform, which, however, is still under discussion at the time of writing.

While mantras such as "banks should not be allowed to speculate with household deposits" resonate with politicians and the general public, however, a more in-depth analysis suggests caution against simplistic solutions of separation. The legal definition of "speculation" as opposed to hedging or market-making has proved elusive, and the highly complex implementation of the Volcker rule does not appear to satisfy its initial promoters more than its critics. Similarly, the spread of credit-transfer techniques such as derivatives has irreversibly blurred the boundary between commercial and wholesale banking, and it is not evident that the distinction has much substance from a systemic risk perspective.

That said, some principles of separation appear necessary and healthy. Insurance operations in a broader financial group should be conducted in a separate subsidiary with its own capital. Asset management activities also require separation, in order to ensure that funds under a bank's custody are not confused with those under the bank's direct ownership. Furthermore, some structural measures may be necessary to ensure or facilitate a bank's resolution in the event of failure (see below on resolution). But these may be better left to the judgment of supervisors, and thus tailored to the specific situation of each banking group, than defined uniformly in legislation.

For bank capital regulation, the Basel III capital accord, first defined in 2010 and continuously refined since, provides a global framework of reference. The BCBS has initiated reviews of individual jurisdictions' compliance with Basel III in terms of laws and regulations (leaving aside the question of how these are implemented and enforced), dubbed the Regulatory Consistency Assessment Program (RCAP). Asian jurisdictions whose RCAP reviews have been published so far—Japan in October 2012, Singapore in March 2013, the PRC in September 2013, Hong Kong, China in March 2015, and India in June 2015—have all been deemed "compliant," the best grading in the RCAP process. This is in contrast with both the United States and European Union, which have been found, respectively, "largely compliant" and "materially noncompliant" in their RCAP reports, both published in December 2014. Other Asian jurisdictions that will be reviewed under RCAP in the near future include the Republic of Korea (June 2016) and Indonesia (September 2016).[3] No equivalent assessment is available at this point for developing Asian jurisdictions that are not BCBS members.

The Basel III framework has occasionally been criticized for being ill suited for developing or emerging-market economies and for excessively constraining, for example, bank lending to small and medium-sized enterprises (SMEs). The Basel calibrations, however, have taken into account observations from across the BCBS membership, including emerging-market economies. The critique of the impact on SME lending has been acute in Europe as well, leading to deviations from Basel III in setting capital charges for loans to SMEs in the legislation that transposes Basel III into EU law, known as the Capital Requirements Regulation (CRR). This is a significant reason for the low grading of the European Union

3. BCBS website, www.bis.org/bcbs (accessed on August 6, 2015).

under RCAP as materially noncompliant. In reality, lending to SMEs is inherently risky and the artificial reduction of the corresponding capital charges, as in CRR, represents a questionable distortion of the prudential framework.

In any case, the Basel framework is intended only for larger internationally active banks. In general, developing Asian countries should aim at such large banks' compliance with Basel III while engaging actively with the BCBS standard-setting process in order to ensure that it fairly takes into account the realities of all jurisdictions. The Basel III standards on bank capital and leverage, and the complementary standards from the FSB on additional requirements on systemically important financial institutions (SIFIs) and total loss-absorbing capacity (TLAC) requirements currently under discussion, are based on long-standing experience with capital requirements. Many aspects remain hotly debated, including the principle of measuring capital ratios against risk-weighted assets; nevertheless, the framework can in general terms be considered tried and tested, and broadly balanced.

By contrast, the parts of Basel III that deal with liquidity issues are more experimental in nature and subject to more uncertainty as to their possible unintended consequences. These include the liquidity coverage ratio (LCR), aimed at ensuring resilience against a temporary liquidity shock, and the net stable funding ratio (NSFR), aimed at ensuring ongoing sustainability of a bank's funding structure. The LCR is still in a period of phasing-in that will be completed only in early 2019 (BCBS 2013). The definition of the NSFR was finalized only in October 2014, and its introduction is planned for early 2018 (BCBS 2014). Countries in developing Asia, especially those that are not BCBS members, have no need to rush into implementation of these measures and may gain from observing their early implementation in other jurisdictions.

For all its importance, regulation is only one part of the banking policy framework and must be complemented with effective arrangements for supervision and crisis management. In spite of some improvement, bank supervision capacity remains constrained in many developing Asian countries. To be effective, supervision must be based on an in-depth analysis of risk in the banks' balance sheets and their environment and not just on the formulaic application of prudential ratios. Capacity constraints make it particularly important to complement supervision with an effective framework for market discipline, based on strong standards for accounting, auditing, and supervisory disclosures (the so-called third pillar of the Basel framework). Similarly, stress testing has emerged as an increasingly prominent component of the supervisory toolkit (Goldstein 2015) but also requires the buildup of adequate capacity.

Resolution frameworks are an even more challenging issue for many developing and emerging-market economies, including those in Asia. The familiar tradeoff, when a bank faces severe difficulties, is between bailing out all creditors, at the risk of a severe fiscal burden and erosion of market discipline in the rest of the banking system, and "bail-in" (the imposition of losses on creditors and, if necessary to plug the capital gap, on some depositors), at the risk of contagion to other banks and a larger eventual financial and economic cost. The case of Kazakhstan's BTA Bank in February 2009 shows that such contagion can be managed in some cases, at least in countries with a strong fiscal position.[4] Ideally, an orderly resolution system makes it possible to distribute losses to private sector stakeholders in a manner that does not undermine systemic trust. The US Federal Deposit Insurance Corporation (FDIC)'s track record of resolving small and medium-sized depository institutions offers the most prominent model for this. It is now being emulated in the European Union with the Bank Recovery and Resolution Directive (BRRD) of 2014 and in the euro area with the establishment of a Single Resolution Board to handle future bank crises.

A predictable resolution system, however, involves a lot of prerequisites in terms of the rule of law, functioning court system (because the resolution process is always defined with reference to the alternative of court-ordered insolvency), and the administrative capacity of the resolution authority itself. Even in the United States, the operation of the Dodd-Frank Act of 2010 in the case of future crises involving systemically important financial institutions remains entirely to be tested. As a consequence, developing Asian countries should put emphasis on crisis prevention rather than resolution and carefully observe developments in other jurisdictions to optimize their capacity to respond to future banking crises.

The creation of a credible system for deposit insurance is another component of bank crisis management frameworks. The specific features of deposit insurance schemes are important to ensure effectiveness, and poorly designed systems can be detrimental rather than beneficial to financial stability (Demirgüç-Kunt and Detragiache 2000). But if properly set up and funded, a deposit insurance framework can have an important stabilizing effect by reducing the disruption associated with retail bank runs. Here again, the buildup of adequate capacity and credibility is crucial to the effectiveness of the policy framework.

A proper competition policy is also important in the banking sector, which is prone to concentration of market power in a limited number of dominant banks that benefit from an implicit "too big to fail" guarantee. Local credit unions, cooperatives, and microlending institutions often play a vital role in financing small businesses and job creation in developing economies as in advanced ones. Public authorities should ensure that the environment does not prevent their development, while simultaneously refraining from giving them special competitive privileges.

In banking as in other economic sectors, new technology is disrupting the competitive landscape, fostering both new risks and new opportunities. The massive spread of computing power and mobile service accessibility, combined with increasingly large mobilization of venture capital for "fin-tech"

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4. "Restructuring Banks: Don't Start from Here—Kazakhstan shows it is possible to make banks' creditors share the pain," *Economist*, November 25, 2010, www.economist.com/node/17583123 (accessed on August 7, 2015).

(financial technology) startup enterprises, is likely to significantly change the way financial services are offered and delivered in the next few years. The M-Pesa money transfer service, pioneered by Vodafone in Kenya and Tanzania since 2007 and now used in a growing number of other countries, and the Alipay payment platform, launched by Alibaba in the PRC in 2004 and complemented by a highly successful online savings offering (Yu'e Bao) since 2013, are illustrations of the transformative power of mobile finance. Better use of technology also holds vast potential to combat corruption, money laundering, and the financing of terrorism across borders, in spite of numerous practical and political obstacles.

Because developing countries in Asia and other regions are less encumbered with legacy systems, they can often adopt such new technologies quickly and can thus "leapfrog" services or practices that are more widespread in advanced economies but are rapidly becoming obsolete. Technology-enabled access to financial services, including on a cross-border basis, may increase the cost of financial repression and reduce its effectiveness. The disruption of finance by these technologies has barely started, and it is not possible at this early stage to predict its future intensity and the exact challenges it will entail. What is already clear, however, is that public authorities in developing Asia and elsewhere need to devote appropriate resources to monitor financial technology developments in real time and understand what these developments mean for them.

NONBANK FINANCE

The Asian financial crisis of 1997–98 memorably led the then chairman of the US Federal Reserve to observe: "Before the crisis broke, there was little reason to question the three decades of phenomenally solid East Asian economic growth, largely financed through the banking system. The rapidly expanding economies and bank credit growth kept the ratio of nonperforming loans to total bank assets low. The failure to have backup forms of intermediation was of little consequence. The lack of a spare tire is of no concern if you do not get a flat. East Asia had no spare tires."[5] Since then, countries in developing Asia and elsewhere have endeavored to develop bond markets and local-currency issuance (Goswani and Sharma 2011). In the PRC, some diversification away from a purely bank-dominated system has been achieved through the toleration by public authorities of the rapid development of "shadow" finance (Borst and Lardy 2015). The concern to develop nonbank finance is by no means limited to Asia. In the European Union, the European Commission has similarly announced an agenda of "capital markets union," even though its exact content has not yet been determined (European Commission 2015).

5. Alan Greenspan, "Do efficient financial markets mitigate financial crises?" Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, GA, October 19, 1999, www.federalreserve.gov/boarddocs/speeches/1999/19991019.htm (accessed on August 7, 2015).

The development of nonbank finance has a two-pronged rationale. First, the “spare tire” argument holds that alternative financing channels can take the baton of credit provision when banks need to deleverage and restructure themselves, which typically happens after a systemic crisis. Furthermore, capital markets, particularly their equity component, provide a powerful mechanism for risk sharing across regions (Asdrubali, Sørensen, and Yosha 1996; IMF 2013). As in natural ecosystems, diversity of the financial system is a factor of resilience and stability. Second, capital markets and the nonbank sector offer forms of financing that are better suited than bank lending to support specific patterns of development, especially service innovators and other high-growth companies that don’t have tangible assets to pledge as collateral (Philippon and Véron 2008). Thus, the development of nonbank finance enhances the economy’s growth potential and counts as a form of structural reform.

These arguments are generally compelling when applied to advanced economies such as the European Union (Véron and Wolff 2015, Langfield and Pagano 2015). In developing economies, their relevance has to be assessed against each country’s specific context. Even well-developed local-currency bond markets primarily benefit larger companies. Corporate loan securitization is unsuited to lending to small companies, because the costs associated with the required documentation and corresponding corporate transparency are prohibitively high: Even in the world’s most developed securitization market, the United States, the volumes of SME loan securitization are low. Thus, countries where SMEs carry out most of the business activity will struggle to establish vibrant national capital markets. These countries might benefit more from opening up to cross-border capital flows to favor external—but not necessarily foreign currency—financing of their highest-potential companies through foreign intermediaries rather than domestic ones (see section on Cross-Border Integration).

The development of the Chinese shadow banking sector also offers an important reference point for developing Asia. Given the sector’s generally insufficient transparency, it is difficult at the time of writing to form firm opinions about its medium-term economic impact. There are widely different assessments about the risk it represents for overall systemic stability. Nevertheless, the authorities appear to have reached the conclusion that, even if it does put competitive pressure on the incumbent banks, the shadow banking system cannot be allowed to grow unchecked. The lack of data makes it difficult to evaluate the contribution of the PRC’s shadow banking system to nonfinancial corporate financing at this point, but in any case, it is unlikely to grow as dynamically as it has in the last few years. Furthermore, the unique size of the PRC economy and internal market means that its experience cannot be directly replicated in other countries of developing Asia.

Dynamic capital markets and nonbank finance can be very beneficial to the economy if they function properly, as the example of the United States illustrates. But to function properly, they have to meet a number of conditions. In particular, insolvency and debt restructuring frameworks are essential components of the intangible infrastructure that supports them. In countries where insolvency processes are either inefficient or easily hijacked by special interests or both, riskier forms of nonbank credit (such as high-yield bonds, securitization, or mezzanine credit) are likely to be difficult to introduce, because of the lack of underlying trust that creditors' interests will be suitably defended in case the supported venture is not successful.

Similarly, equity markets and several segments of nonbank credit markets require a high standard of corporate governance and financial transparency to function properly. Many developing Asian economies have made progress toward accounting transparency by adopting International Financial Reporting Standards (IFRS), which generally represent an improvement on preexisting national standards in terms of the quality of financial statements. As of mid-2014 this was the case in Brunei Darussalam; Cambodia; Hong Kong, China; the Republic of Korea; Malaysia; the Maldives; Mongolia; Nepal; Singapore; and Taipei,China, among others. Furthermore Bangladesh, Myanmar, Pakistan, Sri Lanka, and Uzbekistan are using standards that differ from IFRS only on a limited number of points, while the PRC, India, Indonesia, Japan, and Thailand have for the moment retained national accounting standards even though these are partly modeled on the IFRS (Pacter 2015). In any event, accounting standards are only one part of a robust corporate financial reporting framework. Equally important are the requirements and practices that govern auditing and the enforcement of accounting standards by public authorities (generally securities markets regulators). On both these dimensions, and despite the near total absence of reliable comparative data, it appears that most developing Asian countries have significant potential for progress.

Financial ecosystems change only slowly. In their ambition to foster financial development and particularly the expansion of nonbank finance, policymakers in developing Asia should resist the temptation to artificially accelerate the financial evolutionary process by subsidizing market segments that they see as desirable or granting them special tax or regulatory privileges. This is particularly true in the area of venture capital (VC), a segment that many governments in developing, emerging-market, and advanced economies alike view as disproportionately beneficial to the economy because it is associated with innovative, high-growth firms, including disruptive technological innovators.

In Europe, for example, a number of governments have intervened directly in the VC market, by setting up public funds that either invest in private sector VC funds or invest directly in companies, alone or in coinvestment with private sector VC funds. Many such funds exist in Europe at the subnational, national, and European levels (the European Investment Fund is managed by the European Investment Bank). Generally speaking, the track record of these funds is poor, and there is even evidence that they represent a drag rather than a stimulant for the growth of a healthy VC sector (Veugelers 2011). It appears that the stringent control mechanisms that are inherent in the deployment of public money are incompatible with the high-risk, high-failure-rate, judgment-based approach that defines VC investment.

Developing Asian countries should learn from the European failures in this area. Rather than throwing scarce public money at the sector, they should focus on the environment that shapes VC activity, including the quality of higher education, predictability of tax and regulatory developments, protection of intellectual property rights, openness to foreign investment, and integrity of the justice system.

All things considered, the potential for nonbank finance in developing Asia depends heavily on each country's specific context of financial, economic, and institutional development. For some, a homegrown nonbank financial sector with critical mass can provide benefits in terms of both higher growth potential and higher stability; for other countries, it is more promising to become more open to financing from outside by pursuing cross-border financial integration (see section on Cross-Border Integration). Banks will continue to play an irreplaceable role in the financing of the economy in all Asian countries.

MACROPRUDENTIAL TOOLS AND THEIR USE

Macroprudential policy concepts have evolved gradually since the 1970s from the realization that the regulation and supervision of individual financial firms may not always be sufficient to ensure the stability of the financial system as a whole (Borio 2003, Clement 2010). The corresponding instruments include, in particular, loan-to-value (LTV) limits, countercyclical capital buffers and time-varying reserve requirements, and targeted taxes and levies on financial activities. The existence of a track record varies depending on the instrument: Some measures have been used long before being given a "macroprudential" label, the use of which has become significantly more widespread over the last decade; others are largely or entirely untested.

The dataset of past macroprudential actions assembled by Longmei Zhang and Edda Zoli (2014) suggests that Asian countries have a higher propensity to engage in such measures than jurisdictions in other regions (figure 2). This dataset establishes a distinction between macroprudential policies and capital flow management (CFM) measures, which are occasionally associated with a macroprudential objective. The same source identifies a marked increase in CFM measures in Asia following the peak of the financial crisis in late 2008 but at a pace that is far lower than that of the Latin American region, which leads in this category.

Macroprudential measures, of course, distort the operation of market mechanisms and in principle should be introduced only in response to a specifically identified market failure. The absence of relevant general equilibrium economic models of financial systems, however, implies that there is a strong heuristic element in the elaboration of such measures, which itself is made more challenging by the difficulty of assessing their effectiveness in terms of both benefits and costs (Claessens 2014).

The area in which macroprudential measures appear to have had the most compelling record of effectiveness is in real estate booms and busts. Such booms and busts are one of the major drivers of systemic financial crises, as illustrated in recent years by the United States but also by several European countries including Ireland, Spain, and the Baltic countries. Developing Asian countries should introduce macroprudential tools to dampen property booms, or maintain and refine them if they already have (Jeanne 2014). Beyond this sector-specific aspect, there is a case for being cautious—developing status and absence of a globalized financial center in this instance can be a virtue, as most asset price booms with systemic implications will be confined largely to real estate (whether commercial or residential).

In any event, it is important for all Asian countries, as in the rest of the world, to devote resources to better monitor and understand developments in their financial system beyond the banking sector. These include the timely collection and publication of statistics. For these, Asian countries should seek compliance with international standards and practices as developed by the BIS Irving Fisher Committee and the work developed since 2008 under the aegis of the G-20 to address "data gaps" (FSB and IMF 2014).

CROSS-BORDER INTEGRATION

Financial stability frameworks are not purely domestic, since cross-border financial integration affects all countries at least to a certain extent. The impact of such integration on stability, however, is ambiguous and easy to misunderstand. Generally speaking, the judgment of national authorities is inherently skewed in this area, as they tend to view and treat homegrown risks that arise under their watch more leniently than risks coming from abroad. A quintessential example of this bias was offered by European prudential authorities in the first few years of the recent financial crisis, which they blamed on the United States without an in-depth examination of why European banks had ended up with an aggregate exposure to the US subprime market risk that was equal to if not larger than that of American banks (IMF 2009). It took an unjustifiably long time for these authorities to finally admit that faulty risk management systems and inadequate incentives, not just cross-border financial integration, had played an essential part in the corresponding buildup of risk in European banks' balance sheets and that these could and should be addressed through domestic initiatives (Posen and Véron 2009).

Depending on circumstances, cross-border financial integration can be a source of financial resilience or of financial fragility. For example, the presence of foreign banks can have a powerful stabilizing effect in a domestic crisis. A classic example of this was the housing market downturn in the three Baltic countries of the European Union (Lithuania, Latvia, and Estonia) in 2008–09. Following large-scale privatizations in the 1990s and early 2000s, most banks in these countries were owned by foreign financial institutions from Sweden and Norway. These banks were able to absorb the losses associated with the downturn without suffocating the local economies through a massive credit crunch, an outcome that would most probably not have been achieved if the banking sector had been domestically owned. This factor played a significant role in the rapid rebound of growth in these countries after a severe downturn and fiscal adjustment. More generally, in Central and Eastern Europe, the large presence of foreign (mostly Western European) banks, which in several countries of the region represent more than half of total banking assets, helped absorb the initial shock of the crisis in 2008–09. It became a potential drag, however, when several of these banks, for example, those headquartered in Spain and Italy, were forced to reduce their exposures to the region because of problems in their home countries.

In this context, developing Asian countries should take a pragmatic and open approach to cross-border lending and cross-border bank ownership. The presence of foreign banks can provide significant and welcome competitive pressure, forcing domestic banks to improve their efficiency and to offer better-quality services, even if domestically headquartered banks retain the largest share of the local banking market, as is the case in most Asian jurisdictions. Similarly, the offshoring by domestic banks of some of their activities to regional or global financial centers, especially in wholesale market activities such as derivatives trading and asset management, can be a good thing for the local economy if it enables these banks to offer better-priced services based on those financial centers' critical size and depth. Most developing Asian countries should try to leverage the strength of existing regional financial centers, primarily Singapore and Hong Kong, China, rather than trying to -create international financial centers of their own—a seductive objective for many developing countries but that more often than not results in costly failure to reach critical mass and attract international market participants.

In Asia, financial integration lags compared with economic integration more broadly, and the level of financial integration is typically higher with non-Asian countries than inside the region (Kim and Lee 2008, Borensztein and Loungani 2011, Pongsaparn and Unteroberdoerster 2011). This suggests a significant scope for allowing more cross-border financial services and investment without creating a risk to financial stability. Developing Asian countries might consider measures such as the reduction of tax and regulatory distortions between domestic and foreign banks and investors as well as adopt an open-minded approach to inward mergers and acquisitions in the banking and financial sector.

Developing Asia would also gain from a common institutional framework to level the playing field and ensure convergence in financial standards and practice. Realistically, the ambition should stop short of a seamlessly integrated single market in financial services. The experience in the European Union suggests that such "deep" financial integration can lead to destabilizing incentives for national authorities when it is not accompanied by a strong supranational supervisory and regulatory function, which is eventually being created in Europe (in particular with the euro area's banking union) but is not realistic in the Asian context (Dobson 2011).

Specifically, the Association of Southeast Asian Nations (ASEAN) endorsed a regional Banking Integration Framework in 2011 and is working on implementing it at a differentiated pace among its members. Unlike the European banking union, this development is unlikely to alter the ASEAN countries' fundamental reliance on national policy frameworks for banking sector soundness and financial stability (Wihardja 2013). Rather than emulating European banking integration, Asian countries could build on the existing institutional framework at the international level. International financial institutions have markedly improved the representation of Asian jurisdictions in their membership and decision-making bodies since the start of the financial crisis, mostly through a reduction (but not elimination) of the prior overrepresentation of European countries (figure 3).

This recent rebalancing, however, is not yet sufficient to ensure adequate "ownership" of these global institutions by Asian policymakers and public opinions. While the membership of the global bodies has evolved, their leadership remains heavily skewed toward nationals from the United States, Europe, Canada, and Australia (Véron 2014). Furthermore, their location in Europe and the United States creates an imbalance that makes it more difficult for Asians to engage, in terms of distance and time zones. The relocation of at least some of the existing institutions to Asia, as well as the establishment in Asia of any newly formed global financial regulatory organization, would improve the prospects for a more balanced system.[6]

CONCLUSION

Asian policymakers are right to put financial stability at the top of their agendas, right to question whether Anglo-American turbo-charged financial liberalization really serves development, and right to doubt that the measures undertaken by the FSB and G-20 will provide their economies with adequate or targeted buffers. The questioning, however, should not go so far as to result in an excessive distrust of financial liberalization. The path to financial stability has more similarity across levels of development than may first appear. Upon closer examination, it quickly becomes clear that similar sorts of crises arise at all levels of financial development—the parallels between the Asian crises of 1997–98 and the US/UK (2007–10) and euro area (2007–15) crises are quite evident. If anything, the Americans and Europeans would likely have done better in responding to their crises had they adhered to the recommendations they made to Asia a decade earlier (Rhee and Posen 2013). Of course, financial stability and development are more than matters of crisis response, so the common threads are a little less obvious than avoiding throwing good money after bad and injecting capital where necessary.

We believe the most important parallel with respect to financial stability between the recent advanced economies' experience and the challenges facing Asian policymakers is the repeated failure of financial repression to provide stability. Across southern Europe even in recent years, and earlier in the American

6. Nicolas Véron, "Move the Financial Stability Board's Secretariat to Asia," RealTime Economic Issues Watch, Peterson Institute for International Economics, May 10, 2012, http://blogs.piie.com/realtime/?p=2871 (accessed on August 7, 2015).

"heartland" and among the mid-sized banks in Japan, various forms of financial repression bottling up household savings in protected financial institutions were widespread—and instability still befell these economies. While the recent North Atlantic financial developments were importantly worsened by too big to fail distortions, in Europe in the 2010s, like in Japan in the 1990s and the United States in the 1980s, most of the problems were generated in and on the balance sheets of government-guaranteed smaller financial institutions (Goldstein and Véron 2011, Mikitani and Posen 2001). Similarly, cross-border capital flows also played a huge part in the buildup of unsustainable lending—be it in Greece or Nevada, Ireland or Florida—but those destabilizing inflows took place across a wide variety of exchange rate regimes, levels of development, and even domestic financial institutions.

Because there is no simple positive correlation between financial liberalization and instability, the optimal policy approach is not about achieving a lukewarm compromise between repression and liberalization. We have offered a few specific suggestions for Asian policymakers about how to implement a balanced strategy in practice. These general principles can be followed at most stages of economic and financial development and are not complicated matters of sequencing or conditionality depending upon what form development has taken to date.

This wide applicability comes from the fact that financial stability ultimately stems from having adequately varied sources of commercial credit and outlets for household savings, so that fragility—or even mismanagement or supervisory capture—of one piece of the system does not bring down the economy's whole framework. The greater depth and diversity of the US financial system versus the UK concentrated banking development meant the former contributed to a much better and more rapid recovery from crisis than was seen in the latter.[7] A similar argument could be made for Singapore versus some other smaller East Asian economies in 1997–98, or the resilience of Japan in 2008 versus 1988. Capital markets and local lenders are both good things to have.

Thus, our foremost recommendation is that Asian policymakers should promote diversity in domestic financial institutions, which is generally a factor of resilience and stability. This calls for diversification of national financial systems away from the dominance of banks and for openness to cross-border (though not necessarily foreign-currency) financial services and intermediaries. This is indeed a call for continued financial liberalization where needed but not for laissez-faire supervision or the ongoing diminution of traditional banking or importation of all the latest financial innovations. The issue is one of institutional structures within the financial sector.[8]

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7. Adam Posen, "Why is their recovery better than ours? (Even though neither is good enough)," speech at the National Institute of Economic and Social Research, London, March 27, 2012, www.bankofengland.co.uk/publications/Documents/speeches/2012/speech560.pdf (accessed on August 7, 2015).

8. This statement is based solely on financial stability considerations. There is a historical and plausible economic argument that a Japan–Republic of Korea–Taipei,China bank-centric model fosters helpful industrial policy through a state-dominated banking

We repeat that diversity is also a call for multiple financial institutions within any given (sub-) sector—that is, for number not just type. While the many examples cited indicate that problems can arise in protected small institutions like Spanish savings banks (*cajas*) or US savings and loans, that is simply a caution not to assume size is everything or that more players are always better. We fully endorse the idea that every developing economy should have more than one major bank or financial institution, even if a foreign-owned one, given all the political economy problems that too big to fail entails, and that there is no development advantage to promoting a financial "national champion"—what matters is the resilience of provision of financial services to the economy, which is better served by multiple players in type and number.[9]

Second, we recommend that financial repression be limited to those measures that can be equally characterized as strong prudential regulation—that put the focus on financial sector activities, the most destabilizing of which can be identified and restricted. So doing takes away the focus on restricting the location and investment vehicles of household savers. Bad financial repression of the sort focused on bottling up savings to subsidize lending is actually destabilizing for economies at all levels of development. Interest rate compression will lead to increasingly frantic efforts by savers to get around limits and even border controls, which will result in speculative bursts in limited asset classes to potentially great harm. Arguably, this is the source of the market instability and the real estate downturn in the PRC in 2015. Low interest rates or a large gap between what savers get and borrowers pay from what the market rate would be are not only an inefficient, often politicized, way to allocate resources but also contrary to financial stability goals. Again, a sensible set of policies includes strong regulatory oversight of financial activities without having to resort to either full-on liberalization or ongoing financial repression.

Third, policymakers should carefully monitor the potential impact of the use of new information technology in finance in the next few years. While banks and other financial firms have not been subject to as much technology-based change as other sectors for the moment, such change is likely to become increasingly prominent as the potential of mobile services in finance is operationalized. The development of a data-centric culture, together with enhanced public transparency about financial firms and systems in compliance with international data standards, can help prepare for future disruptions. This is a situation where diversity and entry by new players can rapidly be taken too far, and some consumer protection as

system insulated from the outside world. While we are skeptical of the virtues of this approach, also shown to have limits in Western Europe, we recognize that policymakers in developing Asia will have to take into account the desire to follow this model in tradeoff with the financial stability benefits of a more open and diverse capital system. For a longer-term perspective on these developments, see Jeanne et al. (2014).

9. The pursuit of national champion banks even by global financial centers in an advanced economy is mistaken for the same reasons. See Adam Posen, "It's time the UK stopped 'fetish-ising' its banks," remarks at the Just Banking Conference, Edinburgh, April 19, 2012, www.ianfraser.org/boes-adam-posen-at-the-just-banking-conference (accessed on August 7, 2015).

well as supervision is called for. In this area as well, there is room to distinguish between leapfrogging past constraints via mobile and internet in terms of payment systems, including government disbursement, which should be encouraged, and allowing a free-for-all in internet-driven trading and investment offers, which should not.

Asian policymakers need to develop an information and supervisory infrastructure that keeps pace with development—something that actually is feasible, so long as best practices can be imported and advised and so long as the presumption is "allow but only within the tent." Similar to the old saying "trust but verify," this means that policymakers concerned about financial stability can indicate that they are always open to new products and providers, but only so long as those new offers are under some form of disclosure, monitoring, and clear accountability for losses.

Less financially developed economies whose policymakers eschew financial fads and national champion banks can actually benefit from not having to be at the innovative cutting edge. There is little cost to the economy from using blunter tools than sometimes are available in the most advanced markets and from requiring all financial sector–like developments to be centrally monitored. Disputes over the cost of regulating financial innovation, and the risks that go with excessive game playing, can be left to the handful of global financial centers—so long as the policymaker of developing Asia is committed to ongoing relative innovation, that is bringing the domestic financial sector along toward the frontier of deepening markets. A similar argument is valid for the use of macroprudential tools in terms of blunt instruments to temper large sustained asset price swings: So long as the underlying and general commitment is to market-determined asset prices, financial and monetary policymakers need not worry about the occasional use of overwhelming force to stem, say, real estate bubbles fueled by foreign capital (as in fact a number of Asian authorities are rightly doing at the moment). In a less developed financial system, such tools should be more effective than in economies where financial innovation and globalization shields some financial activities from macroprudential policies' reach. That should give Asian policymakers the confidence to continue to pursue financial development, just not at breakneck speed.

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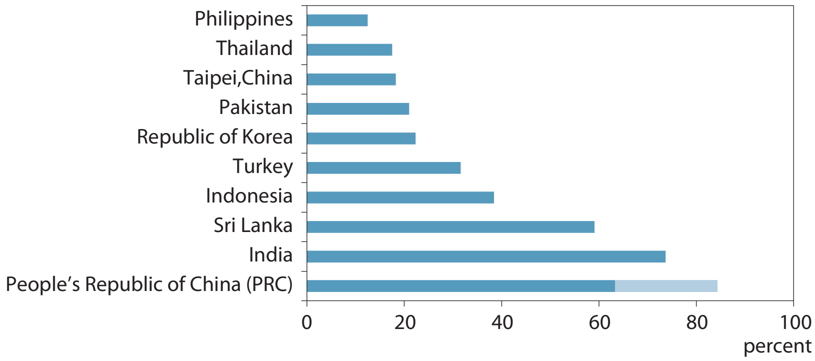
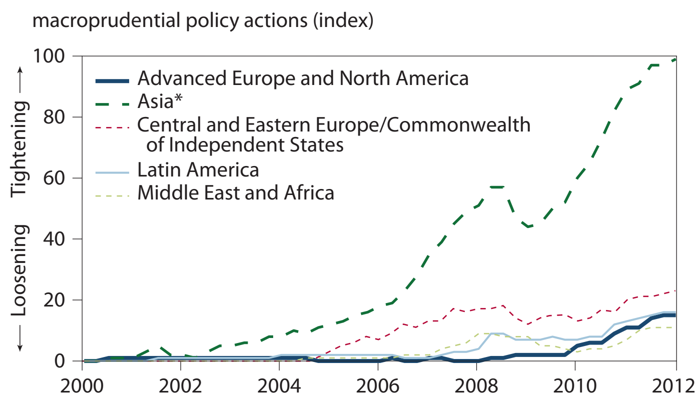
Figure 1 Share of state-owned banks in selected Asian economies



Notes: Ratio of aggregate assets of state-owned banks to total banking assets, as of 2011 (PRC) and 2010 (other countries). The light-shaded section on the PRC bar refers to banks in which a government entity holds a controlling minority stake.

Sources: Opper, Andersson, and Burzynska (2013) and authors' calculations for the PRC; World Bank Banking Regulation and Supervision Survey, 2013, for other economies.

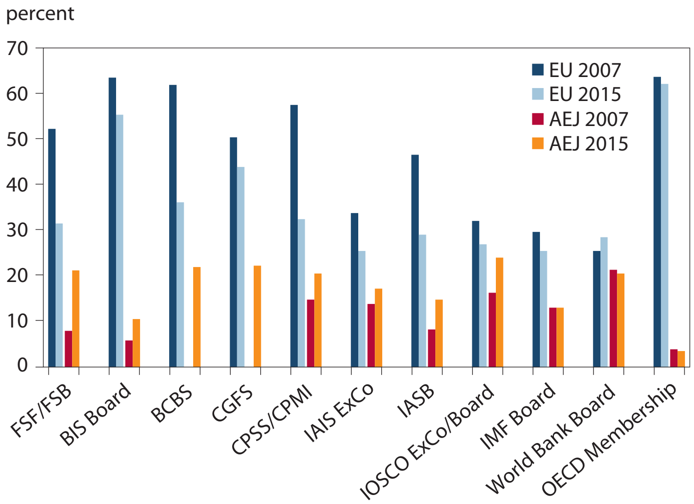
Figure 2 Macroprudential actions in Asia and other regions, 2000–2012



* Economies include the People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Mongolia; Philippines; Singapore; Taipei,China; Thailand; Viet Nam.

Source: Zhang and Zoli (2014).

Figure 3 EU and Asian (excluding Japan) representation in global financial bodies



AEJ = Asia excluding Japan; EU = European Union; FSF/FSB = Financial Stability Forum/Financial Stability Board; BIS = Bank for International Settlements; BCBS = Basel Committee on Banking Supervision; CGFS = Committee on the Global Financial System; CPSS/CPMI = Committee on Payment and Settlement Systems/Committee on Payments and Market Infrastructures; IAIS ExCo = International Association of Insurance Supervisors Executive Committee; IASB = International Accounting Standards Board; IOSCO ExCo = International Organization of Securities Commissions Executive Committee; IMF = International Monetary Fund; OECD = Organisation for Economic Co-operation and Development

Sources: Institutional websites and authors' calculations.