Financial and Monetary Policy Studies 40

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Central Banking and Financial Stability in East Asia

Springer

Financial and Monetary Policy Studies

Volume 40

Series Editors

Ansgar Belke, Essen, Germany

More information about this series at
http://www.springer.com/series/5982

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ISSN 0921-8580 ISSN 2197-1889 (electronic)
Financial and Monetary Policy Studies
ISBN 978-3-319-17379-5 ISBN 978-3-319-17380-1 (eBook)
DOI 10.1007/978-3-319-17380-1

Library of Congress Control Number: 2015943583

Springer Cham Heidelberg New York Dordrecht London

Printed on acid-free paper

Springer International Publishing AG Switzerland is part of Springer Science+Business Media (www.springer.com)

Preface

"Central Banks, Financial Stability and Legal Issues in East Asia" was the title of an international conference staged at the East Asia Institute in Ludwigshafen in May 2014. The conference brought together leading experts from academia as well as monetary authorities from Asia and Europe to explore issues of central banking and financial stability in East Asia from different economic, legal, and policy perspectives. The papers delivered at the conference form the basis for this book.

The conference was made possible through the generous support of the *Deutsche Bundesbank* and the *Haniel Foundation*, which is gratefully acknowledged. Likewise, we wish to thank Springer International Publishing for accepting this volume into its series entitled *Financial and Monetary Policy Studies*. Finally, we are indebted to Chris Engert for his excellent work in the language correction and copy-editing of the manuscript.

Ludwigshafen am Rhein, Germany — Frank Rövekamp
Frankfurt am Main, Germany — Moritz Bälz
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List of Abbreviations

ABC	Agricultural Bank of China
AML	Anti-Money Laundering
BoC	Bank of China
BoCA	Bank of Canada
BOE	Bank of England
BoJ	Bank of Japan
CBI	Central Bank Independence
CBRC	China Banking Regulatory Commission
CBSG	Central Bank Study Group
CCB	China Construction Bank
CCP	Chinese Communist Party
CFA	*Communauté Financière Africaine* (African Financial Community)
CFT	Combating the Financing of Terrorism
CISIDA	Comprehensive Iran Sanctions, Accountability, and Divestment Act
CPI	Consumer Price Index
CPR	Common and General Provisions Regulation
DFS	Department of Financial Services
DNB	Dutch National Bank
DPA	Deferred Prosecution Agreement
EAFRD	European Agricultural Fund for Rural Development
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Community
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EEC	European Economic Community
EFSF	European Financial Support Facility
EFSM	European Financial Stability Mechanism
EGTC	European Grouping of Territorial Cooperation
ELA	Emergency Liquidity Assistance

EMFF	European Maritime and Fisheries Fund
EMU	European Monetary Union
EPA	Economic Planning Agency
ERDF	European Regional Development Fund
ESCB	European System of Central Banks
ESF	European Social Fund
ESM	European Support Mechanism
EU	European Union
FATCA	Foreign Account Tax Compliance Act
FCPA	Foreign Corrupt Practices Act
FDI	Foreign Direct Investment
Fed	US Federal Reserve
FFI	Foreign Financial Institution
FIFG	Financial Instruments for Fisheries Guidance
FILP	Fiscal Investment and Loan Program
FinCEN	Financial Crimes Enforcement Network
FRB	Federal Reserve Bank
FSB	Financial Stability Board
FY	Financial Year
GDP	Gross Domestic Product
GFCC	German Federal Constitutional Court
GG	*Grundgesetz* (German Basic Law)
GHQ	General Headquarters
HICP	Harmonised Index of Consumer Prices
ICBC	Industrial and Commercial Bank of China
ICJ	International Court of Justice
IMF	International Monetary Fund
IRS	Internal Revenue Service
IT	Inflation Targeting
JGB	Japanese Government Bonds
LDP	Liberal Democratic Party
LGFP	Local Government Financing Platforms
LTRO	Long-Term Refinancing Operations
MoF	Ministry of Finance
MTO	Medium-Term Objective
NDRC	National Development and Reform Commission
NPC	National People's Congress
NPL	Non-performing Loan
NY	New York
OECD	Organisation for Economic Co-operation and Development
OFAC	Office of Foreign Assets Control
OMT	Outright Monetary Transactions
PBoC	People's Bank of China
PCIJ	Permanent Court of International Justice

PM	Prime Minister
QE	Quantitative Easing
QQE	Quantitative and Qualitative Monetary Easing
RMB	Renminbi
SDP	Social Democratic Party
SME	Small- and Medium-sized Enterprise
SMP	Securities Market Programmes
SNB	Swiss National Bank
SOE	State-owned Enterprise
TEEC	Treaty Establishing the European Economic Community (Treaty of Rome)
TEU	Treaty of European Union
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance
TSF	Total Social Financing
UK	United Kingdom
UN	United Nations Organization
US	United States of America
USD	US Dollars
WMP	Wealth Management Product

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Introduction: Financial Stability in East Asia—A Tentative Assessment

Frank Rövekamp, Moritz Bälz, and Hanns Günther Hilpert

Abstract The global financial crisis which began in 2007 has induced a wealth of research on financial stability. Many open issues remain, but a useful framework from which to draw lessons from the crisis has been developed by Stanley Fischer. It assesses the role of monetary policy at the zero interest lower bound, macroprudential supervision and exchange-rate management for the preservation of financial stability. It furthermore assigns important functions to central banks in dealing with bubbles and in fulfilling the role of lender of last resort.

This introduction takes up Fischer's "lessons" in order to put the contributions in this volume into perspective and to draw tentative conclusions on the state of financial stability in East Asia: while there are no signs that a financial crisis is imminent, the task of preserving stability remains nonetheless arduous.

The breakdown of financial stability in Western markets during the global financial crisis of 2007–2010 came as a shock to world governments and the general public alike. After the sub-prime mortgage bubble burst, major financial institutions collapsed or had to be bailed out by massive capital infusions, the banking credit market and the commercial paper market nearly came to a halt, sovereign bonds were charged with huge risk premiums and the real economy took a nosedive. The great crisis has served to remind authorities not only of the well-known virtues of stable monetary and financial policies (as well as of fiscal discipline), it has also taught them some new lessons. East Asia, which had already undergone its own financial crisis in 1997–1998, was largely spared on the financial side this time, but also incurred heavy losses in the real economy. And yet, the jury is still out on the

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*,
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_1

thorny question of how prone East Asia actually is to financial instability. How resilient are East Asia's financial institutions?

Stanley Fischer, for decades one of the most prominent figures in international financial policy-making, has filtered out precisely what central banks, the institutions he considers to be important guardians for financial stability, should learn from the global financial crisis.[1] This introductory chapter first recalls Fischer's lessons, then it takes a look at the contributions to this volume, all of which deal with various aspects of central banking and financial stability in East Asia both from economic and from legal perspectives. As a comparative reference, two chapters on Europe are included, too. Finally, it asks what policy conclusions East Asia's financial authorities can, and indeed should, draw. Is financial stability in East Asia at risk? What institutional weaknesses remain?

Essentially, Fischer's lessons can be summarised in seven points:

1. *Even after reaching the zero interest lower bound, monetary policy can continue to be effective.*
   Before the crisis, it was conventionally held that monetary policy loses its effectiveness if the nominal interest rate reaches zero. Only fiscal policy could make a difference then.[2] The FED, the Bank of England and, prominently, the Bank of Japan, however, even under zero interest conditions were able to increase liquidity and to affect long-term interest rates and thereby influence the private sector's demand for longer term assets. Occasionally, they were even the lenders of last resort. Thus, the policy of quantitative easing (QE) has shown the potential for central banks to act under extreme circumstances. It remains to be seen, however, whether the expansionary monetary measures taken subsequent to the first round of monetary easing are actually doing good to the economies affected.[3]

2. *A strong and robust financial system is of critical importance.*
   The events after 2007 have re-affirmed that, during a global crisis, countries with a weak financial sector suffer a much deeper and long-lasting output crisis. This is because, if the financial system is robust, standard measures such as cutting interest rates encourage investment in machinery equipment, in housing and the purchasing of durable consumer goods, thereby mitigating the downturn. The collapse of the financial system, however, blocks the monetary transmission mechanism, and renders the standard crisis responses ineffective. Measures to improve the resilience of the financial system include capital requirements for banks, an appropriate structure of incentives, corporate governance, risk management, and resolution mechanisms for failing systemically important financial

[1] Fischer (2012, pp. 1–16).

[2] More than 10 years ago, Bernanke et al. (2004) provided evidence that monetary policy even has options at the zero bound.

[3] For a cautious view, see Bean et al. (2010), and Goodhart (2014).

institutions. In this respect, emerging Asia's regulators and financial institutions have shown that they learnt some lessons from their own financial crisis of 1997–1998.

3. *Macroprudential supervision is necessary.*
   Macroprudential supervision is a rather recent notion.[4] It involves supervision related to the entire financial system with a special view on systemic interactions. This implies financial system regulation at a very broad level well beyond the banking system, and requires co-ordination among different regulators. The need for macroprudential supervision is exemplified by the role of the shadow banking system and the bankruptcy of Lehman Brothers during the present ongoing global financial crisis.

   The respective policy tools are still somewhat elusive. Beyond awareness-raising by financial stability reports, counter-cyclical capital requirements are sometimes stated as an example. Macroprudential supervision serves to strengthen the role of central banks, as it is they who are entrusted with developing the concept.

4. *Bubbles matter and need to be dealt with.*
   Formerly, the idea was held that central banks should not react to asset prices. This notion has been widely discarded as a result of the financial crisis,[5] although it remains a challenge to identify correctly bubbles with potentially systemic implications and to apply effective counter-measures in a timely manner.[6]

5. *A lender of last resort is needed.*
   Whereas the idea of central banks as lenders of last resort in the case of liquidity crises is well accepted, problems with the concept nonetheless remain. First, it is not easy, in practical cases, to distinguish between a liquidity crisis and a solvency crisis. The existence of a lender of last resort furthermore raises moral hazard issues. Nevertheless, without such a lender, massive costs might be imposed on an economy far surpassing any negative impact of moral hazard.

6. *The exchange rate matters.*
   Erratic fluctuations of the exchange rate produce hugely negative effects, especially for small open economies. Thus, exchange rate management to absorb the fluctuation margins by meaningful interventions in the currency markets can be

[4] Galati and Moessner (2011) provide a comprehensive overview about the issues at hand. For a short assessment, see Claessens and Kose (2013, p. 37).

[5] See, for example, Dell'Ariccia et al. (2010), Claessens and Kose (2013, p. 36).

[6] For a discussion on adjusting monetary countermeasures, see Bean et al. (2010).