



# THE FINANCIAL THREAT TO ASIAN ECONOMIC PROGRESS

UNDERDEVELOPED CAPITAL MARKETS COULD  
CRIMP THE REGION'S GROWTH

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Asia has become much richer, not only absolutely, but relatively, too. Over the past 10 years, its share of global gross domestic product has increased from 24 percent to 31 percent. Its vast population is increasingly urban and middle-class.

This growth has been achieved by following an “old economy” industrial and export-driven model. Because this model depends on low wages and the acceptance of environmental damage, it is unsustainable. Success drives up wages and wealthier populations typically demand cleaner and healthier environments.

As we first pointed out in *Asia Finance 2020: Framing A New Asian Financial Architecture*, a study we conducted with the Fung Global Institute in 2013, Asian economies will need to modernize in order to continue growing toward Western levels of per capita income. They will need to depend less on exports, industry, and unpriced environmental inputs, and more on regional consumption, services, and innovation.

This transition needs a financial system that can facilitate it. Specifically, it needs the free flow of goods and capital within Asia, a ready supply of finance for new enterprises, and stable funding for trade and infrastructure.

Alas, having evolved to serve the needs of the old industrial model, the Asian financial sector is ill-suited to this role. Inconsistent national regulations and barriers to foreign competition drive up the cost of cross-border business. Over-reliance on asset-based lending restricts finance for young and innovative firms. And shallow capital markets limit the funding available for infrastructure and other major projects.

If the Asian financial sector fails to adapt, Emerging Asia risks getting stuck as a group of middle-income nations.

## UNDERDEVELOPED CAPITAL MARKETS

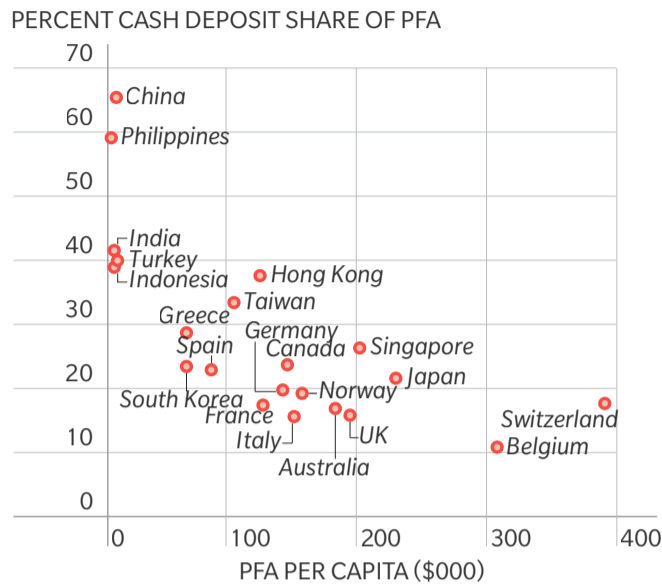
Long-term financing of the kind required by large infrastructure projects is best supplied by “real money” investors, such as insurers and pension funds. Unlike banks, which largely rely on short-term funding, insurers and pension funds have stable, long-term liabilities. This allows them to invest more in long-term and illiquid assets.

Yet most Emerging Asian countries suffer from a paucity of real money investors. (See Exhibit 1.) Whereas Westerners typically build up personal financial assets to provide incomes in retirement, retirees

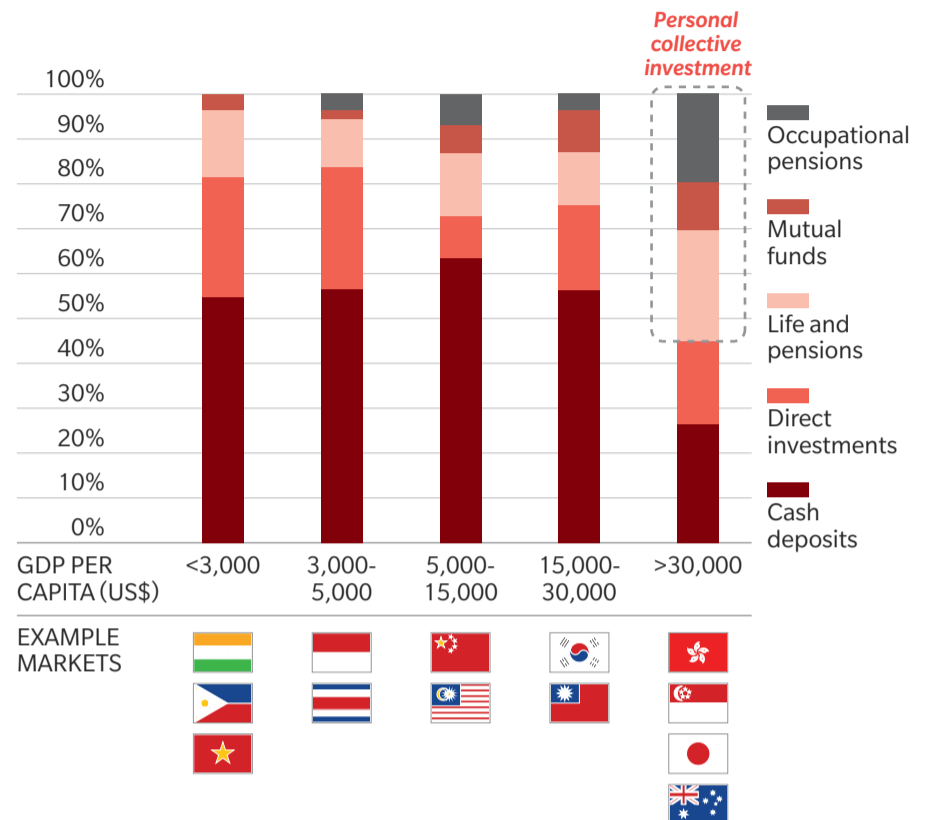
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## EXHIBIT 1: DISTRIBUTION OF PERSONAL FINANCIAL ASSETS (2012)

HELD IN CASH, DEPOSITS, AND SAVINGS ACCOUNT FOR EACH COUNTRY



FINANCIAL DEEPENING AT HOUSEHOLD LEVEL, 2012\*



Source: IMF world economic outlook database, OECD, Oliver Wyman analysis  
\* Excludes home equity

in Emerging Asia still rely heavily on their children to support them in old age. And what personal financial assets they do have are disproportionately held in cash and deposits.

The flipside of this allocation of savings is underdeveloped capital markets and an over-reliance on short-term bank funding. Bank lending accounts for 47 percent of financing in Asia and 160 percent of GDP. In the United States, the comparable figures are 22 percent and 95 percent.

A sustainable mix of funding sources will need to include a bigger contribution of securities from Asian issuers. Home market demand for these will naturally rise as Asian personal financial assets grow. However, governments can accelerate the transition with policies that encourage savings via pensions or fund managers. The most direct way is through compulsory private pensions, which exist in Singapore, Australia, and now Malaysia. Malaysia is an especially good example, as its pension assets have risen to 46 percent of GDP due to its mandatory pension program.

Alternatively, Asian governments can give tax breaks for savings in long-term vehicles and direct pooled investments in rural infrastructure, as in the United States and many European countries.

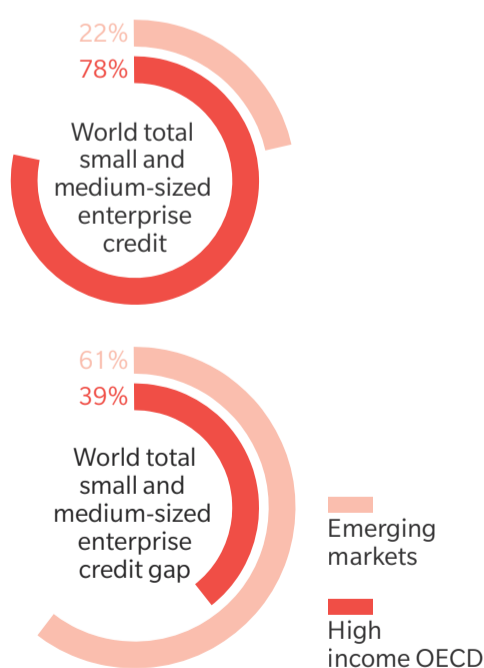
## SUPPORT FOR SMALL AND MEDIUM-SIZED ENTERPRISES

Innovation tends to occur in new and small firms. Between 1993 and 2009, small and medium-sized enterprises accounted for 65 percent of new job creation in the United States and produced 16 times more patents per employee than large firms in the high-tech industry. If Asian economies are to modernize, startups and risk-taking will need to be encouraged. Small and medium-sized enterprises will need ready access to funding as they grow and evolve.

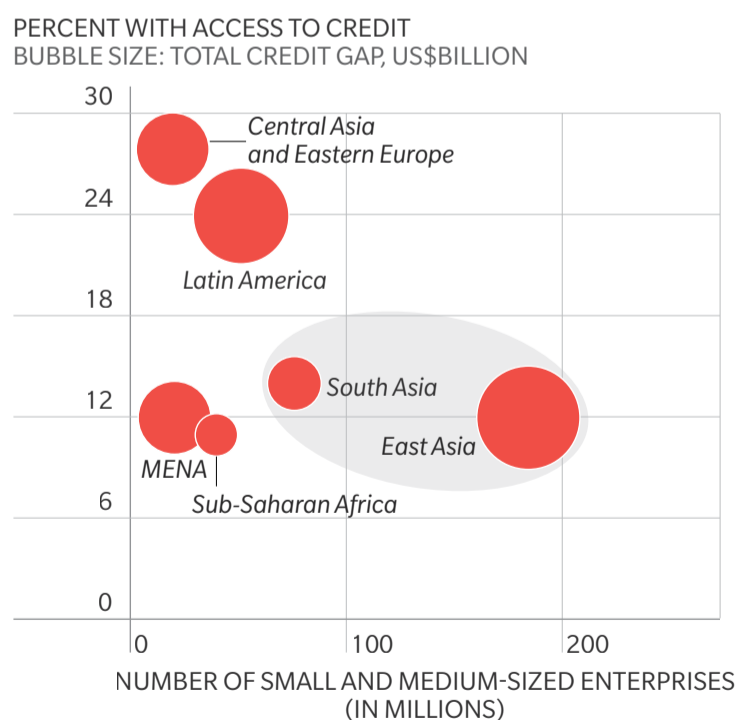
However, banks in Emerging Asia are ill-equipped to extend credit to small and medium-sized companies, especially those in the services or high-tech sectors. To compensate for limited data and cash-flow lending capabilities, Asian banks typically rely on taking security against tangible assets. However, firms that provide services or aim to produce intellectual capital can rarely provide such collateral.

### EXHIBIT 2: GLOBAL SMALL AND MEDIUM-SIZED ENTERPRISE FINANCING GAP

TOTAL CREDIT GAP RELATIVE TO OUTSTANDING SMALL AND MEDIUM-SIZED ENTERPRISE CREDIT GAP 2011



SMALL AND MEDIUM-SIZED ENTERPRISE FINANCING GAP 2011



Source: IFC, Oliver Wyman analysis

Governments can help by providing credit guarantees or seed capital for qualifying small and medium-sized enterprises. Moves in this direction are already happening in Singapore and China and can be further supported by credit bureaus.

Governments can also improve data availability to banks that lend to small and medium-sized enterprises. We recommend this not only at the national level but also at a regional – Pan Asia-Pacific – level.

The flow of capital to smaller companies is further threatened by the new Basel III rules, which will significantly increase the amount of capital that banks must hold against loans to smaller companies. As we are starting to see in Europe, this means lower returns to banks or higher prices for small firms and, thus, less lending to them.

Asia missed the opportunity to coordinate lobbying of the Basel Committee early on in the process. This was a result of the complacent assumption that Asian financial firms had plenty of capital and liquidity. It was also difficult for regulators from countries as far apart in economic development and regulatory sophistication as Japan and Cambodia to achieve a unified view.

The “post-Basel III economics” of lending and trading businesses, combined with realistic scenarios around a Chinese slowdown and political instability in parts of Asia, paint a challenging picture for the Asian banking sector.

Asian banks and regulators must now quickly embark on an agenda of gaining a deeper understanding of product-level economics.

## ASIAN FRAGMENTATION

Asian dependence on exports to the West can be reduced only by more Asian consumption and intra-Asian trade. However, intra-Asian trade is hindered by impediments to the flow of capital within the region and to cross-border financial business.

One such impediment is mechanical. Cross-border payments systems for large, wholesale transactions in Asia are generally state-of-the-art. However, cross-border retail transactions are less developed and threaten to hold back the burgeoning area of e-commerce.

**47%**  
The percentage  
of financing  
that is bank  
lending in Asia  
versus only  
22 percent  
in the  
United States

Asian regulators should seek to improve current payments systems by:

- Ensuring the provision of payment-and-settlement infrastructure with multiple-currency capabilities and extended services covering lower value transactions.
- Supporting international standards on e-payments to enhance efficiency and connectivity.
- Closely monitoring and ensuring the security of digital payment solutions which emerge in the private sector.

An uncoordinated approach to regulation also drives up the cost of cross-region business, as financial firms need to comply with materially different regimes. More importantly, regulatory inconsistency can create systemic risk. For example, different levels of deposit insurance create the potential for massive and destabilizing cross-border flows during stress periods.



## MAKING PROGRESS

Asia remains the world's most economically dynamic region. To continue its progress, however, Asia's financial sector must modernize. Bringing this about won't be easy, especially at a time of global financial and political instability. As highlighted in our article on political risk, the difference between success and failure can have major consequences for the future of these nations. (See "Political Risk in Emerging Markets," on page 15.) But the profound economic reforms made over recent decades show that it can be done, and that emerging Asian countries can continue their extraordinary progress.

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