FEDERAL RESERVE BANK OF SAN FRANCISCO

Comments on “Financial Developments in Asia,” by Barry Eichengreen

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Earlier work argued Asia "overbanked"

- Eichengreen and Luengnaruemitchai (2006)
  - Demonstrated that relative to bank finance, Asian nations had less bond financing
  - Characterized as a weakness contributing to '97 crisis
  - Banks aggressive in expanding credit …
    - Borrowing offshore
    - Exposed themselves to maturity and currency mismatches
    - Regulators slow to catch up
  - … and in contracting credit when things turned bad
    - Calling in short-term loans

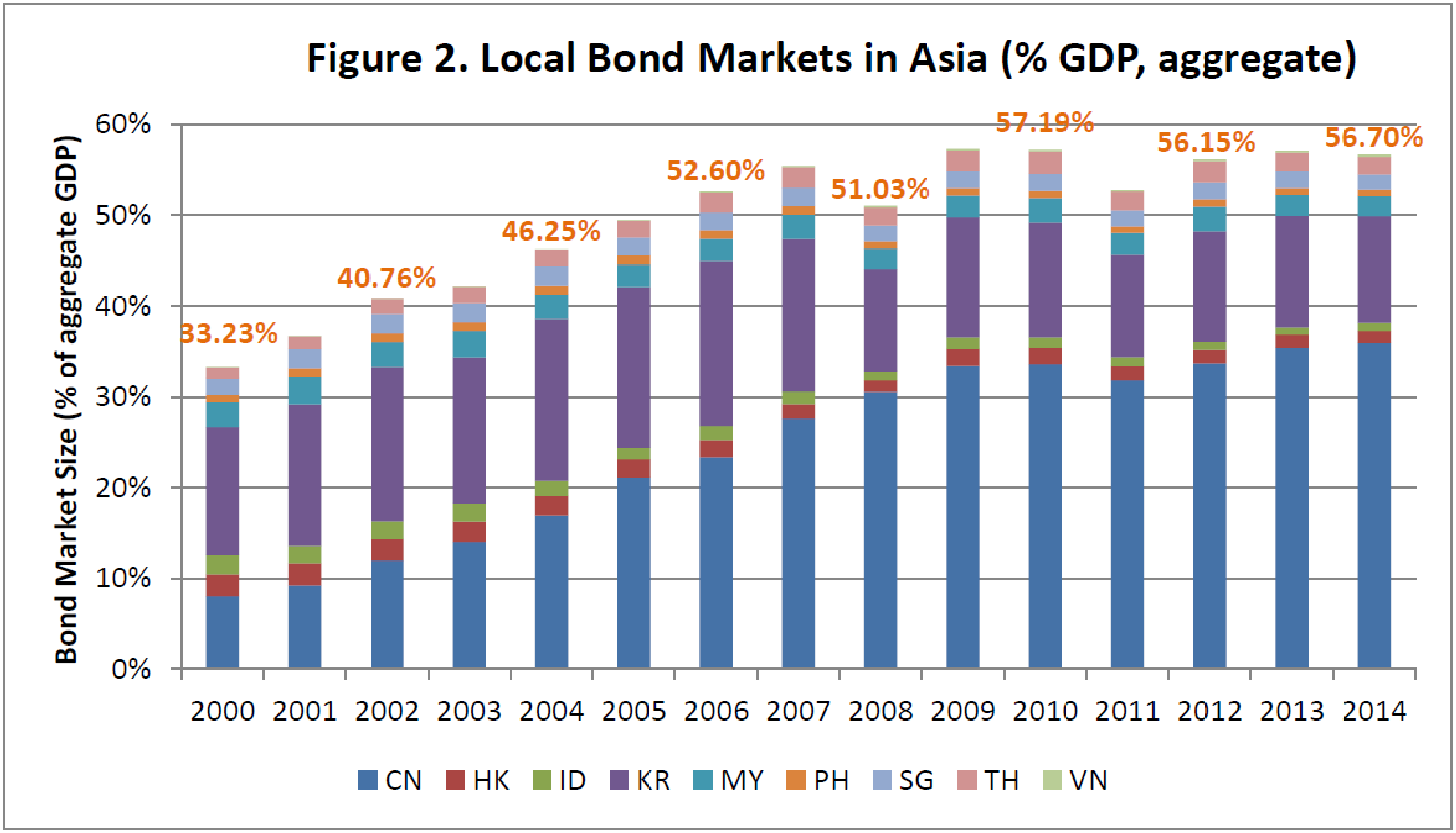
Current paper more agnostic about advantages of bond finance

- 2006 paper argued for superior “risk-sharing” characteristics of bond finance
  - Risks efficiently spread across large number of individuals
  - Existence of liquid secondary markets encourage longer-term borrowing
- But problems in bond markets as well
  - Moral hazard and adverse selection
  - Securitization in derivatives did not lead to stability
  - “May not even be a spare tire”

Revisit of depth of Asian bond markets

- Using new and old BIS data, confirms increased depth in Asian bond markets
- Would expect some improvement
  - ABMI and other initiatives have encouraged Asian bond market development
  - ABMF harmonized market practices in region
  - Growth in Chinese economy, combined with added financial depth of that economy

Bond market depth in Asia has Improved, but China is most of story



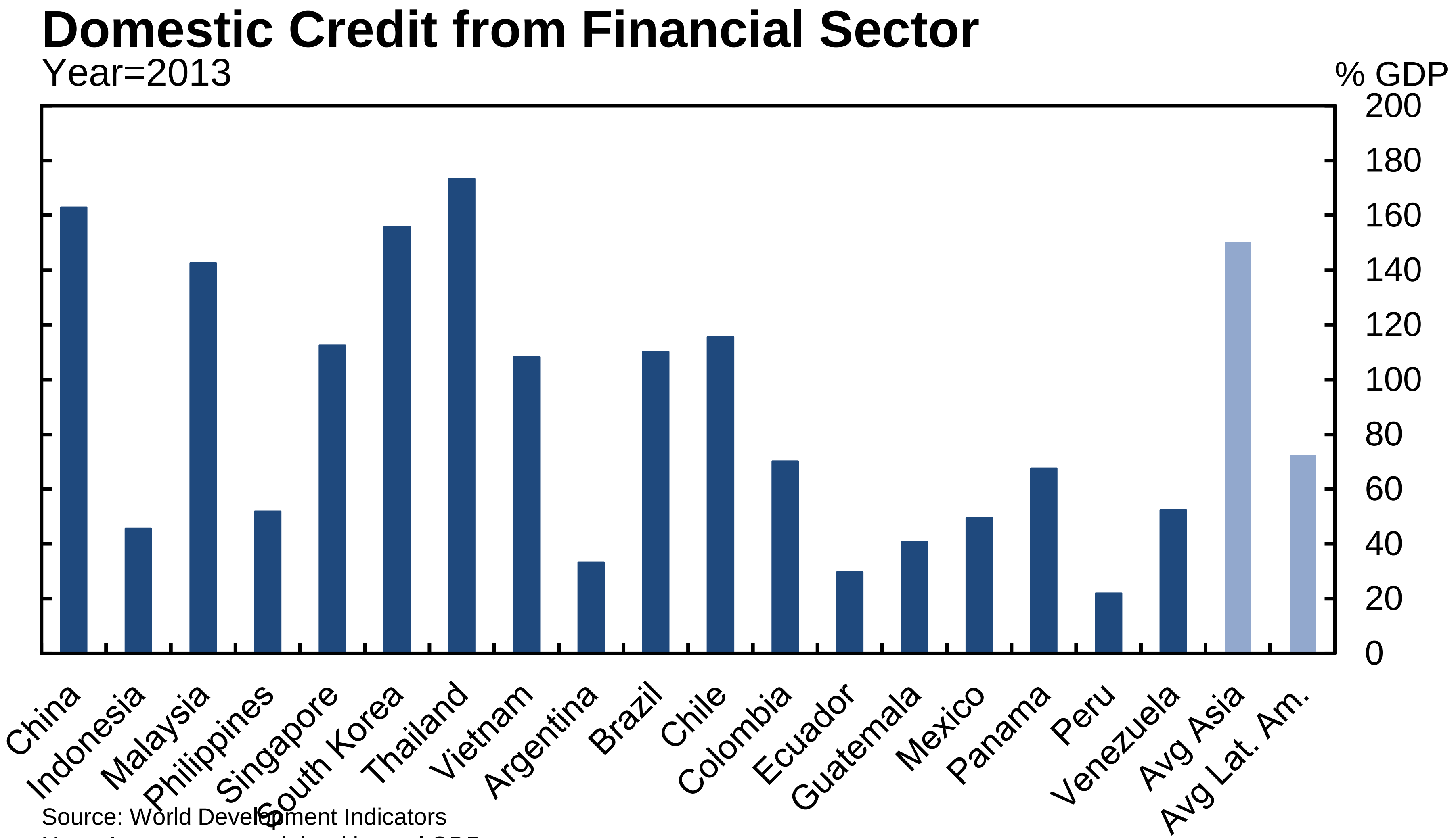
Parametric results

- Asia had smaller-than-predicted bond markets in 1996, but larger-than predicted in 2012
  - Robust to other controls, such as institutional environment
- Also robust to dropping Japan
  - Ex-Japan, growth concentrated in private issuance
  - What happens if you drop China?

Two different questions:

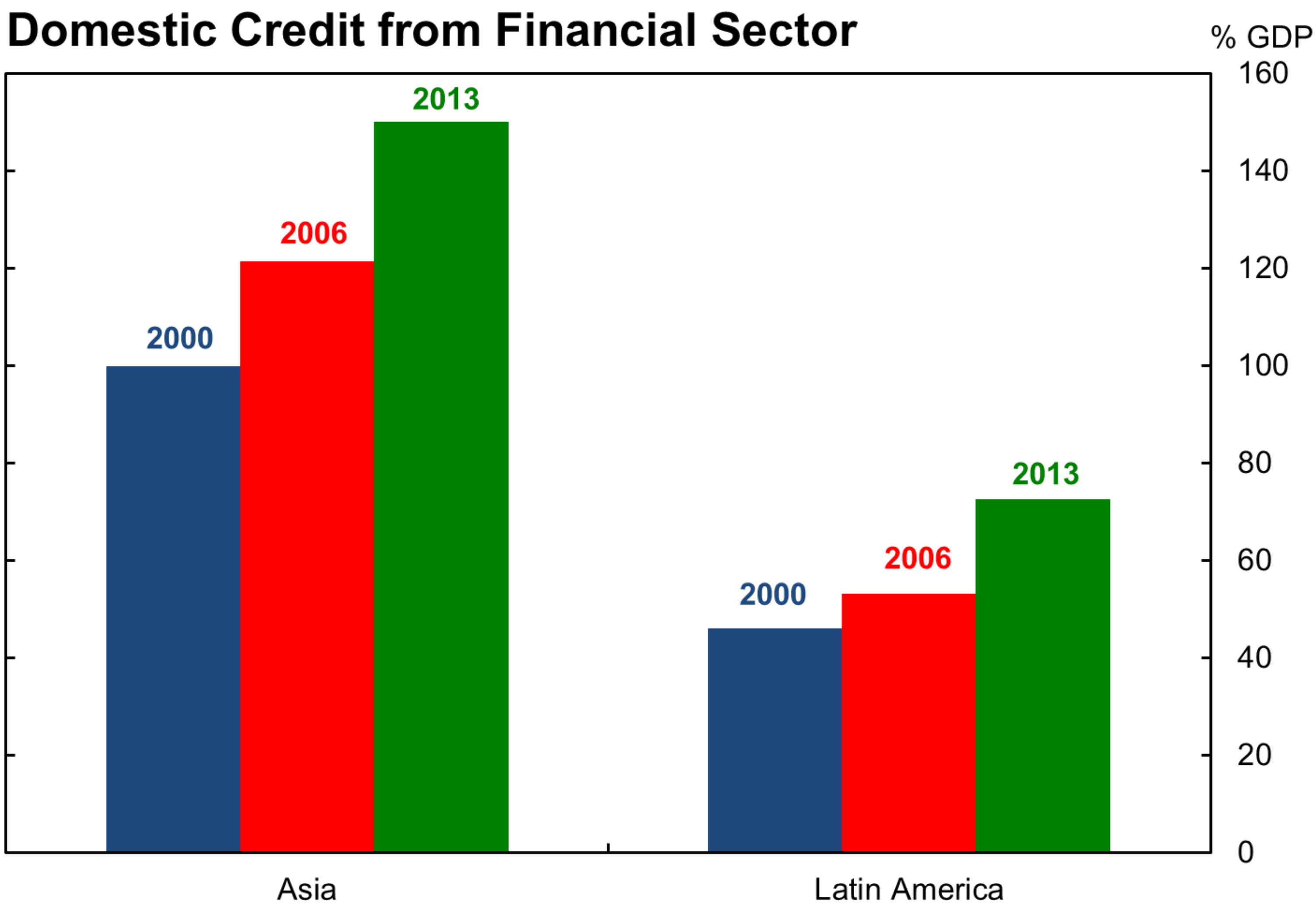
- Does Asia still have exceptionally high levels of bank finance relative to bond finance?
- Are Asian economies well-served by their financial services industry?

Asian nations still have more banking



Source: World Development Indicators
Note: Averages are weighted by real GDP

Reason is that growth in Asian banking sectors have also been robust



Source: World Development Indicators
Note: Region averages are weighted by real GDP

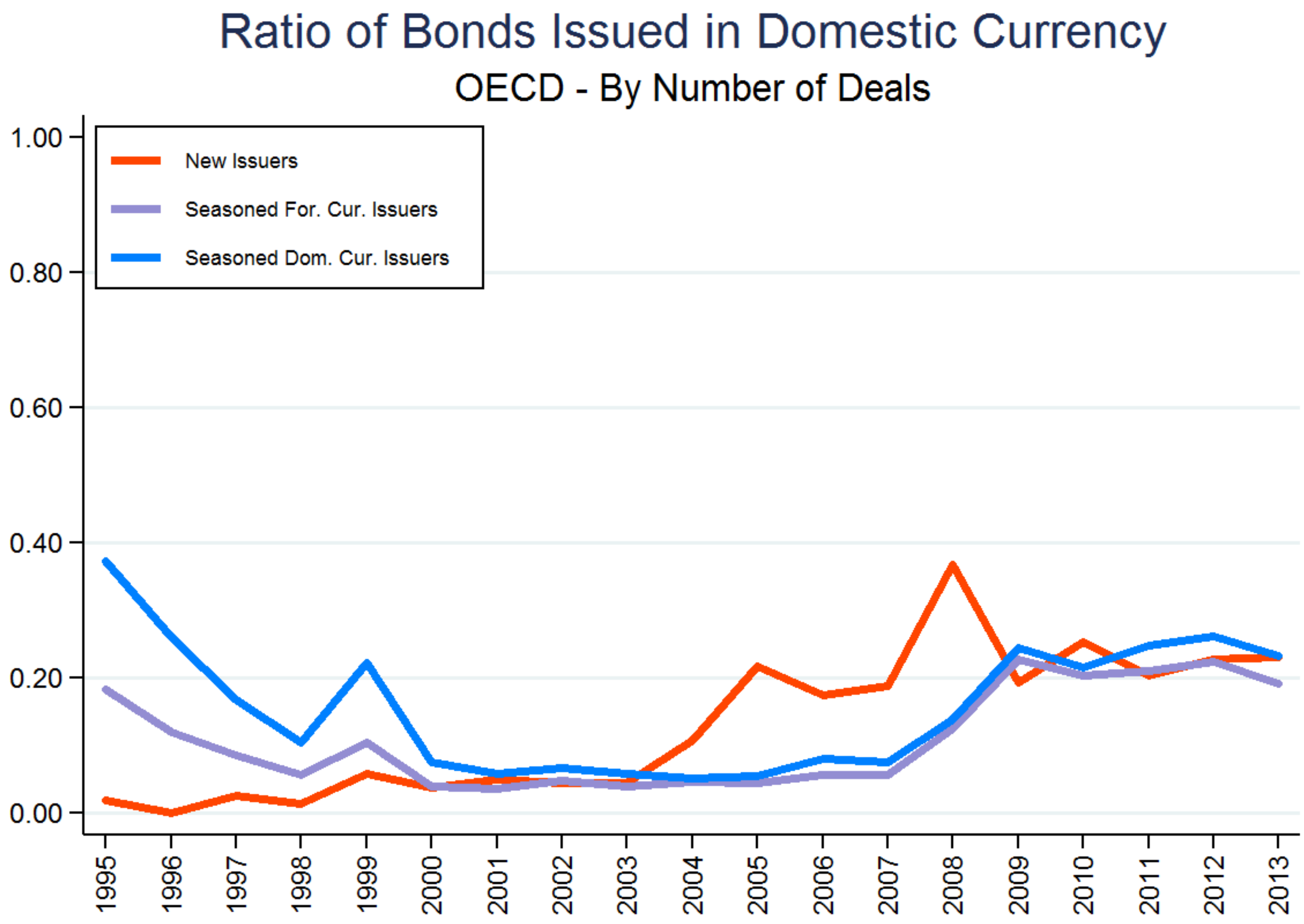
Quality of Asian financial services?

- Unclear that measures of depth proxy as measures of quality of intermediation
- Global crisis hit advanced, and more financially deep, economies hard
  - Paper cites studies identifying adverse returns to increased financial depth
    - Singapore, Malaysia, Hong Kong, South Korea, Thailand, and China all above peaks
  - But hard to think of two things more endogenous than financial depth and growth
    - Also, wouldn't include financial centers, such as Singapore and Hong Kong, in such a regression

Increases in home currency issuance not addressed in BIS data

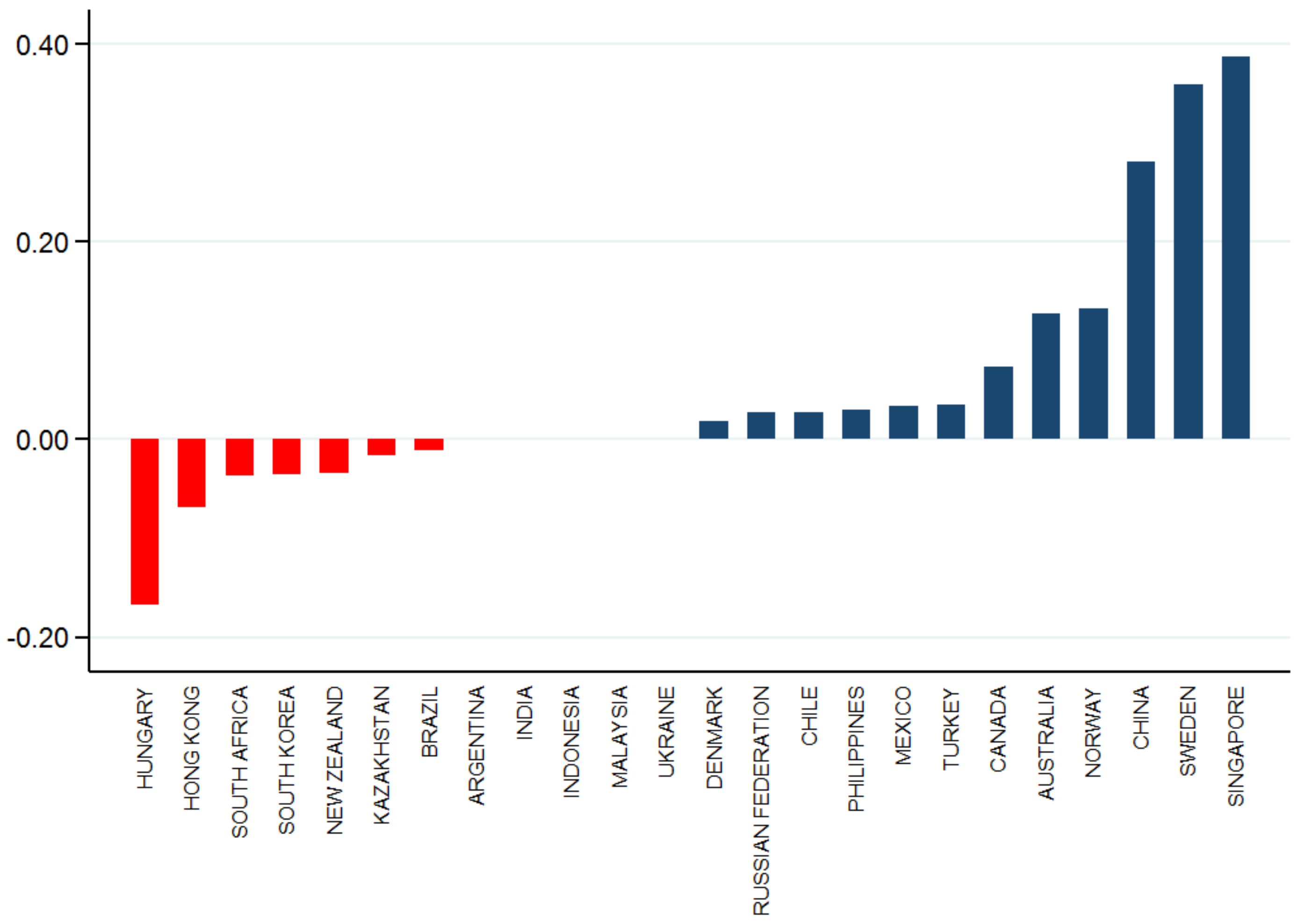
- Hale, Jones, and Spiegel (2015): Increased ability to issue in home currency over last fifteen years
- Particularly since crisis
  – Enhances quality of intermediation by mitigating currency mismatch exposure
- Impact greatest in countries “close” to being able to issue in home currency
  – Non-standard AE currencies (Aussie $)
  – EMEs with stable monetary regimes (Chile)

Impact of crisis on original sin particularly apparent in smaller AEs



As in this paper, some Asian nations fared better than others

Change in the share of bonds issued in home currency between 2002-2006 and 2009-2013.



Financial depth and openness

- Openness associated with deeper bond markets
  - Increased competition and funding, but also exposure to shocks and sudden stops
  - Potential for technology transfer to domestic financial services sector
- Financial depth
  - Some evidence benefits peak and then decline
  - Role for government quality
  - More work needed

China

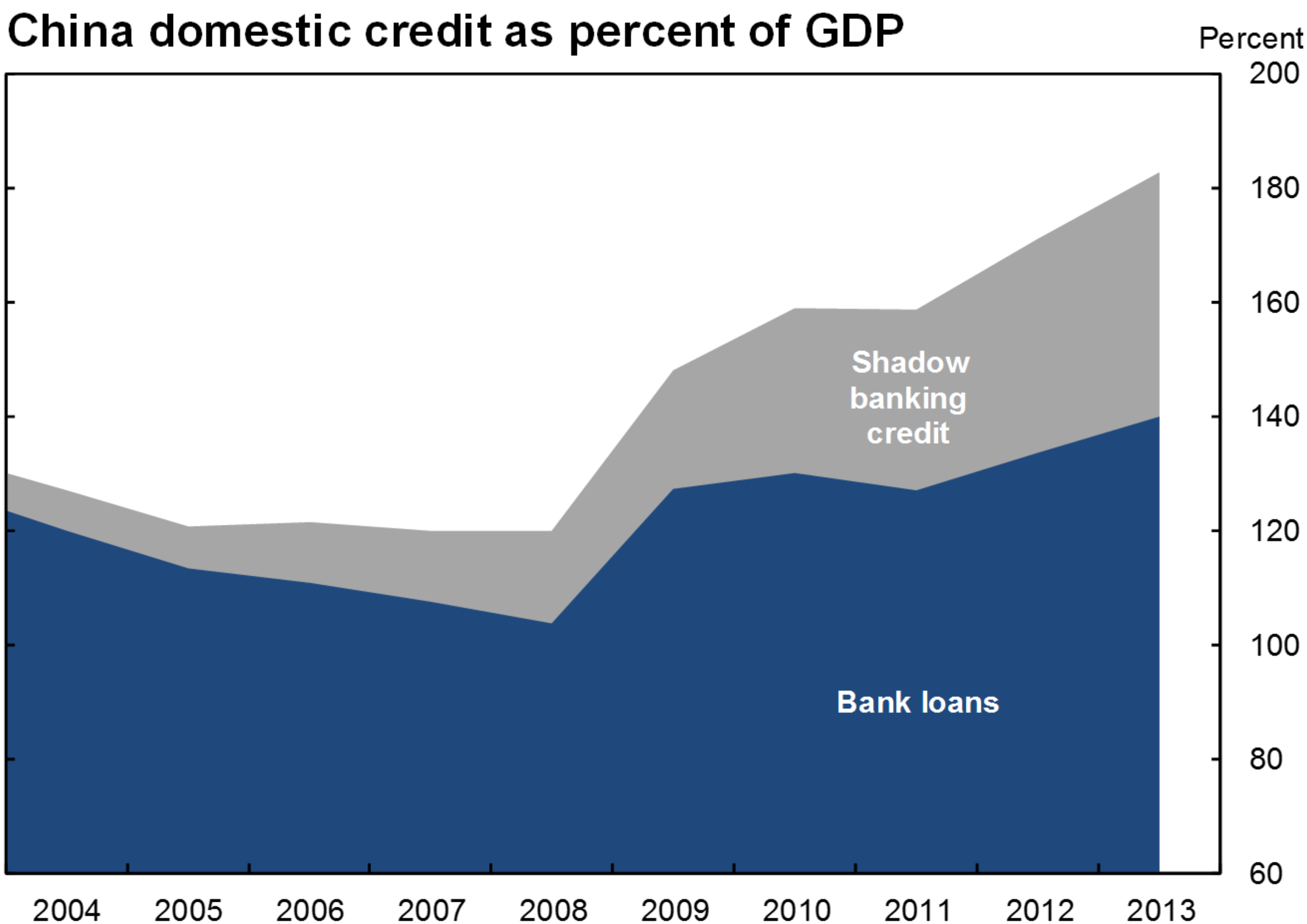

The Economist
Just close Guantánamo
The tills are alive: thriving musicals
The sharp end of Europe's credit crunch
Enter Gnatbot, the tiny flying robot
Britain's posh schools go global
Let's party like it's 1793
Xi Jinping, the "Chinese dream" and a return to greatness

Credit growth has fueled problem loans, including "ghost towns," such as Ordos

Paper advocates reforming and strengthening Chinese banks

- State-owned and other banks heavily influenced by government
  - Evidence in current stimulus measures
  - In such environment, guarantees needed
- Paper calls for reforms
  - Launch of deposit insurance program
  - Removal of interest rate ceilings
  - Widening regulatory oversight to shadow banking system

Large share of credit growth in China outside banking sector

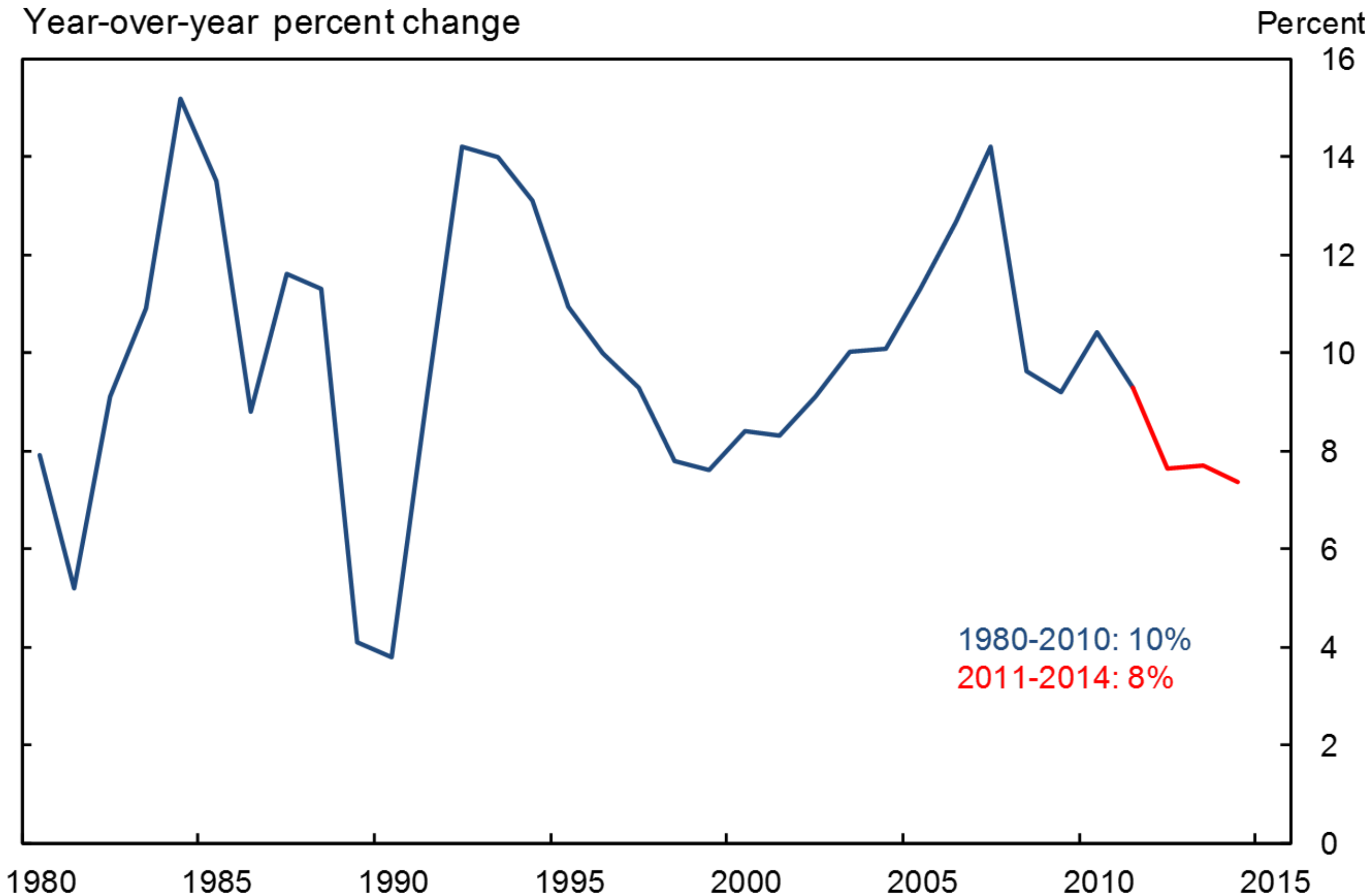


Source: CEIC, World Bank

China is now slowing down, raising concerns for financial stability

China real GDP growth

Year-over-year percent change



Source: IMF World Economic Outlook, CEIC

Slowdown concerns and reforms

- In short run, export-oriented SOEs handy vehicles for absorbing labor
  - Dampens taste for reform, financial or otherwise
- Capital account liberalization may encourage inflows, deepening bond markets
  - Reform interests aligned may help stem slowdown
  - But (as paper notes), reasons for caution
  - Firm and bank leverage may increase at reckless pace

Could bond market growth help?

- Bond volumes growing rapidly
  - Corporate issues about half of growth
  - But much still short-term and mostly SOEs
- Is this a good thing?
  - Scale economies: Need volume for analyst coverage
  - Some liberalization, such as foreign institution access, and some defaults
- Would recall bond market problems in GFC
  - Moral hazard; adverse selection
  - Problems special to China, e.g. heavy exposure by banks limiting turnover volumes
  - In particular, unlikely to ease banking sector problems

Conclusion

- Important and timely update of important work
- Conventional wisdom that lessons learned from ’97 crisis prepared Asian nations to weather ‘08 crisis
  - Bond market development initiatives part of this
- But crisis also demonstrated risks of excessive financial depth and openness
  - And limits to risk superiority of bonds vs. bank loans
- Still, likely that bank and bond finance better service different clients
  - Leaves movement towards balance desirable