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An Asian Response to International Financial Reforms

Hoe Ee Khor & Kim Song Tan
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An Asian Response to International Financial Reforms

by

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(I) Introduction

Asia has emerged as a much more important player in the global economy after the recent financial crisis. Together with other emerging market economies, Asia is expected to be a key driver for global economic growth in the near to medium term. Along with this, there is a rising chorus for an “Asian approach” to financial reforms in the region and internationally. There are also calls for Asia to play a bigger role in designing the new architecture for the global financial system.

Such calls reflect Asia’s dissatisfaction with the Anglo-Saxon model of financial market development. Many Asian economies see the recent financial crisis as a “Western”, rather than a “global” crisis, caused by the excesses of financial liberalization in the US and Europe. They believe that they have fared much better and recovered more speedily than the West because of their more cautious approach to financial liberalization and other financial sector reforms that they had undertaken in the past decade. They see the Dodd-Frank Act, the most comprehensive financial sector reforms in the US since the 1930s, as an attempt to rectify the weaknesses in the financial systems in the West, with limited relevance for their own financial systems.

More broadly, Asian economies are facing very different policy challenges from those confronting the West. While the US and the Europeans economies are still struggling to get back on a more robust growth path, saddled with high debt, poor sovereign credit ratings and the burden of increased regulation etc, Asian economies (except Japan) have recovered so rapidly that many of them are now facing the potential risk of overheating and asset bubbles. A key concern for Asian policy makers today is the management of capital inflows, especially short term speculative flows that can cause the exchange rates to become overvalued and result in asset bubbles. The broader policy challenges have a strong bearing on Asia’s views on the priorities in financial system reforms.

In this paper, we will discuss the divergent views between Asia and the West on the recent financial crisis. We will also look at the “Asian approach” to financial sector reforms and what Asia expects to see in the new architecture of the international

financial system. The paper is divided into 4 sections. In Section II, we will look at the question of why the recent crisis is seen to be more “Western” than “global”. In Section III, we discuss the various measures that Asian economies would like to see implemented under an “Asian approach” to financial sector reforms. Specifically, we will highlight the different policy challenges that Asian economies face compared with the US and Europe, and how these differences influence their priorities in financial sector reforms. We conclude in Section IV.

(II) A “Western” Financial Crisis

The fundamental causes of the recent financial crisis are arguably no different from the past crises in the world, including the 1997/98 Asia financial crisis. At the root of the crisis is a liquidity and insolvency crisis triggered by a panic run by investors and financial institutions after an extended period of excessive lending and borrowing. Investor greed, misguided policies and lax regulation and supervision helped fuel the explosive growth of credit and liquidity leading up to the crisis.

What made this crisis different from the previous ones were the heightened systemic risks in the financial sector that allowed the “trigger” to be “amplified” rapidly across the globe, making the impact much greater and more widespread than it would otherwise have been. A number of new developments in recent years have helped account for the heightened systemic risks. These include the emergence of an elaborate structure of new financial instruments that substantially increased the opaqueness in the financial system and a lax regulatory regime that allowed an extremely high level of leverage to develop within a few years.² Just as significant is the aggressive financial liberalization in the West that led to an unprecedented degree of interconnectedness among financial markets around the world.³

Like the West, most Asian monetary authorities failed to rein in the credit and liquidity growth in their own economies before the crisis. But their caution in

² This is typified by the following statement from Alan Greenspan, the former Federal Reserve Chairman, on 25 September 2002, when commenting on regulation towards over-the-counter derivatives market: “... **But regulation is not only unnecessary in these markets, it is potentially damaging**, because regulation presupposes disclosure and forced disclosure of proprietary information can undercut innovations in financial markets just as it would in real estate markets.”

³ See for example, Blanchard, 2009, and Blanchard, 2010.

financial liberalization helped spared them the worst of the “amplifier” effects. In particular, they were reluctant to open up their financial sectors aggressively over the past decade, despite strong urging from the West and the IMF. Fear of capital flow volatility which was seen as the main cause of the 1997/98 Asia financial crisis, remains a key concern among Asian policy makers. Such reluctance to open up the financial sector often subjects them to criticism of being too cautious and conservative in reforming their financial systems and developing their capital markets, with the result that the financial systems are viewed as “inefficient”.

Ironically, it is such “inefficiency” that proved to be an important strength in the recent crisis. For example, the various layers of capital controls and the reluctance among some Asian countries (e.g. Japan) to promote “innovative financial products” helped prevent the financial systems from being infected with “toxic assets” that brought down the US and the European financial institutions. Meanwhile, the slow progress in financial sector integration in Asia is seen to have helped limit the contagion effect across the region.

Asian economies were also helped by the many fundamental reforms they had carried out after the Asia financial crisis. Many of them adopted policies and measures aimed at protecting themselves from the vagaries of the capital markets and the perceived bias of the international monetary system. They restructured and recapitalized the banking systems and the corporate sectors, opened up the real economies to trade and investment, strengthened the supervisory and regulatory frameworks of the financial systems, and adopted an inflation targeting policy framework to enhance the credibility of their macroeconomic policy management.

The large and persistent current account surpluses that Asian economies ran and the substantial amounts of foreign reserves that they built up as a result, provided self-insurance against currency speculation and sudden capital withdrawals. The central banks intervened in the foreign exchange market to sterilize the inflow or outflow of speculative funds, so as to minimize their impact on the exchange rates and bank liquidity and to maintain financial stability. Asian countries also set up various regional mutual support mechanisms such as the Chiangmai Initiative, to help pool the foreign reserves in the region as a form of regional self-insurance.

Asia's success in managing the crisis and in staging a strong and robust recovery has led to increased scepticism about the financial reforms prescribed by the West and the IMF. It has strengthened the belief among Asian economies that they should take an "Asian approach" to such reforms. It has also prompted many Asian countries to ask for a bigger role in setting the pace and the agenda of global financial system reforms.

The credibility of the US and the European policy makers was further undermined by what Asia perceived as the "double standards" that they practised in their responses to the recent crisis. Both the US and the European countries responded to the outbreak of the crisis with a massive bailout of the financial system by easing monetary policy, expanding the balance sheets of the central banks and pumping massive amounts of liquidity into the system. This was something that the Asian countries were strongly advised against during the 1997/98 Asia financial crisis. It was also something that Asia could not have done on its own without the liquidity support of the IMF and the US as it would have led to a collapse of their exchange rates and financial systems. The reserve currency status of the US dollar and the shortage of dollar liquidity worldwide during the recent crisis, however, allowed the Federal Reserve to carry out such monetary expansion without causing a run on the US dollar. The main alternative to holding the US dollar would have been to hold the Euro but Europe was just as badly affected by the crisis as the US.

During the crisis, the US and Europe also mounted the biggest post-war fiscal budgets to help prevent a collapse in economic activity, knowing that such massive fiscal programs could lead to a sharp rise in their public debt and a deterioration in their sovereign credit. In contrast, Asia was advised by the IMF and the West to do the opposite and to tighten their budgets in 1997/98, in order to support their exchange rates. Such policies were extremely contractionary which inevitably added to the steep decline in economic activities and eventually caused the collapse of a few Asian economies.

(III) An “Asian” Approach to Financial Reform and Integration

A hierarchy of financial system and regulatory regimes...

The recent reforms proposed in the US, UK, Europe and by the IMF and Financial Stability Board (FSB) are directed at remedying the fundamental weaknesses in their financial systems, as revealed in the recent financial crisis. These weaknesses include, among others, the opacity of the cumulative risk inherent in structured products, the lack of oversight of the off balance sheet risk of banks, the repackaging of mortgages to offload the underlying risk to investors, the moral hazard problems posed by big financial institutions which are deemed “too big” and/or “too interconnected” to fail etc.⁴ While many of the problems highlighted by these proposals could serve as warnings to Asian economies of potential hazards in future, they are not pertinent to most Asian countries at this point in time.

Asia is a heterogeneous region with a very diverse group of countries at different levels of economic and financial development. On one extreme are countries like Japan, Hong Kong, Singapore and Australia which are advanced developed economies with sophisticated economic and financial systems. On the other extreme are countries like Laos, Cambodia, Myanmar and Mongolia which are among the least developed economies in the world with only basic economic and financial structures. The majority of the Asian countries are medium-income emerging markets economies at varying levels of development.

Except for the few more advanced countries, the financial systems in most Asian economies are still fairly simple comprising the banking system, the stock market and a fledging bond market. The main functions of the financial institutions are to provide liquidity and payment services, mobilize domestic savings and provide loans to households and businesses. Many of the flaws that contributed to the meltdown of the financial markets in the Western economies in the recent crisis such as those mentioned above, are hardly relevant in most Asian economies. Neither is there the same degree of close inter-connectedness among individual Asian financial markets

⁴ See US Senate, 2010 for a more detailed description of these proposals.

or between Asian and Western financial markets that contributed to the severe contagion effects in the West.

Even in the more advanced economies like Japan, Hong Kong and Singapore, the capital markets are not as “advanced” and “liberalized” as those in the US and UK. The challenges these countries face are therefore quite different. For example, while some of the problems that the Dodd-Frank Act addresses such as the management of the off-balance sheet liabilities of banks, the OTC trading of Credit Default Swaps (CDS) and other derivatives etc are also present in the advanced Asian economies, the problems are far less severe and far from being the most important issues confronting the financial regulators in Asia. In some ways, one could argue that the Dodd-Frank Act represents a step back by the financial regulators in the US, and a move towards the more conservative stance of Asia.

Given the diversity of these countries, it is natural that the type of financial system that is suitable and along with that, the type of regulatory regime that is appropriate for each of them will be different. There is no “one size fits all” financial system for the whole region. Each country should choose a regulatory regime that can effectively facilitate and not stifle its economic development. The choice of regulatory regime should not be dictated by that prescribed for the advanced Western economies.

A Different Approach to Financial Integration in Asia...

A major contributor to the recent crisis, as we noted earlier, was the high degree of inter-connectedness among the financial markets in the West. Asian economies are not against greater financial sector integration and inter-connectedness. On the contrary, a number of major initiatives have been rolled out after the Asia financial crisis to promote greater regional financial integration, especially among the ASEAN+3 countries in order to improve the efficiency of financial intermediation in the region. However, what Asian countries have learned from the recent crisis is that financial integration can be a major source of contagion as they provide a channel for financial crisis to spread rapidly across countries. They are mindful of the need to avoid the mistakes that Europe and the US made in financial integration.

A major challenge for Asia is to develop a financial superstructure that is able to integrate the diverse financial systems across the region so that they complement and support each other, despite the different levels of economic and financial development, in order to help raise the efficiency of capital flows for the whole region. Such a financial superstructure would, for instance, channel excess savings from the surplus countries to the deficit countries in the region. It would also facilitate the provision of advanced financial services from the more advanced economies to the less developed ones. In addition, it should intermediate the flow of funds not only within the region but also between the region and the rest of the world.

The architecture of such a financial system would be analogous to that of the production and trade network that has developed in the region where each country specializes in a particular segment of the production value chain.⁵ In the case of the financial sector, financial institutions in various countries will be providing financial services to the local economies and drawing upon the more advanced centres like Hong Kong and Singapore for services which are not available locally such as investment banking and advisory, private banking, asset management, and hedging products. Over time, as the economies grow and the demand for financial services expands, the financial system in each of the countries will also grow to meet the local demand. The economics of agglomeration will likely lead to the emergence of a few regional or global centres which serve as the financial services hub for the whole region.

A key player in this architecture will be the large regional and global banks which are able to provide the full range of financial services and have branches across the region. These banks are able to customize their financial services to the domestic needs of the individual economies by deciding whether to provide a particular financial service locally or by drawing on the resources of their parent banks. This is not unlike the role played by the large global multinational corporations (MNCs) in the manufacturing sector. Typically, the parent MNC will slice up the value chain of the production process and decide where to locate the production of each segment of the value chain to take advantage of the cost competitiveness of each country. Such a production network has transformed Asia into a highly competitive manufacturing

⁵ See Tan and Khor, 2006.

hub for the world, with efficient flows of resources across the whole region. Managed well, a similar outcome could be achieved for the financial sector.

With such a regional financial superstructure, there should be a hierarchy of regulatory regimes corresponding to the range of financial systems in the region. The regulatory regimes should be structured in such a way that, over time, as the financial system in an individual country develops and becomes more advanced, its regulatory regime will also evolve and become more sophisticated. Such a regulatory structure would imply for instance that it is not necessary nor appropriate for the majority of Asian countries to adopt the regulatory changes currently being proposed in the US and Europe. However, over time, as their financial systems develop and become more advanced, the regulatory regimes could converge.

Different Priorities of Asian Economies...

Asian countries are generally more concerned about the risks posed by speculative capital flows to the stability of their economies and financial systems. They attribute a large part of their own success in coping with the recent crisis to their ability in managing and containing such speculative capital flows, drawing on lessons they learned from the Asia financial crisis a decade earlier. However, the potential “overheating” problems currently faced by several Asian countries show that minimising the risk of speculative capital flows remains a key challenge for them.

Asian economies would like to see the issue of volatile capital flows and exchange rates addressed in a holistic manner in the reform of the international financial system. The reform should take into account the risks that such volatility posed to the economic well-being and financial stability of the region. The cost of insuring against such volatility should be borne equitably by all the countries so that individual countries do not have to resort mainly to building up a huge stock of foreign reserves as self-insurance. In this regard, Asian economies would also like to see a greater global consensus on the use of capital controls and other macro prudential measures to mitigate the adverse effects of capital flows on financial stability.

Some progress has been made in these areas. For example, in its latest Global Financial Stability Report (GFSR), the IMF appears to openly endorse the judicious

use of capital control and other macro prudential measures to deal with the adverse effects of capital flows.⁶ In the wake of the recent financial crisis, there has also been a massive increase in the financial resources of the IMF and the IMF has established a short term liquidity facility (SLF) to provide large upfront financing to countries with strong policies and a good track record but which are facing temporary liquidity problems arising from developments in external capital markets. These measures offer some assurance that the IMF has become more responsive and is now more willing and able to provide liquidity support to Asian economies in the event of a balance of payment crisis. This could in turn help enhance Asian economies' confidence in the IMF and persuade some of them to reduce the use of foreign reserves as a form of self-insurance.

Indeed, Asia's seemingly relentless accumulation of foreign reserves has long been a controversial issue. Some economists believe that this had been an indirect cause of the recent crisis. Most of Asia's foreign reserves are invested in liquid financial assets in the West such as US Treasury bills. This had contributed to the easy liquidity condition or what Greenspan termed the "interest rate conundrum" which facilitated the financial innovations, excessive borrowing and lending, and the debt and asset bubbles that eventually burst and caused the financial meltdown.

A Stronger Voice in International Forum...

Asia is seeking to have a stronger voice in the governance of the international monetary and financial system, to reflect their increasingly larger presence in the global economy. They want the regulatory framework for the global financial system to be sufficiently flexible so that it can be sensitive to the developmental needs of the developing countries and is able to accommodate a wide range of financial systems. A number of recent developments have helped start this process.

The elevation of the G20 into the premier international forum for managing the global economy and the international financial system is one such development. In effect, the G20 has now replaced the G7 as the premier global economic grouping. The change marks the emergence of the big developing countries, led by China, as a global

⁶ See IMF, GFSR, October 2010.

economic power and a force to be reckoned with in any discussion of global economic and financial issues. With six members, Asia is well represented in the G20 grouping. The grouping could provide the platform for Asia to push for major reforms of the IMF and other major international organizations, to make sure that their policies are aligned with Asia's interests.

The expansion of the Financial Stability Forum and its re-establishment as the Financial Stability Board (FSB) in 2009, too, has given Asia a bigger say in providing oversight over the global financial system. Meanwhile, there are efforts to expand the BIS and other international standard setting bodies to include more countries from Asia and other regions. Asia is expected to play a more active role in the BIS and other international standard setting bodies such as Basel Committee on Banking Supervision, IOSCO, CPSS and IAIS, to ensure that these bodies take into account the economic circumstances of the Asian countries in setting the international standards for the various regulatory frameworks. In recognition of the growing weight of the developing countries in the global economy (including Asia), reforms have also been initiated at the IMF to increase the quotas of the developing countries although this has met with resistance from some of the European countries which are at risk of losing their shares.

(IV) Conclusion

The recent financial crisis which paralyzed the financial markets in the US and Europe has highlighted the need to fundamentally reform and strengthen the global financial system to make it more robust and resilient to shocks. The US and Europe were hit hard by the crisis, both of which experienced a severe economic downturn and a near-collapse in their financial systems. Many Asian countries felt the impact of the crisis mainly through the trade channel while their financial systems remained relatively unscathed. This difference in experience explains the muted response from Asia to the various proposals for financial reforms that have been put forward so far. These proposals are seen largely as attempts to address the weaknesses and flaws of the financial systems in the US and Europe.

However, Asia has important stakes in the global economy and should not be a bystander in the broader reform of the global financial system. While the most immediate cause of the recent crisis may be attributed to the weaknesses in the financial systems in the US and Europe, its deeper causes can be traced to systemic risks in the global economy related to issues such as the large and persistent macroeconomic imbalances in the global economy, the size and volatility of capital flows, the flexibility of exchange rates, the inadequacy of the regulatory regimes and the architecture and governance of the international financial system. Being among some of the most open economies in the world (even if their financial markets are not as liberalized as those in Europe and the US), it will not be possible for Asian countries to insulate themselves from global events. Asia's ability in escaping the worst excess of the recent crisis does not mean that it will be as lucky the next time. Post crisis, Asian economies should capitalize on their strengthened position to play a bigger role in international financial reforms, to ensure that the reforms are in line with developments in their own economies and are thus sufficiently broad to be effective in preventing future crises.

Recent experiences in reforming the governance structure and regulatory regimes of the international financial system reinforce the view that Asian countries should play a more pro-active role in such reforms. While many of these reforms are headed in the right direction, some of them do not go far enough in addressing the concerns of the Asian countries. For instance, there have been strong resistance against the proposals for a major reform of the governance structure of the IMF to raise the voting shares of dynamic developing countries, particularly those in Asia, by a significant amount because such reforms would reduce the shares of certain European countries by an equivalent amount. Consequently, Asia should remain engaged in the current financial reforms of the international financial system to ensure that its interests are taken into account in the reforms.

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