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Shifting structure of financial sector in Asia and the Pacific

The 2030 Agenda for Sustainable Development was adopted by the 193 member States at the United Nations headquarters in September 2015, New York. The new development agenda aims to turn the policy focus of countries to sustain inclusive economic growth, energize investment for social justice, and prioritize efforts towards environmental sustainability.[1] This global development process received additional boost due to the adoption of a new financing for development framework which was adopted at the Third International Conference on Financing for Development in July 2015, Addis Ababa.[2] The financing agenda is comprised of a comprehensive set of policy actions with over a hundred concrete measures that are aligned with outcomes of the sustainable development goals.[3]

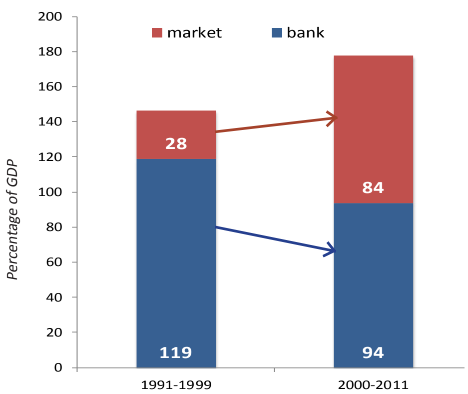
Financial sector structure

In this context, the policymakers are encouraged to prioritize structural reform measures and financial sector deepening strategies to mobilize domestic public resources, leverage domestic and international private financing, and explore the potential of international public financing that is expected to create a long-term sustainable financing for productive investment sectors.[4]

The development of financial sector is one of the key elements of the financing for development framework. There are two general models for financing economic activities: (i) a market-based approach and (ii) a bank-based system.[5] At the national level, actual financial sectors are found in a continuum between these two types of financial structure. In the region, traditionally bank-based finance have been dominant, but lately market-based financing has been growing steadily.[6] For example, in comparison to the 1990s, the countries in the region have shown much more reliance to leverage and securitize the financial products to transform short-term portfolio positions into long-term finance in the past decade (figure 1)[7].

At the country level, due to the varying stages of development, the deepening of financial sector has been uneven and shallow in Asia and the Pacific region as well as in other regions.[8] A closer look at the financial structure demonstrates the disparate direction of change over the past two decades. The increase in the market-to-bank ratio suggests a financial structure has been steered towards market expansion in a number of countries, such as China, India, Indonesia, Japan and Australia. On the other hand, several countries (e.g. Papua New Guinea, Nepal, Sri Lanka, and Mongolia) use banks as the primary source for long-term financing mechanism, and consequently these economies still need to put in a new set of financing strategies to expand the scope of the financial sector deepening.[9]

Figure 1. Financial sector development in Asia-Pacific economies, 1991-2011



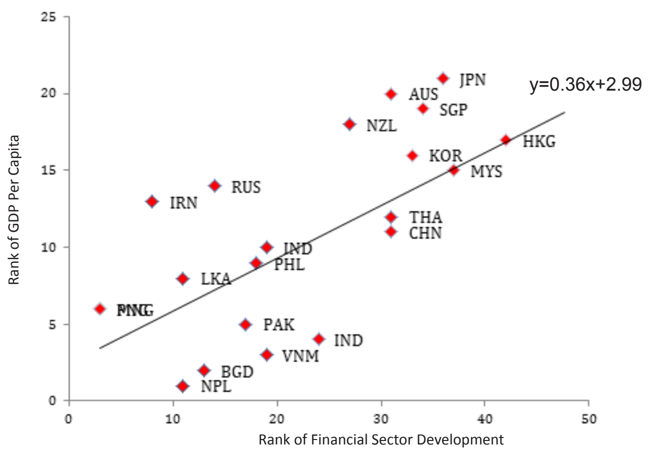
Source: ESCAP, based on World Development Indicators, World Bank (accessed 20 October 2015).
Notes: "market" is measured by the total stock value traded as percentage of GDP; "bank" is measured by "bank credit to private sector as percentage of GDP. The regional average is weighted by country GDP. Sample countries: Australia, Bangladesh, China, Hong Kong, China, Indonesia, India, Islamic republic of Iran, Japan, Republic of Korea, Sri Lanka, Mongolia, Malaysia, Nepal, New Zealand, Pakistan, the Philippines, Papua New Guina, Russian Federation, Singapore, Thailand, and Viet Nam.

Financial sector and growth

With the development of the financial sector, it can efficiently intermediate funds from savers and investors. Therefore, a vibrant financial sector has a positive relationship on economic growth through several channels including efficient allocation of productive resources, aggregate demand expansion, and promotion of the economy-wide productivity. Figure 2 displays a significant correlation between a stronger financial system and higher GDP per capita in Asia and Pacific region. Separately, both bank credit and market total stock value maintain a positive correlation with GDP per capita, even after excluding developed member States such as Australia, Japan, and New Zealand. However, the relationship also illustrates that the majority of countries are clustered in the low-stock value and low-GDP per capita range, whereas they are more spread-out on their level of bank-based financing.[10]

The impact of the financial sector on inclusive growth and development is critically dependent on the country size and the stages of development. This is particularly relevant for the small island developing States and the least development countries.

Figure 2. Finance and growth: a positive link



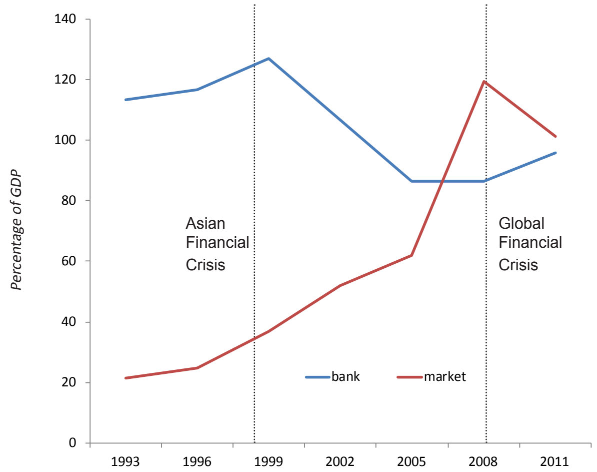
Source: ESCAP, based on World Development Indicators (WDI), World Bank; International Financial Statistics (IFC), International Monetary Fund. (accessed 20 October 2015).
Notes: The financial sector development is based on the deepening of bank-based and makret-based indicators. On the x-axis is the sum of a country's rank of bank and market development among all sample countries. On the y-axis is the rank of average per capita GDP over the 1991-2011 period, where large number indicating higher per capita GDP. The larger number implies higher level of GDP per capita and financial sector development.

Towards a financial sector stability

At the policy level, it is critically important that the Governments of Asia-Pacific economies take into account the potential impact of financial sector instability on inclusive growth and sustainable development. Policymakers need to carefully manage financial sector stability in an effective manner to minimize adverse effects on investment profiles and overall macroeconomic stability.

The experience in the region clearly shows that despite the positive impact of a well-diversified and developed financial sector on economic growth, there have been multiple episodes of financial market uncertainties over the last decades that caused challenges to the orderly growth of the real sector. The financial sector of the Asia-Pacific economy witnessed a major setback, experienced a pro-long downturn after the 1997/1998 Asian Financial Crisis and the 2008/2009 Global Financial crises (figure 3). In particular, these two crises have raised several questions regading the process and sequencing of the liberalization of the financial sector as well as emphasise on the pre-eminence of finance-led growth without adequate provisions of checks and balance.[11]

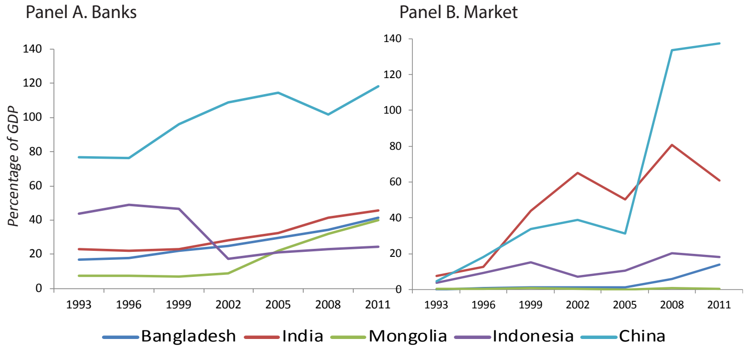
Figure 3. Financial sector volatility in Asia-Pacific economies, 1991-2011



Source: ESCAP, based on World Development Indicators (WDI), World Bank.
Notes: "Bank" and "market" are calculated as the GDP weighted average for all countries across the sample. The average based on 3 years: 1991-1993, 1994-1996, 1997-1999, 2000-2002, 2003-2005, 2006-2008, and 2009-2011.

Figure 4 provides another illustration of the evolution of bank-based and market-based growth trajectory of a selected number of countries, such as Bangladesh, China, India, Indonesia and Mongolia. The evidence suggests that a great divide in the expansion of the bank-based versus market-based system trends in these countries. For example, Bangladesh saw the steady increase of bank-based financing, whereas market-based system has only picked up in the last decade and since then it has grown in parallel with bank-based system. India historically relies on bank-based financing, yet market is slowly catching up. China has experienced the growing dominance of the bank-based sector since early 1990s, much like other big economies in Asia and the Pacific (e.g. Republic of Korea and Malaysia), with declines during the 2001 dot-com bubble bust and the 2008/2009 Great Recession that dampened the growth prospects. In contrast to the slow increase of bank financing, financial sector had a soaring growth since early 2000s. Financial sector development was stagnant in Mongolia until 2000; and banking sector has since dominated and quadrupled relative to the size of the GDP. Indonesia, however, suffered from the 1997/1998 Asian Financial Crisis and has been in slow recovery. Banks are still the main source of development financing, matched by slow growth of the financial market in Indonesia.

Figure 4. Trends in financial sector structure in selected Asia-Pacific economies, 1991-2011



Source: ESCAP, based on World Development Indicators (WDI), World Bank.
Notes: "Bank" and "market" indicators are calculated on the average of 3 years: 1991-1993, 1994-1996, 1997-1999, 2000-2002, 2003-2005, 2006-2008, and 2009-2011.

Way forward

In Asia and the Pacific region, policymaking and policy advisory services for deepening financial market will critically depend on the basis of the national economic condition. For example, until domestic institutional investors base are developed, banks can continue to provide a good interim solution for financing long-term sustainable development agenda. In developing financial markets for the financing of public goods, such as infrastructure, policymakers need to take into account that private agents seek profitability, implying that projects need to be bankable. Simultaneously, policymakers are required to promote enabling environment and enhance effective legal framework, and strengthen macroeconomic fundamentals that will eventually support the development of financial sector.

In sum, the countries need to devise a robust financing strategies to regulate policies for the financial market development. Therefore, national financing strategies will play a pivotal role to broaden and deepen markets infrastructure that will recognize the importance of going beyond deregulation and finanical market liberalization.

[1] *Transforming our world: the 2030 agenda for sustainable development.* A/RES/70/1 Available from www.un.org/ga/search/view_doc.asp?symbol=A/RES/70/1&Lang=E.
[2] *Addis Ababa Action Agenda of the Third International Conference on Financing for Development.* Available from www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.
[3] *Economic and Social Survey for Asia and the Pacific: Part 2 - Balancing the Three Dimensions of Sustainable Development: From Integration to Implementation*. Available from www.unescap.org/sites/default/files/survey2015-pt2-cs71-theme-study.pdf.
[4] *Financing for Transformation: From Agenda to Action on Sustainable Development in Asia and the Pacific.* Available from www.unescap.org/resources/financing-trans-formation-agenda-action-sustainable-development-asia-and-pacific.
[5] "market" is measured by the total stock value traded as percentage of GDP; "bank" is measured by "bank credit to private sector as percentage of GDP. The regional average is weighted by country GDP. Sample countries: Australia, Bangladesh, China, Hong Kong, China, Indonesia, India, Islamic republic of Iran, Japan, Republic of Korea, Sri Lanka, Mongolia, Malaysia, Nepal, New Zealand, Pakistan, the Philippines, Papua New Guina, Russian Federation, Singapore, Thailand, and Viet Nam.
[6] Another measure of financial market development – "market capitalization", the share price times the number of shares outstanding as a percentage of GDP – suggests a similar trend of market expansion. The weighted average market capi-talization across ESCAP sample countries is 56.77 (percentage of GDP) from 1990-1999, and increases to 76.21 over the 2000-2011 period.
[7] Using data on 30 ESCAP member States, statistical test was carried out between the average bank credit and market stock value data for 1990-2000 and the 2000-2011 periods. Upon calculation of the weighted average over each period, paired t-test suggested that the average total bank credit to private sector (% GDP) was significantly different in the two periods at the 10% confidence level (p-value = 0.0900); and the total stock value traded was different at the 5% confidence level (p-value = 0.0365).
[8] The change also occurs in other UN economic regions. The bank and market sector development respectively in each of the remaining four regions: ECA region (15 sample countries): 37.75 and 9.63 (1990-1999), 47.11 and 39.60 (2000-2011); ECLAC region (17 sample countries), 46.52 and 71.18 (1990-1999), 54.96 and 200.90 (2000-2011); ECE region (33 sample countries), 81.14 and 30.03 (1990-1999), 113.56 and 84.39 (2000-2011); ESCWA region (4 sample countries), 24.44 and 10.11 (1990-1999), 39.17 and 103.23 (2000-2011).
[9] The macroeconomic perspective states that financial market can pool all information together, reduce the loss of resources required to allocate capital, and raise capital productivity.
[10] Data of 21 ESCAP countries suggests a strong correlation between financial development and economic growth. We rank all sample countries by their average bank and market development from 1991 to 2011 using aforementioned indicators, and add up the two numbers to create a measure for overall financial development.
[11] *UNCTAD Trade and Development Report 2015.* Available from http://unctad.org/en/PublicationsLibrary/tdr2015_en.pdf.

The MPDD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue is prepared by Sudip Ranjan Basu and Rui Xu. For further information on this issue, please contact Aynul Hasan, Director, Macroeconomic Policy and Development Division, ESCAP (escap-mpdd@un.org).

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