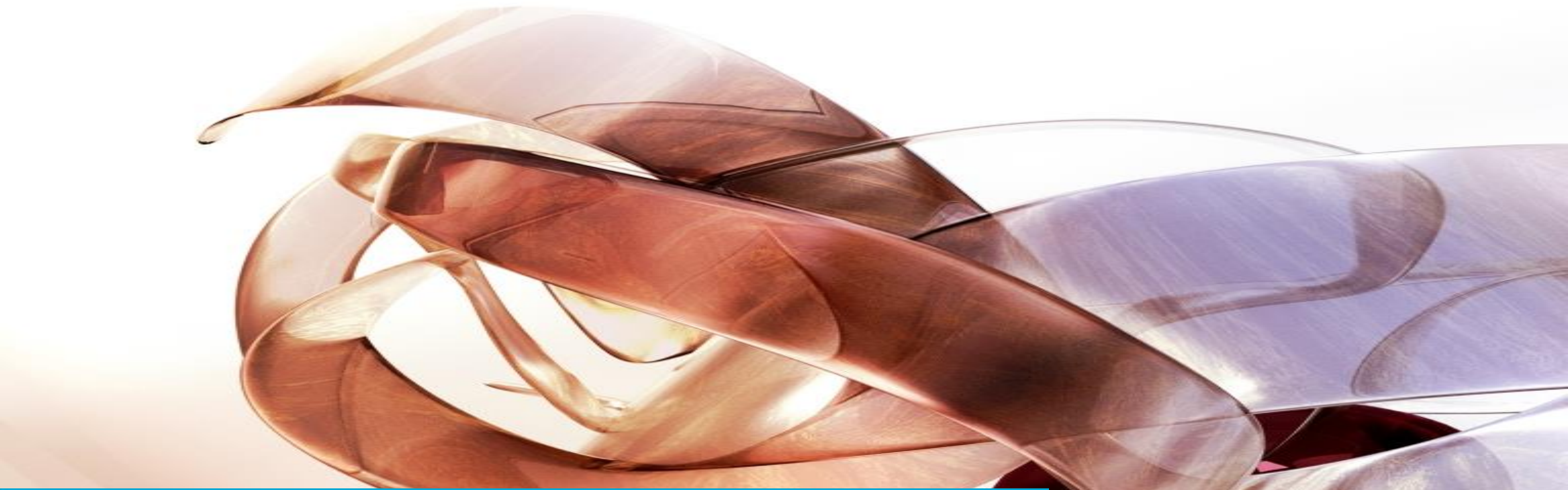

ASIAN DEVELOPMENT OUTLOOK 2015

FINANCING ASIA'S FUTURE GROWTH

ASIAN DEVELOPMENT BANK

Asian Development Outlook 2015: Financing Asia's Future Growth

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GRIPS,
Tokyo, Japan, 15 May 2015

Outline

- **The case for financial sector deepening in Asia**
- Financial development for growth
- Financial access for inclusion
- Financial stability to safeguard inclusive growth
- Financing Asia’s future growth: key overall messages

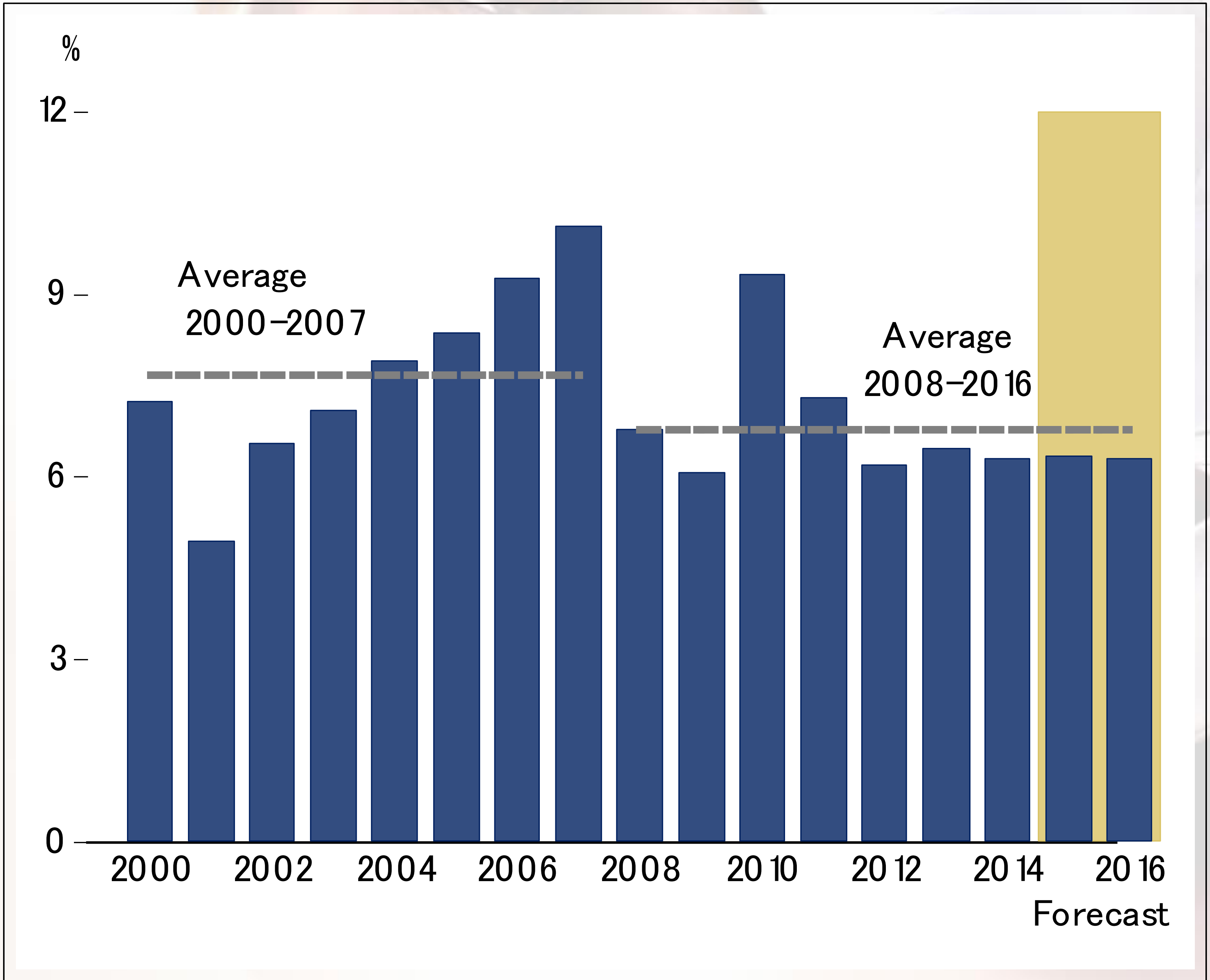
Case for financial development

- Real-financial dichotomy in developing Asia
  - Dynamic real economy versus backward financial system
  - This is an old issue, so why re-visit it now?
- The global financial crisis (GFC) gave finance a bad name
  - Sophisticated financial innovations triggered GFC
  - Too much finance?

Case for financial development

- But Asia is well inside the global finance frontier
  - Asia is not New York or London
  - In Asia, financial development refers to much more basic task of building up a sound and efficient financial system
- More fundamentally, finance can give Asia a growth dividend
  - Asia's growth has slowed down since GFC
  - In the past, Asia grew rapidly *despite* a backward financial system, not *because* of it
  - Therefore, the case for financial development is stronger now than ever before

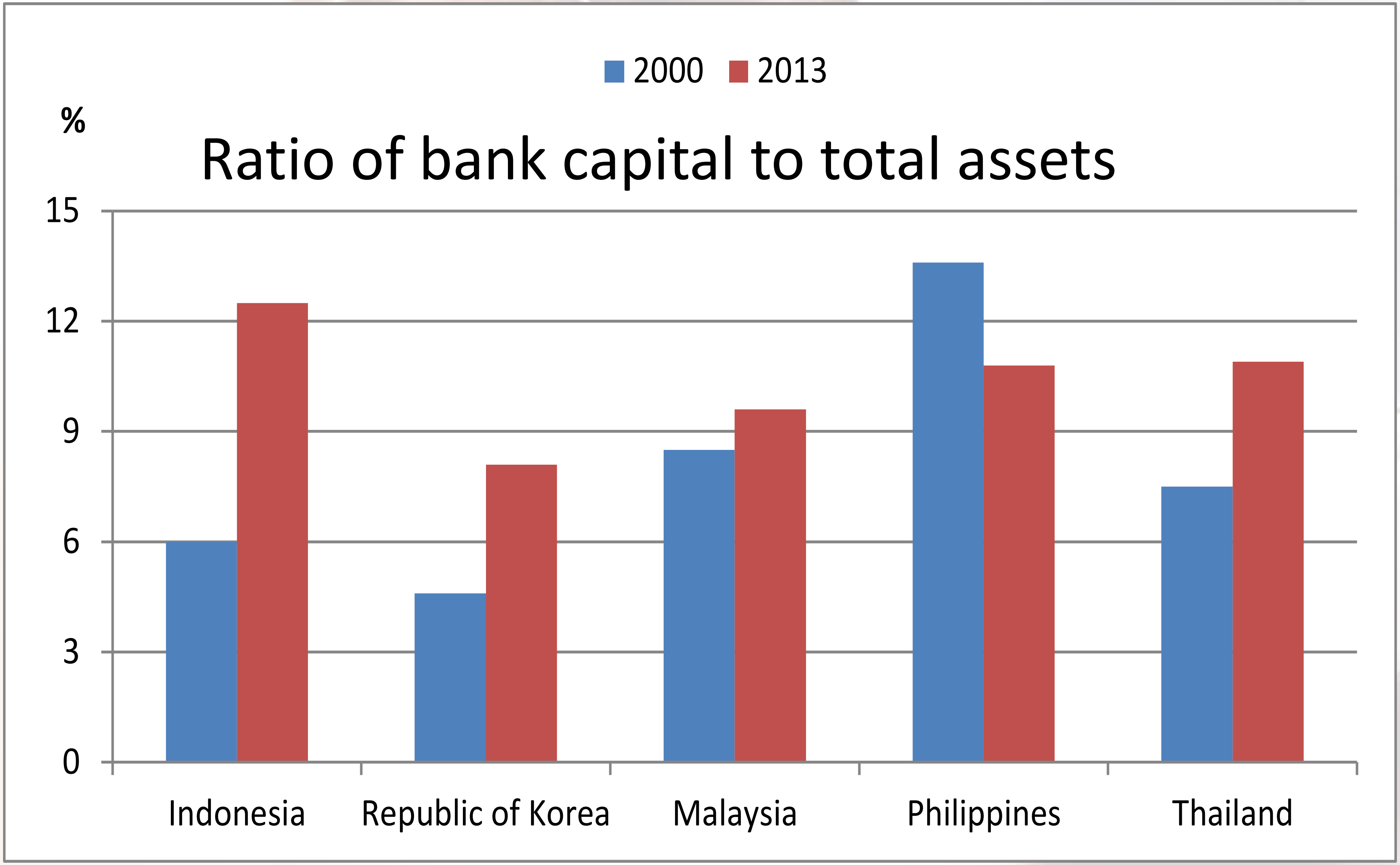
Asia's growth decelerated since GFC



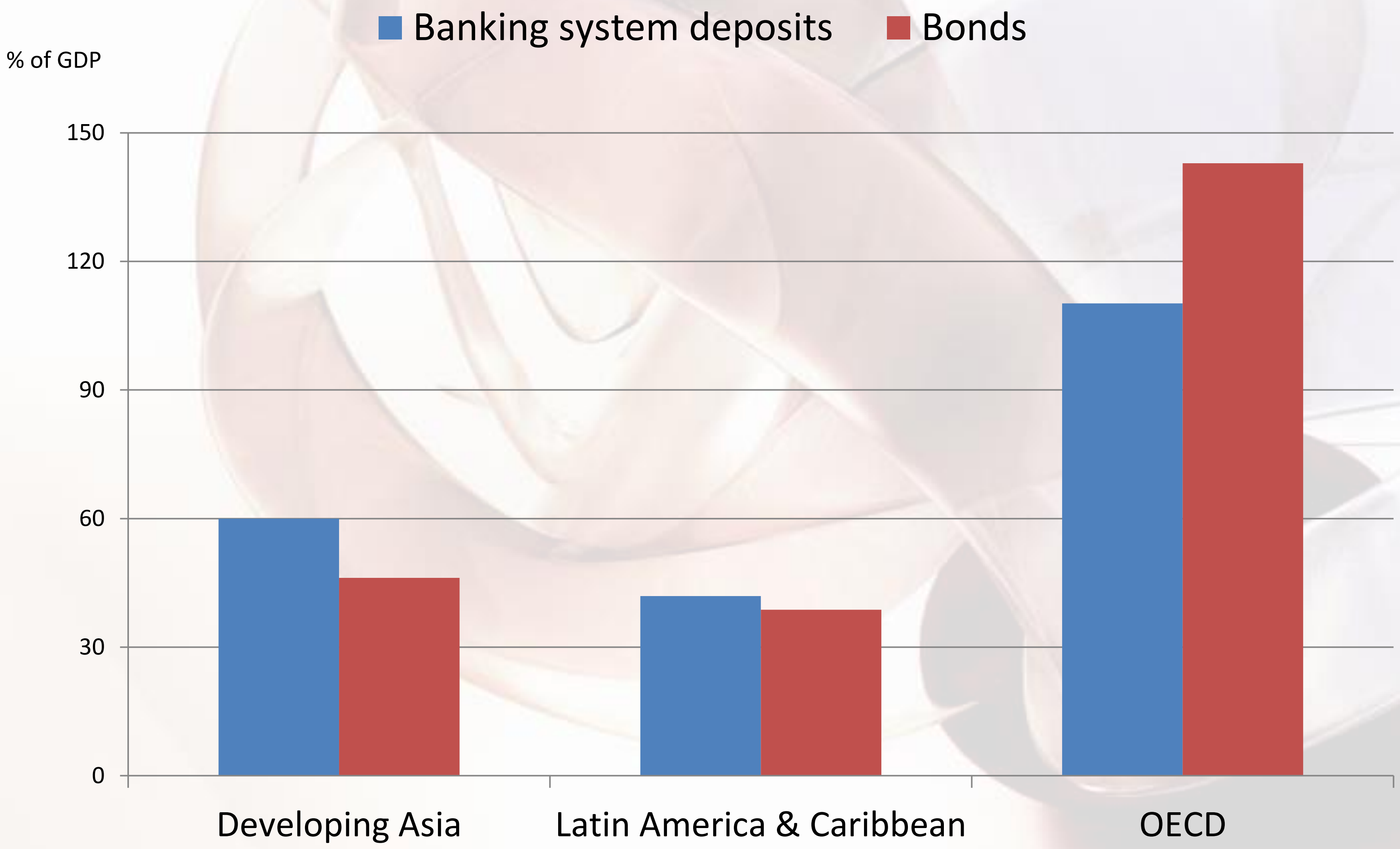
Case for financial development

- In addition, financial development can contribute to equity and stability
  - Government must take action to foster inclusive finance
  - Safeguarding financial stability promotes both growth and equity
- Convergence of 3 strategic challenges adds sense of urgency to financial development
  - Re-igniting growth
  - Tackling rising inequality
  - Maintaining financial stability

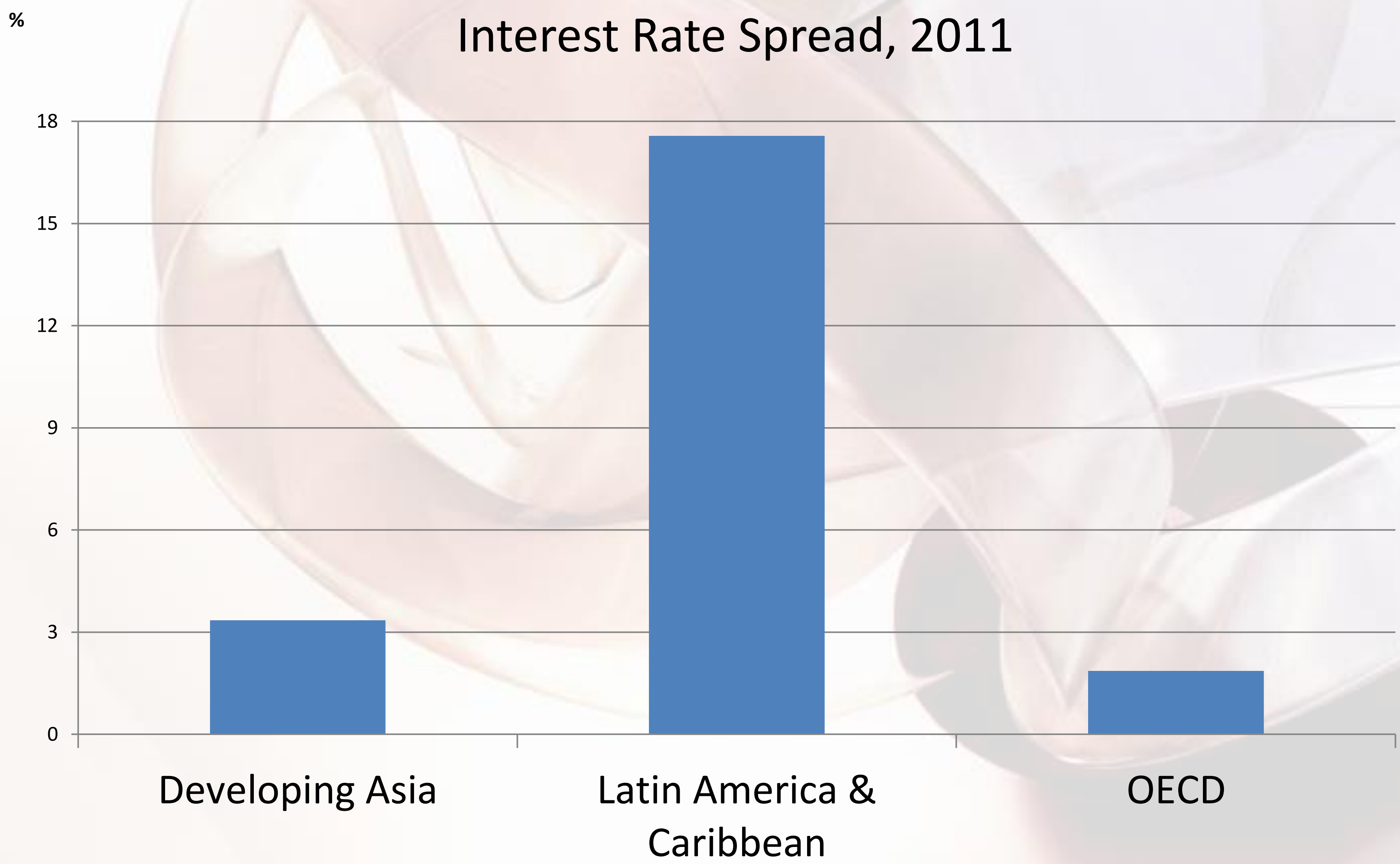
Asia's finance has improved since AFC.....



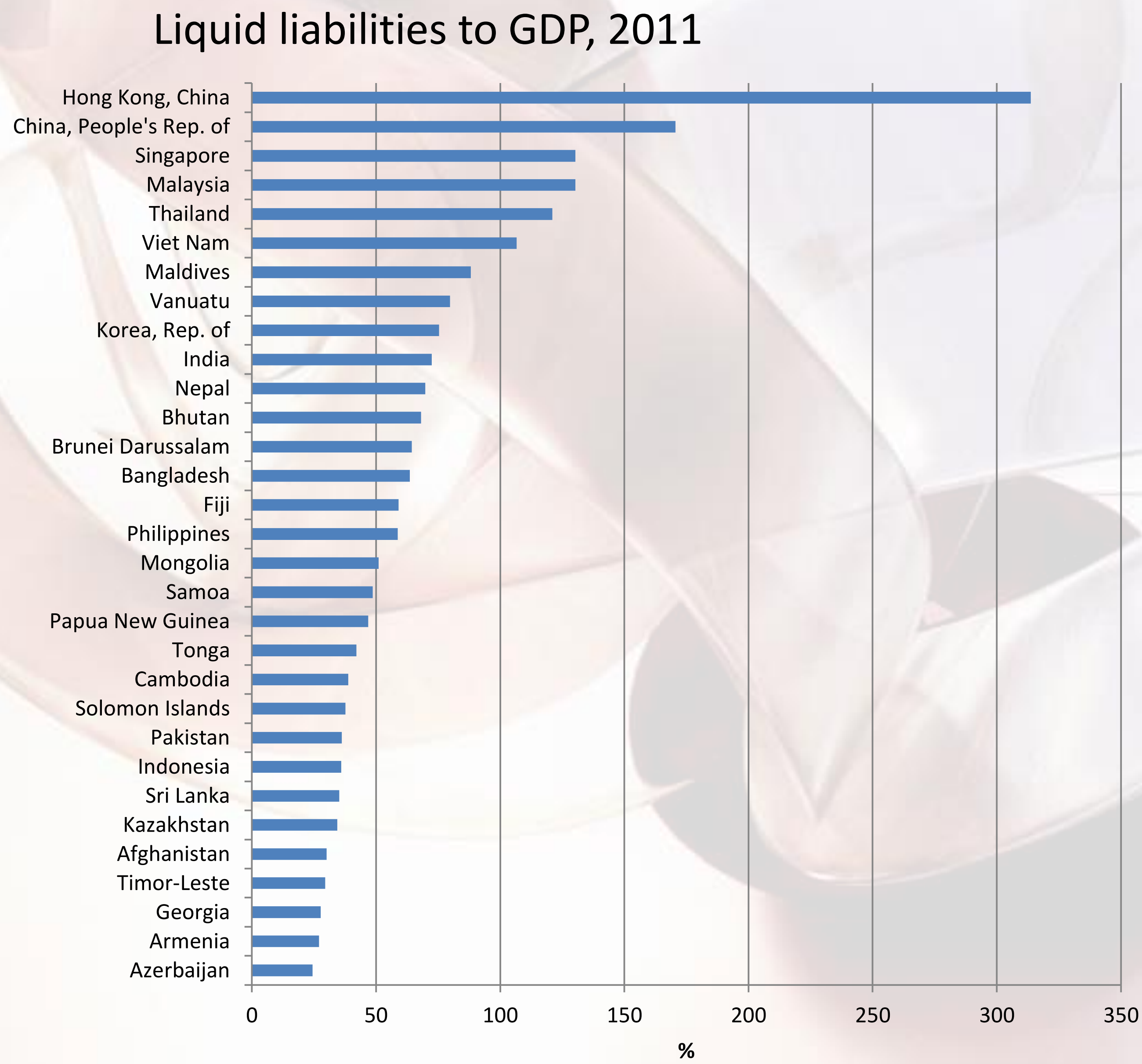
…..but still lag OECD economies in size



…..and in efficiency

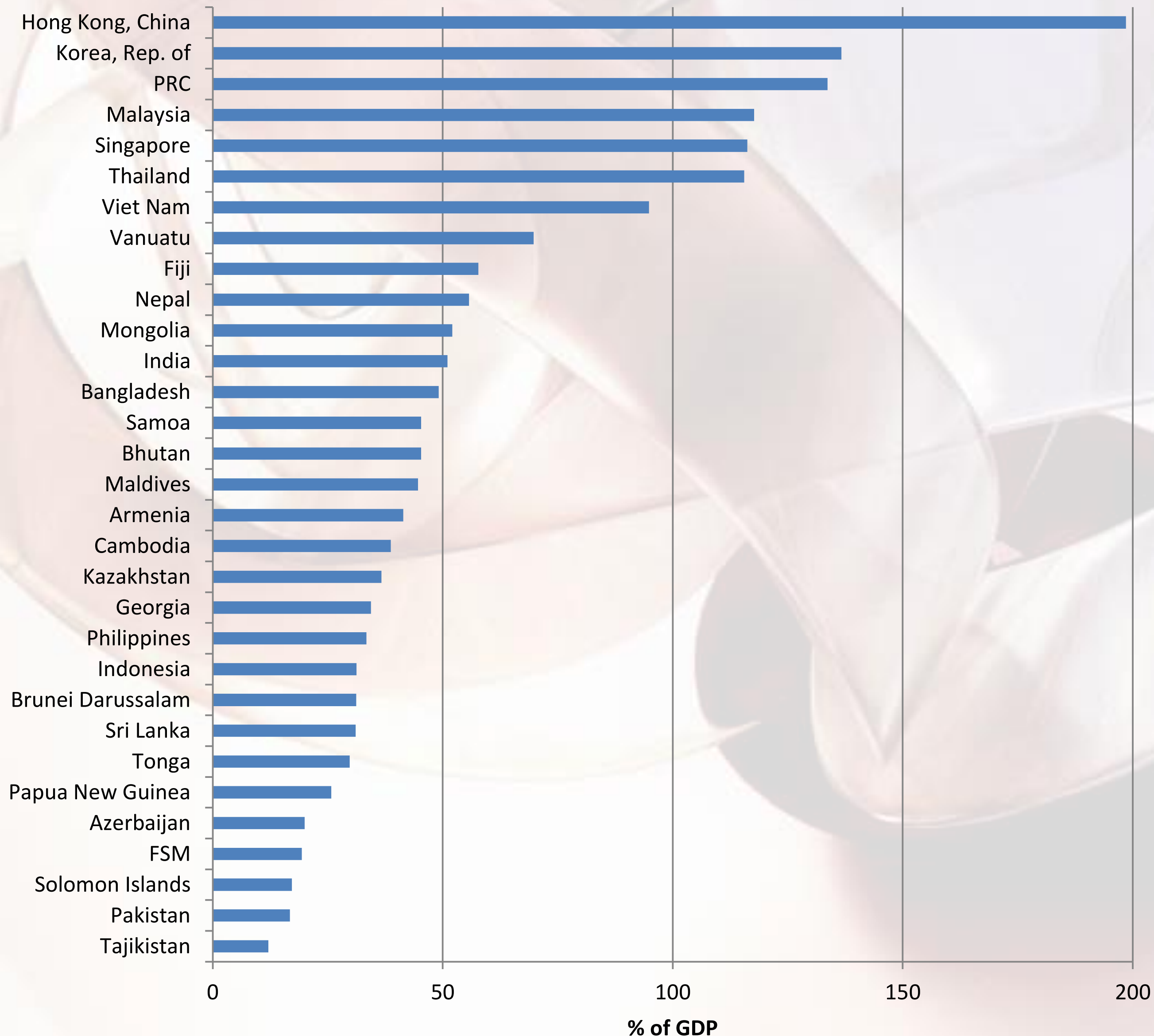


And, while Asia performs well relative to other developing regions…..



….the favorable aggregate picture masks enormous heterogeneity

Private credit to GDP, 2012

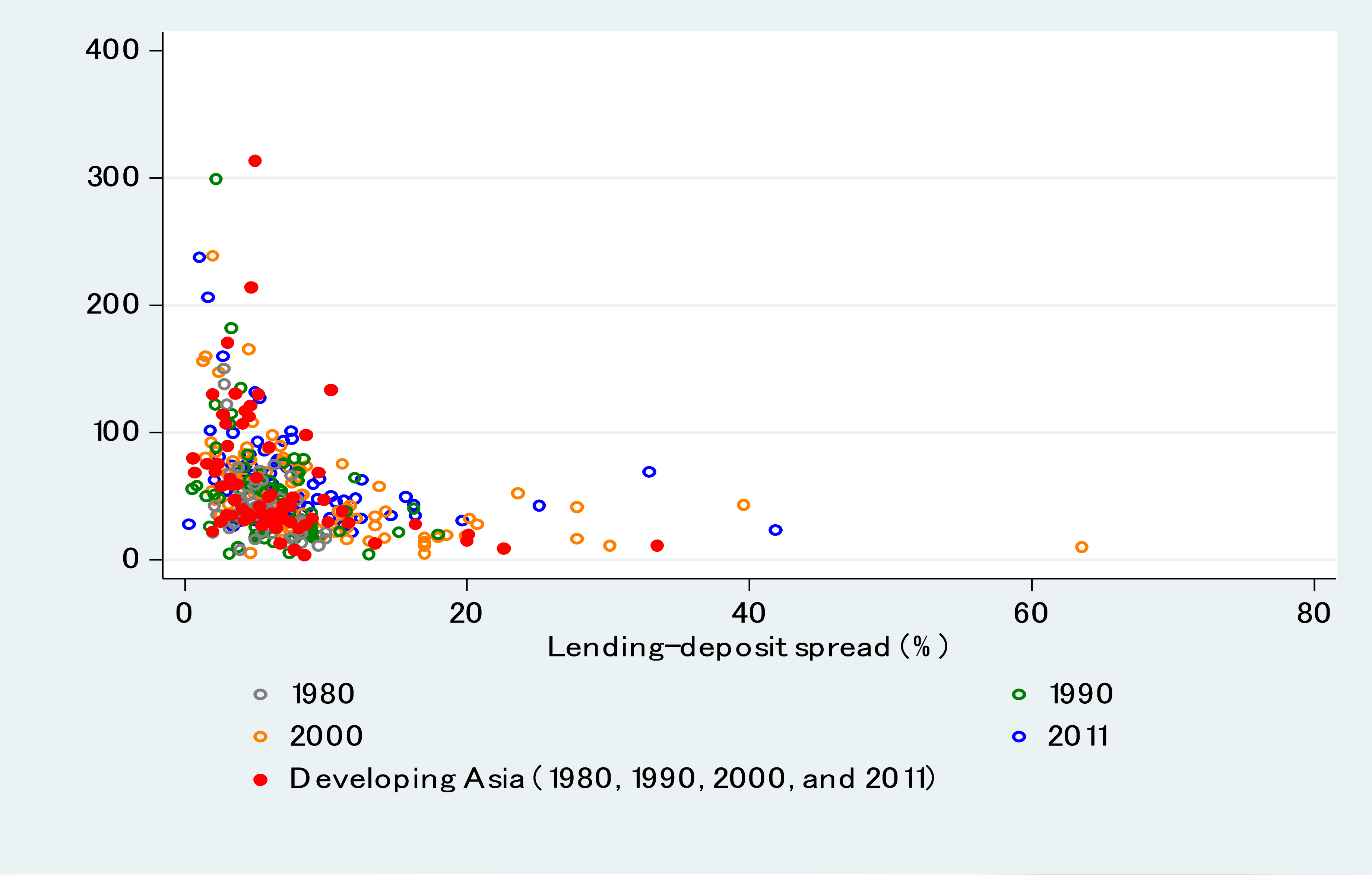


Evidence confirms growth benefits of finance

- Many cross-countries support a positive impact of financial depth on growth
  - King and Levine (1993), Rajan and Zingales (1998), Beck and Levine (2004), Cihak, Demirguc-Kunt, Feyen, and Levine (2013)
  - Arcand at al (2012), Cecchetti et al (2012), and others find a non-linear relationship
- Two big problems with the literature
  - Measures of financial development or financial depth are highly imperfect
  - Two-way causality → growth may promote finance too

Evidence confirms growth benefits of finance

Measurement problems, but a roughly suggestive correlation…..



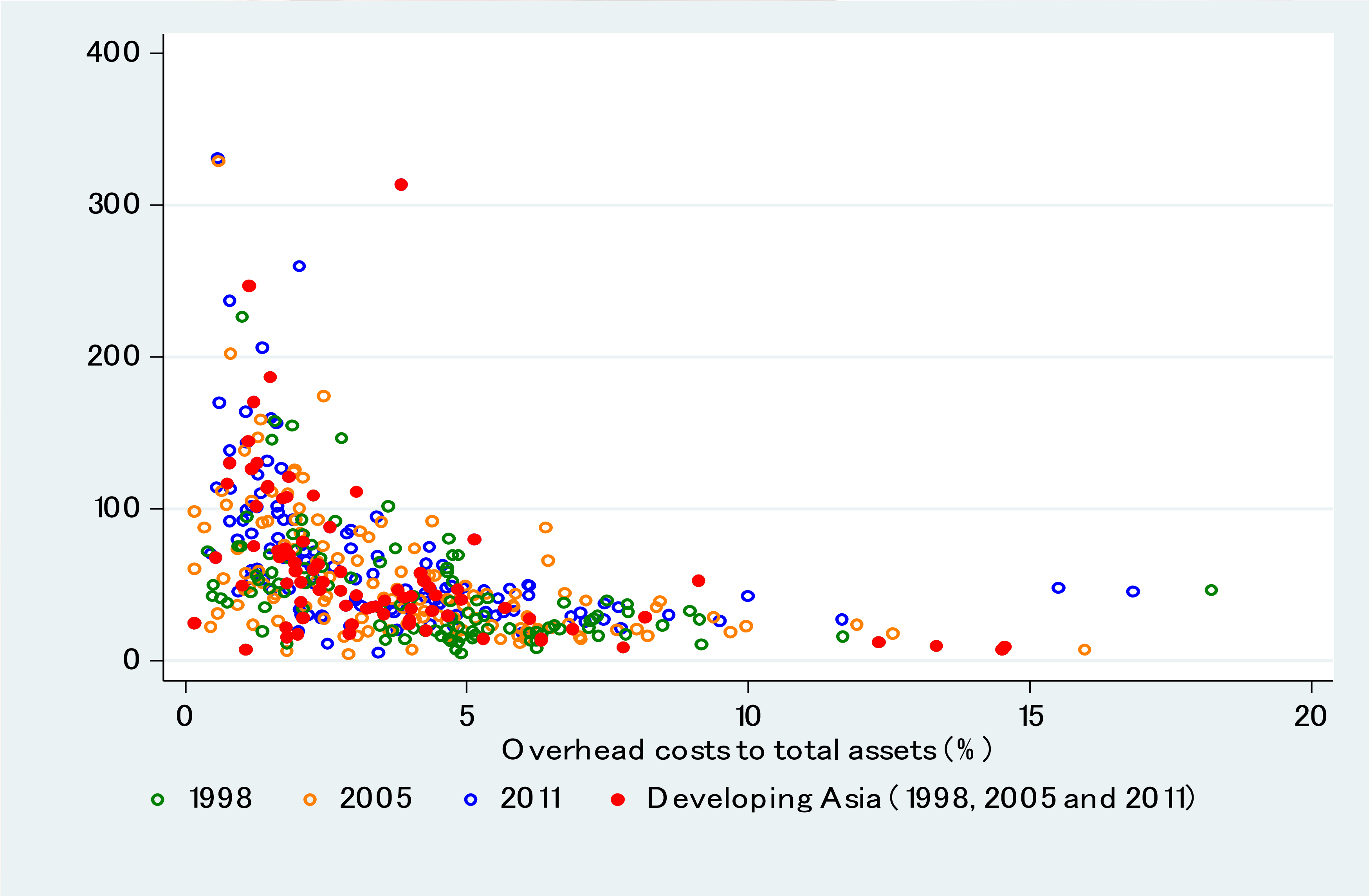
Evidence confirms growth benefits of finance

- Estrada, Park, and Ramayandi (2015) perform additional empirical analysis
  - Updates data to 2011, and expands sample to 108 countries [20 from Asia]
  - Incorporates country characteristics → e.g. developed vs developing
  - Incorporates financial openness
  - Incorporates foreign exchange rate regime
  - Use GMM to address endogeneity

Evidence confirms growth benefits of finance

- Key results from Estrada, Park, and Ramayandi (2015)
  - Re-confirm positive effect of financial depth on economic growth
  - Positive effect is especially evident in developing countries, especially Asia
  - Both banks and capital markets have a positive impact
  - Financial openness has a positive effect
  - Foreign exchange regime is insignificant

Measurement problems, but another roughly suggestive correlation…..



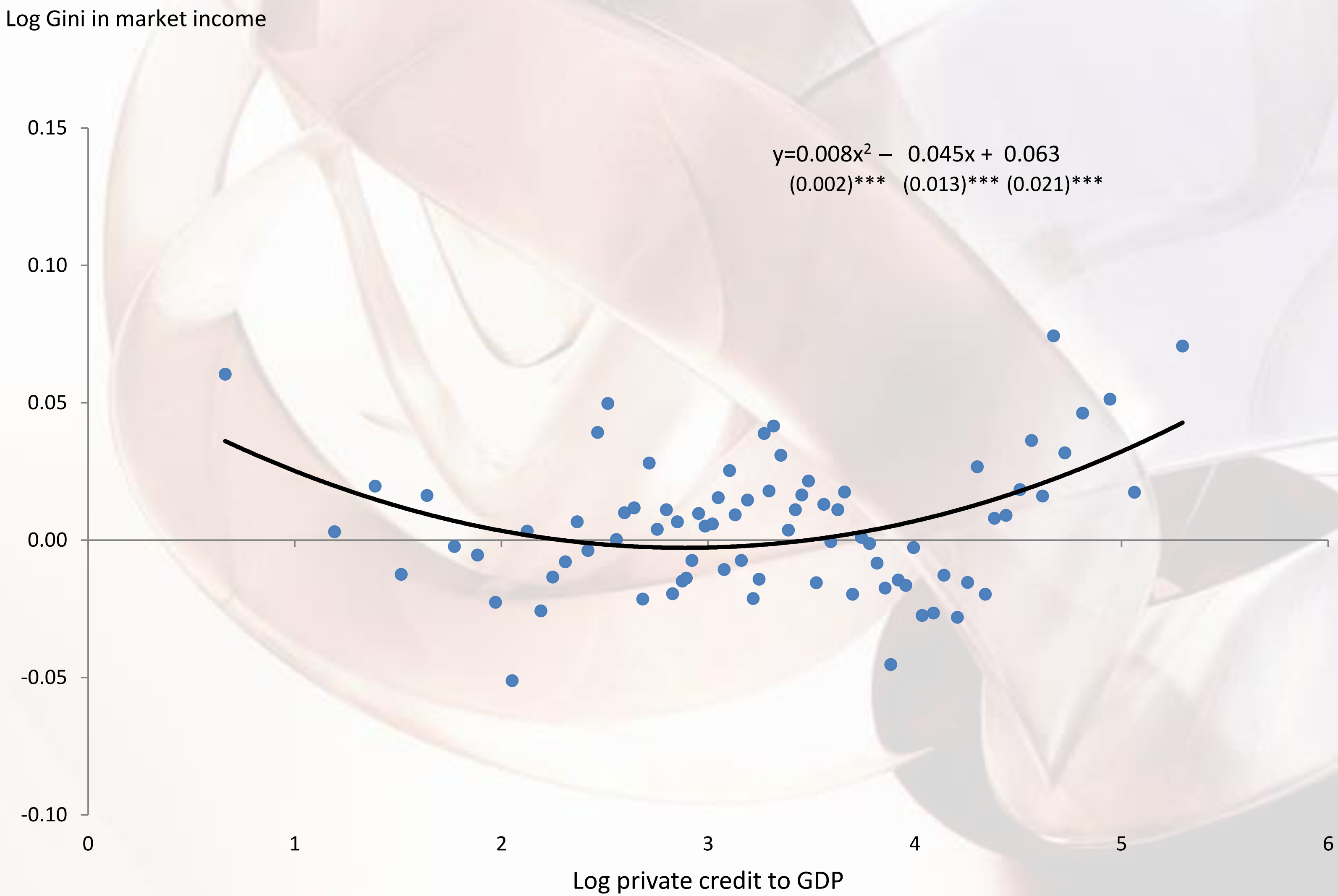
Evidence confirms growth benefits of finance

- Key results from Estrada, Park, and Ramayandi (2015)
  - For example, boosting developing Asia's average ratio to GDP of liquid liabilities—currency plus checking and interest-bearing accounts in financial institutions—from about 65% to 75% adds almost 0.4 percentage points to average annual growth of GDP per capita.

Finance-equity link is conceptually ambiguous

- Conceptually, finance can either reduce inequality or worsen inequality
  - Financial development can reduce inequality if it leads to more and better financial services to the poor
    - The poor can borrow to finance their education
  - On the other hand, financial development can worsen inequality if it mainly raises returns to capital or the pay of financial professionals
    - The US before the global financial crisis

Empirical evidence is mixed too



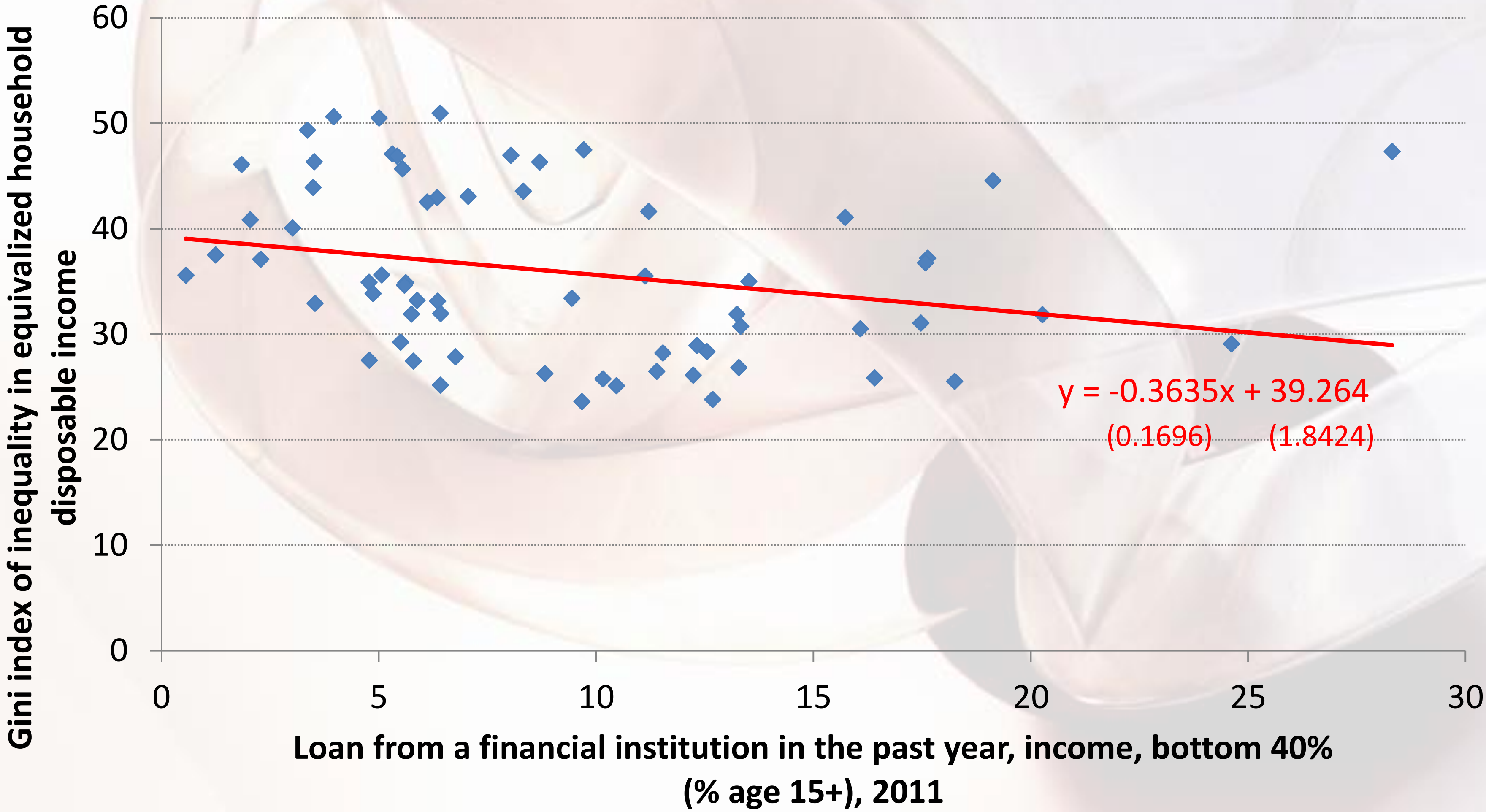
Park and Shin (forthcoming)

Empirical evidence is mixed too

- More precisely, we find evidence of a U-shaped relationship
  - Financial development reduces inequality, but only up to a point
- Financial development does not necessarily promote equity
- Therefore, it must be accompanied by concerted government efforts to boost financial inclusion

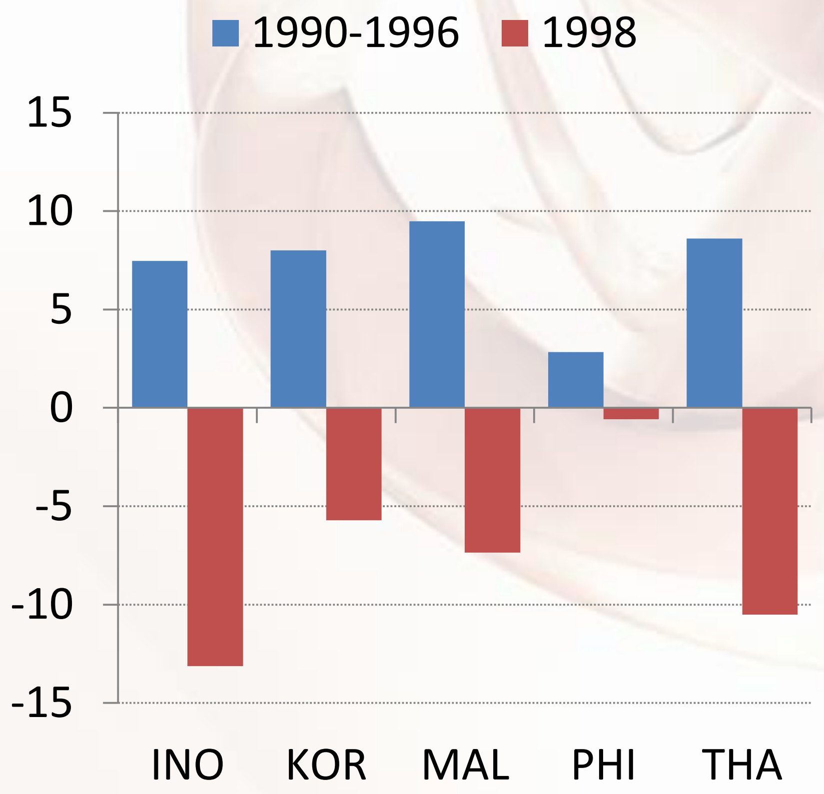
Finance-inequality nexus

Negative correlation between
income inequality and financial inclusion



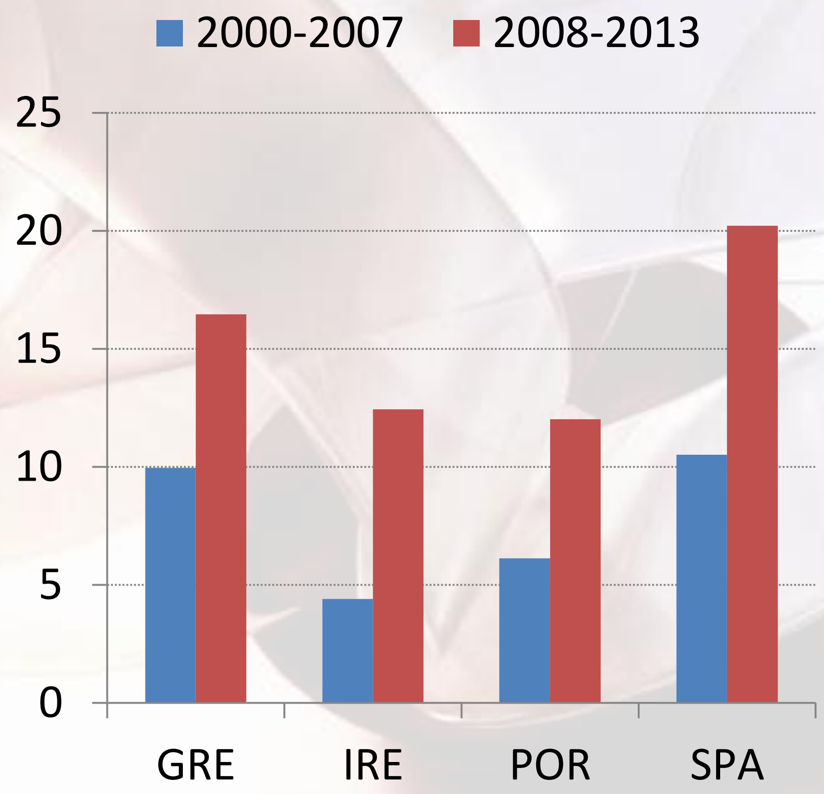
Financial instability harms growth, and exacerbates poverty and inequality

Pre- and post-Asian financial crisis growth rates



INO=Indonesia; KOR=Korea, Rep. of; MAL=Malaysia; PHI=Philippines; THA=Thailand

Pre- and post-global financial crisis unemployment rates



GRE=Greece; IRE=Ireland; POR=Portugal; SPA=Spain

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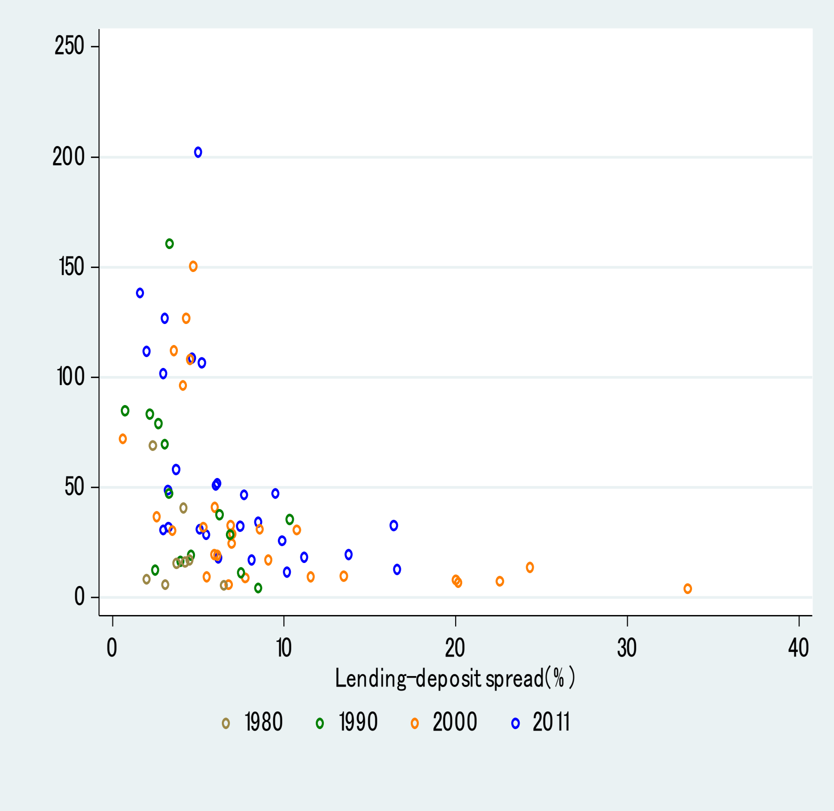
Financial development for growth

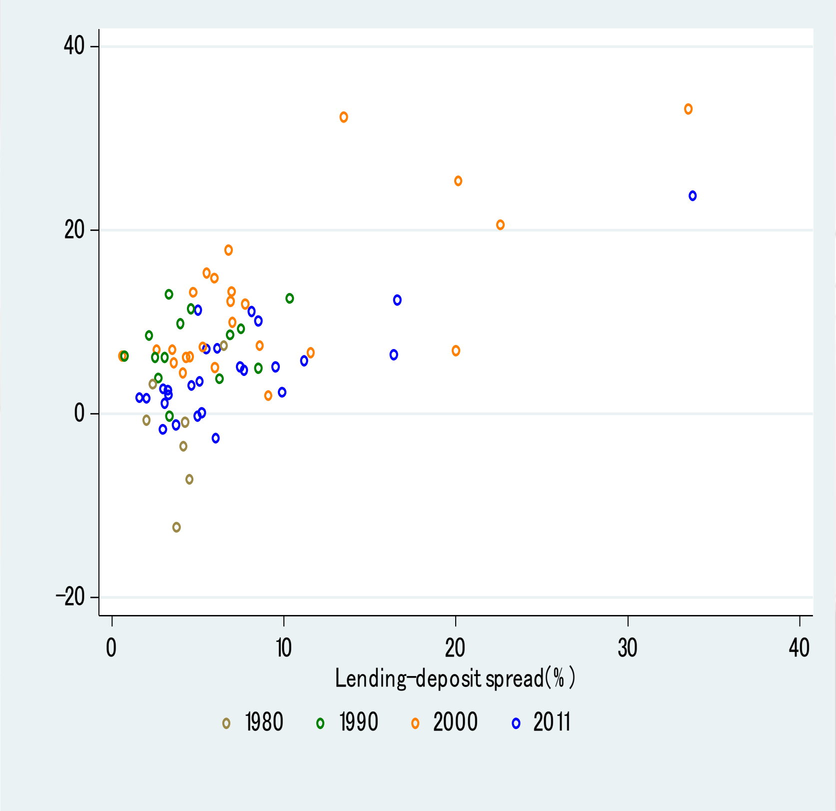
- Ample and efficient finance boosts investment, productivity, and growth
- Banks underlie sound and efficient financial systems in Asia
- Capital built by long-term finance is vital for productivity growth and innovation
- Bond market development deepens pool of long-term financing
- The approach to developing the financial sector must fit each country’s circumstances

Financial sector efficiency raises credit availability and lowers credit cost

Private credit and lending-deposit spread, developing Asia

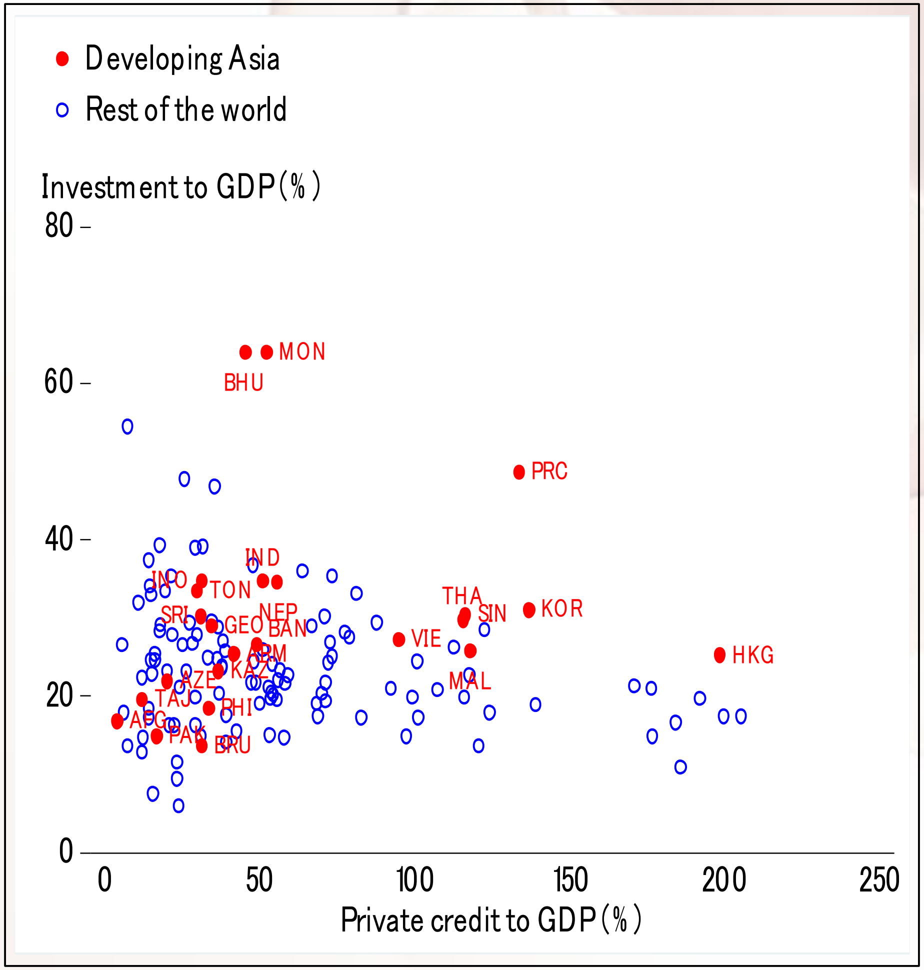


Real lending rate and lending-deposit spread, developing Asia

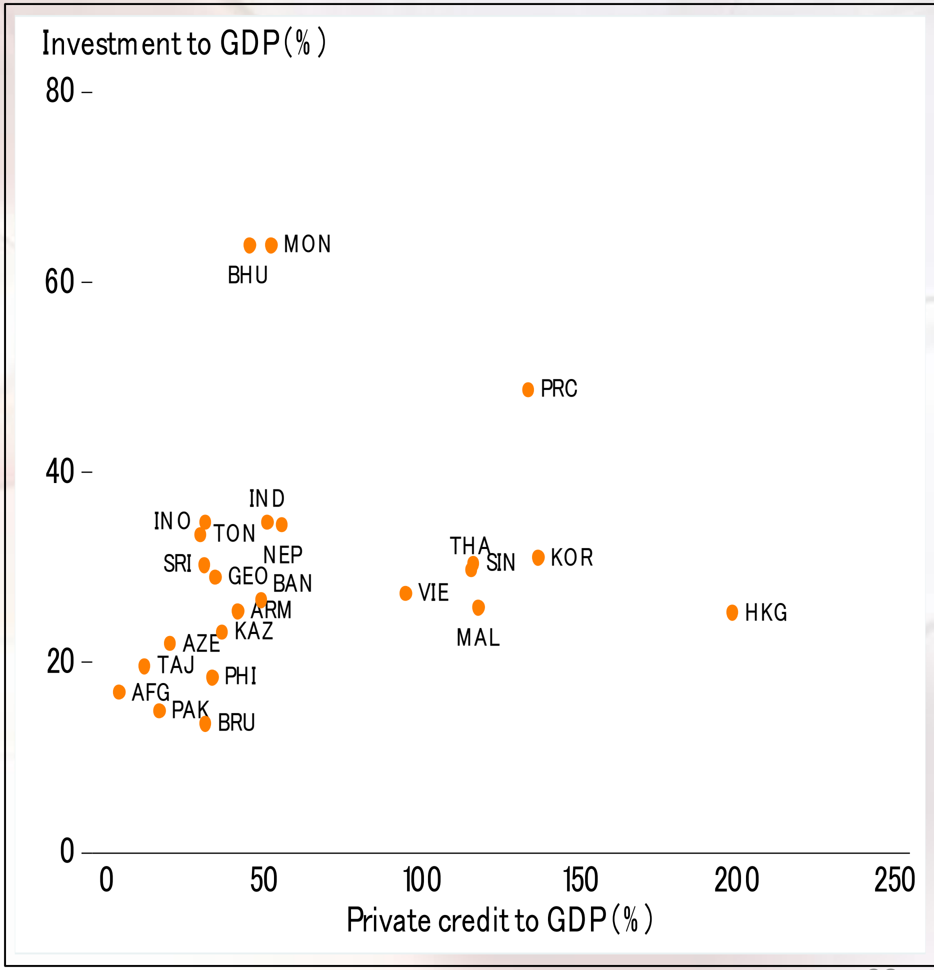


Tighter link between finance and investment in Asia than elsewhere

All countries

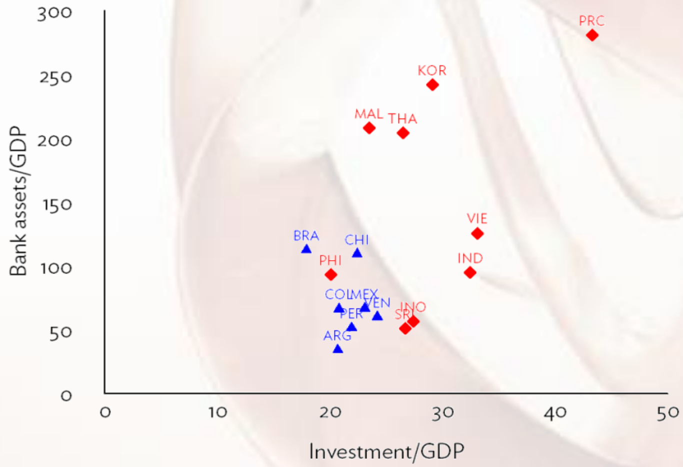


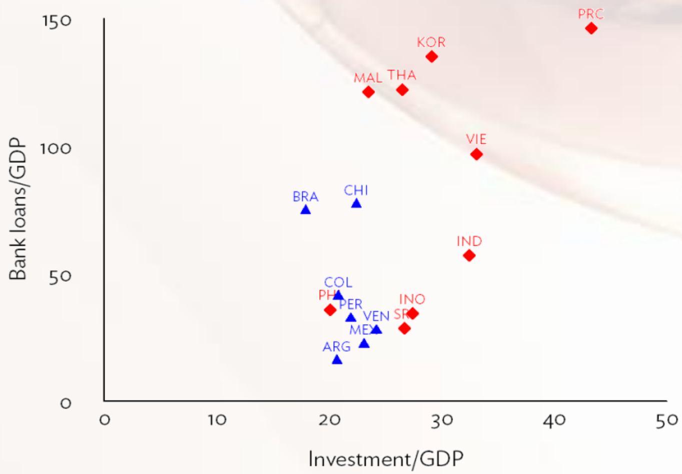
Developing Asia



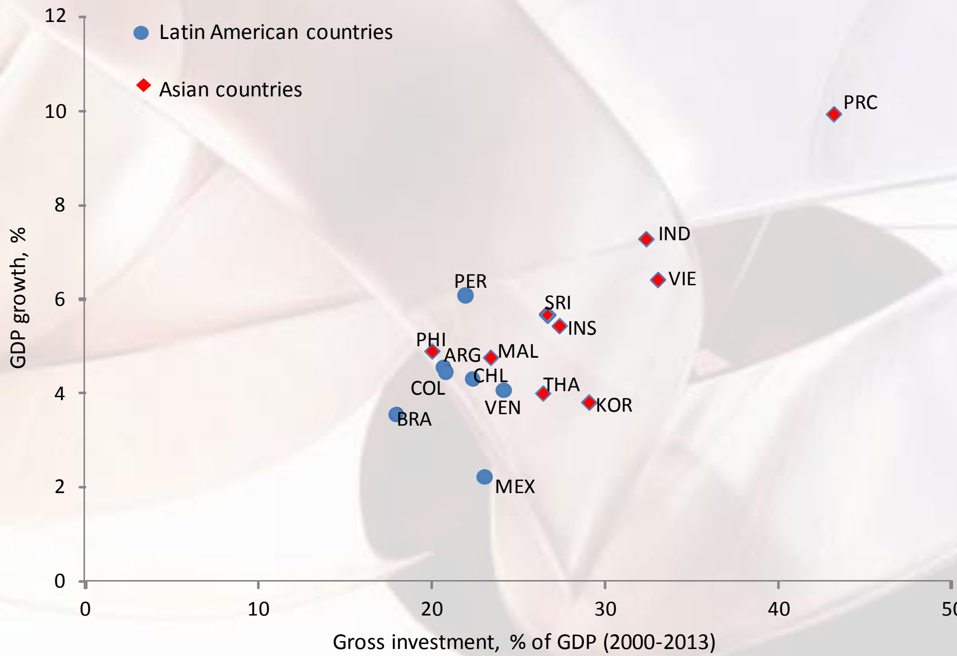
Banking sector development contributes to investment, which feeds into growth

Banking sector and investment

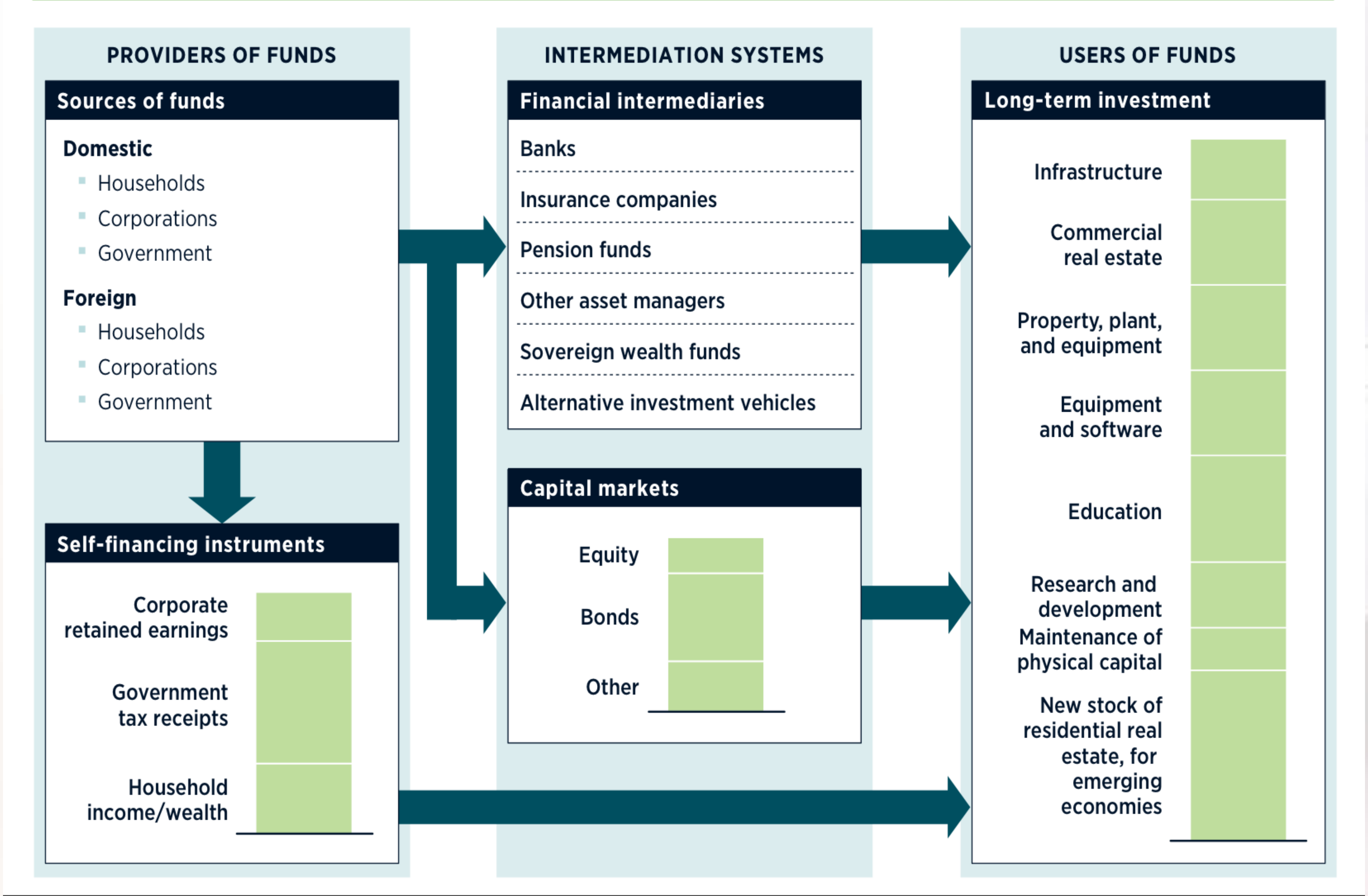




Investment and economic growth

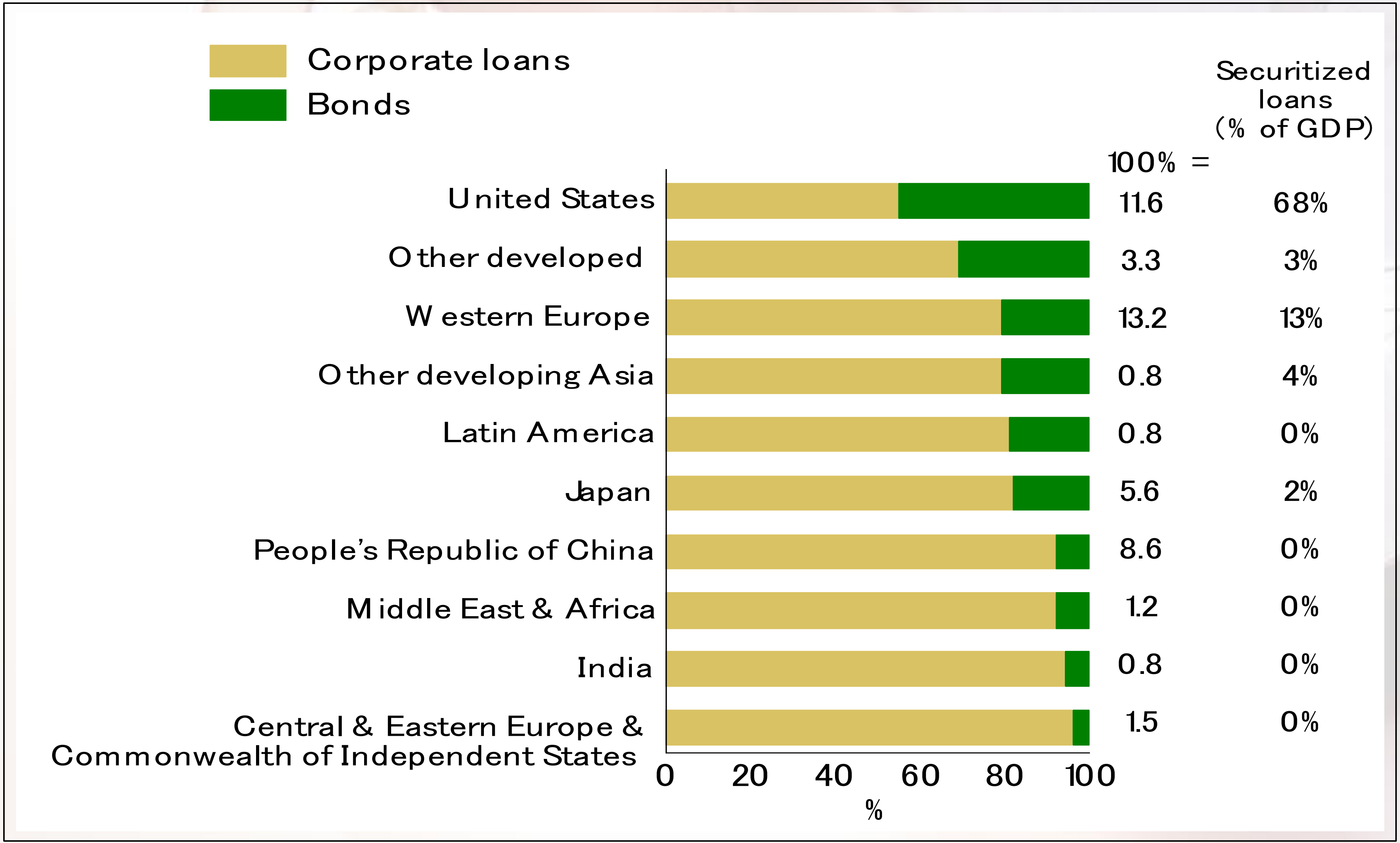


Long-term finance and investment enhance productive capacity



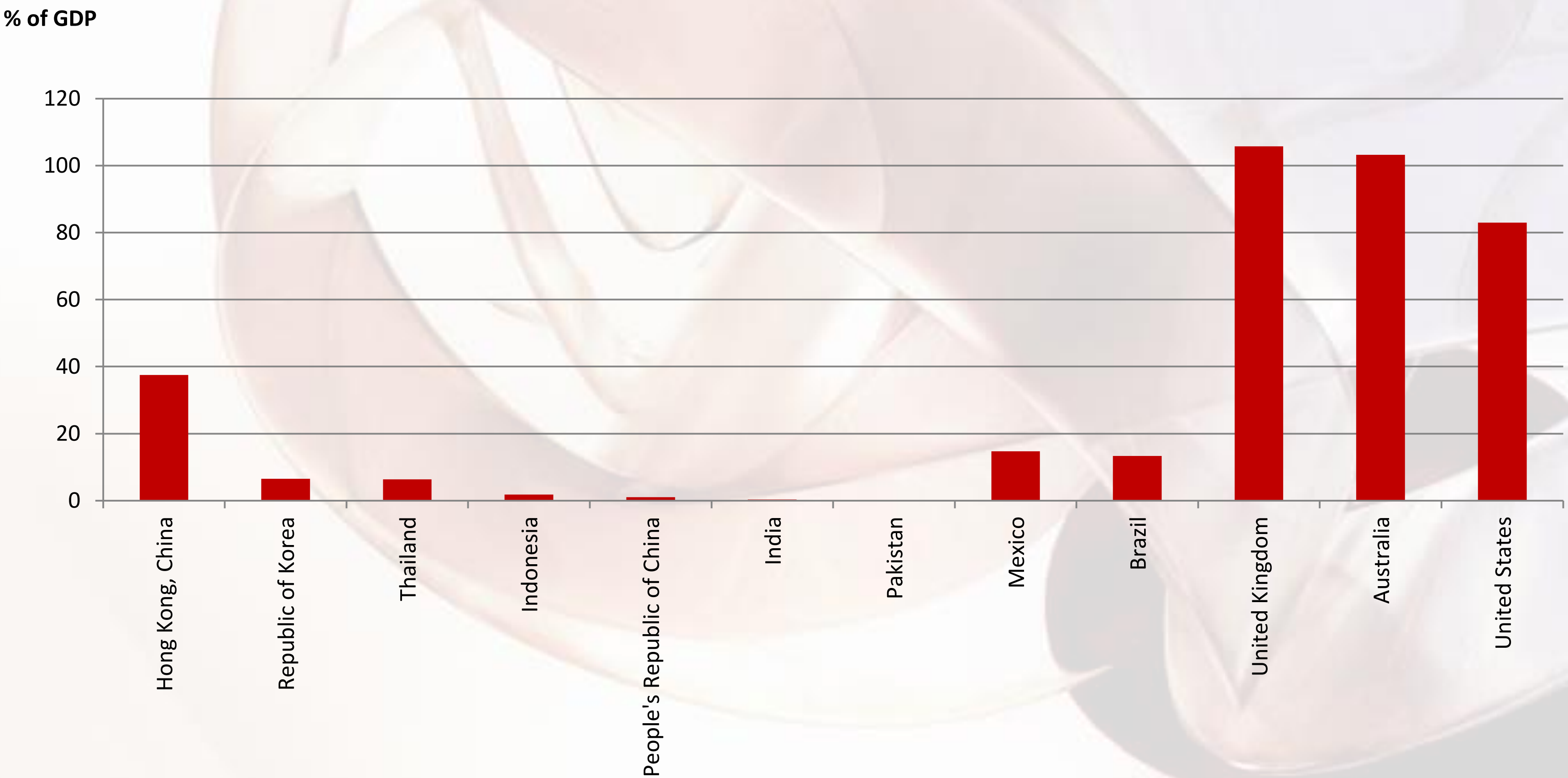
But the range of long-term finance instruments in Asia remains narrow…..

Debt financing of nonfinancial corporations by region, year-end 2011



....pointing to a need for a broader and more diversified long-term investor base

Ratio of pension assets to GDP in selected economies, 2013



Asia's bond markets are bigger than those of other developing regions.....

		Total	Local currency denominated			
		$ billion	$ billion	% GDP	% total	% govt.
Advanced economies	Total	74,371	67,912	164	91	49
	Euro area	22,106	20,147	157	91	39
	Other	22,857	19,134	140	84	72
	US	29,409	28,630	191	97	40
Emerging market economies	Total	8,119	7,070	32	87	59
	Europe	699	500	24	72	89
	Lat Amer.	1,406	1,053	22	75	80
	Asia	5,667	5,260	41	93	50
	Other	347	255	11	74	75

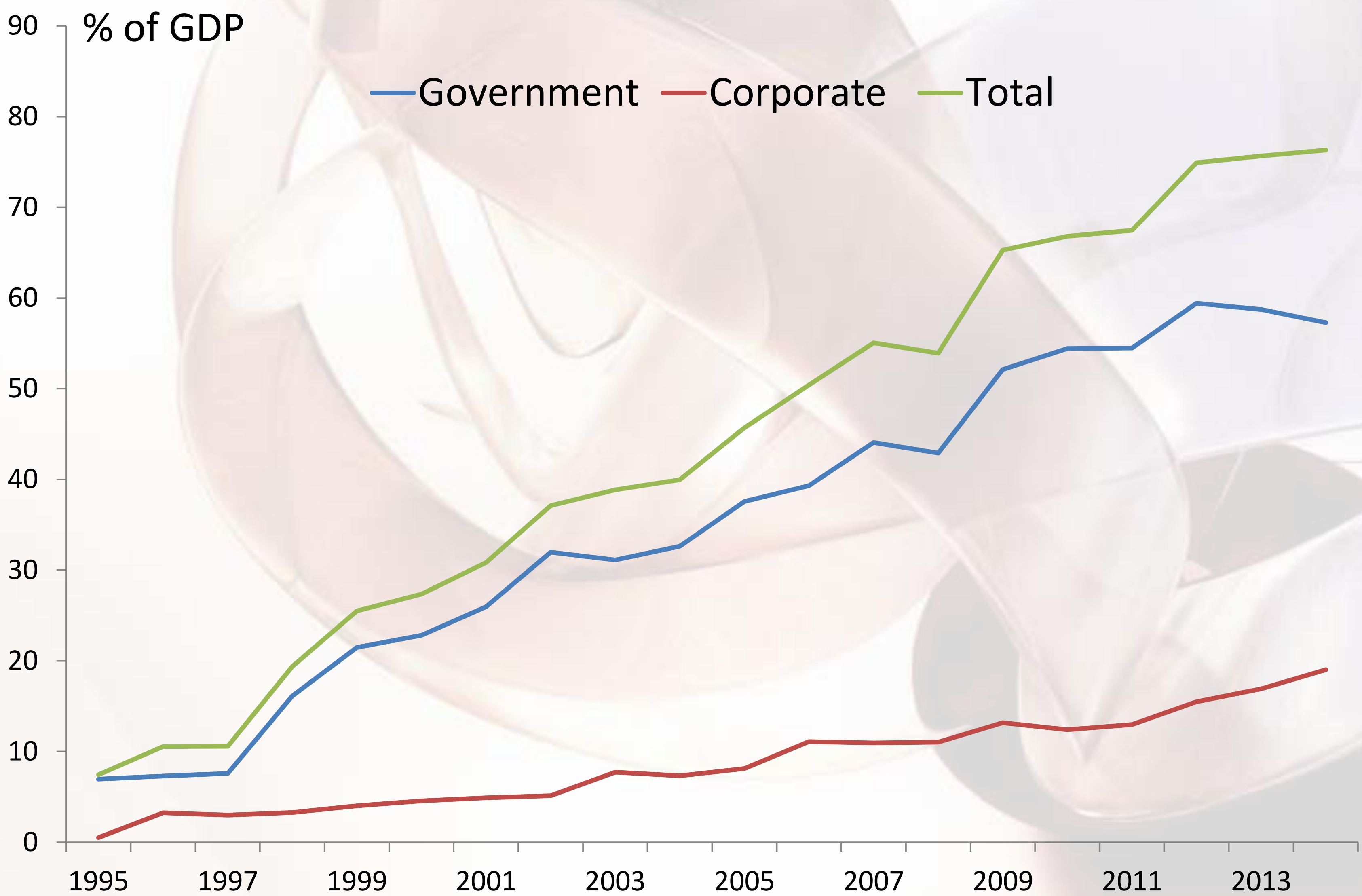
…..but masks a great deal of heterogeneity

	Total	Local currency denominated						
		2011			2006		2001	
	$ billion	$ billion	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total
Asia	5,667	5,260	41	93	39	90	33	88
China, People's Rep. of	2,956	2,938	40	99	27	98	18	95
Hong Kong, China	116	45	18	39	19	53	15	54
India	515	489	26	95	30	95	25	97
Indonesia	113	84	10	74	15	87	27	96
Korea, Rep. of	1,265	1,117	100	88	94	91	85	91
Malaysia	260	233	81	90	59	79	57	77
Pakistan	34	32	15	94	15	90	22	96
Philippines	101	63	28	62	26	50	21	48
Singapore	130	90	37	69	40	60	35	69
Thailand	175	170	49	97	37	89	28	80

Lots of progress in bond market development in Asia, but scope for further growth

- Asian EMEs experienced rapid improvement in the currency structure of bond markets
  - The proportion of foreign-currency bonds falling from 10% around 2000 to just 4% in 2013
    - In the PRC, India, Malaysia, Pakistan, and Thailand, more than 90% of bonds are now denominated in local currency
- Big differences exist across Asia, and bond markets in many financially underdeveloped countries are still embryonic or nonexistent
- Furthermore, in the region as a whole, the market for corporate bonds remains less developed than the market for sovereign bonds

Thailand's local-currency bonds outstanding



Financial development must fit country circumstances

- Low-income countries that rely heavily on banks can benefit from reform that mobilizes domestic savings, lowers credit costs, improves access, and promotes credit allocation to most productive sectors

- Middle-income countries can reap productivity gains from developing equity and bond markets that can lower long-term capital costs to facilitate investment and innovation

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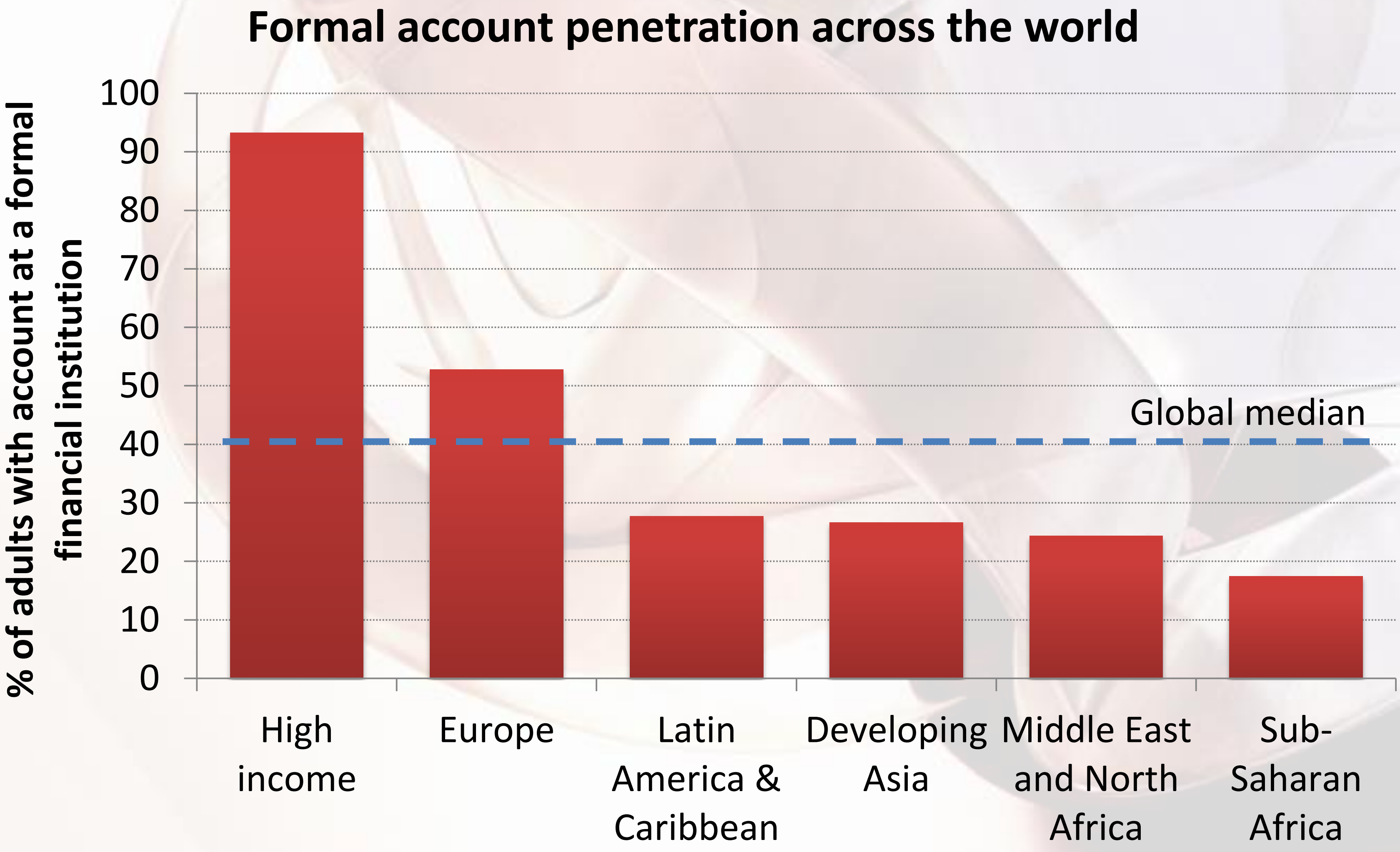
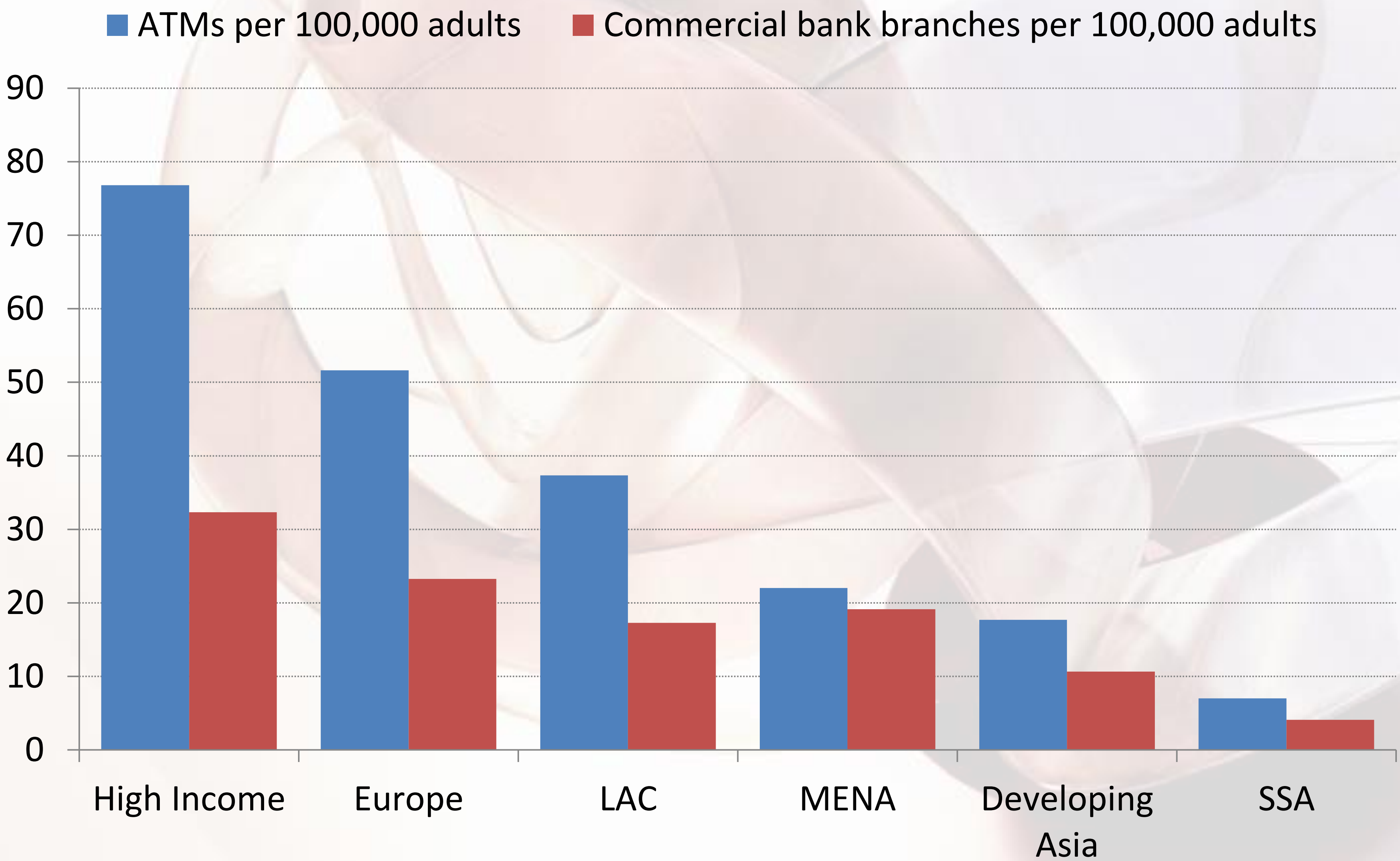
Financial inclusion is a vital ingredient of inclusive growth

- Although financial development promotes growth, it does not necessarily promote equity
- What matters more for inclusive growth is financial inclusion – i.e. broadening financial access to poor households and smaller firms
- Financial services can raise the well-being of the poor and increase their income potential
- They facilitate the entry of new and smaller firms, and thus promote competition and dynamism
- Yet the region fares relatively poorly in financial inclusion

Low degree of financial inclusion

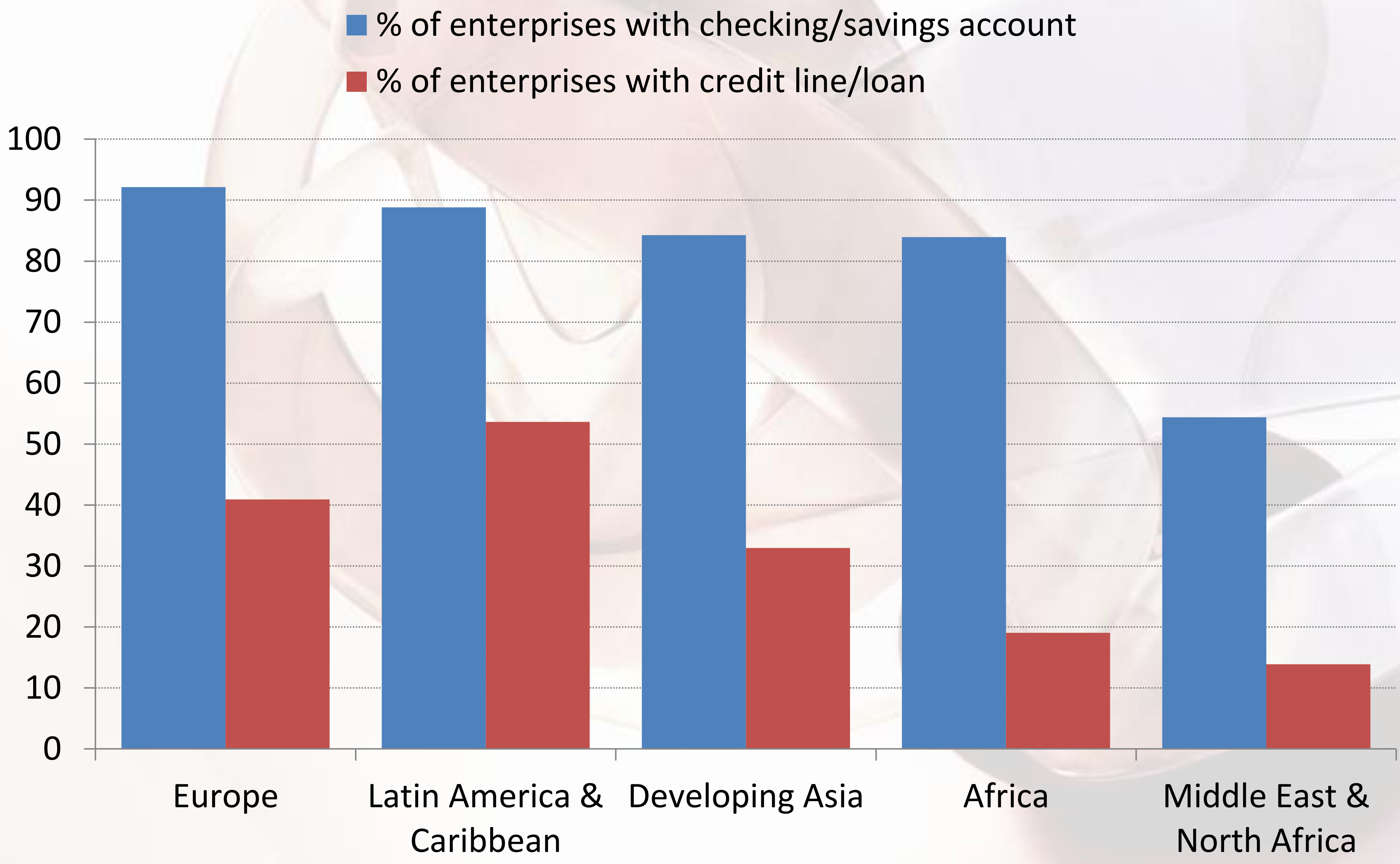


Limited access to banks



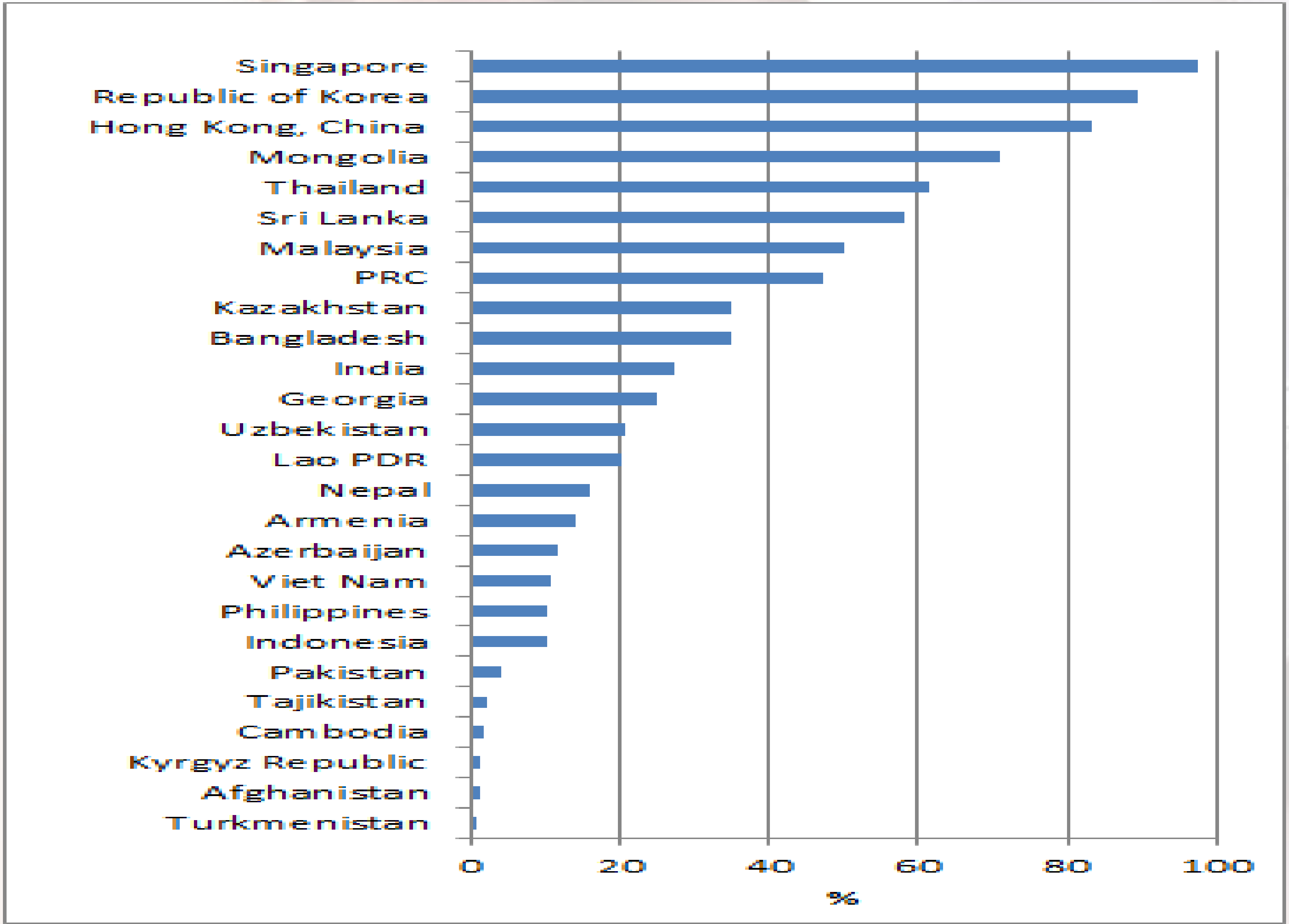
LAC=Latin America & Caribbean; MENA=Middle East and North Africa; SSA=Sub-Saharan Africa

Low financial usage and access for firms



Financial access is low in poorer Asian countries

Adults with an account at a formal financial institution, bottom 40 percentile by income, 2011



A range of barriers impede Asian household and corporate access to finance

- More than simply a lack of money holds Asian households back from opening bank accounts.
- Household surveys find that account fees, difficult geographic access, and stiff documentation requirements get in the way.
- For Asian firms, the major deterrents to borrowing are unfavorable interest rates, complex application procedures, and high collateral requirements.

Innovations and policies to improve financial inclusion in Asia must address cost and risk

- The fixed costs of extending traditional financial services, such as establishing a branch in a rural area, often make it prohibitively expensive to reach the poor
- More cost-effective delivery channels, such as mobile phones and banking agents, can reduce costs by as much as 19%

Innovations and policies to improve financial inclusion in Asia must address cost and risk

- Further, serving clients with no steady income flow, formal property title, or even personal identification entails high risk
- However, biometric identification initiatives such as India's Aadhaar program, for example, can address the lack of proper identification and facilitate access for the poor to financial services

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Financial stability for growth and equity

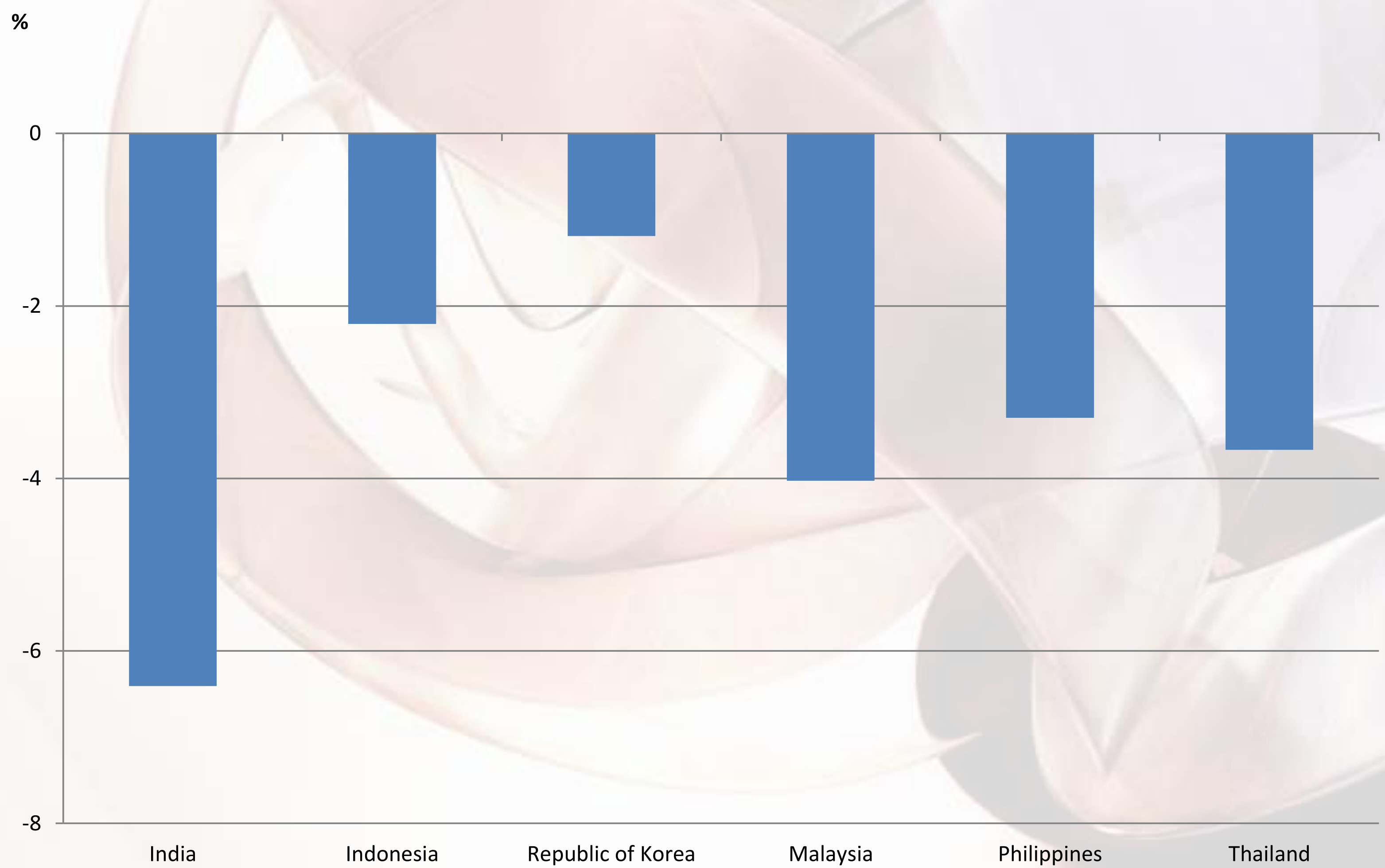
- Financial sector development can sometimes lead to instability and volatility in financial institutions and financial markets
  - Especially, if financial development is accompanied by financial liberalization and opening up
- Yet, as we saw earlier, financial instability can harm both growth and equity
- Therefore, a major strategic challenge for many Asian countries is to further develop their financial sectors in a stable way
  - For example, this is a huge priority for the PRC

External and domestic risks to stability

- Asia's financial systems have become much healthier since reform following the Asian financial crisis of 1997–1998
- Even so, external shocks have the power to unsettle local markets, as they did in May 2013, when news of a possible change in US monetary policy decimated Asian stock prices and currency values in the so-called taper tantrum
- Lurking in the background, meanwhile, are such homegrown risks as large shadow banking systems in some economies and unrestrained household debt expansion in others

Asia is vulnerable to global financial shocks

Nominal rate changes against the US dollar during the taper tantrum, 23 May–30 June 2013



Bank regulation is first line of defense

- International experience during the global financial crisis provides valuable lessons for Asian bank regulators
- Above all, the crisis underlined that sound and effective bank regulation is vitally important to financial stability
- The crisis reflected the failure of the regulatory authorities to keep pace with financial innovation
- The sobering lesson for Asia is that even financially advanced economies are susceptible to risks from lax regulation and reckless lending.

Advent of Basel 3 further complicates the task of Asian bank regulators

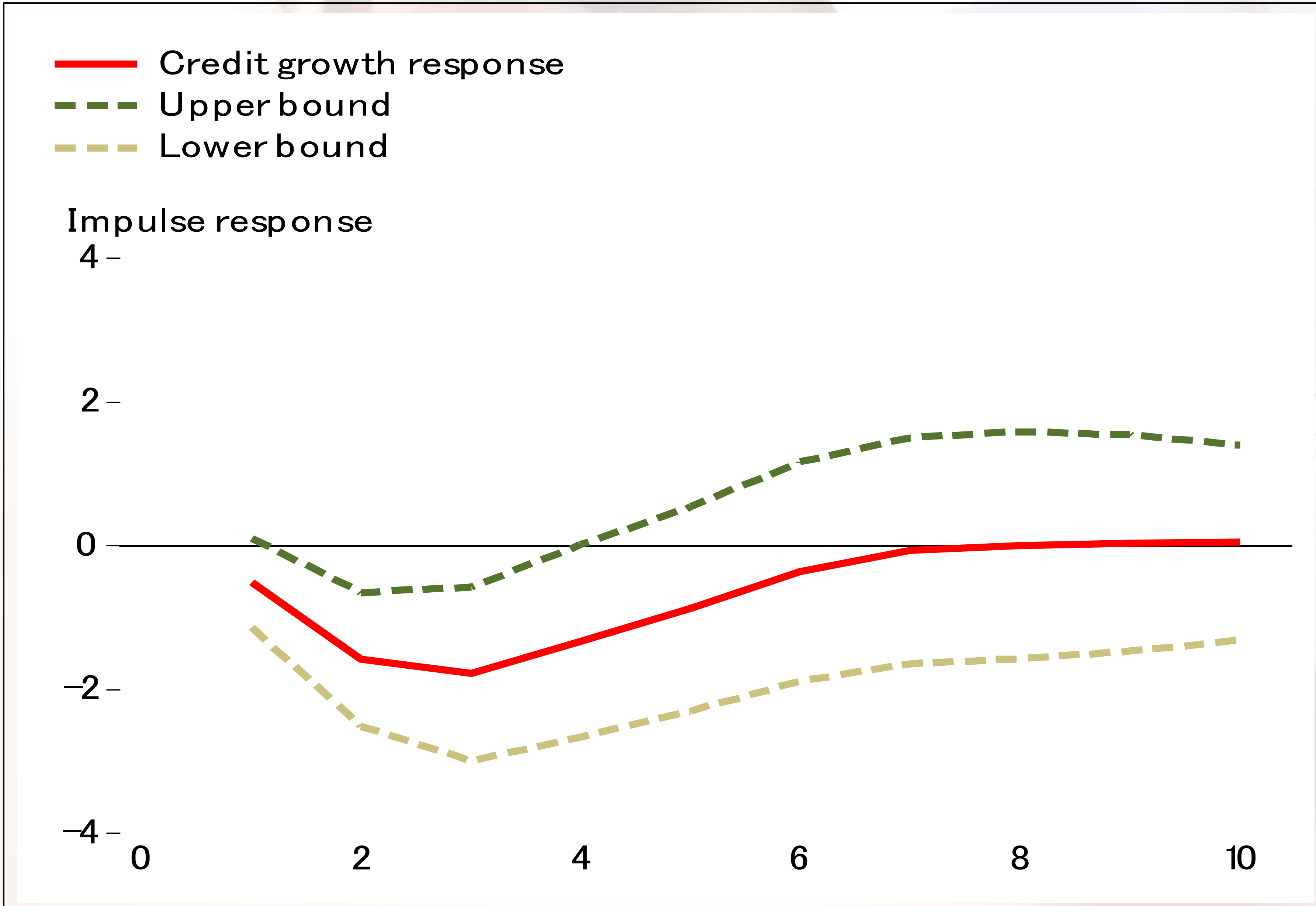
Comparison of Basel II and Basel III capital requirements

% of risk weighted assets	Capital requirements							Additional macro prudential overlay	
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer	Additional loss-absorbing capacity for systemically important financial institutions
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	Range	
Basel II	2.0			4.0		8.0			
Memo:	Equivalent to about 1% of an average international bank under the new definition			Equivalent to about 2% of an average international bank					
Basel III New definition & calibration	4.5	2.5	7.0	6.0	8.5	8.0	10.5	0.0–2.5	1.0–2.5
								10.5–15.5	

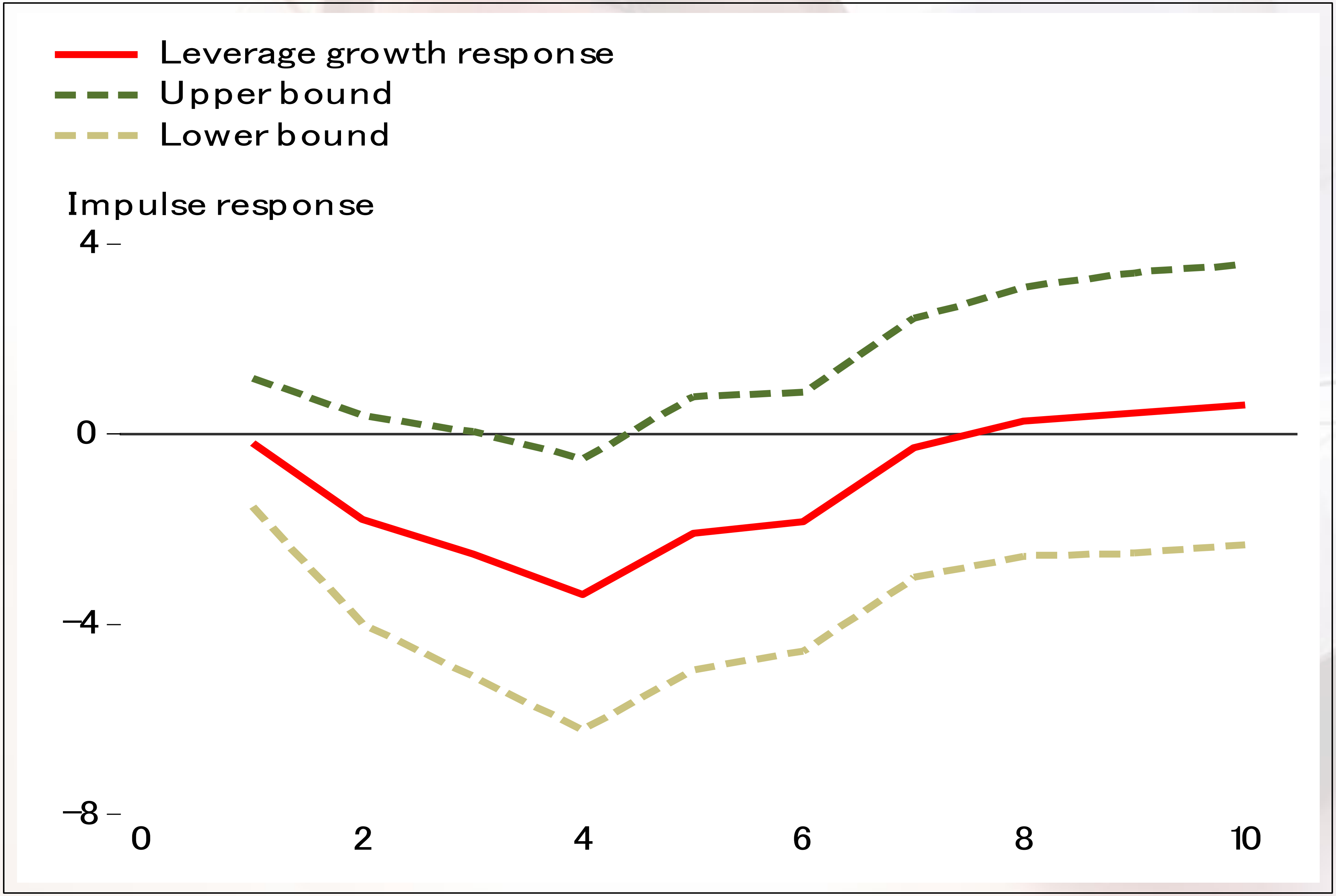
Macroprudential policies can also help…..

- Macroprudential policies seek to mitigate risks that could undermine the entire financial system by imposing, for example, capital requirements and limits on foreign currency borrowing that apply to all banks
- They are designed to complement microprudential regulation, which monitors risks specific to individual institutions
- Evidence indicates that macroprudential policies can indeed manage and mitigate macroeconomic risk in Asian economies

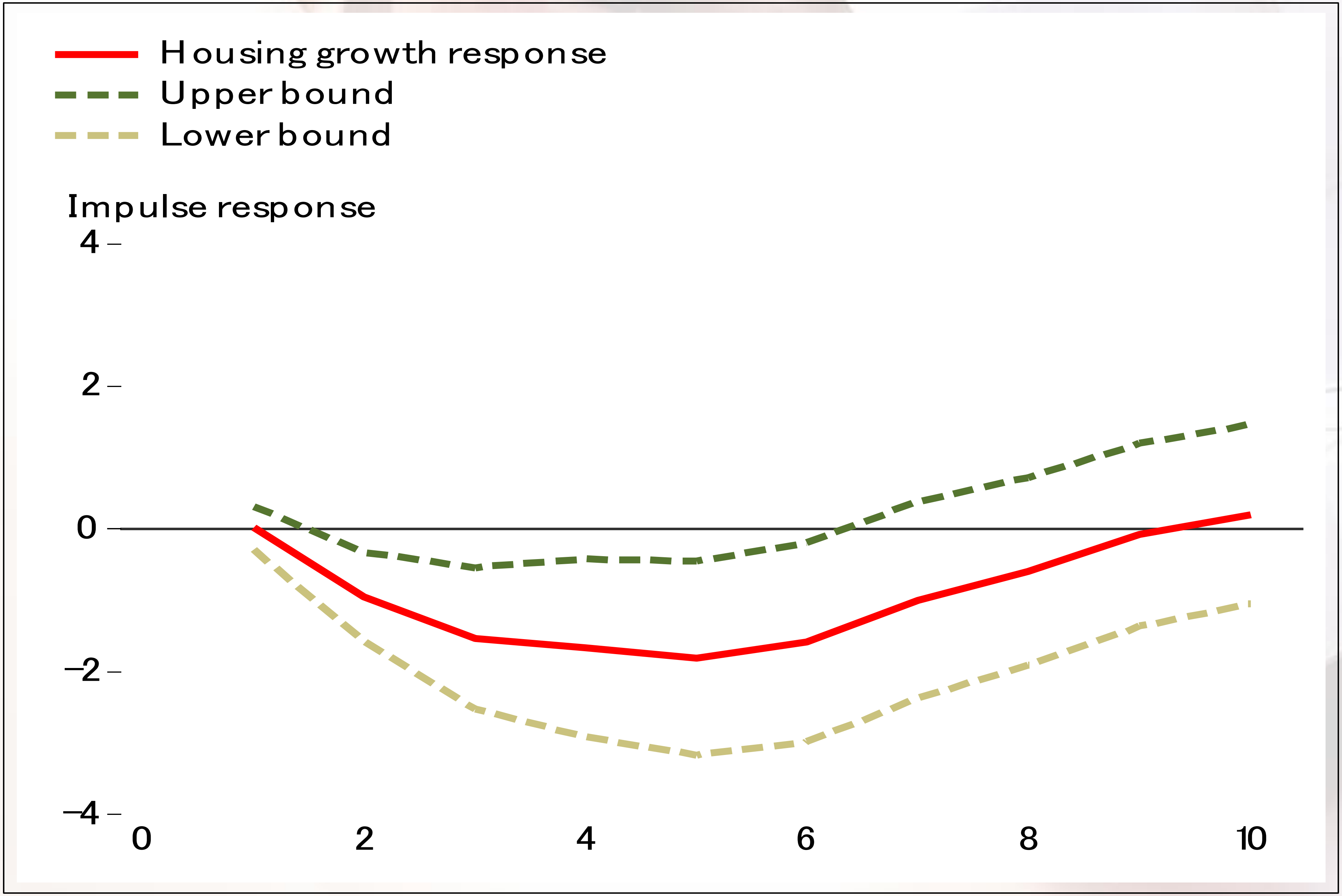
Credit growth response to credit-related macroprudential tightening in India



Leverage growth response to liquidity-related macroprudential tightening in Indonesia



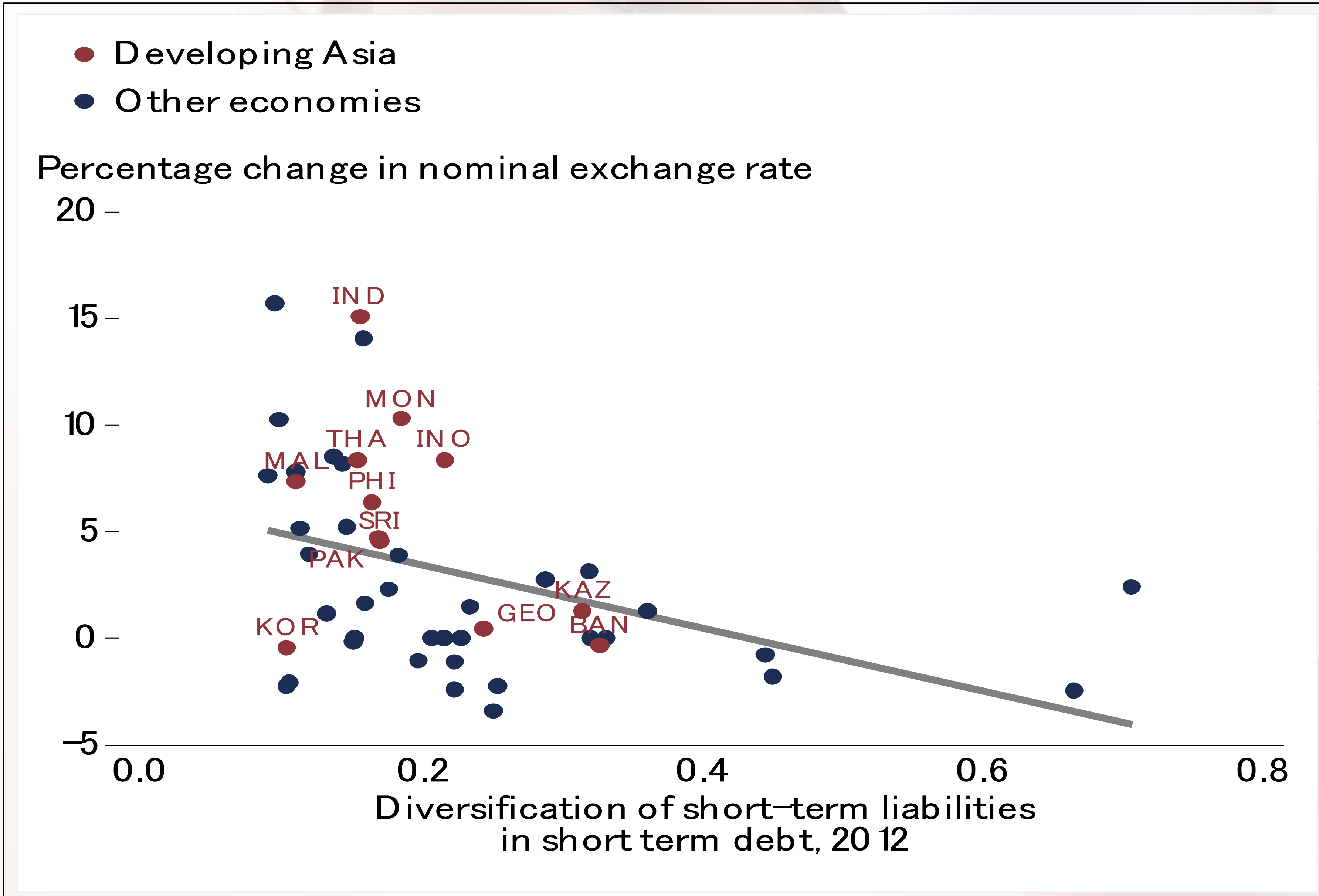
Housing growth response to credit-related macroprudential tightening in the Republic of Korea



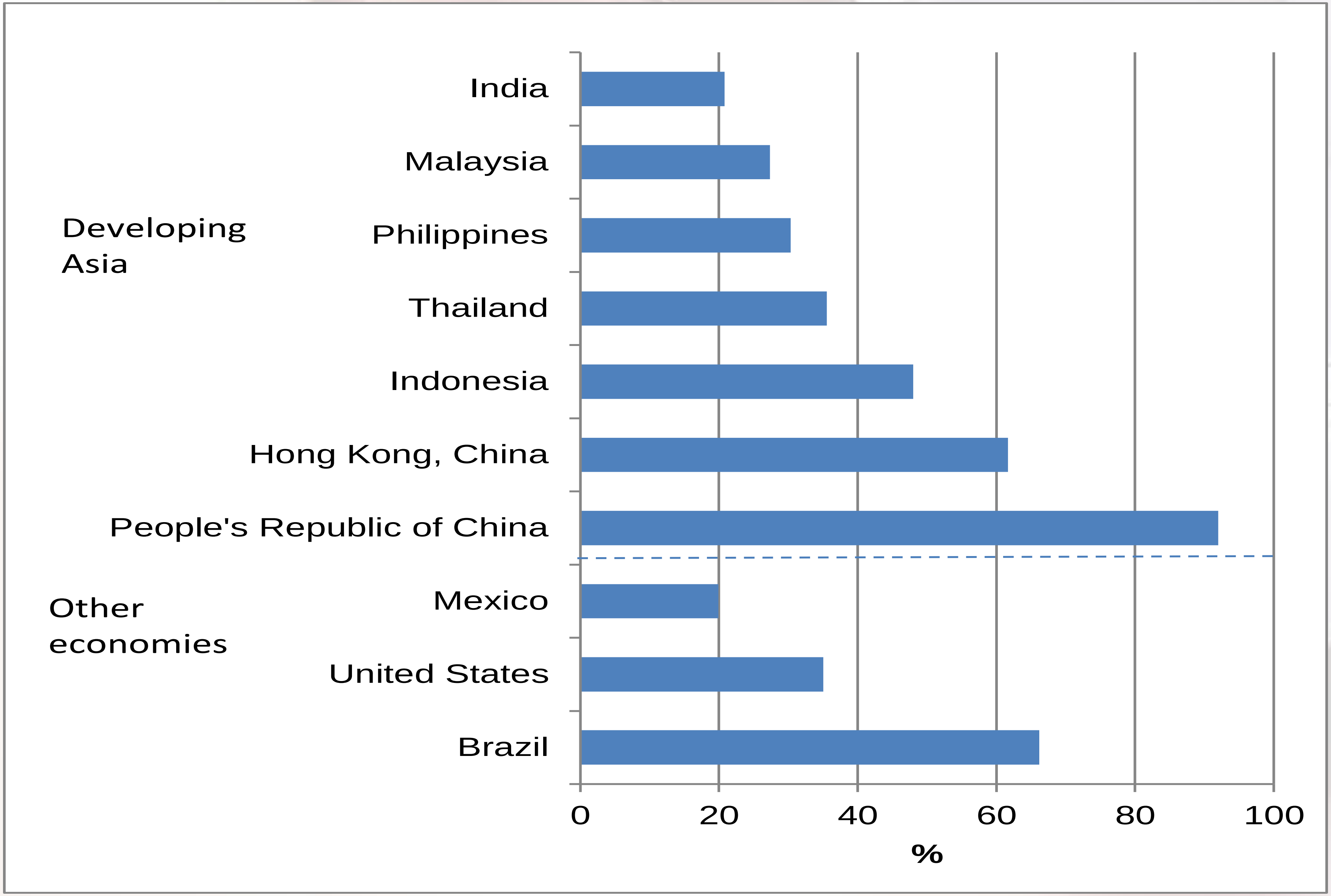
…as can FDI and diversified foreign funding

- The literature offers ample evidence that a higher share of foreign direct investment in foreign liabilities stabilizes financial markets
- Empirical analysis across economies further shows that those with more diversified foreign funding when the taper tantrum struck suffered less exchange rate depreciation
- When borrowing foreign currency, it is prudent to minimize currency mismatch

Diversification of external liability in short-term debt and currency depreciation during QE taper tantrums



Share of foreign direct investment in the foreign liabilities of selected economies, 2012



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Key overall messages

- Financial sector development can foster inclusive growth in Asia.
  - Finance has a generally positive effect on growth.
  - The benefits of growth will be even larger if finance promotes a more market-based allocation of resources.
    - Experience in the PRC shows, for example, that the entry of private foreign banks can enhance the efficiency of state-owned banks.
  - But the impact of finance on equity is uncertain.
    - To safeguard inclusive growth, further sector development must be accompanied by steps to ensure broad access to finance for households and firms.

Key overall messages

- Regulators will be challenged, however, to find the right balance
  - The region’s financial institutions are well placed to meet the more stringent regulatory standards being adopted globally, as many already surpass requirements under Basel III.
  - Yet regulators must act to strengthen financial institution governance and clamp down on inefficient and inequitable practices like crony lending and insider trading.

Key overall messages

- Regulators will be challenged, however, to find the right balance
  - They must appreciate how strong regulation protects stability by preventing the accumulation of systemic risks, but weigh it against the potential benefits of flexible regulation that promotes investment, productivity, innovation, and economic growth
- Reforms in other areas will magnify the benefits of financial sector development
  - A benign investment climate strengthens the link between finance, entrepreneurship, and investemt
  - Education reform that improves school equality will increase the gain from borrowing for education