

The Global Financial Turmoil and the Evolving Financial Interdependence in Asia

May 11-12, 2009, Hong Kong

Conference Summary

An international conference on “The Global Financial Turmoil and the Evolving Financial Interdependence in Asia” was held in Hong Kong on May 11-12, 2009, sponsored jointly and co-organised by the APEC Study Centres at Lingnan University and at Columbia University and the Hong Kong Institute of Monetary Research. The conference brought together around 40 local and overseas experts from academia, business and policy, to discuss the key issues around the two axes indicated in the title of the conference: qualitative trends in the evolution of financial interdependence in Asia, and the way the ongoing financial crisis has affected those markets and trends. The conference consisted of a series of sessions centred on the individual lead contributions, where the authors summarized their findings and views and leading experts provided a formal commentary, followed by general discussion by the audience. The conference closed with a policy panel with a larger public in attendance, where a panel of leading academics, business participants and regulators offered their views on the regulatory challenges the international financial system faces at the present juncture.

The papers presented at the conference raised important issues and generated lively exchanges of ideas. Some of their arguments and findings included:

1. Resisting financial globalisation in Asia: Robert McCauley and Guonan Ma (BIS)

Major Asian economies’ resistance to financial globalisation have differed in their extent and consistency. China’s wide-ranging controls left it exposed to the financial turmoil largely through trade, while their openness to equity flows left India, Korea and Thailand providing liquidity to global investors. In particular, Korea’s banking openness, a compound of policy

choices and rapid credit growth, led it to extraordinary policies, funding the banking sector with dollars while guaranteeing the foreign liabilities of the banks.

**2. Hong Kong's financial market interactions with the US and Mainland China since 2001:
Dong He, Zhiwei Zhang, and Honglin Wang (HKMA)**

The authors study how financial markets in the US and Mainland China affected equity, money, and FX markets in Hong Kong during the current financial crisis and how these linkages changed compared with experience since 2001. A broad interpretation of their findings, after looking at high-frequency data on equity, money, and foreign exchange markets, is that Hong Kong's financial markets appear to be more aligned with the US markets in turbulent times but relatively more integrated with the Mainland's markets during tranquil periods.

**3. The link between FX swaps and currency strength during the credit crisis of 2007-2008:
Hans Genberg, Cho-hoi Hui, Alfred Wong, and Tsz-Kin Chung (HKMA)**

This paper analysed the impact of the global credit crisis on the money market and its potential implications, including for FOREX markets. Examining the situations of six currencies (euro, yen, British pound, and the Australian, Singapore and Hong Kong dollars), the authors find that that risk premia have gone in tandem with money market rate spreads (a popular measure of potential banking insolvency) and that risk premia bear a negative relationship with the strength of spot rates of the respective currencies, which is consistent with increased pressure in the money and swap markets. The implication of the analysis is that the directions of fund flows among different economies may reflect the relative safety and soundness of their banking systems during the credit crisis period.

4. Assessing the Emerging Global Financial Architecture: Measuring the Trilemma's Configurations over Time: Joshua Aizenman (UCSC), Menzie Chinn (U Wisconsin), and Hiro Ito (Portland State U)

The paper proposes "trilemma indexes" based on proposed metrics for the degrees of exchange rate flexibility, monetary independence, and capital account openness. The evolution of these indexes illustrates that since the early 1990s industrialized countries accelerated financial openness but reduced monetary independence while sharply increasing exchange

rate stability, all reflecting the introduction of the euro. In contrast, emerging market countries have converged towards intermediate levels of all three indexes, with managed flexibility that retains some degree of monetary autonomy and accelerating financial openness. This recent trend appears to be sustained by using sizable international reserves as a buffer. The paper also finds that the weighted sum of the three indexes adds up to a constant, validating the notion that a rise in one trilemma variable should be traded-off with a drop of the weighted sum of the other two. The paper also addresses the trilemma policy choices to macroeconomic outcomes such as level and volatility of output growth and inflation, finding *inter alia* that greater monetary independence can dampen output volatility while greater exchange rate stability implies greater output volatility, which can be mitigated by reserve accumulation, and that greater monetary autonomy is associated with a higher level of inflation while greater exchange rate stability and greater financial openness could lower the inflation level.

5. The Composition Matters: Capital Inflows and the Spread of Credit Crunch in 2008-2009: Hui Tong (IMF) and Shang-Jin Wei (Columbia University)

International capital flows, while potentially beneficial, are said to increase a country's vulnerability to crisis, especially if it is skewed to non-FDI types. This paper examined whether the volume and composition of capital flows affected a country's degree of credit crunch faced by its non-financial firms during the 2008-09 crisis. It finds that, on average, the decline in stock price was more severe for firms that are intrinsically more dependent on external finance for working capital and long-term investment. The volume of capital flows has no significant effect on credit crunch. However, the composition of capital flows matters: for emerging economies, the pre-crisis exposure to non-FDI capital inflows worsens credit crunch, while the exposure to FDI alleviates liquidity constraints.

6. The (Mythical?) Housing Wealth Effect: Charles Calomiris (Columbia U), Stanley D. Longhofer, and William Miles (both Wichita State U)

This paper presented a strong case against the notion, central in guiding policy by the U.S. Fed and found in several recent empirical studies, that the effect of housing wealth on consumption is large in absolute terms - and in fact larger than the wealth effect on consumption from stock holdings. Existing empirical work on the housing wealth effect sometimes finds large effects from housing wealth on consumption, but failing to control for

the fact that changes in housing wealth may be correlated with changes in expected permanent income, biasing the resulting estimates. The authors re-examine the impact of housing wealth on non-housing consumption, employing the same Case-Quigley-Shiller data on U.S. housing wealth that have been used in prior studies to estimate a large housing wealth effect. They show that controlling for the endogeneity bias resulting from the correlation between housing wealth and permanent income, housing wealth in fact has an insignificant effect on consumption. The housing wealth has a small and insignificant effect on consumption. Robustness checks show a significant housing wealth effect in only a few specifications, and these effects are much smaller than the impact of stock market wealth.

7. Disconnect and Information Content of International Capital Flows: Evidence and Theory: Eric van Wincoop (U of Virginia) and Cedric Tille (Geneva Graduate Institute HEID)

International capital flows share two key features of asset prices: they are largely disconnected from current publicly observed fundamentals, and contain information about future fundamentals after conditioning on current fundamentals. The paper brings out these features in the context of an open economy dynamic general equilibrium portfolio choice model with private information dispersion, whose calibration suggests these features to be quantitatively significant.

8. The Role of Bank Regulation, Supervision and Monitoring and Bank Efficiency: James Barth (Auburn U and Milken Inst), Chen Lin (City U of HK), Yue Ma (Lingnan U), Jesús Seade (Lingnan U), and Frank Song (HKU)

This paper works on microdata for nearly 2000 banks in 60 countries to examine how different elements in bank regulation and supervision affect bank operating efficiency. The papers findings include (i) that the first pillar of Basel II, the capital requirement, tends to reduce bank operating efficiency, which is not surprising but confirms the need to carefully assess the side effects of capital requirements designed to reduce bank risk. The paper also finds that (ii) strengthening official supervisory power, the second pillar of Basil II, is not significantly related to bank operating efficiency, but that (iii) increasing the independence of the supervisory authority tends to enhance bank efficiency. An interesting result the paper finds is (iv) a strong positive interaction between the previous two variables: the strength and the

independence of official supervisory power—enhancing either when the other of these variables is strong has a marked positive effect on bank efficiency. This result is important as it suggests that independence of supervisory agencies from both the politicians and the banking firms are conducive to bank efficiency. It also suggests that putting the official supervisory power in the hands of independent supervisors might be helpful to improve the safe and soundness of the banking system. Finally, market-based monitoring of banks in terms of more financial transparency is positively associated with bank efficiency, suggesting the positive role of the third pillar of Basel II is helpful in banking efficiency.

9. International Portfolio Holdings: Source and Host Country Influences on Home Bias: David Parsley (Vanderbilt U)

Traditional theories of international portfolio investment suggest that host country features should be relevant for investors, regardless of where investors reside. This paper asks whether source country features also matter for international portfolio investment. [*Notes pending*]

10. Panel discussion: Towards a New Framework for Financial Stability.

Moderator : **Robert Pringle**
Managing Director, Central Banking Publications

Panellists : **James Barth**
Lowder Eminent Scholar in Finance, Auburn University

Charles Calomiris
Henry Kaufman Professor of Financial Institutions, Columbia University,

Alicia Garcia-Herrero
Chief Economist for Emerging Markets, Banco Bilbao Vizcaya Argentaria (BBVA), and

Martin Wheatley
Chief Executive Officer, Securities and Futures Commission Hong Kong

The discussion focused on identifying defects in the current regulatory system suggested by the on-going financial crisis and possible remedies for financial stability.

In his introduction, **Robert Pringle**, the title of whose recently published book (co-edited with David Mayes and Michael Taylor) was borrowed as the title for this session, **Towards a New Framework for Financial Stability**,

- Asked the question: “*What are the chances now of the overall policy response, including but not limited to reforms of regulation, being smart, in the sense of being likely to produce a better system?*”
- Expressed concern that the opportunity for radical reform looked increasingly likely to be missed: that governments “will settle for anything so long as they can draw a line under the crisis and get banks lending to support economic growth”;
- Referred to the “system of perverse expectations” that has been created, where the public will in future look to governments and regulators, not to market participants, to control risks and ensure they stay within acceptable bounds.
- Stressed that “even if we could miraculously produce international agreement on all (the needed) regulatory challenges” we would still not have a “much smarter system ... unless at the same time we attend to the structure of the banking sector and the complex relationship between banks, markets and the public authorities.” And
- Concluded that “we have to attend to the structure of banking and finance, to make the system ‘supervisable’, if we are to give market discipline a chance to work again and to make bankers responsible for their actions. Yet who among the regulators or governments is talking about that? There seems nobody willing or able to articulate a vision of a reformed banking and finance system dealing with moral hazard, too-big-to-fail and similar basic incentive issues. Unless we address those issues, can the other regulatory reforms be effective?”

Opening up the discussion, **James Barth** first reviewed the rise and fall of the U.S. mortgage and credit markets and pointed out that high leverage and excess risk-taking were the main factors that caused the subprime crisis. To prevent/mitigate credit booms and busts, he recommended:

- (1) A systemic risk regulator for financial market stability, with regulation that takes into account liquidity mismatches, is countercyclical and addresses the issue of *too-big-to-fail*.

- (2) Greater transparency for derivatives markets. This can be done by requiring clearing and settling of derivatives transactions through a central clearing houses or exchanges, which provides for greater monitoring of exposures and posting of necessary collateral.
- (3) Change the fee structure of credit rating agencies. The Nationally Recognized Statistical Rating Organization (NRSRO) designation should be eliminated and the use of ratings in regulatory systems should be decreased.
- (4) Eliminate treatment of residential mortgages as non-recourse loans, and merge Freddie Mac and Fannie Mae. Mortgage originators should share the risk.
- (5) Modify the current incentive/compensation system to discourage excess risk-taking.
- (6) Reform the overall structure of the regulatory system, with greater coordination among regulators in different countries to avoid regulatory arbitrage. Centralized supervision or deposit insurer could be established in some regions.

Charles Calomiris attributed the current financial crisis to loose money, housing subsidies delivered through leverage, buy-side agency problems, and regulation failure – especially the *too-big-to-fail* issue after March 2008. On long-term regulatory reform, he emphasized both micro- and macro-prudential aspects. On micro-prudential regulation, he suggested to use loan interest rates in measuring the risk weights applied to loans for purposes of setting minimum capital requirements; establishing a minimum uninsured debt requirement for large banks; and reforming the use of credit ratings, either eliminating their use or otherwise requiring NRSROs to predict *probability of default* or *loss given default* rather than giving letter grades, and holding them accountable for accuracy. But because of the agency problem, micro-prudential regulation is not enough. On the macro-prudential side, he suggested that:

- (1) Capital requirements should be made counter cyclical, increasing regulatory requirements for capital, liquidity, or provisioning as a function of credit growth, asset price growth, and possibly other macroeconomic risk measures.
- (2) To fix the *too-big-to fail* problem, he suggested a regulatory surcharge on large, complex banks, such as increased capital or liquidity requirements and more aggressive provisioning; and defined plans/formulas for loss sharing among international subsidiaries that would be pre-approved by regulators in the countries where the subsidiaries are located.
- (3) He also suggested winding down Fannie Mae and Freddie Mac; phasing out the FHA and Federal Home Loan Banks; and the replacement of those leverage subsidies with

down payment assistance to low-income first-time homebuyers; reforming bank corporate governance; and improving the transparency of OTC market and counterparty risk management.

Alicia Garcia-Herrero focused her discussion on how to make the regulatory system less procyclical based on the Spanish experience. She first pointed out that regulatory capital requirements, loan loss provisioning and fair value accounting are procyclical. Although there are a few options to mitigate procyclicality such as moral suasion, controlling quantities, macro-prudential Taylor rule, changing capital requirements according to the amount of leverage, she thought that dynamic provisioning is the most interesting regulatory tool, since its objective is the proper accounting recognition of ex-ante credit risk. This was introduced in Spain in 2000 with the clear macro-prudential goal of limiting credit growth. Although its impact was limited, with credit still growing very fast the following years, dynamic provisioning did smooth provisioning trends and profit streams. It also proved to be very useful in limiting the impact of the current crisis on Spanish financial institutions. For it to be more effective, there is scope to improve the Spanish model. But it seems worth exploring as an experience for other regulators.

Martin Wheatley shared his perspectives as a securities market regulator in Hong Kong in the current financial crisis. The failure of Lehman Brothers led to unexpected consequences in Hong Kong: Lehman mini-bonds were a popular investment product and Lehman's failure meant that most of such securities lost much of their value. Investors claimed that sales personnel in distributing banks sold those securities without proper explanation of their risk profiles, misleading investors into believing that they were bonds that carried little credit risk. The event had become a politically sensitive issue, and will take time to be sorted out. While this is not a case of regulatory failure, a review of the current regulatory structure may be warranted; the pros and cons of various options, including the "twin-peak" model, where the functions of prudential regulation/supervision and market conduct/consumer protection are separated in two different agencies, need to be carefully considered.

Attachment 1: Conference Programme

Attachment 2: List of Participants



Lingnan 嶺南大學
University



COLUMBIA UNIVERSITY
IN THE CITY OF NEW YORK

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An International Conference Co-sponsored by:
Hong Kong Institute of Monetary Research;
Columbia University's APEC Study Centre; and
Lingnan University's APEC Study Centre

May 11-12, 2009, Hong Kong

Conference Programme

11 May 2009 (Monday)

Venue: Lingnan University

09:15 – 09:30 Registration and Coffee

09:30 – 09:40 **Welcome and opening remarks**
CHAN Yuk-Shee - President, Lingnan University

Session 1

Chairman: Jesús Seade - Vice-President, Lingnan University

09:40 – 10:15 **Resisting financial globalisation in Asia**
Robert McCauley and Guonan Ma - Bank for International Settlements

10:15 – 10:30 *Discussant: Li Cui - Head, External Department, Hong Kong Monetary Authority*

10:30 – 10:40 Floor Discussion

10:40 – 11:15 **Hong Kong's financial market interactions with the US and Mainland China since 2001**
Dong He, Zhiwei Zhang, and Honglin Wang - Research Department, Hong Kong Monetary Authority

11:15 – 11:30 *Discussant: Yue Ma - Lingnan University*

11:30 – 11:40 Floor Discussion

11:40 – 12:00	Coffee break
12:00 – 12:35	The link between FX swaps and currency strength during the credit crisis of 2007-2008 <i>Hans Genberg, Cho-hoi Hui, Alfred Wong, and Tsz-Kin Chung - Research Department Hong Kong Monetary Authority</i>
12:35 – 12:50	<i>Discussant: Anella Munro - Bank for International Settlements</i>
12:50 – 13:00	Floor Discussion
13:00 – 14:30	Lunch
Session 2	
Chairman: Shang-Jin Wei - Columbia Business School	
14:30 – 15:05	Assessing the Emerging Global Financial Architecture: Measuring the Trilemma's Configurations over Time <i>Joshua Aizenman, Menzie Chinn, and Hiro Ito - UC Santa Cruz</i>
15:05 – 15:20	<i>Discussant: Dong He - Hong Kong Monetary Authority</i>
15:20 – 15:30	Floor Discussion
15:30 – 16:05	The Composition Matters: Capital Inflows and the Spread of Credit Crunch in 2008-2009 <i>Hui Tong - IMF, and Shang-Jin Wei - Columbia Business School</i>
16:05 – 16:20	<i>Discussant: Hongyi Chen - Hong Kong Institute for Monetary Research</i>
16:20 – 16:30	Floor Discussion
16:30 – 16:50	Coffee break
16:50 – 17:30	The (Mythical?) Housing Wealth Effect <i>Charles Calomiris - Columbia Business School</i>
17:30 – 18:00	Floor Discussion
18:00	Conference adjourns
19:00	Conference dinner

12 May 2009 (Tuesday)

Venue: Hong Kong Monetary Authority

08:45 – 09:00 Registration and Coffee

Session 3

Chairman: Dong He - Hong Kong Monetary Authority

09:00 – 09:35 **Disconnect and Information Content of International Capital Flows:
Evidence and Theory**
*Eric van Wincoop - University of Virginia, and Cédric Tille - Graduate
Institute for International and Development Studies in Geneva*

09:35 – 09:50 *Discussant: David Cook - Hong Kong University of Science and Technology*

09:50 – 10:00 Floor Discussion

10:00 – 10:35 The Role of **Bank Regulation, Supervision and Monitoring and Bank Efficiency**
*James R. Barth - Auburn University, Chen Lin - City University of HK, Yue
Ma - Lingnan University, Jesús Seade - Lingnan University, and Frank M.
Song - Hong Kong University. Lingnan University International Financial
Centres Research Programme*

10:35 – 10:50 *Discussant: David Parsley - Vanderbilt University*

10:50 – 11:00 Floor Discussion

11:00 – 11:20 Coffee break

11:20 – 11:55 **International Portfolio Holdings: Source and Host Country Influences on Home
Bias**
David Parsley - Vanderbilt University

11:55 – 12:10 *Discussant: Joshua Aizenman - UC Santa Cruz*

12:10 – 12:20 Floor Discussion

12:20 – 14:00 Lunch

14:00 – 16:00 **Session 4:** Panel discussion “Towards a New Framework for Financial Stability”

Moderator: Robert Pringle - Central Banking Publications, Managing Director

Panelists:

- *James Barth - Auburn University and Milken Institute*
- *Charles Calomiris - Columbia Business School*
- *Alicia Garcia-Herrero - Chief Economist Emerging Markets, BBVA*
- *Martin Wheatley - Chief Executive, Securities and Futures Commission, Hong Kong*

16:00 **End of Conference**



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