49th SEACEN Governors' Conference and High-Level Seminar

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Right Honorable President, Honorable Finance Minister, Governors, Excellencies, and Distinguished Guests. Good morning! It is a great pleasure to join you today for the 49th SEACEN Governors′ Conference and High-Level Seminar. I would like to express my gratitude to the organizers, particularly to Governor Khatiwada of Nepal Rastra Bank, and to all who have contributed to the excellent organization of this event. This has given me a wonderful opportunity to again visit this beautiful country.

This conference on **"Financial Sector Development Strategy for Inclusive Growth"** takes place at an important time for the economies and financial systems of emerging and developing Asia.

Asia has made great progress over the last decade, not least in reducing external debt, lowering corporate leverage and allowing greater exchange rate flexibility. This has set the region on a high growth path, supported by financial systems that have remained robust in the face of the global financial crisis. But this year we have seen increased financial volatility in anticipation of tapering by the U.S. Federal Reserve, and more importantly growth prospects have weakened a little. Indeed in October we downgraded our forecast for the emerging Asia region by almost a full percentage point relative to six months ago.

Nevertheless, developing the financial sector continues to hold the promise of sustained and more inclusive growth. But there are medium-term challenges that have to be addressed first. I would like to focus on some of these as well as the near-term challenges.

Medium-term challenges

Limited access to financial services by a large portion of the population hinders inclusive growth and constrains the region′s economic potential. So the challenge is boosting access to financial services, and in particular access to banks. Here in Nepal, the central bank is promoting broader access to financial services, both by extending the reach of banks and through microcredit institutions. Increasing financial inclusion is especially critical for countries where social vulnerabilities have recently increased. Financial sector policies could also help channel credit to job-creating small- and medium-size enterprises, which often face severe constraints to accessing finance. This is especially true for countries where the share of the working-age population is rising.

While domestic capital markets in Asia are developing apace, there is still significant room for them to grow, not least to help promote investment. And this is the second challenge I would like to flag. Issuance of local-currency *government* bonds has increased, in part due to the Asian Bond Markets Initiative. But the infrastructure investment needed to sustain growth will require higher availability of long-term funding. Larger *corporate* bond markets can facilitate financing of these infrastructure projects, and also help banks diversify the maturity structure of their liabilities.

Third, there is the challenge of greater financial market integration. Asia's financial markets are not as integrated among themselves as with the international markets. For instance, cross-border financial flows still take place mainly with advanced economies outside Asia. Closer regional financial integration, for example as envisaged in the ASEAN Economic Community by 2015, could also help channel funds from net saving countries to borrowers, and enable better risk sharing across countries. Financial market integration will likely advance in the period ahead, creating more opportunities for growth within Asia but also new risks.

The fourth challenge relates to the emergence of nonbanking institutions. As capital markets develop, nonbank financial players will become more prominent, which generates new risks. No doubt they provide a valuable addition in the financial system. However, it is essential to put in place prudent and comprehensive regulatory-supervisory frameworks that extend beyond banks to include the monitoring of the shadow banking sector.

Short-term challenges

I will now turn to the short-term challenges. Earlier this year, with the prospect of tapering of quantitative easing by the U.S. Federal Reserve, Asia faced a wave of capital outflows. While the overall impact has been manageable, some countries such as India and Indonesia have been subject to greater market stress. Market conditions have stabilized and indeed improved in recent months. However, these developments have highlighted the urgency of addressing the region's short-term challenges.

Tapering will eventually come, so Asia needs to be ready, especially those economies with weaker fundamentals and higher exposures to global financial conditions and external demand. In some countries, the effects of tapering could be amplified by domestic financial vulnerabilities arising from high household debt and leveraged corporates. Countries with strong fundamentals and credible policies would be able to offset imported tightening through lower policy rates and fiscal support. But others that have delayed reforms, left fiscal vulnerabilities untackled, or tolerated high inflation, might be forced to respond with a pro-cyclical tightening that would further weaken growth.

A second short-term challenge concerns monetary policy. The current accommodative monetary stance provides some insurance against downside risks in those economies with subdued inflation and slowing activity, and there would be scope for easing should downside risks materialize. But where inflationary pressures and reliance on foreign inflows are high—as in India and Indonesia—or where credit growth has been overly expansionary—as in Mongolia and Lao PDR—monetary policy may need to be further tightened.

There is also the challenge of rapidly rising asset prices and credit growth experienced in some parts of Asia. The resulting financial imbalances need to be addressed through a combination of monetary and macroprudential policies as well as regulation. For example, in China, the priority is to advance financial reforms to prevent a further buildup of risks and foster a more efficient allocation of investment. Macroprudential policies together with strong micro-prudential efforts will continue to play a role in safeguarding financial stability, protecting the financial systems as global conditions tighten.

I would also like to underscore the urgent need to strengthen the regulatory framework. Here in Nepal, the Nepal Rastra Bank is strengthening supervision—diagnostics of individual institutions are being conducted, improvements to the legal framework are in train, and a crisis management framework is being developed. Much has been done in the region, but the process is incomplete. Delays in these reforms are a source of continued vulnerability and are causing regulatory uncertainty that may affect banks' willingness to lend. Financial supervision needs to become more comprehensive, forward-looking, and risk based.

Further work is also needed on the fiscal side. For most countries a moderate pace of consolidation is warranted to rebuild fiscal space. Should growth disappoint, there is generally scope to allow automatic stabilizers to operate and in some cases provide fiscal support. But for countries with high deficits and debt, there would be little room for countercyclical fiscal policy. The case for structural reforms has become even clearer, and the relative calm in the global financial markets offers an opportunity for further progress on this front.

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Finally, I would like to stress that the IMF's mandate calls for it to support the efforts of countries that are addressing many of the challenges that I have just outlined. We continue our efforts to support sustainable financial deepening in countries with shallow financial systems. We continue to support members in developing policies to tackle volatile capital flows, and in preparing for and managing spillovers from the anticipated scaling back of monetary accommodation in the advanced economies. We are tracing out the interconnections within countries—say, between the financial sector and the real economy—and between countries. In today's interconnected world, the spillovers from domestic policies may well feed back to where they began, and we have been giving these implications a lot more attention in our surveillance. The IMF also stands ready to provide financing in support of appropriate adjustments and reforms, as an essential element of the global financial safety net. We also continue to strengthen the IMF's lending toolkit—for example, we are exploring the possibility of enhanced synergies with regional financing arrangements.

In closing, let me say that policymakers' responses will, of course, need to be tailored to individual countries' needs. Nonetheless, we can continue to learn from each other's experiences. We at the IMF look forward to contributing to financial sector development in Asia, and even closer cooperation with SEACEN members.

Thank you.

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