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Bank of Japan

Finance in Asia: Banking Business and Capital Markets

Keynote Address at the Dinner Reception

Hosted by the Japan Securities Dealers Association

Preceding the International Conference

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I. Introduction

Thank you very much. It is my pleasure to speak at this dinner reception hosted by the Japan Securities Dealers Association that precedes tomorrow's international conference.

The conference, entitled "Asian Market Integration and Financial Innovation," brings together senior officials from such international forums as the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Board (IASB), as well as a number of capital market experts in Asia. I look forward to lively discussions tomorrow on the future evolution of Asian financial and capital markets, the direction of the strategic reshaping of financial infrastructures in Asia, and other important subjects.

Since the Lehman crisis in 2008, major central banks have undertaken a variety of policy measures that transcend the conventional boundaries of central banking. In this process, central banks have become more closely involved in capital markets. For example, the Bank of Japan has been buying risk assets such as corporate bonds, exchange-traded funds (ETFs), and domestic real estate investment trusts (J-REITs). These purchase programs are truly extraordinary in central bank history.

Given that the global financial landscape, including policy responses, is undergoing profound changes, today I would like to share my views on financial and capital markets in Asia, with a principal focus on the interplay between banking business and capital market development.

II. Current Economic Conditions in Asia

Let me start with the recent economic and financial developments in Asia.

We are now entering the third year since the European sovereign debt problem surfaced in Greece. Without doubt, the way the debt problem in Europe will play out remains a key factor shaping the near-term outlook for the global economy. Concurrently, for the past several years emerging economies have been the propelling force behind global economic growth. Among them, Asian countries have displayed particularly robust growth, driven

mainly by China and India. In its latest projections, the International Monetary Fund expects the global economy to grow by 3.3 percent this year, with the 27 countries of developing Asia contributing nearly 60 percent of that.

Despite the concerns over the global economic outlook, there are reasons to believe that Asian economies are better placed to sustain solid growth. Most fundamental are their rich human resources, rapid urbanization, and a competitive technological base. In addition, various policy initiatives taken after the Asian financial crisis in the late 1990s have played an important part. In response to the Asian crisis, countries in this region carried out ambitious reforms on many fronts, including fiscal consolidation, monetary policy management aimed at price stability, improvement of financial supervision and regulation, and development of regional financial markets. In hindsight, the Asian crisis could be considered a blessing in disguise in the sense that it prompted tough reforms which in normal times might have been difficult.

Yet, Asian economies are not immune to the sovereign debt problem in Europe. Three potential channels of contagion can be noted: first, trade links; second, financial market disturbances; and third, deleveraging by European financial institutions. Naturally, these three channels are not mutually exclusive. For instance, the longer the disturbance continues in European financial markets, the harder the hit to the balance sheets of European financial institutions, which causes European deleveraging in Asia. If this spreads to disrupt trade finance, Asian economies heavily reliant on exports would surely suffer.

So far, the spillovers from Europe to Asia have been mild. Deleveraging by European financial institutions looks moderate for the most part, with Asian financial institutions filling the shoes of European banks in some cases. Given that European financial institutions have enjoyed a visible presence in Asian financial businesses -- most notably in corporate syndicated loans, trade finance, and lease finance involving ships and aircraft -- it is sensible, however, to pay careful attention to deleveraging by European financial institutions.

III. Business Model of Asian Financial Institutions

With regard to the brisk growth of Asian countries, there is another factor we should keep in mind. This is the limited exposure of Asian financial institutions, in the run-up to the subprime crisis, to complex securitized products and risk transfer techniques.

It seems that the subprime crisis has generated skepticism or soul-searching vis-à-vis cutting-edge financial innovations. In order to enhance social welfare, such innovations should be in line with the core functions of finance, that is, financial intermediation and payment and settlement services. Without this connection, financial innovations cannot help boost the productivity of the economy at large.¹ We can see that some resecuritized products deviated from this basic tenet before the subprime crisis. Even in simple secured transactions such as repos, the same securities posted as collateral were used repeatedly for a chain of transactions, with liquidity multiplying in the process. Put differently, we saw a sharp increase in collateral velocity through the nexus of repo transactions. We now know that Asian financial institutions were not deeply involved in such financial daisy chains, which probably helped them navigate the post-Lehman turbulence.

Asian banks have been known for their traditional or basic business models, in which loans are funded primarily by domestic deposits. In fact, the loan-to-deposit ratios are below 100 percent in many Asian countries (Chart 1). Business models built on such domestic deposits are less susceptible to an acute funding squeeze than models dependent on wholesale funding. I think this feature has also provided Asian banks with some advantages over their Western counterparts in weathering the current crisis.

On the other hand, the economic ties among Asian countries have grown stronger on the back of continued economic growth in this region. In line with this, cross-border transactions have grown substantially and more sophisticated financial services are being called for. In this regard, the expansion of the so-called transaction banking services in Asia is noteworthy. Transaction banking makes it possible to provide cash management

¹ For further discussion on this point, see Masaaki Shirakawa, "What Is So Special about Financial Innovation?" keynote address at the conference entitled "Welfare Effects of Financial Innovation" held by the De Nederlandsche Bank (via videoconference) on November 11, 2011 (available at http://www.boj.or.jp/en/announcements/press/koen_2011/ko111114a.htm).

and trade finance services in an integrated fashion and beyond national borders. In a similar vein, supply chain finance seems to be gaining momentum in Asia as the need grows for cash flow management through the entire supply chain.

IV. Challenges for Asian Financial Institutions

These developments suggest that the business model of Asian banks is evolving, and is not immutable. In this connection, I would like to mention two challenges facing Asian banks.

The first challenge concerns demographics. We all know that Japan is already feeling the pinch of this headwind. Asian countries now enjoy ample labor forces, but rapid aging coupled with low birth rates will inevitably present these countries with demographic adversities in the next decade or so. In fact, the ratios of working-age population to total population are nearing their peaks in many Asian countries, which means that the size of the labor force relative to population in these economies will start diminishing in several years (Chart 2). These demographic changes could constrain economic growth from both the supply and demand sides. For the banking industry, population aging could shrink the depositor base through dwindling savings.

One way to mitigate this negative trend is to promote financial inclusion -- that is, a provision of financial services to wider segments of society. In Asia, this can be done by taking advantage of the rapid expansion of the middle-income population and small enterprises. In this context, the prevalence of mobile banking in Asia is remarkable. Mobile banking aims to connect mobile phone users with basic financial services, giving them greater access to financial intermediation and payment and settlement services. Designed properly, mobile banking could offer great promise in terms of improving social welfare.

The second challenge for Asian banks is to strengthen risk management amid the increasing demand for longer-term credit. Because of rapid urbanization and industrial agglomeration, Asian countries are in need of well-functioning infrastructure such as transportation, energy supplies, and telecommunication networks. According to the Asian Development Bank, estimates of infrastructure needed in Asia from 2010 through 2020

could reach roughly 8 trillion U.S. dollars.² To satisfy this need, reliance on fiscal spending alone is not sufficient. Instead, it is necessary to effectively mobilize private-sector funds such as bank loans. Normally, infrastructure loans have maturities longer than ten years, exceeding the average deposit maturities by wide margins. Unless these maturity mismatches are managed appropriately, banks cannot involve themselves in long-term infrastructure projects. This problem also exists for long-term mortgage loans. For Asian banks, therefore, dealing with maturity mismatches poses a formidable challenge going forward.

V. Development of Capital Markets in Asia

In order to reduce maturity mismatches of banks as intermediaries, development of capital markets, especially corporate bond markets, will play a key role.³ In this regard, I would like to mention two points. First, if banks can diversify their funding sources by issuing bonds, they will be able to manage maturity mismatch risks more effectively. Second, development of corporate bond markets will facilitate direct funding of infrastructure investment. Infrastructure projects, because of their long-term nature, are prone to unexpected shocks. If both bond issuance and bank loans are available, the stability of funding for such projects will presumably be enhanced.

Unfortunately, Asian corporate bond markets are far from fully developed. A number of projects are underway to nurture regional corporate bond markets, and the Bank of Japan has participated actively in some of these initiatives, including the successful launch of the Asian Bond Fund (ABF). But the saving-and-investment balance in Asia has remained lop-sided since the Asian financial crisis. In other words, Asia has excess savings, with the region's investment still below the levels seen prior to the Asian crisis. Development of corporate bond markets in Asia is one effective way to align savings with investment within the region. Also, given the aging trends in Asia, well-developed corporate bond markets would offer the additional merit of creating long-term investable assets for such institutional investors as pension funds and life insurance companies.

² For more details, see *Asian Development Outlook 2010 Update: The Future of Growth in Asia*, Asian Development Bank, 2010.

³ For more details, see "Weathering Financial Crises: Bond Markets in Asia and the Pacific," BIS Paper No. 63, Bank for International Settlements, 2012.

With regard to capital markets, I would also like to touch briefly on the subject of Asian stock markets because stock markets, together with bond markets, are a vital part of capital markets.

Asian stock markets have grown exponentially in recent years. According to statistics from the World Federation of Exchanges, equity finance in the Asia-Pacific region accounted for 46 percent of the world total last year. During the same period, half of all global initial public offerings took place in the Asia-Pacific region. Asia's stock market capitalization accounts for 31 percent of the global total, indicating that the pace of recovery in stock markets following the Lehman crisis is fastest in this part of the world (Chart 3).

It seems that a virtuous cycle is operating in Asian stock markets, in which larger trading volumes and higher market liquidity reinforce each other, prompting both regional and foreign firms to seek funding in Asia. Last year, for example, we saw Glencore, one of the world's leading commodities traders, listed in both London and Hong Kong. This event points to the vitality of Asian stock markets.

By making its stock markets more attractive as funding venues, Asia can open up its plentiful savings to globally active firms. The flip side of this is that Asian investors will have greater opportunities to invest abroad. To achieve further development of Asian capital markets based on their interactions with global firms, it seems necessary to harmonize market infrastructures and financial regulations at regional levels. In this respect, I think that Europe offers some insights for Asia in terms of its experience of financial market integration.

To broaden the degree of financial market harmonization, market participants also need to play a prominent role. For instance, cross-national tie-ups between stock exchanges would not only create efficiency gains in systems terms but also have the potential to alter the entire dynamics of the regional capital markets. A notable example is the ASEAN Trading Link initiative, which aims to build a joint electronic platform for cross-border trading between the exchanges of some ASEAN countries. I look forward to seeing how this and

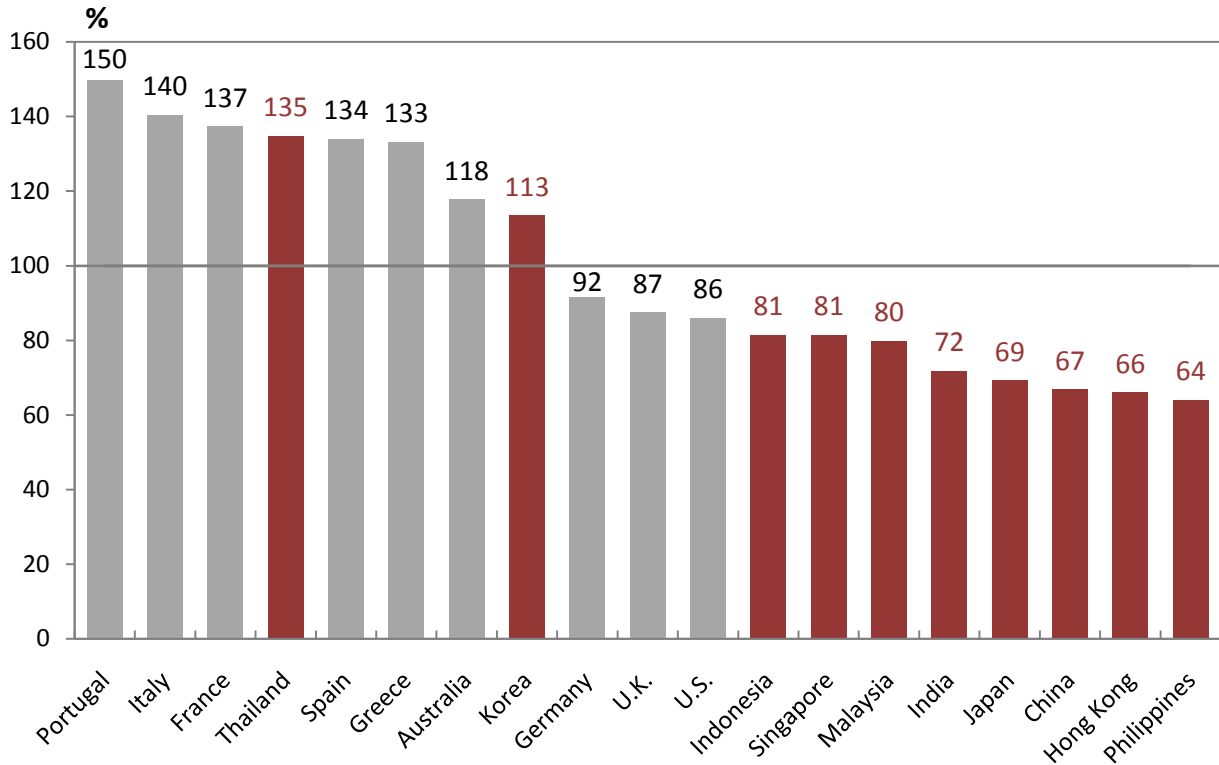
other intra-regional projects will reshape Asian capital markets in the years ahead.

VI. Concluding Remarks

Today I presented my views on banking business and capital markets in Asia. Coexistence of robust banking systems and capital markets is conducive to financial system stability. But this is not a sufficient condition for such stability. In Asia -- where a deepening of trade links has preceded that of cross-national financial ties -- ample scope remains for regional financial cooperation. In collaboration with colleagues in this part of the world, the Bank of Japan remains committed to the salutary development of financial and capital markets in Asia, while placing a special focus on central bank expertise in payment and settlement infrastructures, cross-border collateral arrangements and so forth.

Thank you for your attention.

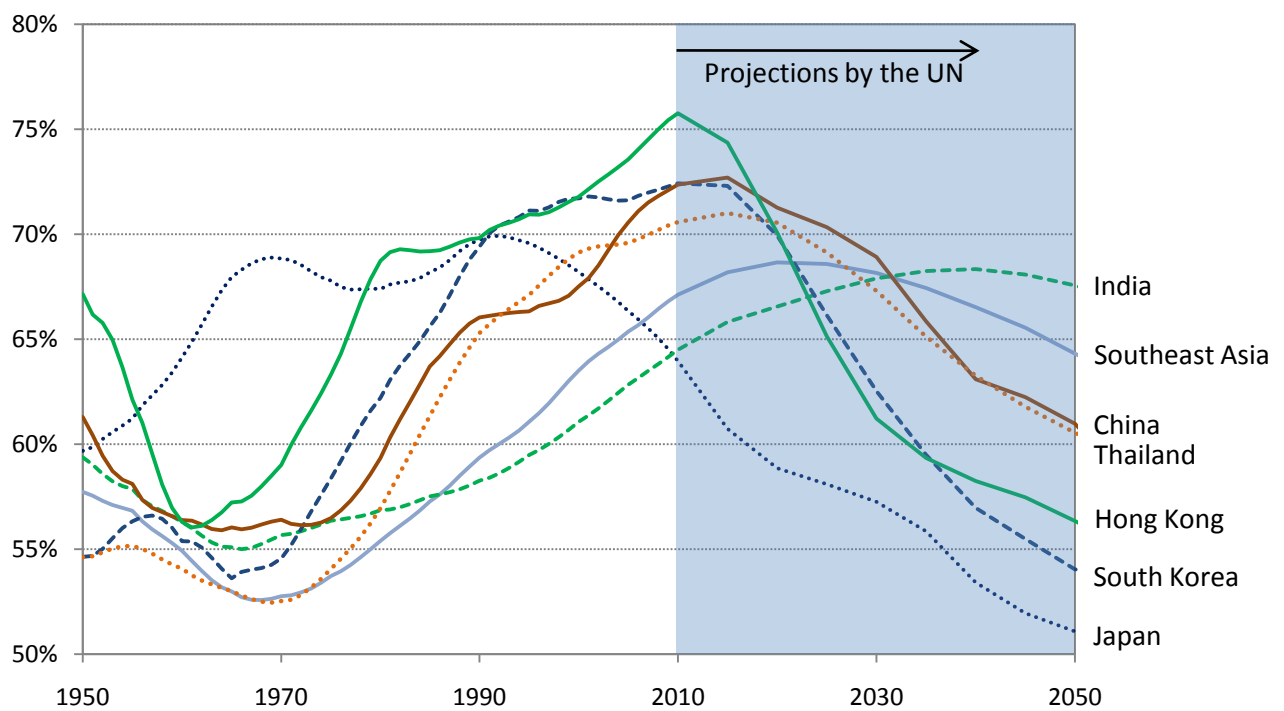
Chart 1. Loan-to-deposit ratios of banks



Note: Figures are for 2011.

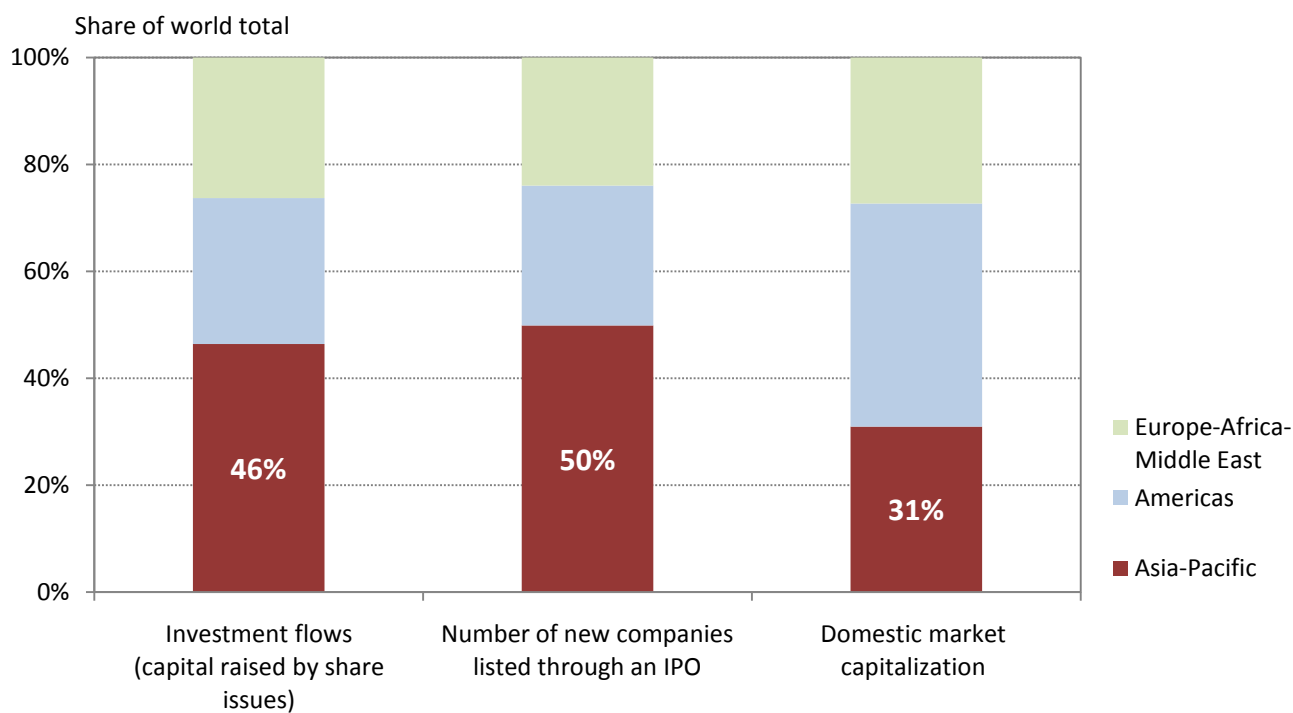
Sources: CEIC; Federal Reserve Board; IMF, *International Financial Statistics*.

Chart 2. Share of working-age population



Source: United Nations, *World Population Prospects: The 2010 Revision*.

Chart 3. Presence of Asia-Pacific in the world capital market



Note: Figures are for 2011.

Source: World Federation of Exchanges Database.