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APEC's Growth – the critical role of finance

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Proposition

The proposition I want to develop in my address is that APEC, as an organisation, has historically been very focused on the deregulation and freeing up of trade among its members. In the future, deregulation of cross-border capital flows must receive an equal focus.

APEC Meeting – Hanoi

In the Hanoi Declaration at the 14th APEC Economic Leaders' meeting in Vietnam last month, the leaders:

- Noted the importance of open and robust financial systems and the orderly adjustment of global imbalances through
  - fiscal sustainability
  - price and exchange rate flexibility
  - reforms to promote investment
  - strengthened financial markets
  - more balanced domestic demand; and
  - improved corporate governance and legal infrastructure
- They welcomed the progress made on IMF reform, including quota reform, and the proposal to create a new liquidity instrument to help prevent financial crises in the region.
- They recognised the importance of financial stability for the region's continuing economic growth and development

Formally, the Leaders' meeting press release stated that the Leaders discussed, the theme of 'Towards One Dynamic Community for Sustainable Development and Prosperity' under two umbrella topics: 1. Advancing trade and investment in a changing world and 2. Fundamentals ensuring dynamism, growth and sustainable development in APEC.

However, despite financial flows featuring quite prominently, it is difficult to miss the overwhelming attention paid to trade issues by APEC. Of the 6 pages in the Hanoi Declaration, 1.5 pages are dedicated to issues related to free trade, while issues relating to the free flow of capital (financial market development) are given a paragraph. Human Security, Dynamic and Harmonious Communities, Corruption etc made up the other 4 pages.

Similarly, the Hanoi Action Plan to implement the Busan Roadmap toward the Bogor Goals (the goal of reaching free trade and investment by 2010 for developed economies, and by 2020 for developing economies) is very heavily focused on the exchange of goods and information, rather than on the movement of capital. Moreover, the short section on investment in the Hanoi statement focuses on foreign direct investment and investment promotion, with little attention paid to development of domestic financial sectors that can provide the funding for overall investment in a sustainable manner.

Why Should the Deregulation of Capital Flows Receive More Attention

Why are global capital flows significant for APEC economies?

1. Time and again in both developing and developed economies, the experience has been that a sudden shift in capital – particularly in cross-border capital flows – has the potential to rapidly destabilise financial markets and result in a shock to the real economy. To prevent this from occurring, governments need to ensure sufficient monitoring of capital flows to be aware of potential risks, while also minimising or avoiding regulation of the sort that either obscures or distorts global capital flows. The more opaque and regulated financial markets are, the more likely it becomes that highly leveraged players such as hedge funds will seek to exploit "imperfect" markets with large trading positions. In this scenario, shifts in capital flows are more likely to present a shock to the real economy because of the leverage involved.

2. Since the Asian crisis, the developed economies of APEC have attracted substantial net foreign capital inflows and harnessed these for productive investment. In contrast, the developing economies of APEC have become net exporters of capital to economies such as the US, Australia and NZ. Over-regulation in the capital account, high transactions costs in the financial markets and the lack of depth of local capital markets in developing APEC economies is partly to blame for this state of affairs. There is no doubt that the present circumstance under which developing APEC economies are exporting capital to developed economies represents a real opportunity cost for emerging Asia. Taking China as an example, The McKinsey Global Institute estimates that the reform of China's financial system – including improved banking sector efficiency, widespread introduction of electronic platforms and increased equity market trading efficiency – would raise GDP by US$321 bn annually, or 13.4% of GDP. APEC should act to encourage the development of financial markets across all of its member economies so that capital can be allocated efficiently into productive investment, ultimately promoting sustainable economic growth and poverty reduction.

What Do The Size of Capital Flows Look Like Versus Trade Flows

The magnitude of cross border capital flows today at least meet and sometimes exceed that of the flow of goods for the developed economies. For example, take Australia and the US:

IN AUSTRALIA

- Gross foreign investment flows into and out of Australia reached around A$260 bn in 2005, or just under 30% of GDP
- Total trade flows, the sum of our exports and imports of goods and services, was A$379 bn, or 41% of GDP
- We had a trade deficit of A$17 bn
- Conversely, we had net investment inflow of A$63 bn
- Moreover, the magnitude of Australia's exposure to global capital flows is rising as the value of Australia's net foreign liabilities has risen from A$343 bn (48% of GDP) at end-2001 to A$530 bn (57% of GDP) as at end-2005.

IN THE UNITED STATES

- Gross foreign investment flows last year were US$2.6 trillion, or 20% of GDP
- Total trade flows were also 20% of GDP
- The capital account showed net capital inflows of US$1.6 trillion, or 13% of GDP
- The US received more inbound investment last year than it did gross revenue from the export of merchandise goods.

The evidence therefore strongly suggests that the significance of financial flows is much larger than the attention given by policymakers, relative to the attention paid to real goods and services flows.

The Impact of Financial Deregulation on the Size and Significance of the Financial Sector

Perhaps one reason why APEC has not focused on the role that financial markets play within and between its members is because the member economies used to fall into two basic camps: developed economies whose capital accounts were fully open; and developing economies whose capital accounts were heavily regulated or closed.

Developed economies generally feature deregulated capital accounts and have been basically open to cross border capital flows for a number of years. This has forced their financial markets to develop and deepen. It has also required the regulatory authorities to develop standards that mitigate against systemic risks arising from shifts in cross border capital flows.

What are some of the "numerical' consequences?

- At present, the size of the financial market in the USA – adding together the size of the government and corporate bond markets, plus the capitalisation of the equity market, equates to roughly 300% of GDP. For the EU, the percentage is somewhat lower at about 250% of EU GDP.
- The United States holds roughly 40% of the global financial stock, making it by far the largest and most liquid capital market in the world.

In contrast, the financial markets in Asia are much smaller.

- The size of the financial markets in emerging Asia is about 175% of regional GDP, so a little over half of the equivalent measure of the United States.
  - The only countries in which the size of the financial markets exceeds 200% of GDP are Hong Kong, Malaysia and Singapore.
- In addition to being small relative to the size of their economies, Asian financial markets are small relative to the role these countries play in the global economy.
  - The bond and equity markets in East Asia excluding Japan comprises only 5% of the world total of US$71 trillion (as estimated by McKinsey's).
  - In contrast, on a purchasing power parity basis, East Asia excluding Japan is now 22% of global GDP.

Similarly, East Asia excluding Japan is now responsible for 21% of global merchandise exports.

A Change in Direction

Historically, this arrangement in which developed economies both generated and held most of the financial stock may have seemed reasonable. Developed economies could offer a stable funding base for investment in developing economies, as evidenced by the existence of current account deficits in developing economies throughout the second half of the 20th century. However, more recently, developed economies have becomes destinations for portfolio investment from developing economies. Ben Bernanke's take on the global imbalances debate (with which I agree) is that the US current account deficit is being driven by a huge surplus in the capital account – which is in turn a function of the United States offering the largest, most liquid and best regulated securities market in the world. Under this view, the "imbalance" that everyone talks about in the US external accounts may, in fact, represents a huge global demand for US services in wealth management.

The Asian financial crisis was caused by a sudden reversal of capital flows into emerging Asia. Now emerging Asia is in the position of being a net creditor to the developed economies of APEC. As such, today's "global imbalances" are the reverse of a similar phenomenon that occurred in Asia in the 1990s, the unwinding of which resulted in the Asian crisis of 1997-1998.

In the two years prior to the Asian crisis, 1995 and 1996, net private capital inflows into the Asia region totalled more than US$150 bn, or about 9% of regional GDP. The inflows were concentrated in short-term commercial bank lending, which reached a US$80 bn (net) in 1996.

- Inflows were concentrated in the countries that experienced the crisis. Net inflows in 1996 were more than 10% of GDP in Thailand, Malaysia, Indonesia and the Philippines (7.8% of GDP in Korea). In contrast, net private capital inflows into China were US$56bn or only 6% of GDP in 1996 (and in China's case these were dominated by FDI).
- The sudden reversal of capital flows – particularly commercial bank loans – in 1997 and 1998 caused a severe shock to the real economy, transmitted through a poorly regulated banking sector that had significant FX mismatches on its balance sheet. The crisis was further exacerbated by what is now, with the benefit of hindsight, seen as an inappropriately sharp tightening of monetary policy driven by the view that it would arrest the precipitated slide in currencies. In the year following the initial crisis, each of the "crisis" economies experienced a recession, with real GDP contracting by more than 10% in Thailand and Indonesia, and by more than 5% in the other crisis economies.
- Although the magnitude of global capital flows is now back to the pre-1996 level, there is a vast difference in the composition and direction of these flows. Asia is an increasingly important contributor to global capital flows, as the East Asia's current account surplus is now US$450 bn, or 37% of regional GDP. Total foreign exchange reserves have risen from US$2.3 trillion in 2004 to US$2.8 trillion this year (all figures including Japan). In developing Asia, the current account has shifted from a deficit of US$27 bn (2.5% of GDP) in 1996 to a surplus of US$266 bn (24% of regional GDP) in 2006.

Specific Concerns For Australia and New Zealand

Any abrupt curtailment of funds currently flowing from Asia to the developed economies now running high current account deficits – the US, Australia, New Zealand -has the potential to destabilise the developed economy members of APEC.

A specific example of the phenomenon is the Japanese Uridashi market in Australia, where on average A$1.3bn of Uridashi bond issues have matured each month this year. The rollover of Uridashi issuance probably has a much greater short-term effect on the Australian dollar than does the trade balance. In fact ANZ's Australian Dollar fair value model indicates that interest rates are an increasingly important determinant of how the Australian dollar trades against the US dollar – and are in fact more important now than commodity prices, which used to be the main driver of Australian dollar movements.

The issue is of even greater importance to New Zealand. In Australia, we estimate that the stock of Australian-issued bonds held by offshore investors is about 6% of Australian GDP. In New Zealand, the stock of bonds held offshore is nearly 34% of GDP, with this figure almost double the level of a year ago. Moreover, a large proportion of these bonds are NZ Uridashi issuance, which tend to be short term bonds held by Japanese investors keen to take advantage of New Zealand's relative high interest rates. The Uridashi phenomena is so important in New Zealand, particularly with relation to the currency that, it is believed, its Reserve Bank took up the matter at official levels in Japan.

How Long Can The Present Pattern of Financial Flows Continue

Present trends suggest that there is still great potential for even larger flows of capital to leave emerging Asia and enter the financial markets of developed APEC economies. To understand the magnitude of potential future financial flows from Asia, consider what is happening with financial market liquidity as represented by base money growth. The monetary base in East Asia excluding Japan is already more than 50% the size of the G7's monetary base. Moreover, base money growth in East Asia is high at around 15% annual growth. At this rate, emerging Asia's monetary base could be the same size as that of the G7 in just a few years' time. Of course, much of this growth is due to China, where the monetary base is about US$4 trillion and is growing at an annual pace of around 17%. One only has to look at the liquidity coming out of Hong Kong or Singapore to begin to understand how this is starting to affect the region. Banks in Hong Kong have cut their Prime rates to the lowest spread vs the HKMA rate in history (as far as I can see) because of the high liquidity and low inflation environment.

At the moment, the regulation of cross-border capital flows in developing APEC economies is both encouraging global imbalances (eg an outflow of capital from Asia) and costing the Asian region in terms of lost investment opportunities.

- Although real GDP growth in Asia over the past five years has been strong, investment is still relatively weak. The World Bank points out that East Asia's investment rate of 25% of GDP for 2000-2004 is well below that of the pre-crisis level of 34% of GDP (excluding China).

- The financial systems of Asia are still under-developed with the stock of financial assets in Asia is still heavily dominated by the banking sector.
  - According to the World Bank, in the United States, banking sector assets total about 75% of GDP
  - In most of Asia, banking assets are well over 100% of GDP and are largest in China (163% of GDP); Malaysia (169%); Thailand (113%); and Singapore (221%).

I noted earlier the 1997/98 consequence of excessive reliance on banking by Asian Financial Systems.

- Another feature of the imbalance is that regional financial institutions are focused on corporate borrowing needs in the current environment. Increasingly there will be a need to satisfy retail demand for financial products – including consumer financing and asset management. These products must become available if Asia is to be less-export reliant in the future. Financial flows in East Asia must fit a larger domestic retail "home".

The World Bank Report released at the IMF/World Bank Annual meetings in September points to the following factors that are impeding cross-border capital flows within Asia

- Differences in credit rating standards
- Differences in legal and regulatory systems
- Differences in accounting and auditing standards and practices

There is a great deal for APEC policy makers to achieve in each of these areas.

Finally, one interesting consequence if Asia's financial markets develop and grow, is that the developed economies like Australia will have to compete more for funds. The financial world will no longer be "bi-polar" as it is right now, with the only real choices for large portfolio investors seeking investment grade assets being either in the "dollar bloc" countries of the US, Canada, Australia and NZ or in the euro bloc. Developed countries may find that they have to compete harder for foreign funds. Australia is a good example – the ASX will naturally lose allocation by global investors who dedicate a proportion of their portfolio to the Asia Pacific region, as global portfolio managers will have more investment opportunities elsewhere in the region. Perhaps, over time, there may be as much tension about the import of capital as there is now about the import and export of goods.

Conclusion

My comments on the need for the developing countries of Asia to open-up their financial systems may sound western thought dominated and even self serving. In fact, it is with a considerable sense of "déjà vu" that I discuss the case for financial market deregulation. It was not too long ago that the AUD was a controlled currency backed with an all embracing exchange control regime. The AUD float, in 1983, was implemented over the strident opposition of many including, I think, the Secretary of the Treasury. Foreign investment in financial services – notably banking – was restricted until 1985. We still have peculiar vestiges of capital control, FIRB, that amongst other things still regulates offshore investment in Australian housing – a hangover from the supposed effect of Japanese investment in Australian (Sydney) housing on housing prices.

Every country that contemplates freeing up the financial systems, particularly, to foreign involvement undergoes a policy crisis of self confidence and usually encounters a not inconsiderable hostile political constituency. However, the need for general deregulation, not just of trade but also of financial flows, should be a more equal issue. Perhaps the practical issue is the speed and pattern of deregulation that developing countries have to contemplate. In considering the speed, developing countries will no doubt have to re-learn some old lessons. It is hard to be "open" in some areas and "closed' in others. Inconsistencies are too powerful in the end and demand resolution in the best interests of each country and the region's future economic and social outlook. Of all these broad areas requiring deregulation, financial deregulation in the APEC countries would seem to deserve a higher priority.

Dr Bob Edgar