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BOOK REVIEW ARTICLE

Review of *Global Shock, Risks and Asian Financial Reform*

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Global Shock, Risks and Asian Financial Reform. **Edited by Iwan J. Azis and Hyun Song Shin.** Cheltenham, UK and Northampton, USA: Asian Development Bank and Edward Elgar Publishing, 2014. Pp. 731.

Since the 2007–08 Global Financial Crisis (GFC), there have been many books written on the future of Asian finance and financial reform. This book, edited by Iwan J. Azis and Hyun Song Shin from the Asian Development Bank (ADB)/Cornell University and Princeton University respectively, is the most comprehensive and in-depth study of the issues facing Asian finance to date. A hefty volume of over 700 pages and 18 chapters, written by ADB specialists, leading academics and financial policymakers, it deserves serious attention. Professor Shin has since moved to become the Economic Adviser and Head of Research at the Bank for International Settlements, helping to shape one of the most creative research agendas on current global finance, monetary and regulatory policy.

The book comprises five parts: an introductory overview and summary by the editors; macro-prudential supervisory system and development impact; issues and challenges for the legal and institutional framework; (regional) financial integration and cooperation to support financial stability; and financial supervision and development challenges. Each section has an introduction with an overview of the findings and issues raised.

The book is the outcome of an ADB research project on regulatory reform post-GFC and is very useful as a compendium and reference on regulatory issues for Asia up to 2012. The book focuses mostly on East Asia (particularly ASEAN countries). In contrast, South Asia and the Middle East economies are not given as much attention as they deserve.

The overview in Part I by Azis and Shin provides a very useful summary but lacks a historical perspective, which begs a simple yet strategic question: as Asia evolves from the world's global supply chain to become a net lender through high savings and surplus, can it develop its own financial sector to better use its savings? Currently,

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the region suffers from exporting excess savings to advanced markets in London and New York and re-importing these back through foreign direct investments and portfolio flows that earn significantly higher returns. The region is also hostage to volatile capital flows and both India and China still maintain capital controls.

How Asia manages its financial sector, particularly the difficult transition to totally open capital markets, will define its role in global leadership in the twenty-first century.

In other words, the book takes the orthodoxy as given, recognizing that financial deepening is broadly good, albeit with risks to be managed. Even though it recognizes that there is no "one-size-fits-all" regulation or regulatory structure, it hints at current advanced markets — dominated by American and European thinking — as a model for Asia.

The field of finance moves so rapidly that since the book was written, four major trends and events have turned and are turning the industry almost upside down. First, macroeconomic theory and finance is being challenged by central banks' unconventional monetary policy of moving interest rates beyond the lower boundary of zero. The spillover effects of such a move on financial markets and investor behaviour are still being digested and the outcome is highly uncertain. All that can be said is that savers recognize that they are being taxed indirectly, but steps made to adjust their portfolios remain to be seen. Second, financial technology platforms are challenging the payments, investment and transaction profits of traditional banks, insurance companies and asset managers. Their market valuation is currently worth more than the market capitalization of the largest banks. Third, as the implementation of the complex regulatory and legal reforms introduced post-GFC is being phased in, there has been some unexpected impact on market behaviour, such as flash crashes, high volatility and sudden liquidity stops. It is unclear whether these are due to new technology from algorithmic trading or simply traders becoming risk-adverse in light of tighter regulations. Fourth, the international financial architecture, particularly the Bretton Woods institutions are being challenged by the creation of the Asian Infrastructure Investment Bank (AIIB) and other new regional multilateral development funds.

Market-driven changes are happening so fast and at such scale that no academic study can do justice to the complexity of these emerging issues.

To be fair, macro-prudential issues and development challenges are superbly covered in Part II (Chapters 2–4), written largely by Professor Shin and colleagues from South Korea. These chapters empirically prove the importance of monitoring the procyclicality of core and non-core liabilities of the banking sector. In Asia's dominant banking systems, domestic deposits are often relied upon as core funding for banks' activities. However, as the economy advances in sophistication, banks would draw on non-core funding, such as asset-backed securitization or foreign exchange liabilities, exposing themselves to new and untested risks. The Asian Financial Crisis (AFC) of 1997–98 and the GFC demonstrated the risks of over-reliance on non-core funding, which dries up in times of crises or market stress. Monitoring the procyclicality of such funding is therefore a useful indicator of system vulnerability. Chapter 4 by Shin and Zhao highlights a notable trend where non-financial companies become "financialized" by acting as financiers — some in terms of supply chain credit, but mostly in using leverage to earn extra profit, which amplifies financial cycles.

Chapter 5 by Azis and Yarcia focuses on the shifts in the Asian economy since the AFC when Asian economies became excess savers. Using flow-of-funds analysis, the authors examine the implications of that shift in terms of macro-prudential and socio-economic risks. Since the AFC and GFC, unconventional monetary policy in the advanced economies created higher exposures to large gross capital inflows and outflows, requiring more sophisticated macro-prudential tools to manage exchange rate and financial stability. Besides analysing the flow of funds, the chapter also touched upon social inequality as only a small percentage of people has access to formal finance. By providing wider access to many rural people who have mobile phones but not bank accounts, financial technology (fintech) platforms are addressing the issue of social and financial inclusion.

Part III is a useful survey of the major financial reforms and laws introduced since the GFC that have an impact on the Asian institutional framework. Written mostly by academics from Australia, Hong Kong and Europe, Chapter 6 surveys the issue of financial regulatory design and examines the steps to deal with new complex legislation and rules introduced after the GFC, such as the SIFIs (systematically important financial institutions)[1] and shadow banking. The legislation to resolve SIFIs have been uneven thus far. Similarly, as shadow banking is not as developed in Asia, regulators here have not paid much attention to the rise of related products and institutions, which may become an issue over time. This is certainly true in China and India, as regulators there confront fintech innovations.

In Chapter 7, Buckley, Arner and Panton examine the issue of financial innovation. This is a somewhat disappointing chapter. Whilst the chapter correctly identifies Asian regulators as being cautious about financial derivatives and new innovation, which shielded them from the GFC, they have been quite pragmatic in new innovations. The reality on the ground is that despite a widespread view in the West that Asians are copycats in technology and innovation, the appearance of Alibaba and Tencent in China and their variants in India and ASEAN is changing the landscape of fintech platforms worldwide. The academic literature is lagging in this field, but published works by McKinsey, Oliver Wyman, Gao Feng and other consultants show that in some fields, the Asian innovations are ahead of their Western counterparties in terms of speed, scale and convenience.

Both China and India have incorporated financial innovation and technology into their national strategies as a means of transforming their economic models. For example, both fintech giants Alibaba and Tencent have been granted banking licences and have ambitious plans to challenge existing bank, insurance and asset management institutions in their business models. The fact that Internet transactions cost 1–2 cents versus US$1 per bank transaction is already an incentive for many consumers to switch to licensed fintech platforms, using mobile phones.

Chapter 8 is a comprehensive survey of global financial regulatory policies on systemic risks in Asia by Fariboz Moshirian of University of New South Wales. Developing an SRISK index of systemic risk, he concluded that Asian banks would be strong enough to withstand another Lehman-type shock. Asian banks have the capacity to withstand these shocks because many are state-owned or state-backed, and after the AFC, Asian macroeconomic conditions have improved by moving into net lender positions, higher foreign exchange reserves, and more cautious supervision. Unfortunately, globally lower interest rates have created asset bubbles, particularly in real estate, the implosion of which could severely impact Asian banks.

Part IV looks at regional financial integration and efforts to support financial stability. The two major initiatives after the AFC were the Chiang Mai Initiative to increase swap lines between ASEAN+3 central banks to US$240 billion and the Asian Bond Market Initiative to deepen local bond markets. An ASEAN+3 Macroeconomic Research Office was created in 2011 in an attempt to institutionalize and deepen regional cooperation. The move to institutionalize bilateral swaps into a multilateral arrangement has met with obstacles, mainly due to large member rivalry. Indeed, the biggest innovation was the bilateral central bank swaps line between People's Bank of China and seven Asian central banks,[2] totalling RMB1.4 trillion (US$226 billion) (Zhu 2015). This move is not only likely to increase the use of the renminbi for trade purposes, but also serves as a contingency facility to help provide some support against shocks to regional stability.

Chapter 9 is the only chapter that touches on the equity market and confirms a home equity bias in portfolio allocation in the Asian region by the fund managers, partly due to portfolio restrictions and partly because fund managers know their markets better. Unfortunately, the excess savings countries in Asia tend to be used to invest in liquid bonds and also those outside the region, since most official savings are in the form of foreign exchange reserves. This arises from Asian regulators' preference to diversify excess savings outside (in dollars and North Atlantic sovereign credit risks) rather than within the region. Indeed, with exchange controls still in place in China and India, the biggest challenge is how to internationalize the renminbi and rupee in the next two to three decades. As recent events in 2016 showed, the People's Bank witnessed a reduction of nearly gross US$1 trillion (including current account surplus of US$300 billion in 2015) or one-fourth of its foreign exchange reserves in less than 18 months maintaining stability in the currency, which implies that self-insurance is necessary but no longer sufficient to maintain foreign exchange rate stability.

Chapter 10 draws policy and regulatory lessons from the Eurozone crisis, but its relevance to East Asia is at best mixed. The obvious lesson is that contagion can spread very fast, but the nature of the crisis and its resolution is highly contextual. Asia does not have monetary integration or a single currency, and is not bound by the need to consult the regional central bank (European Central Bank) or to comply with regional regulatory and architectural requirements, such as a single regulator.

Chapters 11 and 12 by Michael Andrews on deposit insurance and resolution mechanism provide very useful technical reviews of the stage of development of existing systems (or non-existence) in Asia. The different stages of development in each country reflect the respective stages of financial sophistication and legal developments. The insolvency laws dealing with the failure of financial institutions are far more complex than general ones that it is not surprising that they have been slow to evolve.

Chapter 13, prepared with the help of experts from the Bank for International Settlements, focuses on capital structure and the issuance of corporate bonds in Asia. While the size of local currency bonds has grown in Asia, the next stage of development will depend on the extent of market liberalization, such as the entry of foreign players, derivative markets and exchange controls. Whilst bond markets in Hong Kong and Singapore are reasonably liquid and transparent, the same cannot be said for many other Asian markets. The quality of issuers, in terms of credit risks, financial condition and corporate governance are still opaque. Without active participation of long-term fund managers and institutional players, and a lack of complementary development of deep equity markets, bond markets do not solve the problems of excessive leverage in Asia.

Part V looks at specific issues of regulatory development in Asia, such as financial inclusion, SME funding, and how to develop institutional players that invest for the long-term such as the insurance and pension sectors. The development of these sectors is grossly neglected in emerging Asia, which has a young demographic profile and hence less pressure for urgent pension and social security coverage. Furthermore, Asian export manufacturers, who have a large role in influencing policy, would not be supportive of the idea of paying for social security, which will result in higher labour costs. But as Asia matures, the problem will become a pressing one. To develop this sector, professional debt management of long-term financial savings is needed alongside sound financial markets. However, we have a chicken-and-egg problem, as neither the former nor the latter are well developed in the region. Pension and social security funds are necessary pre-conditions for deeper financial markets and deserve more policy attention. Asian policymakers would do well to carefully examine the 2013 Group of Thirty study on long-term financing.

The final chapter is a useful reminder to regulators that trade finance remains very important in Asia and that global rules cannot apply as a blanket without understanding that countries have different conditions from each other. Asia's orientation towards trade is so strong that any bias against trade finance would hurt real trade.

All in all, experts, investors and academics of financial markets should read this book for an in-depth understanding of the current state of Asian finance. The region is clearly under stress on different fronts — geo-political, social and economic. After the AFC, the region became a net lender to the rest of the world, indicating its readiness to move on to the next stage of becoming a rule-maker in the new global financial order. Whether the region can move on from being a rule-taker will critically depend on how well Asian economies manage their financial development. They can either leap-frog through technology and innovation, creating financial sectors that "best fit" their own policy goals, or remain mired in "best practices", trying to copy and implement the global standards that suit more advanced financial markets. The current generation of Asian regulators and policymakers therefore play a critical role. It is important for them to learn from the mistakes from previous financial cycles to develop resilience in the system so that they will be better prepared when a financial crisis happens again.

NOTES

1. There are more domestic SIFIs than global ones in Asia.
2. Asia comprises: the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

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