## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Authors</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td></td>
<td></td>
<td>iii</td>
</tr>
<tr>
<td>Summary of Proceedings SEACEN 30th Anniversary Conference</td>
<td>“Greater Financial Integration and Financial Stability”</td>
<td></td>
<td>iv</td>
</tr>
</tbody>
</table>

### Session 1: Opening Addresses

- Opening Remarks by Dr. Zeti Akhtar Aziz, Governor, Bank Negara Malaysia | 1 |
- Welcome Remarks by Mr. Hookyu Rhu, Executive Director, The SEACEN Centre | 7 |
- Keynote Address by Dr. Christine Cumming, First Vice President, Federal Reserve Bank of New York | 11 |

### Session 2: Macro-financial Linkage: Issues and Challenges

- Macro-Financial Linkages: Issues and Challenges By Dr. Yuba Raj Khatiwada, Governor, Nepal Rastra Bank | 20 |
- Macro-Financial Linkages: Issues and Challenges By Choongsoo Kim, Governor, The Bank of Korea | 35 |

### Session 3: Greater Cross-border Financial Integration and Supervisory Policy Challenges for Central Banks

- Cross-Border Financial Integration and Supervisory Challenges for Central Banks By José Luis Escrivá, BIS Chief Representative for the Americas | 59 |
Financial Integration and Supervision Challenges for Central Banks
By Nestor A. Espenilla, Jr., Deputy Governor
Bangko Sentral ng Pilipinas ......................................................... 78

How to Have Financial Integration with Financial Stability
By Mr. Ravi Menon, Managing Director
Monetary Authority of Singapore .................................................. 101

Session 4:
Greater Financial Integration and Thoughts on the New Global Financial Architecture – Moving Forward

Greater Financial Integration and Thoughts on the New Global Financial Architecture – Moving Forward
By Dr. Chea Chanto, Governor, National Bank of Cambodia .................. 109

Thoughts on a New Global Financial Architecture
By Ajith Nivard Cabraal, Governor, Central Bank of Sri Lanka .............. 120

Greater Financial Integration and Thoughts on the New Global Financial Architecture – Moving Forward
By Pongpen Ruengvirayudh, Deputy Governor
Monetary Stability, Bank of Thailand ............................................. 130

Presentation by Dr. Fernando Tenjo Galarza, General Director,
Center for Latin American Monetary Studies at the SEACEN’s 30th Anniversary Conference “Greater Financial Integration and Financial Stability” ......................................................... 135
The increasing interconnectedness of financial markets has spread to the other sectors of the economy via the so-called macro-financial linkages. Macro-financial linkages, a direct indication of the deepening globalization and financial liberalization, consist of continuous feedback loops between two sectors. We now need to view the financial sector holistically in order to have an explicit understanding of the connectivity between the macroeconomic and financial conditions. This is no easy task given the complexity of the relationship between the two sectors.

Many have argued that the cross-border financial integration is now an irreversible process and the benefits of financial integration will outweigh the cost of financial contagion. In the long-run, the pros of the increase in efficiency of the financial system far offset the cons of potential build-up of imbalances and transmission of adverse external shocks. On the other hand, others have argued that cross-border financial integration per se is not always beneficial. The question then is that given this scenario, what is the nature of this relationship between greater financial integration and financial stability? How does one implement a consistent set of monetary and supervisory policies, domestically and cross-border to safeguard growth and financial stability? Is there a threshold to financial integration?

Given greater financial integration, there is little doubt that realistic regional initiatives and actions are required which calls for a well-defined framework of cross-border collaboration. What is the nature of this collaboration? In the longer run, given greater financial integration, do we need to reform the global financial architecture? And what is Asia’s view on this?

It is with these questions and concerns in mind that the SEACEN 30th Anniversary Conference was convened on 20 October 2013 at Sasana Kijang, Kuala Lumpur, with the overarching theme of “Greater Financial Integration and Financial Stability”. The Conference, which was sponsored by Bank Negara Malaysia, provided a unique forum for policy makers of central banks and monetary authorities from Asia-Pacific to exchange views and experiences on pertinent and emerging issues and challenges on areas such as macro-financial linkages; greater cross-border financial integration and supervisory policy challenges for central banks, financial integration and the new global financial architecture.

The Conference was very timely in view of significant changes in the financial structure of SEACEN economies in the last two decades, especially in the aftermath of the Asian financial crisis in 1997 and the recent Global Financial Crisis. The rapid expansion in the financial
services industry and globalization of financial markets has made maintaining financial system stability an area of concern for central banks. In view of this, SEACEN has initiated the SEACEN Financial Stability Journal (SFSJ) to promote thought leadership on policies, practices and topical issues related to financial stability, the inaugural issue of which was launched at the opening ceremony of the Conference. This important new strategic initiative is intended to advance thought leadership and collaboration on financial stability matters among our members, contextualized to the Asia-Pacific region. We also hope to influence international policy debates on promoting financial stability. There are numerous high-quality research journals devoted to economics and monetary policy. On the other hand, there are very few publications focus on practical implementation issues related to promoting financial stability and systemic risk management from a central bank/monetary authority perspective.

It remains for me to thank Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, for officiating at the opening ceremony of the Conference and Bank Negara Malaysia for rendering valuable assistance in organizing the Conference. My deepest appreciation also goes to all the speakers, discussants and moderators of the Conference for sharing their valuable experience and expertise with the delegates in the various sessions. We are indeed elated that they have allowed their papers presented in the Conference to be made available to a wider audience through the publication of this Conference Proceedings.

Hookyu Rhu
Executive Director

February 2014
Greater financial integration has been a mixed blessing for the world economy. In good times, it has allowed financial flows to travel across borders to countries where domestic savings have been insufficient to finance real economic growth, in bad times they were the major channel for the transmission of shocks when crisis struck. This Conference addressed three related topics - (i) the macro-financial linkages; (ii) the supervisory challenges for central banks from greater financial integration; and finally, (iii) a discussion on whether the global financial architecture allows policy makers to address the emerging challenges. These issues were discussed with focus on Asia, in particular SEACEN member economies.

Turning to the macro-financial linkages, a salient feature of closer financial integration has been the immediate feedback from financial conditions to the real economy. In good times, easy financial conditions allowed a credit and housing boom to evolve, manifesting itself in strong spending and production. This phenomenon could be observed not only in advanced economies (AE), but increasingly in emerging market economies (EME). In the AE, the build-up of imbalances in the financial sector precipitated the crash of 2008 with fallout for the global real economy. Yet, after so many years, the calm after the storm continues to evade us.

While central banks have ample theoretical and empirical knowledge about the effects of monetary policy on the real economy, the feedback from the financial sector to the real sector (with the exception of a fall in stock prices) is an emerging subject from the theoretical as well as empirical point of view. A common view has emerged that the build-up of credit financed debt manifests itself in rising asset prices, weakened balance sheets and financial imbalances. This should be addressed by monetary policy such as raising interest rates at times when inflation would not warrant any intervention. This is particularly so in cases where the central bank has a financial stability mandate.

The nature of macro-financial linkages was explored. They are changing in character and strength, and a feedback loop between the real and financial sector is at work. They are determined by the depth and size of the financial sector. With the deepening and widening of the financial sector, and with greater financial integration, non-conventional transmission
channels, notably credit availability, asset prices and market liquidity explain financial sector links with the real economy. However, it has been difficult to quantify these transmission channels.

In the past, monetary policy had an impact on the real economy through well researched transmission channels, assuming a sound supervised banking system. Recently, the ‘shadow banking system’, broadly defined as credit intermediation outside the regular banking system has gained importance, which has created a potential for systemic risk. Regulatory arbitrage has moved funds from the regulated to the unregulated financial intermediaries and exacerbated the pro-cyclical build-up of leverage. It was mentioned that the unregulated system provides up to 80% of real estate financing in some economies. In response, the Financial Stability Board (FSB) has recommended the appropriate monitoring and regulation of the shadow banking system in its report 2012, and ASEAN central banks are in the process of preparing such a report for the region.

In low income countries, macro-financial linkages vary over time and across countries, depending on the degree of institutional development, the depth and size of the financial markets and the degree of financial integration. Given the poor linkages among financial variables, the interest rate and exchange rate channels of monetary transmission are not effective in explaining macro-financial linkages.

In AE, macro-financial linkages haven weakened after the Global Financial Crisis (GFC), as has the link between output gap and inflation. They warranted monetary policy measures, such as lower interest rates as well as balance sheet measures, such as the injection of liquidity. Negative interest rates have been avoided by the Quantitative Easing (QE). In EME, macro-prudential measures were chosen, and their timely adoption to mitigate pro-cyclicality and to reduce capital flow volatility have reined in credit expansion and stabilized housing markets as well as reduced the likelihood of sudden stops.

Global financial integration through global systemically important banks (G-SIB) as well as regional systemically important banks (R-SIB) has brought new challenges for authorities of banking supervision in EME. Since the GFC, international bank lending has been stagnant due to the balance sheet consolidation of G-SIB, first and foremost European banks. This retrenchment has allowed US and Japanese G-SIB to expand their cross-border lending to some extent. This opportunity was also picked up by R-SIB in Emerging Asia and Latin America.
However, as EME acted only as host countries in the past, their regulatory supervisory framework has not been fully adapted to the new double role, as host and home supervisors.

The drivers for regional cross-border banking were push factors (such as the limited domestic markets) as well as pull factors (such as the gaps left by the retrenchment of the G-SIB). The overseas expansion of R-SIB entailed benefits (such as diversification) but also costs (such as more complex supervision). The new double role of EME supervisory authorities raised a number of micro as well as macro-prudential concerns. Among the most prominent ones are the form of overseas establishment (branches or subsidiaries) and the location of loss-absorbing capital. Other concerns are liquidity management and access to lender of last resort in the host country, the transmission of funding shocks in the home market, the adequate assessment of macro-economic and/or financial risks in the host markets, as available information might not meet home supervisory requirements. Concluding MoUs between home and host supervisors can go a long way to address these concerns.

As a result of their newly acquired double role, supervisory authorities in EME need to enforce global governance standards for local financial conglomerates. They need to be up to date on the challenges facing international banking regulation, such as the level and distribution of capital, and the coordination among jurisdictions to be prepared for any adverse developments. Credible and enforceable coordination agreements (COAG) between home and host authorities for regular supervision, stress times and resolution preparation should underpin further financial integration. Uncoordinated regulatory efforts might hamper financial development and integration.

One such regional example is closer ASEAN financial integration which comprises capital account liberalization, integrated payment and settlement systems, banking integration as well as capital market integration, such as the ASEAN+3 Bond Market Initiative. Such a comprehensive integration scenario requires extending the microprudential as well as the macroprudential framework for addressing financial stability concerns. It was acknowledged that moving from local stability to regional integration requires greater convergence in regulatory and supervisory approaches and standards in addition to enhancing monetary and financial cooperation.

As there is significant diversity across jurisdictions in the ASEAN region (notably the centralized versus decentralized capital and liquidity management in R-SIB), the following issues need to be addressed. Is there a need for a regional prudential framework (similar to the Basel global framework)? Should there be regional frameworks for crisis management, consumer protection
and problem bank resolution? How integrated should regional capital markets be in order to avoid sudden capital flow reversals and disorderly exchange rate movements among ASEAN currencies?

The fact that financial integration has lagged trade integration in ASEAN is not all bad. The region has thus avoided many risks of pre-mature globalization and preserved sound financial systems. Progress has definitely been recorded, such as greater flexibility of exchange rates, which has allowed the exchange rate to act as shock absorber, lower external debt and robust foreign exchange reserves. Regional banks are healthy, loan-to-deposit ratios lower than in AE and sound supervisory frameworks are in place. A multilateral safety net is in place in the form of the Chiang Mai Multilateral Initiative (CMIM).

The urgent requirements for ASEAN to move forward are i) regional initiative for coordination among supervisors; ii) cross-border regional crisis management and bank resolution framework; and, iii) strengthening the resilience to cross-border spillovers of credit cycles. During the process, monitoring of leverage and financial integration based on sound data should be put in place. Under these conditions, the ASEAN 2015 target should be achievable.

The last topic was whether the present Global Financial Architecture (GFA) is conducive for further integration in diversity such as in ASEAN, which is characterized by differences in the level of development of the economies and the financial sector, a fragmented infrastructure and variety in regulatory standards?

In the aftermath of the GFC, it has become clear that the current GFA has been focused on the concerns of AE. A closer dialogue between AE and EME should result in a more stable global monetary and financial system. One pillar should be a multi-polar currency system, based on global rules rather than on domestic rules. The G20 could be instrumental in developing such rules. If the IMF were to participate, the voting power in the IMF should reflect new economic realities. The world needs assurance and confidence that G-SIB will not be allowed to fail; global contagion and spillovers should be minimized. The role of the rating agencies should be revisited, the global transfer of liquidity through ‘round tripping’ should be addressed and EME must be given active and stable support to build strong economies and financial systems.

In the new global financial architecture, regional players will have larger roles in a rebalanced global economy. They will provide new currencies in a multi-polar economic and currency
landscape and adhere to new conventions based on a more sustainable market-based approach.

In this new framework, foreign banks will be established as subsidiaries, which have to comply with local regulation as well as the regulation of the home country. They will rely more on local funding of their activities. This model will lend more stability to regional financial systems to withstand global shocks.

Such a new GFA should  i) explicitly procure financial stability; ii) strengthen regulatory frameworks and impose restrictions on what business financial institutions are allowed to do; iii) focus on curtailing pro-cyclicality of the financial systems to prevent systemic risk; and, iv) deal with failing G-SIB and R-SIB.

The actual reform of the GFA has slowed since the GFC due to lack of motivation in AE and lack of common views in EME. However, the subsequent dialogue between SEACEN and CEMLA was perceived as a step in the right direction of forming a common response in EME to global challenges. On the whole, EME central banks are now better prepared to face the challenges of inevitable further financial integration.
Session 1: Opening Addresses
OPENING REMARKS BY GOVERNOR DR. ZETI AKHTAR AZIZ
AT THE SEACEN 30TH ANNIVERSARY CONFERENCE "GREATER FINANCIAL INTEGRATION AND FINANCIAL STABILITY"
20 October 2013

Bank Negara Malaysia is honoured to welcome you to the SEACEN 30th Anniversary Conference on “Greater Financial Integration and Financial Stability”. We are especially honoured by the presence of Governors and senior officials who are here today, despite the pressing demands on our institutions during this period of persistent uncertainties in the global financial and economic environment. We continue to face challenging and often testing times. Over the recent five years, we have been confronted with recurring episodes of turbulence, followed by phases of transitory recoveries. We have seen, and have been part of, extensive collaborative measures and reforms pursued at both the regional and global level. Yet, the calm after the storm continues to evade us.

The SEACEN and Asian economies have seen significant structural adjustments and wide ranging financial reforms in this decade. During this period intra-regional trade activity has rapidly increased, signifying the deepening of economic ties within the region. Intra-regional trade in East Asia has expanded from an average of 44% of total trade in 1995, to 50% in 2012. Intra-regional investment activity has also been on an uptrend. Asia’s young and increasingly urban and increasingly more affluent population, supported with policy initiatives to strengthen social safety nets – including for healthcare and retirement - will further enhance domestic demand in the region. This will further unlock our trade and growth potential. Our diversity also continues to be an important source of strength for the region. The complementarities between the economies in the region provide significant opportunities for greater shared prosperity and mutually reinforcing regional growth. The progressive liberalization of the domestic financial sectors, the development of domestic capital markets and the integration of payments and settlement systems have opened up new channels for regional financial institutions and markets to intermediate funds across borders. These developments have facilitated the recycling of surplus funds from the region for economic development in the region, while also enabling greater diversification of risks.

The lessons drawn from the Asian financial crisis more than 15 years ago also continue to shape our financial sector reforms, liberalization and economic and financial integration in the region. The focus is on developing a financial sector that serves the needs of the real economy,
and which is built on solid foundations of sound risk management and strong financial buffers.

An important precondition for financial liberalization and integration in the region has been ensuring that we build the capacity and financial infrastructure that would enable us to respond to emerging risks while also minimising their contagion effects. The recent global financial crisis and its aftershocks remind us that these lessons remain relevant and that we need to stay firmly on course in strengthening our foundations and resilience. A gradual and phased approach to financial liberalization and integration has served the region well, allowing time for the building blocks to be put in place, and flexibility to set the pace at which our financial systems can continue to grow and expand in line with the capacity to manage the attendant risks of a more open and interconnected financial landscape.

To date, financial integration in Asia has mainly manifested itself in the form of the increased regional presence, with increase participation of indigenous Asian banks in the regional financial system and increased participation in regional financial markets. The prospects for such greater regional financial integration are significant given that large flows of capital currently continue to be directed to developed economies outside the region. This is in contrast to the trade patterns in the region where intraregional trade flows account for more than half of total trade in the region. Promoting greater financial integration in Asia will not only serve to reinforce economic integration, but also enhance the depth and breadth of Asia’s financial markets, contribute to the development of more sustainable funding sources for economic development, and potentially improve terms of trade by reducing transaction and information costs.

The strategy and path towards greater financial integration in Asia seeks to preserve the strengths inherent in the diversity of the region, while raising the standards which promote financial stability in the region. Recognizing the various stages of development across our economic and financial systems, the Asian financial integration model for the ten ASEAN economies is focused on: (i) strengthening preconditions through collective capacity building to promote more open market access; (ii) progressively reducing barriers to facilitate cross-border trade; (iii) developing the market infrastructure and an enabling environment to promote the efficient and effective intermediation of cross-border financial flows; and (iv) establishing appropriate safeguards for financial system stability. Two distinct elements of this process are important. The first is that it allows for different speeds of integration depending on the state of readiness of respective member countries. The second is the commitment of members to support each other in developing the preconditions that would make financial integration viable for the group as a whole in the long run. These elements are important for achieving a process and outcomes that will be sustainable.
The modernization of Asian financial systems during this period has also been accompanied by significantly strengthened regulatory and supervisory frameworks, improved financial safety nets, more effective surveillance of financial stability risks and stronger legal underpinnings. These reforms supported the transition towards more market-oriented financial systems that are anchored in stronger institutions, risk management capacity and governance. Today, our financial markets are better able to intermediate volatile financial flows and our financial institutions are supported by stronger financial buffers to withstand adverse developments and shocks. Significant strides also continue to be made in strengthening consumer protection frameworks, promoting financial inclusion, and enhancing market discipline. These developments continue to support the region through the recent episodes of turbulence in the global financial markets.

The region has also made important strides in enhancing monetary and financial cooperation arrangements to address regional financial stability issues and global policy spillovers. Much has been accomplished in the areas of surveillance arrangements, financial safety nets and crisis prevention, management and resolution. We have already experienced the important benefits of having these arrangements in place as the region came together to respond where needed to events that were unfolding during the global financial crisis. The authorities in the region remain committed to build on these foundations to bring regional cooperation to higher levels not only to reap its benefits but to also preserve financial stability in the region. In this effort, the current priorities for cooperation include improving information flows on risk assessments; advancing regional financial infrastructure and capacity building; and providing a regional voice on key international developments that may affect the region.

As financial integration gains pace, the demand will increase for greater convergence in regulatory and supervisory approaches and standards, including their implementation across borders. An important objective of such regulatory convergence is to ensure that cross-border financial linkages act to foster regional growth, while mitigating the propagation of systemic risk across borders through such linkages. The convergence of standards has proceeded in different ways in different parts of the world. In Europe, regulatory convergence has been driven by EU-level bodies and agencies, including the European System of Financial Supervisors and the European Systemic Risk Board. The EU-wide prudential rules are formulated and implemented through directives and regulations legislated by the European Parliament and European Council, with limited room for member states to apply “national discretion”. Recent proposals to establish a single supervisory mechanism for banks led by the European Central Bank, and a
single resolution mechanism, will further reinforce the role of EU-level institutions in the management of financial stability in the Euro area.

With significantly more diverse economies and financial systems, promoting greater regulatory convergence in Asia is more likely to proceed on the basis of a set of shared principles for developing and maintaining sound financial systems, while providing for the unique and distinct legal, financial, social and economic structures of individual countries within the region. It will be important to have clarity around the key principles, an inclusive process in agreeing on these principles, and mechanisms that support their effective implementation in individual countries. Under such an approach, individual countries will have the necessary degree of flexibility to tailor national implementation approaches to reflect the specific characteristics of their respective economies, while committing to uphold the essential regulatory and supervisory principles that underpin financial stability.

With Asia’s varied experience in weathering financial crises, in developing our financial systems and in implementing the various regulatory reforms, valuable lessons can be drawn from the region to advance the progress and development of our respective financial systems and of the region as a whole. SEACEN has had an instrumental role for more than 30 years in the efforts to share this knowledge and experience widely among its members through providing a platform for such information sharing and through its research, training and capacity building initiatives. Today, SEACEN takes yet another important step forward in advancing this agenda with the launch of the SEACEN Financial Stability Journal. We live in a world in which the management of financial stability is a highly complex undertaking, and its dimensions have continued to evolve in an environment that is rapidly changing. It is hoped that the Journal will contribute ideas, perspectives and insights and thus generate the intellectual dialogue and discourse on financial stability issues. As a region, Asia has many unique perspectives and experiences to share with others facing similar challenges in managing financial stability. I congratulate the SEACEN Centre on this important initiative. I wish it every success and look forward to contributions from SEACEN members and from the other parts of the world. The Journal can have a significant influence in drawing attention to the financial stability issues that are most important and thus contribute towards the thinking and responses on these issues. It is a process that should have an inclusive participation in this important agenda of financial stability.

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WELCOME REMARKS

MR. HOOKYU RHU
EXECUTIVE DIRECTOR
THE SEACEN CENTRE
WELCOMING REMARKS BY
MR. HOOKYU RHU,
EXECUTIVE DIRECTOR, THE SEACEN CENTRE
FOR
SEACEN 30TH ANNIVERSARY CONFERENCE ON
GREATER FINANCIAL INTEGRATION AND FINANCIAL STABILITY
20 October 2013
Sasana Kijang, Malaysia

His Excellency Mr. N. Zoljargal, Governor, Bank of Mongolia and Chairman of the SEACEN Board of Governors
Her Excellency Dr. Zeti Akhtar Aziz, Governor, Bank Negara Malaysia
Your Excellencies Governors and Ambassadors
Distinguished Guests
Ladies and Gentlemen

On behalf of SEACEN, I would like to extend to all of you a very warm welcome to Sasana Kijang, Kuala Lumpur and to SEACEN’s 30th Anniversary Conference on Greater Financial Integration and Financial Stability. First of all, let me extend my deep appreciation to Her Excellency Governor Dr. Zeti for her gracious presence in officiating at this opening ceremony of the Conference and Bank Negara Malaysia for rendering valuable assistance in organizing this important conference. I also wish to thank His Excellency Governor Zoljargal of the Bank of Mongolia for his presence at this Conference as Chairman of the SEACEN Board of Governors and Dr. Christine Cumming for gracing this occasion as our distinguished keynote speaker.

Ladies and Gentlemen,

SEACEN has reached a significant milestone, marking the 30th anniversary of its establishment. For the benefit of those who are not familiar with SEACEN or are participating in a SEACEN event for the first time, let me spend a couple of minutes introducing SEACEN.

The SEACEN history began in 1966 when a group of governors from South East Asian central banks began the first of their meeting in Bangkok, Thailand. The purpose of the meeting was to exchange information, views, ideas and experiences on issues and
problems confronting economies in the South-East Asian region. This was a remarkable initiative at the time when international meetings were rare, and central banks in the region were just established. The recognition of the immense benefits from pooling resources to build capacity and learning from one another prompted the governors to initiate a secretariat body to provide training and conduct research for central bankers in the region. Consequently, on 27 January 1982, the South East Asian Central Banks (SEACEN) Research and Training Centre was established with two main purposes: (1) to update the knowledge and analytical skills of central bank staff; and (2) to undertake research studies relevance for central banking. We have come quite a long way since the ratification of SEACEN as a legal entity 30 years ago. From its original 8 founding members, SEACEN’s membership has grown to 19 member central banks and monetary authorities. In addition to the full membership, SEACEN invites 16 observer and invitee central banks in the Asia-Pacific region to its learning programmes and collaborates closely with 26 regional and international strategic partners.

In 2010, SEACEN was tasked with a more focused Vision and Mission. The main impetus of the new vision “To be the Regional Learning Hub for Central Bank in the Asia-Pacific Region” is for SEACEN to drive central banking excellence in the region. This is fulfilled through our mission of building capacity in central banking and fostering networking and collaboration through platforms to represent members in the regional and international forums.

All our member and invitee central banks and monetary authorities as well as strategic partners have played a significant role in the success and accomplishments of SEACEN thus far and will continue to play vital roles going forward in fostering networking and collaboration in order for us to become a key enabler for thought leadership on regional views. With all these, the brand positioning of SEACEN as the learning hub for central banks in the region is envisaged to meet the learning needs of member banks as well as to attract demand from other central banks to participate in the Centre’s collaborative learning platforms.

At this juncture, I would like to take this opportunity to thank our member and invitee central banks and monetary authorities and strategic partners for their ardent support in the last three decades. This time of celebration evokes many different responses inside of us: we have great joy in being able to look back over 30 years of service. We are thankful indeed that we have been given this unique opportunity of organizing this conference at a
pivotal moment amidst tremendous changes in the regional and global financial environment.

Ladies and Gentlemen,

The Conference topic is certainly timely as there have been significant changes in the financial structure of SEACEN economies in the two decades, especially in the aftermath of the Asian financial crisis in 1997 as well as the recent Global Financial Crisis. There has been a very rapid expansion in the financial services industry and also globalisation of financial markets. While all these have enhanced economic growth opportunities, they have also at the same time, increased risks in the financial sector, making it very challenging for central banks to maintain financial system stability. Moreover, the recent crisis has clearly demonstrated the importance of maintaining systemic stability in the financial sector. A stable financial system not only facilitates efficiency in financial intermediation and resource allocation but also provides an effective conduit for transmission mechanism of monetary policies. Meanwhile, as we have seen and still continue to witness, the absence of financial system stability is costly as it may lead to financial crisis resulting in dire consequences of lower economic growth, higher fiscal burden, and even social and political instability.

In pursuing their mandates to contribute to the stability of the financial system, many central banks are publishing financial stability reports on the current state of the systemic health of the financial systems. Central banks’ roles involve monitoring both domestic and international financial developments and highlighting potential areas of concern relevant to the financial system.

Ladies and Gentlemen,

With these concerns in mind, SEACEN has initiated the SEACEN Financial Stability Journal (SFSJ), the main objective of which is to provide an accessible high quality resource to the SEACEN stakeholders and promote thought leadership on policies, practices and topical issues related to financial stability. This important new strategic initiative is intended to advance thought leadership and collaboration on financial stability matters among our members, contextualized to the Asia-Pacific region. We also hope to influence international policy debates on promoting financial stability.
There are numerous high-quality research journals devoted to economics and monetary policy. On the other hand, there are very few publications focus on practical implementation issues related to promoting financial stability and systemic risk management from a central bank/monetary authority perspective.

I am indeed very honoured that Their Excellencies, Governor Dr. Zeti and Governor Zoljargal can be at hand to help launch the first issue of the SFSJ which coincides with this 30th Anniversary Conference.

Ladies and Gentlemen,

The 30th Anniversary Conference with its theme of Greater Financial Integration and Financial Stability will focus on issues and challenges for macro-financial linkages; greater cross-border financial integration and supervisory policy challenges for central banks as well as the new global financial architecture moving forward.

We are indeed very honoured to have Dr. Christine Cumming, Vice President of the Federal Reserve Bank of New York to share her experience and expertise with us in the keynote address. The conference discussions will be also led and facilitated by Governors and Deputy Governors, heads of internationally reputable institutions as well as from the academia. It is hoped that the conference would raise thought provoking issues and engender a greater understanding of the topic at hand but most importantly, spearhead the strengthening of networking among the central banking fraternity.

We very much appreciate our speakers, discussants and moderators in sparing of valuable time to be with us. I am sure that their contributions to the conference discussions will be invaluable.

Ladies and Gentlemen,

In closing, let me once again thank Her Excellency Governor Dr. Zeti for giving the opening remarks and His Excellency Governor Zoljargal, Dr. Christine Cumming, speakers, discussants and moderators for supporting us in this conference. I wish everyone here a productive and rewarding conference. Lastly, I also hope that you will be able to find the time to enjoy the beauty and rich culture of Malaysia.

Thank you.
It is a privilege to be here today at this conference celebrating the 30th anniversary of SEACEN. Thank you to The SEACEN Centre for inviting me to participate, and congratulations to the Centre on the launch of the new SEACEN Financial Stability Journal.

We are at a good moment to consider financial integration, its benefits and costs, its prospects, and its challenges. We have gained a few years’ distance and some perspective on the causes and consequences of the global financial crisis that began in the United States and Europe. We have seen for more than a decade sustained growth in many regions of the world, especially Asia, above that in the advanced economies, with important implications for the distribution of global income, wealth and financial activity.

In addition, the global financial crisis and the accompanying Great Recession in the advanced economies have produced a long list of challenges for central banks and supervisors: reform of the regulatory framework for global, systemically important financial institutions, strengthening of the financial infrastructure, and significant new efforts to monitor financial stability and proactively address vulnerabilities and threats. Central banks within the advanced economies are conducting unconventional monetary policy to combat the continuing sluggishness in their economies. All central banks are seeking to understand the channels of transmission of these new approaches to monetary policy and the zero-bound interest rate environment. The transmission channel to emerging market financial markets is important to study, both because of the market turbulence we’ve seen this year and the potential effects on emerging market economies and overall global growth.

In my remarks today, I will focus on the prospects for continued financial integration and then three challenges associated with stabilizing a financial system in which financial integration is
substantial and advancing. As always, I will be expressing my own views and not those of the Federal Reserve System or the Federal Reserve Bank of New York.

**Increasing Financial Integration**

Modern financial integration really began in earnest with the resumption of international trade and financial activity in the 1960s. It is now 40 years since the postwar fixed-rate exchange-rate regime gave way to a more flexible, floating regime. Significant financial deregulation soon followed in the advanced economies, where such features as interest rate ceilings and credit controls were not uncommon in the 1970s. Several waves of liberalization reduced long-standing post-war restrictions on capital flows. Much of this liberalization took place because strong market forces made fixed exchange rates and the old controls on domestic financial activity and international capital flows increasingly ineffective and expensive to maintain. At the same time, market and technology forces also reshaped large parts of the financial sector, eventually producing the very large global financial institutions we have today.

Without question, global financial integration has advanced substantially over the last 30 years. The measurement of financial integration, however, is difficult.

Financial integration is often measured by the size of cross-border financial flows. Those flows over the past decade provide a very mixed message about progress in international financial integration. But interpreting flows during that period is complicated by our realization in hindsight of just how much the run up to the financial crisis distorted real and financial activity over this period. The tremendous expansion of U.S. housing finance, its amplification through the repackaging of risk exposures for global distribution, and the large rise in household and financial leverage created a volume of finance that was unsustainable. Quite possibly, that financial climate played some role in fostering strong capital flows to the emerging market economies. After the financial crisis, the unwinding of those exposures and the continuing impact of the recession depressed financial activity, including with it, capital flows. Moreover, the challenging macroeconomic impacts in the advanced economies and the resulting policy responses to them have no doubt contributed to volatility in those capital flows.

Yet capital flows are simply our proxy for the hard-to-observe features of financial integration. The benchmark for full financial integration is pricing of global financial assets that enables an efficient allocation of global resources. Two characteristics we might look for as signs of that pricing mechanism. One is the completeness of markets, including, for example, capital
markets for business and government and markets for household credit. A second is greater convergence in the distribution of risk-adjusted interest rates and financial prices in national markets around financial prices in international markets. Such convergence may require strengthening the risk profile of financial institutions and financial activity in local markets as well as eliminating barriers and business practices that create a “wedge” between international and national financial prices.

So rather than look at the slowdown of capital flows since the financial crisis as a sign that financial integration is decreasing and may be difficult to restart, we could look closely at developments outside the advanced economies and come to a very different conclusion—that financial integration is continuing now and will persist in the future. I see three ongoing drivers of integration.

First, the composition of global GDP has changed markedly in the last decade—the share of the advanced economies has fallen from roughly 80 percent to just over 60 percent today; and that of the rest of the world has doubled, with the rise in share most pronounced in Asia. The rise in incomes and standards of living around the world creates new consumer and business credit demand. Since investment, economic activity and finance gravitate to where incomes are growing, this redistribution of global income increases the impetus to financial integration.

Second, the continuing shift away from policy instruments that fix prices and quantities, such as interest rate ceilings, credit controls and capital flow restrictions, is another force behind continuing financial integration. As national or regional policymakers turn toward the use of open market operations and regulatory capital requirements, they are using instruments that seek to influence, but not determine market prices and the cost of capital. This shift in policy instruments promotes the interaction of national policies to occur in the price domain, rather than the quantity domain.

Finally, we have the continuing efforts around the world to strengthen the regulatory framework and financial infrastructure. Through forums such as the SEACEN Centre, the Asia-Pacific region has been working to strengthen prudential supervision and explore greater regional integration, including the development of regional capital markets. Those efforts are likely to contribute to the greater completeness and alignment of financial marketplaces that is a hallmark of financial integration. To the extent that Asian and other emerging countries continue to develop their domestic banking and capital markets, financial infrastructure and regulatory and supervisory regimes, the potential for further financial integration is good.
The benefits of financial integration are hard to disentangle from the benefits of economic integration—such as international trade and real investment. The benefits of global integration overall, however, are clear: standards of living and life expectancies have increased dramatically, poverty rates have dropped sharply in the countries of highly integrated countries, such as many in Asia. After several decades of stagnation, the gap between income levels between the advanced economies and the emerging countries, while still large, has narrowed, in emerging Asia especially dramatically.

But the rise in incomes and standards of living has not resolved all issues. The global financial system is still vulnerable to frequent and sometimes severe crises. Progress is being made on the international agenda to mitigate those risks, but much work is still to be done. And the level of real and financial wealth has grown staggeringly. With it, the size of the financial sector in the advanced economies has grown dramatically, as have levels of compensation in the financial industry. That growth has raised questions about the efficiency and the fairness of our financial mechanisms.

The post-crisis reforms are designed to address the issue of vulnerabilities and tools of crisis management, but may also have impacts on the size and structure of the financial sector. Let me turn to areas of post-crisis reform, beginning with globally systemically important financial institutions, the so-called G-SIFIs.

**Global Financial Institutions**

The activities of global systemically important financial institutions or G-SIFIs have been a major driver of financial integration. The recent financial crisis illustrates dramatically that problems at large, systemically important firms can have impacts on markets and the real economy not only where they are domiciled, but across the globe. This spillover has long been a concern of financial authorities in host countries.

The regulatory and financial stability agenda being advanced by the Financial Stability Board and the Basel Committee on Banking Supervision is intended both to reduce the probability that such firms could fail and to mitigate the costs of their failure, should it occur. Measures to raise both the quantity and quality of capital at the G-SIFIs, such as Basel III and enhanced prudential standards, are aimed at reducing the probability of failure. The work on recovery and resolution planning, as set out in the *Key Attributes for Effective Resolution Regimes*, a new global standard published in 2011, aims at mitigating the cost of failure by developing the institutional
arrangements and concrete plans to place a failing G-SIFI into resolution. These initiatives at the global level have been mirrored at the national level in many countries.

I’d draw special attention to stress testing in its role in reducing the probability of failure and resolution planning in reducing failure’s social cost, because both represent an important shift of focus for the supervisory community. Both processes focus attention on the far adverse tail of the probability distribution of outcomes for a firm. Technology, financial modeling, and risk management theory and practice have greatly expanded and enhanced the supervisors’ ability to address those severe adverse outcomes.

As a result, supervisors and resolution authorities are having conversations with firms that were simply unimaginable prior to the crisis. For example, the U.S. requirement for firms to produce a “living will” or resolution plan under the U.S. Bankruptcy Code is forcing firms to confront the sources of their long-tail risk and the consequences to the firm of adverse outcomes in a manner never discussed before.

I mention the breaking of these barriers because it is relevant to another set of conversations that have proven difficult: the conversation between home and host supervisors. Host jurisdictions for over 20 years have sought greater information about the parent organization as they supervise local subsidiaries and branches of global financial firms. The information need is felt most acutely, of course, when the global firm is in distress.

Resolution planning is developed in relatively small groups of authorities in the jurisdictions in which a G-SIFI’s largest operations are located. Currently, work is underway under FSB auspices to find a way to communicate with other host supervisors where the local operations are systemically important in that nation.

Just as the dialogues within firms and between firms and their supervisors have had to break through old barriers, the dialogue between home and host supervisors will also need to break new ground. The preconditions for that dialogue are ensuring that safeguards to ensure the confidentiality of information are in place. Information about a troubled firm will need to be communicated with economy, given the time pressures and scope of communication needed in a crisis.

We do not know yet how the reform agenda will affect the international activities of G-SIFIs, although we can see some early indications. Higher capital requirements and more stringent
prudential standards are causing some firms to re-examine their correspondent and business relationships and make new cost-benefit assessments. The greater focus on stress testing and resolution planning may lead to more discussion of firm structure, including the number of subsidiaries, the alignment of the corporate structure with the firm’s business activities, the management of intragroup exposures, the use of parent guarantees, and the correlation of the firm’s capital and liquidity structure with the firm’s business and legal entity structure.

In my personal view, discussion will no doubt lead to action, in the best scenario, by G-SIFIs themselves. In my personal view, these issues reflect areas where the true costs of managing a large, complex, internationally active firm have not yet been fully internalized by the firms. Said differently, the cost of international financial activity has probably been too low, and as it rises, some readjustment of those activities will be inevitable.

This touches on one area of global financial firm recovery where more progress will need to be made. I like to benchmark progress toward financial institution recovery against the program that U.S. regulators used in the domestic banking crisis of the early 1990s. Because the problems at that time were simpler, the remediation program imposed by supervisors was easy to understand and it was effective. The program had three principal actions: a troubled bank had to raise additional capital and strengthen its liquidity; it needed to fully identify its problem assets and exposures, isolate them and place them in workout; and it needed to develop a new business plan.

The international community of supervisors has done a great deal to address the need for more and better quality capital through new capital standards. The identification and workout of troubled assets has made significant progress, which we can observe in the recovery of markets for some troubled assets. But global financial firms are still working on the new business plan. From the financial press, it’s clear that many large financial companies are rethinking their strategies, often along the lines of increasing the focus on nonfinancial businesses and households and reducing the focus on expanding capital markets businesses. But I believe we are more at the beginning than toward the end of that reconsideration.

**Complexity**

Let me turn to complexity. The development of international and domestic capital markets has been one of the dramatic developments of the last 30 years. A combination of new instruments, new national markets, and the development of a range of complex securitization
and derivatives structures has made the financial system substantially more complex. The
global financial crisis underscored the difficulty of monitoring and containing mounting financial
stress in the global system and the specific dangers that lie in very complex products with
opaque risk characteristics.

Complexity is a fact of modern life—look at the global supply management chain or the
integration of activities guided today by “smart” technology. Cost, however, can grow
geometrically with complexity, and may be one reason why the share of the financial sector in
GDP has grown so much. For central banks and supervisors, complexity makes it difficult to
identify emerging problems, understand the potential for one adverse development to trigger
others, and close gaps in regulatory coverage that encourage regulatory arbitrage.

Whatever the costs of complexity are under normal operating conditions, those costs escalate
sharply under conditions of distress. Indeed, in the early stages of the recent crisis, many
financial market participants had to scramble to understand the nature of their exposures down
to the details, including details about the clearing and settlement of transactions.

Complexity therefore needs to be managed and reduced meaningfully whenever we have the
opportunity. I would point to four ways that we in the official community can reduce complexity.

First is the development of international standards in forums such as the Financial Stability
Board and the Basel Committee on Banking Supervision and the application of those standards
in all our jurisdictions. Consistency in our approach to supervision and regulation across
jurisdictions can make the regulatory environment more seamless and less subject to arbitrage.

The expansion of the Financial Stability Board and other standard setting bodies to include the
G-20 countries means that more voices are heard as these standards are developed. Regional
organizations such as the SEACEN Centre, as well as the FSB’s regional consultative
meetings, provide a forum for discussion of policy matters with a much wider set of countries.

Second is the move to regional financial markets. A regional financial market has obvious
benefits in scale and liquidity. It can harmonize market practices across many jurisdictions and
consolidate financial infrastructure, thereby simplifying the financial system.

Third is greater standardization of financial products. The global financial crisis highlighted
weaknesses in infrastructure and risk management because of the lack of standardization in the
global derivatives markets. Highly customized complex transactions produced large losses in part because their inherent risks were poorly understood; conventional risk management and infrastructure systems could not capture and flag all of the risk dimensions.

The Financial Stability Board and in the U.S., the Dodd-Frank Act, as well as earlier international supervisory efforts led by the Federal Reserve Bank of New York, have pushed forward centralized clearing of derivatives. The move to trade repositories and clearinghouses may also lead toward more transactions through exchanges or electronic trading platforms, where products are generally standardized.

Fourth is seeking greater transparency into firms and markets. International standards and standardization of financial products create some of that transparency. But much more is needed. Requiring a financial institution to explain to the public the nature of its risks and their management is a strong discipline on both risk-taking and complexity.

**Financial Stability**

Let me end with a few words on financial stability. How adeptly financial institutions and financial supervisors manage the risks associated with complexity and large, globally connected institutions will have important implications for financial stability. However, the experience of the financial crisis has drawn attention to the need to identify threats to financial stability and address them promptly and to create the institutional arrangements that ensure that need is met. The result has been an effort to strengthen the focus on financial stability as a mandate and provide the necessary powers to address it in national statutes.

The policy discussion now describes three realms of relevant policy: macroeconomic, such as monetary policy; microprudential, such as financial institution supervision; and macroprudential. At least two issues figure prominently in discussion of these realms: who is responsible for financial stability and which policies and policy tools should be considered macroprudential.

I’d like to offer an analogy that might be helpful. A major financial loss in a financial institution almost always reflects the breakdown of multiple sets of controls. The supervisory program the supervisor would have liked to have had in place before the loss would involve asking the firm to take multiple corrective actions to have prevented the breakdown.
I would posit that instances of financial instability result similarly from the coincidence of several failures or breakdowns requiring policy intervention. Financial instability events are by definition systemic; their scope and size cause them to impact real and financial activity across multiple sectors. The financial crisis that began with the U.S. boom in residential mortgage financing grew to be so destructive because of increased leverage in the household and financial sectors and a series of poor and risky practices in the marketing, mortgage underwriting and securitization of housing loans.

This view has two implications. It means that coordination is essential to financial stability and it also means that several measures will likely be necessary to address emerging financial instability. Thus, the full range of macroeconomic, regulatory and market conduct policies need to be available to deal with the emergence of instability. Coordination involves quickly laying out the sources of stress and the transmission paths of that stress as clearly as possible and then calibrating a response across the complete policy toolkit available.

Such an approach may lead to a concern that conflicts could arise among the goals of macroeconomic, macroprudential, and microprudential objectives. In many cases, the overarching goal of stability will create alignment because the stabilization goals of monetary policy and financial supervision are prerequisites for financial stability. But where conflict exists or targeting is needed, coordination and a sufficiently large toolkit allow the authorities to craft a response to a systemic threat that minimizes any short-term conflicts among goals.

The focus on coordination also forces us to ask what structures and mechanisms create strong incentives for coordination and address conflicts within the group of policymakers. In some countries, much of the coordination of policy tools could be led and overseen by the central bank—for example, one that serves as both monetary authority and a primary microprudential supervisor. In a country like the United States, with our numerous regulators, the coordination mechanism Congress has put in place is the Financial Stability Oversight Council, known as FSOC, chaired by the Secretary of the Treasury.

What guarantees that the ten or so agencies at the U.S. Financial Stability Oversight Council, table will coordinate? The requirement to publish an annual assessment of financial stability risks, that is, shared concerns, is one such incentive. A second is the escalation processes built into the FSOC process, should the members disagree. A recent example of disagreement arose when the U.S. Securities and Exchange Commission (SEC) did not approve a proposal asking for comment on possible avenues to reduce the risk of runs on money market mutual
funds, a source of concern highlighted in FSOC’s financial stability report. Many FSOC members thought it important to move forward with reform in this important area. The FSOC process offers a range of options, exerting peer pressure to formal actions that could involve imposing new requirements. With further deliberation, the SEC put out a new proposal for comment.

Finally, I believe we need in the official sector a bias toward action and a willingness to take risk in confronting emerging financial instability. It will almost always be uncertain whether an emerging problem will become systemic. Any supervisory actions taken will have an immediate impact, curtailing someone’s profitable opportunity; moreover, the results of an action might not be discernible for some time. Yet we need to overcome the inclination to wait, especially in light of the rapid rate of deterioration of financial firms and markets we observed in the financial crisis. To respond timely and with sufficient force, policymakers need to be agile; observing the impact of their actions, they need to able to adjust their program to improve its impact. Given the need for agility, we may also need much more flexibility in our policy instruments and processes.

To sum up, I’ve highlighted three challenges we need to address to continue to foster international financial integration and reap its benefits:

- We need to complete the reform agenda dealing with large financial institutions.
- We need to manage and contain complexity.
- We need to coordinate more fully on meeting threats to financial instability.

We have plenty of work ahead.

Thank you for attention today.
Session 2:

Macro-financial Linkage: Issues and Challenges
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NEPAL RASTRA BANK
MACRO-FINANCIAL LINKAGES: ISSUES AND CHALLENGES

By

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Respected Chairperson
Esteemed Discussants
Distinguished Participants Observers and SEACEN Strategic Collaborators
Ladies and Gentlemen

Let me first congratulate fellow Governors of the SEACEN Board, Executive Director, and staff of the SEACEN Centre at this occasion of celebrating 30th anniversary of the SEACEN Centre. Our collective effort supported by several non-members and institutions has taken this organization to a new height which is reflected in its growing attraction. While celebrating this event, the Centre has created an opportunity for many central bank Governors to visit the Centre, may be for the first time to some of us - at least in the Governors' capacity. I also appreciate the Centre's initiative to carry forward discourse on financial stability and particularly on an evolving and increasingly popular issue of macro-financial linkages. We all know that this issue has drawn the interest of central bankers and macroeconomic policy analysts, particularly with the advent of the financial crises. I would like to sincerely thank the Centre for giving me this opportunity to share some of my thoughts in this area to this august gathering of fellow Governors and other dignitaries.

Fellow Governors,

A key feature of recent financial market development has been the close and immediate feedback between the real economy and financial conditions. We have observed that in many countries, the credit and housing boom that preceded the recent financial crisis went hand in hand with strong spending and production. And during the economic crash, deteriorating financial conditions helped cause the recession and in turn exacerbated the deep declines in economic activity. This is manifested in the extraordinary financial market dislocations coinciding with a global macroeconomic free fall. Such a macro-financial linkage has brought public policy makers, macroeconomists and finance economists together to better understand the important aspects of the recent intertwined financial crisis and economic recession.

We know that there are strong theories and vast empirical literature regarding the effects of monetary policy on output and other macroeconomic aggregates. Also, there is a rapidly growing literature that pays special attention to monetary policy shocks (defined as the portion of the central bank policy variation not caused by systematic responses to variations in the state of the economy) which affect output with long delays, that their effect is highly persistent, and this accounts for the movement in aggregate price levels. But macroeconomic effects of monetary policy often differ from one study to the next with regard to both their timing and magnitude. However, the feedback from financial sector to the real economy is an emerging subject from both the theoretical and empirical aspects. Empirical studies show that financial market crashes decrease aggregate demand through a reduction in wealth and a rise in the cost of capital. This may also reduce consumer spending and real investment. Thus, stock market disturbances can produce additional stress on the economy, possibly leading to intervention by the central bank. Often times, the monetary authorities may react to movements in stock prices in order to stop bubbles from getting out of hand, or alternatively try to prop up the stock market following a crash through adopting an expansionary policy stronger than the one indicated (by straightforward effects on aggregate macroeconomic variables). Central banks would do so if stock market crashes have the potential to destabilize the financial system and to produce more stress on the economy.

Over the last few years there have been dramatic changes in the operation of the financial system and the conduct of monetary policy, with the emergence of new ideas on how monetary policy affects real economic activities, leading to further evolution in our understanding of the macro-financial linkages. The advent of recent global financial crisis has exposed more complex and intricate linkages in the transmission mechanism of monetary policy. Consequently, the central bankers and policy analysts have now began to focus their attention from traditional monetary system to the entirety of financial system and its linkages to the real economy.

Empirical studies suggest that monetary authorities take disruptions in the financial market into account when assessing monetary policy. A monetary authority’s response to asset price movements is also taken as an expanded mission for monetary policy, but there are concerns that it might complicate inflation targeting procedures. It is argued that monetary policy is a macroeconomic policy tool that should be used for macroeconomic purposes, not for a single market or localized events, as in the financial market. However, as suggested by advocates of central bank intervention (in case of financial crisis), asset price movements may lead to sizeable debt build-ups, weakened balance sheets and financial imbalance which can generate financial instability and in turn, macroeconomic fluctuations. As monetary policy contractions and stock market collapses both have real effects on economic activity, monetary authorities have to take these facts into account when developing an optimal policy.
Distinguished Participants,

As greater trade and financial integration has contributed to many recent episodes of global financial crisis and have thus made more complex the maintenance of financial stability, the roles of central banks are also changing so as to address these newer challenges. The macro-financial inter linkage suggests that the direction or causality is potentially both ways, i.e., there is a feedback loop. Moreover, recently there has been considerable discussion regarding the appropriate monetary policy selected during the aftermath of a financial crisis. This suggests that there is a relation between monetary policy and financial stability, but there is still no clear consensus on how one affects the other. It is argued that the key problem facing monetary policymakers is not stock market crashes, but rather financial instability. Also not all stock market collapses are associated with financial instability, for they also arise from other sources such as a banking system crisis.

Some empirical studies reveal that monetary policy and financial shocks have significant effects respectively on output, price level and on other variables. It is then suggested that the central bank has to take the effects of financial collapses into account when conducting monetary policy, even when targeting price stability. We also find series of macro-financial research that focus on the linkages between interest rates and the economy. As a theoretical matter, asset prices and the macro economy are inextricably linked, as asset markets are the mechanism by which consumption and investment are allocated across time and types.

The nature of macro financial linkage is changing as there is both the trend for development of financial sector as well as greater trade and financial integration in the global economy. This can be reflected in the 'depth' and 'extent' of the financial system. The depth of financial linkage is analogous to the depth of financial system. Traditionally, it involves indicators of banking institutions’ activities such as the ratio of private sector credit to GDP. The sophistication of providing services, i.e. through technological innovation, is also reflected in the depth of financial system. This reflects the extent of interconnections between the real economy and the financial system. On the other hand, there is no consensus on the 'extent' of financial system; however, it can be characterized as the breadth of financial services, which includes deposit taking money market, capital market, and insurance market institutions, among others.

There is a widespread consensus regarding the impact of changes in financial conditions on real economy, particularly on household and business spending decisions. But, quantifying the overall strength of this linkage has been a great challenge for policy makers. A number of empirical literatures have shown relative role of the various monetary transmission channels through which the monetary impulses transmit to growth, employment and overall economic development. Traditionally, the transmission mechanism of monetary policy has been explained through either interest rate or exchange rate channels. With the deepening
of financial markets and global integration, the development of other transmission channels
namely, credit availability, asset price, and liquidity channels, have evolved to explain the
financial sector linkages to the real economy. The effectiveness of either of these channels
depends on the structure of the economy and the stage of financial system development.

Ladies and Gentlemen,

The macro-financial linkages could be analyzed from different channels, namely the credit
channel, wealth channel, exchange rate channel and monetarist channel which also
suggests a wide perspective of such links. In this regard, there has been a voluminous
discussion, especially after the global financial crisis beginning later 2007, on the effect of
the macro-financial link such as on real business cycles – i.e. the finance accelerator and the
relationship with the 'external finance premium'. In this regard, a BIS working paper identifies
three channels which exist between the financial and real sectors - namely the borrower
balance sheet channel, the bank balance sheet channel and the liquidity channel. The
borrower balance sheet channel refers to both firms and household whereby lenders are
unable to fully assess and monitor relevant risks as well enforce fully their repayment of
debt. The bank balance sheet channel refers to financial institutions, which affect their
lending behavior and affects economic activity. The liquidity channel refers to banks ability to
extend credit and in turn to affect real economic activity. However at a fundamental and
basic level, these channels simply suggest how financial markets efficiently allocate
resources and risks to facilitate wealth accumulation, which leads to overall growth and
development.

One way the macro-financial link can be characterized is via the textbook IS-LM analysis of
the real and monetary sectors, where changes in the interest rate, i.e. the cost of funds,
leads to an opposite change in national income via allocation of investment since an interest
rate rise indicates a rise in the cost of funds, a reduction of both credit demand and
investment, leading to an overall reduction in national income. Thus, interest rate can be
specified as an instrument of the macro-financial linkage connecting the real sector with the
financial markets, which provides information for the efficient allocation of scarce resources
(financing) as well as a measure of risks via external finance premium. Given this
characterization, we can also sense the role of monetary authority in affecting the macro-
financial linkage. This is reflected in the monetary authorities’ choice of the transmission
mechanism relevant for their respective economies. Based on the above characterization,
this is reflected in the credit market, where supply of credit meets its demand as determined
by the interest rate.

More recently, macro prudential measures exercised by the regulatory authorities affect the
financial market along with the interest rate. Macro prudential regulation, specifically Capital
Adequacy Ratio (CAR), credit to deposit ratio, loan-to-value ratio, liquidity ratio, single
borrower obligation or sectoral credit restrictions influence the quantity of available credit. A higher CAR affects lending standard and the quantity of credit made. This categorizes the credit market into risk profile and accordingly the amount of credit available in the market (which will also affect the structure of the interest rate). This can be taken as a time varying external finance premium, which affects the economy business cycle (and is described as amplifying the effect of shocks hitting the economy).

The 'nature' of the macro-financial linkage is changing, as there is a trend of economies' internal financial deepening and greater trade and financial integration with the global economy. Let me start the discussion from closed economy case followed by open economy and then the depth and extent of the linkage.

The 'depth' of the financial link is analogous to the depth of the financial system. When banks are the only regulated institution which can provide loans, this could be a relevant measure of the credit depth of the monetary system. This measure would be too narrow when there are more institutions than banks doing the credit operation. The sophistication of providing services i.e. through technological innovation, have also to be reflected in the depth of the financial system. On the other hand, for 'extent' of the financial system - and as mentioned earlier - there is no consensus on this definition. However, it can be characterized as the breadth of financial services. The former is classified as an indirect source of financing while the later is characterized as a direct source of financing (similarly with the above measure for the monetary system, depth of the direct financing system can simply be taken as the stock market capitalization and outstanding domestic private debt securities to GDP ratio) with other non-regulated forms of the financial system being a part of them. The depth and extent of the financial system in a closed economy indicate the 'nature' of the macro-financial linkage and thus gives information to the monetary authority for maintaining domestic financial stability.

The above description of financial system development is only one of the contributors to the nature of the macro-financial linkage. As I had mentioned earlier, the discussion of the linkage from a closed economy perspective has to be changed to an open economy context with higher degree of globalization (reflected in economic and financial integration). There is also a cross-cutting effect which relates to the flow of credit. The major contributors for analyzing the flow of credit is its ability to move beyond domestic borders and are affected by both the state of the capital account and the exchange rate regime in the domestic economy. Thus having a more liberalized capital account, where there are fewer controls and restrictions on the mobility of funds, as well as having a more flexible exchange rate make the flows of credit more responsive; and thus make it harder to predict the magnitude of the macro-financial linkage.
Let me also refer to some empirical studies on macro-financial links and factors which affect them. Empirical results from US data from 1961:1 - 1996:2 suggests that there is the presence of a macro-financial linkage in the US and that domestic monetary policy management has been effective in influencing the output gap. The same exercises with an update in 2009 suggest that securitization (i.e. activity that pools various types of contractual debt and sells them as bonds or securities) activities dampen the interest rate elasticity of output in the US. The result implies that controlling for the relative share of securitized mortgages (i.e. in the property market) reduces the traditionally negative relation between output gap and real interest rates. The same methodology with data from South Africa suggests that the growing use of mortgage securitization in South Africa had, to some extent, eroded the general sensitivity of real output to monetary policy. A study done by SEACEN in 2010 shows similar but weakening link of traditional monetary policy. The above results suggest that there are unexplained factors which are not adequately captured, but which influence economic growth. These unexplained factors are of concern since they complicate monetary policy management. The unidentified factors, lumped together are mostly reflected in 'shadow banking' which I will discuss later.

Let me delve a bit on whether monetary policy continues to impact the real economy directly or through the financial system, and whether assigning single objective to monetary policy like that of controlling inflation is still a valid proposition. The traditional interest rate channel of monetary transmission is a key component of how monetary policy effects are transmitted to the real sector. This channel explains the impact of changes in interest rates on the cost of capital and hence on business and household investment spending. As we know, a lower real interest rate leads to higher investment (fixed, residential housing, inventory, etc.) and consumer spending, and this result in higher aggregate output and employment. Standard neoclassical models of investment explain that the user cost of capital is a key determinant of the demand for capital that has direct impact on real economy. But in the presence of extensive non-banking services, the traditional short term interest rate mechanism becomes weak to affect the real economy.

The exchange rate channel also involves interest rate effects when capital flows are open. As domestic real interest rate falls, return on domestic assets declines and hence it becomes less attractive relative to that on foreign assets. The interest rate arbitrage may lead to an outflow of capital pressing to depreciation of the domestic currency. Thus, changes in the interest rate directly affect the exchange rate and hence the external sector. This mechanism of course is effective in those economies having open capital account and flexible exchange rate regimes. The changes in net exports following exchange rate movement have direct impact on aggregate output and employment. The sensitivity of exchange rate to interest rate plays vital role for the effectiveness of this channel. Small and more open economies tend to have larger effects through this channel.
In the recent times, much attention has been paid to the credit availability channel in the monetary transmission process. This channel focuses on the role of banks in financial system particularly in reducing the problem of asymmetric information. Credit channel particularly becomes relevant for small firms/borrowers as they cannot raise external financing sources through the capital market. This channel directly works through its effect on investment and aggregate output. Lower interest rates may not always lead to higher investment spending. They may be constrained by regulatory requirements. Availability of credit directly affects the borrowers' decision, leading to a change in aggregate output and employment opportunities.

The role of macro-prudential policies is particularly important for effective macro-financial linkages through credit channel. The macro-prudential measures are designed to manage pro-cyclicality and to reduce interconnectivity and systemic risk. An improved financial market infrastructure with prudential regulatory and supervisory framework is critical to strengthen monetary transmission through this channel. Moreover, the enforcement of credit contracts needs to be strengthened to ensure reliable and rapid resolution of defaults, bankruptcies and disputes. The credit conditions provide an important conduit through which financial conditions affect real output. Improved credit conditions lead to greater availability of credit and reduction in spreads, which has significant impact on growth. And, only a stable financial market condition can ensure such uninterrupted credit flows.

Monetary impulses are also transmitted through the asset (real estate and stocks) prices channel. Fluctuations in asset prices influenced by monetary policy impulses have important impact on the real economy. A higher monetary expansion lowers the interest rate and, consequently, stocks become more attractive thereby leading to a higher stock price. Conversely, lower interest rate raises the demand for real estate, resulting in a higher price. Asset price channel works through Tobin's $q$ and wealth effects leading to a change in business investment and households wealth which consequently affects the aggregate output accordingly. In an abnormal financial market situation, this channel also gets disrupted and the real economy is adversely affected.

Empirical studies on macro-financial linkages, which examine the role of credit markets in the transmission of macro-financial shocks through the prism of a financial conditions index, conclude that credit conditions dominate the market variables highlighting the importance of credit supply in the monetary transmission process. Some studies suggest that securitization activities dampen the interest rate elasticity of output implying that controlling for the relative share of securitized mortgages reduces the traditionally negative relation between output gap and real interest rates.
Distinguished Participants,

Let me now move on to shadow banking and its implication for macro-financial linkage analysis. The 'shadow banking system' can broadly be described as credit intermediation involving entities and activities outside the regular banking system. The shadow banking system can become a source of systemic risk, especially when it is structured to perform bank-like functions like mobilizing current or call deposits, undertaking off-balance sheet activities, doing maturity transformation, and leveraging and when their interconnectedness with the regular banking system is strong. The interconnectedness implies that any shocks in the shadow banking will be transmitted to the proper banking system with a bearing to the real sector as well. Therefore, Financial Stability Board suggests that appropriate monitoring and regulatory frameworks for the shadow banking system needs to be in place to mitigate the build-up of risks. The Board also recommends that the mostly entity-based focus of the 'macro-mapping' should be complemented by obtaining more granular data on assets/liabilities (e.g. repos, deposits) or expanding activity-based monitoring, to cover developments in relevant markets where shadow banking activity may occur.

Despite that shadow banking system plays an important role in the economy by ensuring credit intermediation through extension of credit or through facilitating its intermediation, two concerns arise with the use of shadow banking system: (i) systematic risk concerns; and (ii) regulatory arbitrage concerns. The former predominantly deals with activities that generate maturity and/or liquidity transformation, that involves flawed risk transfer, and that create or facilitate leverage, much like banks however using non-deposit instruments without an 'explicit official sector backstop and/or without being subject to the same prudential standards and supervision'. Thus this implies that there may be a built up of leverage within shadow banking system. This has implication on pro-cyclicality within the economy (i.e. shadow banking system can facilitate high leverage when asset prices are high and vice versa). The later deals with activities for circumventing and undermining bank regulation, which generally has more restriction and supervision. This is attributed to the interconnectedness with the banking system where funds can easily move to take advantage of different regulations regarding assessing risk – this will lead to an unnatural buildup of leverage and risk in the system.

There are several challenges posed by shadow banking system in macro-financial linkages. This in large part may be due to regulatory arbitrage concern, where funds move between the regulated and unregulated banking system and vice versa. This interconnectedness 'raises systematic concerns and can exacerbate the pro-cyclical build-up of leverage and thus heighten the risks of asset price bubbles', for example, property markets which has a bi-directional feedback to the financial sector. This is more concerning with financial integration where credit is internationally mobile and affecting financial stability. Thus and based on the market situation, the nature of the link may be very fluid and dynamic, more volatile, makes
warning of contagion effects more difficult and thus has made the job of identifying stress as well as monetary policy management more complicated.

Given the discussion and since shadow banking appears outside the scope of regulation but has an important impact in regard to monetary policy management, I feel that the monetary authorities have no choice; and they are compelled to address this issue. In my view, an important first step in addressing this challenge to monetary policy management is to enhance the monitoring framework on shadow banking system. In this regard, I want to emphasize that enhancing data collection is very important. This includes the quantitative approach from both the macro and micro perspective and qualitative information (i.e. market intelligence). The need for enhancing better system wide data has also been voiced in a number of forums. In parallel, the scope of regulation of the non-banking sector in credit creation must be expanded, which in my view may necessitate coordination among domestic regulators. This may eventually be visualized to harmonize and open the channel of communication between different regulators (both domestic and international) and perhaps initiate the unification of these fragmented regulations to fully encompass the financial system. In my personal opinion, such activities will enhance our early warning ability.

Ladies and Gentlemen,

Let me now turn to the relative importance of various channels which are particularly relevant for low income economies. The relevance of these mechanisms vary over time and across countries, depending on the degree of institutional development, depth and size of financial markets, modalities for conducting monetary policy, degree of financial integration, among others. Given the characterization of various transmission channels, we can also sense the role of the monetary authority in affecting the macro-financial linkage. This is reflected in the monetary authorities' choice of the transmission mechanism relevant for respective economy.

As I explained before, the transmission process evolves through both price and quantities of credit. In price-mediated mechanisms, monetary impulses affect real economic activities through its effects on interest rates, asset prices and exchange rates. Given the existing monetary, financial and exchange rate framework and poor linkages among the financial variables, interest rate and exchange rate channels of monetary transmission have not been so effective in explaining the macro-financial linkages in the low income economies. This is because in these economies real economic activities are less elastic with the price-mediated transmission channels. Additionally, in low income economies, where the informal financial market exists with high interest rates and the limited supply of fund cannot sufficiently meet the demand for credit, availability rather than cost of capital primarily determines the investment demand.
Empirical evidence have also shown that in emerging and developing economies with underdeveloped financial markets, quantitative regulations on credit, significant degrees of dollarization, and weak sensitivity of exchange rate with interest rate, the price-mediated channels, viz. interest rate and exchange rate channels, are less effective in explaining the monetary transmission process. Likewise, the asset price channel that also requires deep and sophisticated financial markets is less likely to explain the monetary transmission process in these economies. Such price-mediated mechanisms are supposed to be more effective in advanced economies in normal times but, they become more relevant again in the management of the financial crisis. This can be evidenced from the recent experience of many central banks, which provided liquidity not only by lowering interest rates but also by easing credit during the financial crisis.

The recent experience of the global financial crisis has highlighted the relative strength and weaknesses of monetary policy transmission mechanism. In particular, interest rate and exchange rate channels seem to be quite limited in some countries, while the credit channel appears to be stronger in some other countries. However, the weak interest rate pass through should not be interpreted as total ineffectiveness of this channel. The other factors, such as changes in risk premium and investment environment, could also offset the effects of interest rates on investment spending.

Ladies and Gentlemen,

Global experiences and a number of empirical works have shown a strong correlation between financial sector development and economic growth, with the causation running in both directions. A developed financial sector is better able to allocate resources and thereby promote economic growth. In the reverse direction, economic growth generates demand for financial services and spurs financial sector development. A downturn in economic activities lowers household and business income, which ultimately reduces the financial resources thereby adversely affecting the financial system. Moreover, decline in household/business income results in lower saving, leading to a higher interest rate or cost of capital.

Both borrowers’ and banks’ balance sheet positions are important in considering the real and financial transmission channels. Banks’ balance sheet influences their ability to extend credit, which has direct impact on real economic activities. Weaker macroeconomic conditions reduce the profits of businesses and incomes of households, which results in slower increase or in some cases decrease in net worth. Moreover, weaker business revenues and household incomes push up borrowers’ default risks, which in turn weaken the position of banks’ balance sheets. Probably, the speed of this reversal mechanism (from real to financial sector) is slower but, the results may be more pervasive!
Ladies and Gentlemen,

Let me now conclude.

In the context of changing economic and financial landscape, understanding the evolving monetary transmission mechanism and its linkage to both the real and financial sectors is crucial for the macro policy makers. The issue of macro-financial linkages has regained its importance particularly after the advent of recent financial crisis, which has made it increasingly complex. It is, therefore, critical for the central bankers to assess the nature of linkages, strengthen macro-prudential oversight accordingly, know how long it takes before their actions fully transmit to the economy and what determines the speed of transmission. The deepening financial liberalization and higher financial integration have a deep and pervasive impact on the monetary transmission mechanism, which also suggests a ‘blurring’ of the traditional macro-financial linkage. The pro-cyclical nature of financial sector in amplifying macroeconomic volatility has made monetary management even more complex.

The recent financial crisis has renewed the interest in exploring the linkages between financial variables and real economic variables. The central bankers are now facing obvious policy challenges in conducting monetary policy in an environment where financial development seemingly matter for their target variables. But, the question is how exactly do these macro-financial linkages work? Experience and the recent empirical works have called for the identification of more explanatory financial indicators that link the transmission process effectively.

The ever changing financial sophistication and their relationship to financial indicators, cross border financial integration and existence of shadow banking, particularly in low income economies, are magnifying the complexities in analyzing the extent of macro-financial linkages. We central bankers, therefore, need to be alert to the implications of such challenges and calibrate our policy responses to macroeconomic developments. For this, the policy authorities should enhance greater coordination and adequately monitor the financial system with upgraded data collection as well as analysis techniques.

Finally, I would once again like to express my sincere appreciation to the SEACEN Centre for providing me this opportunity to share with you all some of my views in such an important theme.

Thank you very much!
References


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Macro-financial Linkages
- Issues and Challenges -

Choongsoo Kim
Governor, the Bank of Korea
Contents

I. Increasing Importance of Macro-financial Linkages

II. Macro-financial Linkages, by Type of Financial Intermediation

III. Policy Implications
I

Increasing Importance of Macro-financial Linkages
I. Increasing Importance of Macro-Financial Linkages (MFLs) (1/4)

- Importance of Macro-Financial Linkages (MFLs) highlighted since global financial crisis
  - **Before**: Shocks amplified through borrowers’ and banks’ balance sheet channels
  - **After**: Procyclicality among economic agents builds up systemic risk

![Diagram showing the before and after effects of macro-financial linkages](image_url)

- **Before Crisis**
  - Borrowers’ B/S
  - Financial Accelerator
  - Banks’ B/S
  - Liquidity supply depending on banks’ leverage, maturity mismatches, mark-to-market factors

- **After Crisis**
  - Households, Corporations
  - Pro-cyclical Behaviors and Feedback
  - Financial Sector
I. Increasing Importance of MFLs (2/4)

- **Before**: Economic phenomena understood by focusing on the real sector

- **After**: Understanding MFLs essential to promoting sustainable growth

**Before Crisis**
- Real Sector
  - Financial Institutions
  - Intermediation
  - Financial institutions intermediate for real sector

**After Crisis**
- Real Sector
  - Financial Sector
  - Sectors interact on equal footing
  - Financial sector plays important role in economy, just like real sector
I. Increasing Importance of MFLs (3/4)

- Macro-financial delinkages occurring over past few years
  → Financial sector liquidity not flowing into the real sector
- Necessity for central banks to restore normal MFLs, through credit policy, etc.

Now: Macro-financial Delinkage

- **Central Bank**: Inject Liquidity (by QE, LTRO, Zero interest rate)
- **Banks**: Return as reserves
- **Households, Corporations**: Delinkage

Liquidity circulates within financial sector
I. Increasing Importance of MFLs (4/4)

- Further research and analysis of MFLs necessary (BIS, 2011)
  
  ✓ Analyze MFL feedback effects in macro-stress test models, and effects when capital flows included in the models

  ✓ Research on effects of borrowers’ normal balance sheet positions on terms of credit, access to credit, and real economy as a whole

  ✓ Development of models reflecting MFLs’ non-linearity, structural changes, etc.
Macro-financial Linkages, by Type of Financial Intermediation
II. Macro-Financial Linkages (MFLs), by Type of Financial Intermediation (1/7)

- Identify characteristics of Macro-Financial Linkages (MFLs) by type of financial intermediation, centering on financial sector.
MFLs in credit market show up in form of pro-cyclical behaviors of economic agents

- **Good times**: Credit-related systemic risk gradually accumulates

→ Monitor whether or not credit expansion reflects real sector growth
Bad times: Negative interactions between two sectors increase, and credit crunch occurs.

Especially, information asymmetry between banks and corporations rises sharply:
   → Appearance of macro-financial delinkages

⇒ Credit policy can provide incentives for banks to increase credit supply.
Ⅱ. MFLs, by Type of Financial Intermediation (4/7)

( Capital Market )

- MFLs in capital market show up indirectly, through changes in value of securities as assets or collaterals

  ✓ Asset price bubbles form and burst, due to herd behavior and speculative funds

    → Volatility of real as well as financial cycle rises
Ⅱ. MFLs, by Type of Financial Intermediation (5/7)

✔ Capital market a pivotal route transmitting overseas shocks to domestic economy
⇒ For emerging countries, more efforts to reduce capital flow volatility needed

**Capital Flow Volatility**

- Equity
- Bonds
- Bank borrowings

Note: 1) 12-month moving standard deviations of capital flows in percentages of GDP (annualized)

**Bank Borrowings** and **Business Cycle**

Notes: 1) 12-month moving averages
2) Shaded areas indicate cyclical upswings
Shadow banking functions as intermediary similar to traditional banking system, but without public supervision/backstop.

In advanced economies, shadow banking creates high yields through high-leverage strategies.

- In times of crisis, however, shadow banking network structure is too complicated to control.

- Enhancing transparency by public disclosure, applying regulation, and strengthening of monitoring required.
In EMEs, shadow banking has complementary functions such as diversifying funding sources, contributing to economic growth, and facilitating financial inclusion.

⇒ Balance of shadow banking’s positive and negative effects should be considered.

**Shadow Banking Shares of Assets**
(as of 2011)

**Degrees of Financial Deepening**
(as of 2012)

Notes: 1) Bonds, Equities, and Bank Assets (% of GDP)
2) NIEs: Newly-industrialized Asian economies
Central banks now have dual mandates – for price stability *and* financial stability.

- Deeper understanding of Macro-financial Linkages (MFLs) a key to successful central bank policy implementation.
In Korea, several macroprudential measures already introduced or being considered:

- Macroprudential policy tools to mitigate procyclicality → LTV, DTI, and Loan-to-Deposit ratio, as well as credit policy for SMEs

- FX-related macroprudential measures to reduce capital flow volatility → Leverage cap, Macroprudential Stability Levy, Resumption of withholding tax
LTV and DTI regulations have helped to stabilize housing markets, and to keep credit expansion under proper control. (Choongsoo Kim, 2013)

III. Policy Implications – Korean Case (LTV, DTI) (2/3)

Potential Effects of LTV (six months before and after tightening)

Potential Effects of DTI (six months before and after tightening)
Leverage cap and Macroprudential Stability Levy appear to have contributed to improving the maturity structure of banks’ external debt and reducing the likelihood of sudden stops. (Choongsoo Kim, 2013)

**Maturity Composition of External Debt**

<table>
<thead>
<tr>
<th>(Domestic banks)</th>
<th>(Foreign bank branches)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009Q1</td>
<td>2010Q1</td>
</tr>
</tbody>
</table>

Note: 1) Black and green vertical lines refer to dates of introduction of Leverage Cap and Macroprudential Stability Levy
### III. Policy Implications

- Things to bear in mind when introducing macroprudential measures
  - Differences in Macro-financial linkages between emerging and advanced economies
  - One size does not fit all.
Thank you!
Session 3: Greater Cross-border Financial Integration and Supervisory Policy Challenges for Central Banks
Cross-border financial integration and supervisory challenges for central banks

SEACEN’s 30th Anniversary Conference
Kuala Lumpur, Malaysia
20 October 2013

José Luis Escrivá
BIS Chief Representative for the Americas
Contents

- Recent trends in international banking
  - Stagnant activity of global banks
  - Emergence of regional banks

- New challenges in banking supervision for EMEs

- The challenges of effective supervision across multiple jurisdictions

- Conclusions
Recent trends in international banking

- International bank lending has been stagnant since the global financial crisis, mirroring the poor performance of international trade.

**Graph 1**

Ratio of international trade and bank international claims to global GDP

In per cent of GDP

Recent trends in international banking

- Cross-border flows have been very volatile, against a background of steady local-currency lending.
European banks are reducing international exposure...

- Which in some regions created space for US banks’ expansion

Cross-border claims of selected BIS reporting banks vis-à-vis emerging markets

In billions of US dollars; changes in claims\(^1\) vis-à-vis all sectors

<table>
<thead>
<tr>
<th>Latin America(^2)</th>
<th>Emerging Asia(^3)</th>
<th>Other EM economies(^4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro area</td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Changes adjusted by estimated exchange rate.  
2. Argentina, Brazil, Chile, Colombia, Mexico and Peru.  
3. Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.  
4. Czech Republic, Hungary, Israel, Poland, Russia, South Africa and Turkey.

Source: BIS locational banking statistics by residence.
From G-SIBs to R(egional)-SIBs: domestic banks are expanding in Latam and Emerging Asia

- Aggregate figures mask the remarkable growth of cross-border activities of regional banks

Foreign claims of BIS reporting banks

Vis-à-vis regions; in billions of US dollars

Graph 4

<table>
<thead>
<tr>
<th>Latin America</th>
<th>Emerging Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>60</td>
</tr>
<tr>
<td>2007</td>
<td>45</td>
</tr>
<tr>
<td>2009</td>
<td>30</td>
</tr>
<tr>
<td>2011</td>
<td>15</td>
</tr>
<tr>
<td>2013</td>
<td>0</td>
</tr>
</tbody>
</table>

1 Brazil, Chile and Mexico. 2 Chinese Taipei, India and South Korea.

Source: BIS consolidated international banking locational statistics.
Drivers of regional cross-border banking

- After 20 years of relatively smooth economic and financial growth, domestic banks in Latam and Emerging Asia are going regional

- Many traditional reasons for that:
  - Banks following their domestic customers abroad
  - Economies of scale (growth limited by domestic market size)
  - Diversification
  - Ready access to international financial markets
  - Growth opportunities offered by other countries in the region

- Regulatory framework (domestic and international) is not there:
  - Faulty/incomplete domestic regulation about foreign investments of local banks
  - G-SIB standards apply only to 28 (mostly AE) banks
New challenges in banking supervision for EMEs

- Regional expansion of EMEs domestic banks is likely to continue
- EMEs have traditionally played the role of host markets
- Now, they can often (and increasingly) play the dual role of host and home → financial stability considerations grow in complexity
Micro-prudential concerns of host markets

- Location of loss-absorbing capital: home regulation and supervisors’ guidance will introduce home-bias incentives
  - Where should capital instruments be issued?
  - How should conversion be triggered? How the cost of additional capital be treated?
- Liquidity management: no clear rules for availability of centrally-held liquidity outside parent bank
- Asymmetric treatment of creditors (eg depositors in home market could get preferential treatment)
- Asymmetric treatment of comparable risks (eg local currency sovereign exposure in home and host)
- Developing a mechanism to ensure all relevant jurisdictions are invited to supervisory colleges
  - Relevance determined by systemic importance for the host, not the home supervisor
Macro-prudential concerns of host markets

- Bank funding-lending structure determines shock transmission
  - Funding shocks in home market may affect local credit provision
  - Stronger spillovers of home’s monetary and financial policies
  - External shocks may compromise solvency on-shore and strain local safety nets
- Branch/subsidiary may be deprived of liquidity in home market shock
- Scarcity of HQLA might distort developing capital markets
  - Eligible issuers (ie governments) issue more debt, increasing credit risk despite lower yields → Crowding out of private sector

Sample balance sheet structures of banks’ foreign offices

<table>
<thead>
<tr>
<th>Source location</th>
<th>Destination location</th>
<th>Strictly local</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residents (all sectors, local currency)</td>
<td>Residents (foreign currency)</td>
<td>Residents (foreign currency)</td>
</tr>
<tr>
<td>Resident banks (foreign currency)</td>
<td>Non-resident non-banks</td>
<td>Non-resident banks</td>
</tr>
<tr>
<td>Resident non-banks (foreign currency)</td>
<td>Inter-office</td>
<td>Net position vis-à-vis residents</td>
</tr>
<tr>
<td>Non-resident central banks</td>
<td></td>
<td>Net position vis-à-vis non-residents</td>
</tr>
</tbody>
</table>

Positive bars indicate gross assets while negative bars indicate gross liabilities.

Source: BIS Quarterly Review, September 2010: “Bank structure, funding risk and the transmission of shocks across countries: concepts and measurement”
Macro-prudential concerns of (new) home markets

- Macroeconomic and/or financial risks are harder to assess
  - Difficult to determine adequacy of capital and liquidity provisions

- No (or inadequate) lender of last resort in some host markets

- Banks’ legal responsibility limited to capital invested → actual responsibility can be much higher (reputational cost)

- Liquidity shocks in host can compromise FX market at home
  - Greater concern if host is financially dollarised (or euroised)
  - New liquidity standards do not contemplate dollarisation: home banks might need to hold high foreign currency assets that do not match the currency of the actual liquidity risk
Micro-prudential concerns of (new) home markets

- Domestic regulation often does not properly contemplate foreign investments of local banks

- Host country information requirements might not comply with home requirements (quality, quantity, periodicity, disaggregation)

- Much relies on establishing MoU defining roles of home and host supervisors → what can hosts really deliver?

- Develop adequate governance standards for local financial conglomerates, ensuring accountability and transparency
Challenges of international banking regulation: Capital distribution

- Main challenge of the international banking regulation/supervision agenda is to reconcile the interests of home and host authorities
- Where the loss-absorbing capital should be located? Crucial for resolution → Level is not the only concern
  - Single point of entry (SPE): resolution executed from the top, capital located at the holding company (home)
  - Multiple point of entry (MPE): resolution executed at the constitutive parts of the group, where the capital should be (host)
- International framework in place (Concordat, Core Principles of Banking Supervision, Capital Accord) do NOT set criteria that guarantee a sensible distribution of capital across the constitutive parts of a banking group
Challenges of international banking regulation: Capital level

- Capital requirements must be flexible: prudential authorities should have enough discretion to adjust them to the world of varying degrees of riskiness
- Discretion v. rules: decisions should be guided by method
- Stress-testing of banks could be an important part of the answer
  - Systematic guidance on remedial or preventive measures
  - Accountability
- Challenges:
  - Scenario design
  - Bank models: regulator or firms? Both?
  - Publication
Challenges of international banking regulation: Coordination among jurisdictions

- Given the difficulties in the proper assessment of global banks’ situation, some (advanced) jurisdictions are proposing additional administrative measures
  - Size limits
  - Prohibiting or limiting certain activities
  - Ring-fencing certain activities or operations

- Unintended consequences: new structures might foster the development of new vulnerabilities → shadow banking

- Extra-jurisdictional effects: liquidity, market fragmentation

- Backward looking approach → Preparing for the previous war
Challenges of international banking regulation: Coordination among jurisdictions

- Host country regulators are also taking measures to protect the local operations of banks in their jurisdictions
  - Foreign banks only allowed to operate through subsidiaries
  - Limits to risk exposure with parent banks
  - Prior authorisations for sizeable transfers of assets and liabilities between parent and subsidiaries
  - Capital instruments allowed only for subsidiaries listed in local stock exchange
- Need to develop credible and enforceable coordination agreements (COAGs) between home and host for regular supervision, stress times, and preparation for resolution
- Race-to-the-bottom: competitive/conflicting regulation could lead to much less global banking and financial fragmentation
Conclusions

- International banking has been stagnant since the global crisis
- Withdrawal of European banks has created room for the expansion of regional and US banks
- Emergence of R-SIBs: no international framework for dealing with them
- Agenda of international regulation is long, broad scope for coordination between home and host countries
- Growing uncoordinated regulatory efforts might hamper financial development and integration
Cross-border financial integration and supervisory challenges for central banks

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Financial Integration and Supervision Challenges for Central Banks

Nestor A. Espenilla, Jr.
Deputy Governor
Bangko Sentral ng Pilipinas
Issues Covered in this Discussion

• The premise of regional integration (with specific focus on ASEAN Financial Integration Framework)

• How banking supervision needs to adjust under the mandate of financial stability and policy direction of regional integration (the strategic framework)

• Some policy challenges faced by banking authorities arising from greater cross-border integration (the tactical concerns)
Herd of Net Private Capital Towards EM/ASEAN
Came in Together, Went Out Together as Well

Net Portfolio Flows (in million USD)

Covers The Philippines, Singapore and Thailand
The Prospects May Not Be As Obvious to All

- Forecast Gross National Savings rate for ASEAN 5 in 2013 is 30.61 %

- The world's average Gross National Savings rate is only at 18.95 %

- Historically, ASEAN saving has been invested outside ASEAN
Using ASEAN Financial Integration as an Example

- Capital Account Liberalization
- Integrated Payment & Settlements Systems
- FSL / ASEAN Banking Integration
- CMD / ASEAN+3 Bond Market Initiative
The Linkages are Clearly Comprehensive

- Linking jurisdictions requires linking financial markets and setting omnibus standards for acceptable behaviour.

- But markets are never going to be identical across jurisdictions... gaps and overlaps will be inevitable.
Financial Stability, Banking Supervision and Regional Integration
Our Stylized Approach Towards Bank Supervision

Conflicts of interest are mitigated by having the bank supervisor take an active role between the financial consumer and the bank itself.

But the pursuit of financial stability will change the nature of the prudential relationships.
Supervision Framework Has to Consider FinStab

It is no longer enough to ensure that each bank is operating safely and soundly.

Linkages matter, the sequence of effects matter and the expected magnitude of impact certainly matters.
Macroprudential versus Micro Oversight

Stable and Resilient Financial System

Prudential Policy Framework
- Capital Adequacy
- Market Conduct
- Consumer Protection
- Safety and Soundness

Other Policy Considerations
- Monetary policy
- Payments system policy
- Securities market policy
- Insurance market policy
Macroprudential versus Micro Oversight

Macro-Prudential Policy Framework

SYSTEMIC (and SYSTEMATIC) RISKS

Prudential Policy Framework

Other Policy Considerations

- Monetary policy
- Payments system policy
- Securities market policy
- Insurance market policy
Setting Up What is Needed At Home

In-country situations will be different as you move from one jurisdiction to another.

There will be a lot of focus on idiosyncratic conditions across jurisdictions.
Moving from intra-country dynamics to inter-country linkages presents a major challenge.

Harmonizing the prudential framework within the region will not be a trivial task.
Some Policy Considerations for Banking Authorities
The Integration Agenda is About **Gaps & Overlaps**

- There is significant diversity across the jurisdictions in the region

- The adjustments to be made by banking regulators will depend on the form of regional integration:
  a) The prudential framework in effect (A regional Basel Accord?)
  b) Cross-border financial transactions
  c) Cross-border network of FIs
  d) Focusing on the Regional Customer
Open Financial Access to Regional Markets

- Open economies always face the double-edged sword of external flows.

- The portion that stays as financial investments typically:
  a. are prone to sudden reversals since they are driven by spreads and gaps
  b. affect market spot and forward rates
  c. thus, distort fundamentals

The Idea Behind Qualified ASEAN Banks (QABs)

- Multilateral Standards
- Bilateral Discussions Among Banking Authorities

Harmonized Banking Supervision Framework

Resolution Mechanism (Both Corporate & Personal)

45 Possible Bilateral Agreements
The Agenda for the Regional Customer

1. Crisis Management and/or Remedial Measures
   - 1. Bilateral Agreement
   - 2. Evolving agenda item for EMEAP, FSB-RCGA

2. Consumer Redress Mechanisms
   - 1. Own country Consumer Protection Framework
   - 2. ASEAN CP Committee

3. Capacity Building for Regulators (By Regulators)
   - 1. SEACEN; FSI; IMF
   - 2. ABIF Capacity Building
   - 3. Individual CB Initiatives
Issues Covered in this Discussion

• The premise of regional

• How banking supervision needs to adjust

• Some policy challenges faced by banking authorities as a result of greater integration

• Potential is clear

• But significant adjustments are needed

• Has to start from an agreed prudential framework . . . and let’s not forget the consumer
Financial Integration and Supervision Challenges for Central Banks

Nestor A. Espenilla, Jr.
Deputy Governor
Bangko Sentral ng Pilipinas
In Southeast Asia, we have made significant strides in economic integration.

- AEC blueprint aims to create a single market and production base by eliminating trade barriers, and increasing capital and labour mobility.
- Virtually all goods move through the region at zero tariff.
- In 2012, intra-ASEAN trade made up 25% of total ASEAN imports and exports, compared to 21% before AFC.
- ASEAN member states have eight packages of commitments under the ASEAN Framework Agreement on Services.

Financial integration has tended to lag economic integration, although its benefits are well-known.

- Complements economic integration by facilitating cross-border trade settlement and investment.
- Improves allocation of capital across region to where it is needed most;
- Deepens domestic financial markets, which can then better support economic growth.

Financial integration lagging economic integration is not such a bad thing.

- First, financial integration is not costless
- Second, its benefits can be fully realised only if preconditions are in place.

Financial integration is not costless. It enables crisis contagion that can undermine financial stability.

- Open capital markets are an important channel through which spillovers from other economies are transmitted to the domestic financial system and economy.

---

• The operations of internationally active banks are another channel of contagion. There is no international regime for bankruptcy and resolution of global FIs.

Benefits of financial integration can be fully realised only if preconditions are in place.

• Macroeconomic fundamentals must be strong: internal and external balance.
• Domestic financial system must be resilient, with strong regulation and supervision.
• Domestic financial markets must be deep and broad.
• Crisis prevention and resolution frameworks must be in place: cross-border risks need cross-border solutions.
• AFC has served as cautionary tale of perils of premature financial globalisation without preconditions in place.

If preconditions are in place, we can have financial integration with financial stability.

Where is SEA on these preconditions?

First, on macroeconomic fundamentals, SEA has made clear progress in strengthening resilience since AFC.

• Exchange rates are more flexible and not over-valued. They can act as a shock absorber against external shocks, as shown in recent months.
• External debt is lower, especially foreign currency denominated debt.
• Current account positions are stronger although there has been some deterioration in recent years.
• Reserves are significantly higher, at ten months of imports on average.

Second, on financial system resilience, banks in SEA are healthier and stronger.

• Capital adequacy ratios are good, ranging from 12–18%
• Loan-to-deposit ratios are not high: 90-110% compared to 100-170% prior to AFC
• NPLs are low: at around 3%.

Quality of regulation and supervision is higher.

• Capacity building and skills development have been an ongoing process.
o SEACEN has been invaluable in raising level of regulatory expertise. In 2013, SEACEN will have conducted 21 learning events covering macroeconomic and monetary policy management, financial stability and supervision, and payment and settlement systems.

o The IMF has also provided important training through regional training institutes and programmes. Since 1998, over 10,000 officials have passed through the Singapore Regional Training Institute.

Third, domestic financial markets are taking shape, though there is some way more to go.

- In ASEAN-5 economies, financial markets have grown deeper and broader, especially in fixed income and equity markets.
- In CMLV countries, markets are at a more nascent stage.
- Bilateral and multilateral technical assistance has been useful.
- Vietnam now has two major stock exchanges. It is working towards implementation of Basel II by 2015.
- Cambodia is in process of amending the National Bank of Cambodia Law and the Banking Law, and is moving towards aligning its prudential regulatory framework with international standards.

Fourth, crisis frameworks have been strengthened.

- Set up the Chiang Mai Initiative Multilateralisation in 2010 with capacity of USD120 billion. It doubled its capacity to USD240 billion in 2012, and introduced a precautionary facility.
- Continued to establish and strengthen bilateral swap arrangements among ASEAN+3 economies. PBOC and BNM signed a RMB180 billion bilateral swap arrangement in 2012.
- On supervisory front, regulators have stepped up dialogue on regionally active banks through supervisory colleges
- However, cross-border resolution of FIs is still in its infancy and very much focused on G-SIFIs currently.

Further upstream, there has been strengthening of multilateral surveillance to detect problems early.

- IMF collaborates with FSB on a semi-annual Early Warning Exercise.
• Launched Spillover Reports and Pilot External Sector Reports to assess impact of policies and imbalances of major economies.
• Implemented a new Financial Surveillance Strategy to identify risks to global financial stability.
• In Asia, ASEAN+3 Macroeconomic Surveillance Office (AMRO) now puts out twice-yearly country reports, playing an important role: surveillance of Asia from an Asian perspective.

So, is SEA ready for more financial integration? Definitely more ready than ten years ago and we should accelerate the pace, especially among ASEAN-5.

Pace has picked up in recent years, especially in capital markets, in line with deepening in these markets.

• In 2012, stock exchanges in Thailand, Malaysia, and Singapore launched ASEAN Trading Link, which allows investors in any of these countries to trade securities in other two markets through a single access point.
• Earlier this year, Thailand, Malaysia, and Singapore implemented harmonised ASEAN Disclosure Standards for prospectuses, so that a single prospectus can be used across all three countries.
• Next step is to streamline approval process for prospectuses across these countries to minimise time needed for listing in multiple markets.
• And just this month, the three countries signed an agreement to facilitate cross-border offering of collective investment schemes, so that funds established in one country can be offered to retail investors in other two countries under a streamlined authorisation process.
• These developments will help to further deepen financial markets, cultivate a wider investor base, and encourage companies to raise capital in ASEAN markets.

But we need to further strengthen preconditions in two key areas, to move to an even deeper level of integration.

• Boosting supervisory and regulatory co-operation across SEA.
• Accelerate progress on resolution of cross-border banks.
• Enhancing domestic toolkits to improve resilience to spillovers
First, improve home-host cooperation on supervision of FIs with regional footprint.

- Making progress on harmonisation of regulatory frameworks through international standards such as Basel III and regional initiatives such as ASEAN Banking Integration Framework.
- Supervisory colleges should be strengthened, particularly in their information-sharing function. Colleges are key to effective consolidated supervision, but also serve to build trust and dialogue between supervisors.
- There may be a need to update or supplement the 1983 Basel Concordat in view of the growing role of home-host collaboration

Second, accelerate progress on resolution of cross-border banks.
Crisis management groups have been created but: Institution-specific cross-border cooperation agreements have not been enacted.

- National legal frameworks for cross-border resolution are not complete.
- Feasibility of recovery and resolution plans developed by systemically important banks has not been assessed.
- Until there are effective and credible mechanisms to tackle cross-border externalities of bank failure, countries will have little choice but to protect and ringfence national systems.

Third, enhancing domestic toolkits to improve resilience to spillovers.
Financial integration transmits and generates credit cycles with potentially dangerous consequences for financial stability.

- Alan Taylor’s research shows that crises are “credit booms gone wrong.” Financial stability risks emanate from both pace of credit creation as well as high credit levels.
- Claudio Borio argues that the amplitude of financial cycles exceeds those of business cycles due to the “excess elasticity” of the financial system to credit creation.

And there is a prominent international dimension to financial cycles.

- Reinhart and Rogoff find that “periods of high international capital mobility have repeatedly produced international banking crises.”
- Borio finds that the excess “elasticity” of financial system is related to availability of external financing more generally.
Kristin Forbes has found that global risk is the most consistently significant variable in predicting surges and stops in capital inflows; domestic factors are usually not significant.

**A robust domestic policy toolkit must therefore include instruments that can directly affect credit and leverage growth in particular sectors.**

- Asia’s challenge has been in restraining exuberance in asset markets – either in housing or financial assets - amid a global search for yield in a zero interest rate environment.
- Number of Asian authorities have implemented macroprudential measures to temper housing price inflation.
  - Indonesia has reduced LTV ratios for property loans.
  - Malaysia has implemented shorter loan tenure limits for property and personal finance.
  - Singapore has implemented a range of measures including LTV, DSR, additional stamp duties, and loan tenure restrictions.
- Macroprudential tools have been reasonably successful in Asia and their use is gaining popularity.
  - But there is insufficient understanding of calibration of these tools, and potential unintended consequences.
Session 4:
Greater Financial Integration and Thoughts on the New Global Financial Architecture – Moving Forward
SEACEN 30th ANNIVERSARY CONFERENCE

GREATER FINANCIAL INTEGRATION AND THOUGHTS ON THE NEW GLOBAL FINANCIAL ARCHITECTURE – MOVING FORWARD

Chea Chanto

20 October 2013
Progress on Regional Integration

• Over the last fifteen years, regional integration has been deepening.

• The share of intra-regional trade and investment rise.

• Regional financial integration is also moving ahead.
Progress on Regional Integration

• Major challenges: Large differences in the levels of development, including differences in regulatory standards and fragmented infrastructure.

• This may be observed, not only in the ASEAN scope, but also in the European Union.
Cambodia’s Economic Performance

• Sound management of macroeconomic conditions

• The Government’s efforts toward regional integration.
Financial sector in Cambodia develops quickly, particularly the banking sector.

Cambodian commercial banks are mostly foreign-owned and their parent banks or groups are within the ASEAN region.
Cambodia’s Efforts in Regional Financial Integration

- Cambodia makes its best efforts to actively take part in the Regional Financial Integration.

- There is no effective Regional Financial Integration without financial stability.
Regional Financial Integration

- Cambodia is positively welcoming the further Regional Integration and considers it as an additional chance to continue improving its own banking sector.
Regional Financial Integration

• Achieving Regional Convergence in the Financial Sector is a common objective.

• Further efforts are needed to reach this purpose for the sake of regional interest.
Regional Financial Integration

- Short-term approaches or to rapid execution are very risky.

- Envisage medium-term and long-term perspectives in order to consolidate as much as possible our Regional Integration.
Thank you very much for your attention
MR. AJITH NIVARD CABRAAL
GOVERNOR
CENTRAL BANK OF SRI LANKA
Thoughts on a New Global Financial Architecture

Presented by

Ajith Nivard Cabraal
Governor
Central Bank of Sri Lanka
There is a growing call for the revamping of the existing Global Financial Architecture...

- For several decades, the global financial architecture has been focused on the exchange rates, international reserves and balance of payments of the more developed economies.
- The aftermath of the global financial crisis and the more recent developments have prompted the re-visit of the Global Financial Architecture for the furtherance of the world economy at large.
- In addition to IMF, emerging economies have now secured a voice in global forums such as G – 20, Financial Stability Board, BIS.
- Several other regional monetary, financing and surveillance arrangements such as ASEAN, APEC have also been helpful.
- A closer dialogue between the advanced and major emerging economies should result in a more stable global monetary and financial system.

A few thoughts on a possible new Global Financial Architecture will be relevant. These follow.....
1. Move towards a multi-polar currency system

- It is imperative to avoid dependence on a single global currency, especially in the context of heavy volatility associated with such reliance.
- It is strange that currencies such as Chinese Renminbi are still not recognised by the IMF despite their prominent role in the world economy.
- The global currency system should be based on global rules, rather than be based on domestic rules of few economies.

Perhaps, IMF and/or G20 could be instrumental in developing such rules.
2. Re-visit the voting power of IMF to reflect the new economic realities.....

• The voting power of IMF is based on shareholding of different regions/countries, which is on their historical shares in the world economy, e.g., Europe – 33% and the USA – 17%

• The openness of Europe is considered high, due to inter-regional trade, though it constitutes several small economies

• The emergence of new counties and regions to the top positions of the world economy is disregarded, e.g., Despite becoming the 2nd largest economy, China is still the 5th/6th position in voting!

• IMF decisions are sometimes biased, and do not represent individual country’s/region’s contribution to the global economy

The voting power of IMF should be adjusted to provide a fair representation of member countries.
3. ‘Too big to fail’ Institutions must be dealt with in such a manner, that they will not actually be allowed to fail....

• Supervision alone cannot guarantee continuity, although an effective surveillance system should be put in place to ensure that TBTF Institutions/Systems are continuously monitored

• The current approach to intensify supervision of operations of GSIFIs and DSIFIs are noteworthy, but any triggers of potential risks should be promptly dealt with to minimise contagion and spillover effects

World needs a firm assurance and confidence restored that such institutions/systems are managed proactively....
4. The role of rating agencies should be re-visited, and must be regulated more effectively....

- The assurance of safety and soundness of financial systems should not be based on third party assurances only
- The assessment methodologies of rating agencies should pay adequate attention to certain country/region specific circumstances
- The high dependence on few rating agencies should be avoided through promotion of strong regional rating agencies
- A globally acceptable institutional arrangement for a strong oversight framework of rating agencies should be developed
- The mechanism should also allow for a mechanism to take appropriate action on any losses due to negligence or reckless ratings and statements

The emerging economies should reduce their reliance on global CRAs and develop a mechanism to assess and rely on each others strengths to promote inter-regional investments/savings
5. The significant losses suffered by emerging economies via the “round-tripping” of funds must be recognised and addressed..

- The global liquidity transfers from emerging nations to developed nations, and from developed nations to emerging nations, must identify new concepts and search for new methods for investments of reserves.
- The regular uncertainty surrounding investments that have been traditionally identified as “risk free”, must be given consideration, when taking investment decisions.

The anxiety over safety and quality of investments in emerging economies must be dealt with via new instruments such as SWAPs, Regional guarantees, reciprocal investments, etc.
6. Emerging nations must be given active and stable support to build strong economies....

- Inadequate and high cost of funding for development has led to high cost of financing, e.g., huge insurance fees and commitment charges

- Reliance on short-term external financing increases vulnerabilities to external market conditions, e.g., hot money inflows

- The adverse impact of unfair mechanisms created by the current global financial architecture, (endorsed by multi-lateral institutions like IMF) such as ‘Round-Tripping’ has extended even more pressure on emerging economies

Greater attention should be paid to reduce volatility of capital flows that impact the macro-economic stability of emerging nations.....
7. The developed economies and the multi-lateral agencies must be made responsible and accountable for a stable global financial system...

• In deciding global rules, attention is generally paid to the concerns of developed nations only, e.g., when trade or investment “sanctions” are imposed on certain countries, the countries that have legitimate trade with, or rely on economic imports from, the sanctioned countries suffer enormous economic stresses and losses.

• Perhaps, the recently set up FSB RCG Forum is a step in the right direction towards formulating a hybrid Global Financial Architecture, and this dialogue must be strengthened and pursued....

In future, adequate attention must be paid to the local circumstances of all nations, both developed and emerging nations.
MRS. PONGPEN RUENGVIRAYUDH
DEPUTY GOVERNOR, MONETARY STABILITY
BANK OF THAILAND
Greater Financial Integration and
Thoughts on the New Global Financial Architecture
– Moving Forward

Pongpen Ruengvirayudh
Deputy Governor, Monetary Stability
Bank of Thailand
Kuala Lumpur, 20 October 2013
Framework of cross-border collaboration for financial integration

• **Real economic integration** would lead to further progress toward regional financial integration.

• **Intra-regional business activities** can be facilitated by investing in cross-border infrastructure developments.

• **Cross-border collaboration frameworks** such as the AIF and the ABMI can help channel Asia’s excess savings to support cross-border infrastructure developments.

• **Collective regional efforts** should be placed on enhancing these regional initiatives to produce more tangible outcomes.
Asia’s outward oriented regionalism bodes well for Asia’s highly divergent economic development.

Although the integration endeavors of EU and Asia are different, EU could give valuable lessons.

The experience of European financial integration: Does it apply to Asia?

- Sufficient safety net to assist crisis countries
- ‘Complementary-monitoring mechanism’ of national/regional/global surveillance system
- Enhance trust & farsightedness among policymakers
- Establish a ‘close-knitted policy dialogue’ to coordinate or share information
Asia’s view on the New Global Financial Architecture

“New key players”  Regional players will have larger roles which should help build the rebalanced global economy.

“New currencies”  New key players will move us closer towards multi-polar economic and currency landscape.

“New conventions”  A more sustainable market-based approach becomes more welcomed.
Introduction

I would like to thank the South East Asian Central Banks Research and Training Centre for the invitation to participate in this Conference, which is a great opportunity to learn from the experience of this region and to strengthen the ties between SEACEN and CEMLA.

I will spend just a few minutes highlighting how Latin America and the Caribbean have fared in the most recent wave of globalization and financial integration, to derive from there some basic principles that could be taken into account when thinking of a new global financial architecture. My suggestion is: first, do not aim for a perfect world but for a more stable one. And second, rely on regional, bilateral and cross-border arrangements as the building blocks of a more comprehensive regulatory framework.

Latin America and the Most Recent Wave of Globalization

Various authors have identified different phases of globalization in terms of both the depth of the process itself and the relative importance of the various types of mechanisms and capital movements involved. This history of globalization, however, is far beyond the scope of this brief presentation, which has as its time framework the latest of those phases, characterized by the considerable importance of gross capital flows led by the behaviour of international banks.

Economic globalization has been gaining speed since the mid-1990s and further intensified during 2004-2007, although the recent crisis slowed and even temporarily

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1 See for example Obstfeld and Taylor (2003) that surveys the development of international capital mobility since the mid-nineteenth century. This study documents a U-shaped pattern traced out by the creation of a well-integrated global capital market by 1914, its collapse during the interwar years, and its resurgence since 1970.
reversed this process.\textsuperscript{2} According to Lane and Milessi-Ferreti (2007) and Lane (2012), the cross-border financial integration of advanced economies, measured by foreign assets plus foreign liabilities over this group’s GDP, climbed from 45% in 1970 to 100% in 1987 and to a peak of 438% in 2007. However, not all regions have integrated at the same speed nor have they reached similar levels of integration into the world economy. For example, international financial integration for emerging markets and developing economies tracked the behaviour of the advanced economies until the early 1990s, but then lagged behind and in 2007 that ratio stood at only 73\%.\textsuperscript{3}

The strong financial globalization seen in the advanced economies encouraged growth in some types of novel credit markets, especially the US securitization boom. As analysed in Brunnermeier et al. (2012), the international banking sector was at the heart of the considerable expansion in gross capital flows across countries that have not necessarily been accompanied by (important) changes in net capital flows. For example, before 2008 there were large capital outflows from the U.S. with which European global banks raised dollar funds in the wholesale market that they invested in securitized claims on U.S. borrowers, re-entering the initial outflows and supporting the “shadow banking system” in the U.S. The flows associated with the banking sector in the globalization process are of the wholesale variety, and most of them short term, which poses risks to financial stability. They are specially pro-cyclical and volatile because they respond, in part, to risk perceptions and reflect the way banks manage their balance sheets in terms of size, composition and leverage.

In the case of many Latin-American countries, foreign banks are established as subsidiaries, which means that they have to comply with local regulation as well as with

\textsuperscript{2} Focusing on flows, as opposed to stocks, Dobbs and Lund (2013) report that cross-border capital flows represented 4\% of global GDP in 1980 and 5\% in 1990, but by year 2000 they were 13\% and reached a peak of 20\% in 2007. The global crisis reduced these flows to 3\% of global GDP in 2009 and in 2012 they were estimated at 6\% of global GDP. Meanwhile, developing economies that did not experience a long-lasting reversal in capital inflows have been capturing a growing share. For example global capital inflows to developing countries went from 5\% ($0.2 trillion at 2011 prices) of global flows in 2000 to 14\% ($1.6 trillion) in 2007 and 32\% ($1.5 trillion) in 2012.

regulation in the country where the parent bank is established. In fact, foreign-owned banks in Latin America have had to carry out their activities under a more stringent local regulation when compared to many advanced economies. For example, regulation in Latin America contemplates (as a very important ingredient) a strict limit on the deposits that the subsidiary can make in the “parent” bank, thus reducing the risks of “sudden start of outflows”.4

Furthermore, the regulatory framework in the region makes foreign-owned banks rely mainly on local sources to finance their activities. In some countries there are restrictions on currency mismatches in banks’ balance sheets. This means that Latin American banking systems are, theoretically speaking, less vulnerable to sudden variations in the availability of funding from abroad or in foreign currency.

It follows from here that an important difference between the current model of financial integration in Latin America, on the one side, and Central and Eastern Europe, on the other, refers to foreign currency risk exposure. Unlike in previous periods of financial distress, foreign currency assets now exceed foreign currency liabilities in many countries of Latin America. In other words, they have taken a “long” position in foreign currency, with central bank’s international reserves as the most important component in the asset side, which even allows central banks to serve as lender of last resort. In contrast, emerging Europe has taken a “short” position in foreign currency and is now more vulnerable to exchange rate fluctuations.

Even with the substantial reduction in capital flows that took place in 2008q45, Latin America has been more resilient during the current global financial crisis than in previous crisis, and part of the explanation has to do with the model of integration of the region as well as with a more counter-cyclical economic policy framework.

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4 For a detailed analysis see the Appendix A: On Subsidiarization in Brunnermeier et al. (2012).
5 In 2008q4, total Latin American cross-border claims dropped almost 50,000 billion U.S. dollars, while in Asia the fall was greater than 75,000 billion U.S. dollars.
Despite the apparently more favourable scenario for Latin America, the recent months have underlined how true it is that globalization means greater integration and, more importantly, increased interaction among countries. A simple suggestion by the Federal Reserve that it might consider a normalization of its policy stance sometime in the near future produced a revision of risk perceptions and an outflow of capital from a good number of emerging economies. Whether it was an overshooting in risk perceptions, or evidence that all the talk about decoupling is just a mirage, we still do not know.

In any case, the scenario reinforces the concerns that globalization is a two-edged blade that justifies a careful evaluation and perhaps some action on the part of both individual countries and the international economic organizations.

**Globalization and a New Focus for Regulation**

It is then understandable that the global financial crisis has given rise to a deep-rooted search for economic, institutional and political arrangements to prevent the occurrence of this type of episodes in the future and to be better prepared to respond to them. These efforts have been accompanied by thorough analyses of the possible factors that explain the crisis itself.

The point of departure is the idea that financial globalization and the increasing integration of the world economy are, to a good extent, responsible for the painful events that marked the recent five years in most advanced economies and in a good number of emerging and developing countries. The uncritical faith in the benefits of unregulated markets, it is also said, has the burden of the blame in the explanation of the crisis.

The search for new arrangements or for a new global financial architecture has followed various paths that include calls to reverse financial integration and efforts to design a more administered framework with an explicit global orientation, coupled with greater policy coordination.

There is also a middle of the road position that recognizes both the benefits of greater market integration and, at the same time, the risks that are inherent to such a process.
Integration opens opportunities for new investment and diversification fronts that can turn into their opposite, that is, a source of systemic risk.

It is probably around this concept of **systemic risk** at a global level that a more sensible view towards globalization can be found. It is sometimes contended that it was the lack of an explicit focus on preserving financial stability where the problems of the pre-crisis regulatory framework lie. The alleged faith in the benefits of financial markets, it could be argued, may not be as harmful as the lack of recognition of the pro-cyclicality of financial markets, the herd-instincts of international bankers, or the collective action problems involved in global financial networks.

It follows from here that a serious flaw in the current financial architecture, and one that became visible early in the outbreak of the crisis, was the implicit idea that the global economy is equal to the sum of its parts. Whatever features will characterize the new financial architecture, thinking in terms of the system as a whole and having a more top-down perspective will necessarily be among them.

A fruitful way of operationalizing the concept of systemic risk is through the notion of **global liquidity** which, in turn, is closely related to capital flows and to the factors affecting financial stability in Latin America. Very briefly, the dynamics of global liquidity are closely related to such things as the leverage cycles of international banks, the stance of monetary policy in advanced economies, how monetary policy decisions are transmitted internationally, risk perceptions of international investors, etc., among others. To the extent that global liquidity reflects the ease or tightness of financial conditions in the world economy, it may help to focus the discussion around the new financial architecture.

One could then argue that the current scenario of the world economy, now that the causes and consequences of the recent financial crisis seem to be clear, is ripe for the definition of the basic principles of a new global architecture. Such architecture; (i) should explicitly aim at procuring financial stability; (ii) probably strengthen supervision and impose further restrictions to what financial institutions are allowed to do; (iii) focus on the pro-cyclicality of the system in order to prevent systemic risk at the global level; and (iv) include mechanisms to deal with failing institutions. Moving away from a belief that markets are perfect and recognizing that they are inherently unstable is a huge step forward that calls
for monitoring and preventive action, policy coordination and a more global framework of supervision and regulation.

A Dilemma of Governance with Interaction: Limited Scope for Global Frameworks

The problem is that any attempt to move in this direction will have to come to terms with a dilemma: whereas globalization and integration go hand in hand with greater interaction, economic policies are still taken at a national level, in response to national interests, from a particular view of the world, and with no regard for their consequences on other countries. This means not only that economic policy decisions taken by one country may inadvertently affect other countries, but also that the policy responses of the latter also negatively impact third parties. This indirect chain of effects should be included as a consequence of integration or greater economic interaction, in addition to the traditional contagion effect well-known in the literature. Evidence of this indirect chain of effects is now clear in the case of capital controls that are used by emerging countries as a response to the consequences of expansionary monetary policies of advanced economies. For example, Forbes et al. (2012), when analyzing capital controls in Brazil from 2006 through 2011, find that these controls do in fact reduce capital inflows to the host country but, at the same time, shift them to other countries (the “bubble-thy-neighbor effect”). It is clear that there are problems of composition at the level of economic policy when looked at from a global perspective.

One could argue that the probability of giving rise to policy spillovers or externalities of any kind that derive from economic integration could be solved or even prevented if there were a global policymaker that maximizes world welfare and internalizes the costs of policy decisions or, alternatively, if there existed more instances of negotiation where these decisions are openly discussed. Both scenarios are not very likely, as you may suppose.

Despite the pessimism behind the previous paragraph, a significant improvement in the functioning of the global financial architecture could be derived from the simple recognition of the need to: (i) aim monetary policy, supervision and regulation at the preservation of financial stability and the prevention of systemic risk; (ii) design an expeditious mechanism to deal with problem institutions; and (iii) device proper responses to crises episodes guaranteeing the adequate and focused provision of global liquidity when and where
necessary. These are, in my personal view, some of the key elements that would have to be taken into account in any effort to prevent the occurrence of events similar to the recent financial crisis. I am not sure that they comprise what is known as a new global financial infrastructure, the design and implementation of which may take a long period of time.

The experience of the previous decades in issues related to international trade may point to a practical formula for building a more financially sound global economy. Bilateral, cross-border and regional arrangements among interested and closely integrated parties have run parallel to, and, furthermore, seem to be more important than, attempts to consolidate a global and comprehensive trade organization. For example, connecting cross-border payment systems may greatly contribute to alleviate, at least temporarily, the negative impact of shrinkages in global liquidity.

In terms of how either build a new global financial architecture or fix the current incomplete one, there is a potential, and highly relevant, role for regional institutions to improve global governance and reinforce emerging global institutions. As pointed out by Ocampo and Titelman (2012), this role is also based on the greater sense of ownership of regional and sub-regional institutions by member countries, associated to the stronger impact they have in these organizations relative to global ones where big nations capture almost all the attention.

In Latin America, institutions that exemplify the complementarity between global and regional institutions have a long history. These include the Latin American Integration Association (LAIA) created in 1980 to provide clearing mechanisms for intraregional payments; the Latin American Reserve Fund (FLAR) created in 1978 to support members with balance of payments crises; and two successful development banks: the Inter-American Development Bank (IADB) established in 1959 and the Corporación Andina de Fomento (CAF) founded in 1970. There is no doubt that these institutions have provided useful services, despite the fact that participation of the largest countries has been rather weak, except in the clearing agreement and more recently in the Inter-American Development Bank.

A final note to say that CEMLA, the institution I am honored to lead, has, for a little more than sixty years, offered a forum for the exchange of views on macroeconomic policy, in
particular monetary policy, and for dissemination of best practices in central banking for the Latin America and Caribbean countries. It is through these tasks that CEMLA has contributed to better decision making in the region. Here we have another example of a regional organization that, by responding better to the interests and needs of its members, contributes to global stability.
References


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