# Introduction

MARCUS NOLAND and DONGHYUN PARK

This volume revisits the issue of financial sector development in developing Asia. The region's real economy has grown by leaps and bounds in the past few decades. In particular, export-oriented industrialization has transformed the region into the factory of the world, and the People's Republic of China (PRC) and India have emerged as globally significant economic powers. At the same time, Asia's financial system remains underdeveloped relative to those of the advanced economies. Asia's financial weaknesses came to a head during the Asian financial crisis of 1997–98. While the region's financial sector has made tangible progress since that crisis, it remains well behind the global finance frontier. For example, Asia continues to recycle much of its abundant savings through the financial markets of the advanced economies. In light of the stark contrast between a dynamic real economy and a backward financial sector, financial sector development has long been one of the region's salient strategic challenges.

While financial development is thus hardly a new issue for Asia, at least three reasons warrant revisiting it now. Above all, financial development matters for sustaining rapid economic growth. In light of the region's growth slowdown since the global financial crisis of 2007–08, and the vital role of a sound and efficient financial system in growth, now is the perfect time to take a closer look at the role of financial development in the region's growth and development. Secondly, a more inclusive financial system will greatly abet the

*Marcus Noland, executive vice president and director of studies, has been associated with the Peterson Institute for International Economics since 1985. Donghyun Park is principal economist at the Asian Development Bank.*

region's quest for more inclusive growth. Finally, the region must safeguard its financial stability even as it develops its financial system since financial instability, especially financial crises, can derail growth. In short, the convergence of three strategic growth-related challenges—reigniting economic growth, tackling rising inequality, and maintaining financial stability—adds a sense of urgency to the long-standing task of building sound and efficient financial systems in developing Asia.

The visible slowdown of economic growth across developing Asia since the global financial crisis makes it imperative for the region to fully exploit all sources of economic growth. A sounder and more efficient financial sector is one such potential engine of economic growth. One may object that in the past Asia managed to grow rapidly on a sustained basis despite being saddled with a backward financial system. Some observers, in fact, interpret the coexistence of a backward financial system and dynamic real economy in Asia as evidence of the secondary importance of finance. The global financial crisis can, on its surface, serve as an indictment of financial innovation and further fuel skepticism about the benefits of financial development. However, developing Asia grew rapidly despite financial underdevelopment, not because of financial underdevelopment. With a stronger and better financial system, developing Asia may have grown even faster than it actually did. Or, it could have achieved the same level of growth with lower savings and investment—i.e., at a lower cost in terms of foregone consumption.

Therefore, a weak and inefficient financial sector is a luxury that the region can no longer afford. The loss of growth due to financial inefficiencies looms larger when an economy is growing at, say, 5 percent than at 10 percent. Equivalently, the growth dividend from a sounder and more efficient financial system matters more. In addition to a growth slowdown, the region faces the prospect of a different growth paradigm in the future. Sustained rapid growth has catapulted Asia from a capital-scarce, low-income region to an increasingly middle-income capital-abundant region. Going forward, as diminishing marginal returns to capital set in, productivity growth will become more important for economic growth, even though investment and factor accumulation will remain vital. Therefore, to support future growth, Asia's financial system will have to evolve to contribute to productivity growth, in particular R&D and other innovative activities, along with infrastructure and other long-term investments.

Sustained rapid growth has sharply reduced poverty rates in Asia, but the region now faces another difficult challenge, that of rising inequality. In countries that collectively account for over 80 percent of the region's population, the Gini coefficient—a measure of inequality—has worsened between 1990 and 2010. Financial development can affect inequality but the direction of the impact is ambiguous. If financial development creates financial products that largely benefit the rich, then financial development can widen the gap between the rich and the poor. On the other hand, if financial development promotes financial inclusion—i.e., broadens access to financial services to more households and firms—then it can mitigate inequality. For example, in many parts of Asia, only a small proportion of lower-income households have access to financial services. If the poor can borrow to finance their education or health care, they can then accumulate human capital, which, in turn, will enable them to earn more.

Financial development, innovation, and liberalization can entail substantial risk to financial stability. The global financial crisis of 2007–08 highlights the potentially enormous damage that poorly regulated and supervised financial development can inflict on financial stability. Financial crisis, in turn, can have devastating consequences for economic growth. For example, the global financial crisis almost brought the world economy and trade to its knees. Closer to home, the Asian financial crisis of 1997–98 devastated the financial systems *and* real economies of a group of high-flying East and Southeast Asian economies. A major external threat to the region's financial stability in recent times has been quantitative easing (QE) and unwinding of QE in advanced economies, as witnessed during the taper tantrums of May 2013. In addition, a number of homegrown domestic risks to financial stability, such as rapid growth of household debt and the shadow banking system, loom on the horizon. Therefore, the challenge for Asian countries is to further develop their financial sectors while safeguarding them from growth-harming financial instability.

The ten chapters in this volume explore various key dimensions of Asia's high-priority task of building sounder and more efficient financial systems—banks and capital markets—that will help the region sustain growth without sacrificing financial stability. The book is organized into roughly two parts. The first part, consisting of the next five chapters, essentially focuses on the relationship between financial development and economic growth in developing Asia. The second part, encompassing the remaining five chapters, addresses the financial regulatory issues to ensure that financial development delivers growth and not instability.

Chapter 1 by Gemma B. Estrada, Arief Ramayandi, and us provides an overview of the issues. We conclude that the financial systems of developing Asia are well within the global efficiency frontier. The issue for the low-income countries of the region is essentially a lack of finance, while for the middle-income countries the quality, not the quantity, of the financial system is more at issue. And throughout the region, inequality and financial exclusion remain issues for the poor of these societies. From a political economy perspective, addressing these issues has become more difficult, however, as the 2007–08 global financial crisis has given financial sector reform a bad name.

In chapter 2, Estrada, Park, and Ramayandi explore these issues empirically. Their research generally supports the conventional wisdom that financial development is generally good for growth but that the evidence on the relationship between financial opening, defined as increased integration with foreign financial systems, and growth is more ambiguous. They conclude that the composition of the financial system does not matter so much—both direct finance through the capital markets and indirect finance through the banking system can contribute to growth. Indeed, they find that the pro-growth effects of financial development are more pronounced at lower-income levels.

With respect to financial openness, they uncover some evidence that what matters are actual cross-border capital flows, not de jure measures of openness (i.e., nominal openness only really matters when capital begins to flow across borders), and that exchange rate flexibility increases the likelihood that those cross-border flows will support growth. But these conclusions are more provisional.

The next two chapters, by William R. Cline and Joshua Aizenman, Yothin Jinjarak, and Donghyun Park, respectively, delve into these issues in greater specificity and make comparisons between developing Asia and Latin America. In chapter 3, Cline argues that in part due to reforms undertaken in the aftermath of the 1997–98 Asian financial crisis, for the most part the region's financial systems are meeting their most essential task of avoiding crisis. This accomplishment, together with the restoration of growth following the global financial crisis, suggests that on the whole developing Asia's financial systems are performing reasonably well.

For the middle-income countries, strengthening regulatory systems, particularly with respect to nonbank financial intermediaries, is a higher priority than financial deepening per se. Cline also observes that "Clearer resolution plans would also seem prudent considering the potential too-big-to-fail problems," (p. 110) given the degree of bank concentration in some of these economies.

In chapter 4 Aizenman, Jinjarak, and Park examine the "too much finance" argument as it applies to developing Asia. Specifically they investigate the possibility that the relationship between financial sector development and growth may be nonlinear, unstable, and/or vary across different sectors of the economy. As might be expected, their results, particularly with regard to comparisons between developing Asia and Latin America, are not entirely robust. At the most general level they concur with Cline that much of developing Asia has reached the point where the quality of finance matters more than the simple expansion of the financial sector. They also find some evidence, which they term "preliminary," of a financial "Dutch disease" effect: the faster the growth of the financial sector and the wider the lending-deposit spread, the slower the growth of manufacturing.

This theme of the impact of the financial sector on nonfinancial parts of the economy is continued in the final paper of the first part of the volume. In chapter 5 Ajai Chopra addresses the issue of how to structure the financial sector to encourage productivity- and innovation-led growth in developing Asia. He starts from the simple observation that productivity increase is a multifaceted phenomenon requiring a package of interlocking policies or reforms. The particulars and priorities will vary across countries depending on specific circumstances, especially with respect to distance from the technological frontier. Examining developing Asia with regard to these issues, Chopra reaches two broad conclusions. First, given the amount of savings the region generates, the dearth of mechanisms for long-term finance (for infrastructure projects, for example) is remarkable. He makes specific recommendations for financial development in this dimension.

The second broad conclusion is actually a set of recommendations or priorities that vary by level of development. For the poorest countries of the region, conventional banking sector reforms (including the reduction of financial repression) to better mobilize and channel savings into its most productive uses should be at the top of the agenda. For the middle-income countries, capital sector reforms to encourage financial sector deepening and improve access to finance for start-ups and innovative firms and projects become more important.

Finally, for countries approaching the technological frontier, public policy interventions, which may include the encouragement of specialized finance, including public sector finance or incentives, may be more relevant. The experiences of more advanced countries in Asia and elsewhere may be salient in this regard.

The second part of the volume turns from the finance and growth nexus to the nature of financial sector regulation. In chapter 6, Adam Posen and Nicolas Véron observe that while the advanced financial systems of the West triggered the global financial crisis, "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" (p. 230). (They advise that poorer countries may actually benefit from not being at the cutting edge of finance.) So how to square the desire to have world-class financial systems with the maintenance of stability?

The authors survey recent global financial developments and offer some guidelines for developing Asia in making these choices. In summary, these are that (1) financial systems centered around banks are not inherently more stable than ones with a greater role for direct finance; (2) domestic financial systems should be diversified in terms of available instruments and number of institutions (and therefore probably types of institutions as well); (3) financial repression should be oriented toward activities of managers and institutions, not lending-deposit spreads; (4) cross-border lending may be limited but local-currency lending and bond issuance by multinational banks' subsidiaries should be encouraged; and (5) the efficacy of macroprudential tools varies depending on circumstance, but they may be particularly useful in dealing with real estate booms/busts. Finally, Posen and Véron conclude that developing Asian policymakers, indeed policymakers globally, should carefully monitor the use and impact in finance of advances in information technology in the next few years.

In chapter 7, Michael J. Zamorski and Minsoo Lee narrow the focus to the key issue of bank supervision. They survey developments in international bank supervision standards focusing on the Bank for International Settlements' Basel Core Principles (BCP), which form the touchstone of effective bank supervision. In their analysis the authors emphasize the role of external policy anchors in leveraging domestic reform efforts. They make a number of recommendations for developing Asia, which might be summarized into four broad areas: (1) adopt international banking standards and conduct self-assessments to ensure compliance with the BCP, involving outside assessors as necessary; (2) ensure that legal powers exist to permit comprehensive assessments, including of bank affiliates and unregulated entities, both by domestic authorities broadly defined and their foreign counterparts; (3) equip domestic authorities with necessary surveillance methods to implement adequate microprudential and macroprudential risk assessments; (4) ensure that domestic authorities are adequately resourced and trained to proactively assess bank strategy and risk-taking beyond simple compliance; (5) and, reminiscent of arguments made by Cline, require that well-defined crisis management and resolution plans be in place and that domestic law provide for timely interventions and resolutions of nonviable banks.

In chapter 8, Morris Goldstein addresses the role of bank stability from another perspective, asking what developing Asia might usefully learn from the stress test exercises conducted in the United States and European Union. He derives five basic lessons: (1) stress tests are a useful tool, more flexible than the Basel Accords discussed in the previous chapter; (2) that said, the usefulness of these tests depends importantly on their design, and the general failure of stress tests conducted prior to the global financial crisis to provide early warning of bank vulnerability demonstrates that the specifics of the exercise are crucial; (3) when capital shortfalls are identified in the tests, the remedies should be implemented in a growth-consistent way, defining capital adequacy in absolute terms, and avoiding increases in capital ratios through cutting back on loans, manipulating risk weights, or fire-sale of assets; (4) because assessing risk weights is difficult and empirically leverage ratios have done a better job of identifying problem banks, these should be included in stress tests; and (5) because the Basel III capital adequacy targets are inadequate, Asian policymakers (and indeed policymakers globally) should gradually increase the capital adequacy standards in stress tests.

Chapter 9, by Nicholas Borst and Nicholas Lardy, marks a thematic departure from the previous chapters by focusing on the financial sector in a single, albeit crucial, country, the People's Republic of China. The PRC's financial sector is globally important: Its banking sector is the largest in the world, and its capital markets have approached the size of those existing in advanced countries. Certain characteristics of the financial sector (its large size at early stages of development and its orientation toward corporate rather than household borrowers) distinguish it from those prevalent in other parts of developing Asia, but Borst and Lardy derive three transferable lessons. First, it is possible to rapidly improve the efficiency of state-owned banks. (In chapter 3 Cline also notes the prevalence of and concerns about state-owned banks elsewhere in Asia.) Second, while Chinese gradualism is often held up as preferable to "big bang" type reform, there are risks to moving too slowly, and some of the problems evident in the Chinese financial system today are the result of excessively deliberate and incremental change. The final lesson, as the authors put it, is “the difficulty of rooting out implicit guarantees and moral hazard in a financial system dominated by state-owned actors” (p. 343)—a recurring theme in this volume.

Having examined banking issues in depth, the book concludes with an analysis of bond market development by John D. Burger, Francis E. Warnock, and Veronica Cacdac Warnock. Contrary to the conventional wisdom of as recently as a decade ago that emerging markets would never develop local-currency bond markets, the growth of these markets in developing Asia has been notable. This development is significant because as noted in several other chapters in this volume, robust bond markets are a component of a well-diversified financial system. Moreover, the characteristics associated with the growth of local bond markets are also associated with improved financial inclusion more generally, as well as reduced reliance on borrowing in foreign currency–denominated instruments. The latter development naturally ameliorates currency mismatches and concomitantly should reduce the likelihood of financial crisis and enhance macroeconomic stability. In short, the concluding chapter documents trends, which if sustained, augur well for the ability of developing Asia to achieve growth, inclusion, and stability.