

EABER WORKING PAPER SERIES

PAPER No.50

MANAGING FINANCIAL RISKS

SUNIL SHARMA

IMF-SINGAPORE REGIONAL TRAINING INSTITUTE

PAPER PREPARED FOR DISCUSSION AT THE
*FINANCIAL SECTOR REFORMS AND ECONOMIC INTEGRATION IN ASIA, IN CONJUNCTION WITH THE
INSTITUTE OF WORLD POLITICS AND ECONOMICS/INSTITUTE OF ASIA PACIFIC, CASS.*
BEIJING 14 - 15 MAY 2009



Managing Financial Risks

Remarks by Sunil Sharma

Director, IMF-Singapore Regional Training Institute

Seminar on Asian Economic Integration: Financial and Macroeconomic Issues

Beijing, China, May 14 -15, 2009

The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.

Outline

- Financial Stability Analysis
- The Crisis and Shocks to EMs
- Managing Sovereign Liquidity
- Regulatory Reforms
- “Regional” Issues

Framework for Financial Stability Analysis

Sectoral Balance Sheets:

- Non-financial (Households, Firms)
- Financial
- Government
- External

Financial Soundness Indicators:

- Leverage
- FX exposures
- Return on assets
- Asset (incl. real estate) prices

Quantitative and qualitative information on:

- Data issues
- Domestic cross-sectoral balance sheet linkages
- Government influence on the other sectors
- Cross-border financial linkages

Framework for Financial Stability Analysis

Financial Sector Vulnerabilities

Risk Exposures:

- Credit
- Market
- Liquidity
- Operational

Capacity to absorb shocks

- Capital
- Earnings
- Liquidity

Financial Soundness Indicators:

- Asset quality
- FX and interest rate exposure
- Market liquidity
- Capital ratios
- Earnings

Market indicators:

- Equity prices
- Credit spreads
- Price of derivatives
- Credit ratings
- Qualitative information on lending rules

Stress Tests

Framework for Financial Stability Analysis

Institutional framework, financial stability policies, other policies:

- Legal, institutional, and structural issues
- Accounting, disclosure, and governance rules and practices
- Insolvency regime & creditor rights
- Regulation and supervision
- Systemic liquidity arrangements (payments system, markets for liquidity, LOLR)
- Policies affecting risk taking (guarantees, taxes, subsidies, exchange rate regime)

Qualitative analysis of framework and practices:

- Regulation and supervision
- Liquidity arrangements
- Accounting, disclosure, and governance
- Insolvency regime and creditor rights
- Deposit insurance system and other relevant policies affecting risk taking

Surveillance

- Data provision
- Standards and codes
- Information availability and transparency
- Macroeconomic surveillance
- Financial sector surveillance
- Assessments of frameworks, policies, institutions, and markets
- Multilateral and regional perspectives

Questions

- Identification and analysis of macro-finance linkages
- Role of financial sector in initiating and amplifying shocks
- Potential cross-border contagion
- Assessment of risks of financial crises
- Role of the financial sector in enhancing growth and fostering stability

Operational Issues

- Absence of an overarching analytic framework
- Linkages are not yet fully understood
- Role of expectations
- Increased complexity of modeling and prediction
- Institutional diversity across countries
- Data constraints

The New Environment...

- Increasingly open financial markets
- Rise in cross-border capital flows
- Possibility of rapid reversals in capital flows, and contagion from abroad
- Rapid portfolio shifts that may entail huge exchange rate overshooting to elicit appropriate current account responses
- Large balance sheet effects
- Large potential financing needs

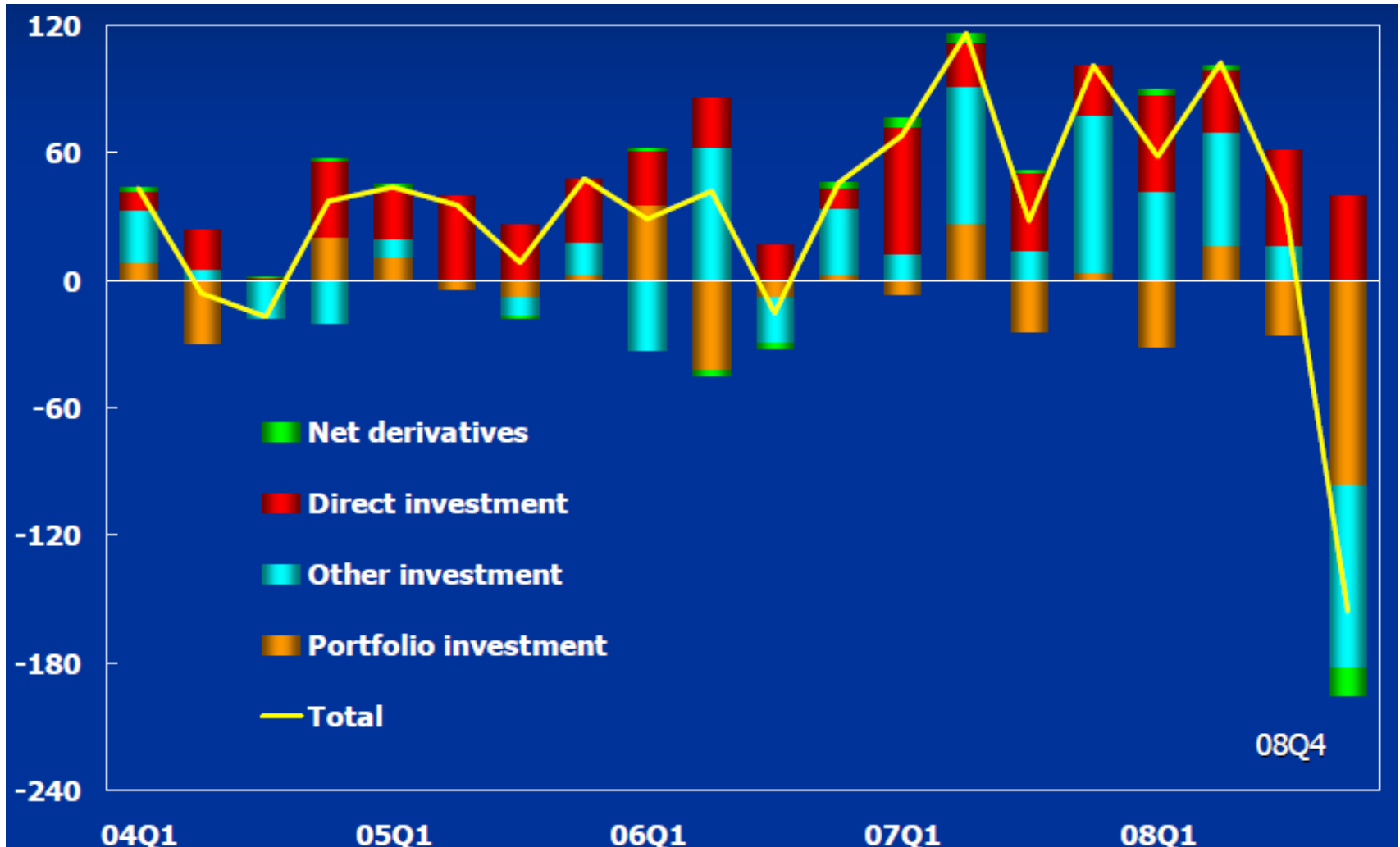
...and the Implications for EMs

- Managing expectations of domestic and foreign investors is very important
- Much greater uncertainty attached to estimates of financing needs
- Financing may have to be provided in anticipation of need
- Important role for mechanisms that give EMs access to liquidity to deal with capital flow reversals and contagion

The Crisis and Shocks to EMs

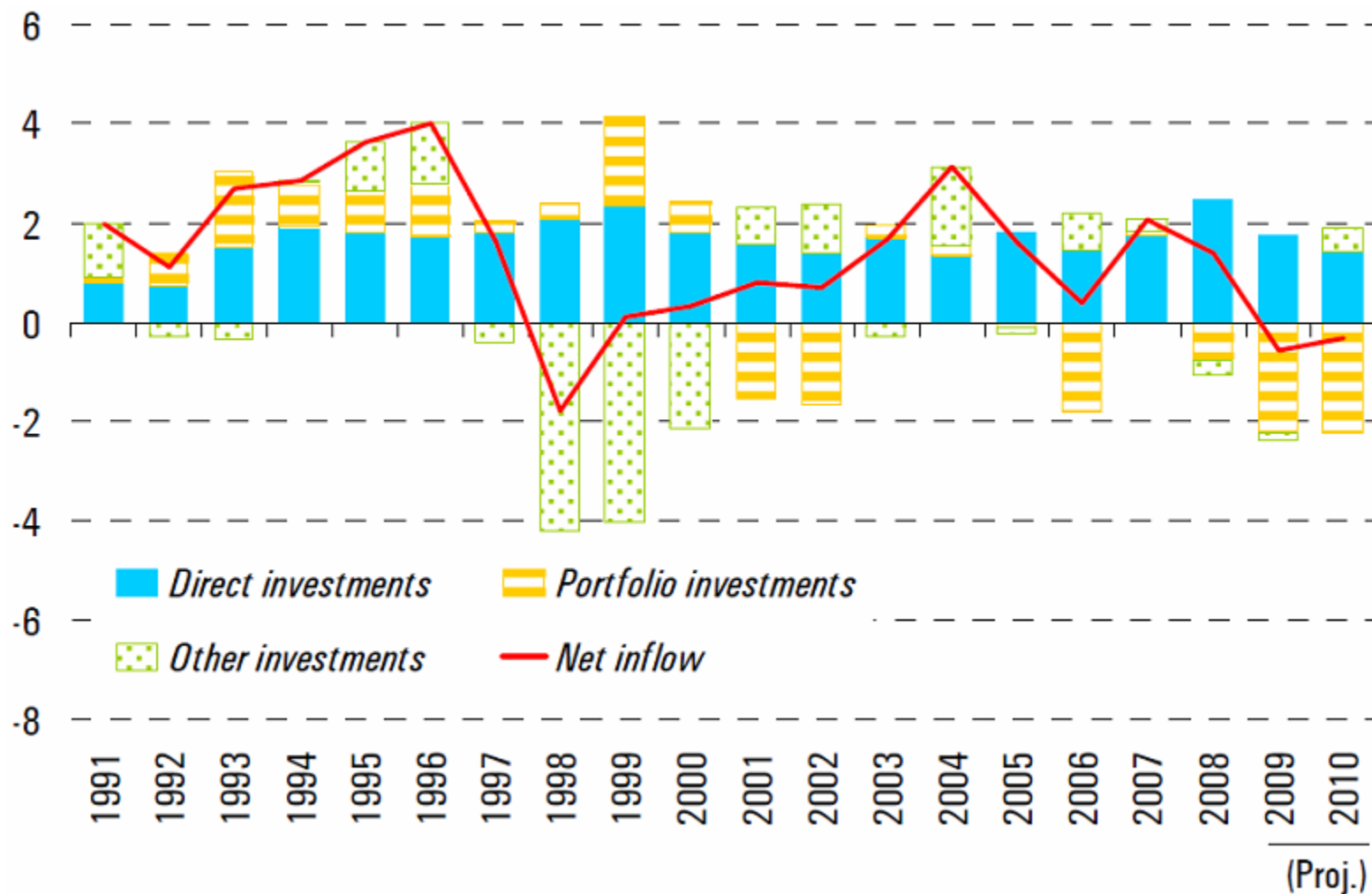
- Collapse in export demand
- Sudden stop in capital inflows due to global deleveraging

Emerging Economies: Net Capital Flows (US\$ billions)



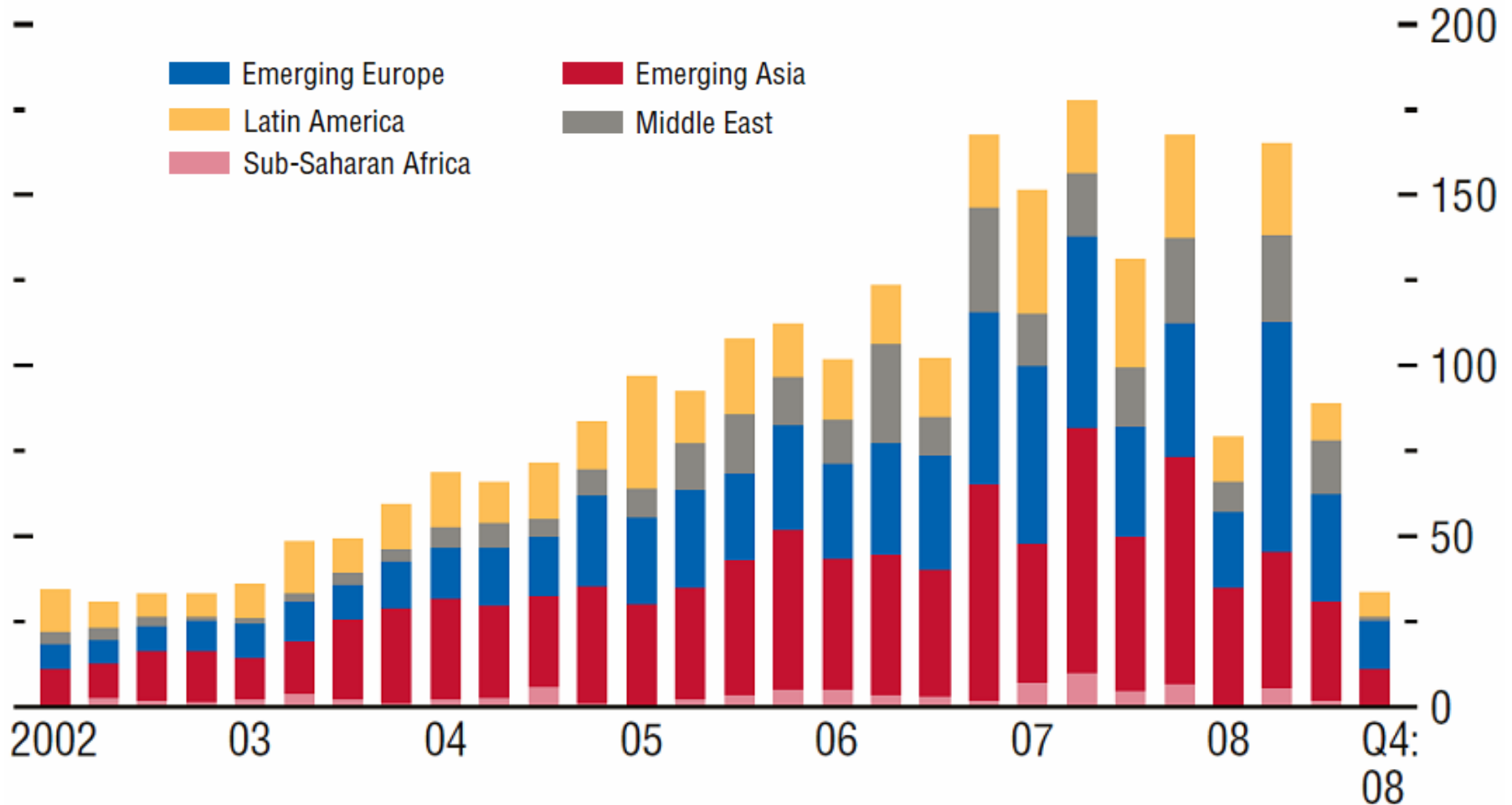
Source: IMF

Emerging Asia: Net Private Capital Flows (percent of GDP)



Source: IMF

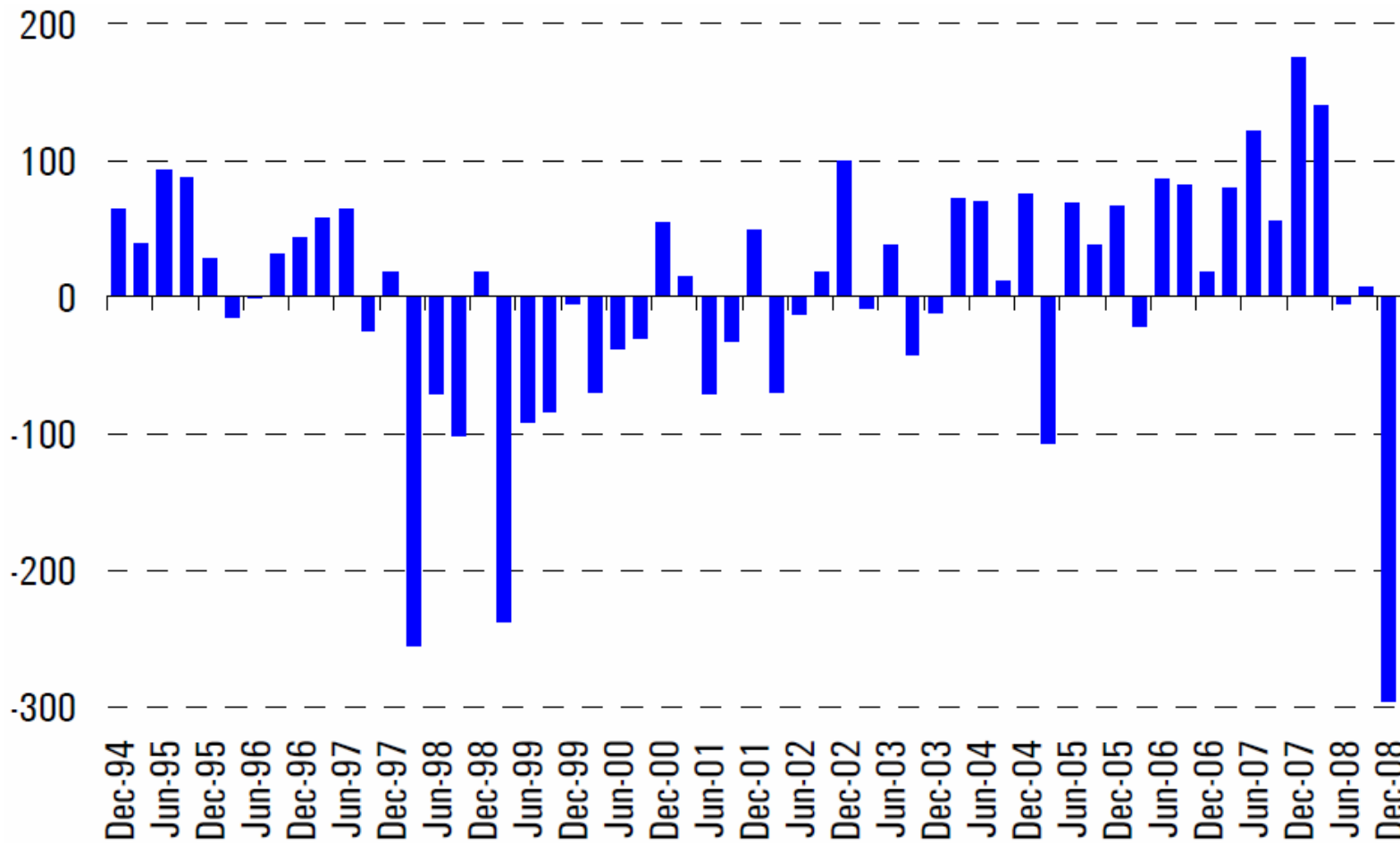
Inflows to Emerging Economies (Bond, Equity and Loan Issuances, US\$ billions)



Source: IMF

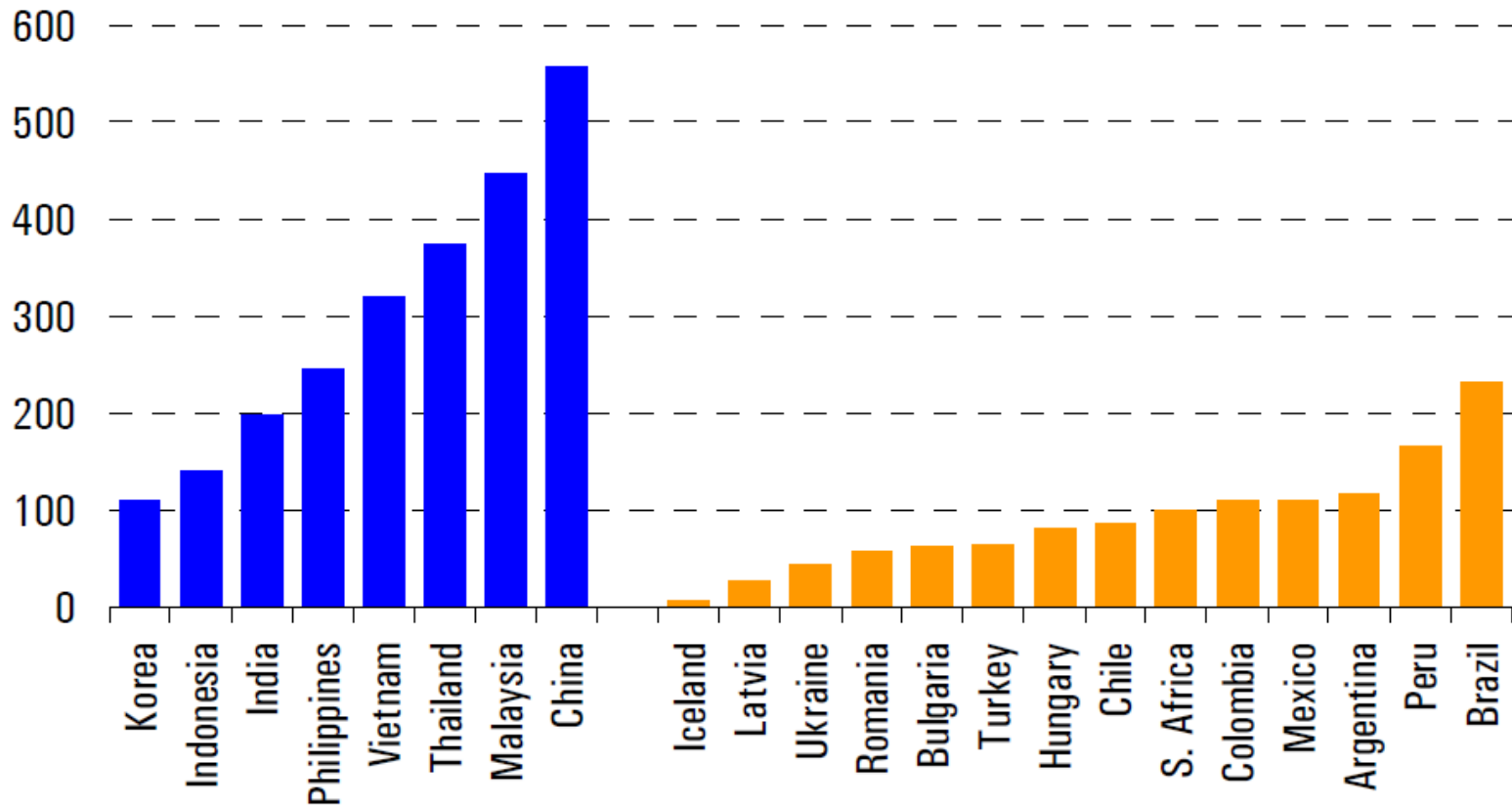
Changes in International Claims of Reporting Banks vis-à-vis Asia

(Adjusted for exchange rate changes; US\$ billions)



Source: BIS

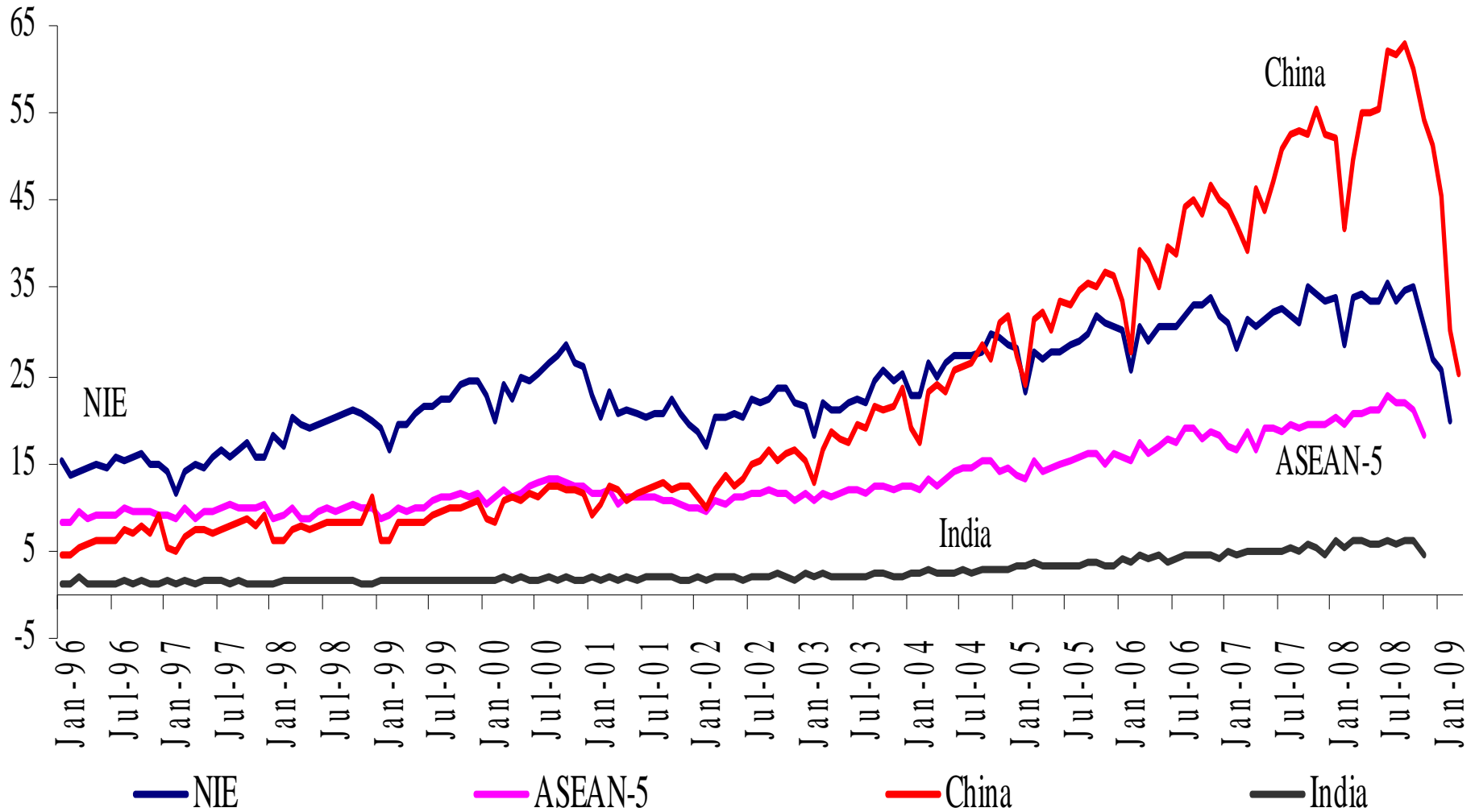
Foreign Reserves over External Financing Requirements (percent)



Source: IMF

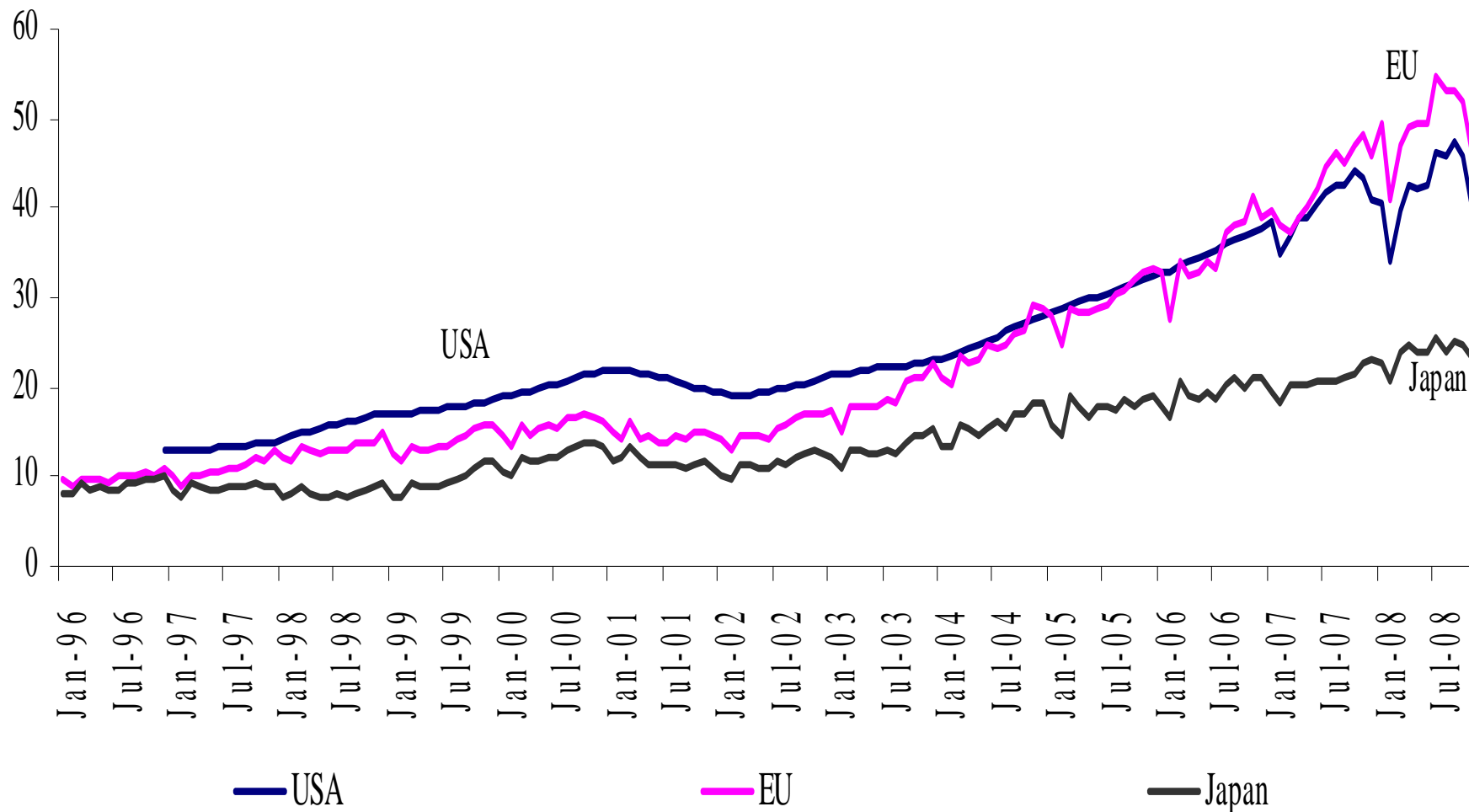
Gross international reserves (December 2008) in percent of external debt maturing in 2009 (projected) plus projected current account deficit for 2009

Total Exports to Japan, EU and USA: ASEAN-5, China, India, NIE (US\$ billion)



Source: CEIC, IMF

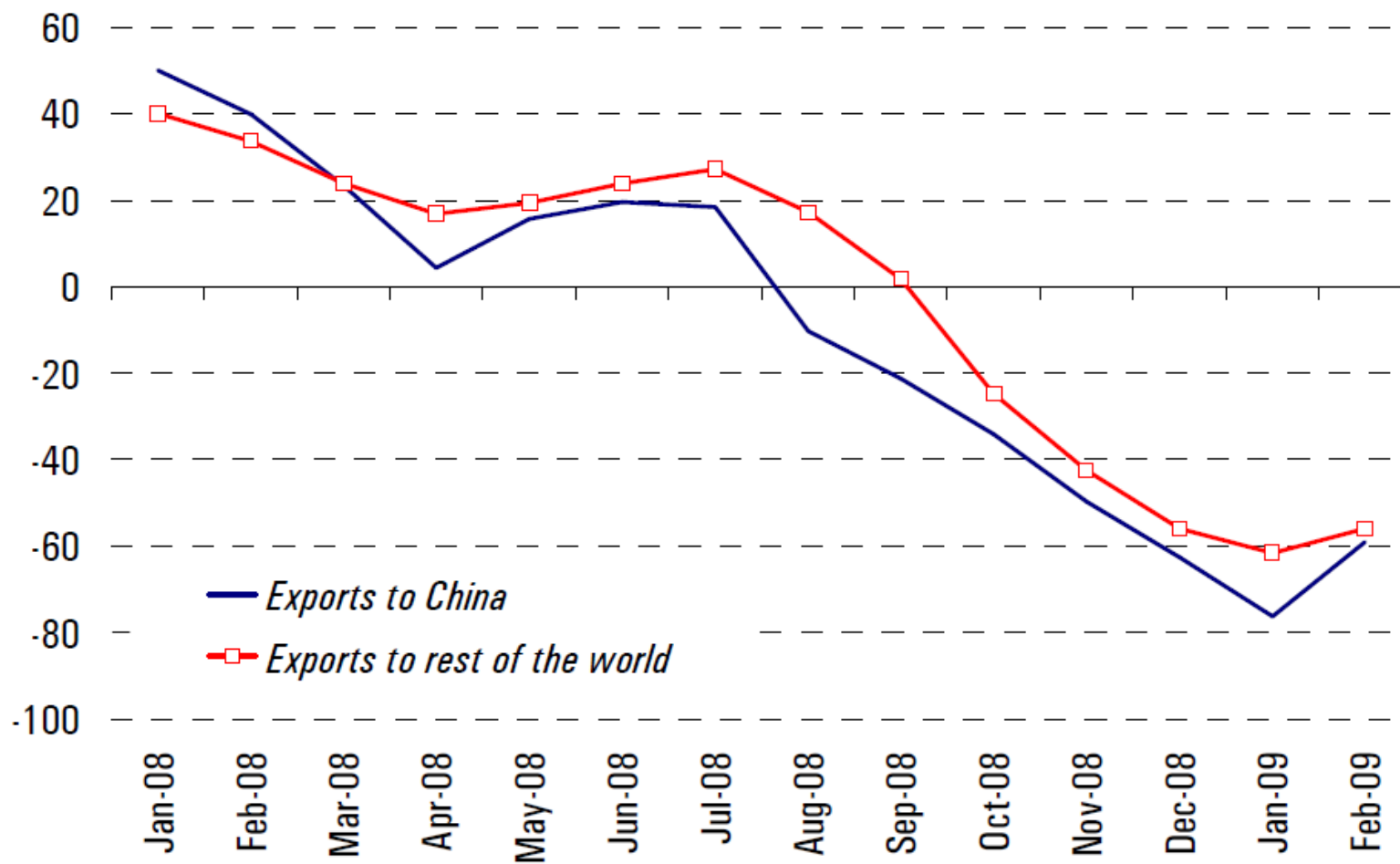
Total Exports of ASEAN-5, NIE, China and India to Japan, EU, and USA (US\$ billion)



Source: CEIC, IMF

Data for USA before Jan-2007 are 12-month moving averages

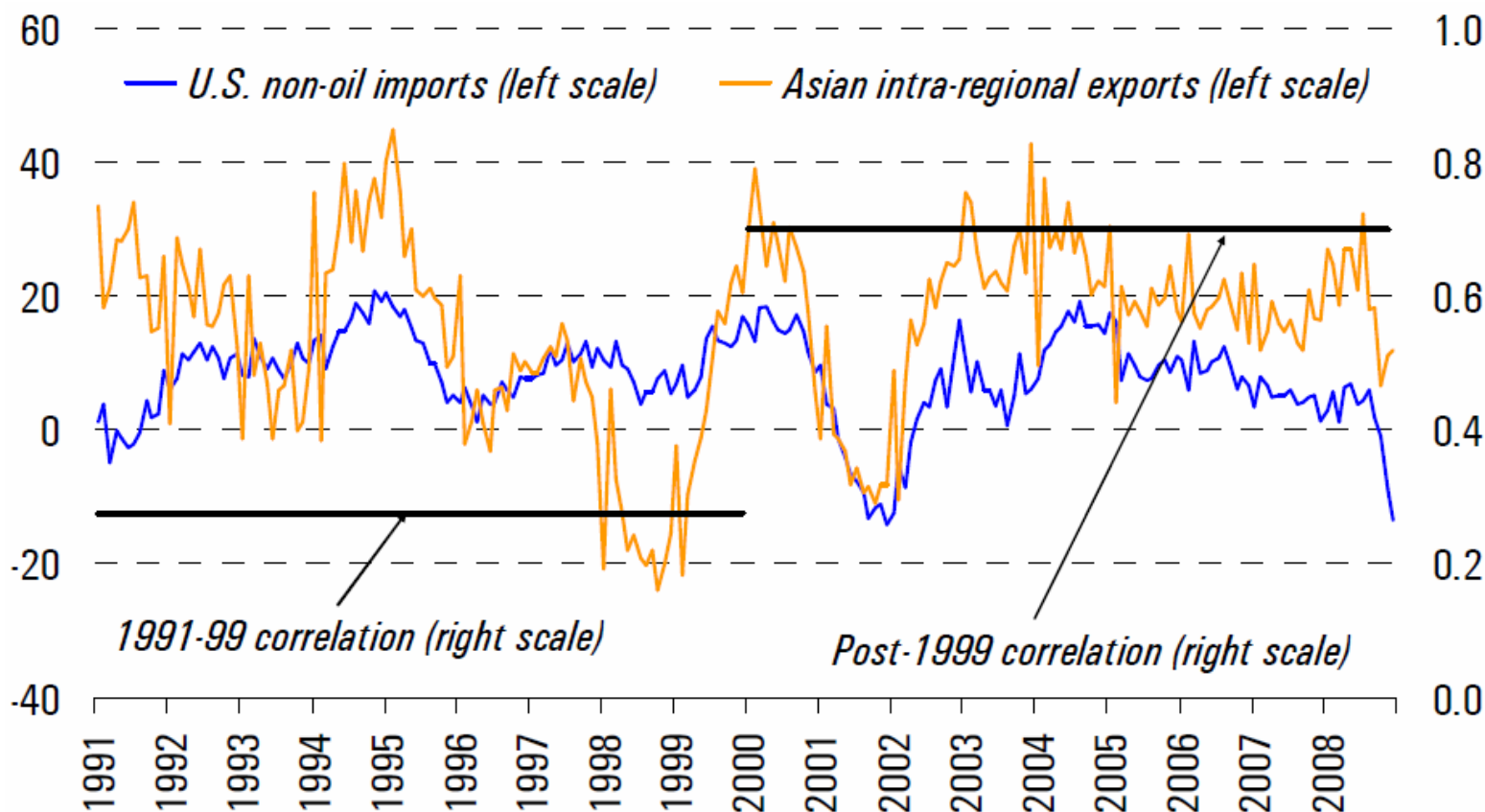
Emerging Asia (Excl. China and India): Direction of Exports (3-mth percent change of 3-mth moving average, SAAR)



Source: IMF

Emerging Asia Intraregional Exports and United States Non-Oil Imports

(Year-on-year percent change)



Source: IMF

Emerging Asia includes China, Hong Kong SAR, Korea, Singapore, Indonesia Malaysia, the Philippines and Thailand

Role of the IFIs

- Surveillance – identification of vulnerabilities and possible crisis triggers
- Liquidity and loan facilities – if policies are poor and vulnerabilities are large then marginal impact of IFI resources on crisis prevention is also low
- Technical Assistance – capacity building

Sovereign Liquidity Management

1. Foreign exchange reserve accumulation
2. Contingent financing
 - Private Contingent Credit Lines (CCLs)
 - Liquidity facilities at the IMF
 - Flexible Credit Line (FCL)
 - High-Access Precautionary Arrangements (HAPAs)
 - Regional reserve pooling arrangements

IMF's Flexible Credit Line

- Pre-set qualification criteria
- Term of 6 months, or 12 months with a mid-year review of eligibility; renewable
- No cap and access determined on a case-by-case basis
- Flexible disbursement; large upfront access
- Repayment period of 3.25 to 5 years

IMF's HAPAs

- High access; possibly frontloaded
- Simplified cost and maturity structures
 - new time and level-based charges
 - commitment fees that increase with size of precautionary arrangements
 - Elimination of time-based repurchase expectations
- Variable frequency of reviews
- Review based focused conditionality

Regional Reserve Pooling Arrangements

Benefits:

- lower costs through co-insurance
- possibly greater automaticity
- complements resources provided by IFIs
- may deepen dialogue within the club

Costs:

- operating costs, including the costs of a surveillance system

Regional Reserve Pooling Arrangements

(contd.)

- Does the pooling truly diversify risks
- To what extent does it provide assured funding
- Nature of regional surveillance
- Pool conditionality and its relationship to IFI conditionality
- Coordination of decision making with other IFIs
- Seniority of claims relative to IFIs

Regulatory Reforms Suggested by the On-going Crisis

- Wider perimeter for prudential regulation
- Leverage and procyclicality
- Market discipline and information gaps
- Strengthened cross-border and cross-functional regulation
- Improved systemic liquidity management
- Governance and remuneration issues

“Regional” Issues

- Regional cooperation on trade, financial development and stability issues
- National and regional surveillance systems
- Stronger regional networks of public officials at all levels
- Data generation, collection, and analysis
- Human capital and skills development