

Where is Global Finance Heading? [♣]

Bandid Nijathaworn

Bank of Thailand

Thank you Chair

First, let me thank the Central Bank of Peru and Reinventing Bretton Woods Committee for the invitation. It is an honour to be speaking to you today.

The topic of this first session is “Time of upheaval: Where global finance is heading?”. This is definitely an important question given the current crisis is now almost two years old and is still evolving. Judging from the implications that the crisis has had so far on the world economy and financial markets, this is truly the first crisis of globalization. The crisis shows that financial upheaval can happen in any country, regardless of whether it is large or small, emerging or developed, and once happens, it can impart huge externalities on the rest of the world given the globalized nature of the world’s trade and

[♣] Presented at the Conference “Where is Global Finance Heading? The Stake of Emerging Economies in the International Financial System” Organized by Central Bank of Peru and Reinventing Bretton Woods Committee, Cusco, Peru, July 13-14, 2009.

payment systems. But more importantly, the crisis points to the weakness in the configuration of policies and financial regulation in the period leading up to the crisis that led to excessive risk-taking in the intermediation of global savings and investment across economies.

Compared to the Asian financial crisis twelve years ago, the dynamic of macroeconomic adjustment in this crisis also looks similar, although the trigger point this time is more bank-led than currency-led. The real surprise, however, was in the timing, the scale, and the intensity of how the problem quickly deteriorated into a major global turbulence. According to the IMF, compared with the previous crises, the cost of the current crisis in terms of financial losses could be as high as 10 percent of US GDP. This implies a very substantial welfare loss.

Is this the time of upheaval? My answer is both yes and no. The “No” part refers to the fact that, despite the magnitude of the current crisis, aggressive policy response and the willingness to do more by Governments have successfully contained the fallout to the extent that collapse of the global financial system has been avoided. Financial markets, to an appreciable extent, are stabilizing, risk appetite is returning, and signs of improvement in the real economy are beginning to emerge on a world-wide basis. Although it is still early

days, they do point to the beginning of stabilization which is an important first step for economic recovery to take hold.

The “Yes” part of my answer comes from what I see as a major challenge in the ideas and policies on how best to manage the global economy going forward in this era of globalized finance. For instance, with this crisis, we witness a breakdown in the key assumptions that form the basis of our thinking about the efficiency and the self-correcting nature of markets which, for a long time, underpin the rationale for globalization, liberalization, and deregulation. These assumptions are now being challenged.

Next, in this crisis, the most damage comes from the most regulated sector of the economy, notably the financial sector. What we saw is that, even with regulation in place, the sector surprisingly exhibited important failure in risk management discipline across a variety of institutions and players, including banks, institutional investors, credit-rating agencies, and regulators. On this, a better way to manage risk to support the process of international financial intermediation still needs to be worked out. And finally, the global economy has never before been put in a position that it might have to deal with the consequences of the massive policy response that have been put in place both on the fiscal and the monetary fronts. These

consequences are the known unknowns, and the approach we choose to address them will importantly influence the direction that global finance will take going forward.

Given the focus of this conference is on the stake of emerging economies in the international financial system, let me share with you briefly how emerging economies in Asia so far have managed in the current crisis, and how we see the direction of global finance evolving.

This time emerging markets are not the cause of the crisis, but are affected by its global contagion. Emerging markets in Asia, this time, were able to weather the impact of the crisis with a relatively strong initial position. The strengths are found in the region's banking sector, which so far has been resilient because of the limited exposure to subprime-related and other toxic assets, the sector's strong capital base, and its low reliance on external funding. This time external vulnerabilities of the region's economies are low. They are supported by high levels of international reserves, continued current account surplus and low external debt. More importantly, economic fundamentals of the region have improved markedly, and these have helped enhance the room for policy as well as the ability of the economy to adjust to shock. Suffice it to say that these improved qualities are no accident. They are the results of deliberate policies to

reform the domestic economy, maintain discipline in macroeconomic management, build up a liquidity buffer for self-insurance, and strengthen supervision of the banking system.

Notwithstanding the improved qualities, the impact of the crisis on the Asian emerging economies have been substantial, and largely transmitted through three channels. The first is the tightened access to international capital market as a result of the global credit crunch. The second is the reversal of capital flows linked to the process of global deleveraging. And the third is the impact on the real economy on account of the collapse in exports. For Asia, the impacts have been uneven across countries, depending on the size of the initial capital inflows and the maturity composition of external debt. Nonetheless, because of the higher levels of reserves, the absence of significant currency mismatches, and greater flexibility in the exchange rate regimes, emerging markets in Asia have been able to adjust better to the shock without undermining economic and financial stability.

However, it may be noted that, so far, the impact from the trade channel has been the most severe. This is because of the large share of exports and manufacturing in the region's GDP. For example, exports from the five ASEAN economies fell by about 12 percent in

the fourth quarter of last year, and by 28 percent in the first quarter of this year, while GDP growth over the same two quarters fell by 0.6 percent. This decline is large and shows that Asian emerging markets remain closely tied to the global business cycle. Therefore, without improvements in the world economy, a sustained recovery in Asia will be difficult in the near-term.

Reflecting this, the focus of the policy response, at least in Thailand, has been to help the economy adjust to the impact of the crisis through a supportive stance of monetary and fiscal policies while maintaining the overall policy discipline. As for banks, the supervisory approach has been to ensure that the banking system remains healthy, and continues to operate fully to support the economy with good risk management and adequate capital.

At this time, consistent with developments elsewhere, more positive signs in the real economy are also beginning to emerge in Asia, and this has led to a view that conditions for recovery look more promising in Asia, given the lesser impact on the region's economic fundamentals and the banking sector. I find this view quite plausible. This is because, in the case of Asian financial crisis, it was also the countries that did not have a serious financial sector problem or

external vulnerabilities that were able to recover relatively more quickly.

On this note, let me digress to the issue of decoupling. If we divide the dynamic of financial crisis into three phases, namely, first the shock of the news phase when everything is on a downturn, to the second phase of market stabilization, and the third phase of economic recovery, it is clear from what has happened so far that, on the downturn, it is a recoupling story both for the real economy and for finance. The downturn has been quite synchronized because of the globalized nature of the world's production, trade, and financial investment. Nonetheless, for the market stabilization and the economic recovery phases, I see decoupling in the timing and in the pace of recovery being a strong possibility. This is based on significant differences that exist, between the core-crisis countries and the countries affected by contagion, in the relative strength of the economic fundamentals, the state of the banking sector, and the perception of risk by investors. However, beyond the initial recovery, sustained economic decoupling will be difficult without a major restructuring in the sources of growth which, in the case of Asia, calls for a reorientation of the growth driver from exports to domestic demand.

Making this transition safely in this era of globalized finance will be the next important challenge for emerging markets in Asia. In the past ten years, the share of domestic demand in the region's GDP fell by 6.3 percentage point, and the share is now 12.3 percentage point below its peak in 1994. Moving the ratio back will require major restructuring in both the demand and the supply sides of the economy, which needs to be supported by policies that redirect economic incentives from savings to domestic consumption and investment. Such task is gigantic. Chief amongst the policies needed to support this transition will be the development of the region's financial system, to ensure an efficient intermediation of savings into productive investment. This is really the key issue where the challenge and the constraint to economic decoupling lies. One of the prime reasons underlying the current global imbalance is the limited capacity of the financial systems in emerging markets to generate investment from their local savings. As a result, the intermediation was taken up instead by financial systems in the advanced economies which, as we know, led to risk-taking and a major asset price bubble.

In closing, I want to end my remark by making a few observations on the direction of global finance going forward.

As a matter of fact, the current crisis is also a crisis of globalized finance, considering the damage that has been done to the global banks and financial markets. Lessons learnt from this crisis will definitely bring about important changes in the global financial landscape, as well as in the regulatory approach to bank regulation and supervision. On this, key trends we can expect to see in the emerging financial landscape will include, on the demand side, consumers becoming more risk averse and having preference for local institutions and for simplicity of transactions and instruments, while demanding greater accountability and transparency. On the banking side, business models of banks will become more conservative, relying less on wholesale funding and on the use of leverage, while giving greater importance to risk management and higher liquidity buffer. And on the regulatory front, more emphasis will definitely be on public surveillance and the use of macroprudential oversight, with focus on system-wide stability, closer supervision of the systemically important financial institutions including non-banks, and establishing an international procedure for an orderly unwinding of a troubled systemically important global player. These changes will help reduce the likelihood of crisis and contain the impact of a systemic failure to the level that can be managed by conventional policies.

In parallel with this, on the economic front, adjustment to the financial crisis will continue and, in the process, the global economy will likely move into a world of two halves. The first half is the core-crisis countries whose immediate policy concern will be to rebuild financial fundamentals and resume growth. The second half is the less-affected economies, including emerging markets in Asia, whose policy focus will be to sustain growth and avoid financial instability. This latter point is important because, given abundant liquidity, the shift in the pattern of global growth towards the less-affected economies will spark a new financial cycle driven by a resumption of large capital flows to emerging markets. The challenge for emerging markets, therefore, is to grow safely by managing all the attendant risk associated with the strong capital flows. In this context, it is important that the experience of the last ten years, when the fall in Asian demand after the Asian financial crisis was offset by a boom in US residential investment, must not be repeated. Otherwise, the crisis risk will remain high, and globalized finance will be seen only as a threat to long-term economic stability.

Managing this risk and growing safely will be the stake of emerging market economies going forward. To achieve this, policymakers will need to acknowledge the risk and come up with the appropriate safeguards. First and foremost for emerging markets is the

continued strengthening of the domestic financial sector as I have noted, which is the key pre-requisite for raising the ability of the financial system and the economy to manage risk. Next, regional financial mechanism will also need to be strengthened to provide additional safeguards in the context of market surveillance and coordination of crisis prevention and resolution efforts. One lesson we have learnt dearly from the current crisis, as well as from the Asian financial crisis, is that globalized finance can be a source of serious risk to global economic and financial stability. Policymakers at the global level must accept this fact and be prepared to respond to it in a forward-looking way.

I probably have used up the allocated time. Again, I want to thank the central bank of Peru and Reinventing Bretton Woods Committee for the invitation. It has been a pleasure, and thank you for your attention.