The FUTURE of Asian Finance

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As Asia leads the world in growth, will its financial systems lead too?

IN spring 1988, a bank in the Shenzhen Special Economic Zone, established eight years earlier in southern China near the border with Hong Kong SAR, began to buy and sell shares in local companies to investors. A few other financial institutions quickly noticed a lucrative business and became involved. Two years later, the Shenzhen Stock Exchange was founded.

Today, Shenzhen is among the world's 20 largest stock exchanges, and the companies listed there have a total market capitalization of about $1.1 trillion, comparable to the stock markets in Switzerland and Madrid. Across Asia, the rapid growth of financial sectors is an important part of the growth miracle that has made Asia the world's most dynamic region. Analysts look closely at the financial risks that Asia faces today, but sometimes it's interesting to look farther forward. So with this dynamism expected to continue, what will Asian financial sectors look like in the future?

As countries get richer, their consumers demand more financial services, from mortgages to credit cards, and the financial needs of their businesses, from buying property for new stores to financing equipment for new factories, grow as well. Asia's growth has thus facilitated an equally dizzying expansion of the region's financial sectors.

Between 2000 and 2012, the total value of companies listed on India's stock markets rose from one-third to two-thirds of GDP, and those in Indonesia from one-sixth to almost one-half. The total volume of loans provided by banks rose from 75 percent of Korean GDP in 2000 to 169 percent in 2012, while in

Shenzhen stock exchange building, Shenzhen, China.

Vietnam, it rose from 33 percent to 105 percent. The financial markets in these countries, combined with the global financial hubs of Hong Kong SAR and Singapore and the large and developed markets in Japan, Korea, and Australia, make for an extensive financial sector in Asia as a whole.

Different from others

Asian countries tend to have larger financial sectors than countries in other regions at similar levels of income. But Asia is a diverse place, and while financial sectors in its dynamic emerging markets are large, they are not yet as large or as sophisticated as those of Asia's advanced economies. For example, while bank lending among Asia's emerging markets—105 percent of GDP at the end of 2012—tends to be a larger share of GDP than in emerging markets in other regions, the share among Asia's advanced economies is 194 percent.

Asian financial sectors differ in other ways from those in the rest of the world, too. Banks dominate the financial sector in most Asian advanced and emerging markets, as they do in Europe, but unlike in the United States, where equity and bond markets have a larger role.

Asian banks also tend to be more focused on the traditional bank businesses of deposit taking and consumer lending to households and companies, and rely less on lending to other banks and on selling products such as swaps and other derivatives. This was an advantage during the global financial crisis, when dependence on borrowing from other banks created problems across the United States and Europe as markets seized up.

This reliance on traditional banking is why shadow banking—whereby nonbank financial institutions engage in services traditionally provided by banks—is a relatively new phenomenon in most Asian economies, even though such activities are widespread in many markets in Europe and North America. And while shadow banking and other nontraditional financial services are grabbing headlines and growing quickly in places like China and the Philippines, the base from which they have grown so rapidly was small 10 years ago.

Another area in which Asia's financial sector differs from the rest of the world is its capital markets. Stock markets in Asia tend to be highly volatile compared with those in other regions, though they often enjoy higher returns. Although Asia's advanced economies have relatively sophisticated and deep equity markets, the region's emerging markets have not been able to rely as much on equity capital and thus have focused more on bank intermediaries.

Similarly, Asian countries' budget deficits, with some exceptions, tend to be relatively small. As a result, the development of bond markets has been somewhat slow: without a government yield curve, it is more difficult for investors to price the bonds of a country's corporations. Bankruptcy law and procedures are opaque in many Asian countries, which raises the risk to investors of buying bonds and further slows development. Despite these challenges, however, Asian equity and corporate bond markets remain similar in size to those in many other regions.

Government plays a bigger role in banking in many Asian emerging markets, especially in China and India, than in the rest of the world. In China, the five largest banks are controlled by the government, while in India, public banks account for about three-quarters of system assets. This extends to nonbank financial institutions as well: in India one of the world's largest life insurers, the Life Insurance Corporation of India, is controlled by the Indian government. Here, too, there is disparity across the region—public banks in countries such as the Philippines and Thailand comprise a much smaller share of total banking sector assets, and private institutional investors play a significant role in Malaysia.

Asian countries are very well integrated into the global trading system, trading extensively not only with advanced and developing economies outside the region, but also, as manufacturing has become more regionally integrated, as part of an Asian supply chain connecting southeast Asia, China, Japan, and Korea. But financial integration has lagged. If we measure the share of GDP made up of domestic assets held by foreigners and foreign assets held by nationals, emerging markets in Asia tend to be less globally integrated than in other countries.

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As always, there are exceptions. Malaysia, with a large and active institutional investor sector, is as globally integrated as any emerging market, but India and Indonesia are at the other extreme and have smaller international investment positions than emerging markets in other regions.

What's ahead

The first challenge for Asia's financial sector will be to support *rapid growth* in the region. Asia's emerging markets are expected to move from 30 percent of world GDP (measured at purchasing power parity) to 41 percent in 2023. As financial markets deepen, new IMF research suggests, the proportion of emerging Asia's financial assets could rise to 31 percent in 2023, from 18 percent today.

In addition to financing this rapid growth, Asian finance will also have to tackle two other significant challenges.

First is the region's *infrastructure deficit*. With more people living in cities, growing trade across the region, and rising demand for communications and travel, Asia will need to invest heavily to meet its infrastructure needs. Estimates of spending for clean water, telecommunications, highways, and other basics over the next 20 years vary widely, but in all cases the numbers are large. Ensuring that Asia's large pool of savings can be directed into long-term financing that will close these infrastructure gaps will be difficult. Infrastructure projects tend to require huge up-front investments that pay off only over a long period of time.

Construction of a new airport, electricity generation plant, or water treatment facility requires a capital provider willing to invest a lot for a long-term payoff. Since the global financial crisis, this type of financing, for various reasons, has become more expensive around the world, and in Asia it will be especially tough to develop.

The second challenge is *demographic change*. China, Japan, Korea, and other countries in Asia have among the world's most rapidly aging populations (see "The End of Cheap Labor" in the June 2013 *F&D*). As the working population ages in these countries, people must save more for retirement (see "The Price of Maturity" in the June 2011 *F&D*) and will need good investment opportunities to ensure those savings earn a good return. On the other hand, in countries such as India and Indonesia the working-age population is expanding rapidly, and there is a huge need for investment not only in infrastructure but also in new businesses, housing, and other areas. Given the high saving rates in many of Asia's aging economies, and the significant investment needs across the region, finding ways to match the two could help growth and address the region's demographic challenges. There are many ways to make this happen: individually purchased mutual funds could buy stocks in emerging Asian companies and pension funds could invest in those companies' bonds. Banks could lend funds from the savings accounts of their customers to banks in other regions, which could in turn finance new enterprises. But institutional investors are relatively small in most emerging markets in Asia, and barriers to investment across borders are still high, so this will be a difficult long-term process.

Larger, higher, stronger

These changes call for larger financial systems: higher incomes will lead to more demand for mortgages and cars, working capital for more companies, trade credit for Asia's increasingly global companies, and bonds to finance infrastructure and provide stable incomes for retirees. But all these changes will also make Asian financial systems more complex.

In many Asian financial systems today, margins between banks' lending and deposit rates are relatively high, meaning that banks can be quite profitable while focusing only on traditional business models. But once the low-hanging fruit of high-margin lending from consumers newly entering the market or from new lines of business is gone, banks will have to look farther afield. In some economies, such as Japan, where this process has already begun, banks are looking outward for profitable investments. As increased efficiency begins to whittle down interest margins in emerging Asia, banks may turn to new income sources, such as money management and securitizing consumer loans, and the prospects for more interbank lending could rise.

This complexity will not only be domestic. At least some of the savings in Asia's (demographically) older and richer economies will wind up in Asia's younger and poorer countries through bank borrowing across borders, increasingly interconnected equity and bond markets, and cross-border

Bank skyscrapers in Hong Kong SAR.

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borrowing by corporations. All three channels will engender more complex financial systems as banks contend with larger foreign exposures, equity and bond investors demand increasingly sophisticated credit and exchange rate hedges, and corporations look to neutralize their own exposure to exchange and interest rate changes. The very process of greater regional integration will thus lead to greater provision of increasingly complex services by Asian banks.

An example of these changes can already be seen in Asia's increasingly sophisticated bond markets. Although many Asian emerging market economies have improved the size and liquidity of their bond markets in recent years, these markets remain dominated by low-risk issuers, including governments. Developing a market for riskier borrowers (such as the so-called high-yield segment), as other countries, especially the United States, have done, would do much to support two of Asia's financial goals. It would raise returns for pension funds and retirement savers, helping on the aging front, and would allow more savings to be channeled into infrastructure, addressing Asia's deficit in that area.

But this requires new tools. One option is for banks or insurance companies to provide protection by issuing credit default swaps to reduce risk for investors in new bond markets. Foreign investors may also want so-called plain vanilla interest rate or exchange rate swaps, but may try to lower their costs by hedging with more complex instruments. These services could be provided by foreign banks, but Asian banks will have the expertise and presence in key markets to make their own investment in these new areas highly profitable.

These new tools and the new sophistication of Asian financial systems will make financial institutions themselves larger and more complex. While advanced Asia is home to three global systemically important financial institutions—Mitsubishi UFJ, Mizuho, and Sumitomo Mitsui in Japan—

across the rest of Asia, only China, the world's second largest economy, hosts such institutions—the Bank of China and the Industrial and Commercial Bank of China. But as Asian companies move abroad, as Asian financial systems become increasingly connected with the rest of the globe, and as domestic investors become more numerous and more sophisticated, Asian financial institutions stand to grow rapidly in size and complexity. The financial markets of India and the countries of the Association of Southeast Asian Nations (ASEAN) may also soon host globally significant institutions, potentially sparking the same concern that arose across Europe and North America about banks that are "too big to fail."

Even if Asia's financial systems develop differently and do not raise such concerns, the ongoing crisis in the euro area, combined with worldwide shifts in regulation, has already led to many kinds of financial changes. One such area is trade financing: European banks, in response to regulatory and economic changes that have pushed them to focus on core markets, have pulled away from Asia. In regions such as central Europe and the Middle East, these changes have led to a reduction in trade credit, while in Asia, regional banks, especially Australian and Japanese banks, have filled the void. Initially this decline seemed to be limited to low-margin short-term trade financing. But as the United States and the European Union contemplate tighter restrictions on banks in their jurisdictions and European banks try to shore up their domestic balance sheets, more expensive services, such as aircraft leasing and complicated long-term trade financing, have also been curtailed, and Asian banks are trying to take up the slack. With this innovation, however, comes the need for regulation and supervision.

Public banks

Because the largest banks in some Asian economies are controlled by the government, there is a question of how public involvement will change over time. In Hong Kong SAR and Singapore, as well as in Australia and New Zealand, public banks have a minimal role. But in Asia's other advanced economies, Japan and Korea, the public sector still looms larger than in many Western economies, especially the United States and the United Kingdom. On average across countries and over time, public banks have been less profitable and less innovative than private banks, which has meant riskier and less profitable balance sheets in many countries.

Public banks can be useful tools for government policymakers. But, on average, they also give rise to inefficient banking practices, continuous calls for more capital to maintain the share of public banking, and government bailouts. How policymakers across the region treat public banks will depend on the circumstances of each economy and each bank. But in the long run, financial systems dominated by government-controlled banks are unlikely to offer the competitive and efficient financial systems necessary for Asia's growth challenges.

Another key to the puzzle will be growing financial integration. Pairing the savings in more rapidly aging economies with investment projects in Asia's younger economies will require rapid growth in cross-border financial flows. Savers also want to diversify their risk, which could be achieved, for example, by allowing Korean investors to spread their risk across their home market as well as those in India and Thailand. For now, most assets held abroad by Asian investors tend to be in developed economies, particularly in liquid government debt.

But this will have to change. We expect Asian economies to become more entwined, with investors more and more likely to buy assets in other countries over the next 20 years. This will be particularly true in southeast Asia, where ASEAN countries are cooperating to further integrate their economies.

Another key requirement will be a loosening of capital account restrictions in China and India. Today, India's and China's capital accounts are more closed than those in the rest of the region. But both countries have gradually loosened restrictions, and both governments have plans to continue this liberalization, which will help savers find more outlets abroad and allow foreign investors to diversify more effectively by buying Chinese and Indian assets. If China and India are as open in 2023 as some advanced economies are today, we estimate the total size of their financial sectors will be 10 to 30 percent larger than if they remain at current levels of openness.

Asian financial systems are expected to become significantly larger, more complex, and more interconnected than they are today. To ensure that these changes do not lead to a buildup in the kinds of risks that brought down some countries in the region during the Asian financial crisis and laid the global economy low during the global financial crisis, regulators and supervisors in Asia must stay on their toes. This applies also to the IMF, which hopes to work closely with Asian countries to identify and minimize risks before they materialize in order to avoid the mistakes of previous crises.

More interconnected financial systems can allow households and pension funds, among others, to diversify, thus reducing their risk, but can also allow bankruptcies and bank failures to spread across borders. Regulatory cooperation has become key as the world's financial sectors have become more integrated. Asia has an active role to play in international forums to ensure that this process can continue safely.

Fortunately, Asia is accustomed to change. After the Asian financial crisis, the region's governments, supervisors, and financial systems moved swiftly to address problems such as excessive leverage and unhedged foreign borrowing that exacerbated the damage of the crisis. Asian banks rapidly paid down their debts, while supervisors ensured that those imbalances didn't arise again. These changes helped the region better weather the global financial crisis and proved that Asia is nimble and able to change with the times.

As Asia continues to outpace the world in economic growth, the question will be how to make sure the world's fastest-growing financial system can also become its safest. ■

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