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# Development of Financial Services in the Asia Pacific: Issues and Opportunities

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*This Economic Letter is adapted from a speech given by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, to the 31st Conference of the Governors of Southeast Asian Central Banks in Singapore on May 8, 1996.*

In these remarks, I'll begin with a brief review of where financial markets are now along the path of development, and how they got there. Then I'd like to look toward the future—specifically, I'd like to discuss some ideas on what the next steps toward liberalizing financial markets should be in this region, and why it's so important to take those steps. Finally, I'll touch on a vital issue that central bankers must grapple with as their countries liberalize their financial markets. That issue is how to allow greater competition in financial markets while still safeguarding their stability.

### The age of technology

Let me start with the description of where we are now. Quite simply—we're in the Age of Technology. And its effect on financial markets has been nothing short of remarkable. Technology has virtually revolutionized the way we process financial information about asset returns and risk. The revolution has brought improvements not only in hardware and software for computer and telecommunications technology, but also in "brainware"—that is, advances like the theory of options. With these innovations, there are now cheaper, easier, and more effective ways to collect financial information, evaluate it, and manage it.

In concert with this technological revolution, attitudes toward governmental restraints on the financial sector have undergone a revolution as well—a revolution that has led to wide-ranging deregulation. In

part this deregulation was driven by technological innovations. They unleashed market forces that made it increasingly difficult to maintain a tightly regulated financial system, as funds found their way more easily to unregulated parts of the system.

Deregulation also was driven by a new view about the appropriate *role* of government in financial markets. Finance, of course, is *not* an end in itself. Rather, it's an institutional means of facilitating the production of goods and services. And policymakers in most countries—industrial as well as emerging—have come to recognize that limiting the efficient flow of funds from savers to investors only hinders economic growth. In other words, they're adopting the position that government should play less of a role in directing resource allocation. Instead, it should let market forces work to reduce domestic distortions and inefficiencies.

These developments have led to huge changes in the financial market landscape. I'll focus on three of the major developments. First, they've expanded the array of financial instruments and services available in the marketplace. A good example is the proliferation of derivative financial instruments—such as futures, options, swaps, and synthetic bonds and shares.

Second, these developments have facilitated the cross-border flow of funds and financial globalization. Every day, over a trillion dollars' worth of transactions takes place on foreign exchange markets. That's more than double the size of the market just six years ago, and more than one hundred times the size in 1973. Moreover, we've all heard about the pools of money that race around the world's stock, bond, and currency markets in search of the highest returns each day.

Third, these developments also have vastly changed the face of competition in financial markets. This is evident in several moves to deregulate in Asia. Let me just recount some of the most recent examples.

(1) The Philippines has purposely opened up its domestic banking sector to foreign bank competition by permitting ten additional foreign banks to open full service branches. (2) For several years, Indonesia has taken steps to liberalize its domestic financial sector to promote more competition for its state banks. (3) Thailand is increasing banking competition by issuing new commercial banking licenses to foreign banks for the first time since 1966. (4) Malaysia has adopted several financial development measures. These include establishing new financial futures exchanges and wholly automating the stock exchange. Finally, (5) Singapore is allowing more competition by mutual funds for Central Provident Fund investments.

As we look to the future, the issue of further liberalization looms large on the horizon. Further liberalization is an essential ingredient in fostering the region's continuing economic growth. At the same time, it adds some problematic dimensions to policymaking. Specifically, it raises concerns about risk and stability in the financial system. Let me address these issues one at a time.

### **Why further liberalization?**

First, we've seen that the rapid development of the region's economies has led to a corresponding increase in the demand for capital. And the demand will only build if East Asia keeps up its extraordinarily high rate of growth. That raises the critical question of where the financing will come from. The answer for many countries in the region is that much of it will come from domestic saving. Compared to the rest of the world, domestic saving rates in East Asia are quite high. For example, in Singapore the saving rate is over 40 percent of GDP. And in Malaysia, Thailand, and Indonesia, it's over 30 percent.

In addition, of course, countries with current account deficits will need to rely on financing from abroad. Now, some gloomy forecasters claim that this demand for foreign capital may create a shortage. Specifically, they say that the pressing capital needs of developing Asian economies, together with those of Latin America and Central Europe, will lead to a significant increase in world interest rates.

But I don't think this is going to become a problem—in the near term, at least. The main reason is that the capital demands of those regions aren't as big as you might think in the overall scheme of things. Just to illustrate, I've seen estimates that the private net capital inflows to Asia—excluding Japan—could amount to about thirty billion dollars this year. That number is *dwarfed* by the size of America's recent current account deficits—one hundred and fifty billion dollars in 1995 alone! The point is that, in the near term, world interest rates are largely determined by what's happening in the major industrial countries, like the U.S., Japan, and Western European countries. So, on that score, I don't see that Asia's growing capital demands will lead to an imminent global capital shortage.

In fact, it's likely that some foreign capital will come from countries that are right in the neighborhood. Recently, Taiwan, South Korea, and Singapore have been net *exporters* of capital. And much of that capital is being invested elsewhere in Asia. Of course, when we talk about international capital flows, we also have to remember that they can be volatile—Mexico's recent experience gave us a vivid reminder of that fact!

The next critical question is whether the financial systems here in Asia are liberalized enough so that the capital actually *gets* to the most productive uses. In the past, financial inefficiencies and weaknesses may not have mattered so much because manufacturing sector strengths were so outstanding. But today's world is different. An inefficient financial sector means that many good firms—especially smaller, more entrepreneurial ones—may go begging for credit, while less productive ones get all they ask for.

One way to make capital and financial markets more efficient is to develop both their breadth and their depth—that is, to encourage the development of alternatives for channeling savings to appropriate investments, as well as financial instruments to help manage risk. Clearly, encouraging alternative channels for the flow of funds creates competition for existing financial institutions. And that can make life uncomfortable for them. But I think the U.S. experience with deregulation in the last fifteen years provides an interesting and enlightening example of how institutions can adapt to a new environment.

Our commercial banking sector certainly has faced plenty of new competition as a result of the revolutions in technology and regulation. Today U.S. banks have to compete with foreign banks, with nonbanks, such as pension funds and mutual funds, as well as with open capital markets that issue equities, corporate bonds, and commercial paper. While the stiffer competition has made some deep cuts into banks' traditional lines of business, it has by no means dealt a mortal blow to the industry. On the contrary. It's precisely the stiff competition that has given U.S. banks the sharp incentive to find new ways to do business. They're becoming skilled at using a broad array of new financial instruments to help manage risk. And they've expanded their business lines in a number of directions. For example, they've built up their activities in fee-based, off-balance sheet products and services, such as letters of credit, loan commitments, derivatives, and so on. They've also moved into investment-related activities, such as underwriting, advising, and brokering mutual funds. The result is that the banks that have survived had one of their most profitable years ever in 1995.

Regarding the situation in Asia, as I pointed out at the beginning, financial market liberalization is well underway in most of the region's countries. And I certainly expect that there's more liberalization to come, though the pace, of course, will differ from country to country. Let me just give you an example or two of further steps that could be taken.

One area where continued liberalization is desirable is in developing and expanding securities markets. These markets can be especially beneficial in channeling funds when banks and certain sectors operate under fairly restrictive government guidelines. In addition, they help make Asia a more attractive place for investments. Bond and equity issues—rather than bank credit—are now the preferred vehicles for international financing of investment in emerging economies.

Another area for further progress would be to open the door to the full array of financial instruments,

including futures contracts, options contracts, and other derivatives. These instruments offer the necessary flexibility to hedge and manage various kinds of price risks—such as the risk associated with interest rate and exchange rate volatility.

## Problems for policymakers

Now, while I've been encouraging further liberalization, I also know that, as a central banker, liberalization can present problems. The one I'll focus on today is the concern about financial sector stability. With more competition comes more risk that some institutions will fail. But let me stress that our goal as policymakers isn't to *eliminate* risk. Likewise, our goal isn't to protect against individual failures. Failures happen. And failures are a necessary dynamic, because they ensure that inefficiency and mistakes are weeded out. In a world where failure is prevented, moral hazard problems will distort decisionmaking and probably lead institutions to err in assessing risk.

Our goal as financial regulators—whether in Asia or the U.S.—is not to eliminate risk or failure, but to ensure the overall stability of the financial markets. To do this, we must balance two kinds of responsibility: One is to monitor the operations of financial institutions and respond appropriately in times of crisis. The other is *not to impede* the socially efficient operation of competitive forces.

Finding this balance isn't easy, and there are plenty of examples of severe regulatory problems in the U.S. and other advanced economies. To cite just a few, there's the American savings and loan crisis of the late 1980s, and last year's billion dollar Barings Securities fiasco. And right in my own state of California, there was the case of Orange County's disastrous investment in derivatives—another example of problems with investment *policies* and not with derivatives themselves.

But, as costly as these problems were, we still need to be very careful not to overreact to them. The losses from episodes like these are nothing compared to the losses from overly restricted financial markets. Because without liberalization, these markets can't achieve the efficient allocation of resources and therefore contribute to the maximum long-run potential of the country's economy.

## Conclusion

In bringing my remarks to a close, I'd like to emphasize this last point: Contributing to the maximum long-run potential of the country's economy is our ultimate goal and the very reason for our existence as central banks. I think that sometimes it's easy to lose sight of that—especially in an environment as full of change and innovation as ours is today.

But so long as we *do* keep our eyes on that goal, we also see more clearly the things we need to do to reach it. For countries in Asia, it will become increasingly vital to foster efficient capital markets in order to compete for the capital needed to finance the next stage of growth. I'm sure these countries will find that their success in establishing efficient capital markets will be worth the effort—for it will pave the way to achieving their goals of economic prosperity.

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