Toward a more balanced financial system in Asia

- The financial system transition in Korea -

2009. 7. 10

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AGENDA

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I. INTRODUCTION

- Financial development matters for long-run economic growth
  - Causal link from financial Intermediation to growth
    - more saving (capital accumulation)
    - better resource allocation (productivity)
    - less intermediation cost (transaction / information cost)
- Does financial structure matter for economic growth?
  - Evidence supports financial services / law & finance views
- Actual financial structure is determined endogenously
  - Reflecting political economy factors and the nature of information asymmetry
- Relative role of banks and capital markets evolves with economic development
  - Banks seem to be more important in early stages
  - Capital markets develop as a complement
- Is the post-crisis financial structure in Asia evolving toward a more market-based system?

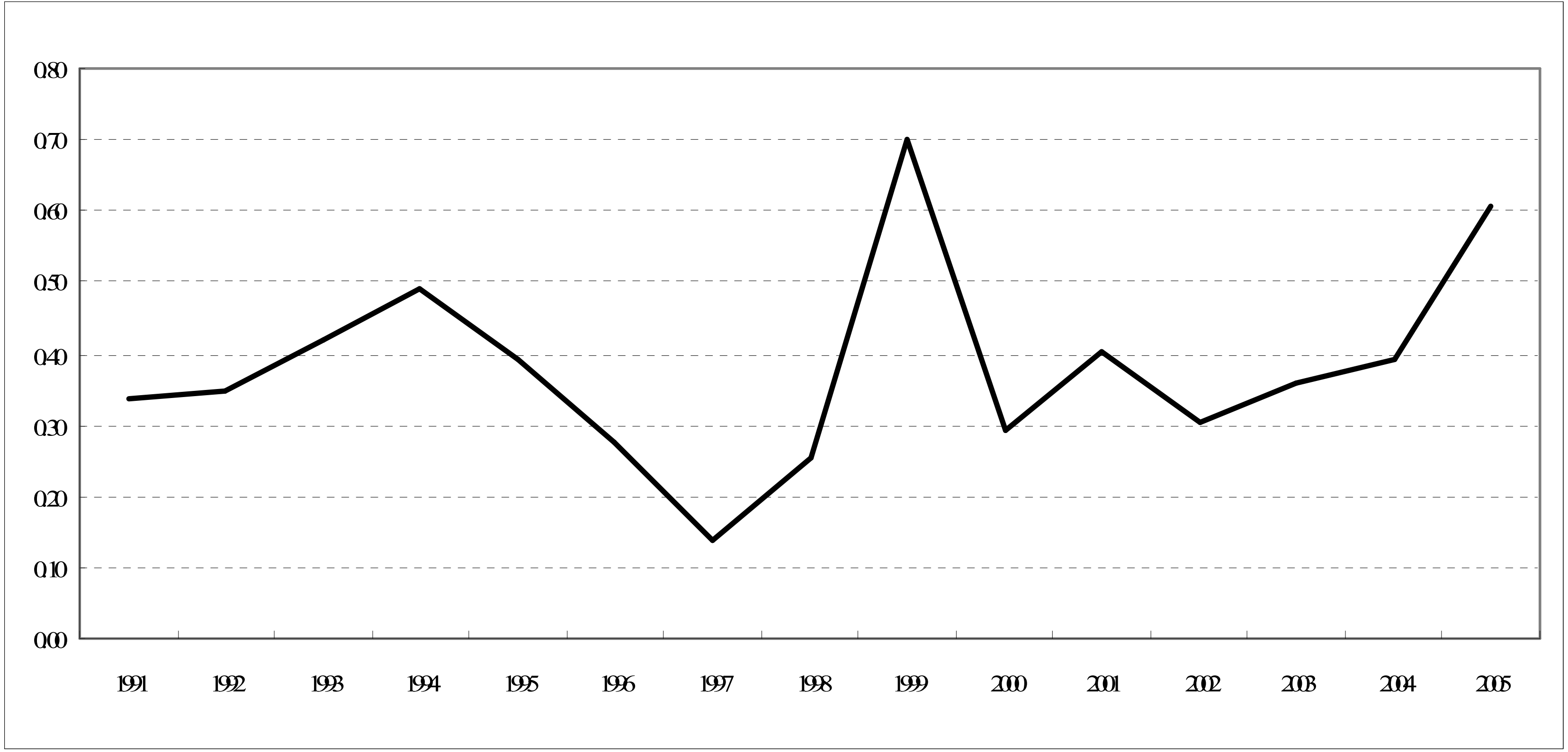
- Rationale for the evolution toward a more market-based system in Asia

e.g.) Rajan and Zingales (1998)

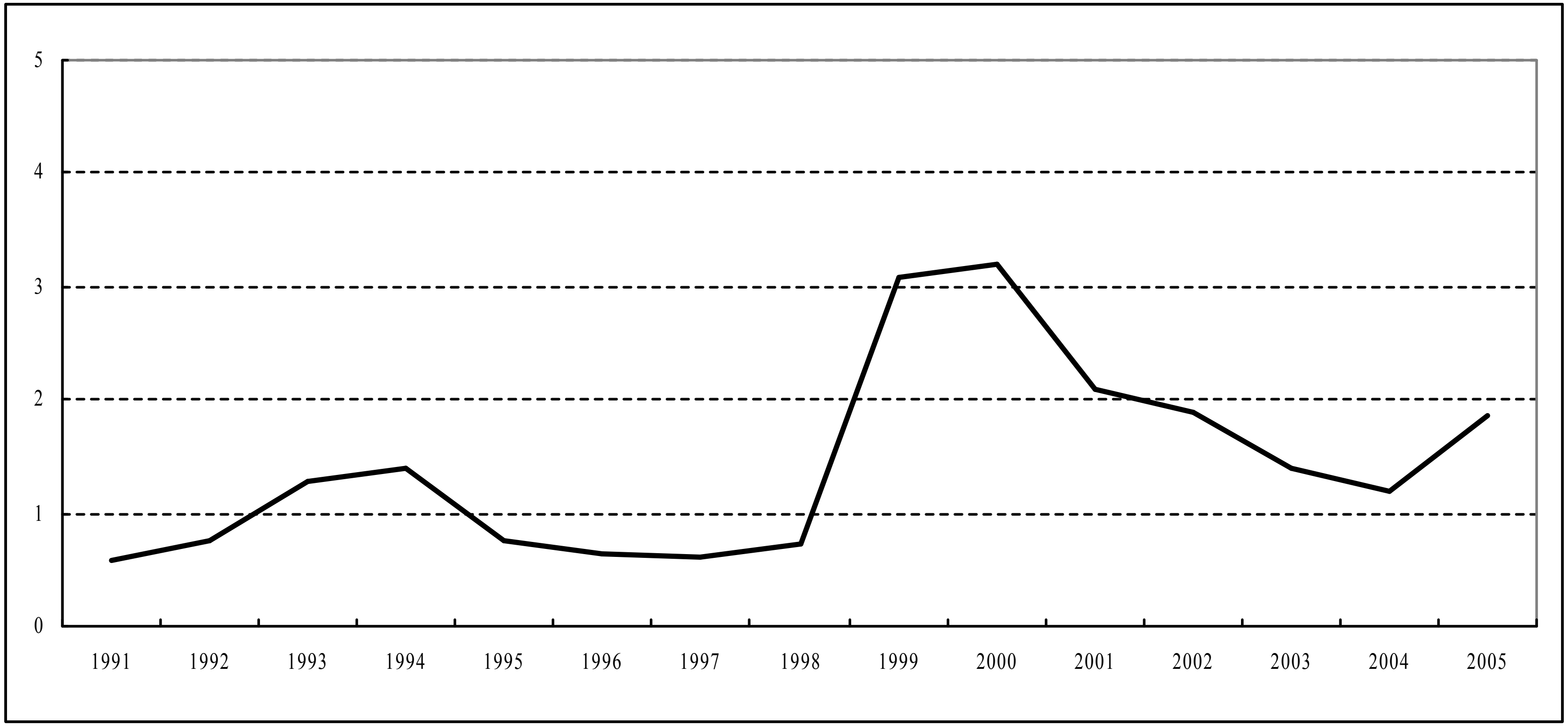
	Low Capital / Opportunity	High Capital / Opportunity
High Contractability	**Both**	**Market-based (Arm's length)**
Low Contractability	**Bank-based (Relationship-based)**	**Neither**

Demirguc-Kunt and Levine (2001) : Financial Structure Index

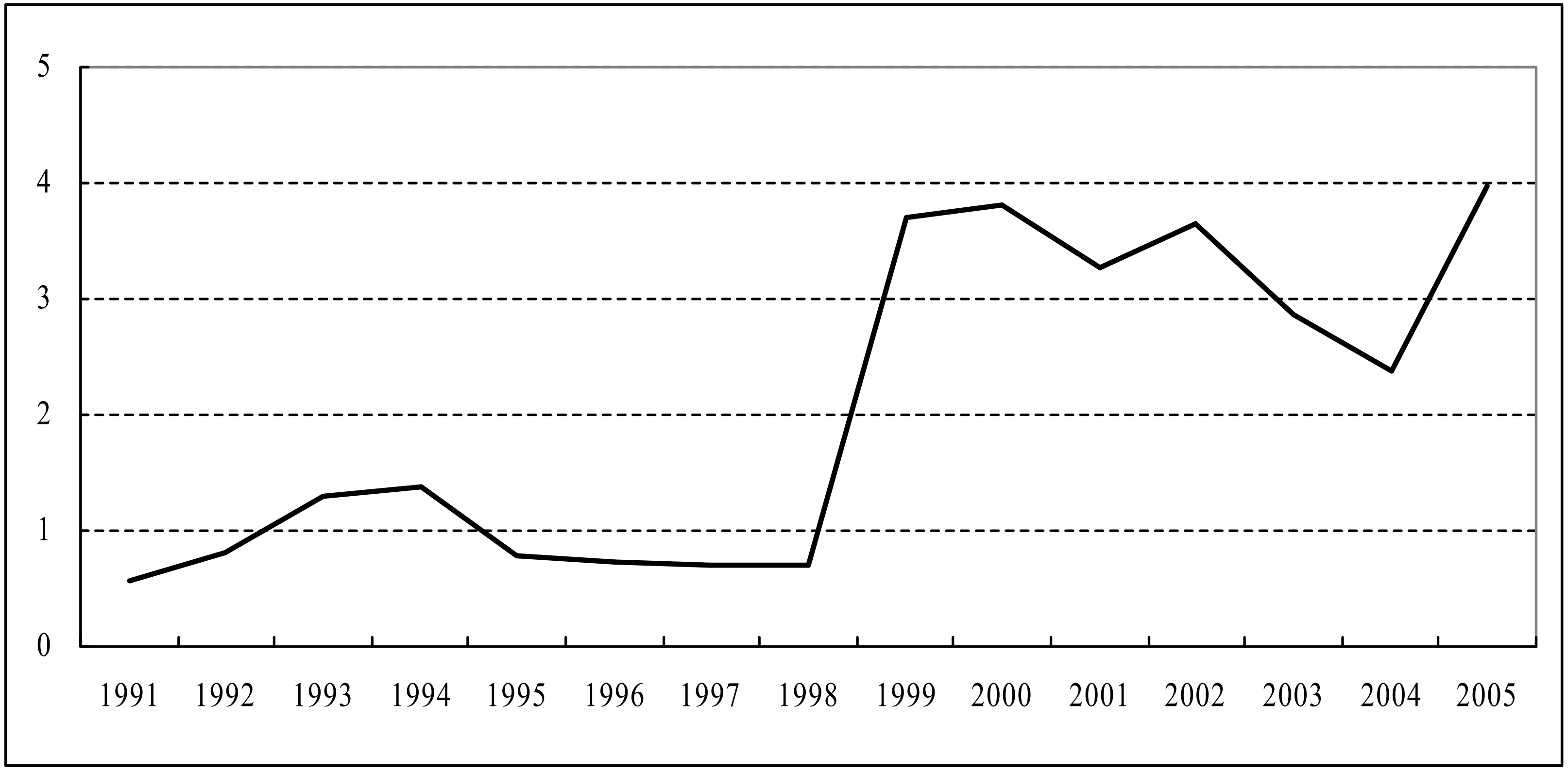
Size Index (stock market capitalization / deposit money bank asset)



Activity Index (stock trading value / deposit money bank private credit)



Efficiency Index (bank net interest margin · stock trading value / GDP)



- Korean system appears to be slowly evolving toward a more market-based financial system
  - However, it remains to be seen whether the transition is to be successfully consolidated

Factors behind the limited success in transition

- Delayed resolution of corporate insolvency and adverse selection problems in capital markets
- Less demand for external funds from qualified firms that have access to direct financing
- Flight to quality and low risk appetite of financial savers
- The ‘bank-first, NBFIs-later’ restructuring policy of the government
- Weak legal / information capital market infrastructure
- Transition from manufacturing to service industries raises moral hazard uncertainty and demand for relationship banking

III. POLICY IMPLICATIONS

- Considering East Asia’s increasing dependence on intensive growth factors, deeper and more sophisticated capital markets are critically important for sustained growth

- The transition toward a more market-based financial system has been limited despite recent expansion of capital markets due to bank-centered financial policies and poor capital market infrastructure

- To institute a more balanced financial system, it is necessary to shift the foci of financial policies to fostering synergy and economies of scope-based growth of financial institutions and capital markets
  - For instance, bank’s functions of savings mobilization and information production can be flexibly combined with capital market functions such as risk absorption and diversification

- However, as evidenced by the US subprime crisis, building an efficient and fully operational capital market is not an easy task

III. POLICY IMPLICATIONS

- Indeed, the subprime crisis is the failure of capital market-based financial intermediation, which resulted from distorted risk pricing
  - Inter-temporal risk diversification vs. intra-temporal risk trading
  - Do markets know best? Not necessarily due to incentive gap + information gap (opaque and complex nature of off-balance sheet financial transactions)

- Hence, it's crucial to make risk pricing mechanism fully operational
  - Strengthen accounting standards, disclosure, CRA reform
  - Mitigate agency problems such as moral hazard and conflict of interest
  - Improve incentive schemes and corporate governance

- Need better management of systemic risk that arises from the liquidity channel
  - Drivers of systemic crisis have shifted from credit risk to liquidity risk due to marking to market and active B/S adjustment of highly leveraged financial institutions

III. POLICY IMPLICATIONS

- Strengthen macro-prudential systemic approaches to financial supervision
  - Limit procyclical behavior of leveraged institutions
  - Strengthen maturity mismatch regulations
  - Increased role of central bank as a ‘market maker of last resort’

- How to ensure more stable financial environment for sustainable growth of Asian countries
  - Early warning system calibrated to Asian emerging market economies
  - International mechanism to cope with emerging market FX liquidity risks
  - Foster development of regional capital markets such as Asian bond markets

END OF DISCUSSION