EXPLAINER

Why Balancing Asia's Economies Is an Increasingly Perilous Act as Digitalization Accelerates

Digital disruption in the banking sector is transforming the way people access financial services and products. Photo credit: Asian Development Bank.

Policy challenges include the shift in financial intermediation away from traditional banks toward digital finance providers.

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Introduction

Macroeconomic management is a growing challenge for policy makers globally as digitalization accelerates during the coronavirus disease (COVID-19) crisis.

The increasing prominence of the digital economy and digital finance calls for a better understanding of how this will affect measures to stabilize the economy and for policies that maximize the benefits and mitigate the risks posed by this trend.

This explainer is adapted from a podcast interview with Asian Development Bank Institute (ADBI) research fellow John Beirne. It draws upon the new book, *Macroeconomic Stabilization in the Digital Age*

, which Beirne co-edited with David G. Fernandez, director of the Sim Kee Boon Institute for Financial Economics at Singapore Management University. The interview is part of the ADBI podcast series, *Asia's Developing Future.*

What are the new challenges faced by policy makers in the digital age?

The rise of the digital age has created challenges for policy makers around the globe in managing their economies, particularly in ensuring macroeconomic stability amid uncertainty. Early work on the impact of technological advancement found that macroeconomic management becomes more complex in this environment given shifting trend productivity and difficulties in estimating potential output.

For emerging market economies, these policy challenges have been exacerbated by the rise of digital finance in the aftermath of the global financial crisis as well as COVID-19, when many of these economies were experiencing large and volatile capital flows. Innovations related to payments systems, maturity transformation, and the allocation of capital can hinder macroeconomic stabilization to the extent that they disrupt the efficacy of policy tools used to manage the economy. Against this background, a key challenge for policy makers is that advances in digital finance have led to a shift in financial intermediation away from traditional banks, with large technology firms increasingly providing financial services particularly over the past decade. This can be a source of regulatory uncertainty for policy makers, which clearly has implications for both financial and macroeconomic stability.

In addition, the so-called "nonbanks" and their involvement in liquidity transformation and leveraged lending creates financial vulnerabilities at the systemic level. These vulnerabilities are amplified given the interconnectedness of nonbanks with the traditional banking sector. Competition from the traditional banking sector for deposits and funding may also lead to excessive risk-taking.

Therefore, while the ongoing diffusion of digital finance into financial intermediation activity can spur economic activity and promote financial inclusion, there may be scope for rising financial fragility and systemic risk. Managing the related uncertainty, while also enabling the realization of the benefits of digital transformation, is a key policy challenge at the current juncture, where the pace of digitalization has accelerated, not least due to the pandemic

What are the implications of digitalization for international capital flows?

Emerging market economies have had to deal with large and volatile capital flows in the post-financial crisis period, and also in the current COVID-19 period. While these flows can have substantial benefits for economies in terms of growth and development, they can also pose risks to macroeconomic stability if not properly managed.

Where capital inflows lead to increases in the volatility of domestic consumption, currency and maturity mismatches, as well as boom and bust cycles in asset prices, achieving macroeconomic stability can be fraught with difficulty. Abrupt capital outflows from emerging economies, which can occur during crisis episodes or periods of amplified uncertainty in financial markets, can also be disruptive to macroeconomic stabilization objectives. In these types of environments, new approaches to capital flow management and improving resilience to capital flow shocks become ever more important. The onset and growth of fintech and its implications for cross-border capital flows is an issue warranting further consideration in this context.

On the one hand, reductions in cross-border transaction costs via digital platforms have helped to improve the efficiency of global value chains. On the other hand, the expansion in cross-border capital flow channels in the digital age places additional challenges on authorities in emerging markets in managing capital flows, with potentially greater exposure to monetary policy spillovers and negative externalities.

How does the situation in Asia and the Pacific compare to other areas of the world?

Asia and the Pacific has developed substantially over the past decade or so in terms of utilizing and adopting digitalization to improve efficiency in their economies, particularly in the area of digital payment systems. The region has been particularly adept at reaping benefits from “leapfrogging technology” using mobile and internet-based solutions.

In addition, it is notable that a number of large global technology firms are Asian firms, with consumers also very much accustomed to operating in a digital world. The adoption of mobile and internet technologies throughout the region has benefited the economy through enhanced overall financial inclusion and related regional economic development.

In line with the broader digital transformation underway in trade, commerce, and payments systems, it’s also worth noting that governments in Asia and the Pacific have been actively supporting the development of smart cities in recent years.

One of the aspects that differentiates the region may be its mindset and openness to shift to newer and more technological-driven ways of doing business. This makes the process of transformation much smoother and facilitates efficiency gains by firms and consumers alike. That said, the shift to digitalization differs across countries in Asia and the Pacific as regards to the rate of take-up of technology and diffusion of digital finance. And this is closely linked to differences in the level of development in digital payments infrastructure and connectivity and broadband penetration in the region with some economies more undeveloped than others, such as in parts of Southeast Asia.

On the whole, however, while Asia and the Pacific are at the forefront in terms of the growth of e-commerce and fintech adoption, it is important for regulators to strike a good balance between enabling the benefits of digitalization while also ensuring that consumers and firms are sufficiently protected.

How well are central banks and financial supervisors adjusting?

Given the implications of digitalization for monetary policy transmission and financial stability, central banks and financial supervisors have had to respond and are still in the process of doing so. For example, in the digital age, the emergence of private, decentralized cryptocurrencies erodes the ability of central banks to affect the money supply. This has led to discussions by central banks globally on whether they should issue their own digital currency. While the scale of private cryptocurrencies is not at the moment at a level that would detrimentally affect macroeconomic stability and the conduct of monetary policy, there still remain questions as to how a central bank digital currency would affect traditional bank operations, particularly in times of financial crisis.

Some academic research indicates that a central bank digital currency would enhance the effectiveness of monetary policy to the extent that these currencies bear interest. Other research indicates that macroeconomic stability is enhanced when a central bank digital currency bears an adjustable interest and that exchange rate fluctuations are more stable in this environment. This latter point is particularly important for central banks in emerging markets that may be subject to bouts of capital flow and exchange rate volatility.

Overall, central banks and financial supervisors have adjusted to the new environment in an effective manner. However, in an era of rapid technological change, particularly in payment systems, they need to be wary of possible risks to financial stability, such as those posed by the growth of private cryptocurrencies as well as by regulatory arbitrage of financial intermediation by nonbanks.

How can policy makers address the challenges posed by digitalization moving forward?

Policy makers need to be aware of the increasing prominence of the digital economy and digital finance and seek to understand better how continued digitalization will affect policies aimed at managing the economy. In particular, the effect of traditional fiscal and monetary policies for stabilization purposes might be less potent in an era of ongoing digitalization. This calls for national authorities to be vigilant of the effects of digitalization and to devise and implement additional targeted policies to aid stabilization, for example, aimed at the nonbank sector. Finally, international policy coordination becomes increasingly important in such an environment.

Resources

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