East Asian Financial Markets: Some thoughts on the way forward*

by

Bandid Nijathaworn
Bank of Thailand

* Presented at a high level panel on "East Asian Financial Markets: the Next Frontier" seminar organized by the World Bank and Hong Kong Monetary Authority

Hong Kong
June 22nd, 2006

Thank you Mr. Chairman,

First, let me thank the World Bank and the Hong Kong Monetary Authority for the invitation. It is always a pleasure to be here in Hong Kong, and I should also congratulate the organizer for putting up what looks like another important and useful seminar.

My task today is to speak on East Asian financial markets. In the recent years, I think there is no disagreement that the economies and the financial markets in East Asia have gone through an important phase of transformation and growth. So, it is ideal that we do take stock and think ahead on how things should best evolve going forward, so that the region's economic potentials would be best leveraged, and to see what role can the region's financial markets play.

Given the limitations of time, I want to use this opportunity to make just two points. The first is the issues that are currently being discussed in the region on the areas that we need to do more in developing financial markets in East Asia. And the second is my view on the role that policy can play in supporting future developments.

But to set the context on what I am going to say, given that financial markets cannot be discussed separately from the real economies, I want to begin with a few observations on the current macro and finance trends in the region.

In the context of key macro and finance trends in the region, I think at least four developments stand out as the current defining themes.

First is the region's much improved economic resilience and fundamentals. These qualities now offer the region a prospect of continued strong long-term growth and potentials. At the same time, the region's financial prowess – in terms of high saving rates, current account surpluses, and strong international reserves – has continued to improve, and thereby enhances the region's financial influence in the global economy.

Next is the increased interdependency. With the growth in economic activities, we are also seeing more economic interdependency within the region, especially in trade, and especially in trade between China and the rest of the region. Intra-regional trade is now the largest component of total trade for most East Asian economies. And its momentum has been an important driver of the region's trade and economic growth.

And third is the growth of finance, flows, and market transactions, propelled by the increase in trade and investment between the region and the rest of the world and also by trade within the region. This growth, in my view, is underpinned by a much improved and more diversified financial sector, as well as by a strong presence of international financial firms competing to provide services in the region.

And the fourth is the deepening process of regional financial integration, defined as cross-border trade and investment flows within the region. But, many have noted that the progress, while well and good, seems to lag behind that of trade integration.

On account of these developments and achievements, two questions are often raised.

The first is how the development of the region's financial markets should move forward so that it can best leverage on the region's economic interest and potentials, as well as to ensure that the region will benefit fully from its own financial strength and resources.

And the second is that, as the region becomes more integrated financially with the rest of the world, in what way can we ensure that the risk that comes with increased integration is adequately managed, and that the region's financial interest is well protected.

These two questions, in my view, are the central themes or the points of focus around which the issues of financial markets and development in East Asia are now being discussed in all circles. And from these discussions, a number of important observations have been made that point the ways to the next possible areas of focus in our efforts to further develop the markets.

Let me share with you some of these observations.

The first is that, while it is agreed that more needs to be done to achieve a robust and diversified financial system, the key focus of financial sector reform in the region should remain to be the serviceability or access to finance for the majority of the region's population. This is to say that for financial sector development to really matter, the people of East Asia across all income groups must be able to enjoy the access to and the benefits of a modern financial sector.

The second is the observation that the region's financial sector continues to be less integrated within the region than with the rest of world. And it follows that, with weak regional integration, the region will lose the opportunity to leverage on its own high levels of savings to support investment. The financing cost for corporates and SMEs will also be higher because of the round-tripping of funds. This, I think is a fair and important point, because greater reliance on the region's own savings will help reduce the volatilities associated with capital reversals that we have seen in the recent months.

The third is the concern that, despite rapid growth, the role of Asian financial institutions remains small. Their participation in the region's finance, especially cross-border finance, is not at par with the flows of savings that need to be intermediated. The challenge here is to promote greater roles of Asia's own financial institutions without compromising the open, competitive, and level playing field that has been the hallmark of the region's financial markets.

The fourth observation is the concern about the attendant risk associated with increased financial flows and integration. With increased flows, the region's financial markets are susceptible to greater risks and spillovers from the international financial markets. The issue then is whether a better system is needed to help mitigate and manage these risks.

And the fifth is the concern about the region-wide benefits of the efforts we are doing on financial market development and integration, given the vast diversity of the economies and markets in the region. Ideally, regional financial development should be a win-win situation. Nonetheless, the uneven pace of development and unbalanced focus could risk hallowing out the region's financial system. And if this happens, it could sow a seed for future instabilities.

I think these observations and concerns are important, and in a way they point to the issues that should be addressed in our next step of financial reform. And it is in this context that I see the World Bank Flagship study on East Asian financial markets to be timely. And from what I heard this morning, significant benefits and insights can probably be gained from this study, and be useful to our future works in the region.

I also have a number of specific remarks and views to make on the aspects of East Asian financial markets to be discussed in the next sessions. But for the benefit of time, I think I should leave them for later opportunity. For now, let me close by saying a little bit about the role of policy.

Government policies, in my view, have played an important role in the current development of East Asian financial markets. The key policy, of course, has been the implementation of financial sector reform which has resulted in a much improved financial system, especially the banking sector. Policies have been directed at developing the region's capital markets too, especially the bond market. Policy coordination has also been strengthened to increase regional financial integration and to develop a policy coordination framework that can help the region deal better with the likelihood of a crisis. I am referring here to the CMI or the Chiang Mai Initiative and its surveillance process.

But while policies have been important, the process of financial market development in East Asia has essentially been left to the market, in the sense that the process is basically a market-driven one. But on account of what is perceived to be a slow progress, question arises whether policy should do more.

My view is that the process should continue to be market-driven and not policy-driven. But there are areas that government policies can do more, especially on issues that involve efforts on a region-wide basis. In this context, future efforts at policy coordination should start by setting out a clear and concrete medium-term goal, then followed by a few but concrete and specific issues to be addressed or projects to be executed. A case in point is the development of a shared regional financial infrastructure such as linking the clearing and payment systems, harmonizing minimum regulations on cross-border investment flows, and developing a shared facility to promote greater flows of investment information. This type of specific efforts and projects would be easier to win region-wide political commitment and support.

Another suggestion is that, for the market-based approach to work efficiently, we may need to engage more formally the cooperation of the private sector. On this, I think East Asia can learn a lot from the experience of the EU in engaging the private sector in planning and reviewing major financial initiatives. Specifically here, I am thinking of the Giovannini Group of private experts, established in 1996, which has done at least four useful reports for the EU Commission. Their inputs have helped the EU in introducing the necessary directives.

My last point is on the role of IFI's such as the World Bank. In recent years, in a good way, we have seen active involvement of all major IFI's in the region's financial market development. They contribute to research, ideas, technical assistance, policy advice, and funding. Some are even involved as market participants. I am thinking here of the World Bank, the ADB, and the IMF. But while their efforts are good, well-intended, and should definitely continue, their contributions should aim to cover or be useful to all markets in all countries in the region. This is because of the diversity in terms of stages of market development in the region. And for the IFI's themselves, it can be useful that their resources are not wasted in overlapping projects.

On this point, I see considerable value if each IFI can establish its own areas of expertise and specialization, so that the value added they are contributing collectively to the region are further enhanced.

I think I have take up enough time already and should stop. So, let me stop here and I hope my contributions have been useful.

Thank you, Mr. Chairman.