

FINANCIAL MARKET DEVELOPMENT AND FINANCIAL STABILITY

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Abstract: *This paper analyses the financial stability implication of financial market development in emerging markets. On the one hand, financial market development has enhanced resilience and improved domestic financial stability by providing new tools to raise funds and manage risks. On the other hand, high foreign participation in local currency government bond markets, growing private sector foreign currency debt levels and the growing role of non-bank financial institutions have increased external vulnerabilities.*

Keywords: *financial market development, financial stability risks, capital markets, fintech.*

Financial market development (FMD) has improved overall financial resilience in emerging market economies (EMEs) over the last two decades, according to many of the central bank contributions for this meeting. But FMD has also meant a greater role for market dynamics, bringing “new” risks to the fore, in particular as EMEs become increasingly integrated into the global financial system. This paper analyses the financial stability implications of FMD over the last 20 years. It begins with a brief overview of how FMD has interacted with domestic financial stability. Concentrating on the areas where FMD has had the greatest impact in recent decades, it then turns to the main focus of this paper: the financial stability implications of greater global integration of EMEs’ government and corporate bond markets as well as their FX markets.

The subsequent section evaluates the measures EME central banks have introduced to monitor and mitigate these risks. The note concludes with a forward-looking section that explores the financial stability issues that are raised by fintech companies which provide credit. In the aftermath of the crises in the 1990s, many EMEs sought to encourage FMD. As a result, capital markets have deepened, becoming more liquid and resilient. On some measures, equity and government bond markets in some EMEs are now comparable in size with those in small open AEs. That said, financial intermediation remains heavily bank-based, in particular for household lending. 1 As markets have developed, the private non-financial sector has become more indebted. Corporate borrowing has been rising rapidly. And total credit to EME households has almost doubled over the past decade. In several Asian EMEs, household credit relative to GDP has now reached levels similar to, or even higher than, those in the United States and some other advanced economies (AEs) (Graph 1, left-hand panel). Although banks maintain their dominance, lending by non-bank

financial intermediaries (NBFIs) has increased quickly, their financial assets almost tripling from 2007 to reach 86% of GDP in 2018.² Expansion was especially rapid in China, where the assets of other financial intermediaries (OFIs), a sector dominated by investment funds, soared from \$270 billion in 2007 to \$11 trillion in 2018 (Graph 1, centre panel). Assets of pension funds have also grown in many EMEs, reflecting the strengthening of existing voluntary pension systems or the launching of new mandatory schemes (Graph 1, right-hand panel). But, except in a few jurisdictions, their size remains relatively small. These changes have benefited EMEs in many ways. Most importantly, by borrowing in local currency governments have overcome the “original sin” problem, ie the inability to borrow internationally in domestic currency.

Doing so can shield EME governments from the debilitating effects of large domestic currency depreciations, which at times has led to crises historically. However, several central bank notes see the growing share of foreign participation in LCGB markets, especially by large global asset managers, as a risk.⁶ The top 25 asset managers, almost all based in the United States and in Europe, manage some \$40 trillion of assets, almost double the value of the world’s gross savings (, fourth panel). Even small changes in the asset allocation of one asset manager could lead to large capital flows for small EMEs. Destabilising price dynamics could also arise from the institutional and governance features that may impinge on asset manager behaviour. For example, tightened value-at-risk constraints during stressed periods could lead to forced asset sales or increased hedging activity, further amplifying volatility in the system. Moreover, the reliance on peer comparisons or benchmark indices to monitor fund performance could lead to herd behaviour by fund managers or too much risk taking in efforts to beat the benchmark (Morris et al (2017)). Finally, there is run risk.

In times of stress, this may force asset managers into fire sales, which can lead to destabilising price spirals for less liquid assets such as corporate bonds. In addition, increased foreign participation in LCGB markets may not completely shield EMEs from the risks of currency mismatches and sudden stops, or as coined by Carstens and Shin (2019), “original sin redux”. In effect, the currency mismatch is no longer borne by EME governments but by foreign investors, whenever they are unhedged.⁸ This can give rise to unwelcome feedback spirals. As large increases in domestic-currency bond yields often coincide with currency depreciation, this “double whammy” can trigger risk limits, leading to asset sales or more hedging. The Hong Kong Monetary Authority (HKMA) note finds empirical support for this mechanism. For a start, low foreign investor participation has no impact on the dynamics of nominal yield spreads in Asian EMEs. Yet, once a critical threshold – estimated to be 13% – is breached, increases in participation widen yields when the local currency is expected to depreciate in line with the “original sin redux” hypothesis (red line, left-hand panel).

By decomposing the yield spread into its credit and currency risk components, the paper finds that the overall effect is only driven by currency risk (Graph 3, centre and right-hand panel). As yet, fintech and big tech credit constitutes only a small part

of total supply, but financial stability risks could emerge, in particular given the rapid pace of developments in other areas such as payments.¹⁷ For example, if these firms become significant suppliers asset backed securities or other structured products to fund their lending, that could transmit the risks to the broader financial system, in particular in times of stress.¹⁸ And even if fintech-based lending platforms evolve to start using their own balance sheet to intermediate funds, maturity mismatches could arise and opening up the possibility of runs without the protection of the standard safety net for banks. Finally, as highlighted by the MAS note, P2P lending is susceptible to swings in investor sentiment and risk appetite. This could result in more procyclical credit provision. Two important shifts characterized the past decade. First is the explosion of private capital flows—especially to developing countries, where private capital flows have dwarfed official flows—including a shift in composition of these flows from syndicated loans to short-term portfolio flows and bond finance. Second is the changing profile and importance of developing countries in the world economy. These shifts contributed greatly to the expansion in global GDP over the decade.

But they also revealed vulnerabilities in the international financial system that are still being dealt with. The most visible manifestation of these vulnerabilities is probably the series of emerging market crises that occurred in the 1990s—including those in Mexico (1994); Indonesia, the Republic of Korea, Malaysia and Thailand during the East Asian crisis (1996–98); Russia (1998); and Argentina (2000 and 2003). The estimated GDP losses over the 1990s due to the financial crises amounted to over \$400 billion. Other manifestations of the vulnerabilities include the increased use of the international financial system for funding terrorism, organized crime and other criminal and antisocial activities as well as the questioning of the IMF’s legitimacy and adequacy to prevent and manage crises. The Secretariat of the International Task Force on Global Public Goods has commissioned papers to explore in depth these issues. The papers are presented in the next section. These four broad causes of financial instability reinforce each other and shed useful light on the problem. Eichengreen thus argues that they all suggest an agenda for action both to solve and prevent financial crises, specifically strengthening institutional procedures for formulating fiscal and monetary policies, developing better methodologies for determining the optimal level of reserves and increasing multilateral surveillance. One key proposal is to encourage the World Bank to fund itself on a larger scale in emerging market currencies. Eichengreen believes that this would be important for the creation of a liquid international market in debt securities denominated in those currencies. Morris Goldstein’s “The International Financial Architecture and the Emerging Economies” is more focused than the paper by Eichengreen. Goldstein, while also assessing the challenge posed by the past decade’s financial crises, gives priority to three issues, all focused on emerging economies: currency manipulation, currency mismatches and debt sustainability. On currency manipulation, he argues that as emerging economies’ share in the global economy increases, how they manage their

exchange rates will matter not only to them, but also to the rest of the world. In the next 10 years international norms for exchange rate policy will be no less necessary than those for trade policy. If the currency rules are not interpreted sensibly and enforced, there will be increased conflict and a heightened risk of protectionist response. Goldstein argues that currency mismatches have been the most prevalent and the most destructive factor in emerging economy financial crises. He proposes a package of reforms, including requiring currency mismatches to be reduced as a condition for IMF loans when the actual or prospective mismatch is deemed too large. On debt sustainability, he supports wider use of collective action clauses to make restructuring more orderly and more timely. Jim Turnbull's "Financial Stability: A Global Public Good" brings together the contributions by Eichengreen and Goldstein.

Building on Goldstein's diagnosis, Turnbull argues that the most significant debt management blunder is the failure to come to terms with the currency mismatch problem caused by an overreliance on foreign currency debt contracts. To address this problem, Turnbull develops Eichengreen's idea for international financial institutions to borrow and lend in developing country currencies. This leaves open the question of why countries are prone to unsustainable and contradictory macroeconomic policies in the first place. Efforts to answer this question have focused increasingly on weaknesses in policy-making processes (see, for example, Poterba and von Hagen 1999). The central bank may lack a clear mandate and adequate independence. Fiscal institutions may allow spending ministries and provinces to spend now and appeal later to the central government for the necessary finance, creating common-pool problems for the fisc. The instability of the political system may encourage leaders to spend and borrow freely without worrying about the intertemporal consistency of their fiscal plans, in order to increase their immediate prospects of staying in power. These theories thus point to the need for stronger policymaking processes as a fundamental prerequisite for financial stability. While it is tempting to blame weak domestic policies and institutions for the difficulty that emerging markets face when attempting to borrow abroad in their own currencies, the fact is that even countries with strong policies and institutions (Chile is a good example) find it difficult to borrow abroad in their own currencies. Empirically, the one characteristic that is robustly associated with the ability to borrow abroad in one's own currency is country size (large countries can, small countries can't). This encourages the view that the difficulty that emerging markets face when attempting to borrow abroad in their own currencies reflects, at least in part, factors beyond their own control—specifically, a combination of first-mover advantages and network externalities.

These observations are related to the literature on the determinants of key currency status (Kiyotaki, Matsuyama and Matsui 1992), which explains the dominance of a small number of currencies in international markets as a function of network externalities and transaction costs. This literature shows how transaction costs in a world of heterogeneous economies can explain both the bias towards a small

handful of currencies and why countries that are early to industrialize or attain financial-centre status are most favourably positioned to attain key-currency status (and to retain it over time). It suggests that the global portfolio is concentrated in a very few currencies for reasons largely beyond the control of the excluded countries. These four broad classes of explanation for financial instability are not incompatible rivals. They all shed useful light on the problem. And, in turn, they all suggest an agenda for action.

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