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Structure Project

Macro-financial Linkages and Financial Deepening in the Pacific Region

Japan Committee for Pacific Economic Outlook

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Macro-financial Linkages and Financial Deepening in the Pacific Region

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PREFACE

This report on *"Macro-financial Linkages and Financial Deepening in the Pacific Region"* is the 13th report in a series of studies conducted by the Pacific Economic Outlook (PEO) Structure Project. PEO/Structure is one of the projects under the Pacific Economic Cooperation Council (PECC) and deals with longer-term structural issues of macroeconomics in the Pacific region.

Through market integration and financial deepening, the pro-cyclical effects of macro-financial linkages appear to magnify global business cycles in the real economy, as evidenced by the current global financial crisis.

In this research, we investigate the interaction between financial volatility and business cycles in the real economy in the Pacific region. In particular, we are concerned with how recent financial innovations/developments affect this interaction process. We are also interested in what role the differences between financial structures play on macro-financial linkages, and more specifically, we would like to know how differences in size and location of financial imbalances and in households' and firms' balance sheets affect the above interaction. Finally, we would like to clarify how these linkages change the role of financial markets on business cycles and its implications on macroeconomic policy management in the economies of the Pacific region.

Japan's lost decade in the 1990s resulted from its bank-based financial development, as opposed to market-based financial development in Anglophonic economies like the United States. The current global financial crisis, however, reveals that either type of financial development is not immune from financial turmoil. On the other hand, financial rehabilitation in Asian crisis-hit economies may or may not be successful in developing less vulnerable bank-based financial development. The business community desperately needs more realistic alternative policy advice.

We are concerned with how we can harmonize these two types of financial development to contain/minimize financial risks along each historical path. From the viewpoint of policy recommendations, at issue may not be whether the policy should be bank-based or not, but what constitutes the best practice in terms of not only short-term and long-term efficiency, but stability with respect to financial intermediation. In fact, we have witnessed the financial sector being involved with more risk-taking rather than financial intermediation, and the nonfinancial corporate sector being dependent on more internal finance than external finance. These tendencies might be short-lived, but misguided macroeconomic management tends to generate huge cumulative economic costs in due course.

As we did in the previous cycles of PEO research on external adjustments under increasing integration, this research will utilize extensive collaboration with a few specialists in academic and/or regional institutions and their inputs into our research as well as information gathering.

This report is a summary of studies conducted by the PEO/Structure Project under the coordination of Dr. Akira Kohsaka.[1] The first section of the report provides an overview, prepared by Dr. Kohsaka, on macro-financial linkages and financial deepening in the Pacific Region. The second section consists of executive summaries of individual countries/regions that were submitted by specialists from each PECC member economy.

The PEO/Structure Project held two International Specialists Meetings in March and September 2010 in Osaka, Japan. These meetings were hosted by the Japan Committee for Pacific Economic Outlook which has been housed in and staffed by the Kansai Institute for Social and Economic Research (KISER).[2] The Committee has been sponsored by the Ministry of Foreign Affairs of Japan and by regional business communities, the relevant organizations of which are the Pacific Resource Exchange Center (PREX) and the Kansai Economic Federation (KEF).

Ambassador Yoshiji Nogami, Chairman of Japan National Committee for PECC (JANCPEC), serves as Chairman of the Japan Committee for Pacific Economic Outlook. Mr. Toshio Takeda, Executive Director, Mr. Kazuhiro Nishiyama, Deputy Executive Director, and Directors Mr. Yutaka Hamafuji and Ms. Machiko Fujita coordinated the management of the PEO/Structure Project. Dr. Janis Y.F. Kea provided editorial support to the PEO/Structure Project.

The PEO/Structure Project presents its reports to the meetings of PECC and the Asia Pacific Economic Cooperation (APEC), forums of government officials and individuals in business, government and academic sectors who are interested in economic issues of the Asia-Pacific region.

For more information on the PEO/Structure Project, contact the Secretariat at the Japan Committee for Pacific Economic Outlook.

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[2] The Kansai Institute for Social and Economic Research (KISER) is a nonprofit organization in Kansai (the region centered in Osaka, Kobe and Kyoto) that has as one of its objectives contribution to the development of the national and regional economies through academic advances. KISER promotes research projects under the cooperation of academia and local business community with the aid of governmental support. For more detail, see the information provided.

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OVERVIEW

OVERVIEW:

MACRO-FINANCIAL LINKAGES AND FINANCIAL DEEPENING IN THE PACIFIC REGION

BY AKIRA KOHSAKA*

Introduction

Focusing on East Asian emerging markets as main targets, this report examines countries' macro-financial linkages to the international capital market and the interactions with developments in their domestic financial systems. The global financial crisis since 2007 has played a significant role in pursuing this line of examination. Moreover, considering the Asian economic crisis of more than ten years ago, it would be interesting, from the above viewpoint, to examine the developments between the two crises. This will be relevant not only for the East Asian and other emerging markets, but will further our understanding of the dynamics of the international capital market and assist in future courses for domestic financial system development.

Among developing economies, emerging markets, including those in East Asia, are those that have intensified financial linkages to the international capital market, and the current global financial crisis will undoubtedly have had large negative impacts. Above all, since the current crisis was triggered by the banking crisis in the United States and Europe, it is not difficult to imagine that those emerging markets that have strong linkages through bank loans would suffer heavily (IMF 2009).

From the viewpoint of emerging markets' linkages to the international capital market, of particular note is the contrast in the external balance between East Asia and Europe. Conventional economic growth theory predicts that international capital will flow from advanced to emerging market economies as water flows from high to low in pursuit of higher marginal product of capital; as a result, expenditures would exceed income (alternatively, investment exceeds savings), generating current account deficits in the recipient countries.

However, conspicuous in the 2000s is the contrast between conventional current account deficits in emerging markets in Europe and unconventional surpluses in East Asian countries. According to an analysis by IMF (2008), a part of the contrast comes, first, from the usual structural factors—namely, large current account deficits in European emerging markets that resulted from liberalization of financial sectors and enhanced growth prospects due to their EU accession, while surpluses in East Asia resulted from insufficient financial sector and capital account liberalization and repressed growth prospects due to various political structures. However, the analysis cannot fully explain how undervaluation of East Asian currencies and/or huge foreign exchange reserves are related to their current account surpluses. In addition, we cannot help but be skeptical about the sustainability of unprecedented large persistent current account deficits in European emerging markets. Furthermore, we wonder whether their fixed exchange rates and capital account liberalization can be continued with a possible sudden stoppage of foreign capital inflow.

Before the Asian economic crisis, the most impor-

* Coordinator, PEO/Structure Project

tant focus of financial deepening in East Asia appeared to be savings mobilization. In fact, despite exceptionally high domestic savings rates, vigorous domestic investment demand required foreign savings beyond domestic savings. In the process, the efficiency of fund allocation deteriorated, investment risks ballooned and then came the currency crisis. After the crisis, the focus shifted to allocative efficiency and risk diversification/ management. Analyzing changes in financial structures in East Asia, Gill and Kharas (2007) argue that, in order to sustain regional trade and investment growth, East Asia should further develop securities markets which have advantages in pricing risks and attracting foreign savings. In reality, however, the current global financial crisis generated serious doubts on the ability of securities markets in evaluating risks, as will be discussed later.

This overview attempts to answer the following questions. First, how are the macro-financial linkages of the East Asian emerging markets characterized in terms of international capital flows and how are they related to the impact of the global financial crisis on the region? Second, to what extent are the capital flows important to these countries' domestic flow of funds and how are the domestic financial developments related to it? Furthermore, how does the global financial crisis affect international capital flows in the region and domestic financial developments, and what policy implications does the economic recovery, after the Asian as well as the global financial crises, have for macroeconomic management and regional financial cooperation regimes?

Our findings to these questions can be summarized as follows:

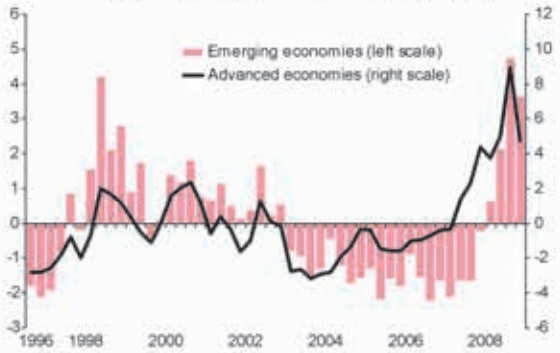
- If we look at the macro-financial linkages between East Asian emerging markets and the international capital market in terms of international capital flows, the composition of capital inflows broadly changed before and after the Asian crisis. For example, in terms of category of capital flows, foreign direct investment (FDI), which is persistent and relatively stable to other types of capital flows, became dominant, and intra-regional flows from old emerging to new emerging economies began to play a larger role than those from the United States, EU and Japan.
- With regard to domestic financial systems in the East Asian emerging markets, it is confirmed that they are significantly less dependent on foreign capital flows and are at higher degrees of financial deepening than in other emerging markets. Moreover, structural reforms in East Asian financial and corporate sectors witnessed some progress. In looking at their role in investment financing for the private sector, however, since the Asian crisis, financial intermediation remains retrenched and their securities market, regarded as an alternative market, did not develop enough to serve as a substitute. As a result, the recovery of their domestic financial systems since the crisis has been far less proportional as compared to their real economic performances.
- Having said this, the current global financial crisis is very unlikely to impose large negative impacts on the East Asian emerging markets as did the Asian crisis. This is probably because of the above-mentioned changes that have occurred in financial linkages and not because of post-Asian crisis development of the domestic financial systems in these countries. Furthermore, post-crisis domestic macroeconomic policies as well as the framework of regional financial cooperation can play only limited roles in preventing the negative impacts of the global crisis.
- Current policy challenges will be, rather, to reestablish flexible macro-monetary policy regimes in the short run that can cope with growing market risks, and to seek domestic financial systems in the longer run that can cope with changing investment risks, beyond the conventional dichotomy between bank-based or market-based systems.

1. MACRO-FINANCIAL LINKAGES AND TRANSMISSION OF FINANCIAL CRISES

The global financial crisis, which began with the bubble burst of the U.S. housing market in 2006, affected not only the United States, but also Europe, where financial institutions held a large amount of securitized products related to U.S. subprime loans; this, in turn, led to the global stagnation and then to the emerging market crises. Specifically, along with increasing integration of the international capital market, the linkages among national capital markets witnessed financial distresses almost comparable to those that occurred in the Great Depression of the 1930s.

Figure 1 shows financial stress indices[1] that measure asset market price volatilities in both advanced and emerging market economies.[2] The figure shows that the indices of the two groups moved together through the various crises, i.e., the emerging market financial crisis in 1997–98, the IT bubble crisis in 2000–01, and the global crisis in 2007–09. In addition, we note that the stress of the emerging markets led that of advanced economies in the first case. However, it was the other way around in the second and third cases, when advanced economies pulled a trigger and their stresses were far larger and were transmitted to emerging markets with some significant time lags.

Figure 1. Financial stress in emerging and advanced economies
(levels of index, GDP weighted)

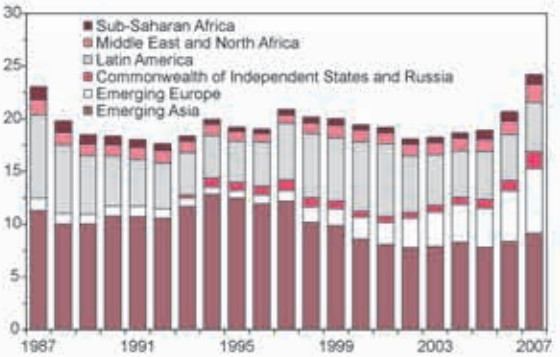


With regard to capital flows to emerging markets before the global crisis, Figure 2 shows the financial exposure of emerging markets to advanced economies. Outstanding amounts of bank (and other) loans and portfolio (bonds and equities) investment flows are shown as a ratio to emerging market GDP from advanced to emerging market economies by region of emerging markets. On one hand, Asia was the largest recipient of bank loans, while Latin America was second and Europe was negligible before the Asian crisis. However, after the crisis and up until the mid-2000s, while Asia and Latin America showed a declining trend, Europe by contrast enjoyed some increase. On the other hand, inflow of portfolio investment steadily increased in Asia, was stagnant in Latin America, and began to increase from an initially low level in Europe. As such, the pattern of inflows varied significantly across category of capital and across regions.

Figures 3a and 3b show the regional patterns of the same capital flows from the investors' perspective. The upper panel of Figures 3a and 3b shows the outstanding amounts of investment as a ratio to investors' GDP of three advanced economy regions. Bank loans remained relatively small in North America, and declined sharply from significant levels in Japan since the Asian crisis. In contrast, for Europe, bank loans increased despite the emerging market crisis, particularly since the mid-2000s. As shown in the lower panels of Figures 3a and 3b, with regard to portfolio investments, the U.S. has been the largest investor, followed by Europe, and

Figure 2. Financial exposure of emerging to advanced economies
(% of emerging economies' GDP)

Liabilities to advanced economies' banks



Portfolio exposure to advanced economies

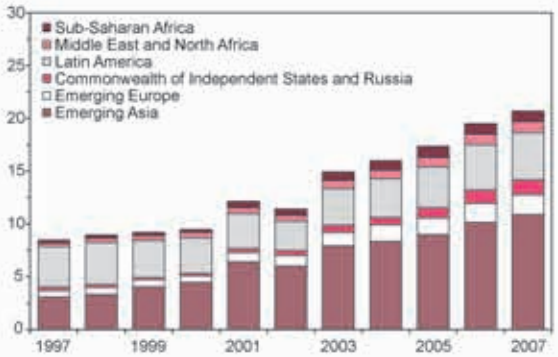
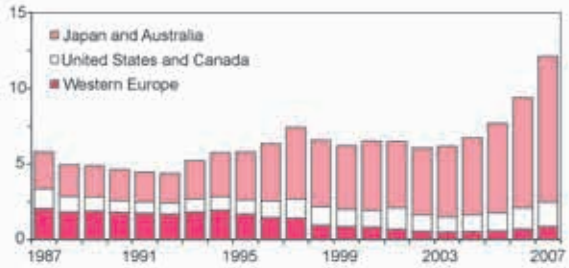


Figure 3a. Financial linkages between advanced and emerging economies
(% of advanced economies' GDP)

Assets of advanced economies' in emerging and developing economies



Portfolio exposure of advanced economies emerging and developing economies

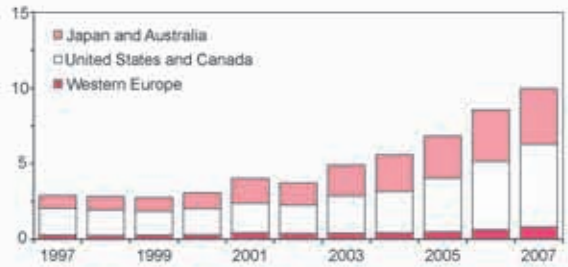
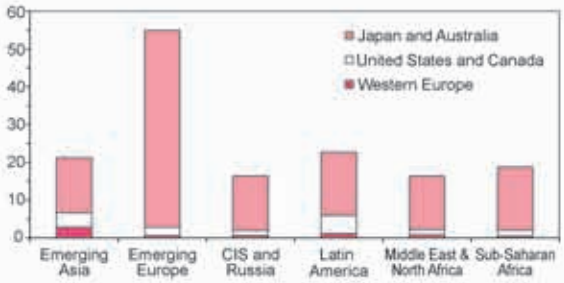
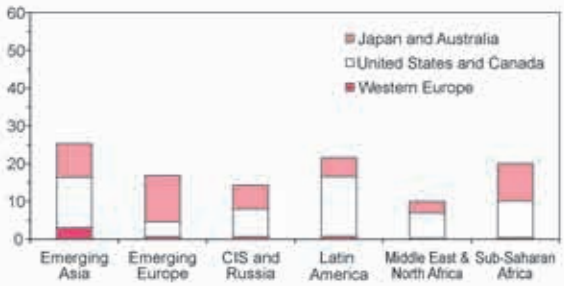


Figure 3b. Financial linkages between advanced and emerging economies
(% of emerging economies' GDP)

Liabilities to advanced economies' banks as of 2007



Portfolio exposure to advanced economies as of 2007



Japan and Australia are relatively insignificant. Both the U.S. and Europe showed strong increasing trends particularly since the 2000s.

These differences and/or contrasts of investment behaviors by investor country/region become clearer when reviewed by both investor and recipient. According to the lower panel of Figures 3a and 3b, advanced economies in Europe have not only an overwhelming share of bank loans in emerging markets in Europe, but a significant share across every emerging market in terms of recipients' GDP. In terms of portfolio investments, however, the U.S. is the largest investor in Latin America and Middle East/North Africa; both the U.S. and Europe are competitive large investors in emerging markets in Asia, CIS/Russia and Africa; and Europe is the largest only in European emerging markets. Thus, we reconfirm that the relationship between investors and recipients varies both across regions and across categories of capital. Similar to investment decisions in general, international investments are a product of complex decisionmaking based on multiple factors, including risks and information asymmetry, which leads to diverse investment patterns across region and category of capital.

2. THE CHANGING PATTERNS OF INTERNATIONAL CAPITAL FLOWS IN EAST ASIA

Recall that bank loans and portfolio investments are only part of the total foreign capital flows to emerging markets. Figure 4 shows foreign capital inflows to East Asia as a ratio of GDP by category of capital. Since the Latin American currency crisis in 1982, the share of bank loans has declined and, instead, foreign direct investment (FDI) has become the principal component. While portfolio bond and equity have become major players since the late

1990s, FDI has maintained the overwhelming share of capital flows. In addition, while bank loans and portfolio investments showed volatile movements (including sudden stops in 1997–98, 2000–01 and 2007–09 when internal and external financial stresses accumulated), FDI remains persistent as well as stable.

Figure 4. Financial inflows to East Asia
(% of GDP)

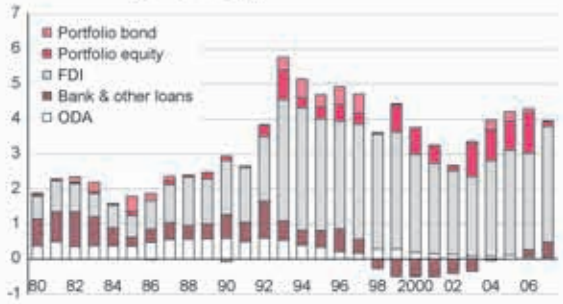
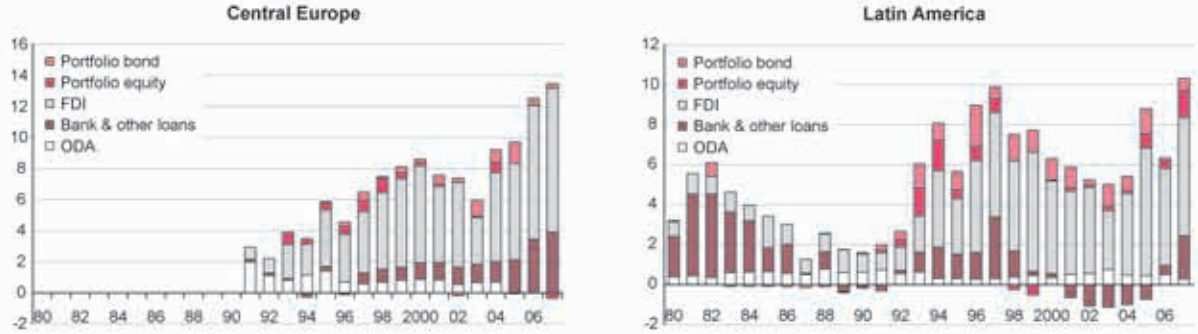


Figure 5, which shows foreign capital flows by category in Latin America and European emerging markets, clearly illustrates these characteristics. In Latin America, the following characteristics of the categories of capital appeared more clearly. First, the sudden stoppage of bank loans, which was the main category until the Mexican crisis, was one of the main factors that generated the lost decade of the 1980s. Second, the role of FDI was relatively minor apart from East Asia. Third, the role of portfolio flows was relatively large in recovering capital inflows in the 1990s. Fourth, the quantitative importance of foreign capital flows was relatively large. In terms of this last point, the capital flows/GDP ratio in East Asia is at most 4 percent and is significantly lower than in Latin America where it is around 7 percent; this is in contrast to the domestic savings rates of the two regions where higher domestic savings rates occur in East Asia than in Latin America. We will discuss the meaning of this point later in more detail.

In the case of European emerging markets, foreign capital inflows surged since the beginning of the 1990s when the transition to market economies began. Foreign capital began to flow in the form of public flows and FDI, and then increased along with the privatization of state enterprises. This was followed by portfolio flows, and finally bank loans began to increase since the latter half of the 1990s, and then surged in the 2000s along with the liberalization of the financial sector. While we will not go into detail, these developments come from the fact that their domestic financial systems relied on foreign banks, which differs from the cases of East Asia and Latin America.[3] In fact, their reliance on foreign capital is 8-12 percent of GDP, which is higher than that of Latin America.

To sum up, we confirmed, first, that, in East Asian emerging markets, the principal category of foreign capital flows is FDI; portfolio investments replaced bank loans as the second-most important category of foreign capital. Second, we also confirmed that while FDI is persistent and stable, portfolio investments (and bank loans) are sensitive to financial stresses and that, while FDI is the dominant category in quantity, portfolio investment is the most volatile flow that dominates the movement of capital flows. Finally, we confirmed an interesting fact that invest-

Figure 5. Financial inflows to emerging markets: Central Europe and Latin America
(% of GDP)



ment behaviors of advanced economies by region appears to show a certain regional bias towards destination of investment. This regional bias can be regarded similar to a home bias in investment. The home bias can be referred to as a bias for domestic investment products apart from the optimal investment portfolio as deduced from a theoretical investment model of CAPM-type investment theory. The bias does not reflect limited rationality, but rather reflects some imperfectness of capital markets. The imperfectness might include differential transaction costs between internal and external factors due to regulations and/or differential information on investment opportunities between domestic and foreign investors.

Imperfect and asymmetric information often depends on geographical and time distances. In fact, the regional bias in investment in East Asian emerging markets is conspicuous in portfolio investment. Table 1 shows the outstanding amounts of international portfolio equity investment between country/region at the end of 2008. International investment to East Asian emerging markets amounted to US$700 million, out of which US$240 million came from the U.S., US$210 million came from Europe (EU15), and US$160 million came from the East Asian emerging market itself. In other words, we should note that East Asian emerging markets have become a major investor in the region next to Europe. While the share of the region as an investment destination remains slightly less than 10 percent of the world total, it is nevertheless worth noting that the region has appeared as a remarkable investment destination among emerging market regions. The fact that intra-regional investment is increasing dynamically is a new, notable development when thinking about the region's future growth finance.

As a matter of fact, increasing intra-regional investments are not solely done via portfolio flows. Rather this is what happened with FDI which, as discussed before, has been the major category of capital flows to East Asian emerging markets where the major investors are the ANIEs (Hong Kong, Korea, Singapore and Chinese Taipei). Of course, we can see some intra-regional flows in Latin America, but to a lesser degree, and they are minimal in Europe. In other words, as far as East Asian emerging markets are concerned, in order to examine their linkages with the international capital market, it is not adequate just to look at their linkages with advanced economies, but is necessary to note the role of *old* emerging markets as intra-regional important investors.

Finally, examining the linkages to the global capital market, in addition to foreign capital flows, it is also important to note the accumulation of official foreign exchange reserves. Since the Asian economic crisis in 1997, there has been a great deal of debate on the huge accumulation of official foreign exchange reserves in emerging markets

Table 1. Geographical distribution of portfolio equity investment (US$ millions, yearend 2008)

Destination \ Investors	Total value of investment	Emerging East Asia	EU15	Japan	United States
China	226,873	107,792	49,161	5,499	53,269
Hong Kong, China	165,473	22,091	56,900	8,915	61,483
Japan	626,077	16,713	197,226	—	347,600
Korea	112,278	7,591	39,259	6,799	45,287
Malaysia	25,278	7,173	7,162	529	6,673
Philippines	7,574	717	2,055	165	4,279
Singapore	60,188	4,408	20,430	3,074	24,028
Chinese Taipei	79,948	5,546	26,294	1,631	41,195
Thailand	24,211	3,215	8,477	683	6,670
United States	1,486,907	54,476	741,220	159,163	—
Emerging East Asia	701,822	158,533	209,739	27,295	242,884
Total value of investment	9,848,594	484,995	4,214,632	394,678	2,748,428

Source: Author's calculation from Coordinated Portfolio Investment Survey.

including East Asia.[4] In each region, the increase in reserves is far greater than before, and is particularly remarkable in East Asia in terms of scale, timing and speed. In addition, various combinations of economies concluded foreign exchange swap agreements in the region, so that their provision of foreign exchange liquidities is far higher than official reserve accumulations in other regions.

From the above, we can summarize the changes of the linkages between the global capital market and East Asian emerging markets since the Asian crisis as follows:

- With regard to foreign capital inflows, non-debt-creating foreign direct investment (FDI) has been the primary category and is stable and persistent, and intra-regional investors have recently become one of the significant investors. Relevant factors explaining these developments include opening-up policies of capital accounts as well as sustained industrial growth in the region.
- Bank loans and portfolio investments are sensitive to developments in the capital market, and often show volatile movements which magnify business cycles. We can point to the inherent imperfectness of capital markets lying in the background, and therefore, we should note the increasing presence of intra-regional investments as a stabilizing factor.
- Accumulation of official foreign exchange reserves in emerging markets since the Asian crisis has been remarkable, particularly in East Asia, and it appears to have helped in coping with capital market stresses. Nevertheless, whether the accumulation of foreign exchange reserves is excessive or not is debatable.

3. FINANCIAL DEVELOPMENTS IN EMERGING MARKETS

How have these changes in financial linkages affected domestic finance? More concretely, we wonder how external finance is linked to the functions of domestic financial systems. First, we examined how important foreign capital is to sustain factor accumulation for economic growth and observe the developments of investment and savings balances.

Figure 6 shows the investment and savings ratios (as a percentage of GDP) in emerging markets in East Asia and Europe. In East Asia, while both investment and savings rates show an upward trend over the 1980s and 1990s, investment fell sharply in the face of the Asian crisis and recovered slowly; as a result, savings is significantly larger than investment for quite a while, and in particular, the gap has expanded since the late 2000s. While both investment and savings amounted to as large as 35-40 percent of GDP for the regional average, domestic investment could be more than financed by domestic savings without relying on foreign capital or savings at least in net terms.

European emerging markets contrast with those of East Asia. First, their investment rate has continued to exceed their savings rate, so that net foreign capital inflows are indispensable to maintain the regional investment rate.[5] The savings rate is around 25 percent of GDP, which is far below that of East Asia which is more than 40 percent. Note, however, that European emerging markets are not an exception among developing economies in this regard. In fact, Latin American emerging markets have similarly low savings rates, and their current investment rates are barely supported by net external inflows.

Figure 6. Savings and Investment (% of GDP)

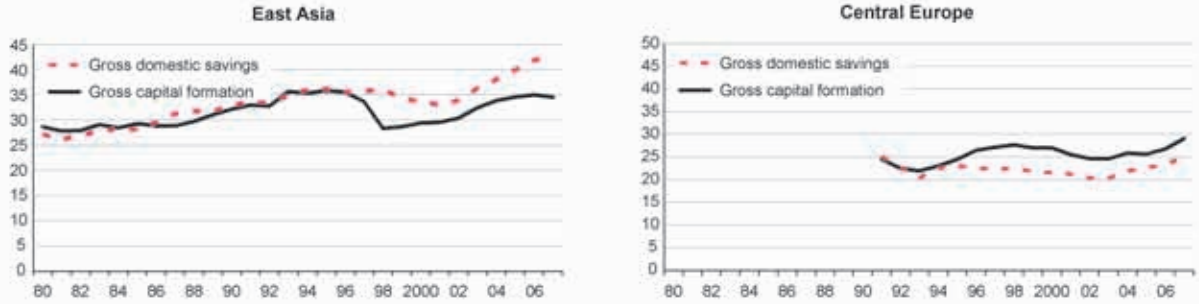
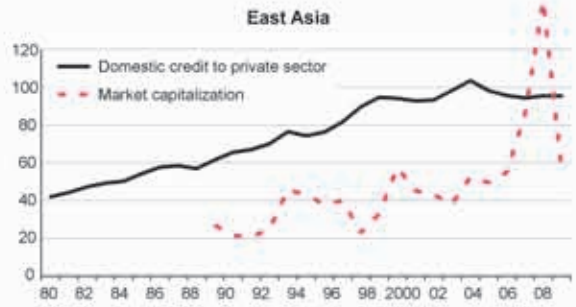
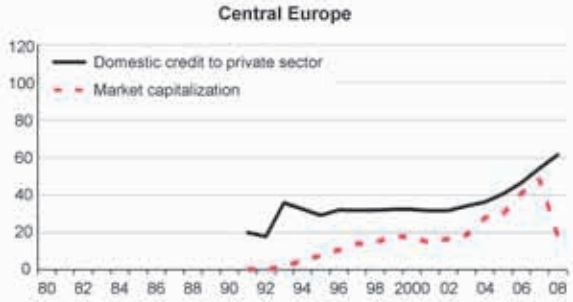


Figure 7. Financial depth (% of GDP)





Next, we look at how and to what extent these domestic savings are used to finance domestic investment. Investment is internally financed through retained earnings and/or externally financed through borrowing or bond issuance, which is usually the case in developing economies, including emerging markets. External finance comes mainly from financial intermediation rather than from the securities market. Reflecting the degree of final intermediation, Figure 7 shows banks' credits to the private sector as a ratio of GDP. According to the figure, the size of financial intermediation in East Asia has maintained a strong increasing trend since the 1980s, and its outstanding amount is as large as that of GDP for the regional average (though there was some stagnation since the Asian crisis). By contrast, those measures in European emerging markets reached at most 60 percent of GDP despite their rapid increases since the mid-2000s. As to the degree of financial deepening, East Asia is again an exception among developing economies.

To sum, in view of the linkages to the international capital market, the contrast between emerging markets in East Asia and those in regions elsewhere can be summarized as follows:

- The reliance on foreign capital flows in East Asian emerging markets is far smaller than is the case in other developing countries.
- In view of the intermediation within domestic financial systems, the size of financial intermediation is not only far larger in East Asia as compared with those of other regions, but it has expanded in a sustained way, thereby leading to greater financial deepening.

4. DEVELOPMENT OF DOMESTIC FINANCIAL SYSTEMS IN EAST ASIA

These factors noted in the previous section above may or may not suggest that the financial system in East Asia can be said to have recovered against the headwinds from the Asian economic crises.

External financing has three channels: (i) the

Table 2. Domestic financial systems of East Asia

	Bank assets				Equity market capitalization				Bonds outstanding			
	US$ billions 1997	% of GDP 2005	US$ billions 1997	% of GDP 2005	US$ billions 1997	% of GDP 2005	US$ billions 1997	% of GDP 2005	US$ billions 1997	% of GDP 2005	US$ billions 1997	% of GDP 2005
China	1,125.7	3,692.2	124.6	163.1	101.4	401.9	11.2	17.8	116.4	552.0	12.9	24.4
Indonesia	74.1	140.0	31.1	49.8	29.1	81.4	12.2	28.9	4.5	55.2	1.9	19.6
Korea	196.4	736.1	37.9	93.5	41.9	718.0	8.1	91.2	130.3	599.8	25.2	76.2
Malaysia	100.9	208.5	100.9	159.4	93.2	180.5	93.2	138.0	57.0	115.1	57.0	88.0
Philippines	46.5	62.2	56.1	63.2	31.2	39.8	37.7	40.4	18.5	36.1	22.4	36.7
Thailand	120.3	183.0	79.7	103.6	22.8	123.9	15.1	70.1	10.7	72.1	7.1	40.8
Hong Kong, China	361.6	790.1	205.1	444.6	413.3	1,055.0	234.5	593.6	45.8	82.9	26.0	46.6
Singapore	117.0	216.4	122.0	185.4	106.3	257.3	110.8	220.4	23.7	79.8	24.7	68.2
Total	**2,142.5**	**6,028.5**	**94.6**	**149.5**	**839.2**	**2,857.8**	**37.0**	**70.9**	**406.9**	**1,593.0**	**18.0**	**39.5**

banking sector, (ii) the stock market, and (iii) the securities market. Table 2 shows the size of the three channels in terms of outstanding amounts (in terms of U.S. dollars) and in terms of the ratio to GDP in East Asia in 1997 and 2005 (Gill and Kharas 2007). Measured by asset size, the size of the banking sector for the regional average increased by about 50 percent, rising from 95 to 150 percent of GDP. The size of the stock and securities markets on regional average, measured by market valuation and outstanding amount respectively, increased from 37 to 71 percent, and more than doubled from 18 to 40 percent, respectively.

These regional averages mask large differences among the individual economies in the region, however. In fact, growth in the size of the banking sector in China, the Philippines and Thailand is less than the regional average, and that of stock market valuation and securities outstanding are also less than the regional average in Malaysia and the Philippines. That is, there are significant variations across economies in the region.

Nevertheless, what matters more is the fact that these measures do not correctly represent the most relevant scale of external finance, i.e., that of resource transfers to the private sector. For instance, bank assets include government bonds, which might have crowded out private sector credit. The same holds true for the outstanding amount of bonds. Government, central bank and other public bonds would crowd out part of domestic savings from the process of resource transfers to the private sector.

Thus, let us look at Table 3, which shows direct measures of financial intermediation to the private sector including private credit for the banking sector

Table 3. Domestic financial systems: Intermediation to the private sector (Ratio to GDP)

Country	Year	Private credit	Private bond	Public bond	Stock market capitalization
China	1992	0.00	0.03	0.03	0.02
	1997	0.00	0.03	0.04	0.17
	2002	0.00	0.08	0.12	0.34
	2007	0.00	0.15	0.29	1.32
Indonesia	1992	0.44	0.00	0.00	0.07
	1997	0.54	0.02	0.01	0.28
	2002	0.18	0.01	0.26	0.14
	2007	0.23	0.02	0.17	0.41
Korea	1992	0.97	0.34	0.14	0.31
	1997	1.21	0.33	0.10	0.18
	2002	1.29	0.63	0.27	0.43
	2007	1.01	0.59	0.48	1.02
Malaysia	1992	0.89	0.18	0.45	1.29
	1997	1.39	0.40	0.25	2.02
	2002	1.20	0.53	0.35	1.29
	2007	1.01	0.55	0.36	1.56
Philippines	1992	0.22	0.00	0.31	0.25
	1997	0.54	0.00	0.27	0.69
	2002	0.37	0.00	0.33	0.53
	2007	0.28	0.01	0.34	0.60
Thailand	1992	0.89	0.06	0.03	0.42
	1997	1.54	0.08	0.01	0.41
	2002	0.97	0.12	0.21	0.33
	2007	0.83	0.16	0.35	0.69

Source: Author's calculation from World Bank, Financial Development and Structure Database. http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/.

and private bonds outstanding that are separated from public bonds of six East Asian economies (China, Indonesia, Korea, Malaysia, the Philippines and Thailand). The data examine two periods before and after the crisis period, 1992 and 1997 and 2002 and 2007. The data reveal several points. First, only China recovered more in the level of private credits between the first and second periods. The level of private credits in the other five economies continued to be stagnant after the crisis, particularly in Indonesia, the Philippines and Thailand (in fact, their private credits have remained as low as half of their 1997 levels). In examining private bonds outstanding, while China, Korea and Malaysia have observed comparatively rapid increases, they are not yet large enough to offset decreases in private credit. Moreover, in the case of Indonesia and the Philippines, no symptom of growth in private bonds can be found. Rather, we only see remarkable increases in public bonds in the region except for Malaysia and the Philippines after the crisis, which may or may not have crowded out private bonds.

To sum, the strong growth of bank assets and bonds outstanding in Table 2 resulted mainly because banks substituted private credit for government bonds and the public sector issued bonds for remedying the banking sector and financing fiscal deficits. The growth was not due to either banks increase in financial intermediation to the private sector or the securities market offering itself as an alternative conduit of resource transfers to the private sector.

Nevertheless, the often discussed and well-known vulnerabilities of domestic financial systems have been restructured significantly thus far. As a matter of fact, there seems to be some evidence in optimization of bank size through bank consolidation, strengthening of bank capital bases through injection of public funds and restructuring of nonperforming loans, and resolution of excess leverages of nonfinancial firms.[6] However, there has been little or no progress on the front of institutional development in private bond markets.

Furthermore, an additional new development is the recent rise in the corporate savings rate. Actually, in both advanced and emerging markets including East Asia, an upward trend in the corporate savings rate has been commonly witnessed since around 2000.[7] This implies that compared to the past, the corporate sector as a whole tends not to distribute dividends, but rather retains their earnings for internal finance.

From the above observations, our preliminary assessment of the domestic financial systems in East Asia is as follows:

- The recovery of the domestic financial systems after the Asian crisis is far from complete. In fact, they have not returned to their pre-crisis levels yet, in contrast to the recovery and dynamism of their real economies.
- Particularly notable are the retrenchment of private credits on one hand and the slow growth of private bond markets on the other.
- Probably because of the above, growth of the real economy appears to be underpinned less by external financing through the domestic financial system, and more by FDI (foreign savings) and own finance (corporate savings), both of which can be regarded as internal financing.

Having said the above, however, we should note that if we compare East Asian emerging markets with those in Latin America and Europe, financial development in the latter regions are far retarded in the long run as well as stagnant now in the short run. As a matter of fact, countries who are facing possible sudden stops of international capital flows triggered by the global financial crisis are not in East Asia nor Latin America, but are rather in the European emerging markets, who could suffer from their lost decades from now.

5. POLICY IMPLICATIONS

In this final section, some policy implications are drawn from the above observations. First, we discuss immediate policy issues that are of concern to the economic policy authorities in the region. Subsequently, some alternative policy frameworks are pursued. Finally, we reexamine the conventional views on development of domestic financial systems in the longer run.

Immediate policy issues

Worrisome issues to domestic policy authorities relate to three aspects. First, what matters are directions of exchange rates and capital inflows in the very short run. The shrinkage of capital markets due to the global crisis has destabilized international capital flows. Losing sight of destination for flight

to quality, the capital flows are likely to rush into emerging markets including East Asia, which appear to be the only growth pole left intact. Because of elevated general risk perceptions, however, the capital flows tend to be sensitive to any news. Consequently, at this moment, currency appreciation due to capital inflows—rather than either sudden stops or capital outflows—is likely to undermine the real economy.

Second, international business cycles are worrisome materials and are potentially affected by several factors including how fast the recovery of advanced economies will be, whether capital flows will change greatly when the United States graduates from monetary easing, how likely China and East Asian emerging markets will be forced to follow monetary tightening to combat inflation, and whether international capital flows tend to magnify business cycles.

Third, with respect to financial systems, worrisome are the issues on domestic financial systems that were revealed by the Asian crisis, i.e., financial disintermediation, high domestic savings rates, and stagnant domestic investment and consumption.[8] Facing the global imbalances, East Asia intends to rebalance toward domestic demand; however, since their trade and investment structure relies on exports, particularly extra-regional markets, the longer the stagnation of EU and the United States, the more difficult the realization of their rebalancing will be.[9]

Policy frameworks for macro-financial linkages

Furthermore, in order to cope with foreseeable volatile exchange rates and international capital flows, both domestic policies and medium-term regional cooperation frameworks will have to be reexamined.

First, in terms of domestic policies, macro-prudential policy and foreign exchange reserve policy must be reexamined. Review of the former is needed to harmonize monetary policy with financial system stability, and one of the new issues is to what extent the policy should weight exchange rates, product price inflation and asset price inflation.[10] Although we managed to control product inflation beforehand, it has become difficult to neglect the influence of volatilities of exchange rates and/or asset prices on business cycles. Conventional wisdom appears to dismiss the need to regard asset inflation as a stability target, but is this true? In fact, some studies using the financial conditions index (FCI) show significant impacts of asset price movements on the real economy in advanced economies.[11]

We need to pursue a more flexible approach to macroeconomic policy management, taking account of multiple nominal anchors instead of a single anchor such as product inflation or exchange rate stability. Then we have to adopt highly sophisticated discretionary policy management, setting up some sophisticated nominal anchor based on continuous monitoring of multiple asset price movements on one hand, and taking structural changes in policy transmission mechanisms into account on the other hand. While rule-based policy management may cope with business cycles that are well-characterized as repetitive games, we may have to prepare for faster structural changes in macroeconomic systems through accelerated technological progress and factor accumulation in both advanced and emerging market economies.

On the other hand, foreign exchange reserve policy can also play a significant role. We have already touched on the numerous debates on whether foreign exchange reserves in East Asia are excessive or not. If emerging markets are not immune from the original sin, and then from external debt crises, their policy authorities understandably feel it indispensable to monitor external debt and accumulate foreign exchange reserves for exchange rate stability. Unfortunately, however, the effectiveness of foreign reserve accumulation in attaining exchange rate stability is doubtful. In fact, these countries had to face severe exchange rate volatilities in the midst of the global financial crisis despite their good macroeconomic fundamentals and ample foreign exchange reserves.[12]

Second, because currency crises tend to be contagious to neighboring economies, a framework of regional cooperation has been pursued. The Chang Mai Initiative (CMI) is a regional policy framework constituting swaps of foreign exchange liquidity, macroeconomic policy dialogue and monitoring capital flows. The Asian Bond Market Initiative (ABMI) is a framework to develop a regional market for regional currency–denominated bonds.

The goal of the former is to try to build a regional safety net for both crisis prevention and crisis management, namely, a regional macro-prudential policy framework. The latter, by easing issuance of regional currency–denominated bonds, enables international financing without being influenced by exchange rate fluctuations among major currencies, thereby becoming immune from original sin problems and promoting bond market development under regional initiatives.

Foreign exchange swap agreements, however, have an intrinsic dilemma; economies may hesitate to use the swap because it gives a negative signal on their credibility to the international capital market. As a result, the swap arrangements may or may not fully play the role of lender of last resort. Moreover, the ultimate goal of exchange rate stabilization in the region heavily depends on exchange rates among major currencies, which are not within the realm of CMI. In fact, in the current global financial crisis, foreign exchange swap arrangements do not seem to have been effective in stabilizing currency values.[13]

With regard to the ABMI, we have already observed that financial disintermediation has prevailed in some domestic financial markets, and that the momentum to restructure and/or develop domestic bond markets has not been met. In addition, the private corporate sector has strengthened internal rather than external finance, and multinational corporations have strengthened intra-firm financing with their headquarters at home. Moreover, as investment rates themselves have remained stagnant, private sector's needs for bond financing are lacking momentum to proceed with ABMI. That is, insofar as the needs for institutional reforms for domestic bond markets are not strong enough to shake the status quo of domestic financial systems, there are reasons why we do not see vigorous momentum for growing domestic bond markets, and in fact, the growth of a regional bond market appears to be far-fetched.

Ultimately, one real outcome of the post-crisis regional economic cooperation might be that the countries have successfully reduced information asymmetry through regular policy dialogues and peer monitoring. While this may have been an unexpected outcome, it reflects important progress. In the private sector, multinational corporations have minimized information asymmetries across borders through their networks; but without a regional framework for economic cooperation, national governments may have had limited opportunities to exchange and share mutual information. If this is the case, the fact that many policy authorities have spared a lot of time and energy in various frameworks of international and regional cooperation can be understood as producing international and/or regional public goods through creating information and/or minimizing information costs.

Future course for financial deepening

Finally, let me touch upon the future course of domestic financial systems in the long run. Securitization has been closed up as an alternative substitute for bank financial intermediation, because the latter is regarded as disadvantageous in financing risky investment such as venture capital. In addition, in the literature on financial development, there are pros and cons over two types of financial development, i.e., bank-based as in continental Europe and Japan vs. market-based as in Anglophonic economies.[14] While it is clear to us that governments often fail, it has been also become clear that markets are not good at looking into the future as well. As a matter of fact, through a series of recent crises, we know that markets tend to support herd behavior in the short run and tend to predict future behaviors via a simple extrapolation of the past and present. Good examples of this are the recent asset market bubbles where self-fulfilling expectations led to a repeated series of bubble bursts.

Information on risky investment opportunities is generally not certain even to actual investors. It is more difficult, therefore, for a third person to price risks using various indirect information. Generally, information on investment opportunities is intrinsically individual and specific so that it should be known to be only partially commonalized and standardized. In this sense, it should be noted that securitization is far from being a panacea for capital market failure and the trend toward securitization needs to be reexamined.

In this respect, what interests us most is the recent upward trend in corporate savings rates or the regression to internal financing started since the 2000s. The rise in FDI as well as retained earnings suggests that those who know best on investment

opportunities have increased self-finance. If this is the case, financial disintermediation of the banking sector and slow growth in bonds markets found in East Asia are part of this trend change and are nothing to worry about. We are not sure, however, that this observation holds true only for advanced economies, but may also hold true for emerging markets in East Asia.

Endnotes

[1] Financial stress indices are calculated as a weighted average of price volatilities of multiple asset markets including long-term and short-term financial markets, the corporate stock market, the bond market, the credit market and the foreign exchange market. For a detailed explanation, see IMF (2009, Appendix 4.1).

[2] The seventeen advanced economies are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom and the United States. The twenty-six emerging market economies are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, the Philippines, Poland, Russia, Slovak Republic, Slovenia, South Africa, Sri Lanka, Thailand and Turkey.

[3] In the literature on financial development, it is often argued that the entry of foreign banks generally contributes to financial development in developing economies through external economies created by the foreign banks' advanced financial know-how. In the case when their activities depend on economic conditions in their home economies (i.e., the activities that are independent of host economies; for instance, as in the current global financial crisis when these banks were forced to retrench credit supply in host economies because of financial meltdown in their home economies), however, the presence of foreign banks generates external diseconomies to hosts. European emerging markets started their transition to a market economy with vulnerable domestic banking systems that were part of their socialist centrally planned economies; as a result, these countries had no choice but to rely on foreign banks. This resulted in an overwhelming presence of foreign banks in the emerging European markets. In contrast, in East Asia, domestic banks have dominated their domestic financial markets and their post-crisis efforts to open up to foreign banks did not produce any significant changes in their market structure.

[4] The accumulation of foreign exchange reserves in East Asia since the Asian crisis is notable both historically and in comparison with other economies. It is conventionally argued that there are two main motives for foreign reserve accumulation, i.e., self-insurance with a precautionary motive against currency crises for one and undervaluation of currencies with *mercantilism* to maintain international competitiveness, to which Aizenman et al. (2011) add exchange rate stability as a third motive.

[5] In assessing macro-financial linkages of European emerging markets to the international capital market, before the global financial crisis, their current account deficits were argued to have promoted their economic growth and has contributed to their income catching-up with advanced economies (Abiad et al. 2007). The winds have changed 180 degrees, however, and the post-crisis literature has been toned down to argue the risk of financial integration, e.g., Fabrizio et al. (2009).

[6] According to Gill and Kharas (2007), the prudence of the banking sectors in East Asia have been significantly improved through restructuring and consolidation, bank regulation and supervision have been strengthened, the corporate sector has been deleveraged and improved their balance sheets, and the banking sectors have expanded their profit basis by strengthening consumers' credit.

[7] For advanced economies, increases in corporate savings are commonly found, particularly since the IT bubble burst. The IMF (2005) and others argue that this is not a temporary phenomenon to simply adjust excess liabilities and capital formation in the 1990s, but may be the result of more significant structural changes including: (i) profits enhanced by low interest rates and tax reduction, (ii) lowered relative prices of capital goods through technological progress, (iii) the shift to overseas capital formation, and (iv) the increased optimal levels of liquid assets because of increased management risks

and growing importance of knowledge capital. Moreover, even East Asian emerging markets including China have shown some upward trend in the corporate savings rates. In particular, although it is often argued that low dividends in state-owned enterprises and weak corporate governance are to blame for the high corporate savings in China, Bayoumi et al. (2010) argues that factors related to high corporate savings rates in China are common with the above global trend.

[8] Prasad (2010) argues that slow consumption in China is in tandem with its high household savings rate. In particular, he emphasizes the importance of financial reforms aimed at expanding domestic demand from the household sector. He argues that households have remained severely constrained in terms of their access to the domestic financial market even though they were severed from the social safety nets since the 1978 opening up of the economy.

[9] Examining the degree of international industrial linkages using international input-output tables, Pula and Peltonen (2009) showed that the development of production networks in East Asia has deepened their linkages to advanced economies such as EU and the U.S., while their trade figures tend to exaggerate their reliance on these advanced economies.

[10] Monetary policy regimes in advanced economies have been analyzed in such contexts as dynamic inconsistency of monetary policy, independence of central banks, nominal anchors for (product) inflation, etc. Meanwhile, monetary regimes in emerging markets have been left outside these contexts; this is because they are merely price-takers in the international market, they are not immune from the original sin problem and their institutions are characterized by information asymmetry, default risks, moral hazard and other kinds of market failure. The global financial crisis revealed that these market failures can be intrinsic to capital markets of advanced economies as well as the international capital market. In fact, Frankel (2010) argues for reexamination of monetary policy regimes for both advanced and emerging markets.

[11] The financial condition index (FCI) attempts to comprehensively capture the business cycle effect of changes in multiple financial markets, reflected in such variables as long-term and short-term interest rates, stock prices, exchange rates and credit market conditions. In the case of Japan, while the financial bubble burst in the early 1990s is well known, the analysis using FCI reveals that the role of financial channels is as large in the global financial crises as it was in the 1990s (Shinkai and Kohsaka 2010).

[12] A typical example is Korea, which experienced the largest exchange rate in East Asia depreciation despite apparently sufficient fundamentals and ample foreign exchange reserves. Korea is also known to have opened up its financial account most actively in East Asia since the Asian crisis.

[13] Examining whether swap lines substitute for foreign exchange reserves based on precautionary motives, using cross-country data, Aizenman et al. (2011) found that the substitution effect depends on the scale of foreign exchange reserves and is fairly limited. They also found that the feasibility of bilateral swap lines is highly limited to cases where suppliers have high credibility (such as the Federal Reserve of the United States) on one hand and where applicants have an excellent macroeconomic stability record on the other; on top of this, there are close interests between these two groups, such as the large presence of US banks. Here again we can see the basic tradeoff that prerequisites for swap lines are too difficult to utilize for those countries that need them.

[14] Recent literature has become negative to this dichotomy between bank-based and market-based financial development (Levine 1997). Rather, Demirgüç-Kunt and Levine (2008) have summarized empirical studies as follows: (i) economies with developed financial systems tend to grow faster whether their financial systems are bank- or market-based; (ii) this is not because of the simultaneity between real growth and financial development; and (iii) financial systems tend to relax external finance constraints on corporate firms as well as industries.

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EXECUTIVE SUMMARIES ON INDIVIDUAL ECONOMIES

AUSTRALIA

BY ANTHONY J. MAKIN

Like many other economies in the world, Australia was safeguarded from the global financial crisis (GFC) by the underlying strength of its domestic banking and financial systems, and it is one of the few economies that did not subsequently experience a serious recession. Australia's banking and financial system also remained robust throughout the crisis, although additional temporary government guarantees were applied at the height of the crisis for domestic depositors and financial institutions borrowing overseas.

Nonetheless, the GFC contributed to a marked slowdown in Australia's GDP, reduced working hours and a rise in unemployment. Australia's real GDP per head, nominal GDP, and two of the three trend measures of real GDP (production- and income-based GDP) recorded at least two successive quarters of negative growth.

There was also a sharp fall in the value of the Australian dollar, as happened during the Asian financial crisis of 1997–98. Between its pre-crisis high point in June 2008 and mid-crisis low point in January 2009, the Australian dollar depreciated by 28 percent in trade-weighted terms and by 33 percent against the U.S. dollar. It reached its lowest value against the U.S. dollar in October 2008 coinciding with the first of a series of fiscal stimulus packages. This massive dollar depreciation continued throughout the crisis interval from March 2008 to December 2009.

The role played by the exchange rate in shielding the Australian economy from the full force of the GFC via the trade balance turnaround has been much neglected in analysis and official commentary on this topic, which has emphasized the impact on consumption and government spending, changes of which were minimal.

During the December 2008 and March 2009 quarters, when the impact of the GFC on the real economy was greatest, the most notable quarter-to-quarter turnaround in aggregate expenditure occurred in investment, including inventories, and the trade balance; the turnaround was not notable in household consumption or government spending, though the latter may have been lower without the stimulus.

Australia's banking sector remains sound by international standards, despite the global financial turmoil of recent years. Yet the nation's current reputation for financial stability has evolved over a very long period of time, in response to episodes of domestic financial instability (notably in the 1890s, 1930s, and, most recently, the early 1990s).

There are no obvious signs of significantly increased financial stress in the household sector in the wake of the GFC. However, a source of risk to continued financial stability is the possibility of a major correction in the housing market, which affects the balance sheets of financial intermediaries through defaults on mortgages.

The growth in lending to households this decade has been associated with a sustained rise in residential property prices and, more recently, with a strong increase in demand for credit by property investors. The ratio of debt to household disposable income is high relative to other developed countries.

The profitability of deposit-taking institutions remains high and market indicators continue to signal confidence in the credit quality of Australian banks. Foreign borrowings entail minimal foreign exchange exposure, as they are either denominated in Australian dollars or are largely hedged through the use of off-balance sheet transactions.

The institutional framework for ensuring financial stability in Australia has evolved over a long time, in response to previous episodes of domestic financial instability, most recently, the early 1990s. At that time, the Australian banking industry experienced its worst losses since the depression a century earlier. The banking sector remains profitable by international standards.

Banks are adequately capitalized. Unlike many other OECD economies, Australia's banking sector stood up well during the global financial crisis. The scale of nonperforming loans on the balance sheets of commercial banks remains small by historical standards and the regulatory system has been strengthened since the early 1990s to cope with the risks associated with a deregulated financial system.

Over the past half-century, there have been major changes in the regulatory system governing Australia's financial markets and institutions. Earlier extensive controls over banks spurred growth in nonbank financial institutions, with banks setting up subsidiaries to circumvent regulation of lending and borrowing practices.

With more internationally integrated financial markets, exposure to financial instability from abroad has increased since the 1990s, as demonstrated by the Asian and global financial crises. The fact that imprudent lending practices were not prevalent in the Australian financial system served to insulate Australia from the contagious effects of the GFC.

CHINA

BY PING YANG

With the progress in economic development and globalization, and in accordance with China's WTO commitments, China accelerated and deepened its financial reforms.

Since the implementation of reforms and the open policy, monetization has been very impressive in China. The ratio of M2 to GDP has been rising, and rose even higher during the Asian financial crisis. Although the ratio slightly in 2008 when the global financial crisis erupted, it rose again to 1.78 in 2009. By 2010, the ratio of M2 to GDP was 1.82, the highest level thus far.

The ratio of nonperforming loans ratio has been declining. According to accounting standards used domestically at that time, in 1998 the Chinese banking system had an NPL ratio of 25 percent. At the end of 2001, both the NPL outstanding and the ratio began to drop, and this trend has continued with the NPL ratio dropping even during the global financial crisis.

China's capital markets grew rapidly with the promulgation of the 1998 Securities Law.

After the State Council issued Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets in January 2004, another round of reforms in the capital markets was triggered and resulted in substantial increasing in the ratio of stock market capitalization to GDP from 2006 to 2007. The ratio of raised capital by issuing shares in the domestic stock market to changes in amount of loan increased. The development of the financial market system offered nonfinancial corporations and households more choice in financing, and nonfinancial corporations obtained more funding from the issuing of securities.

In terms of macro-financial linkages since 1998, the degree of Chinese foreign dependence rose rapidly after the Asia financial crisis. Total trade in goods and services as a percentage of GDP increased uninterruptedly from 38.5 percent in 2001 to 65.2 percent in 2006, but declined to 44.2 percent in 2009. At the same time, the percentage of net exports to GDP increased from 2.1 percent in 2001 to 8.8 percent in 2007, and then fell to 3.9 percent in 2009.

China's increasing integration with the global economy stimulated the rapid growth of fixed assets investment in manufacturing over the years. The growth rate of investment in manufacturing was higher than that of total investment during 2001–07. This situation changed by the time of the global financial crisis. In 2009, the growth rate of investment in manufacturing was lower than that of total investment.

With the accumulation of foreign exchange reserves, the China Investment Corporation was created in September 2007 as a vehicle to diversify China's foreign exchange holdings and improve risk-adjusted returns on its investments in the context of China's macroeconomic requirements and further reform of its financial system.

Since the outbreak of the international financial crisis, China's central bank has been actively engaged in cooperation initiatives at the international and regional levels, including the signing of a few bilateral currency swap agreements with neighboring countries and regions.

SPECIAL CONTRIBUTION TO CHINA

BY KUMIKO OKAZAKI
TOMOYUKI FUKUMOTO

Although China's economic integration with the global economy has been deepening, the recent global financial crisis has not severely affected China's financial markets and its economic growth. Several conditions—some similar to those that China possessed during the Asian financial crisis and other newly developed ones—enabled China's economy to be less vulnerable and realize a quick recovery since the second quarter of 2009.

In 1997, the inconvertibility of the Chinese currency for capital account transactions, massive inflow of foreign direct investment, lower dependence on short-term borrowings, sizable trade surpluses, and increased foreign exchange reserves helped to maintain a relatively stable financial market in China. The Chinese government's guarantee on bank deposits, as well as its intervention in the decision-making process of banks, largely eased the credit crunch in the second half of 1998. Many of these factors continue to be relevant.

On the other hand, there is a significant difference between the Asian financial crisis and the recent global crisis. Today, private capital flows have become larger and more volatile even under the strict control of cross-border capital transactions. Hence, it would have been more difficult for China to maintain a stable economy without strong economic and financial fundamentals including: (i) a favorable external position, (ii) a healthy fiscal position, (iii) modest leverage, (iv) a high amount of domestic savings, and (v) a stable banking system.

The cross-border capital flow to/from China other than transactions on current accounts and direct investments have been relatively small. However, the volume of capital transactions related to portfolio investments, trade credit, as well as bank loans increased after China joined the World Trade Organization, and the fluctuations of international financial markets had substantial impacts on Chinese markets. The second half of 2008 showed a sudden net private capital outflow in China mainly through the trade credit and bank loan channels. However, in the first half of 2009, private capital flow became positive again. In sum, the impact of the crisis was substantial, but China was capable of absorbing it.

The factors that protected and stimulated China's economic growth seem to carry with them substantial risks and challenges to the economy. The Chinese financial system as a whole is not deep and diversified enough to allocate funds effectively and thus to guarantee long-term sustainable economic growth. Too great a reliance on the banking sector and less-developed capital markets distorts the efficient usage of domestic funds. The dominance of the state-owned sector in formal financial markets drives private enterprises into informal financial markets in the country. The rapid increase in bank loans in recent years raises a big question regarding banks' asset quality.

The extremely high domestic savings rate is largely the result of a disproportionately high capital share and insufficient public support for health care, education and pensions. Large state-owned enterprises have accumulated a huge amount of reserves throughout the 2000s, largely owing to the government's preferential treatment. In addition, high corporate savings has been accompanied by a drop in the labor share of national income, which has made China's long-term economic growth less sustainable. The high domestic savings rate also raises a serious discussion about the global imbalance among major countries.

Holding onto rapidly accumulating foreign exchange reserves implies that the Chinese government is subject to large currency fluctuation risks, and promoting an effective foreign exchange reserves management is one of the primary tasks of the government. The government realizes that its excessive dependency on the U.S. dollar in foreign trade, on international capital flows, and on foreign exchange reserves management carries huge risks, and therefore, ideas about the internationalization of

the Renminbi, regional monetary cooperation, and the reconstruction of the international monetary regime have become issues up for discussion.

The widening and deepening economic integration between China and the world is bringing about a massive pressure of cross-border capital transactions, despite strict capital control. Since China has significantly benefitted from the economic globalization and is willing to continue pursuing overseas markets, cross-border capital transactions to/from China will significantly increase in the future. For sustainable economic development, it is important for the Chinese government to grasp movements of international capital flow and adjust the financial markets flexibly with more market-oriented measures.

Since there are huge differences in the economic development condition among business sectors and regions in the country, the implementation of financial market reform requires a well-considered sequence. China's gradualism in the economic reform process has worked very well thus far. However, gradual reform does not imply slow reform. The pace of the reform should be checked frequently, and necessary reform measures should be carried out consistently and should not be delayed.

In accordance with the economic development, China is increasing its economic influence over other countries in the world. Market participants already consider the Chinese economy to be one of the most important contributors to the world economy, and as a result, the successful development of the Chinese financial system is integral to stable growth of the world economy.

HONG KONG, CHINA

BY HELEN CHAN

Hong Kong's macro-financial linkages with the rest of Asia have risen substantially over the years, thanks to China's increasing integration with the Asian region after its accession to the World Trade Organization and as a key part of the production chain in globalization. The increasing trade and financial linkages have propelled financial deepening in Hong Kong, with the massive expansion in "scale" being matched by substantial improvement in "quality."

Hong Kong's macro-financial linkages with Asia will mean that the contagion effects can spread very fast through the trade, investment and financial channels. Indeed, in the initial phase of the 2008 global financial crisis, Hong Kong, as with many Asian economies, suffered an immediate and severe economic downturn caused by a sharp plunge in intra-regional trade and falling asset markets. However, despite the austere external environment in 2009, the Hong Kong economy only suffered a brief and mild recession. The speedy recovery at this time was supported by sound macroeconomic fundamentals and a robust financial architecture, though the quick turnaround in the Mainland economy was also instrumental. Quite unlike the advanced economies, Hong Kong's banks are well capitalized with high CAR and liquidity ratios, and the credit squeeze, if any, was short-lived. The economy is not highly leveraged, with a high savings ratio and huge external assets. The robust fiscal position has also allowed the government to act promptly. All of these factors have been instrumental to the relative stability of the domestic economy at a time when external trade was severely battered by the global recession. When the external environment finally turned around, economic recovery in Hong Kong quickly broadened to a full-fledged rebound, with ready support from internal finance and the return of foreign direct investment.

As a forerunner and beneficiary of globalization, Hong Kong will continue to embrace the challenges and the dark sides from globalization. On this, Hong Kong will need to ensure a robust financial regulatory framework and strong market institutions, so that the financial system remains resilient to withstand shocks. These rules, we believe, are the universal golden rules in maintaining macroeconomic stability in an increasingly globalized era.

INDONESIA

BY MIRANDA S. GOELTOM
DEASY ARYANTI

Macro-financial linkages are at the central attention of the recent global crisis, as the two-way interactions between the real economy and the financial sector can amplify shocks and vulnerabilities in each sector. In this regard, the Indonesian banking system—although not immune to the global shock that stemmed from the bankruptcy of Lehman Brothers in September 2008—did not suffer severely from the 2008 global crisis due to minimum exposure to structured products. Furthermore, the contribution of Indonesian exports to GDP has been relatively small, which on the one hand has somewhat prevented the balance-of-payments position to fall further, but on the other, has minimized the impacts of negative external financial shocks to the Indonesian macro-economy. Although the external trade slowdown in 2007 has affected Indonesia's GDP growth, the downturn has been matched by strong domestic consumption.

In essence, the resiliency of the Indonesian economy was due to the significant policy adjustment brought about after the 1997 East Asian crisis. Since 1998, a broad-based policy package was introduced—a tight monetary policy, prudent fiscal policy, and a restructuring and recapitalization of the banking system—as well as structural adjustment and reform measures to increase efficiency and competitiveness. Prudential regulations and supervisory frameworks have been strengthened and enforced with a sense of urgency to restore the credibility of financial markets in the region.

As a result, in spite of the pressures from the global economy, the Indonesian economy has managed to register higher growth as compared to other countries in the region. Indeed, the recent global crisis has not drastically modified macro-financial linkages in Indonesia, in spite of a temporary decline in external indicators such as periods of significant export decline, eroded foreign reserves, and depreciation of the exchange rate.

Although Indonesia has indeed shown a remarkable degree of resilience in the midst of global financial market unrest, confidence is waning and the threat to the real economy has become increasingly clear and very real. Even Indonesia, which was not exposed directly to subprime mortgage and complicated derivative products, suffered from the sharp increase in the EMBIG Spread. The yield spread of the Indonesian Republic Global Bond to the U.S. T-note soared, largely due to the spike of its CDS. This, in turn, triggered widespread capital outflows from the capital market as investors withdrew and dumped their shares at unprecedented speed. The Government Bonds (SUN) and Bank Indonesia Certificate (SBI) markets experienced the same kind of panic selling resulting in a huge capital outflow in a relatively short period, as well as undermining the volume of foreign exchange transactions on the domestic market. As a result, between October 2008 and December 2008, the rupiah weakened from Rp 10.240/USD to Rp11,200/USD, and the Jakarta Composite Index plummeted while the SUN yield rose significantly. This loss of confidence and rise in counterparty risk led to liquidity tightness in the domestic banking industry, which was evidenced by a decline in the ratio of liquid assets to noncore deposits (NCD) at banks and the tightness in the interbank money market; this, in turn, stimulated a rise in the money market interest rate. The crisis, as in many other countries, endured and ultimately eroded economic growth. Growth of the economy, which until the third quarter in 2008 had expanded by an average of 6 percent (year-over-year growth), suddenly slowed to 4 percent in the second quarter of 2009. This downturn was primarily due to sluggish export performance as a result of a slump in global economic growth. Opportunely, consumption

continued to grow, albeit at a slightly slower pace, compensating for the negative impact from the trade channel.

The Indonesian government responded with an array of policies. Initially, policies were designed to restore the confidence of economic players in the banking industry and financial system. In the next phase, policies were instituted to overcome bank liquidity problems. Finally, policies were introduced to maintain sustainable, long-term economic growth momentum.

First, Indonesian authorities responded to the threat to the real economy by implementing an array of policies aimed at restoring market confidence. The policy responses were not stand-alone but rather unprecedented, and bespoke of policies designed to interrelate and complement one another. Innovative new banking policies and deposit insurance policies supported more conventional macroeconomic policies, such as fiscal and monetary policies. The temporary suspension of trading in the stock exchange market and temporary exemption from marking to market of securities owned by banks are some of the unprecedented policies designed to calm the market from an abrupt outflow of capital.

Second, to overcome liquidity risk, Bank Indonesia responded by adjusting its standing facilities corridor, the overnight repo rate, which was reduced from a spread of 300 basis points over BI rate to 100 bps. The Rupiah Reserve Requirement calculation was simplified and the FX Reserve Requirement was lowered from 3 percent to 1 percent to further ease liquidity pressures.

Third, to attain sustainable economic growth and be better able to absorb external shocks, efforts to create a deep financial sector which is well-diversified, efficient and robust were introduced. Bank Indonesia proposed the Indonesia's roadmap of financial deepening, and the development of the Indonesian Financial System Architecture (IFSA). Nonetheless, all these elements of the road map need to be reviewed and revamped. The complexity of the financial products and interconnectivity of the financial institutions are of paramount importance, and undeniably these issues are not sufficiently addressed in IFSA. Issues related to the role of rating agencies and compensation schemes are among others that need to be accommodated in the new financial architecture.

Evidently, behavior of credit and stock prices in Indonesia is consistent with the view that the financial sector is pro-cyclical. Therefore, efforts to develop the Indonesian financial market should address the issue of pro-cyclicality of the financial system, which is also crucial to sharpen the monetary policy transmission channel and to ensure economic development and financial stability.

Furthermore, deepening of the financial sector in each economy is an essential precondition to promote further regional financial integration in East Asia, in the hopes of improving liquidity and risk-sharing to support domestic and regional economic growth. It appears that there remains ample room for financial deepening, particularly for the corporate bond, foreign exchange and money markets. Given the variety of size, structure, openness and level of institutional development across emerging market economies, regional financial cooperation should not be impeded by the fear of contagion effects of financial fragility. Rather, there needs to be a substantial level of trust to overcome any obstacles by formulating and implementing effective policies to move towards deeper regional cooperation.

JAPAN

BY SHIGENORI SHIRATSUKA

Financial crises are generally preceded by a period of a benign economic and financial environment with a prevailing euphoric sentiment. Behind the scenes, financial imbalances are built up, typically seen as an asset-price and credit bubble, and the subsequent unwinding of such imbalances produces significant adverse effects, potentially leading to prolonged economic stagnation. Once the economy enters a downturn, the harmful effects of the bubble emerge, exerting stress on both the real side of the economy and the financial system due to the unexpected correction of asset prices. Such financial crisis developments are fundamentally endogenous to the financial system, especially arising from exposure to common risks.

The recent global financial crisis shed light on crucial deficiencies in the regulatory and supervisory framework in maintaining the stability of the financial system as a whole. Before the crisis, mainly from a micro-prudential perspective, it was thought that financial system stability could be achieved by assembling sound financial institutions with adequate capital and liquidity positions as well as proper risk management. Based on our experience from the recent crisis, however, soundness of individual financial institutions does not necessarily ensure stability of the financial system as a whole.

There are numerous arguments calling for more stringent regulations, such as minimum regulatory requirements that are significantly stricter than the existing Basel rules to ensure the quality and quantity of overall capital in the global banking system. Achieving higher stability just by more stringent micro-prudential regulations, however, tends to result in lower efficiency in financial intermediation as a basis for economic growth. In addition, the higher regulatory burden is likely to produce incentives for regulatory arbitrage. To harness the benefits from globalization and technological progress in the financial system, while at the same time limiting its inherent instability, we need additional and supplementary policy tools to balance the efficiency and stability of financial system as a whole.

In that context, macro-prudential policy is often pointed out as a missing element in the current policy framework. To enhance the robustness of the entire financial system, macro-prudential policy needs to identify and dampen systemic risk, which is likely to disrupt the function of the financial system, thereby destabilizing the macro-economy. Macro-prudential policy thus focuses on two key externalities in the financial system: pro-cyclicality in an intertemporal dimension as well as spillover effects in a cross-sectional dimension. Pro-cyclicality concerns an intertemporal amplification mechanism within the financial system as well as between the financial system and the macro-economy. Spillover effects concern a cross-sectional amplification mechanism through a complex network of various types of financial institutions, comprising not only commercial banks but also other market-based financial intermediaries and institutional investors.

The recent crisis fundamentally challenged the dichotomy between monetary policy and prudential policy. Before the crisis, monetary policy and prudential policy were deemed separable and better allocated to different policy authorities. Monetary policy focused primarily on the macroeconomic goal of low and stable inflation, while prudential policy placed emphasis on maintaining the soundness of individual financial institutions, thereby reducing systemic risk. At the moment, however, there seems to be increasing arguments to support the view that pursuing the two objectives, price and financial system stability, in a consistent and

sustainable manner requires the combination of monetary policy and micro-prudential and macro-prudential policies with close cooperation among the related policy authorities.

Given the close interaction between monetary policy and macro-prudential policy, it is crucial for central banks to consider an overall policy framework for central banking, encompassing both policies. This paper proposes a framework of constrained discretion for central banking to pursue price and financial system stability in a consistent and sustainable manner. Such a policy framework extends constrained discretion for monetary policy, proposed as the conceptual basis for flexible inflation targeting, to overall central banking, thereby providing central banks with a basis for implementing monetary policy and macro-prudential policy in a compatible, systematic, flexible and accountable manner.

THE PHILIPPINES

BY CAYETANO W. PADERANGA, JR.

The 2008–09 global economic crisis proved that emerging economies in Asia were only "decoupled" from the U.S. economy up to a certain extent. While their respective financial sectors avoided any direct hit from the U.S. subprime crisis, the resulting worldwide credit crunch led to falling export demand by developed economies from emerging economies. This is true for the Philippines, which saw its economy slow down due to a weaker real sector even as its financial sector was relatively unharmed.

The impacts on the Philippine economy can be analyzed through five channels:

(i) through the impact on confidence and purchasing power because of the asset losses of higher-spending levels of the population, magnified by the losses suffered by banks;

(ii) through the added losses to the investing public as portfolio investments flowed out leading to lower asset values in the country. This, in turn, led to more difficult mobilization of investment resources in the equity and credit markets;

(iii) through the difficulty of raising direct investment capital (FDI) in developed markets (to persist over the next few years);

(iv) through the impact on exports as overseas markets contracted (in October, the decline was large as -37 percent);

(v) through the feared impact on OFW deployment with the resulting adverse effect on the main engine of Philippine economic growth, OFW remittances. This last impact turned out to be less of a factor as remittances slowed down but did not decline in absolute terms.

The negligible impact of the global economic crisis on the Philippine financial sector can be attributed to two factors: (i) the conservative behavior of local firms during the run-up to the crisis, and (ii) stricter standards imposed by regulators which were part of post-1997 financial sector reforms. In the period preceding and during the crisis, the sector was in a healthier state as shown by:

(i) the drop in nonperforming loans (NPL) and noperforming asset (NPA)-to-gross asset ratios after 2009 when both ratios further dropped to 3.66 and 4.48 percent by yearend 2009;

(ii) higher asset levels reserved for possible bad loans in 2009. From 83.33 percent in September 2008, NPL coverage increased to 93.13 percent by end-December 2009. Over the same period, NPA coverage also grew, albeit at a smaller magnitude from 43.34 percent to only 48.69 percent;

(iii) more than adequate capital buffers as indicated by current capital adequacy (CA) ratios which are above the BSP's prescribed 10 percent requirement and even higher than the 8 percent ratio set under the international Basel Accord.

However, the nonbanking sector was not as fortunate since the global crisis renewed lingering concerns over its overall health. Deteriorating conditions abroad led to lower insurance demand with the public preferring cash over investments. From its peak of Php1,080 in 2007, the country's per capita insurance spending plunged to Php859.5 in 2008 before settling at Php845.4 in 2009. This reduction in insurance coverage could reflect (i) a drop in asset values and (ii) a decline in the appetite or ability to pay insurance premiums as revenues suffered, though industry observers attribute the slowdown more to the latter.

The macroeconomic and macro-prudential nature of the global crisis offer two major lessons for the

Philippines and other emerging economies. First, there is an urgent need for these countries to monitor not just their own financial markets but the international financial markets as well, due to the increasing integration and interdependence between the two. The shallow capital and financial markets, which usually characterizes these markets in emerging economies, meant that they were unduly exposed and affected by movements in capital flows and asset prices starting from other more-developed economies. While higher integration to global capital markets allows emerging economies to overcome existing resource bottlenecks, the recent events show that disequilibrium stemming from crisis abroad can be transferred as well.

Second, the global crisis has shown that macro-prudential lapses in some countries can have high impact on other countries. Cautious behavior in some countries may limit, but not fully prevent, the movement of the disequilibrium arising from these lapses. The Philippine experience during the global crisis clearly shows this. Even as its financial markets were spared from the worst impact of the crisis—due to conservative regulation and risk aversion among its citizens—in the end, the country's real sector suffered from a fall in export receipts and guarded behavior of its consumers. Indeed, though the modern, globalized world has been beneficial, it has also given rise to new complications for economies and their policy-makers.

CHINESE TAIPEI

BY SHENG-CHENG HU

The global financial crisis that began in 2007 resulted in a severe downturn in the world economy, and as a mid-sized open economy, Chinese Taipei was not immune from the crisis. Its economic growth rate fell from 5.98 percent in 2007 to 0.73 percent in 2008 and -1.93 percent in 2009, and, in fact, the economy suffered its worst economic downturn in postwar history in the first quarter 2009, when its growth rate was -8.56 percent (year-over-year). Over the same time period, the unemployment rate rose from 3.91 percent in 2007 to 4.14 percent in 2008 and 5.85 percent in 2009.

To counter the sharp downturn in the economy, the government of Chinese Taipei had to take extraordinary expansionary fiscal policy measures, incurring a budget deficit amounting to 5.8 percent of GDP in 2009. The Central Bank of Chinese Taipei also maintained an easy policy.

The financial sector of Chinese Taipei was healthy at the onset of the global financial crisis. The NPL ratio of domestic banks was low (1.84 percent in 2007) and the capital adequacy ratio was in a safe range (10.81 percent in 2007). Although there were no bank runs during the crisis, as a precautionary measure, the government announced a policy to guarantee all deposits in the full amount rather than the normal limit of NT$1.5 million (or around US$46,900) per account. The policy ended at the end of 2010.

Monetary policy was easy and there was plenty liquidity in the market. The growth rate of M2 was 7.0 percent in 2008 and 5.74 percent in 2009, both higher than the mean growth rate (5.22 percent) for 2000–09. In addition, the Central Bank reduced the rediscount rate seven times from 3.625 percent in June 2008 to 1.25 percent in February 2009. However, the base lending rate charged by banks continued to rise until March 2009, when the financial crisis appeared to be under control.

During the global financial crisis, there were greater fluctuations in capital flows, and at times, the Central Bank had to intervene vigorously. The percentage of the annual change in M2 attributable to the international asset position increased from 72 percent in 2007 to 79 percent in 2008 and 134 percent on 2009. There was also increasing volatility in the value of the New Taiwan dollar (NT$). In particular, from July 2008 until February 2009, the value of the NT$ in terms of the U.S. dollar declined by 11.6 percent, reflecting a deteriorating economy and increasing net capital outflows. Overall, the fluctuations in the value of the NT$ were in line with what occurred in neighboring economies, and Chinese Taipei's exchange rate was less volatile.

As in other economies, Chinese Taipei's stock markets were badly hurt by the crisis. In 2008, the decline in the TWSE index was 46.0 percent, that, in turn, resulted in a decline in the market value of stocks by NT$9.51 trillion (US$289.4 billion). However, the losses were almost fully recovered in 2009 when the TWSE index jumped up by 78 percent.

In addition, Chinese Taipei suffered direct losses on its holdings of overseas assets, including subprime mortgages, Lehman Brothers' structured products and others. The losses in toxic assets were estimated to be NT$265.1 billion (US$8.07 billion) or 1.96 percent of its GDP of US$412.6 billion in 2008 (Yen 2009).

During the financial crisis, the ratio of total private sector financing (through bank loans and securities markets) to GDP continued to rise possibly because of the easy monetary policy. Moreover, the ratio of financing through bank loans relative to financing

through securities markets rose as a result of the easy monetary policy and a sharp drop in stock prices.

On the other hand, the economy of Chinese Taipei is heavily dependent on trade for economic growth. In 2009, Chinese Taipei's total exports declined by -20.32 percent as its exports to China, its largest trading partner, fell by -15.9 percent (-40.5 percent, year-over-year in the first quarter), and its exports to the U.S. declined by -23.5 percent (-24.4 percent year-over-year in the first quarter). The sharp drop in exports, in turn, brought about a deep recession and a sharp rise in the unemployment rate. For the first time in history, the ICT companies asked their employees to take unpaid leaves.

Because of the losses in asset value, a sharp rise in the unemployment rate and the resulting collapse of consumer confidence, there was a decline in private consumption. In the first quarter of 2009, despite the government's fiscal stimulus measures, private consumption fell at the real rate of -2.12 percent (year-over-year). For the entire year, the real growth rate of private consumption was only a modest 1.08 percent, compared with the pre-crisis period (2003–07) of 2.91 percent per annum.

Because of declining exports, private investment declined by -35.88 percent in the first quarter and -31.06 percent in the second quarter (year-over-year), and -17.91 percent for the entire year of 2009. The ICT sector which accounts for 13.5 percent of Chinese Taipei's GDP and 31.1 percent of industrial fixed investment as of 2007, experienced a decline in investment by 22.7 percent in 2008 and 29.5 percent in 2009. During the same period, the decline in total private investment was -15.6 percent and -17.9 percent, respectively. The decline in private investment occurred in spite of the easy monetary policy pursued by the Central Bank and the government's urging of banks to support businesses with liquidity.

Chinese Taipei's contagion of the financial crisis was mainly through the nonfinancial channel, particularly the decline in exports. Chinese Taipei's financial sector was relatively stable throughout the crisis. The main effect of the crisis on the financial sector was a decline in stock prices and a loss in the value of its holdings of overseas assets. The real effect of the decline in asset value does not appear to have been as powerful as the decline in exports.

THAILAND

BY CHAIYASIT ANUCHITWORAWONG

The U.S. subprime crisis has demonstrated the extent to which the economic fortunes of all countries are intertwined, although its impacts are relatively country-specific depending on the intensity of trade and financial linkages with the crisis-hit countries. This study explores the resiliency of the Thai economy in the face of a number of setbacks. In so doing, we analyze the macro-financial linkages and impacts of the global financial crisis on macroeconomic performance, the effects of crisis on financial deepening in Thailand, and the role of regional financial cooperation and ways to strengthen cooperation.

The impacts of the global financial crisis depended very much on how close an economy was connected with the crisis-hit countries like the United States and European countries. Over the past few decades, although there has been a significant rise in both international trade and financial linkages with foreign markets, the U.S. subprime mortgage crisis that spread to Europe and Japan tended to affect the Thai economy much more through trade rather than financial channels. The reasons are as follows: (i) the Thai economy has relied substantially on demands directly from the crisis-hit countries, and indirectly from China. Hence, the collapse of external demand in these markets created both direct and indirect adverse spillovers on Thailand's export performance, investment and GDP; and (ii) the Thai financial system is well-functioning and its fundamentals have been strengthened through reforms in various aspects since the aftermath of the 1997 financial crisis. More importantly, Thai financial institutions have a very low exposure to CDO-related investment. Although the crisis did not affect the performance of Thai financial institutions much, it created some impacts on the financial and asset markets such as the fluctuation of capital flows, the deterioration of market prices of equities, the pullback of investment and capital, and the rise in risk premium of financial assets.

There has been an improvement in the level of financial deepening during the past ten years. While Thailand continues to utilize the banking system as the main channel of resource mobilization, the economy is increasingly financed through stock and bond markets. With improvements in risk management practices and supervision, Thai banks on average have high reserves and low exposure to nonperforming loans, and are well-capitalized. They therefore have been well-equipped to survive any disruptions that may come during a crisis. Although the subprime crisis did not seem to directly affect financial deepening of the banking sector, the crisis coupled with political instability during that time undermined investor confidence in the Thai stock market, and resulted in a substantial decline in equity prices and market capitalization.

Lastly, the lessons learned from the two recent crises have been the stimulus for economic cooperation within the region. Although some progress could be observed in the form of cooperation agreements regarding the development of surveillance mechanisms, the bilateral Chiang Mai Initiative, and the Asian Bond Market during the post-1997 financial crisis period, there have been signs of retrogression in recent years. Because no one can anticipate unexpected events correctly and well in advance, it is indispensable to push ahead to promote cooperation and initiate schemes that help prevent the recurrence of a crisis, strengthen the capability to better manage a crisis, and shape the financial environment in the region. Nonetheless, there are three important issues that need careful discussion on the risk management capacity of the international financial system, the issue of pro-cyclicality in the context of international regulatory and supervisory frameworks, and the management

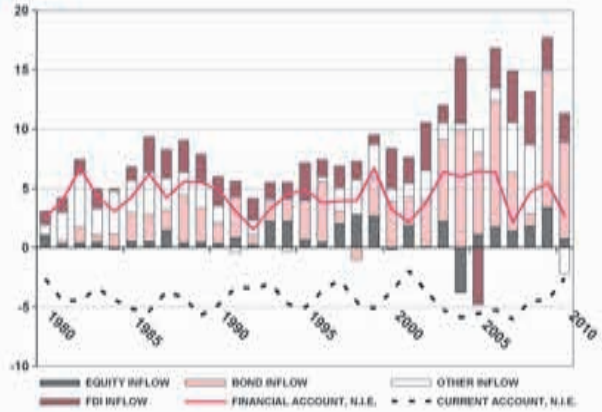
of cross-border spillover effects that can induce severe systemic risk. Essentially, we need to take into account the design flaws of the EU system in order to find out how to deal with fiscal irresponsibility, coordinated fiscal plans, and governance system of member nations.

APPENDIX

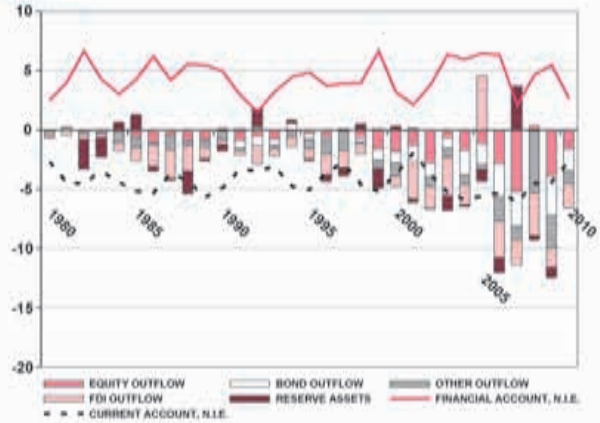
Appendix Figure 1. **Financial Account** (% of GDP)

Australia

inflow



outflow



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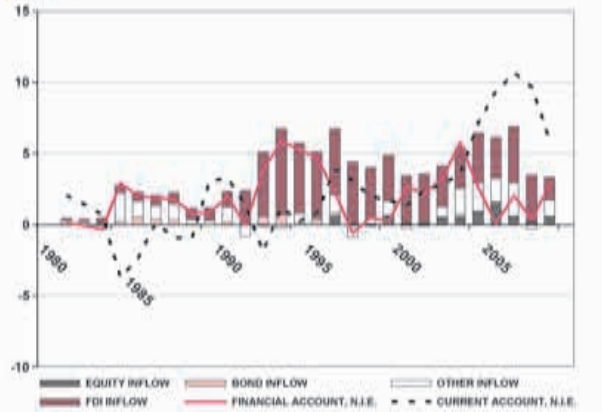

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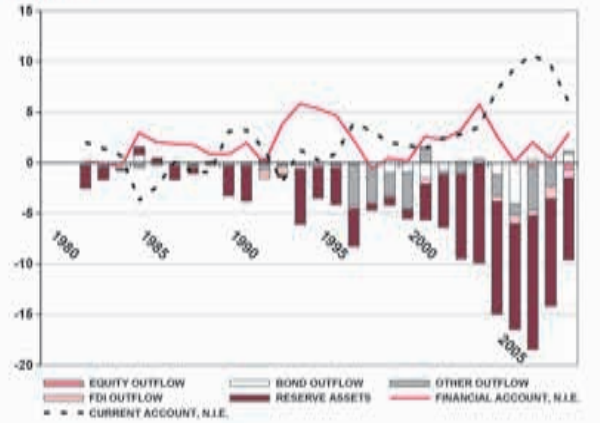

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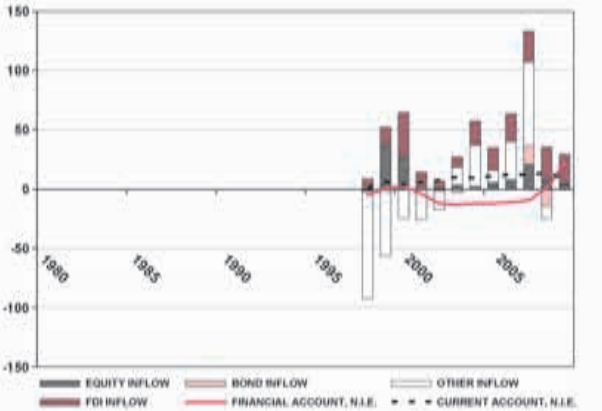

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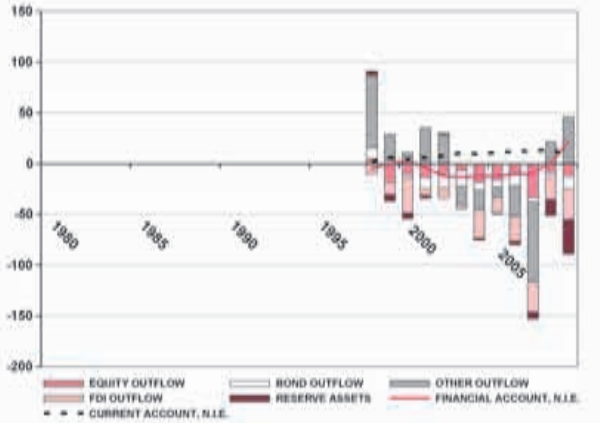

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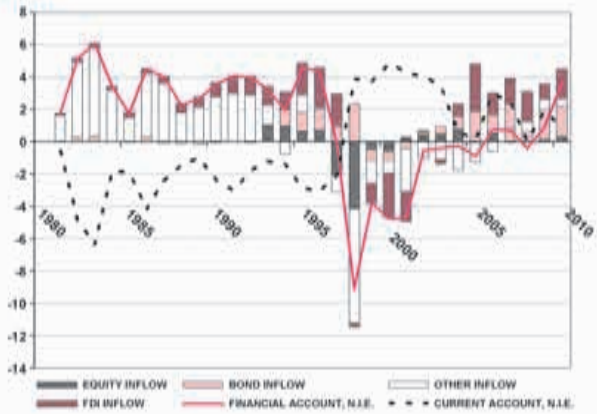

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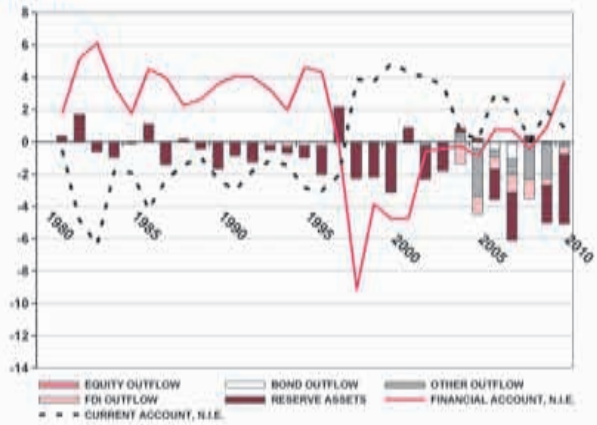

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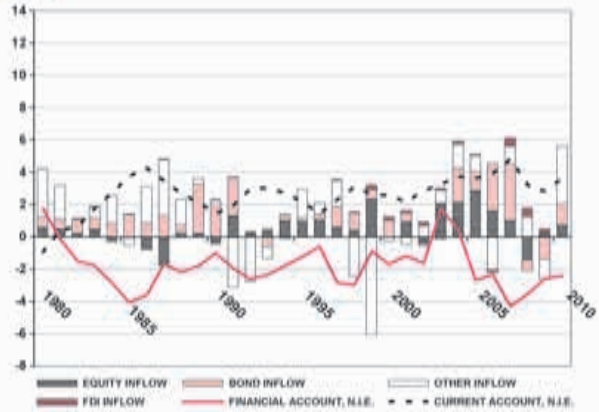

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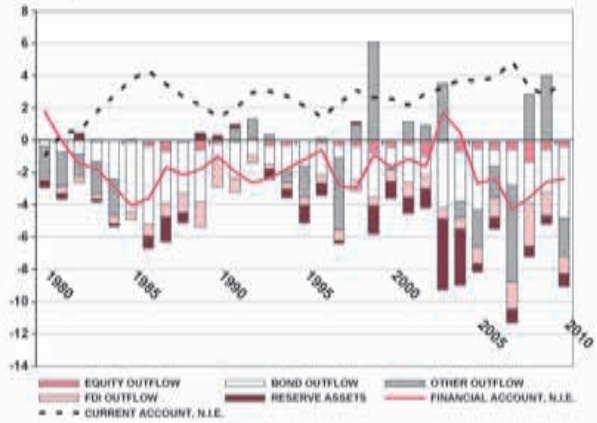

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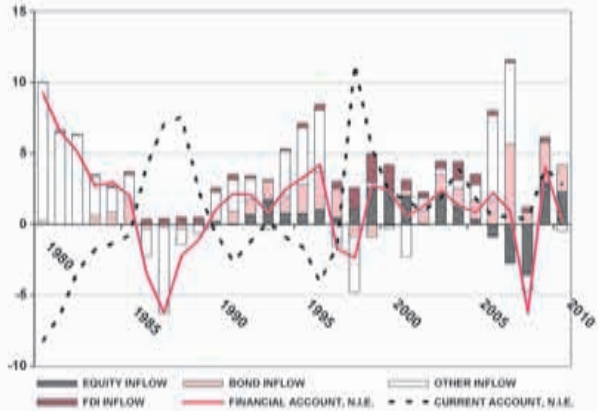

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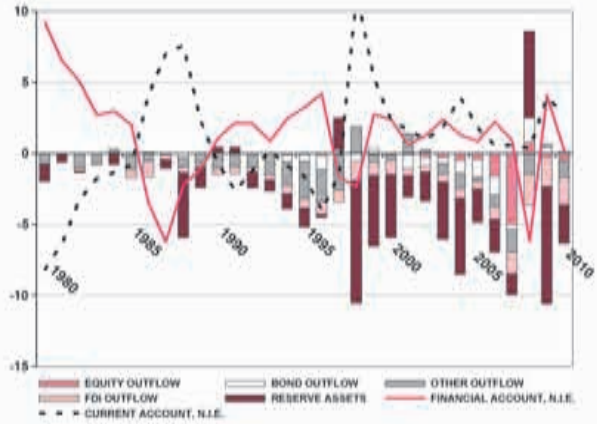

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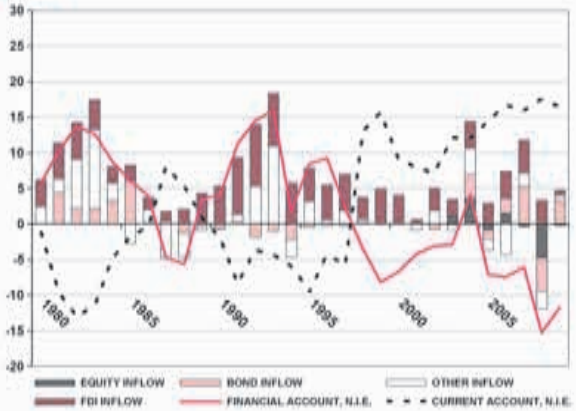

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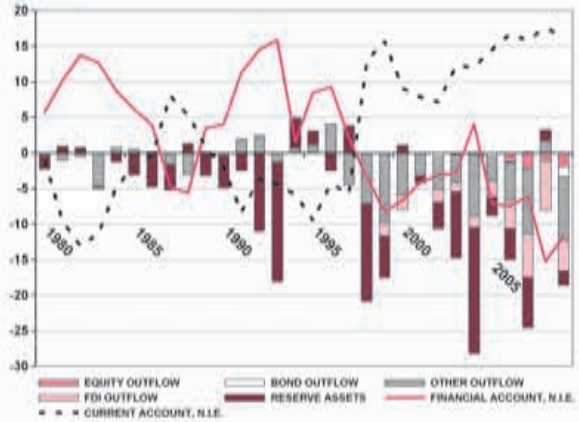

Philippines

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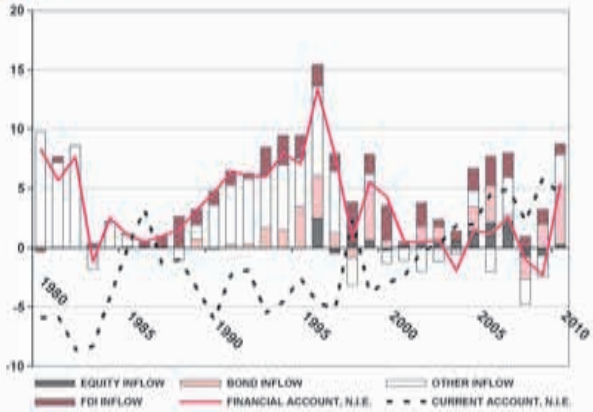

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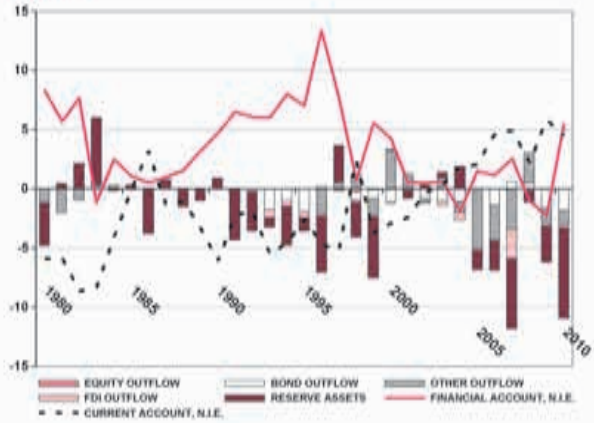

Singapore

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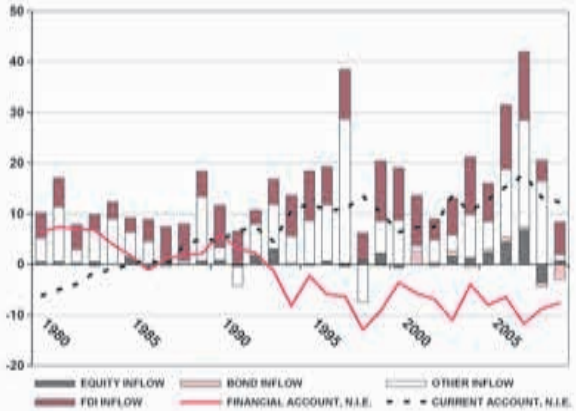

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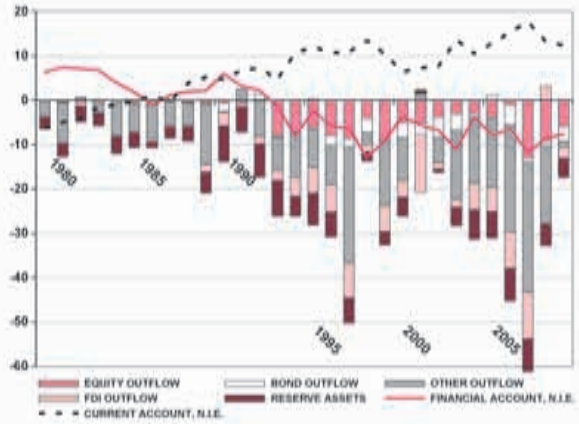

Chinese Taipei

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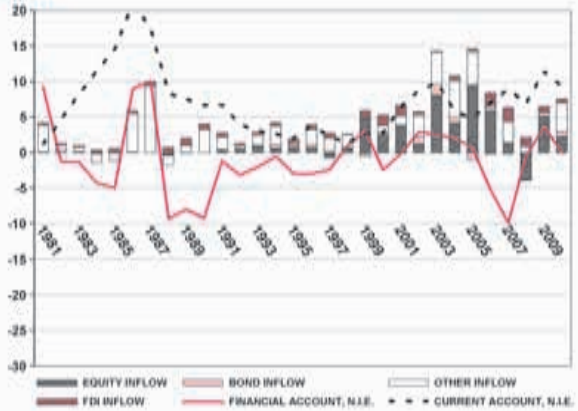

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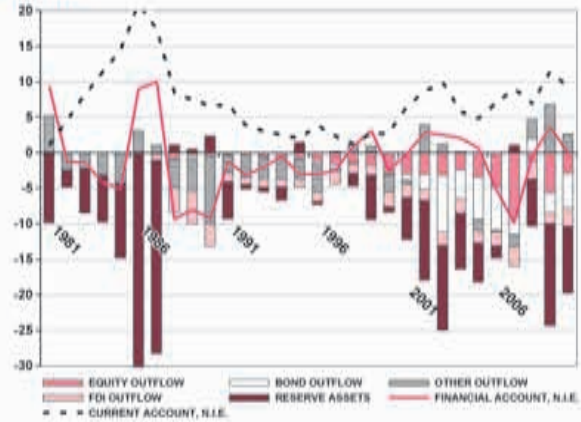

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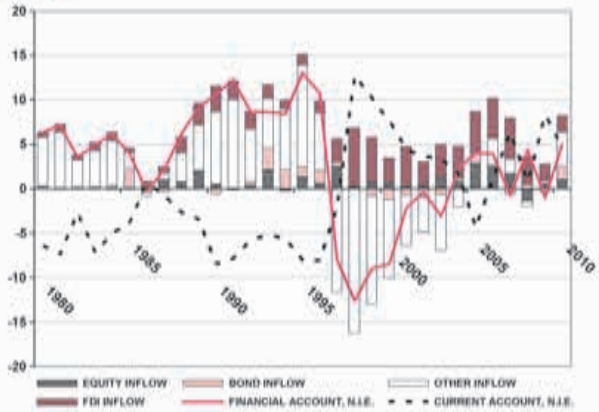

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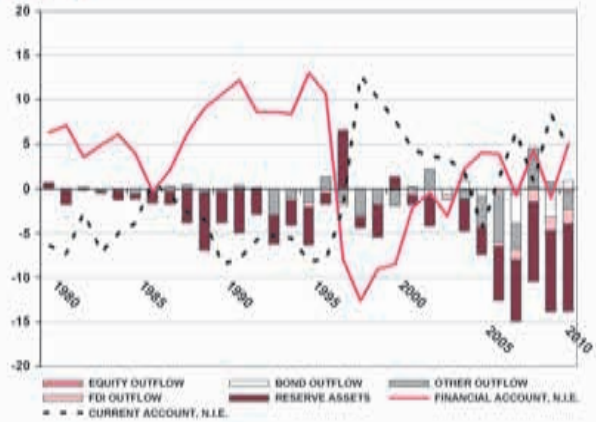

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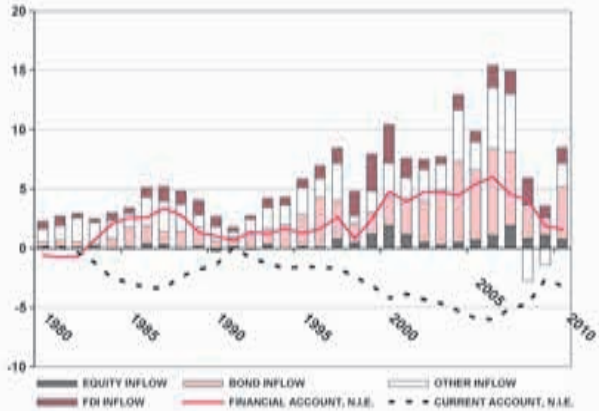

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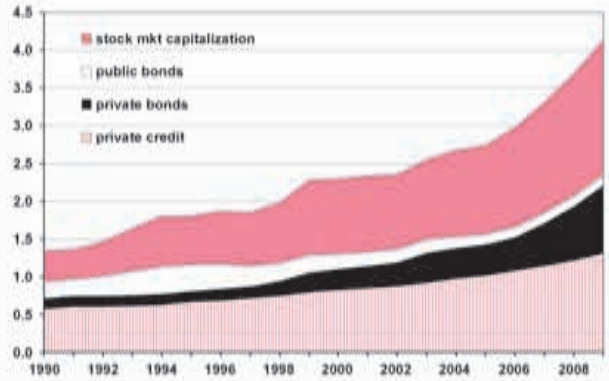
Data source: IMF, International Financial Statistics, CD-ROM.

Appendix Figure 2. **Domestic Financial Structure** (Ratio to GDP)

Australia



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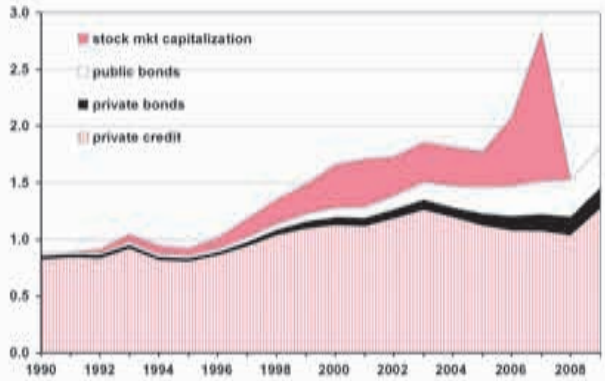
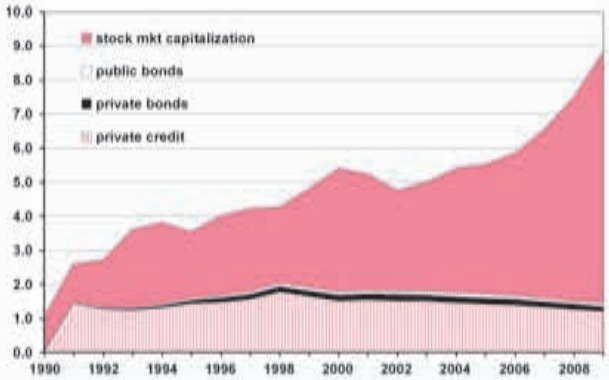


Hong Kong, China



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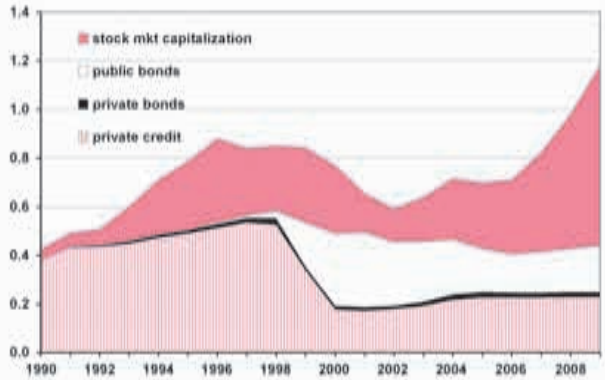
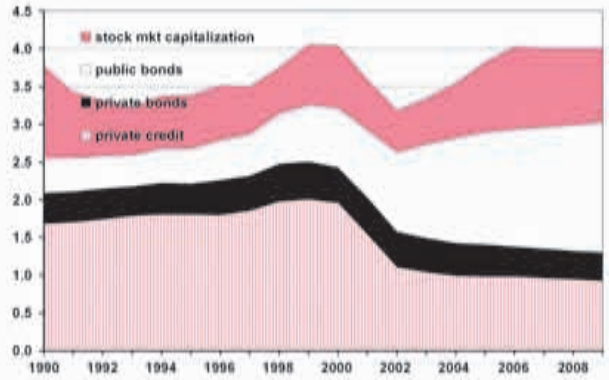


Japan



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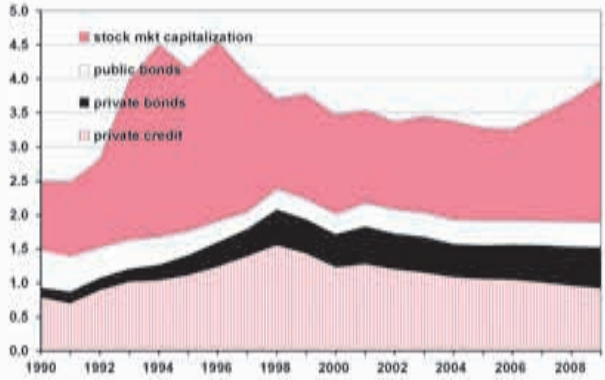
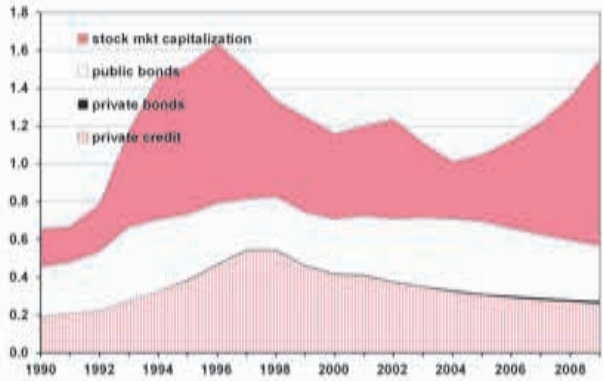


Philippines



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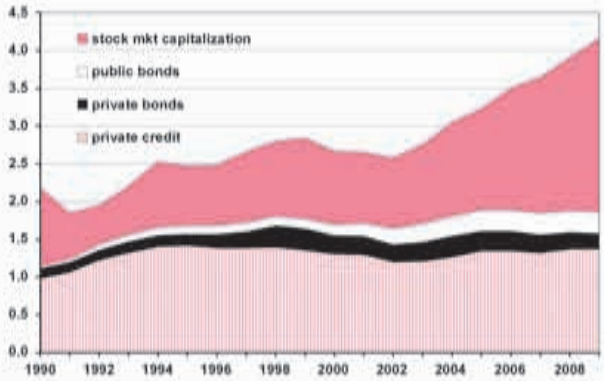

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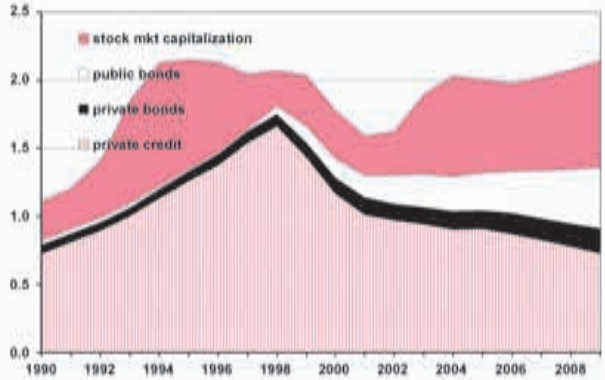
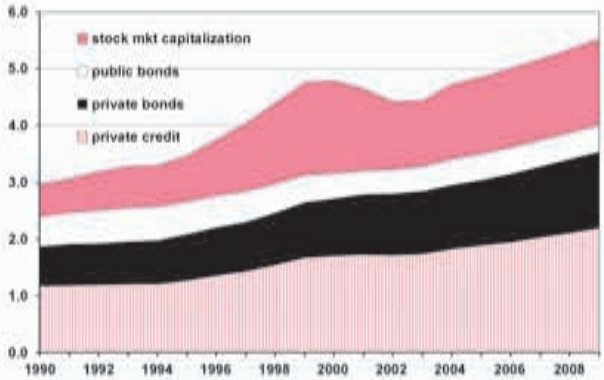


United States



Data source: World Bank, Financial Development and Structure Dataset, http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/

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PACIFIC ECONOMIC COOPERATION COUNCIL

The Pacific Economic Cooperation Council (PECC) was founded in 1980 at the initiative of the Prime Ministers of Japan and Australia, with the aims of serving as a regional forum for cooperation and policy coordination to promote economic development in the Asia-Pacific Region.

PECC is a unique tripartite partnership of senior individuals from business and industry, government, academic and other intellectual circles in 24 Asia-Pacific Economies[1]. All participate in their private capacity and discuss freely on current, practical policy issues in search of broad-based answers to regional economic problems.

PECC advocated the need for a formal, intergovernmental organization in the Pacific from the time of its creation. The regional ministerial process of the Asia Pacific Economic Cooperation (APEC) has realized that goal and now provides PECC with a formal channel by which its practical recommendations can be implemented. PECC is the only non-governmental official observer of APEC since the formation of APEC. PECC has provided information and analytical support to APEC ministerial meetings and working groups.

To promote economic cooperation and the idea of a Pacific Community, the PECC organization's governing body - the Standing Committee[2] - establishes ad hoc task forces to undertake and promote research on issues it has decided need to be addressed by the regional community. For 2008-2009, four signature projects have been established, and PECC's member committees also collaborate on four international projects additionally.

Pacific Economic Outlook (PEO) is among these PECC activities and PEO/Structure, which has dealt with longer-term macro-economic issues in the Pacific region, is the one of the international projects mentioned above. The Japan Committee for PEO also supports activity of "State of The Region", which has been one of the signature projects and made policy recommendation to APEC, since 2006.

The groups of PECC activities meet periodically to organize seminars or workshops, conduct studies and publish their research outcomes and recommendations for the benefit of the Pacific community.

PECC member committees and PECC work groups send tripartite delegations to the PECC General Meetings. In the interim, policy matters are handled by a Standing Committee, and day-to-day administrative and coordinating functions are carried out by the International Secretariat based in Singapore.

For more information on PECC, please contact the PECC International Secretariat.

PECC International Secretariat

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[1] The PECC Economies include Australia, Brunei Darussalam, Canada, Chile, China, Colombia, Ecuador, Hong Kong China, Indonesia, Japan, Korea, Malaysia, Mexico, Mongolia, New Zealand, Peru, The Philippines, Singapore, Pacific Islands Forum, Chinese Taipei, Thailand, The United States and Viet Nam. France (Pacific Territories) is an Associate Member. The Pacific Basin Economic Council (PBEC) is the regional business organization, and the Pacific Trade and Development Conference (PAFTAD) is the region-wide organization of academic economists, both of which are Institutional Members.

[2] The Standing Committee is PECC's governing body. It includes the Chairs of PECC Committees in each of the 24 full member economies.PBEC and PAFTAD also have seats on Standing Committee.

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(Ms.Eunyoung Kim)

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KANSAI INSTITUTE FOR SOCIAL AND ECONOMIC RESEARCH (KISER)

Background

The Kansai Institute for Social and Economic Research (KISER) is a nonprofit organization in Kansai (the region centered in Osaka, Kobe and Kyoto) that has its objectives in contributing to the development of the national and regional economies through academic advances.

KISER was established April 2002 as a result of the consolidation of the three research institutions in the region: the Kansai Economic Research Center (KERC), the Center for Industrial Renovation of Kansai (CIRK) and the Socio-Economic Research Institute in Kansai.

KISER promotes research projects through the collaboration of academia and local business community under governmental cooperation. The necessary funds for KISER are raised through membership fees from approximately 200 leading firms in various industries from all over Japan.

Purpose and Activities

KISER is currently engaged in the following projects:

- Conducting theoretical and empirical research on social and economic issues in Japan and overseas, including economic policies and regional development.
- Making proposals on both national and regional policies formulated through its flexible research capabilities that take advantage of its academic, industrial and governmental networks.
- Encouraging research exchange among Japanese and overseas economists, as well as among foreign residents in Kansai.
- Carrying out research commissioned by government agencies, regional public institutions, and private enterprises.
- Hosting seminars and symposiums by inviting specialists from all over the world.

KISER Highlights

<Research for Policy Proposal>

* **Policy agenda for the national and local governments** (Discussion on policy agendas regarding the most pressing and challenging contemporary themes. Topics include structural reforms, macroeconomic policy and aging fewer children problem among others.).

* **Issues for public administrative and fiscal reforms and for local government's initiatives.**

* **Proposals for revitalization of industrial competitiveness and for regional development strategies.**

<Economic Analysis>

* **Macroeconomic analysis of the Japanese economy.**

* **Quantitative analysis of the regional economy.**

* **Compilation and publishing of a variety of data on regional economy "White Paper on the Kansai Economy"**

<Member Service and Public Interest >

* **Research entrusted by public entities**

* **Sponsoring symposiums, seminars and lecture meetings.**

* **Sponsoring professional conferences and academic meetings** (Modern Economic Policy Conference).

* **Promoting International Academic Exchange**
  PECC-PEO (Pacific Economic Cooperation

Council — Pacific Economic Outlook).

* **Encouraging multilateral relationship among academia, business communities and governmental bodies.**

* **Public Relation Activities** (regularly delivery of the web magazine "KISER" and maintenace for our website).

Senior Officers

KISER is administered by a board of directors, which consists of representatives from major corporations and universities in the Kansai region.

Chairman

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Chairperson, KISER
(Chairperson, Kansai Economic Federation/Chairperson, The Kansai Electric Power Co., Inc)

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Research Director, KISER
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