

FINANCIAL GLOBALISATION IN THE ASIAN REGION

Remarks by Mr Philip Lowe, Assistant Governor (Financial System), prepared for Federal Reserve Bank of Chicago and International Monetary Fund Conference on 'Globalisation and Systemic Risk', Chicago, 27–28 September 2007.

I would like to thank the organisers for the invitation to be part of this panel on the Current State of Financial Globalisation. The timing of the conference is impeccable. As we all know, global financial events have been on the front page of every major newspaper around the world over the past month or so. These events have reminded us of just how interconnected the various pieces of the global financial system have become. Because of these interconnections, when sub-prime borrowers in the United States have trouble paying their mortgages, it is major news in Brisbane, Beijing and Berlin and almost every city and town in between!

In my remarks this morning, I would like to talk about these interconnections and particularly about the globalisation of financial systems in the Asian region, including Australia. This is a challenging task, partly because the experience amongst these countries is so varied, and partly because the financial systems are at very different stages of development. Yet there are some common themes, and the varied experiences point to some possible lessons.

My remarks are in two parts. First, I would like to review the various indicators of financial globalisation and what they tell us about Asian integration into the world financial system. And then second, I would like to touch on a few issues that, in my opinion, will both assist further integration and help ensure that the benefits of this integration are fully realised.

The Current State of Financial Globalisation in Asia

There is no single measure of financial globalisation. Yet, there are at least four indicators that are commonly discussed. These are:

1. the scale of cross-border capital flows;
2. the correlation of saving and investment within a country;
3. the correlation of asset-price movements across countries; and
4. the extent of foreign direct investment in the banking system.

I would like to say a few words about each of these, although I will focus mainly on the first two. Overall, these indicators suggest that the past decade has seen a marked increase in the integration of Asian financial systems into the global financial system, although, compared to other areas of the world, there is a considerable way to go.

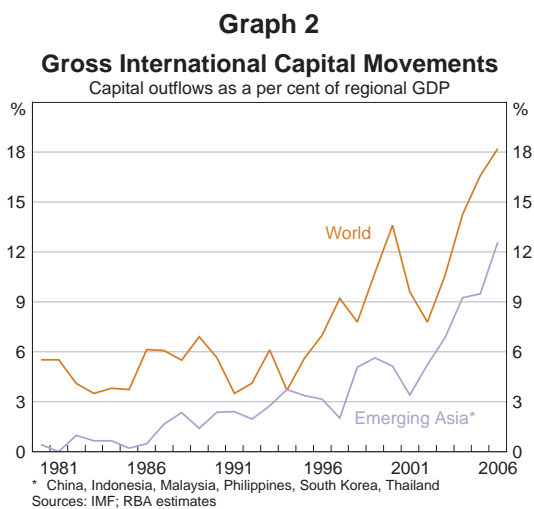
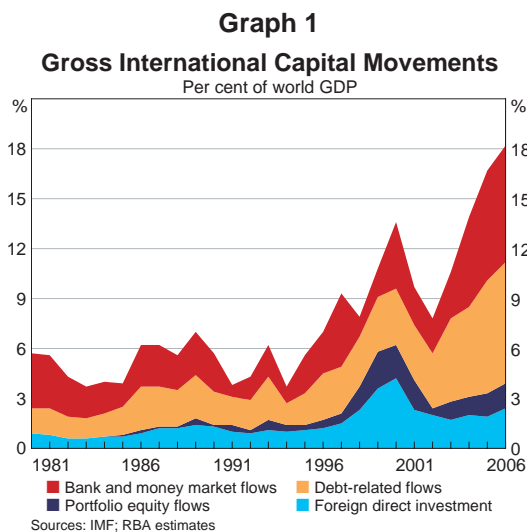
Capital flows and saving-investment correlations

The most commonly cited measure of financial globalisation is the degree of cross-border capital flows. One way of looking at this is to add up all inflows of capital into every country in the world and to scale the result by world GDP (Graph 1). Here the picture is pretty clear: there has been a sharp increase in the movement of capital around the world since the mid 1990s. Between 1980 and 1995, aggregate capital flows averaged the equivalent of 5 per cent of global GDP. In 2006, the figure was more than three times this.

Around this rising trend, there are clear cycles, with capital flows tending to rise during periods of strong global growth, and receding when growth is slower. There has also been a marked increase in the share of capital flows accounted for by debt and interbank lending, and a corresponding decline in the shares accounted for by portfolio equity flows and foreign direct investment.

This increase in the flow of capital has meant that the ratios of gross foreign assets and gross foreign liabilities to GDP have increased for most countries. In Australia's case, for example, the ratio of the sum of foreign assets and liabilities to GDP has increased from around 125 per cent in the mid 1990s, to around 240 per cent currently.

The overall picture in Asia is broadly similar. This can be seen in the sharp increase in the ratio of gross *asset* outflows to Asian GDP (Graph 2). In 2006, this ratio stood at just over 12 per cent, almost four times the average for the 1990s.¹ Despite this increase, capital flows to, and from, Asia, relative to GDP, remain smaller than they are in most other regions of the world. As a consequence, the ratios of gross foreign assets and gross foreign liabilities to GDP are, for the most part, lower in Asian countries than



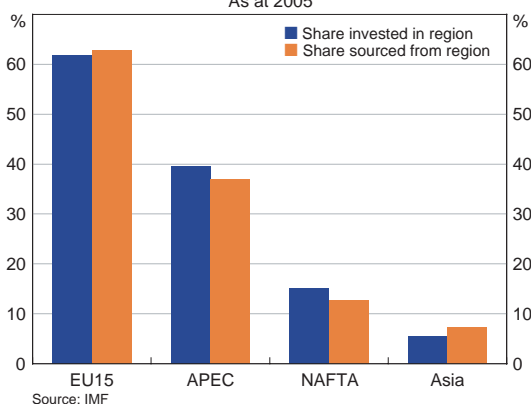
¹ The rise in the ratio of gross capital inflows to GDP is less marked, given that a number of countries have had capital account surpluses over recent years.

for countries in Europe and North America (the main exceptions here are Hong Kong and Singapore). In terms of capital inflow, there has been a tendency for the share of equity liabilities in total financial liabilities to increase in contrast to the experience of the world as a whole.

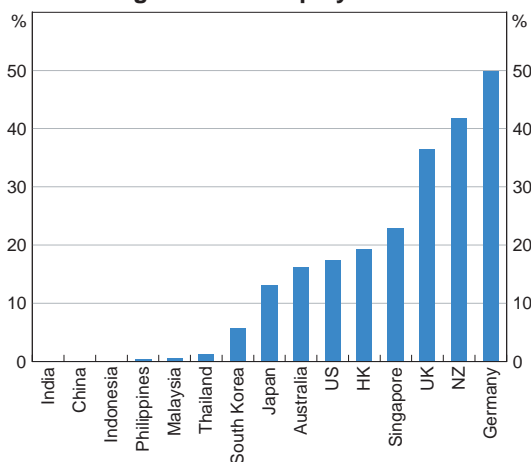
With these broad figures as background there are four aspects of Asian capital flows that I would like to draw attention to.

The first is that most of the flows are to, and from, countries *outside* the region, rather than between countries within the region. One way of seeing this is to look at intra-regional portfolio flows (Graph 3). In 2005, Asian investors allocated only 5 per cent of their international portfolio investments to other Asian countries; in contrast, within Europe, over 60 per cent of total portfolio flows are intra-European. While there are clearly a variety of factors that explain this

Graph 3
Share of Cross-border Portfolio Investment that is Intra-regional
As at 2005



Graph 4
Foreign Share in Equity Portfolio*



* Data for 2006 except for India, Indonesia, Malaysia, Philippines, Singapore, Thailand and US which are 2005
Sources: IMF; RBA; World Federation of Exchanges

outcome, one of these is the relative lack of development of financial markets in some Asian countries. Another is that many of the countries are net exporters of capital, with the developed countries, including the United States and Australia, being the recipients of this capital.

The second is that investors in many countries in the region still exhibit a very strong home bias (Graph 4). Investors in almost all Asian countries have less than 20 per cent of their equity portfolios invested outside their own country, and in most cases the figure is considerably less than 10 per cent. One factor limiting international portfolio diversification in some countries is the existence of capital account controls, with these controls still being more prevalent in Asia than in many other parts of the world.

The third is that most foreign borrowing is in non-local currencies. While it is difficult to obtain comprehensive data, the data that are available suggest that in a number of countries, at least three-quarters of the outstanding debt owed to banks offshore is denominated in non-local currencies. Many foreign lenders

remain unwilling to incur liabilities in local currencies, partly as a consequence of the relative lack of liquid and deep financial markets in which to hedge the currency risk.

And fourth, and perhaps most significantly, is the important role that the public sector is playing in shaping how some financial systems are being integrated into the world financial system. To understand why they are playing such an important role, it is useful to first look at the basic facts about saving and investment.

The correlation between these two variables is often taken as a measure of financial globalisation. In a country that is well integrated into the world financial system, the level of domestic investment is no longer determined by the level of domestic saving, and so the two variables are likely to have a relatively low correlation with one another.

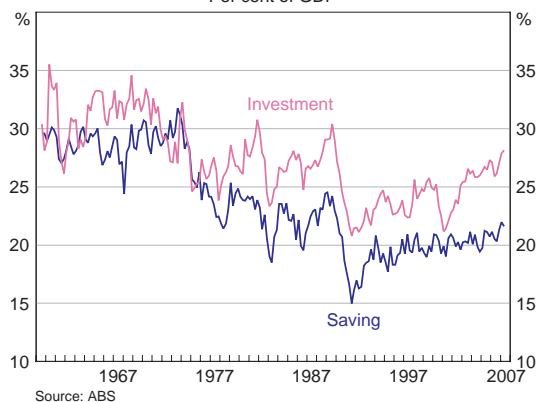
Australia is a very good example of this. Following the liberalisation of the Australian capital account in the 1970s and 1980s, the correlation of saving and investment fell significantly, particularly from the early 1990s onwards (Graph 5). Over the past two decades, the level of investment has continuously exceeded domestic saving, and as a result, the capital account has been in continuous surplus (or equivalently the current account in deficit), averaging around 4½ per cent of GDP. Also, over this period there have been notable swings in the size of this surplus as domestic saving and investment have moved quite differently on occasion: the capital account surplus has fluctuated within a range of 2 to 6½ per cent of GDP over the past 20 years.

Most studies find that saving-investment correlations have also declined in Asia, although these correlations remain higher than in many developed economies. Perhaps the most interesting thing about the decline is that it has occurred as a result of the sharp fall in investment in many countries, following the financial problems of the mid to late 1990s. For the emerging countries of Asia (excluding China), investment averaged around 34 per cent of GDP between 1990 and 1997, but then fell significantly to average a much lower 27 per cent between 1998 and 2006 (Graph 6). In contrast, the saving rate has shown considerably less variation. As a result, the current account for the region as a whole has been in surplus since 1998, with the surplus averaging around 4 per cent of GDP; this is in sharp contrast to the experience of the preceding years.

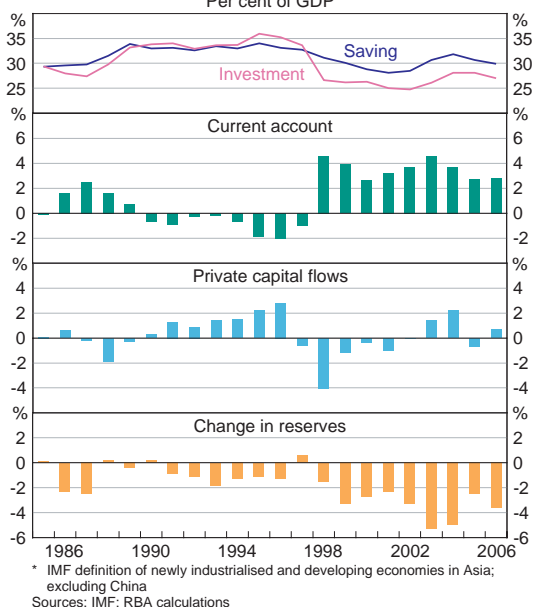
The picture for China is a little different, with investment having been very strong, although China too has run large current account surpluses for a number of years (Graph 7).

When a country has a floating exchange rate and the central bank does not intervene in the market, the counterpart of current account surpluses is an outflow of private capital. However,

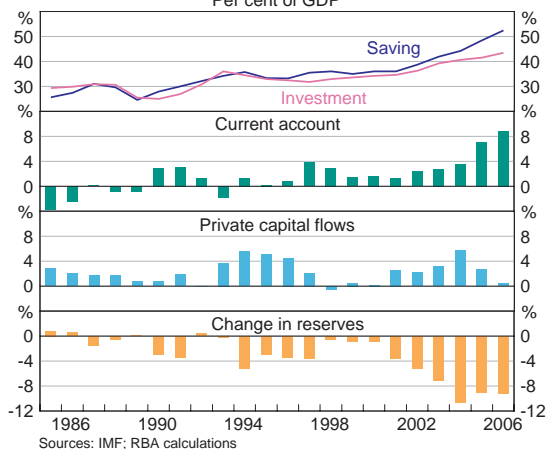
Graph 5
Saving and Investment – Australia
Per cent of GDP



Graph 6
Emerging Asia* – External Balance
 Per cent of GDP



Graph 7
China – External Balance
 Per cent of GDP



for the Asian region as a whole – including China – this has not been the case. Instead, Asia has been a net exporter of goods and services and a net importer of private capital; it has had both current and capital account surpluses.

The counterpart of these dual surpluses is, of course, a build-up in foreign reserves by the central bank. While the experience varies across countries, the scale of these official asset purchases has been very large in some countries. For the emerging Asian countries as a whole (excluding China), the accumulation of foreign reserves has averaged around 3 per cent of GDP per year since late last decade, and in some years it has been the equivalent of 5 per cent of GDP. In China, the purchases have been larger still, averaging around 10 per cent of GDP over the past three years.

This brings me back to my fourth observation about Asian financial globalisation, namely the role of the public sector. In effect, global financial integration has allowed a number of countries in Asia to have saving higher than investment, with the excess saving being channelled through the public sector to the developed countries. This is quite a different model of globalisation to that evident in most of the rest of the

world. It has implications for both the development of financial markets and the returns that these countries might expect to earn on their foreign investments. It also raises potential foreign policy issues, particularly as central banks and sovereign wealth funds come to hold larger investment positions in other countries. At some point the model of financial integration is likely to need to evolve to one in which the private sector takes a greater role, although predicting the exact timing and transition path is very difficult.

Asset-price correlations and foreign direct investment

The third indicator of financial globalisation is the extent to which asset-price movements are correlated across countries. Here, the various studies reach a variety of conclusions, but, on balance, they tend to support the idea that correlations have increased over time, particularly for the stock market (Graph 8).

Perhaps the more interesting observation is that correlations tend to jump globally when major financial disturbances occur. This is because these disturbances are typically caused, or at least associated with, sudden shifts in either risk perceptions or risk preferences by investors across the world. When global risk perceptions or preferences change, domestic factors become, at least temporarily, less important.

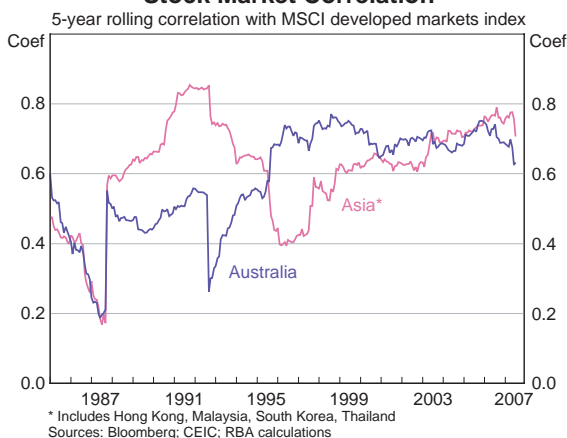
The stock market crash in 1987, and the Asian financial crisis a decade later, are good examples of this. So too are the recent strains in financial systems around the world. The problems in the US sub-prime housing market have been the catalyst for a global repricing of risk and this has affected asset prices in many countries. This is most clearly seen in interbank funding costs, which increased markedly around the world in August and early September, as credit risk was repriced and concerns about liquidity intensified (Graph 9).

Interestingly, the effects have not been as evident in credit markets in many Asian countries, hinting at a lower level of integration than in some other parts of the world. In part, this reflects the fact that Asian banks have recently not relied particularly heavily on international capital markets for their funding, and that structured finance is a less prominent part of the financial landscape in Asia than it is in other parts of the world.

Asian markets, however, have not been unaffected. Credit spreads have increased and Asian stock markets fell significantly in July and the first half of August, before subsequently

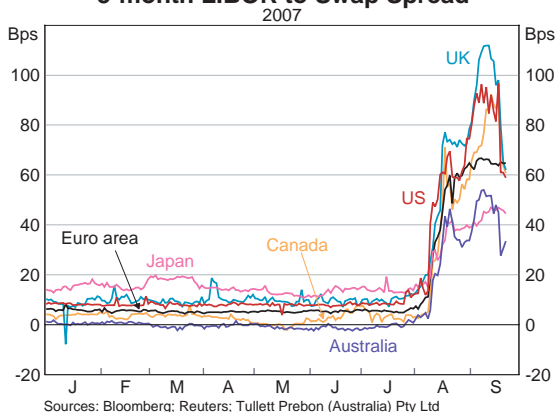
Graph 8

Stock Market Correlation

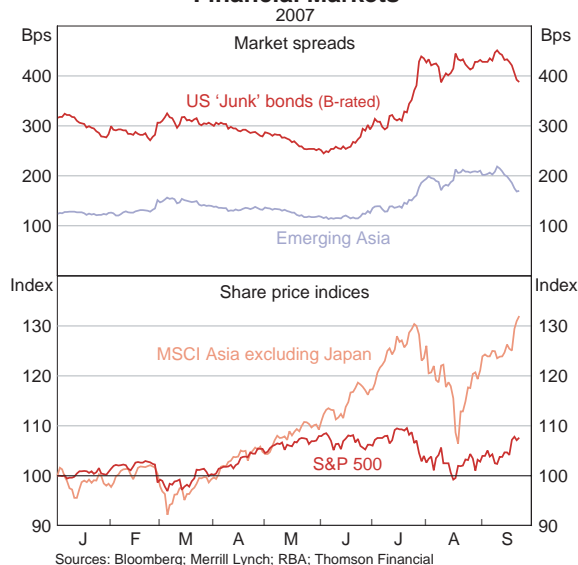


Graph 9

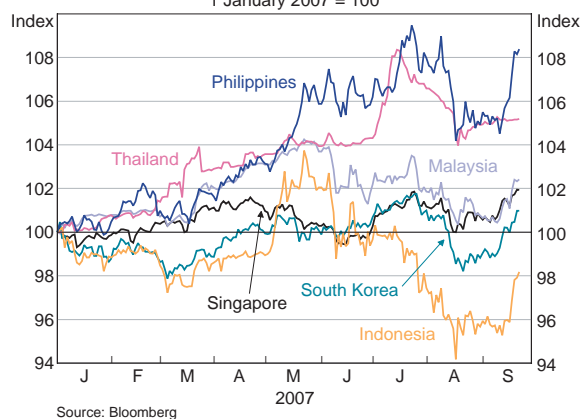
3-month LIBOR to Swap Spread



Graph 10
Financial Markets



Graph 11
Selected Asian Currencies against US\$
1 January 2007 = 100



recovering (Graph 10). Many regional currencies also depreciated sharply over this period, as global risk aversion increased (Graph 11). The Australian dollar was one of these, with the increase in risk aversion triggering an unwinding of carry trades. More recently, most regional currencies have strengthened against the US dollar.

A fourth indicator of financial globalisation is the extent of foreign direct investment in the financial sector. Like most areas of the world, many Asian countries have experienced a significant increase in cross-border merger and acquisition in the financial sector, although foreign ownership remains less extensive than in Latin America or Eastern Europe. Over recent years, foreign banks have established significant presences in a number of countries, including Indonesia, Korea and Thailand. This process has gone the furthest in New Zealand, where foreign banks account for over 98 per cent of the country's banking system assets.

One indicator of the extent of foreign involvement in the domestic banking systems is provided by the BIS's *International Banking Statistics*. For emerging Asian countries, the

value of local claims in local currency of BIS reporting banks has more than doubled over the past three years, with these claims accounting for around 40 per cent of total foreign claims (Graph 12). While this ratio has increased significantly over the past decade, it remains lower than in many other areas of the world.

To summarise these various indicators, it is fair to say that the financial systems in many Asian countries have become more integrated into the global system over recent years, although on a number of measures, they appear to be less integrated than those of many other countries. Perhaps the most distinguishing feature of this integration is the role that the public sector

has played in channelling the region's savings that are not used for domestic investment to borrowers in the developed world.

Further Progress

I would now like to touch briefly on three areas where I think further evolution is important if the region is to successfully travel down the path of increasing financial globalisation. In raising these areas it is important to recognise that different countries are at different stages of development, so that the same arrangements are not applicable in every case. But the direction in which we should be heading is pretty clear.

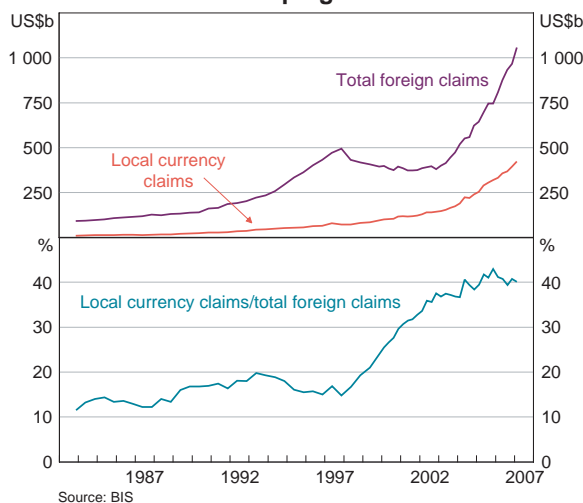
The first of these three areas is the ability of a country to borrow in the international capital markets in its own currency.

Here, the Australian experience is instructive. Australia is one of those many countries that has embraced financial globalisation. It has a flexible exchange rate, an open capital account, relatively deep securities markets, and has made extensive use of the pool of global savings to finance domestic investment. Overall, this integration has served the country well, with few people wishing to see a return to earlier times.

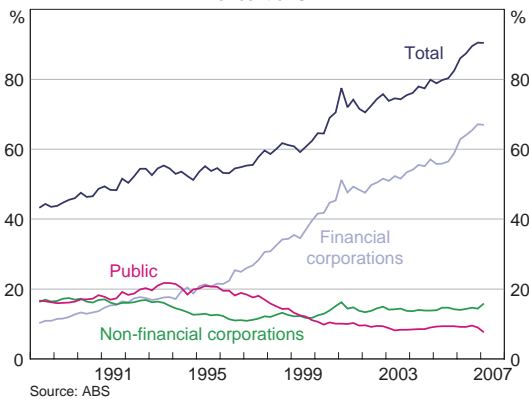
One of the key elements that has allowed financial globalisation to be viewed so positively is the ability of Australian borrowers to borrow offshore in Australian dollars. Historically, many people have tended to think about financial globalisation in terms of the willingness of citizens in one country to own assets in, or to lend to, another – indeed this way of thinking is encouraged by the way that the national financial accounts are put together. But this is only half the story. Equally important is the willingness of citizens in one country to take on assets and liabilities denominated in another country's currency. An unwillingness by investors to lend to a country in its own currency significantly complicates the full integration of that country into the world financial system.

In Australia's case, much of the borrowing from the rest of the world is intermediated through the banking sector, with the banks borrowing in a range of markets; as at June 2007, around three-quarters of Australia's gross foreign debt was owed by financial intermediaries (Graph 13). Some of this borrowing is done directly in Australian dollars, but most of it is denominated in foreign currency. But where it is denominated in foreign currency, the existence of deep and liquid derivatives markets means that the Australian banks are able to swap these loans back into Australian dollars. The result is that they run little, if any, foreign exchange risk. The banks are able to do this because there is a group of investors in the global economy that is

Graph 12
BIS Reporting Bank Claims on Developing Asia



Graph 13
Gross Foreign Debt – Australia
 Per cent of GDP



prepared to take on Australian dollar foreign exchange risk.

Getting to this position took a number of years. I expect that many countries in Asia will also one day get to this position, although considerable progress still needs to be made. How best to travel the path is a difficult question. Having a sound macroeconomic framework and developing confidence in public institutions are important. So too are developing a local currency yield curve and allowing some fluctuations in the exchange rate. Without these

fluctuations, the deep and liquid markets that are required for hedging and managing risks have difficulty developing. And without these markets, foreign investors are likely to remain reluctant to take on local currency exchange rate risk. Having the public sector play such an important role in the capital account is not particularly conducive to this development.

This brings me to my second area – and that is exchange rate flexibility. Having an exchange rate that moves around is clearly important in creating the right incentives for the necessary markets to develop. But it is also important in allowing a country to cope with swings in the international investment community’s appetite for local assets and the local currency.

Again to draw on the Australian experience. During the high-tech boom of the late 1990s, Australia was terribly unfashionable with global investors – we were seen as an old-fashioned economy; a user, rather than a producer, of technology-intensive goods. The result was a marked fall in the inflow of capital. In response, the exchange rate depreciated significantly. While this was uncomfortable at the time, it greatly cushioned the economy from the marked decline in investment in this ‘unfashionable’ economy. Since then, the resources boom has come along, Australia’s terms of trade have risen significantly, and Australian assets and the Australian dollar are back in favour. As a result, the exchange rate has appreciated considerably, and this has again been helpful in terms of macroeconomic management. This exchange rate flexibility has been a key element in Australia’s uninterrupted economic expansion over the past 16 years.

Again, it took Australia a long time to get to this position. We tried almost every type of exchange rate regime (except a currency board!) before we finally got there in 1983. Now that we are there, we see it as a crucial element in living successfully in this globalised financial world.

The third and final issue – and one that is particularly relevant to this conference – is cross-border crisis management. We are moving inexorably to a world of *global* financial institutions that are operating in *global* markets, yet crisis management largely remains essentially *local*. To date, this tension has not caused great difficulties, but then again the current arrangements have not been put under any real pressure. This is an area where changes in the global financial system have clearly run ahead of the supporting regulatory framework.

This lack of progress does not reflect a lack of work or goodwill of those involved. Rather, cross-border crisis management is fundamentally difficult! There are complex technical and legal issues involved. But there are also political, and even foreign policy issues, at stake. Who pays for any bailout? Can you trust the other jurisdiction not to grab all the assets? What happens if multiple jurisdictions can't agree to a common solution?

At least from my experience, discussions on these questions are often stymied by an understandable suspicion that the other country will, in a crisis, act in its own, rather than the common interest. In principle, one way of getting around this suspicion is for both sides to make a credible commitment to a particular approach. However, doing this is far from straightforward, and at least for the foreseeable future probably impossible in most cases.

This, however, does not mean that progress is impossible. In the case of Australia and New Zealand, both countries have recently changed their banking acts to explicitly state that each country's prudential supervisor must take account of financial stability in the other country in its decision-making. This change in legislation represents a high-level political recognition in both countries that there are common interests. In particular, it sends an important message that both governments expect the common interest to be taken into account. It is clearly not a panacea for all the problems that can arise in cross-border crisis management, but it represents a significant step forward.

Thank you. ✨