

* Column title, "Equilibrium"

* Suggested story title: Financial Market Reform in Asia

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Financial Market Reform in Asia

Since the global financial crisis, financial institutions and capital markets are perceived to be a mixed blessing by some and outright evil by many others. Nevertheless, a deep, liquid, and innovative financial sector remains a key determinant of economic development. And, although the financial system in Asia was generally resilient during the crisis, as discussed in a recent article in the IMF's Finance and Development—available at <http://www.imf.org/external/pubs/ft/fandd/2010/06/kalra.htm>—financial sector reforms can help reduce the cost of capital, spur investment, and promote rebalancing in Asia.

Asian economies have weathered the onslaught of the latest global downturn with greater ease than in previous crises. Asian firms' finances have improved significantly since the 1997 crisis. Corporate leverage has declined, and profitability and liquidity have increased. Vulnerability indicators have also improved significantly, and default probabilities in the corporate sector are lower than a decade ago. In short, there is evidence of sounder corporate financing practices and strength in a number of Asian countries hit by the crisis. Financial systems in the region are also stronger. In particular, banking systems' financial indicators have improved over the past decade. So Asian economies can now increase investment spending to meet higher demand at home as they rebalance toward domestic sources of growth and make the most of the global upswing.

How Asian countries make use of these opportunities will depend, in part, on how well their financial systems can allocate investable funds across various investment projects, both by reducing the cost of capital and by directing funds to where they are needed most. Financial sector reforms can help with both.

Financial systems in a number of Asian economies are dominated by banks, with small local currency bond markets and little corporate bond issuance within those markets. In the past, such a bank-based financial system was considered safer, but less conducive to economic development, but this needs to be reexamined in light of the recent financial crisis as the distinction between bank and market based systems has become blurred—for example, many banks in Europe are dependent on “wholesale” funding from the capital markets. Other features of the financial system include the fact that stock market capitalization is relatively low in many emerging Asian countries compared with advanced economies in Asia and elsewhere. Foreign participation in the equity and bond markets is also limited. Indeed, large movements in equity prices generated by periodic bouts of capital inflows are in part indicative of the limited depth and breadth of the stock market. All told, a number of Asian countries' financial systems need to grow and diversify.

Firms in Asia do substitute among alternative debt financing options and would actively seek alternatives to bank funding if capital markets were deeper and more liquid. For example,

there was a large—but temporary—spurt in issuance of corporate securities in local currency debt markets in the midst of the global financial crisis in 2008. At the time, these firms’ financing needs were arguably limited, and the issuance of corporate securities reflected greater risk aversion by banks and a shift from bank financing to bond markets to take advantage of lower spreads.

Since equity and corporate bond markets are relatively small in a number of Asian countries, the cost of credit from banks determines the cost of capital. In turn, countries with higher banking costs generally have higher cost of capital. One measure of banking costs is the spread between the interest rate charged by banks on loans to prime customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. Among other factors, this spread reflects information asymmetries between the borrower and the lender, the quality of collateral and protection of lender’s rights, the level and variability of inflation rates, reserve requirements and capital ratios, and the competitiveness of the banking system. As such, a high spread can well reflect prudent banking practices, but there is also considerable evidence that lending margins partly reflect administrative and operating costs and inefficiencies in the intermediation process.

Regarding the latter, the operating costs of banks in many Asian economies are not only high but have also tended to rise in recent years. This may have contributed to the fact that the net interest margins remained high and increased sharply in many countries. This suggests that there is room for Asian financial systems to lower costs and allocate capital more efficiently. Reductions in the cost of banking can be achieved through financial sector reforms to strengthen bank balance sheets, reduce nonperforming loans, and improve credit information. In addition, structural reforms that reduce credit risk—for example, through clearer collateral requirements and bankruptcy procedures—would also help lower lending rates. In some cases, there may be a need for mergers and acquisitions to take advantage of economies of scale, while avoiding creating “too big to fail” institutions or undermining competitiveness more generally. Generally, financial sector development would particularly benefit small and medium-sized enterprises, which are currently often crowded out of bank financing.

Initiatives are already under way in Asian countries—at the national and international levels—to expand and reform financial systems. At the international level, the Asian Bond Market Initiative is an initiative of the ASEAN, China, Japan, and Korea (ASEAN+3) started in 2003. It aims to develop efficient and liquid bond markets in Asia, facilitating use of Asian savings for Asian investments. This initiative has made substantial headway in fostering local currency bond markets. And pan-Asian stock exchanges are being linked to improve the cross-border flow of capital in the ASEAN region. Such reforms in Asia’s financial markets will make them deeper and more efficient. This in turn will help reduce the cost of capital, spur investment, and promote rebalancing in Asia. Furthermore, developing social safety nets and insurance and pension systems can also directly contribute to rebalancing demand in Asia—by reducing pre-cautionary motives to save—and would create additional demand for longer-dated securities thereby fostering capital market development.

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