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P R O C E E D I N G S

MR. DERVIŞ: Good afternoon everyone and thanks for coming despite the blowing wind and the much colder temperature but this is really a privilege for us to welcome Deputy Managing Director Min Zhu and his team and at the occasion at presenting a very, very interesting book on the Asian Financial System. I won't say too much but it is one of the hottest topics around and most important topics around. Of course there's China but there's the whole of Asia and I think the financial system as we've all learned is one of the absolute requirements for stability and growth to have a solid financial system and is a necessary condition though it may not be sufficient. The Deputy Managing Director Min Zhu was previously the advisor to the managing director, senior advisor and he was the Deputy Governor of the Bank of China and before that chairing a working group on financial issues so there are few in the world if any who knows more about the Chinese financial system but now but the whole world system then Min Zhu and he makes us an honor to come to Brookings for this event so thank you very much. I will cede the floor to him and after his remarks I will introduce the panel we will have some further remarks from two colleagues from the fund from our own Eswar Prasad and I will then launch discussion where we will go from a panel discussion first to then having some questions from the floor. Deputy Min Zhu please and thank you again.

MR. ZHU: Thank you Kemal for your kind words of introduction and also for your warm hospitality to hold this event. I think it's wonderful for us to come to this place to bring this book to the audience and also it's a great honor for me to be here to speak to a very distinguished audience as well. I just realized one thing when I walked in. I feel that Brookings has very good budget resources so Brookings will probably provide everybody a free copy of the book. Because I understand budget constraints but I realize there's a book shelf there so everyone hopefully after this session will go to the book shelf. I cannot afford to give everybody a book but probably we can afford to give everybody who purchases a book a certain degree of discount of the book but once again thank you very much for coming to this session in the cold weather as Kemal mentioned and thanks to Brookings holdings issues. I'm going to have a sort of background information to sort of set the path for the further discussions of what the real experts; the authors will be under to discuss the whole issues. Let me talk about a few things about this Asia financial market. The market broke very strongly and fast. If you're looking for Asia, Asian financial shares include global shares really include five percent to 18 percent to (inaudible) this is a big, big challenge, really big. And if you see all the banking assets 6.6 per cent to a two to three per cent this is a global share. You will see the Asian financial (inaudible) really gaining the market share in the past eight years in a very dramatic way. If we add everything together, if we add Japan together so whole Asia roughly today accounts of 28 per cent of global financial assets which is quite a bit and the gross is very impressive but overall this 28 per cent is still below the Asia GDP percentage in the whole world which is 33 per cent. Then we also see the big structure is very much a banking (inaudible) China you will see the (inaudible) GDP is roughly 183 per cent and before it was 129 but after the market it was only 76 per cent (inaudible). Here is one chart that will tell us the Asia Financial number one strong growth in the past 10 years, really grow strongly particular from five per cent global financial asset to 18 per cent China from two per cent global financial assets to 10 per cent today. But if you're looking for structurally it very much focuses on banking section on the bones of the market are still practically slow and looking further the whole financial sector with very strong growth in the past 10 to 15 years still below Asians GDP shares so there's still room for continued strong growth. Asia in the global pictures is also very interesting. This is (inaudible) international investments positions. This is Asia's attempt to outflow;

this is the inflow to Asia. So you will see roughly in ten years from 2005 to 2015 Asia's international exposure increased dramatically. Roughly Asia exported 10 trillion dollars ten years ago, today 20 trillion dollars. Also Asia imported roughly 8 trillion dollars 10 years ago, today it's roughly importing 17.5 trillion dollars. So international exposure also increased dramatically but most interesting is here. This net producing means on which Asia exports capital home on which imports capital and that is 4.35 trillion dollars. So at the net Asia exports a lot of capital to the whole world. Now that's also a very interesting chart. The chart just says Asia's international exposure increased dramatically in the past 10 years net to net Asia exports roughly oh they're asking me to not step away from the mic. Sorry I'm used to moving around but I will stay here. So you will see net to net Asia exports so far 4.35 trillion dollars to the whole world and the question is Asia utilizes net export capital for the region I think that that's also a big issue. Because of that Asia exposed to the international (inaudible). US seems to be over from roughly from the merging Asia. It's quite high roughly from 50 per cent equity returns and during the process moved 80 per cent drop down today so roughly still around 50 per cent. So Asia's equity market movement roughly 50 per cent (inaudible) economies spill over. There's also a particular feature for the market as well. Now things today when China became bigger and bigger China's financial assets from two per cent global share to 10 per cent global share and also China played a bigger role and China still also has a big impact for the Asian region as well. We compare very interestingly in this chart, I cannot move I'm sorry and the blue bar is the US temporary impact for the region for the equity market movements and the returns. And the red bar is roughly the August episodes the financial impact from China in August last year if you compare the two things you will see that Malaysia, Indonesia, India and you will see on the currency side China still has quite a bit of impact on the Asian regional almost equivalent to the United States particularly on the equity sides and China today has a big impact compared with the paper impact you saw in 13. That's also become the new feature of the whole financial (inaudible) we're facing today. Now this is very the system if I sort of will provide us a very (inaudible). The whole reason China in a very dramatic way the first issue is demographic change. You will see the red line is for Japan. Japan in further year's horizon that's 15 years that people the age over 65 really what increased from 60 per cent to 32 per cent, doubled in 30 years. Also if you look at the source careers that's the blue line, you will see almost a vertical increase in the next 10 to 15 years roughly from six, seven per cent increase to 24 per cent so almost a four time aging increase. This is absolutely an astounding demographic change. If you're looking at China which is the brown line also from six per cent increased to 16 per cent in 30 years. The black line is for the whole world. The compare the whole world we're all getting older in terms of demographic structure. The Asians are getting older faster. This is a big fundamental change because when you're getting older your (inaudible) withdraw and you will start today looking for the long term investment instruments and compare with the financial structure we had before when you move to the equity market and the bank may not necessarily provide enough product to serve the Asian people and Asian population. This is a profound dry force which shaped the financial market and structure in the future given the steep of the curve is so big and it's really moving fast there's a huge financing gap in Asia. This is a UN and ADP calculator to meet SDG requirements, how much money Asia needs. Last year it's a year of development because we had the year of SDG replace MDG's, we have a climate change and we have finance for developments in (inaudible). Back to the region we realize in the next 10 years every year Asia needs 96 billion dollars to fill the remaining capital for MDG, education, healthcare and other few things. They need another 323 billion dollar to fill the capital for income for people who live under two dollar today and need a 718 billion per year for infrastructure investments. A financial section can help to mold by the resource from public, to private. To me it's a one trillion dollar challenge for one year in Asia to meet SDG target. That's a big challenge for Asia financial (inaudible). Meanwhile if we're looking further there's an even tougher challenge that the region faces. We're pulling the four major economies China, Japan, Korea and Taiwan and together we see how much of their capital contributes in the growth. USC takes a career as a dock line because a clear, the capital contributes a gross roughly from three and a half per cent and it grows to roughly five and half and it then gradually down, down, down to less than two per cent. Japan, the red outline also sees the same thing. China kept contributing to gross drops even faster that means with heavy investments and capital return particularly marginal return drops faster than you expected. And because the capital contributed to the gross also the down (inaudible) show that the productivity contributes to gross also drops in quite a dramatic way. USC duck line career productivity increased in the first 10 years and all the way down goes to roughly then one per cent of contributing to gross and those years and also we see Japan the productivity grows very strong in the first 15 years and drop in China the productivity growths remain high around less than four per cent dropped dramatically in the past five years because the capital efficiency and the productivity because the innovation of things slowed down there. What does this tell us? This chart tells us that Asia is facing a fundamental challenge that's to improve the productivity to raise the productivity growth to raise the potential growth. That also means to support a service at a particular window when the region gets immature moves to service (inaudible) economies to support a service at the productivities which is the key challenge here and the financial sector should and could play a very important role in this area but I have to say this is not easy. For the financial sector to support innovations, to support a startup to have a more sort of adventure capital become more flexible to fit the market need to support the growth to support a sustainable growth that's a real challenge. Last but not least on the vast inclusion issues in Asia we will see in the region in the South Asia that has the banking accounts that increase from 2011 to 2014 roughly from 32 per cent to 46 per cent but still only 46 per cent so still way below with the half of people in the South Asia do not have a banking account and even in East Asia we say roughly 30 per cent still don't have a banking account. So there's quite a bit of room to improve the inclusiveness in the financial sectors that we all know today. The financial including is a very important drive force for sustainable growth because it provides the financing for individuals for SME's for the poor families which will bring the productivity and the support of growth. So financial inclusiveness also another very important issue. So bringing the world together there's a few recommendations we're looking for in the futures current structure in the futures and we'll see enhancing financing deepening and integrations one building resilience and also strengths and positive correlations in the regions. Now this is very broad so let me bring them together. What's the story? I think the story just assumes a very few seven to eight slides is what I try to say is number one the Asian financial sector grows strongly in the past 10 years for example China from two per cent to 10 per cent and the region roughly 28 per cent roughly from 10 per cent so really strong growth but there is still room for the future because there is still the financial assets is below the GDP shares in the whole world and structurally still remains a banking (inaudible) and neither developed on the equity market and the bonds market as well and the region export 4.35 trillion dollars to the whole world and the region imported 20 trillion exported 17 trillion dollars which clearly put the region under huge international exposure and when China becomes bigger and bigger and China's margin policy and the market movements that do have capital for the region as well so that's the financial section for which demographic change

I think that's a big one. Where the infrastructure investment needs increased day by day and also ways to help the econostructure move into the more innovative, more service and productivity increase become more and more important and with the financial inclusion still have a gap to fill in the future financial systems for Asia. We have to look into those issues, we have to meet these challenges. So this study tries to understand Asia's financial structure, tries to understand what area we can do we should be able to catch up and what policy is needed for the region after two and half years. These are beautiful books with red color on the cover so that's the one. Thank you once again for coming to this session I hope you enjoy the book afterwards, I hope you buy the book. Thank you very much.

MR. DERVIŞ: So Mr. Chikahisa Sumi will first compliment the remarks of Min Zhu followed by Cheng Hoon Lim. Chikahisa is the Assistant Director, Asia and Pacific Department and has headed this financial sector project. Previously he served as Deputy Advice Minister of Finance for International Affairs and Deputy Commissioner of Financial Services Agency for the government of Japan. And Cheng Hoon Lim is now Assistant Director, Western Hemisphere Department. She reviews the department's financial surveyance work and serves as the mission chief for Canada. Canada is one of the successful financial countries I guess but you can always get better. She has had 13 years in the Monetary and Markets Department of the IMF where she worked on financial crisis and sovereign debt issues including sovereign debt restructuring and the development of analytics to assess systemic macro financial risks and bank soundness. Cheng Hoon is known for working on the effectiveness in many ways of macro prudential policies which as you know is one of the big topics in financial market analysis these days. And then we have our own Eswar Prasad. We have to share him with Cornell University where he is senior professor of trade policy but he's much more from the mentally anchored at Brookings and he is a Senior Fellow in the global economy in the development department and the New Century Chair in International Economics. He's an associate of the NBER (phonetic) and he was at the fund before chief of the financial studies division and head of the IMF China division so I think we couldn't have hoped for a better panel.

MS. HOON LIM: Thank you very much Mr. Dervis. Good afternoon and welcome to this seminar. Mr. Zhu has given you a very nice overview of the book. I would like to pick up on one important message from his remarks and that is Asia's financial sector still has room to grow and it will evolve to meet the needs of the future generations. That could be for infrastructure financing as he mentioned or it could be to mobilize savings for an aging population or managing a higher volume of cross border trade of capital flows. So it is very likely that we will see Asia's financial sector become bigger, more complex and more interconnected. Now in my next five to ten minutes that I've been given I would like to talk a little bit about the importance for Asia to anticipate and prepare for these changes and I will speak from a regulatory perspective. In our view understanding new products, new markets and new risks will help Asia build resilience. So how can Asia best do this, how can it best prepare for the changes that are coming? Well let's look at what Asia's strengths are and areas where it still needs to work on. What are Asia's strengths? Asia has strong and well capitalized banks. It has relatively large provisions for non-performing loans. Asia has good compliance with international regulatory standards. Most central banks have a framework to monitor systemic risks through macro prudential supervision. And Asia has relatively robust crisis management frameworks. So these are all very good but there are areas that Asia still needs to work on and what are these? So I'm going to be like David Letterman and leave you with a top ten list of recommendations from the book and hopefully this will entice you to go out and buy a copy of the book. So I'm going to go through the list very quickly so listen carefully. First, Asia needs to reduce the large role of government in financial intermediation. I'm not going to elaborate I'll do that later but I'm just going to go through what are the key recommendations. Second, Asia needs to reinforce staff and technical capacity at supervisory agencies. Third once you have the supervisors you have to give them the operational independence to make decisions and to enforce compliance. So they need to have authority and willingness to act. Fourth Asia should continue to improve its surveillance of systemic risk through macro prudential supervision and here it's important to be clear about the assignment of accountability. Fifth as financial institutions become more complex Asia needs to enhance consolidated supervision to monitor funding risks and also to monitor connective lending. Sixth, while Asian banks are well capitalized additional capital and liquidity buffers may be needed as the banks grow bigger. Seventh Asia should strengthen its framework to resolve weak financial institutions in a timelier manner. Financial institutions that are no longer viable should be allowed to fail. Eighth Asia could improve the availability, timeliness and quality of financial sector data including the collection of information of non-bank of shadow banking activities. Ninth accounting and auditing rules and practices should be brought closer to international standards and finally number ten there should be greater cross border cooperation and collaboration to share information and coordinate crisis resolution. So this is the top ten list. As you know Asia has done a lot in the decade after the Asian financial crisis in 1997 to improve financial supervision and to improve resilience. We think that continuing to work these financial sector reforms will be important for Asia to preserve financial stability as it transitions to a new growth model. As you know any transition will always have a few bumps along the road. Good macro economic management and financial policies will go a long way to reducing the size and frequency of these bumps. That's all I have to say.

MR. DERVIŞ: Thank you very much. It was very succinct and of course a long menu but said very forcefully in a short time, thank you very much.

MR. SUMI: Thank you very much Mr. Dervis and thank you very much for allowing us to be here. First this is not meant to be tying this is the interlinkage, don't blame us this is what our designer said this is considered to be the financial centers of the world and this red thing is the interlinkage between it. So we are not trying to bind the thing. Now let me add something to the Cheng Hoon's comments. She is from the Monetary and the Capital Markets Department and I'm from the Asia and Pacific Department. This book is a collaboration of these two departments in the IMF. So we at the APD or Asia Pacific Department look at the countries and the MCM looks at the financial sector globally so this is sort of a horizontal versus vertical in terms of assignments. And then she mentioned pretty much as the financial sector of the global Asia or Asia in general. Then however this book also contains the macro economic related chapters like Asia's demographic challenges and the infrastructure needs or the association themselves east Asia nations, financial integration and analysis of factors behind the capital flows. So among these I found that the Asian Financial Integration chapter is particularly popular among the regions policy makers because it has to include the lessons learned from Europe when something went well or something went not so well and then what are the things we should be looking at when you're going ahead with a financial integration. So this is the kind of thing that the policy advice is behind what we intend to provide in this book. So this is the 300 page book. It's reasonably thick and not so regression on models so this is more of an academic book. But then we editors tried our best to make it easy to read. So the topics or main key takeaways of the chapter at the outset of each chapter and also the conclusion at the end of each chapter so you can just read it. Having said that at the IMF we are not in the publishing business so we are to make a policy of the vice to the member countries so what is more important for us is to make the findings of this book into something tangible, something that the policy makers can use in making their own policies and each countries specific circumstances. So what we are doing, let me talk about since the DM Min Zhu gave you a sort of broad overview of the book and then we just supplemented it with some detail so let me talk a little bit about what we are planning to do with the book from now on. Basically we are planning to make our IMF country teams to learn about the findings of the book and then use them in their annual consultation with each member countries so that’s what we’re doing. And particularly in one of the findings in the book is that Asia’s economy with the global financial crisis reasonably well but that was because the starting point was (inaudible). Asia has suffered from the Asian Financial Crisis ten years earlier so they are very much they did their best to make the books in order and then when the global financial crisis hit Asia’s economy was relatively a bit acquisitioned with a relatively conservatively managed the books of the banks to we didn’t have toxic assets to much. So then that resulted in relative resilience of the Asian region in general. But then during the years that pursued in the very, very easy monetary conditions and the very historically low interest rates Asia’s corporate sector has accumulated quite a lot of debt and increasing the (inaudible) along the way. Now last December that very easy money was reversed in one of the major economies and then what happens from here. So that’s the kind of thing we’ll be looking at in great earnest. And the tricky thing here is that the corporate liability average doesn’t say much. Well if country A is suffering or struggling country B has large cash buffers on average that should be okay right, not really. Even if on average the banks corporate sector is okay with repaying the debt but it’s not average it’s an individual country that has to meet the financial obligations. So we are trying to get how much of a percentage of the corporate sector is vulnerable. So these kind of things we are employing and we are trying to predict a forecast on going forward looking at each country and their situations. Another thing is that the macro prudential so far the macro prudential has been utilized in the context of incoming capital flows. Asia has received quite a lot of capital flows in the process, the capital flow granting to real estate and the real estate price on top. So many of the jurisdictions use the macro prudential policy to combat price inflation in the context of increasing or incoming capital flows but now quite possibly the reversal of this risk sentiment and possibly the region will be facing outflow of capital instead of inflow of capital and at the same time we are facing with a bit of softening of the economy so if the economy suffers we lose in the monetary policy but if you lose in the monetary policy then the asset price inflation may be stoked. So what are we going to do with this monetary policy you have to on the one side combat the demand management, you have to loosen to accommodate the economic activities. At the same time you have to make sure that it doesn't stoke the asset price inflation. So the macro prudential policy uses in that regard really become very important. And thirdly the capital inflow would be somewhat more precious in the future. In the past years we have wanted inflow into a region. Now we are not so sure that the capital inflow continues to be that lax so in years to come we need to think about more effective use of capital inflow to perhaps capture the capital into more productive rather than sort of going into somewhat unproductive investments. So how are we going to do it? Many countries has its own structured reasons or historical reasons has certain alignment of incentives. For certain countries because they wanted to encourage house ownership they may have certain bias to buying a house rather than saving so this kind of thing may have certain impact on the choice of investment into productive versus non-productive investments. So these are the kind of things basically what we'll be looking to within this (inaudible) of future wagers of finance project will be looking at in the context of each of the member countries, thank you very much.

MR. DERVIŞ: Thank you very much. Eswar, looking forward to your comments.

MR. PRASAD: Finance has become the life blood of modern economies. Unless you get finance right you don't get growth right and you get a lot of volatility in return. So for the most dynamic region in the world right now despite recent bumps in the road which is Asia I think taking a close look at what is happening and what is needed in financial systems is a very valuable service which this book does very nicely. So in my remarks which build up on the those of the previous three panelists let me talk a little bit about what's been happening on the ground in Asia which in many ways is intriguing then talk a little bit building on the themes of the book about what is needed for financial systems to work well and then talk about one specific example that I think drives so many of these issues and assuming there is some interest in China I'll draw that into the discussion. If one thinks about what happened after the global financial crisis there was a sense that finance had gotten too far ahead of itself. Interestingly enough the year after the financial crisis hit India introduced an instrument that had not been seen there before, credit before swaps. Two years after this China introduced or opened up its foreign exchange diverse markets. At one level this might seem like fool hardy moves after all if it was divertive markets and in particular derivatives like credit before swaps that caused much of the turmoil in global finance. But this speaks not to the folly of these countries but to the sense that financial market regulators had that there was genuine demand for financial products in many of these countries. And one might think about credit before swaps as having gotten ahead of themselves as toxic overly sophisticated financial products but there is a good reason. The columnists like to talk about completing financial markets that is allowing for financial products that allow for insurance against all the states of the world possible. We don't quite get the complete financial markets and the problem is that on the transition to complete financial markets many instruments if you have the wrong incentives, if you have the wrong regulatory frameworks in place can cause a lot more trouble than the benefits they bring. But I think what we are likely to see is at some level a convergence between where finance was in the western world before the financial crisis and where the immerging markets were before the financial crisis with very underdeveloped financial systems. I think the ideal meeting point is somewhere in the middle. A much more very diverse set of financial markets but perhaps not to the extent that we saw in the western world before the crisis and this book very nicely lays out the path. So what are the key attributes that are necessary for finance to work well? I'd argue that there are three: Breadth, debt and inclusiveness and all of these are touched upon in the book. Breadth refers to the scope of financial markets as Mr. Min Zhu pointed out in his presentation, Asia still remains very largely bank dominated and I think having a very broad set of financial markets can serve a variety of purposes. Not only does it provide more competition and discipline to the banking system in and of itself but in addition it gives savers opportunities to diversify their portfolios, it gives firms other avenues of raising capital and I think this sort of competition is ultimately going to be working towards a much better financial system. As Mr. Sumi pointed out if you have good bond markets in particular they're not only very good in terms of intermediating domestic finance but also intermediating foreign finance towards longer and productive projects. If you take many countries in Asia again India being a primary example, there is a crying need for finance in India but what is crucial is there have been ways for foreign investors to participate in the India growth story but in a way that also serves India's long term growth needs which can be done through bond market development. You also need debt in these markets because if you have shallow markets ultimately you get a fair bit of volatility and these markets don't work very well. So the amount of liquidity, the amount of turnover in these markets is important and here I think the part many of the countries in Asia have taken towards opening up their capital accounts more. That's a very useful draw. Much has been said about how premature opening up of capital accounts can be a potential problem and there is certainly truth to that. But I think there is a different perspective that opening up of a capital account in a careful and cautious way can in fact generate what I refer to in some of my research is collateral benefits. That is the benefit of developing parts of the financial system through foreign investor's expertise, their money and their better assessment of risks and so forth. In addition, you do need to have the financial system reach a large part of the economy. If one thinks about the fact that growth in many economies in Asia has been somewhat unbalanced and if you think about the fact that structural reforms of a variety of sorts have not gotten much traction. Part of it is related to the political economy. In many of these countries it is a very viable and important argument that many of the benefits of reforms ultimately go to the political and economic elite who are very well connected, who are able to benefit from the reforms while the shorten dislocations often end up having costs that are born by those that are not well tied in. And tying in ends up being very closely related to financial inclusion because if you're not well tied in to the financial system it becomes difficult to participate in the economy more broadly and to participate from the benefits of growth. So I think that is not only a macro based but also political economy based argument that makes financial inclusion a very important imperative. And we've seen again in many countries in Asia, China, and India and so on, the government recognizing this and taking significant steps to improve financial inclusion. So now let me come to the last part of the discussion and I think China is a very good example of what I think is necessary beyond financial market liberalization and capital account opening. In case you've been watching the news things have been happening in China for the last few weeks and months. My views is this is not the result of policy mismanagement by China alone although certainly things could have been managed a lot better, I think the signals actually things proceeding in the right direction. You might say what the heck do I mean. I think what China has been trying to do is in fact to let markets work well. The problem that China faces is that if you try to liberalize financial markets without the supporting framework things don't go well. What do I mean by the supporting framework? The book refers to needing a much better regulatory framework but if you think about volatility in the stock market why is the Chinese stock market so volatile? Part of the reason is that you don't have the good institution framework to support it. That needs better corporate governance, better auditing and accounting standards, better corporate transparency. If you don't have those then what happens is that even retail investors become momentum traders because they don't have enough information about the corporations they're investing in so they tend to get pulled along when the stock market is going up and pulled down when the stock market is going down. And of course when the government houses its only tool somewhat heavy handed government intervention which looks very (inaudible) where the strategy is not clear that makes things worse. So there has been a great deal of criticism. Some of it I think misguided some of it I think is more right that the government is making things worse by trying to intervene directly in stock markets or currency markets. I think the fundamental issue is here is that for financial markets, equity markets, currency markets, bond markets to work well you need a better supporting framework. So here again I think the book alludes to these issues but this is really going to be the core issue in a merging market economies. Not that you need to hold back on financial market development or capital account opening but make sure that the other (inaudible) in the economy both real side reforms and institutional reforms going (inaudible). Perhaps waiting for those reforms to take place before moving at a financial market reform we'd be waiting indefinitely but I think that's where these economies are going to have to go. So I think this book makes a very valuable contribution in terms of honing in on what China really needs which is better financial markets and also pointing out what else is needed to support good finance in Asia. Thank you.

MR. DERVIŞ: Thank you very much Eswar. Let me ask one or two questions and then we go to the floor. One question I have to the group and you can decide who goes first but it's very hard to separate financial sector management from exchange rate management. It's not the same topic but they're deeply linked by the balance sheets of the corporate sector and by many other factors. Is it a problem that the capital stock or the financial assets stock adjustments that may be happening with liberalization in China particularly, in other words more capital outflow is starting as opposed to inflow which is an asset diversification trend, maybe other things. At the same time as the while the current account surplus is not at the highest level it's been but I just saw yesterday that the trade surplus with the US is at an all-time high with China. So on the one hand you have a capital outflow that will tend to depreciate the exchange rate and there's confusion in the non-specialized press as to what really should be the exchange. On the other hand there's a big surplus and the depreciation other things help constant might increase that surplus. How do you look at that problem?

MR. SUMI: Generally in the IMF we have the external balance assessment and then we look at each countries' current account deficit and surplus and positions and then try to explain it from the fundamentals and the desired policies. And then in each of the countries surveillance we come to explain suppose country A has this surplus of four per cent of GDP but then that is explained by certain factors and then what is the residual which can't be explained by this fundamentals and the desired policies. Then we say that look at the country specific issues and try to come into more balance for that particular country. But I'm not in charge of China and I am sort of reluctant to go into China's specific issues. The China team is currently now in China for their scheduled visit and they will be talking with the authorities as we speak. But each of the country cases we do look at what makes the current account surplus as it is as opposed to what we think the fundamentals of the economy and the desired policy would dictate a current account level to be somewhat different. So what are the differences and why is it happening and then we usually ask the country authorities to think about why this is diverting from the norm and what can they do to reduce that diversion. So I know I'm not answering your question in the way you like but that is how we answer it.

MR. DERVIŞ: Well let me rephrase then maybe for Eswar. When you have a system which is liberalized on both the trade and the capital accounts you still get a lot of volatility but in China and other parts of Asia you have a capital account that was pretty managed and maybe the goods account more and more liberalized and you have a rapid relaxation of capital account management and therefore a stock adjustment on the capital goods side and will that stock adjustment be a challenge to macro prudential policy or let's say corporate balance sheet. I mean banks can be very well capitalized but if the corporate sector has an open position for an exchange that may not mean very much and I'm not saying that's the case but how is the kind of change capital accounts policies of China and other countries impacting financial sector both analysis and policy?

MS HOON LIM: I think it's important to remember that since the Asian Financial Crisis in 1997 Asia as a whole has cut down significantly on its external debt. So there's a lot less foreign currency liabilities on the books of the corporate sector then it was in the past. This actually has allowed many Asian countries to adopt a more flexible exchange rate and you saw that that flexible exchange rate served Asia extremely well during the 2008 crisis. It acted as a very effective shock absorber. Though I think from the exchange rate policy perspective we've seen a sort of a very nice transition from largely managed exchange rate regimes to a more flexible exchange rate regimes and this has served Asia well. From a macro prudential policy perspective and for those who don't know the term macro prudential policy I think in the IMF we forget that sometimes people don't know these terms but it's essentially not supervision of individual financial institutions but supervision of the financial system from an aggregate perspective. So you look at the financial system and you see where the risks are coming so it may be that individually financial institutions may not be at risk. But on aggregate if there is significant exposure to the real estate sector for example that could pose systemic risk to the financial sector. So from the macro prudential perspective I think it's important also to keep in mind that it is different from exchange rate management. Macro prudential policy is to address systemic risk in the financial system. If there are significant capital inflows into Asia as we saw right after the 2008 crisis the macro prudential policy would be the useful tool to use to address exposure of the financial system as a whole to real estate prices to some of the class. Now in the event of capital outflows macro prudential policy could also be loosened in the event that buffers have already been built. Now if buffers have not been built then it's important to make sure that macro prudential policy remains where the vulnerabilities or the exposure of the financial sector remain manageable. This might be a long winded way of saying that I think Asia has a sound exchange rate policy. It's a much more flexible exchange rate regime to absorb shocks, it has, more central banks have a framework for macro prudential supervision and Asia in fact has led the world in terms of implementing macro prudential policies to address systemic risk in the financial system.

MR. DERVIŞ: Let me ask Eswar because he's written so much on the international monetary system. We do have a little bit of a strange situation in the world now from a macro point of view that links up with the financial sector. I mean we have two countries that have very large surpluses. China was reduced but it's going up again and Germany. Both of these countries are imbedded in regions, China in Asia and Germany in Europe but they resemble each other in terms of trade position quite a bit. And yet both of these countries have exchange rates that are depreciating where as in the kind of global imbalance you would hope that they would appreciate any thoughts Eswar?

MR. PRASAD: China is from that traditional framework a bit of a conundrum so the Chinese creates surplus relative to its levels before to global financial crisis has certainly come down a lot although in the last three quarters its gone back up to about six per cent of GDP which is high. But the current account is another matter because this is referred to earlier China has been experiencing capital outflows so there is that complex that is being dealt with right now and the Chinese currency is still managed quite actively against the US dollar and of course the US dollar has risen very sharply in the last year or so at least into last summer. So in China you had an expanding trade surplus at the same time that the currency was appreciating in trade waited or affective exchange rate. A large part of that was a decline in imports not so much import volumes but import prices because the prices of a lot of China's imports especially commodities have been very weak so the configuration is not easy to map into the sort of traditional configuration that we might think about. In China's case as your initial question pointed out I think there are some significant challenges. China has been aggressively opening up the capital account not only to inflows but to outflows. In fact even in the midst of all this turmoil the official capital account opening has continued although China has started tightening up on some administrative requirements to limit capital seepage through unofficial channels. The problem is that the timing was not ideal because you have an increase in capital outflow so what I think of very good reasons because after all there are about 170 per cent GDP worth of deposits in the Chinese banking system about half which is by households, about half corporate and about 10 per cent by the government and it makes good sense to take some of that money out of the banking system for diversification reasons and it would provide some competition for the banking system as well. The problem is that the unofficial capital flows as reflected in the net errors and omissions have started creeping up at the same time that we had these capital outflows so that right reasons. So you have diversification outflows compounded by outflows that are exacerbated by concerns about the economy and also the anti-corruption drive. This creates a very unstable capital flow dynamics which I think is what the government is contending with. So I think as was referred to earlier the notion of Asia as a whole shifting towards a more flexible exchange rate which has been good for the region I think is the story that continues to this day China is trying to move towards that but again without the right supporting framework in place it just creates a lot of turmoil. So I think what is going to be needed to pull things back is not anymore direct intervention in the financial markets or in the equity markets but really this broader conflicts of reforms and policies that are going to be needed to stabilize expectations.

MR. DERVIŞ: One more question and then we'll turn to the audience. I do remember the London G20 meeting and one of the big issues which was partly political messaging was tax havens and information exchange in the financial system. I think it's becoming a more and more important issue. From your point of view I think there is much more decisiveness in the world to fight against illegal tax evasion and it's large, estimates are really large. Second there is also now increasing the decisiveness on dealing with legal tax avoidance issues and a lot of these are financial sector issues one sometimes has the feeling that in Asia there's a lot of reluctance to open up the information exchange and to end whatever tax shelters may still exist. Any views on that?

MS HOON LIM: Well I think it would fair to say that the IMF has done a lot of financial sector assessments for the Asian countries. One component of those financial sector assessments is the assessment of the anti-money laundering infrastructure what you call tax havens and so on and I think the results have been relatively robust. There are areas for improvement absolutely but I don't think that the findings for Asia are any different from other regions of the world. I think globally we need to do more to combat illegal transfers of money and as well as anti-money laundering. So I don't think this is specific to Asia alone.

MR. DERVIŞ: Okay I hope there is of course that international movement that I think if you look at the last five years particularly with the OCD in the lead and also some governments there is a much more decisive move on that and I think it would be welcomed if there is Asian jurisdictions also joined in that movement. It's one of those typical global public goods that a large part of the world doesn't incorporate then you can't really eradicate the disease so that's why I'm asking. Okay lets go to the audience now and take a few questions at once and then we'll go from there. I saw one hand go up immediately in the back. Please identify yourself before you ask the question.

IAN TALLEY, WALL STREET JOURNAL: One I know that we're talking about trying to look at longer term trends but we can't get to the long term if we don't get through the short term and it seems to me that IMF estimated that the over investment capacity of China was something like 25 per cent of GDP. If there are a cascading series of defaults in China that slows down near term growth does it not and causes a massive spill over throughout the rest of the globe. How does China deal with that without causing a nose dive in growth one and two how does Beijing manage the damned if you do damned if you don't on the RMB evaluation? Depreciating it would be allowing greater flexibility while also sending signals to the rest of the world that growth may be a lot worse then they're letting on?

LOU GAGLIONO: Financial markets react to reporting in numbers so let's assume for the moment that the quality of the numbers in China in particular aren't very accurate. How does that affect some of these projections in terms of the financing need that is required and there's a big difference between reality and the numbers being reported is 10 per cent as opposed to being bigger than 10 I'd like to hear your thoughts on that.

MR. DERVIŞ: I do want to remind all of us that this is on the topic of the book and not completely straying away into daily affairs and daily press reports. So while we can interpret that broadly I would appreciate if we tried to ask questions that are more directly relevant to the actual presentation.

KELSY ROSS: You touch on this a little bit when talking about acion but I was wondering sort of the big ten that you had of ways to improve the Asian financial system. How do you expect countries to work together on these or do you expect these reforms and improvements to be individual country made and if so how would those then work in a broader financial system?

LINIA LOGEY: I was just wondering if you could comment on kind of the 20 to 30 year perspective for Hong Kong and Singapore?

PETER WOLGART: You mentioned briefly the issue of increasing debt. I recently read in an article that Asia was in per cent of GDP the clear master. All countries, Malaysia, China you named them were substantially above 150, 200 per cent in total private sector debt. Obviously we just said external debt seems to have decreased. It's in the book that you know statistics on that showing that indeed the internal debt has increased, these would be the external because the overall private sector debt did not look very good to me.

MR. DERVIŞ: All right I think we can now take a turn, why don't you start.

MS HOON LIM: Okay just to address the question on financial sector reform I think the system reformed the agenda for individual countries but there is significant scope for Asian countries to work together and they have various forums in which supervisors and regulators get together and exchange information and analysis. One of the recommendations that the IMF make is that these supervisory colleges should do on a regular basis and they should exchange information that is meaningful and they should do this regularly in normal times and not just in crisis times when there's a problem and then you scramble. So if you have the framework in place during normal times its much easier to coordinate when there is pressure in the financial sector.

MR. SUMI: Let me answer the question about the acion. Of course the acion is comprised of 10 countries and then usually appeared into two acion 5 and then COMV but even within each of these groups they are very, very different in terms of degree of financial deepening then the others so in the first instance they think about their own financial market and then to come up with the solutions which best fits their specific circumstances. But on top of it especially on among the acion 5 like the more advanced countries they are engaging this initiative called acion bone market initiative or ABMI for short and then ADB is helping them coming up with certain collaborative approaches to develop the bone market and also cross training the acion countries with the various stock exchanges. So these regional initiatives are proceeding with the acion, we call it acion plus three, China, Japan, Korea cooperating with the country officials of the acion countries to formulate this financial sector mostly technical assistance. So these are ongoing and then the debt we do notice that one other thing we find encouraging is the development of the local currency illuminated markets. It used to be so called original things or mismatches which resulted in the Asian financial crisis is the mismatches of currency and duration. They tended to borrow short term in US dollars and then flip it over into a long term assets. They eliminated their own local currencies. But when the banks have to refinance their borrowing they cannot call back their long term assets in local currency so they were squeezed to come up with the US dollar to repay it. So that was the basic cause of the Asian financial crisis. So learning from it they have increased the instruments to borrow in a local currency and then it's not entirely the result of a bonified affect. Some of it is a result of the international investor's pursuit of you. They wanted to have a higher yield so the US dollar normally the rates are so low so the investors scrambled before the acion country nominated that which normally has a higher rate and they thought that their currency should appreciate a little bit with the US dollar. So in the context of 2010 something somewhere around there just after the global financial crisis there was an influx of money into the local currency. That increased the size of the local bond and many corporations took advances of chief financing available in that market. That cultivated to the increase in the corporate levels. Again numbers are important but then for us to look at the financial stability issues every number is not important as I explained earlier so what per cent of the firms have accumulated how much debt and therefore how much of the larger portion of the corporate sector is vulnerable should go up by this much and earning generally goes back down that much. So this is a kind of stress testing we will do and then of course we are cautious about this general trend of increase in the corporate sector debt and we'll be looking at that quite carefully in each countries situation.

MR. PRASAD: I was the mission chief of Singapore but then they are very nicely run country, tightly run countries and then Hong Kong is not a direct country but then it has a very strong capacity at looking at the economy and noticing any changes so 30 years is a long time to project but then judging from the quality of people there I have no reason to doubt that they will be successful in the coming years.

MR. ZHU: I have no doubt that Mr. (inaudible) does care about the IMF's views about China not mine but I will take a bullet for my former IMF colleagues. All the currency issues I think what the BBOC indicated it planned to do on August 11 of last year which was to move to a more flexible exchange rate is going to be good for the BBOC, it's going to be good for China. The initial step was not very well executed and at this stage I think it makes a lot more sense to use the flexibility somewhat more aggressively. But the issue again comes back to managing expectations in a very turbulent environment because at this stage with the government still intervening on and off in the markets both in the on shore market and the off shore market I think it's making things potentially worse. So what's a good exit strategy. I'm afraid the answer is a complex one and goes back to what I talked about earlier and what is in the book. If you think about policy or monetary policy in vacuum it does not work very well because you need to have other things working well in the economy. There are concerns about the Chinese economy so what do you need to stabilize expectations you need a mix of macro policies, a little bit of monetary a little bit of fiscal, preferably more fiscal policies and you need to show signs that there are going to be active steps taken to reform the real side of the economy. So unless you have those as confidence building measures I think it's going to be a very difficult struggle. On the issue of debt again there tends to be a lot focus on the level of gross debt on the Chinese economy and the numbers for instance which are now approaching 300 per cent of GDP in China do sound very scary. But as Mr. Sumi pointed out one needs to look behind the debt, one needs to look at what the financial system is that is intermediating that debt, what the maturity structure of the debt is, who is taking the debt and what so that the activities that debt is financing and I recommend the book to you to get a better sense of what is behind those debt numbers. I think the issue for many of these countries again is not just the level of debt in fact having good, vibrant debt markets, bond markets in particular is potentially a very good thing for the financial systems in this economy gives you the depth that I spoke about on my top ten list. But I think those are the key characteristics one should think about. So in the context of many of these economies in Asia again the level of exposure to external debt although that isn't concentrated exposure in certain sectors, all in all it is not a cause for panic just yet although it does constrain many corporations and the macroeconomic policies in some of these countries although again I'm not anywhere near to the extent that it was before the Asian financial crisis and I think the issue here is about developing better regulatory frameworks to make sure that whatever debt we do see in the economy does not necessarily pretend significant problems when conditions like interest rates or exchange rates change. So I don't think it's a huge concern yet but in a country like China the level of debt and the fact that it's been intermediated through a financial system that's not been granted intermediation since most of this debt is bank debt I think that suggests that there's going to be an economic price to pay not in my view a crisis but certainly a price to be paid.

MR. DERVIŞ: Thank you very much. Okay we have time for a few more questions.

MR. ANAN: Mr. Prasad talks about the liberation of the Chinese financial market and my question is regarding the market mechanism right now in the stock market. From what I know you can only buy long and cannot short in the market and if you buy today you can only sell tomorrow. But comparing to the western markets there are three. Buy today, sell today, you can also sell to companies that are not as efficient and not earning money but what happens in the beginning of 2014 the slow-down in the Chinese economy brings down a lot of manufacturing for the exporting industries and these financial capital flows into the financial markets after the slow-down in the economy. So even these companies who are not as efficient, not making money their stock price still keeps going up. Do you think the environment would be less risky if the Chinese government would make the market freer instead of being restricted?

DEMETRI: Thank you very much, very interesting. My question also unfortunately is also for Dr. Prasad. I read your book recently I thought it was a great book thank you very much. My question is if I remember correctly in the book you describe inefficient but stable equilibrium with the dollar at the middle. Would you say that the development of the Asian financial system is leading us towards something better? Are we headed in the right direction in terms of this situation with the dollars role in the global economy?

YVONNE: I just want to ask how do you think the Asian investment bank will influence the Asian economic market environment later?

MR. DERVIŞ: The banks are claiming that after the crisis the regulators have a tendency to overdo it in terms of capital cushion, leverage constraints and things like that. Other claim that quite the contrary that not enough has been done maybe you could say one or two words in the Asian context about this debate as well as anything else and why don't we start with you Ms. Lim.

MS HOON LIM: To answer your question I think the other questions are for my other panelists. I like to think of it as the story about Goldie Locks and the Three Bears and I would say that the global regulatory reform agenda has got it broadly right. So the porridge is not to hot, it's not too cold and we're going to have lobby groups who will say it's going to increase the borrowing costs of banks and therefore they're going to have to pass this cost on to consumers. We actually in the book did a study to see whether or not the impact of the global regulatory reform actually costs lending rates to increase in Asia in the Asian banks and I think this is chapter 11 in the book. We actually saw miniscule effect. Maybe 10 to 25 basis points but it wasn't something to write home about. So we think as the IMF that the global reform agenda has made the global financial system safer and stronger.

MR. SUMI: Well I used to work for the Japanese (inaudible) and I have my personal opinions about the FSP. Talking about the AIIB as we have explained that the infrastructure is huge, it's simply huge. And then the infrastructure investment is a very productive investment and then it has the potential of crowding in private sector investment. So for developing countries usually lacks that funding mechanism for that needed infrastructure investment. So in that sense any help to increase that infrastructure financing would be a nice thing. Except that if one lender lends to the existing borrower in a way that sort of not commiserative with other lenders in terms of the credit to worthiness or say the integrity of the project then the existing borrower will become at risk. So in a sense that if you make an investment decision that has to be made in a transparent way that reflects the shareholders government structure which is the shareholders of the AIAB many of them are the same as the shareholders of the World Bank and other regional developing banks. So we can pretty much see the collaboration. We're looking for the collaboration with AIAB which is run and that's sort of nicely run with good governments and good transparency selection of the project and so on. So we do welcome any help to finance this vast, vast need to update and solve the infrastructure bottleneck which is constraining the growth on the supply side at the moment.

MR. PRASAD: Let me preface my concluding remarks by again recommending this book. Clearly the fact that all of you are here suggest that you care about Asia's finance and it's clearly an interesting and dynamic region and not only is the book a very good book for the policy but as Mr. Sumi pointed out there is also cliff notes at the beginning of each chapter to get the gist of what the book is trying to convey. Ultimately getting finance right is important for any country but especially in Asia given the impact that China and the region as whole is having on the world. The response to a couple of the questions that came up I think the issue also here is ultimately there isn't much of a choice now that these economies have started on the road toward more open capital accounts towards more liberalized markets, I think getting caught in the middle of the road where you have some degree of market liberalization but still the expectation that a government will intervene when things go bad. If you don't have the right sort of supporting framework you end up with a lot of volatility but none of the benefits of market liberalization. I think this book very nicely lays out the path towards the ultimate objective both in terms of defining what the objective ought to be in terms of different aspects of financial development but also help to get there in a very good way. So I congratulate Mr. Sumi and Mr. Zhu for an excellent and timely book.

MR. DERVIŞ: Very good and we thank you for being here and for sharing your thoughts with us and for coming to Brookings. Thank you.

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