Changing Face of Financial Intermediation and Its Impact on Emerging Economies

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IX Annual Seminar on Risk, Financial Stability and Banking
Central Bank of Brazil
15 August 2014, São Paulo

* Views expressed are my own, not necessarily those of the BIS.
“Global liquidity”

- Global factor associated with credit availability and compressed risk premiums
- Strong cross-border element
- Driven by monetary policy at the centre
Global liquidity: two phases

- First phase of global liquidity (2003 - 2008)
  - Bank-driven
  - Key theme is leverage
  - Main actors: European banks intermediating US dollar credit

- Second phase of global liquidity (2010 - )
  - Bond market-driven
  - Key theme is search for yield
  - Main actors: asset managers with global reach
Year-on-year rate of growth in international bank claims
In per cent
Where to draw the boundary in international finance?

- Conventional approach to international finance presumes “triple coincidence” of
  1. Economic territory defined by national income boundary
  2. Decision-making unit
  3. Currency area

- In world with globalised finance, the triple coincidence no longer holds
Traditional approach:
Start with boundary for national income accounting
Traditional approach:
National income boundary defines decision making unit
Traditional approach:
National income boundary defines currency area

Economic territory 1

- Central bank 1
- Residents in 1

Economic territory 2

- Central bank 2
- Residents in 2

Exchange rate
Traditional boundaries ...  
... are not sufficient in understanding the second phase of global liquidity
Emerging market economies¹ (weighted average)

Gross issuance of international debt securities by EM non-bank corporations: amount outstanding at end-June 2014

¹ Bulgaria, Brazil, Chile, China, Colombia, Czech Republic, Estonia, Hong Kong SAR, Hungary, Indonesia, India, Iceland, Korea, Lithuania, Latvia, Mexico, Malaysia, Peru, Philippines, Poland, Romania, Russia, Singapore, Slovenia, Thailand, Turkey, Venezuela and South Africa.

Sources: Dealogic; Euroclear; Thomson Reuters; Xtrakter; BIS.
Projected redemptions on international debt securities of EM non-bank corporations

Emerging market economies, in billions of US dollars
Annual gross issuance of international debt securities by EM non-bank corporations: nationality basis

Emerging market economies\(^1\) (weighted average)

Sources: Dealogic; Euroclear; Thomson Reuters; Xtrakter; BIS.

\(^1\) Bulgaria, Brazil, Chile, China, Colombia, Czech Republic, Estonia, Hong Kong SAR, Hungary, Indonesia, India, Iceland, Korea, Lithuania, Latvia, Mexico, Malaysia, Peru, Philippines, Poland, Romania, Russia, Singapore, Slovenia, Thailand, Turkey, Venezuela and South Africa.
Annual gross issuance of international debt securities by EM non-bank corporations: residence basis

Emerging market economies\(^1\) (weighted average)

1 Bulgaria, Brazil, Chile, China, Colombia, Czech Republic, Estonia, Hong Kong SAR, Hungary, Indonesia, India, Iceland, Korea, Lithuania, Latvia, Mexico, Malaysia, Peru, Philippines, Poland, Romania, Russia, Singapore, Slovenia, Thailand, Turkey, Venezuela and South Africa.

Sources: Dealogic; Euroclear; Thomson Reuters; Xtrakter; BIS.
Longer maturity of outstanding debt securities

- Maturity of debt securities has been increasing
- Average maturity of outstanding EME non-bank corporate international debt securities now exceeds 8 years
- Longer maturities have two effects
  - Mitigates roll-over risk for borrowers
  - But only at expense of increased duration risk for investors
- Longer duration may exacerbate potential for non-linear market disruptions due to flight by investors
- Possibility of perverse impact of increased maturity on roll-over risk if non-linear disruptions shut down dollar bond market for extended period
Projected redemptions of securities of EM non-bank corporations: by nationality basis

Emerging market economies¹ (weighted average)

![Graph showing projected redemptions of securities of Emerging Market non-bank corporations by nationality basis. The graph illustrates the issuance of debt securities on any market and international debt securities in USD billions from 2016 to 2030.](image)

1 Bulgaria, Brazil, Chile, China, Colombia, Czech Republic, Estonia, Hong Kong SAR, Hungary, Indonesia, India, Iceland, Korea, Lithuania, Latvia, Mexico, Malaysia, Peru, Philippines, Poland, Romania, Russia, Singapore, Slovenia, Thailand, Turkey, Venezuela and South Africa.

Sources: Dealogic; Euroclear; Thomson Reuters; Xtrakter; BIS.
Yields of local EM government bonds and the EM exchange rates

The black vertical line corresponds to 1 May 2013 (FOMC statement changing the wording on asset purchases).

Countries included: Brazil, India, Indonesia, Malaysia, Mexico, the Philippines, Poland, South Africa and Turkey.
“Leverage-like” behaviour without leverage

- Relative performance evaluation
  - Ranking influences asset gathering ability
  - “The real business of money management is not managing money, it is getting money to manage” [WSJ 16/11/95]
  - Selling volatility through writing straddles and then hedging price moves with delta hedging
- Marking to market with thin secondary market
- Risk limits and mandates on minimum credit quality
  - What scope for feedback loop with real economy?
- What scope for interactions with other regulatory/accounting restrictions in place for governance motives?
Elements in possible distress loop

1. Steepening of local currency yield curve
2. Currency depreciation, corporate distress, freeze in corporate CAPEX, slowdown in growth
3. Runs of wholesale corporate deposits from domestic banking sector
4. Asset managers cut back positions in EME corporate bonds citing slower growth in EMEs
5. Back to Step 1, and repeat...
Leverage is not the only source of market disruptions

- Our understanding of crisis propagation is heavily influenced by experience of 2008 crisis
  - 2008 crisis was made more potent by leverage
  - However, it does not follow that future bouts of market disruptions must follow the same mechanism as the past
- Long-term investors may be subject to forces that lead to actions that are similar to leveraged players
  - Risk mitigation or hedging techniques
  - Incentives that arise from relative performance evaluation
- All these mechanisms are sharper when prices are more sensitive to shifts in sentiment
Unfamiliar problems

- Asset managers (not banks) are at the heart of transmission mechanism in the Second Phase of Global Liquidity
- Textbooks say long-term investors are benign, not a force for destabilization
- How do we adjust to the new world?