



ADB

ASIAN ECONOMIC INTEGRATION REPORT 2017

THE ERA OF FINANCIAL INTERCONNECTEDNESS:
HOW CAN ASIA STRENGTHEN FINANCIAL
RESILIENCE?

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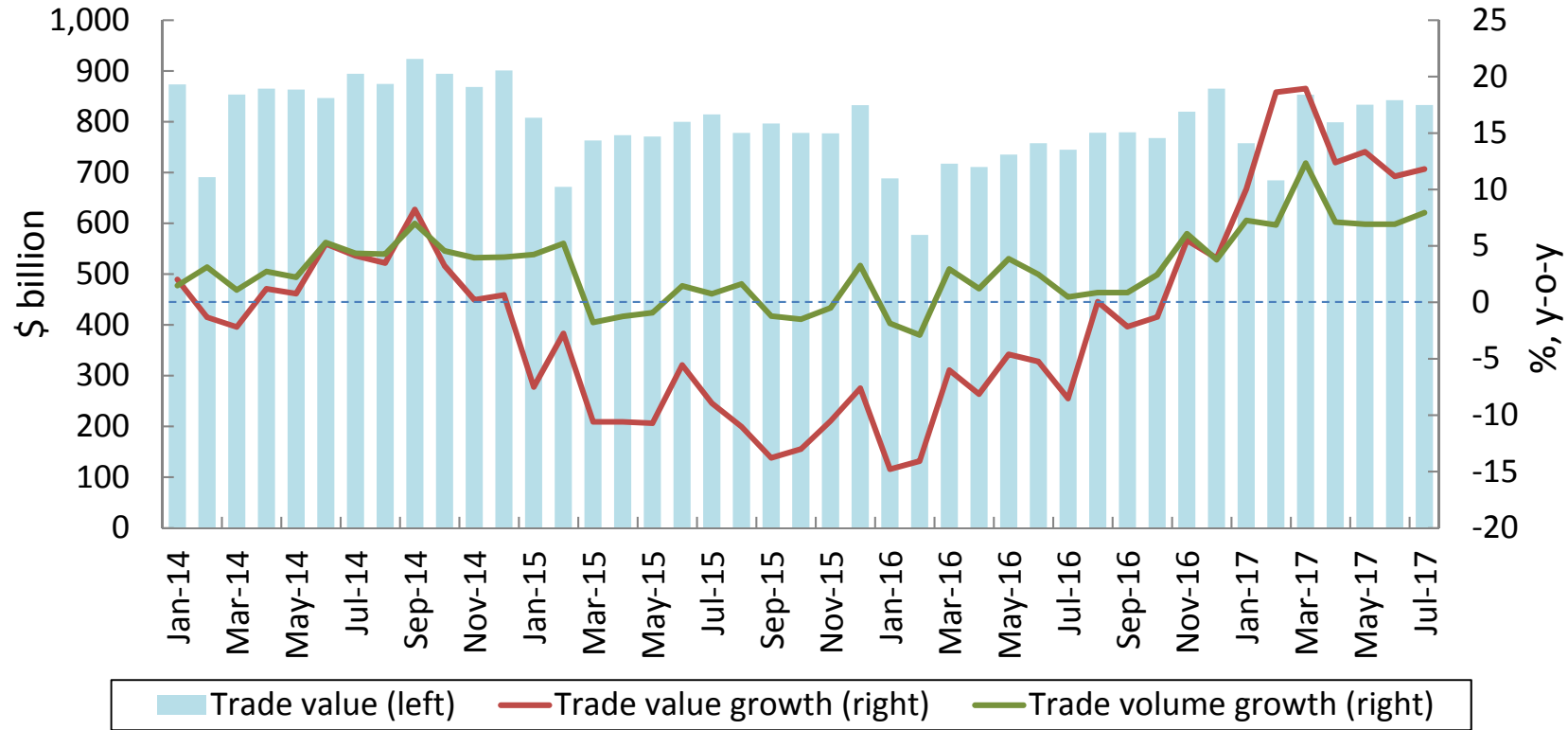
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Key messages

- Asia leads the global trade growth recovery; yet structural factors of global trade slowdown still at play
- Asian financial markets continue to be integrated more globally than regionally
- 20 years after the Asian financial crisis, Asian policy makers need to remain vigilant, deepen financial reforms, and strengthen regional cooperation for financial regulation and safety nets
- Rapid financial globalization should be carefully managed; pockets of vulnerability remain while regulatory policy gaps leaving room for a buildup of financial imbalances.

Recent data point to a trade recovery

Asia's Monthly Trade Value and Volume



y-o-y = year-on-year.

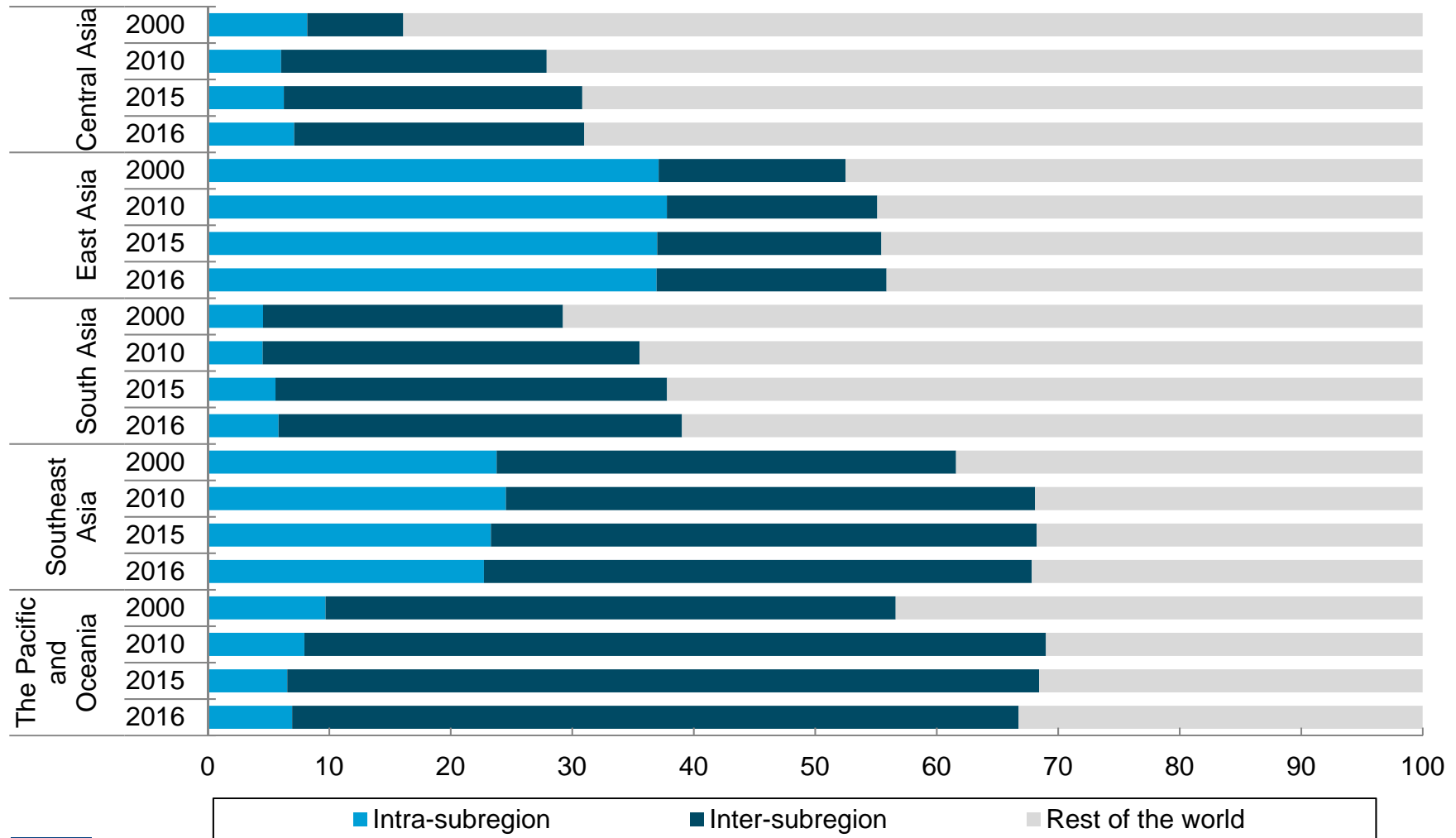
Note: Asia includes the People's Republic of China; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

Source: ADB calculations using data from CEIC; CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor.

<https://www.cpb.nl/en/data> (accessed October 2017).

Intraregional trade integration deepens

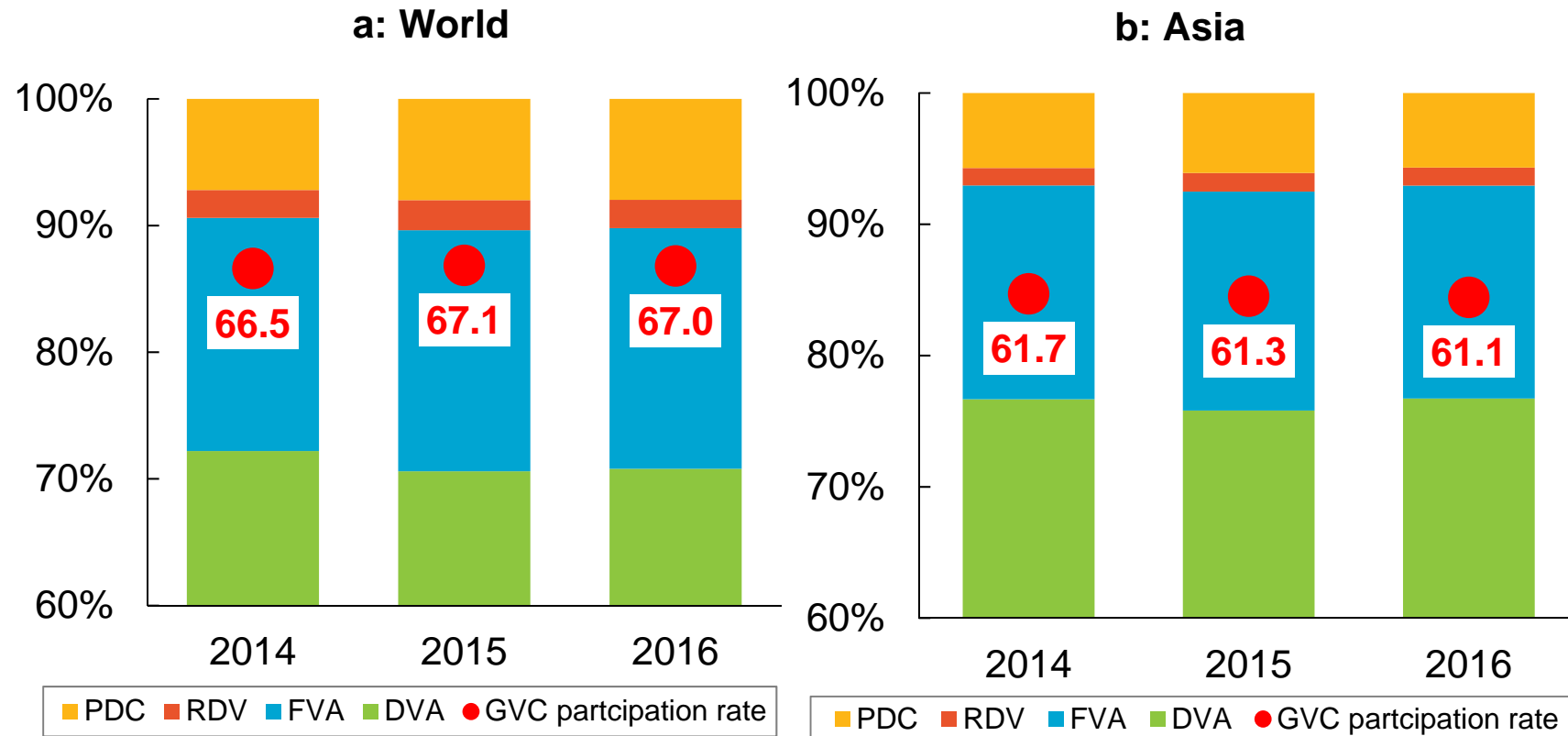
Asia's Intra- and Inter-subregional Trade Shares (%)



Source: ADB calculations using data International Monetary Fund. Direction of Trade Statistics (accessed July 2017).

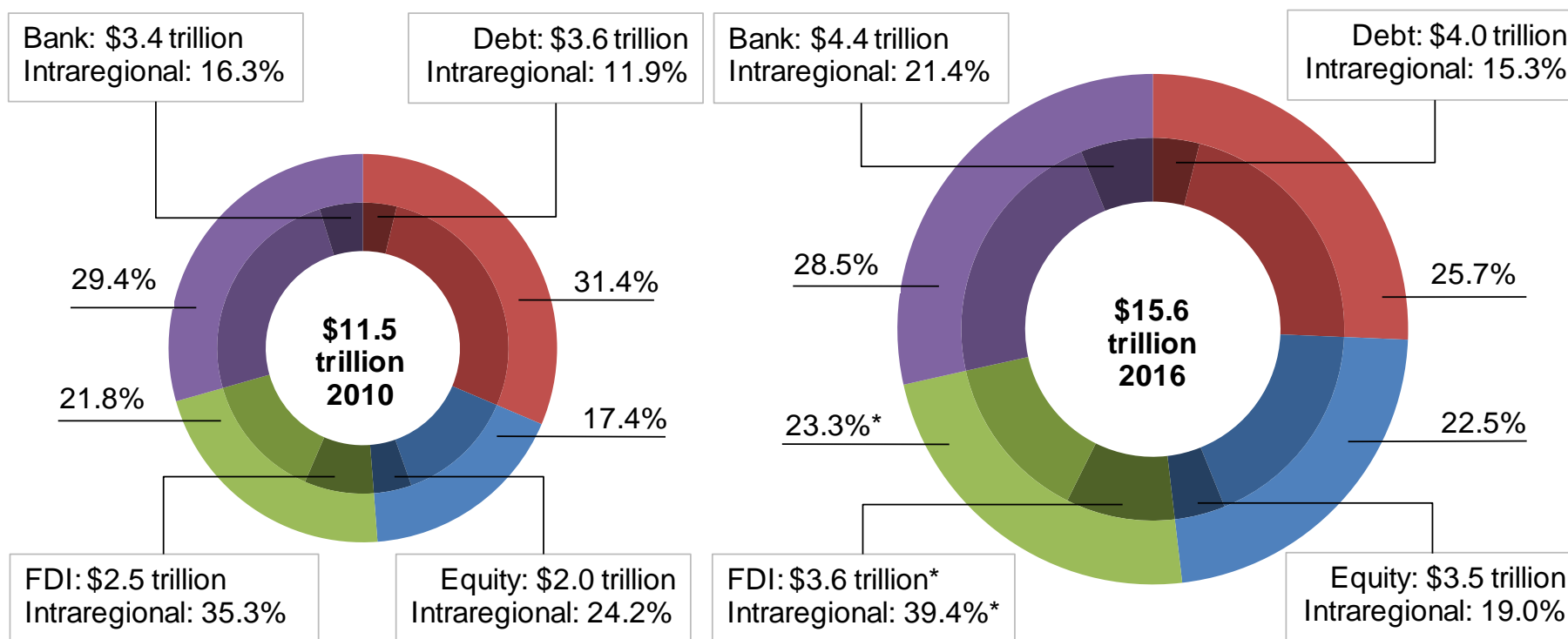
Asia's value chain linkage with the global economy slowed

Components of Gross Exports (%)



DVA = domestic value added, FVA = foreign value added, RDV = returned value added, PDC = purely double-counted terms.
 Source: ADB calculations using ADB Multi-Regional Input-Output Tables, and methodology by Wang, Wei, and Zhu (2014).

Asia's cross-border assets grow



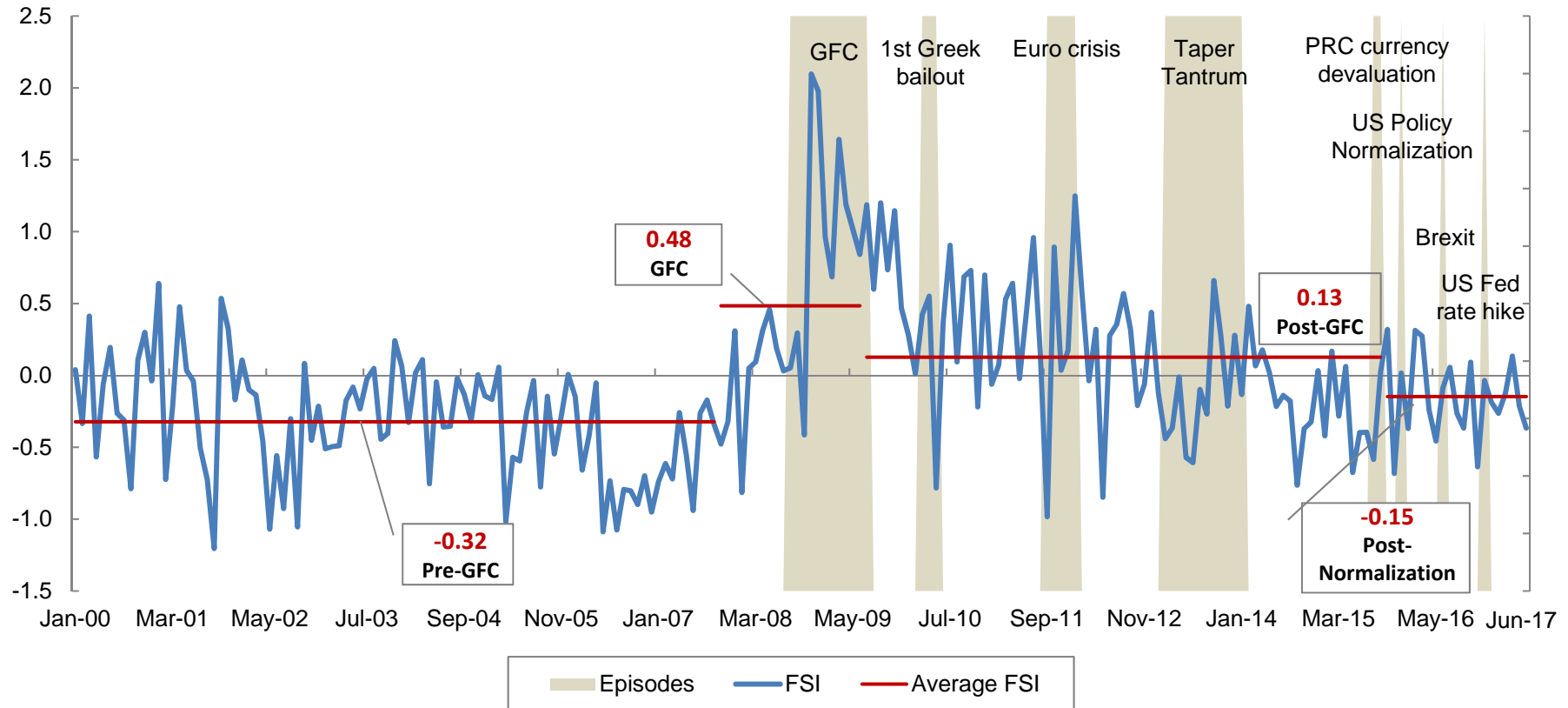
FDI = foreign direct investment; * = data as of December 2015.

Notes: FDI assets refer to outward FDI holdings. Bank assets refer to bank claims of Asian economies. Asia includes all 48 ADB regional members for which data are available as of December 2016.

Sources: ADB calculations using data from International Monetary Fund. Coordinated Portfolio Investment Survey. <http://cpis.imf.org> (accessed September 2017); International Monetary Fund. Coordinated Direct Investment Survey. <http://cdis.imf.org> (accessed February 2017); and Bank for International Settlements. Locational Banking Statistics. <https://www.bis.org/statistics/bankstats.htm> (accessed May 2017).

Financial stress up in response to global and regional shocks

Developing Asia Financial Stress Index



Note: Based on principal components analysis. Includes People's Republic of China; Hong Kong, China; India; Indonesia; Rep. of Korea; Malaysia; Philippines; Singapore; Thailand; Viet Nam
 Source: ADB calculations using data from Bloomberg, CEIC, and Haver Analytics (all accessed September 2017).



The Era of Financial Interconnectedness: How Can Asia Strengthen Financial Resilience?

Key lessons drawn from past crisis experiences

- Rapid financial globalization—timing and sequencing of financial liberalization should be carefully managed;
- Maintaining sound macroeconomic fundamentals is a prerequisite for economic and financial resilience;
- Deepening and broadening financial systems is essential to boosting both financial efficiency and resiliency;
- Greater regional cooperation efforts are needed to reinforce regional financial safety nets for financial resilience.

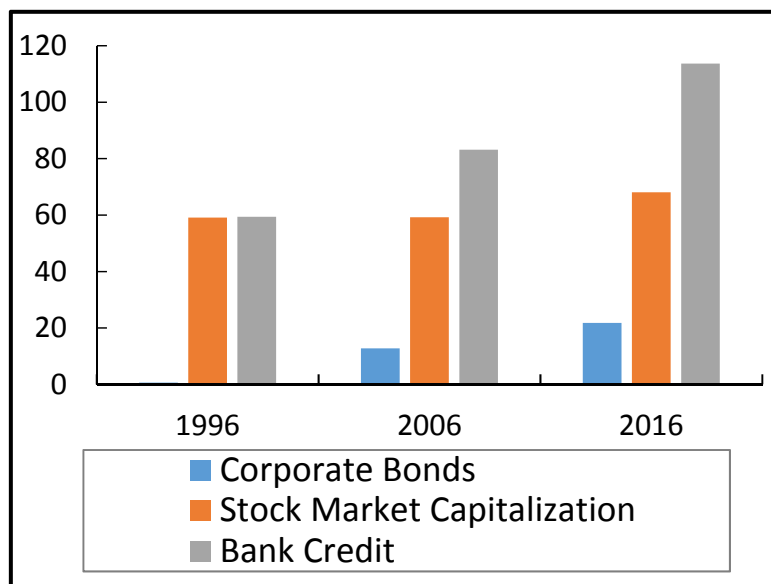
Asia's financial health improved but pockets of vulnerability remain

- Significant challenges remain, along with unresolved financial market and system weaknesses.
- Remaining regulatory policy gaps also leave room for a buildup of financial vulnerability.
- Asia's policy makers must remain vigilant, while continuing to deepen financial reforms.

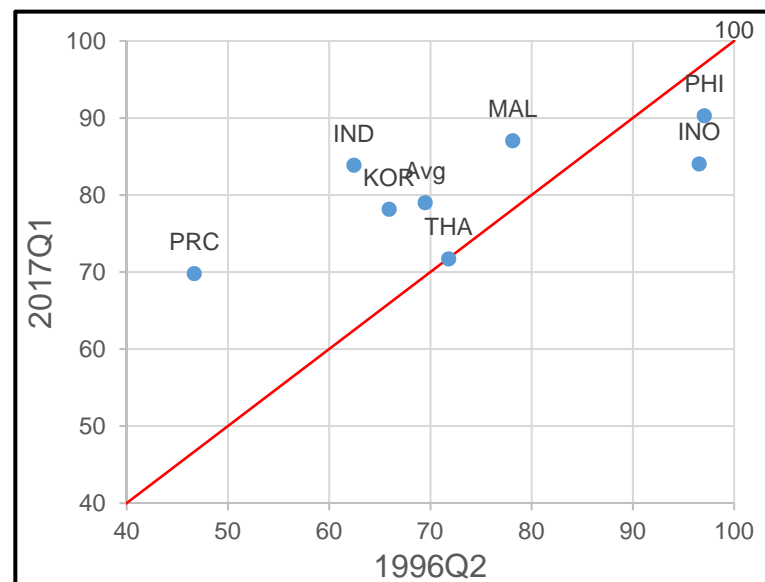
Structural weaknesses remain

- **Limited capital market-based financing solutions** such as long-term local currency bond markets
- **Continued heavy reliance on foreign currency- (US dollar-) denominated debt**

Corporate Financing as % of GDP—Emerging Asia (excluding HKG and SIN)



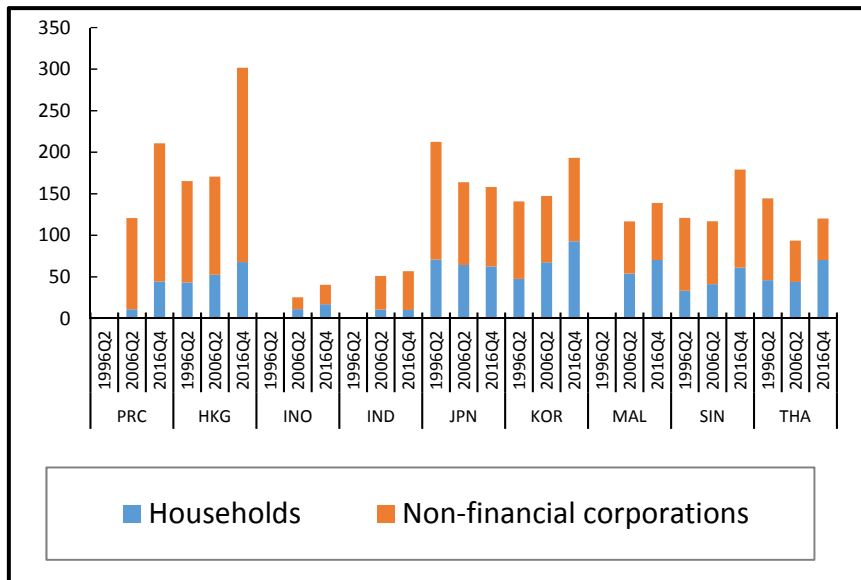
Share of outstanding international debt securities denominated in US dollars (in %) – Pre- AFC vs. latest



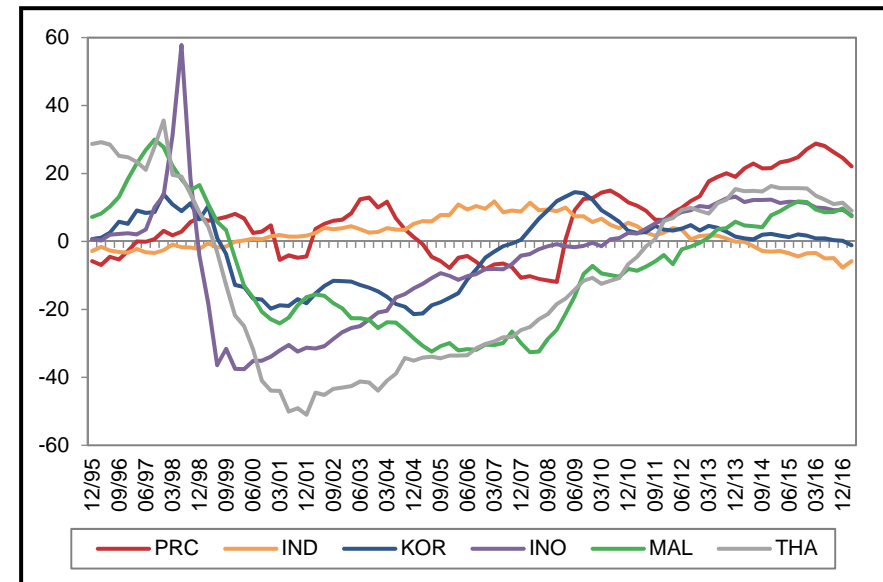
Recent trends to signal financial fragility

- **Rising private-sector debt and leverage**—combined with the rapid growth of shadow banking—increase financial fragility
- **Deteriorating bank asset quality** can have potential macrofinancial feedback effects

Credit to Private Sector—Selected Asian Economies
(% of GDP)



Deviation of Credit-to-GDP from Long-Run Trend (%)



NPL ratios picking up in some Asian economies

Bank Nonperforming Loans (% of gross loans)

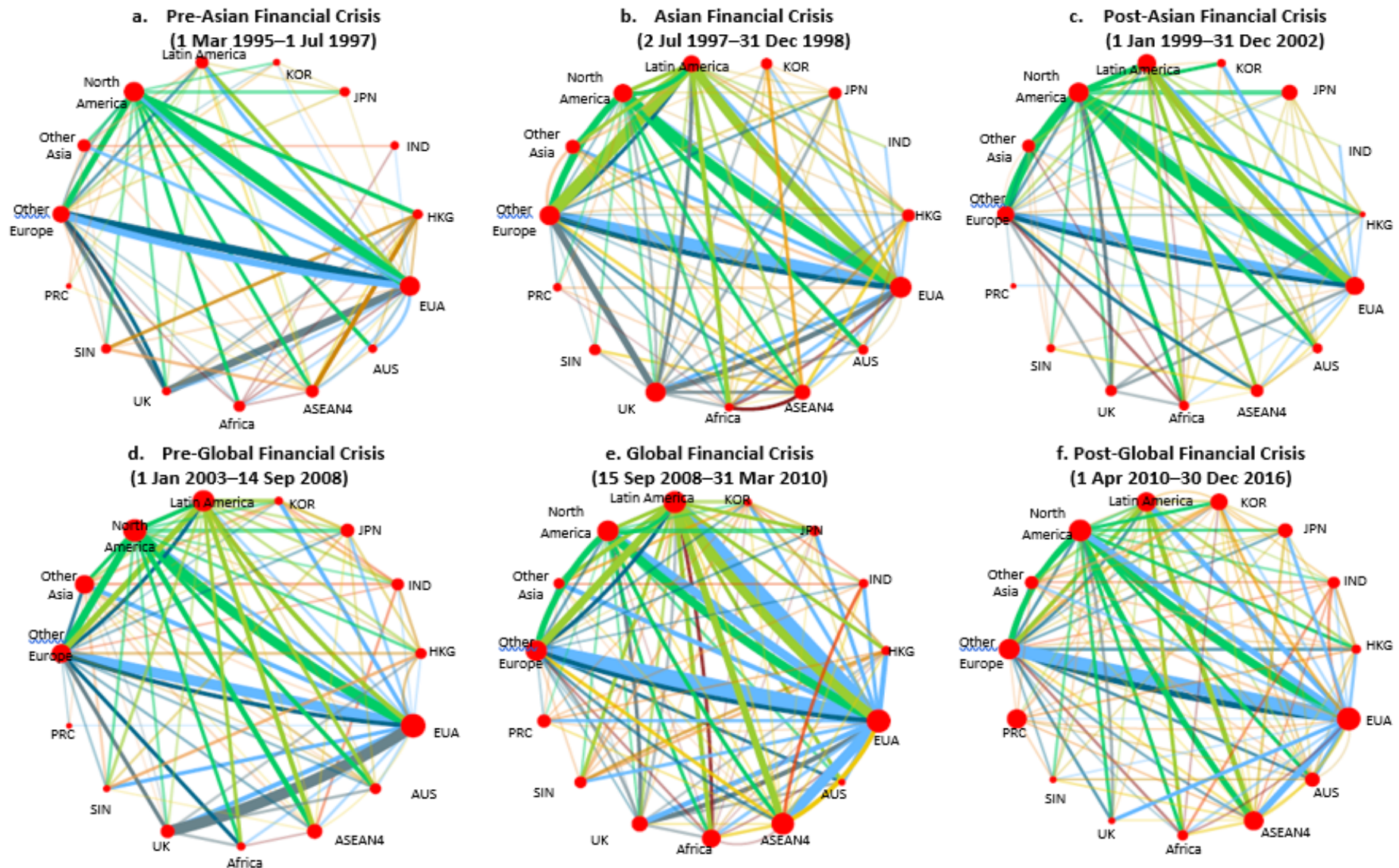
Economy	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Central Asia																				
Afghanistan														49.9	4.7	5.0	4.9	7.8	12.1	15.2
Armenia		6.0	8.0	17.5	24.4	9.9	5.4	2.1	1.9	2.4	2.4	4.3	4.9	3.0	3.4	3.7	4.5	7.0	7.9	9.3
Azerbaijan					28.0	21.5	15.1	9.5	7.2				3.5	4.7	6.0	5.7	4.5	4.4	5.3	
Kazakhstan						11.9	8.4	4.3	3.3	2.4	2.7	7.1	18.9	20.9	20.7	19.4	19.5	12.4	8.0	7.9
Kyrgyz Republic		10.1	30.9	30.9	13.4	13.3	11.2	8.0		6.2	3.6	5.3	8.2	15.8	10.2	7.2	5.5	4.5	7.1	
Tajikistan										11.3	4.8	5.4	9.6	7.4	7.2	9.5	13.2	20.4	19.1	
East Asia																				
Korea, Rep.	5.8	7.4	8.3	8.9	3.4	2.4	2.6	1.9	1.2	0.8	0.7	0.6	0.6	0.6	0.5	0.6	0.6	0.6		
Mongolia												7.2	17.4	11.5	5.8	4.2	5.3	5.0	7.5	8.5
PRC			28.5	22.4	29.8	26.0	20.4	13.2	8.6	7.1	6.2	2.4	1.6	1.1	1.0	1.0	1.0	1.1	1.7	1.7
South Asia																				
Bangladesh		40.7	41.1	34.9	31.5	28.1	22.1	17.5	13.2	12.8	14.5				5.8	9.7	8.6	9.4	8.4	
India	15.7	14.4	14.7	12.8	11.4	10.4	8.8	7.2	5.2	3.5	2.7	2.4	2.2	2.4	2.7	3.4	4.0	4.3	5.9	7.6
Maldives																20.9	17.6	17.5	14.1	11.1
Pakistan	20.7	19.5	22.0	19.5	23.4	21.8	17.0	11.6	9.0	7.3	7.4	9.1	12.2	14.7	16.2	14.5	13.0	12.3	11.4	11.1
Southeast Asia																				
Indonesia		48.6	32.9	34.4	31.9	24.0	6.8	4.5	7.3	5.9	4.0	3.2	3.3	2.5	2.1	1.8	1.7	2.1	2.4	3.0
Malaysia	4.1	18.6	16.6	15.4	17.8	15.9	13.9	11.7	9.4	8.5	6.5	4.8	3.6	3.4	2.7	2.0	1.8	1.6	1.6	1.7
Philippines	4.7	12.4	14.6	24.0	27.7	14.6	16.1	14.4	10.0	7.5	5.8	4.6	3.5	3.4	2.6	2.2	2.4	2.0	1.9	2.0
Thailand		42.9	38.6	17.7	11.5	16.5	13.5	11.9	9.1	8.1	7.9	5.7	5.2	3.9	2.9	2.4	2.3	2.3	2.7	2.9

Notes: White cells denote a nonperforming loan ratio below 5%, yellow between 5% and 10%, and orange above 10%. Blank cells indicate data are unavailable.
Sources: ADB calculations using data from Bank of Mongolia; and World Bank. World Development Indicators (accessed October 2017).

New challenges to Asia's financial stability

- Asian financial markets have grown more interconnected both intra-regionally and across the globe over the past 20 years;
- A more interlinked global banking network can spur the transmission of financial risk from advanced to emerging economies;
- A buildup in NPLs can yield macro-financial feedback effects, with possible spillover effects in increasingly interconnected financial markets.

Asian financial markets have become more interconnected regionally and globally



A heightened financial interconnectedness can transmit shocks across borders

Impact of direct and indirect banking exposures to the crisis-affected countries on capital outflows during the GFC

Variables	Without Control Variables		With Control Variables	
	(1) Outflows	(2) Outflows	(3) Outflows	(4) Outflows
Direct exposure of banking sector	0.257*** (0.075)	0.282*** (0.078)	0.228** (0.085)	0.253*** (0.086)
Indirect exposure of banking sector		0.722** (0.285)		0.359 (0.269)

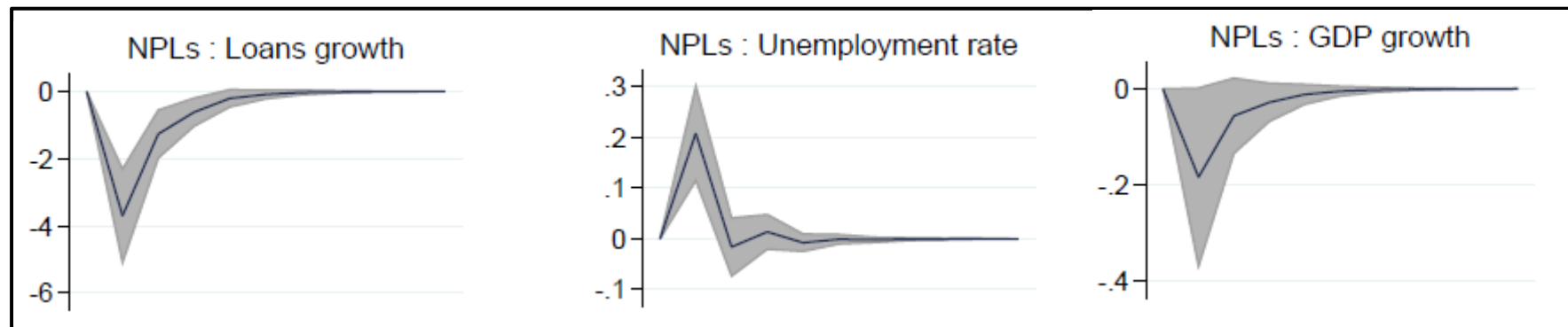
*** = significant at 1%, ** = significant at 5%. Robust standard errors in parenthesis. Coefficients for the control variables are not shown for brevity.

Source: Park and Shin (2017).

Buildup of NPLs can affect real sector and spill over through macrofinancial linkages

- **Macrofinancial feedback effects:** Empirical findings show that an increase in NPLs leads to a reduction in credit supply, a rise in unemployment, and slowdown in overall economic activity
- **Systemic implications:** NPL shocks can transmit across borders through macrofinancial linkages

Estimated Impulse Response Functions to a Shock in the NPL Ratio



Source: Lee and Rosenkranz (2017)

Policy considerations for enhancing financial resilience

- A key lesson drawn from recent crises is the urgent need to strengthen macroprudential regulation and supervision
- Further developing local currency bond markets across the region is key to enhancing financial resilience and mobilizing long-term finance
- Growing regional banking activities and institutions—possibly of systemic importance—underpin the need to discuss regional regulatory cooperation, including resolution mechanisms for interconnected regional banks
- The region should consider reviewing and strengthening existing financial safety nets against potential contagion and spillover effects



Thank You!