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Keynote Speech

Financial Integration, Financial Stability, and Central Banking

Choongsoo Kim
Governor, Bank of Korea

Summary

As we enter our fourth year since the global crisis, it is time to pay greater attention to reviving economic growth and the related policy agenda. Ensuring financial stability is of course a prerequisite for reviving growth, but the converse is also true. In this context, Asia has weathered the global crisis and the following fiscal crisis in Europe well, but needs to play a greater role in the world economy going forward.

Trade integration over the past several decades has enabled Asia to learn from its advanced trading partners and to grow rapidly. Financial integration can do the same for Asia. Financial integration in principle facilitates domestic financial development, improves resource allocation within and across countries, and ultimately promotes growth. And the diverse stages of development and demographics of Asian countries offer fertile ground for efficiency gains from financial integration. These benefits are well understood.

Another important but less known benefit of financial integration is a stronger market base for financial stability. Financial integration tends to bring about greater market liquidity, improved risk allocation and enhanced competition, all of which contribute to financial stability by allowing market participants to better absorb and trade risks. Such stability gains could be quite large for Asia, where the brunt of regional trade and finance is denominated and settled in the dollar. Better integrated Asian markets could produce more safe assets of our own, offer greater risk hedging, and help to reduce financial mismatches. In this light, the Asian Bond Markets Initiative (ABMI) should remain a high priority on Asia's financial reform agenda.

Policies and institutions to promote financial integration may—and perhaps should—differ across time and place. However, in terms of their modus operandi, Asian markets are not intrinsically different from other advanced markets. Asian market integration should therefore be guided by the same principles adopted by advanced markets—greater exchange rate flexibility, freer capital mobility, transparent rules and regulations, fair competition based upon reciprocity, and so on.

While financial integration and deepening could lead to a stronger market base for financial stability at the micro level, it would in all likelihood also lead to increased systemic risk as countries and markets become more interconnected. And for adequate control of systemic risk, enhancement of micro-prudential regulations is, while clearly necessary, not sufficient. A shock in an isolated financial market or in the real sector could quickly spill over into another and, in the process, be dramatically amplified. For this reason, systemic risk control should be approached from a macro-prudential perspective in which real and financial sector linkages take center stage.

Given their mandates and financial resources, central banks are arguably well positioned to develop macro-prudential judgment of systemic risk. To be specific, the existence of real and financial linkages implies that price stability and financial stability cannot be considered in isolation, and that monetary and macro-prudential policies, which are distinct in many respects, should be closely coordinated.

There are sea changes now underway in the governance structures of macro-prudential policy in major financial center countries, where central banks have now become responsible for—or at least involved in—both monetary and macro-prudential policies. Such departure from the so-called Tinbergen Principle reflects the new thinking on central banking and financial stability since the global crisis. There is no one-size-fits-all solution, however, and governance structures must be tailored to individual country circumstances. It should nevertheless be made clear that the central bank needs to play a role in macro-prudential oversight on systemic risk, and that close dialogue and policy coordination between the central bank and the supervisory authority, if they are not the same, is crucial for financial stability.

Korea has in this regard made good progress recently in strengthening its macro-prudential policy and governance for financial stability, with a focus on addressing the risks to stability stemming from its FX liabilities and volatile capital flows. To be specific, a ceiling has been introduced on the forward FX positions of banks, a macro-prudential stability levy has been imposed on banks' non-core liabilities, and our central bank currency swap arrangements with Japan and China have been renewed on larger scales. Regarding governance reform, through last year's amendment of the Bank of Korea Act, the Bank of Korea is now mandated with the responsibility not only for maintaining price stability, but also for paying attention to financial stability. The Bank is required to submit semi-annually an official financial stability report to the Korean National Assembly, and endowed with expanded scope for emergency liquidity support and with greater access to information from financial institutions including non-banks.

In conclusion, Asia can open a new chapter in its economic development by turning to take advantage of relatively unexplored opportunities in financial trade, while at the same time ensuring financial stability. If the trading of goods has enabled Asia to grow rapidly thus far, financial integration and innovation can and should do the same. But the risks attendant to financial integration and innovation are by no means small. Economic growth and financial prowess will prove elusive if systemic risk is not brought under adequate control. And the recipe for success in this regard is well known—stable monetary policy, fiscal prudence, and enhanced financial regulation with a greater focus on macro-prudential oversight.