Paper

Finance and Instability in Asia

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A recent feature of financial systems in Asia is a strong trend towards convergence of what were very different and are still dissimilar financial structures. This diversity, which has received more attention than the common elements in those structures, was seen as reflective of the effort of governments spearheading and overseeing late-industrialization to shape financial structures that were best suited to the relevant national context and the strategy adopted to advance developmental objectives. Neither the financial structures left behind by colonial regimes nor any that had emerged and evolved spontaneously because of market demand were considered adequate for the purpose.

However since the late 1980s, a state-initiated process of deregulation and liberalization is establishing in the region financial structures resembling those prevailing in the Anglo-Saxon world, with similar markets, institutions, instruments and regulatory frameworks. This is ironic and somewhat surprising, because as early as the 1990s, the Savings and Loans crisis in the United States had revealed that deregulated financial systems, besides being unsuited to financing long-term productive investments, are prone to institutional failure and even systemic collapse. Unfortunately, that message had not been adequately absorbed by governments and regulators in the Asian region (as elsewhere).

The nature and consequences of financial liberalization

Financial liberalization can be defined as a state-led process of diluting or dismantling regulatory control over cross-border flows of capital and over the institutional structures, instruments and activities of agents in different segments of the financial sector. Liberalization measures can relate to internal or external regulations. External financial liberalization involves changes in the exchange control regime. Typically, full convertibility for current account transactions accompanying trade liberalization have been either prior or simultaneous reforms, which are then complemented with varying degrees of convertibility on the capital account. Capital account liberalization measures broadly cover the following, in increasing degree of intensity, but with a wide variety of patterns of implementation:

1. Measures that allow foreign residents to hold domestic financial assets, either in the form of debt or equity. This can be associated with greater freedom for domestic firms to undertake external commercial borrowing, often without government guarantee or even supervision. Dilution or removal of controls

on the entry of new financial firms, subject to their meeting pre-specified norms with regard to capital investments. This does not necessarily increase competition because it is usually associated with the freedom to acquire financial firms for foreign players and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets, which often triggers a process of consolidation.

2. Measures that allow domestic residents to hold foreign financial assets. This is typically seen as a more drastic degree of liberalization, since it eases the possibility of capital flight led by domestic residents in periods of crisis. However, a number of countries that receive "excessive" capital inflows that do not add to domestic investment in the net and are reflected in unnecessary accumulation of foreign exchange reserves, have turned to such measures as a means of reducing pressure on the exchange rate.
3. Measures that allow foreign currency assets to be freely held and traded within the domestic economy ("dollarization" of accounts). This is the most extreme form of external financial liberalization, which has been implemented only in very few countries.

Internal financial liberalization typically includes some or all of the following measures, to varying degrees:

1. The reduction or removal of controls on the interest rates or rates of return charged by financial agents. In practice this never means that the range of interest rates are "market determined". The central bank influences or administers that rate structure through adjustments of the bank or discount rate at which it lends to the banking system and through its own open market operations. The government influences interest rates by altering administered interest rates offered on small savings and pension/provident fund depositors. So while liberalization does not fully "free" interest rates, it has other kinds of consequences. It encourages competition between similarly placed financial firms aimed at attracting depositors on the one hand and enticing potential borrowers to take on debt on the other. Competition in these spheres not only takes non-price forms, but leads to price competition that squeezes spreads and forces firms to depend on volumes to shore up their bottom line. That is, within the range implicitly set by the central bank (and at times the government) banks can be encouraged by liberalization of rates to accept lower spreads in the hope of neutralising the effects on profits by attracting larger volumes of business.
2. The removal or dilution of controls on the entry of new financial firms, either through greenfield projects, subject to their meeting pre-specified norms with regard to capital investments, or through acquisition of equity in existing firms.
3. The reduction in controls over the investments that can be undertaken by financial agents, including permitting them to invest in areas they were not permitted to enter earlier. The consequent ability of financial agents to straddle multiple financial activities implies that the linkages between different financial markets tend to increase, with developments in any one market affecting others to a far greater degree than they did before. This increases the interlinkages between and pyramiding of financial structures.
4. Liberalization of the rules governing the kinds of financial instruments that can be issued and acquired in the system, including the securitization of various kinds of credit assets. This transforms the traditional role of the banking system of being the principal intermediary bearing risks in the system. Thus, with liberalization, the focus shifts to that of generating financial assets that transfer risks to the portfolio of

institutions willing to hold them, and earning revenues in the form of fees and commissions as opposed to the interest rate spread adjusted for intermediation costs. Financial instruments allow agents to share to differing degrees financial gains and risks, where the gains involved are incomes and asset price appreciation and the risks are, therefore, income and capital risks.

5. The easing of conditions for the participation of both firms and investors in the stock market by diluting or doing away with listing conditions, by providing freedom in pricing of new issues, by permitting greater freedoms to intermediaries such as brokers and by relaxing conditions with regard to borrowing against shares and investing borrowed funds in the market. In addition, conditions relating to the need to declare share acquisitions that can lead to takeovers are also relaxed.
6. Expansion of the sources from and instruments through which firms or financial agents can access funds. This leads to the proliferation of instruments such as commercial paper and certificates of deposit issued in the domestic market, and allows for off-shore secondary market products such as ADRs (American Depository Receipts or the floating of primary issues in the US market by non-US based firms) and GDRs (Global Depository Receipts).
7. The shift to a regime of voluntary adherence to statutory guidelines with regard to capital adequacy, accounting norms and related practices, with the central bank's role being that of supervision and monitoring. Market mediated controls such as the Basel norms rather than structural controls of the kind imposed by the Glass Steagall Act in the US, which prescribe behaviour and circumscribe fields of activityfor financial firms, define the regulatory framework, with an emphasis on regulatory forbearance rather than strict regulation.
8. The withdrawal of the state from the activity of financial intermediation, on the grounds that this is not conducive to the dominance of market signals in the allocation of capital. This is usually accompanied by the decline of directed credit, and removal of requirements for special credit allocations to priority sectors, whether these are government, small-scale producers, agriculture, or other sectors seen as priority for strategic or developmental reasons. Moreover, specialised financial institutions that survive on state support, such as development banks created to address the inadequate availability of long-term capital or policy banks that address the unmet credit needs of agriculturalists and small enterprises, are closed to 'level the playing field'.

Financial deregulation in Asia

It is remarkable that, despite the evidence of the benefits that had been derived from shaping and subordinating the financial sector in keeping with developmental goals, Asian countries opted for deregulation to differing degrees in the years starting from the 1980s. In some cases, this was enforced by changes in the external economic environment. In others it was in large measure a matter of domestic policy choice.

Consider the Japanese case, for example. Though the regulated financial sector served Japan well till the 1980s, the government was forced to opt for a process of deregulation under pressure. The pressure came, inter alia, from four sources. First, as successful Japanese firms moved abroad to service foreign markets the main banks that had banked them also turned international and wanted the freedom to operate in ways their foreign competitors did. Second, there was lobbying by international banks and financial institutions that wanted Japan to open up its financial sector and provide them space in its financial system. Third, once these external agents were permitted to enter the system, they wanted a dilution of the special relationship that existed between the government, the financial system and the corporate world, since that implied the existence of internal barriers to their entry and expansion. Fourth, these agents, along with some Japanese financial institutions affected adversely by the deceleration of growth in the system wanted greater flexibility in operations and the freedom to "innovate", both in terms of choice of investments and instruments with which they could transact.

There was one principal reason why Japan succumbed to these pressures: its dependence on world, especially US, markets to sustain growth. When faced with US protectionism against Japanese imports, Japanese investors sought to "Americanise" themselves by acquiring or establishing new production capacities in the US in areas like automobiles. In return for the "freedom" to export to and invest in the US, Japan had to make some concessions. But US demands were quite damaging. They began by requiring Japan to appreciate its currency. Following the Plaza accord, arrived at in New York in September 1985, the yen, which had started to appreciate against the dollar in February 1985 from a 260 yen-to-the-dollar level, maintained its upward trend to touch the April1995 level of below 80 yen-to-the-dollar. Any economy faced with such a huge appreciation of its currency was bound to stall, more so an export-dependent one like that of Japan.

This trend, which damaged the balance sheets of overgeared Japanese firms and resulted in the hollowing out of Japanese industry, undermined the principal area of business of the banks as well, which were faced with the prospect that some of their past lending could turn non-performing. It was in response to this that the Japanese banks joined the chorus against financial controls, demanding that they be permitted to diversify away from their traditional areas. The government responded by introducing regulatory changes in the form of a revision of the Foreign Exchange Control Law in 1980 and giving permission for commercial banks to create non-bank subsidiaries to lend against real estate investments. Besides expanding overseas operations, the principal areas into which the banks diversified were lending against real estate and stock market investments. According to Teranishi (1993): "High stock and land prices, increasing the value of collateral, allowed an expansion of bank lending to finance further demand for stock and land, especially by business firms, and this led to a self-feeding rise." The shares of stocks (at book value) in total bank assets rose from 38 per cent in 1979 to 58 per cent in 1989, and that of land from 9 to 13 per cent.

The result of this was a speculative boom triggered by a mad rush into the new areas. Even as GDP growth was slower in the 1980s than in the 1950s and 1960s, the six-largest-cities-index of real estate prices tripled between end-March 1985 and end-March 1990, from 33.6 to 100. Similarly, there was a massive speculative boom in stock markets with the yearly high of the Nikkei stock market index rising from 12,500 in 1985 to 38,916 in 1989. By 1989 it was clear that the asset bubble was bound to burst, and in a belated effort to halt the frenzy and respond to householder complaints that acquiring housing was virtually impossible, the government stepped in by controlling credit and raising interest rates. The net result was a collapse in both real estate and stock markets.

What followed was a huge build of bad debt with the banking system. At the beginning of 2002, the official estimate of the non-performing loans of Japanese banks stood at 8 per cent of GDP. In the past this would not have been a problem, as it would have been met by infusion of government funds into the banking system in various ways. But under the then-new liberalised, market-based discipline, banks were not getting additional money to finance new NPAs. Accumulation of such bad debt inevitably leads to a credit crunch, as banks are strapped for cash and turn wary in their lending practices. Over-geared corporations with outstanding loans on their books were no more favoured customers, resulting in a collapse of investment and a fall in utilisation for lack of long and short-term capital. Added to that, the insecure Japanese consumer chose to hold back on consumption. The point to note is that as growth slowed and firms found it increasingly difficult to show a profit before interest and tax, they were unable to meet past commitments on debt servicing. As a result, the bad loans problem has only increased.

The net effect in Japan was that financial liberalization triggered a recession that consecutive rounds of reflationary spending by the state have not been able to adequately counteract. It was not the cronyism that regulated finance generated, but the speculation and fragility that financial liberalisation resulted in, which explains the collapse of industrial policy and the prolonged crisis of industrialisation in Japan.

Elsewhere in Southeast Asia, financial liberalization in the 1980s and later paved the way for the fragility that came to the fore in 1997. But, in more than one case (excluding Malaysia for a short period) rather than forcing a rethinking of this strategy, the 1997 crisis led to further and more extensive liberalization. Among the consequences of this liberalization, there are a few that are particularly striking. The first is the evidence of the growing integration of these economies with the international financial system, as reflected in rising ratios of net capital flows to GDP in almost all of these countries. That process has intensified after 2003, with a sharp increase in foreign bank claims on these countries in recent years. This outcome is relevant not merely because it amounts to a reversal of the trend seen in the immediate post-1997 years, when as a result of the crisis the access of many countries to foreign finance appeared to be falling. Clearly, countries now are able to attract capital and are also unable to avoid or are unwilling to address the dangers (in the form of balance of payments and/or currency crises) of dependence on volatile cross-border flows. The result has been substantially increased fragility.

From a policy point of view the increase in the presence of foreign capital has necessitated changes in the regulatory framework governing finance in these countries. Governments in the region have adopted more liberal rules with regard to the functioning of different kinds of markets and institutions, provided greater space for new instruments such as derivatives, and shown a willingness to shift to globally accepted rules for regulation. One consequence has been a rapid shift to a Basel-type regulatory framework for the banking system. In fact, countries in the region are on average more eager to move on to Basel III than seems to be the case even in the developed countries where the crisis that forced the transition from Basel II to III occurred. The message appears to be that if countries choose to adopt a macroeconomic policy framework that emphasises the need to attract large volumes of foreign capital, reform of the regulatory structure governing finance in a common, globally dictated direction seems to be a prerequisite.

A third element of commonality in these countries has been a growth process associated with a large expansion of bank credit. Bank credit growth has overshot GDP growth in almost all countries resulting in sharp increases in their bank credit to GDP ratios (Chart 1.1). As is well known, banks that depend on deposits for their capital prefer to avoid exposure to illiquid assets with lower resale value, such as industrial capital equipment, because it exposes them to the risks associated with liquidity mismatches.

The net result has been a substantial increase in credit to the household sector or in retail credit/ personal loans for housing, for purchases of automobiles and durables and for consumption. Even by 2004, of domestic credit that banks had extended to private borrowers, consumer lending accounted for 53 per cent of total bank lending in Malaysia, 49 per cent in Korea, 30 per cent in Indonesia, 17 per cent in Thailand, 15 per cent in China, and 10 per cent in the Philippines. Even in countries where the estimates suggest that retail lending is low, such as China and Thailand, this is because banks that do not lend directly to the household sector often do so indirectly. They provide credit to a second tier of intermediaries, often in the "shadow banking" or informal financial sector, which in turn lend to households. While a large proportion of these loans is for housing, other loans such as for purchases of automobiles or to finance credit-card receivables have also increased considerably. The focus seems to be on lending short term or against assets that considered more liquid.

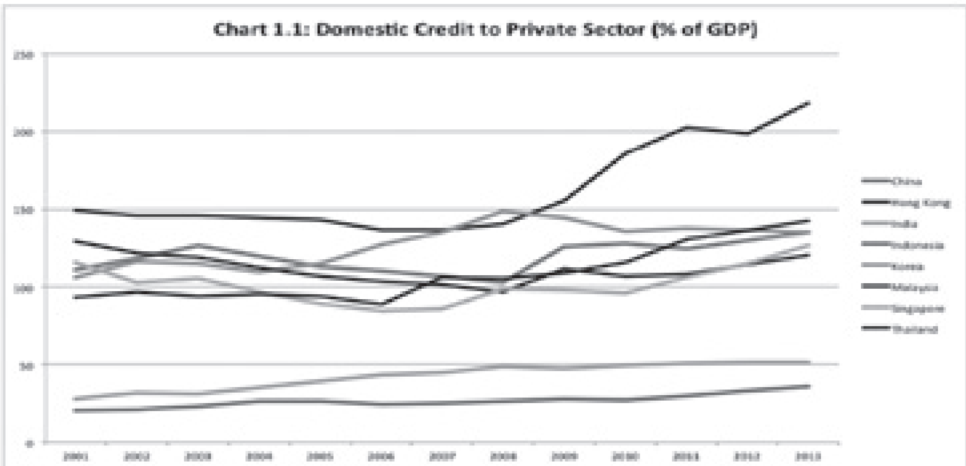


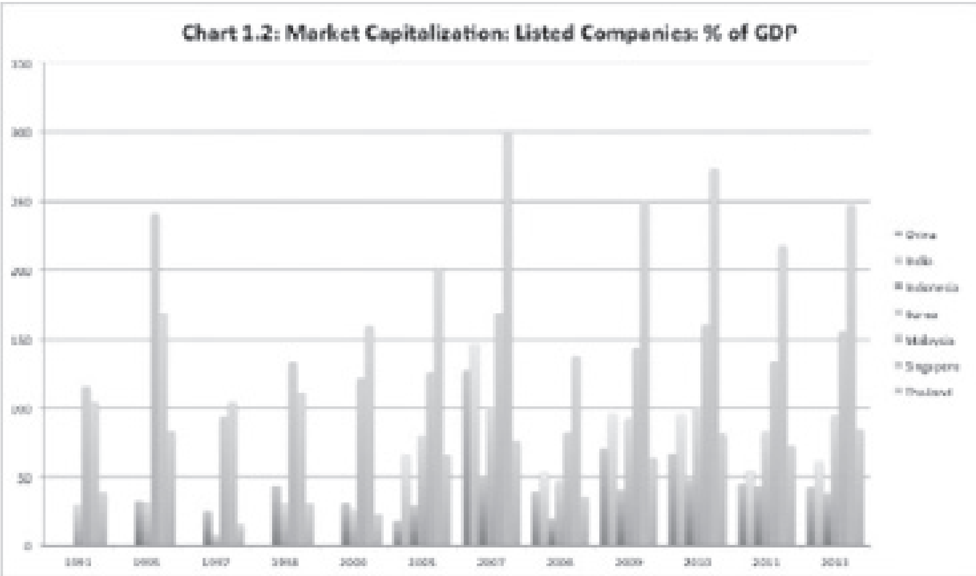
Chart 1.1: Domestic Credit to Private Sector (% of GDP)

→ p.67

Source: World Bank, *World Development Indicators,* available online at www.worldbank.org

The fourth common feature in the evolution of Asian financial structures is the kind of financial diversification visible in these economies. Given the huge increase in banks' claims on other sectors of the economy, the financial transformation of Asia has not been accompanied by a reduction in the importance of banks in the financial sector. Rather, banks still account for a substantial share of assets resting in the financial sector. Yet the evidence of the growing role of stock and bond markets and insurance companies, mutual funds and pension funds is overwhelming.

The nature of this presence needs further examination. Consider, to start with, the stock markets in these countries. An index like the ratio of market capitalization to GDP (Chart 1.2), to a much greater extent than the number of listed companies or the volume of trading, points to a huge increase in the size of these markets. However, much of this is a result of the inflation in stock prices that has resulted from trading in the secondary market. The IPO market (or the role of the stock market as a source of capital to finance corporate investment) is still limited and highly volatile in terms of volumes mobilised. Asset price inflation occurs partly because of the inflow of foreign capital and domestic surpluses into the secondary market which is both narrow (in terms of the number of companies whose shares are listed and actively traded) and shallow (in terms of the number of shares of these companies available for trading after taking account of the holdings of promoters and long-term investors). In sum, though the stock market seems present and growing in size and visibility, it is as yet not an important agent from the point of view of making finance a supply-side spur to corporate investment.



Source: World Bank, *World Development Indicators,* available online at www.worldbank.org

Interestingly, at least until recently, the development of the bond market too was limited across the region (Table 1.1). It is only in South Korea that the corporate local currency bond market exceeded the government bond market in size. Moreover, even where bond markets are developed, government securities seem to account for a significant share of all securities issued in the domestic market. There are differences in the relative shares of the corporate bond market in the incremental growth of these markets, but just as banking dominates the financial sector, government securities still dominate bond markets in most contexts. This is of significance given the trend towards reining in government borrowing not just from central banks but also from the open market. Unless counterbalanced by the growth of the corporate bond market, this could see some shrinking in the relative importance of bond markets in these countries.

As for other segments of the financial sector such as insurance companies, pension funds and mutual funds, growth is driven largely by three factors. One is the lack in many of these countries of an extensive system of social security, necessitating investment in insurance or financial assets to provide for contingencies and retirement. The second is the growing privatisation of parts of even the limited insurance and pension systems, encouraging entry of a new set of private institutions, including foreign ones. And the third is the lack of adequate savings options for sections of the middle class emerging from the process of rising per capita incomes. The latter then turn to investments in mutual funds as a means to invest small sums in equity or debt markets. However, the resources mobilised in these sectors have not percolated into the productive sectors.

A fifth common feature, but one that is uneven in evolution across countries, is the increase in securitisation and the growth of derivatives markets. Given the substantial increase in bank credit and its role in financing a segmented and diverse retail market, banks would want to transfer risk for a fee. To do that, they need to create low risk securities by combining assets from different markets, geographies and income groups. Once the securitisation process begins, the distance to complex derivatives is a short one, and there is a replication of the market for complex and opaque assets in Asian developing countries as well.

Table 1.1: Size of LCY Bond Market in % GDP (Local Sources)

	Ratio of government local currency bonds to GDP (%)							Ratio of corporate local currency bonds in GDP (%)						
	CN	HK	ID	KR	MY	SG	TH	CN	HK	ID	KR	MY	SG	TH
Dec-95		5.3	12.6	15	6.9				12.6	0	8.9	0.5		
Dec-00	16.6	8.2	35.4	25.7	38	26.6	22.8	0.3	27.6	1.4	48.8	35.2	20.9	4.5
Dec-05	36.4	9.2	17.1	45.9	42.6	37.4	37.6	2.8	38.8	2.1	42.1	31.7	28.8	8.1
Dec-11	33.9	37.1	11.4	47.5	56.6	47	54.5	11.4	31.9	2	67	38	28.2	13
Sep-15	36.84	37.02	12.81	52.88	52.68	47.37	54.74	19.36	28.61	2.22	77.06	41.48	32.82	18.33

Source: Asia Development Bank at asianbondsonline.adb.org

Finally, the recent Asian experience suggests that financial proliferation largely facilitates new lines of business in financial services and affects the real economy more from the demand side by the debt-financed household expenditure it promotes. Excessive financial sector exposure to retail markets while driving growth and substituting for the increasing inadequacy of tax-financed public expenditure and investment as a stimulus for growth, is also becoming a source of fragility in these countries just as it did in the developed countries.

All of these point not only to the homogenization of financial structures but their tendency to shape themselves in the image of the deregulated financial structures in the Anglo-Saxon world.

Financial fragility

For these reasons, it is now widely accepted that financial liberalization has resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. These relate both to internal banking and related crises, and currency crises stemming from more open capital accounts, the origins of which can be traced to the shift to a more liberal and open financial regime.

The attempt to render the financial structure more competitive through liberalization involves institutional changes that unleash a dynamic that endows the financial system with a poorly regulated, oligopolistic structure, which could increase the fragility of the system. Increased dependence on fluid foreign finance influenced by developments outside the host country; greater freedom for financial firms to invest, including in sensitive sectors such as real estate and stock markets; enhanced ability to increase exposure to particular sectors and individual clients; and increased regulatory forbearance all lead to increased instances of financial failure. In addition, by institutionally linking different segments of financial markets by permitting the emergence of universal banks or financial supermarkets, the liberalisation process increases the degree of entanglement of different agents within the financial system and increases the impact of financial failure in units in any one segment of the financial system on agents elsewhere in the system.

Financial markets left to themselves are known to be prone to failure because of the public goods characteristics of information which agents must acquire and process (Stiglitz 1993, Rodrik 1998). They are characterised by insufficient monitoring by market participants. Individual shareholders tend to refrain from investing money and time in acquiring information about managements, hoping that others would do so instead and knowing that all shareholders, including themselves, would benefit from the information garnered. As a result there may be inadequate monitoring leading to risky decisions and malpractice. Financial firms wanting to reduce or avoid monitoring costs may just follow other, possibly larger, financial firms in making their investments, leading to what has been observed as the "herd instinct" characteristic of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities, failure of which could have systemic effects. The prevalence of informational externalities can create other problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a run on deposits there.

Disruptions may also occur because expected private returns differ from social returns in many activities. This could result in a situation where market players take on unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are very volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that any losses can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

These tendencies effect real investment in two ways. First, inasmuch as speculative bubbles lead to financial crises, they squeeze liquidity, result in distress sales of assets and deflation that adversely impact on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than that for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

Meanwhile, all too often the expected microeconomic efficiency gains are not realised. Even in the US, bond markets play a limited role and equity markets virtually no role at all in financing corporate investment in these countries. The stock market is primarily a site to exchange risks rather than raise capital for investment. In developing countries the new issues market tends to be small or non-existent except in periods of a speculative boom, and bank lending in a liberalised scenario tends to privilege risky high-return investment rather than investment in the commodity producing sectors like manufacturing and agriculture. The effects on those sectors of liberalisation is indirect, being realised through the demand generating effects of housing and personal finance booms, which too in many circumstances tends to increase the fragility of the system.

Capital account volatility and its implications

External financial liberalization, with associated capital inflows, aggravates these consequences. Indeed, all the evidence on capital inflows and subsequent crises suggests that once an emerging market is "chosen" by financial markets as an attractive destination, this sets in motion processes which are eventually likely to culminate in crisis. This works through the effects of a surge of capital inflows on exchange rates (unless the capital does not add to an increase in domestic investment but simply ends up adding to reserves).

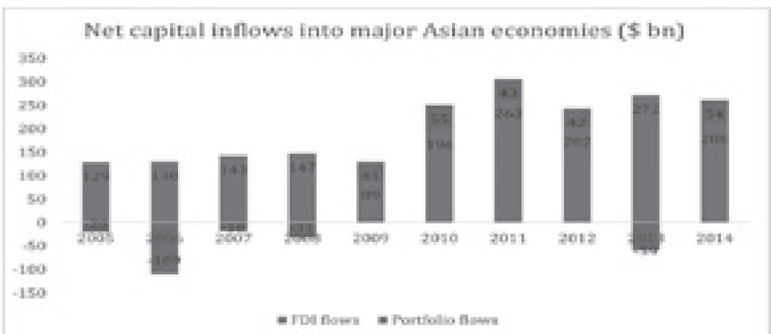
An appreciating real exchange rate encourages investment in non-tradable sectors, the most obvious being real estate, and in domestic asset markets generally. At the same time, the upward movement of the currency discourages investment in tradable sectors and therefore contributes to a process of relative decline in real economic sectors, and even deindustrialisation in developing countries. Given the differential in interest rates between domestic and international markets and the lack of any prudence on the part of international lenders and investors, local agents borrow heavily abroad to directly or indirectly invest in the property and stock markets. Thus it was no accident that all the emerging market economies experiencing substantial financial capital inflows also at a similar time experienced property and real estate booms, as well as stock market booms, even while the real economy may have been stagnating or even declining. These booms in turn generated the incomes to keep domestic demand and growth in certain sectors growing at relatively high rates. This soon resulted in signs of macroeconomic imbalance, not in the form of rising fiscal deficits of the government, but a current account deficit reflecting the consequences of debt-financed private profligacy.

However, once there is growing exposure in the form of a substantial presence of internationally mobile finance capital, any factor that spells an economic setback, however small or transient, can trigger an outflow of capital as well. And the current account deficits that are necessarily associated with capital account surpluses (unless there is large reserve accumulation) eventually create a pattern whereby the trend becomes perceived as an unsustainable one, in which any factor, even the most minor or apparently irrelevant one, can trigger a crisis of sudden outflows.

Aspects of the experience in Asia

The global economic integration of the Asian region has been marked for some time now, but the significance of financial integration and of capital flows became evident only from the 1990s. The boom of capital inflows into some Asian economies in the 1990s came to a rather abrupt halt with the Asian financial crisis that drastically curtailed non-FDI flows especially to the crisis-hit countries of Thailand, Malaysia, South Korea, Indonesia and the Philippines. But global investor perceptions altered by the early 2000s, and over the last decade the region has once again become a significant recipient of net capital inflows.

Chart 1.3



→ p.68

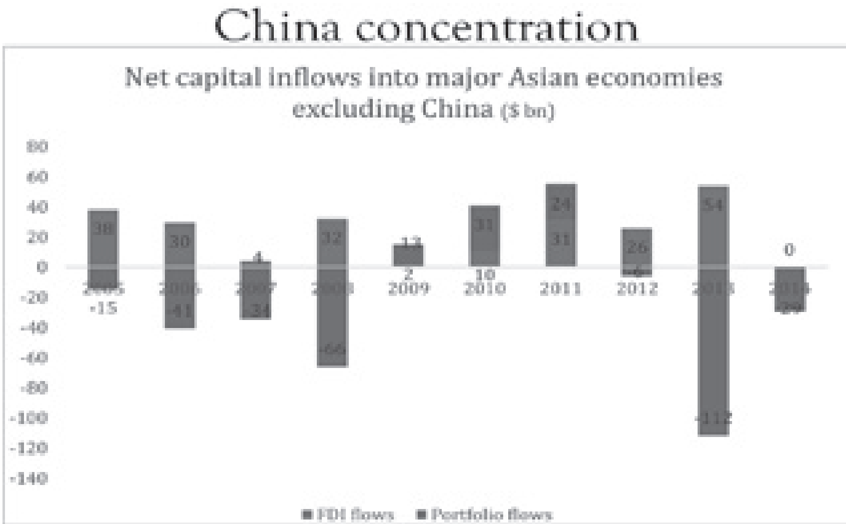
Source: IMF balance of payments database, accessed on 26 December 2015

Chart 1.3 shows net capital inflows into major Asian economies (those included here are China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore, South Korea and Thailand). Throughout the period since 2005, and even during the years of the Global Financial Crisis and its aftermath, net capital inflows into these countries stayed positive. However, this was dominantly because of FDI, as portfolio inflows were far more volatile and negative for particular years, notably 2006 and 2013, when the "taper tantrum" occurred.

This would appear to confirm the perception that FDI flows tend to be more stable and long-term in orientation than portfolio flows. However, given the rather loose definition of FDI (including any purchases of more than 10 per cent of a firm's equity) and the growing significance of private equity investment that is also designed for relatively quick turnaround, this may not be as true in the contemporary global economy as it was in the past.

What Chart 1.3 does not indicate is the relative significance of different Asian economies in this total, but that matters, essentially because so much of these capital flows have been destined for China and indeed the pattern of capital movement across the region in general was largely driven by China. Chart 1.4 shows the same data for this set of countries excluding China, revealing very different trends.

Chart 1.4



→ p.69

Source: IMF balance of payments database, accessed on 26 December 2015

Once China is excluded, we find that net capital inflows into these countries were more often than not negative over this period, incidentally despite very large gross inflows for certain countries in particular years. Indeed, it was only in the four-year period immediately after the GFC that net capital flows to these Asian countries taken together were positive. While net FDI inflows were generally positive, they were also quite small, and indeed declined to near zero in 2014. Meanwhile net portfolio flows have been extremely volatile, but turned negative since 2012. Estimates suggest that the net outflow of portfolio capital from these countries would have been even larger in 2015.

Another peculiar feature of the patterns of capital flows, which has been evident for all emerging market economies but was especially evident in Asia, was the accumulation of foreign exchange reserves. These were not only the result of current account surpluses – indeed in most cases they reflected either a combination of current and capital account surpluses or reserve build-up based on borrowed finance which involved significant interest rate losses for the concerned country. This was yet another unfortunate by-product of the integration into global capital markets: the need to provide self-insurance against future crises by holding large amounts of foreign exchange reserves, which accentuated the attempt to manage exchange rates (so as to maintain external competitiveness) in the face of capital inflows.

Chart 1.5 provides some indication of the huge annual expansion of reserves by the major economies in Asia – dominated by China, but also significant for the other countries taken together. As is well known, a significant proportion of such reserves are held in US securities paying little or no interest; indeed Asian central banks have been the largest purchasers of US Treasury Bills for a decade.

Chart 1.5

→ p.71

Source: IMF balance of payments database, accessed on 26 December 2015

In macroeconomic terms the addition to reserves amounts to the ex ante excess of savings over investment, which in turn means that these countries – many of which are far from completing their development projects and some of which still have low per capita incomes – are not using these resources for investment that could be significant for their future economic expansion. Some aspects of this are considered in the final section of this chapter.

What this indicates is that despite growing financialization, increased integration into global capital markets and associated fragilities, most of the important economies of the Asian region did not really benefit from significant and stable inflows of foreign capital even in the most recent period. Rather, other than for China, such flows have been highly volatile and generally in the net they have been relatively small, not constituting significant additions to domestic savings rates. However, they have been associated with other more problematic features of growth in these economies in the decade leading up to 2014, most notably the dramatic accretion of internal and external debt and the emergence of asset bubbles that have distorted domestic relative prices. Some of these implications are concerned below.

Growing indebtedness

Emerging Asia currently appears to be all wrapped up in debt. It is interesting that the effects on Asian debt of the 1997 crisis (that struck a few countries in the Asia-Pacific region) and the 2008 crisis (affecting the centres of developed capitalism) have been very different. The former was followed by debt reduction, as a result of reduction of household and government debt and repair of balance sheets that began immediately after the crisis. By contrast, the latter was followed by significant increases rise in corporate leverage and other forms of internal and external borrowing in developing Asia.

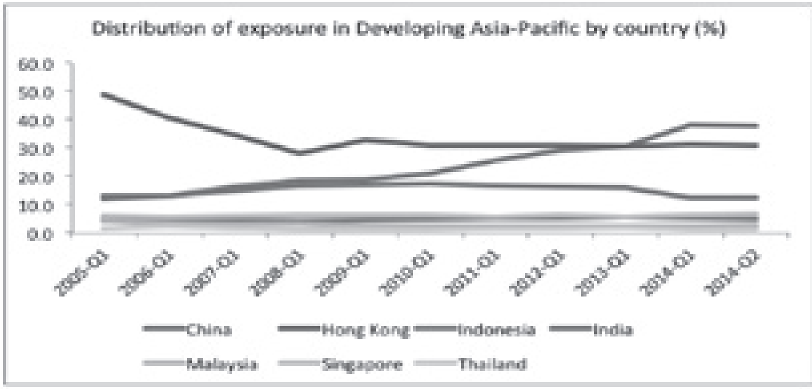
Outstanding international bank claims rose fourfold in the developing Asia-Pacific region, from $503.5 billion at the end of the first quarter of 2005 to $2164 billion at the end of the second quarter of 2014 (Chart 1.6). In fact, in four of the nine years, starting with the year ending the first quarter of 2005, the annual increase in international bank claims in eight leading Asian emerging markets exceeded the highest annual increment of $212 billion in portfolio inflows to those countries, with the increase peaking at $393 billion in 2010-11. International bank claims in these countries fell by $110 billion in 2008-09. In the developing Asia-Pacific as a whole, while exposure rose by between 30 and 40 per cent a year during 2006 to 2008, it fell by 17 per cent in 2009 and thereafter recorded much lower growth rates since.

Chart 1.6

→ p.73

The considerable volatility in bank exposure was a cause for concern also because of the destination-country and source-country concentration of these international bank claims. Over the decade until 2014, international bank claims in the Asia-Pacific were concentrated in Hong Kong (which serves as a financial hub), China and India in that order (Chart 1.7). Hong Kong and China together accounted for between 47 and 70 per cent of aggregate exposure in the developing Asia-Pacific, with the figure exceeding 50 per cent in all but one year. There were signs of a shift in exposure from Hong Kong to mainland China from 2011 onwards, encouraged no doubt by liberalisation of banking in the mainland. When India is added to these countries, the share of the three in developing Asia-Pacific exposure fluctuated between 66 and 82 per cent since 2005. While there have been multiple sources from which this debt was incurred, bank credit remained the dominant and important source.

Chart 1.7



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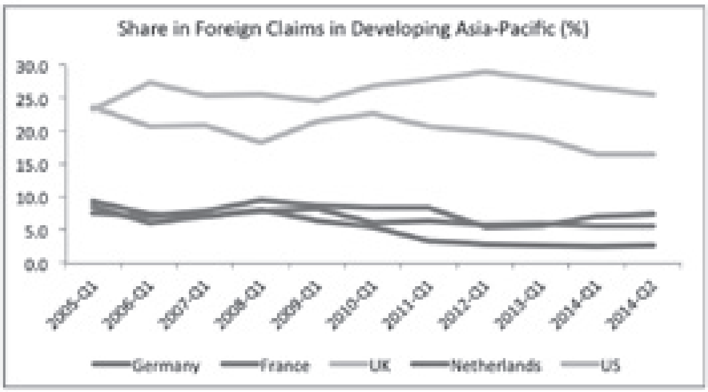
Given the role that local developments in source countries of loans can have in inducing volatility and the danger of contagion signalled during the 1997 crisis, this concentration of debt exposure is disconcerting. More so because banks owned by residents in two countries, the US and the UK account for the bulk of the exposure (Chart 1.8), varying from 43 and 50 per cent of the total during this period. The volatility of bank financing experienced during the "taper tantrum" in 2013 and subsequently since the middle of 2014 as US Federal Reserve rate increases began to be priced in by the markets provided vindication of such concern.

Chart 1.8



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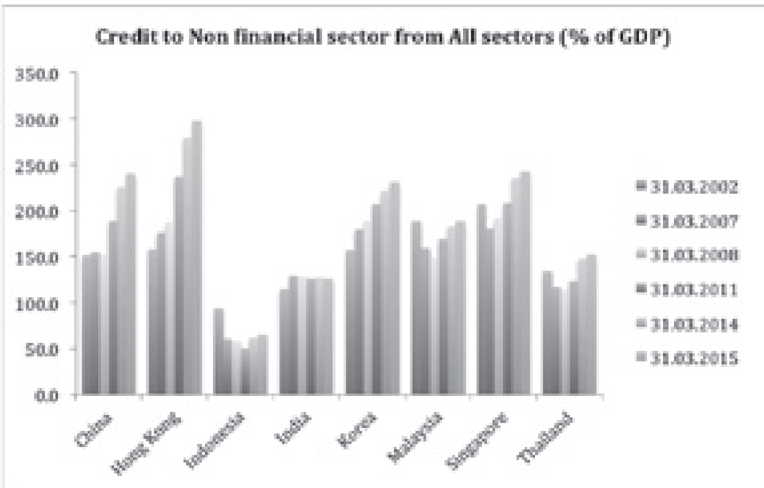
As Akyuz (2015) has noted, in the recent period, a further source of fragility has emerged because of changes in bank ownership, with the increase presence of foreign banks. As a result, finance in developing Asia has become increasingly internationalized through rapid expansion of international assets and liabilities as conventionally defined on the basis of residence as well as on the basis of nationality (because of greater numbers and significance of foreign subsidiaries located in such economies). This may be one reason why the share of private debt in total external commercial debt also increased significantly in several Asian countries between 1995 and 2013, such as from 79.8 per cent to 94.5 per cent in China and 79.4 per cent to 96.6 per cent in India. (Akyuz 2015:27, Table 7) Simultaneously there was a large increase in locally denominated debt held by non-residents. For example, at the end of 2013, in Indonesia and Malaysia, non-residents accounted for more than one–third of locally-issued government bonds, almost all denominated in local currencies (Akyuz 2015:41). However, a very large proportion of external debt held by both public and private sectors is still in reserve currencies for most countries in the region.

In this context, the increase in levels of indebtedness across much of the Asian region over the past decade is truly remarkable. In the cross-section of "emerging" Asian countries described in Chart 1.9, all countries other than India and Indonesia registered sharp spikes in the aggregate debt of the non-financial sector in the period after the 2008 crisis. In most countries this was partly driven by the need to provide a countercyclical stimulus to the economy in the wake of the crisis. In the era when the stress is on holding down government fiscal deficits and on fiscal consolidation, this required relying on an increase in credit provision to spur investment and consumption demand. The Chinese post-crisis stimulus was a typical example of this. As noted above, this was also the period when the massive infusion of liquidity into the system by central banks resulted in a large flow of capital into equity and debt assets in the emerging markets. By 2015 bank credit to GDP ratios were close to 300 per cent in Hong Kong, above 240 per cent in China and Singapore, around 230 per cent in Korea. These were higher than levels that prevailed in the US (239 per cent) and UK (269 per cent) and significantly higher than that in more conservative Germany (192 per cent).

Chart 1.9



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Indonesia was an outlier with its lower absolute ratio being accompanied by relatively moderate increases in that ratio, of around 30 per cent during both 2000-07 (before the global crisis) and 2008-2013. The remaining countries fall into two categories. On the one hand, India and South Korea saw relatively large increases in credit to the private sector during 2000 to 2007 of 61 and 87 per cent respectively, followed by either a low increase (7 per cent in the case of India) or a fall (of 9 per cent for Korea) during 2008-2013. On the other hand, Thailand, Malaysia, Singapore and China recorded falls in the ratio in the first period, followed by significant increases in the second. In sum, if a generalized statement is to be made *for the period since 2000* it would be that except for Indonesia that has been an outlier, the rest have been characterized by relatively high levels of bank credit outstanding and by much volatility, with periods of bank credit expansion giving way to periods of moderation or contraction or vice versa.

When seeking to understand these trends it may be useful to keep three features of the region in mind. First, all emerging markets in the Asian region liberalized regulations governing their financial sectors and eased monetary policy, both of which have increased the flexibility of the banking sector when making lending decisions. This provided the basis for an important commonality across the region: expansion-contraction or even boom-bust cycles in credit provision, which all of these countries (except Indonesia) have experienced to differing degrees. An over-enthusiastic banking sector is forced to correct either because of balance sheet stress or a full-fledged crisis. Second, liberalization came earlier to Southeast Asia, which then experienced the financial crisis in 1997 that left China and India relatively unaffected. So India's credit boom and China's moderation during the first period require explanations that are independent of the last major crisis that affected the Asian region. Third, in the aftermath of the 1997 crisis Southeast Asian countries adjusted differently in terms of both the restructuring of the banking sector and the regulation of capital flows, leading to the variations in experience that are observed.

Indonesian exceptionalism since 2000, reflected in the low level and the gradual growth of bank lending to the private sector, can be explained largely by the damage suffered by its banking industry during the crisis, which necessitated huge loan write-offs and recapitalization. Indonesia was hardest hit by the late 1990s crisis because of the dramatic expansion of banking and bank lending during the 1990s. This was the result of a series of liberalization measures adopted since the early 1990s, starting with the removal of interest rate and credit ceilings and leading up to the comprehensive "reform" of 1998 when private bank entry and branching were liberalized. Together with liberalized lending norms, this led to a sharp increase in bank credit to the private sector, from 47 per cent of GDP in 1990 (which is well above today's level) to 61 per cent in 1997, just before the crisis. Increased lending was directed to the commercial real estate and retail segments including lending for consumption and speculative investment in the property market. Lending to the property sector rose from 6 per cent of GDP in 1993 to 16 per cent in 1996. Not surprisingly, when the crisis hit the region, banks in Indonesia were badly affected, necessitating a change in banking practices that explains Indonesia's exceptional experience in the subsequent period. In essence, Indonesia experienced earlier what other developing countries in Asia have been troubled by more recently.

The adverse impact of the 1997 crisis was visible in Thailand as well, where the private sector credit to GDP ratio, which peaked at 165.7 per cent in 1997, fell sharply to 96.9 per cent by 2001 and remained close to that level for a decade. It was only in 2012 and 2013 that the ratio has registered a sharp rise to 121 per cent, generating once again fears of a bust. In the case of South Korea, on the other hand, lending continued to rise quite significantly after 1997, with the private credit to GDP ratio increasing from 55 per cent in 1997 to a peak of 148 per cent in 2008, only to decline to 135 per cent in 2013. Banks here have implicitly served or were used as countercyclical instruments. But now, fears of a household debt crisis have been expressed over the last couple of years, forcing banks to restructure household debt at the instance of the government.

China and India have not as yet taken a hit of the kind the Southeast Asian countries did in 1997, though they too have been liberalizing their financial sectors. But they have been registering rapid increases in their private credit to GDP ratios over different periods since 2000. China leads in terms of the level of the ratio of credit to GDP and registered a continuous increase in the same except, interestingly, during 2003 to 2008 when the ratio fell, precisely during the years when it rose in India. However, bank credit to the private sector in China exploded since the global financial crisis, as part of the government's stimulus effort. This has led to growing concerns about the state of the banking system because of its exposure to the housing market bubble and to Local Government Financing Vehicles that have borrowed to invest in huge projects without the appropriate revenue model to meet the interest and amortization commitments involved. As for India, though the level of its BCPS ratio is much lower than in other Asian emerging markets (except Indonesia), it too experienced a sharp increase in the ratio during the high growth period between 2003 and 2008. As a result, signs of stress in bank balance sheets and fears of increased default and speculative bubbles in property and other markets now pervade discussion in these two countries as well.

Overall, therefore, while there are significant differences in the volume and growth of bank exposure to the private sector across Asian emerging markets, they were all confronted with signs of bank fragility due to overexposure to a few markets such as the retail sector (especially housing), to real estate and capital intensive projects in infrastructure and industry.

In several of these economies, the difficulties were the result of the internal debt cycle, as the excessive credit that powered the boom just after the Global Financial Crisis was wound down. Indeed, this problem is increasingly recognized by many observers of the global economy: a report by Fitch Ratings noted that “High and rapidly rising private sector debt can have a number of potential adverse effects on economic growth, the health of the banking system and sovereign creditworthiness” in emerging markets.

This impact of liberalization on domestic credit was in most cases combined with the fragility generated by the excess exposure to external debt of the private sector. The September 2014 issue of the Quarterly Review from the Bank of International Settlements (BIS) argued that from the supply side the absence of adequate yields in developed country markets had resulted in enhanced financial (especially debt) flows to emerging markets, including those in Asia. The flip side was that corporations in these countries were overexposed to foreign currency debt and therefore to currency risks. The share of Asian emerging markets in international bank claims on all emerging markets rose from 30.4 per cent in Q4 of 2008 to 52.5 per cent in Q2 of 2014. External exposure of this kind implies that a depreciation of the currency in any of these countries can result in stressed corporate balance sheets. And since domestic banks have also lent heavily to these corporations, any balance sheet pressure on corporations could also affect banks adversely. These feedback loops can give the problem a systemic dimension.

Growing corporate debt became a concern throughout the region, as the debt overhang became one more reason for private corporations to shy away from new investment and therefore to add to the forces making for a deceleration of economic activity. Encouraged by access to large volumes of cheap liquidity in international markets, resulting from the post-crisis policy of monetary easing adopted by developed country central banks, firms across developing Asia had gone on a borrowing spree. By 2014 it was evident that they were increasingly with the problem of stressed balance sheets (BIS Quarterly Review December 2014)

Despite some contraction in bank lending around 2013 resulting from the “taper tantrum”, outstanding cross-border claims of major international banks reporting to the BIS on non-bank borrowers in the rest of the world totalled $12.3 trillion at the end of June 2014, which was close to its pre-crisis peak in 2008. Emerging market economies (EMEs) were important contributors to this increase. As noted earlier the share of Asian emerging markets in total emerging market issuance rose between Q4 of 2008 and Q2 of 2014. And within emerging Asia, the share of China rose from 20.8 per cent of the total to 53.4 per cent in the same period.

China clearly dominated emerging market borrowing after the Global Financial Crisis, leaving behind Brazil, India and Korea, who were also important borrowers in that order. Cross-border international claims on China rose from $153.5 billion in the fourth quarter of 2008 to $1.1 trillion in the second quarter of 2014, or more than 7 times in less than six years.

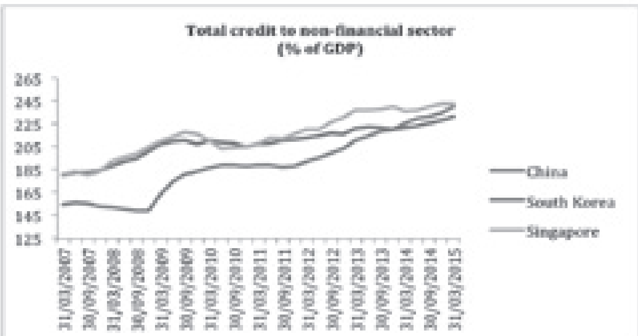
Parallel to these banking developments, non-financial corporates from emerging markets ramped up their issuance of debt securities, resulting in a total issue of such securities of $554 billion between 2009 and 2013. Of that $252 billion, or 45 per cent was mobilised by the issue of debt securities by offshore affiliates of these corporations. This suggests that non-financial corporations in such developing countries were using their foreign subsidiaries as financing vehicles, mobilising capital in the local debt markets to transfer funds to parent firms, or use the capital for financial investments such as loans to other corporates or deposits with banks or non-bank financial entities in the country of its parent at interest rates that offered a premium above the low rates prevalent in some international debt markets.

These trends generated two kinds of vulnerability in Asia. The first resulted from the sheer volume of exposure to debt in forms that provided foreign investors not just the right but the possibility of quick exit. The second was the massive foreign currency exposure this implied. In the event of any significant depreciation of the domestic currency relative to the hard currencies in which the original capital was borrowed, local currency commitments of corporates in the form of interest and amortisation could increase hugely, leading to stressed balance sheets. This process was already underway in 2014. The Financial Times (9 December 2014) reported that on 8 December 2014 the JP Morgan Emerging Market Currency Index fell to its lowest level since it first began to be computed 14 years earlier.

Household debt

Household debt is also an important concern, and one that is likely to become of much more significance in the near future as the financial viability of many personal borrowers comes under question. Here we consider the specific case of three Asian countries where this problem was particularly evident: China, Singapore and South Korea. As Chart 1.10 indicates, in all of these countries, total credit to the non-financial sector grew sharply as percentage of GDP, particularly after March 2009. Furthermore, such debt continued to grow even beyond mid-2014, despite the evident slowdown of economic growth in these economies, with the ratio in the case of China continuing to increase at a relatively rapid rate.

Chart 1.10



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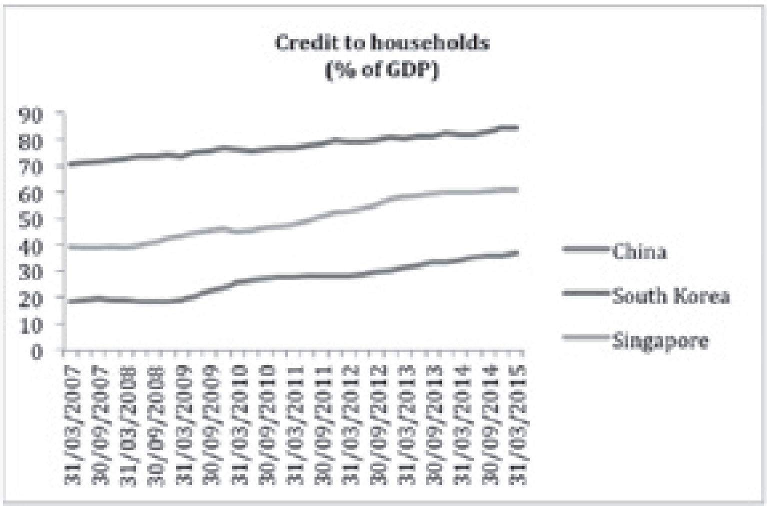
Source: BIS database

Chart 1.11



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Source: BIS database

Household debt grew both as a share of total debt and even more substantially in terms of GDP over this period. In China, for example, credit to households increased from around 15 per cent of total credit to the non-financial sector at the end of March 2007 to 18 per cent at the end of March 2015. In relation to GDP it nearly doubled over the same period, from just below 19 per cent to 37 per cent. In Singapore and South Korea credit to households has moved more or less in tandem with total credit to the non-financial sector, but the increase in relation to GDP has been sharper. In Singapore it went up from 39 per cent of GDP at end March 2007 to 61 per cent at end March 2015. In South Korea the corresponding figures for household debt were even larger, and increased from 70 per cent to 84 per cent.

Obviously personal or household debt was incurred for a variety of reasons, including life cycle events, health spending, education (student loans and their sustainability have become a big issue in South Korea), and so on. The purchase of consumer durables such as cars was also one important source of incurring debt. But by far the single most important cause of household indebtedness, which dominated over all the others, was the purchase of residential real estate. Indeed, in many societies and certainly in developing Asia, it has been seen as a form of household saving, as a means of storing wealth even apart from the urge to own one's home. This is why the phenomenon of increasing indebtedness has been closely linked to asset market bubbles, particularly in housing and real estate, but also in stock markets, as discussed in the next section.

The South Korean case

After the 1997 crisis in South Korea, banks that had overexposed themselves to industry, were increasingly unwilling to lend to industry, especially to bigger firms that were overgeared. Lending increasingly diversified in favour of the household sector with banks withdrawing from the business of lending to industry and expanding their exposure to the retail market through consumer and housing loans. The share of corporate loans in the total fell from 63.8 per cent in 1997 to 43.5 per cent in 2004, and that of public and other legal entities from 16.3 per cent to 1.4 per cent. The major gainer was household loans whose share rose from 20 per cent in 1997 to 55 per cent in 2004funds (Table 5.7) (Kim, Kim and Ryoo

2006).

But this turn in the activities of the financial institutions in the post-crisis period by no means reduced their proneness to instability. Overlending to the consumer sector had led to difficulties by 2003, when it emerged that the solvency of some those companies, including credit card companies, were under threat. By the end of that year the number of credit defaulters exceeded 3.7 million with total credit to households amounting to US three-fifths of Korea's GDP (Kim and Lee 2007). According to the Financial Supervisory Commission this debt crisis was because of the behaviour of the credit card companies including "granting cards to minors without parental consent, renewal or re-issuance of cards after expiration without the consent of the member even though no transaction took place in the member account . . . attempts to attract new members with offers of high-priced giveaways . . . setting credit limits well beyond the card members' income or ability to pay only after perfunctory or negligent verification process, and using the offer of high credit limit as a marketing tool to attract new members." (Quoted in Kim and Lee 2007: p. 41). Though the target of lending changed, the tendency towards runaway increases in credit did not.

Table 1.2: Trend of Shares by Sector in Bank Lending[1] (%)

	1997	1998	1999	2000	2001	2002	2003	2004
Corporate loans	63.8	63.6	61.9	56.5	48.9	45.5	45.6	43.5
Large companies	25.0	22.9	19.0	16.3	10.4	7.6	5.9	5.4
SMEs	38.7	40.6	42.9	40.2	38.4	38.0	39.7	38.2
Household loans	20.0	18.3	34.3	39.0	49.1	52.9	53.0	55.0
Others[2]	16.3	18.1	3.8	4.6	2.0	1.5	1.3	1.4

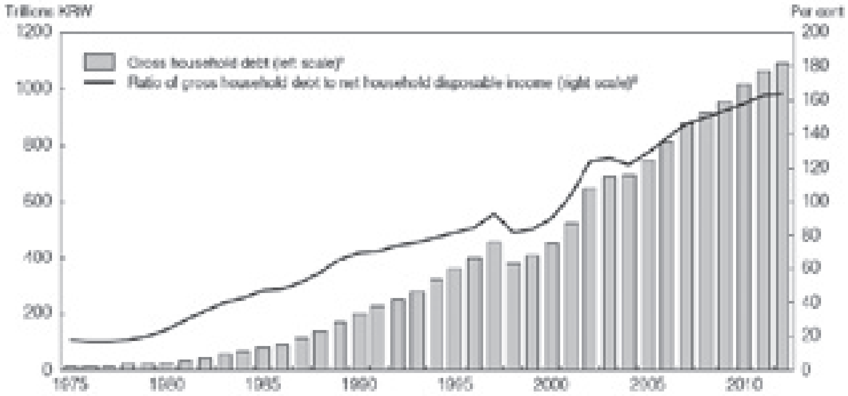
[1] Excludes trust account lending.

[2] Loans to public and other legal entities.

Source: Kim, Kim and Ryoo 2006.

The result was a huge increase in debt especially after 2001, with loans to households rising from 266 trillion won at the end of 2000 to 1,166 trillion won at the end of September 2015 (Charts 1.12 and 1.13). Debt of households stood at more than 80 per cent of GDP and more than 160 per cent of net household disposable income in 2014. This was higher than the level that prevailed in the United States before the subprime crisis broke. Debt of households and Non-profit Institutions Serving Households rose from a little above 10 per cent of GNP in 2004 to more than 80 per in 2015 (Chart 1.14). According to one estimate (OECD 2014) mortgage loans accounted for around half of household debt. Financial institutions held back on lending to poorer households and defaulting borrowers, forcing them to turn to consumer finance companies that lend at higher interest rates, with their average interest rate exceeding 50 per cent in the case of unregistered entities. The curb market seemed to be returning in Korea.

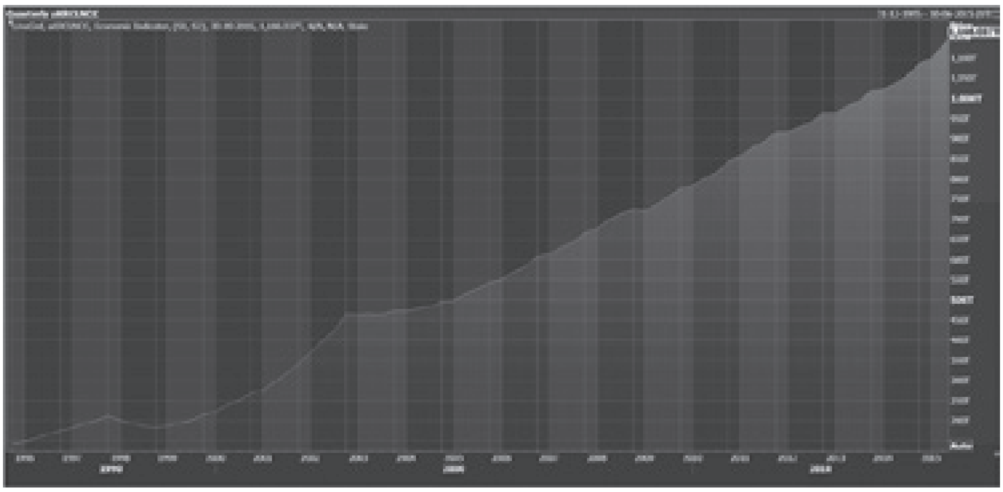
Chart 1.12



1. In real terms, adjusted by the 2010 CPI.
2. In current prices. Data are based on SNA1993.

Source: Bank of Korea.

Chart 1.13



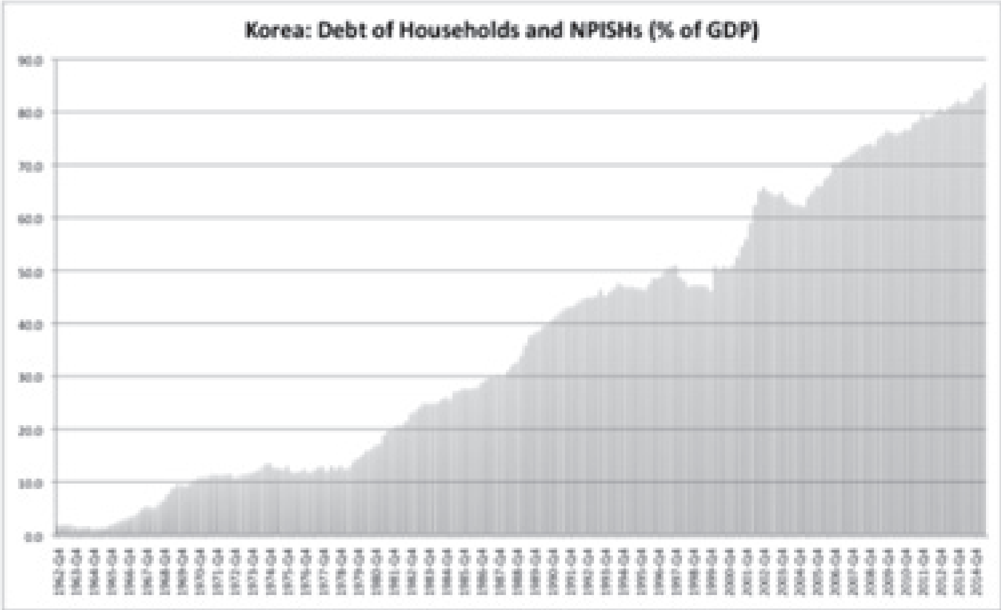
Source: Thomson Reuters Datastream.

The result was a huge debt burden that could not be easily resolved. According toa survey conducted by Statistics Korea and analysed by the Korea Development Institute, six out of ten households in Korea were in debt in 2011, and more than a third of them were unable to meet their annual expenses with their incomes. Debt also weighs heavy on current incomes. One in every 10 households spends more than 40 per cent of annual income on servicing that debt.

With these households having to borrow more to stay afloat and others joining their ranks, a large proportion of households could be caught in a debt trap that would force default. Already, a significant proportion of households in Korea has more liabilities than assets and cannot therefore clear dues by selling assets. In case of widespread default the banks that lent to them will not be able to recoup even a part of their loans, leading to systemic problems of the kind that Asian emerging markets seemed to have been insulated from.An implication of this has been the collapse of the household savings rate in what used to be a high-saving nation: from more than 15 per cent before the 1997 crisis to around 10 per cent in 2000 and a low of

2-3 per cent recently. Increasingly, instead of saving for the future, South Korean households are consuming out of what they hope would be tomorrow's income.

Chart 1.14



Source: Bank of International Settlements at www.bis.org

Thus, while it is indeed true that traditionally banks in South Korea tended to "overlend" to the private sector, financial liberalization has led to important changes. Before the 1997 crisis, banks were substantially publicly owned and their lending to the private sector was focused on the then successful South Korean corporations. Problems began when in the 1990s South Korea chose to open up and deregulate its financial sector, partly as a quid pro quo for continued access to international markets on which its growth was based, partly to diversify into services led by finance because of a growing loss of manufacturing competitiveness, and partly to meet the requirements set for OECD membership. The process, which increased the role of foreign finance in the South Korean economy also led to a shift of lending away from productive investment that had been the main target of directed credit till then, into sectors like the stock market, real estate and housing. That shift was financed with low-cost foreign finance, accessed in large measure by the private sector in South Korea, and directed less to the productive sectors and more to non-tradable services with a strong speculative component. This created the circumstances in which South Korea became vulnerable to the boom-bust cycles typical of foreign financial flows and to the contagion that spread across the region in 1997.

Interestingly, post-crisis adjustment in South Korea (and elsewhere in Southeast Asia) did not lead to the reversal of the liberalisation that enhanced the external vulnerability of a successful "miracle" economy and increased the fragility of its financial system. Rather, the role of the IMF during and after the crisis and the success of foreign finance resulted in the government opening the doors wider to foreign capital and diluting regulation of the domestic financial sector, even while taking over and guaranteeing repayment of the debt that foreign finance had, without due diligence, provided the domestic private sector. As Chart 5.1 shows, South Korea's external debt rose sharply between 2005 and 2014.

Thus, both before and after the crisis, "overborrowing" by the private sector remained high, but the target borrowers were now engaged less in productive activity and more in areas like finance, real estate and housing. Moreover, after the crisis, bankrupt financial firms were displaced or taken over by new players, especially foreign firms. This led in turn to the importation into the country of the practices that had characterised finance in the developed industrial countries. Prime among them was a sharp increase in lending to the retail sector—housing, automobile purchases and personal credit—with the risk associated with such fragmented, large scale lending being concealed by pooling credit assets, securitising these bundles and transferring the risk. The net result is that in this third phase, even though lending to the private sector continued to be important in South Korea, households have been replacing corporates as leading borrowers. South Korea had transited from debt-financed investment through debt-financed speculation to an era of debt-financed consumption. Needless to say, a little of each of these was visible in all periods, but the shift in emphasis was clear.

Excess borrowing is also a result of the adverse impact that the growth pattern after liberalisation has had on the distribution of income in the country. While developed country status has increased the cost of living and the consumption aspirations of the population, incomes among the poorer sections of the population have not kept pace. In the event, as occurred in the US, encouraged by an easy credit environment, the poor have sustained their consumption and diversified into new economic activities with the aid of credit. As the survey of household finances quoted earlier found, while the top 20 per cent also borrowed, the proportion of borrowers in the bottom quintile in terms of income was increasing the fastest. Moreover, while the rich borrowed to acquire real estate, the poor did so to just make ends meet.

The government and the Bank of Korea are conscious of the dangers implicit in this excessive debt overhang. The danger of massive default on such debt, which could have precipitated another major crisis, forced the government to step in and set up an 800 billion won fund to buy distressed household debt from the banking sector at a discount and restructure or write off a significant part of that debt. In 2011the government launched a programme to "induce the soft landing of household debt. According to the OECD (2014), since 2008 debt restructuring programmes "have assisted nearly one million delinquent borrowers, helping to reduce the number from 2.3 million in 2008 to 1.1 million, which is still about 5% of households. The most important programme is the National Happiness Fund, which writes off up to 70% of debt and interest."

The government has also responded with measures to reduce bank exposure to the retail market and to induce borrowers to shift out of floating rate loans to fixed interest loans. The intention is to reduce the impact that any interest rate shock would have on borrowers under strain and unable to meet their debt service commitments. However, with financial liberalisation having created a layered financial system, this did not resolve the problem. Stricter bank regulation may rein in borrowing for speculation by the rich. But the poor, who cannot but borrow, have turned to the non-banking system: mutual associations and credit unions, in particular, which are unregulated and charge exorbitant interest rates. That only worsens the problem.

The South Korean experience thus indicates how some financial liberalisation can lead to crisis, and such crises can in turn generate political economy tendencies for further liberalisation rather than re-regulation of finance. The consequences tend to be adverse for both growth possibilities and financial fragility, and point to the lack of sustainability of this particular trajectory.

Asset market bubbles in indebted Asia

The link between household indebtedness and real estate markets emerges very clearly from Chart 1.12, which describes the movement of average residential prices between 2007 and 2015 in the three countries considered above, that is China, Singapore and South Korea.

Chart 1.12

Source: BIS database on real estate prices

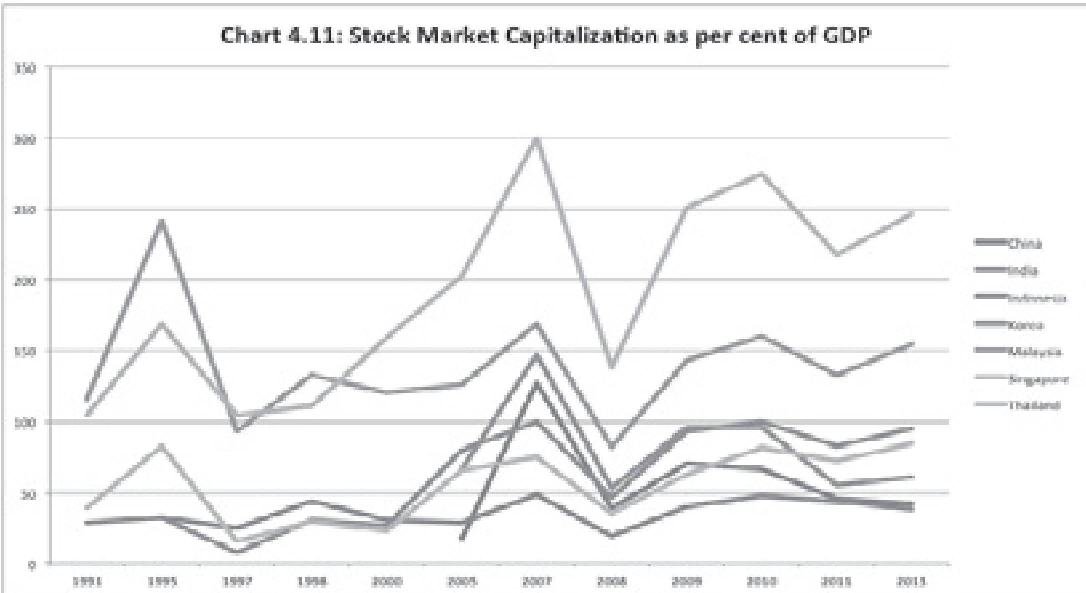
In all of these countries, house prices showed a dip – in the case of Singapore a severe dip – in the aftermath of the Great Recession. However, thereafter they recovered sharply, often actively aided and abetted by government policies that sought to create incentives for personal house purchases as a means of stimulating economic recovery and boost the construction sector. As a result, real estate experienced a boom that was largely fuelled and financed by growing household debt, and construction became one of the most "dynamic" economic sectors in the growth of these economies. However, as we now know from the experience of far too many countries, such debt-driven real estate bubbles eventually come to an end, often painfully.

The recent financial crises in the United States, the United Kingdom, Ireland, Spain and so on were all presaged by declining house prices, especially as some borrowers who could no longer service their debt were forced to default and so more houses started being sold in distress conditions. Once this process starts, the decline in value of the underlying collateral renders more such debt unviable, as other householders realize that selling the assets will not necessarily be sufficient to repay the loan. And this can then have a domino effect on financial institutions that have provided such credit.

The inevitable bursting of the real estate bubble began around 2013. In Singapore house prices peaked in the middle of 2013, and have been falling since then. In China the downturn occurred a year later, in the middle of 2014, but after falling for four quarters residential real estate prices appeared to have stabilized, due to very active intervention by the Chinese government. In South Korea, house prices rose rapidly at first and then were stagnant, but policy moves in 2015 were designed to keep them rising – even if only to postpone the inevitable decline – because so much of household capacity to repay would be affected by major declines.

A significant fallout of the dependence on external finance can be unwarranted asset price inflation in stock markets. For example, there was an artificial explosion in the ratio of market capitalization to GDP (Chart 1.13) in various Asian markets in the 2000s, which largely resulted from trading in the secondary market. The IPO market (or the section of the stock market that serves as a source of capital to finance corporate investment) was still limited and highly volatile in terms of volumes mobilized in these markets, and did not serve as a facilitator of corporate investment. Asset price inflation occurred partly because of inflows of foreign capital into secondary markets that were both narrow (in terms of the number of companies whose shares were listed and actively traded) and shallow (in terms of the number of shares of these companies available for trading after taking account of the holdings of promoters and long-term investors).

Chart 1.13



Source: World Bank World Development Indicators online, accessed 1 September 2015

Changes in important macroeconomic variables

In many of these countries, the post crisis trajectory has been marked by something rather unusual: domestic investment rates fell even as domestic savings rates remained high. So they stopped being net recipients of foreign savings and instead showed the opposite tendency of net resource outflow, as domestic savings were higher than investment. This meant that there was a process of squeezing out savings from the population as a whole but not investing it within the economy to ensure future growth. Instead, these savings were effectively exported, either through capital outflows or by adding to the external reserves of the central banks, which were typically held in very safe assets abroad (such as US Treasury Bills).

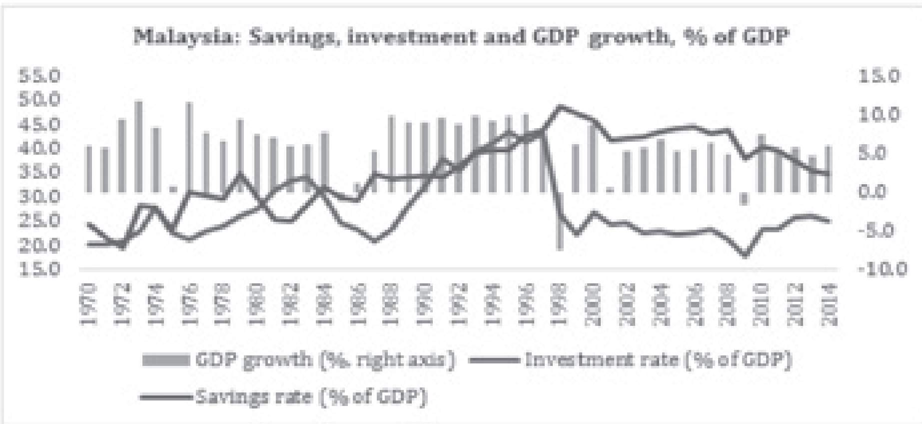
Consider Malaysia and Indonesia, two economies in the region that exhibit this tendency very clearly, and both of which were a little more than a year ago were lauded as emerging markets with significant future potential. Charts 1.14 to 1.16 show the experience of Malaysia while Charts 1.17 to 1.19 illustrate the

Indonesian pattern. These are very different economies, with somewhat different initial positions, varying political trajectories and even dissimilar economic policies over the entire period. Yet they share some basic similarities, from the emphasis on export orientation in the pre-Asian crisis boom as well as subsequently, to the financial liberalisation that was already present to some extent in the 1990s but gathered pace thereafter and particularly after 19998, when both countries also made significant commitments to the WTO in terms of liberalising financial services. Both of them had rising investment rates that were generally higher than the also increasing savings rates in the run-up to the Asian crisis.

Thereafter, investment rates fell sharply in both countries, and have remained low in Malaysia even as savings rates have ruled high. In Indonesia there has been some recent recovery of investment rates but only just managed to reach and exceed the savings rates two years ago. Meanwhile, investment rates have shown little relationship with financial indicators like stock market capitalisation and credit to the private sector. In other words, the recent financial boom that has been associated with these "emerging markets" has not translated into real investment increases. Very significantly for present purposes, the processes of structural change in both economies seems to have been stalled or even reversed, with industry (and manufacturing) shares of value added and employment remaining stagnant in Indonesia and actually falling in Malaysia. Bear in mind that these changes occurred at much lower levels of per capita income than occurred even in South Korea and certainly as per the experience of the currently advanced economies of the West.

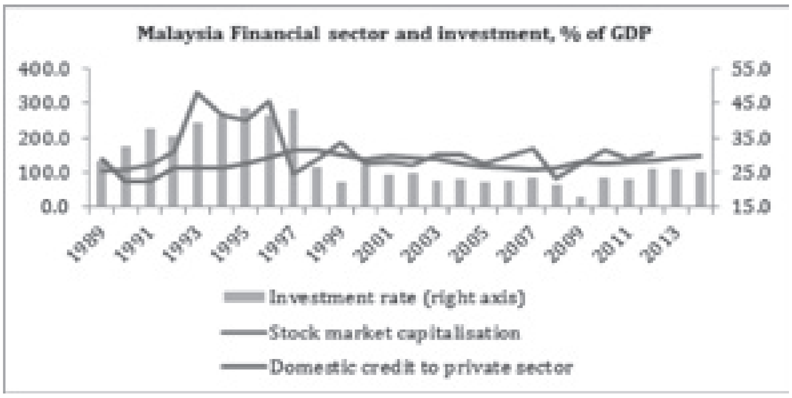
So even as these economies actually became more "open" in policy terms, especially with respect to rules regarding foreign investment, and were celebrated as "emerging markets", they stopped being net recipients of foreign savings and instead showed the opposite tendency of net resource outflow, as domestic savings have been higher than investment. This was in turn associated with both lower rates of growth than previously as well as lower investment rates and reduced impetus towards the desired change in productive structures and sectoral diversification. The entire process was accompanied by a greater reliance on attempts to induce growth through debt-driven bubbles, by encouraging expansion of consumer debt and housing finance, even though these are necessarily time-bound and self-limiting engines of growth and have now already run their course.

Chart 1.14



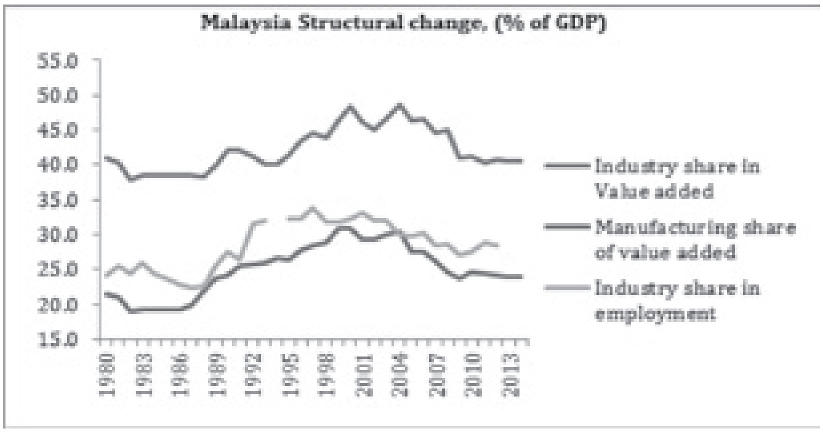
Source: World Bank WDI online

Chart 1.15



Source: World Bank WDI online

Chart 1.16



Source: World Bank WDI online

Chart 1.17

Source: World Bank WDI online

Chart 1.18

Source: World Bank WDI online

Chart 1.19

Source: World Bank WDI online

This shows that that financial liberalisation can do more than simply create sharp and painful economic shocks for the residents of the country – they can also alter longer-term economic trajectories in unfortunate ways. An important fallout has been that the project of the developmental state, which was such an essential feature of economic progress in the region in the past, has effectively been abandoned.

Deflation and developmental effects

A forceful critique of financial liberalization relates not only to the enhanced possibility of crises, but the argument that it has a clear bias towards deflationary macroeconomic policies and forces the state to adopt a deflationary stance to appease financial interests. To begin with, the need to attract internationally mobile capital means that there are limits to the possibilities of enhancing taxation, especially on capital. Typically, prior or simultaneous trade liberalization has already reduced the indirect tax revenues of states undertaking financial liberalization, and so tax-GDP ratios often deteriorate in the wake of such liberalization.

This then imposes limits on government spending, since finance capital is generally opposed to large fiscal deficits. This not only affects the possibilities for countercyclical macroeconomic stances of the state but also reduces the developmental or growth-oriented activities of the government.

Financial interests are against deficit-financed spending by the state for a number of reasons. To start with, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is "autonomous" in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. If deficit spending leads to a substantial build-up of the state's debt and interest burden, it is possible that the government may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending. Finally, since financial interests privilege the role of markets, the presence of the state as regulator and the interventionist activity of the state can be seen as delegitimising the role of finance, which is another reason why the financial markets tend to prefer reduced government deficits.

In sum, liberalization can dismantle the very financial structures that are crucial for economic growth. While the relationship between financial structure, financial growth and overall economic development is complex, the basic issue of financing for development is really a question of mobilising or creating real resources. In the old development literature, finance in the sense of money or financial assets came in only when looking at the ability of the state to tax away a part of the surplus to finance its development expenditures, and the obstacles to deficit-financed spending, given the possible inflationary consequences if real constraints to growth were not overcome. By and large, the financial sector was seen as adjusting to the requirements of the real sector.

In the brave new world, however, when the financial sector is increasingly left unregulated or covered by a minimum of regulation, market signals determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This can result in the problems conventionally associated with a situation where private rather than overall social returns determine the allocation of savings and investment. It aggravates the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and to direct savings to already well-developed centres of economic activity. The socially desirable role of financial intermediation therefore becomes muted.

This certainly affects employment-intensive sectors such as agriculture and small-scale enterprises, where the transaction costs of lending tend to be high, risks are many and collateral not easy to ensure. The agrarian crisis in most parts of the developing world is at least partly, and often substantially, related to the decline in the access of peasant farmers to institutional finance, which is the direct result of financial liberalization. Measures which have reduced directed credit towards farmers and small producers have contributed to rising costs, greater difficulty of accessing necessary working capital for cultivation and other activities, and reduced the economic viability of cultivation, thereby adding directly to rural distress. In India, for example, there is strong evidence that the deep crisis of the cultivating community, which has been associated with to a proliferation of farmers' suicides and other evidence of distress such as mass migrations and even hunger deaths in different parts of rural India, has been related to the decline of institutional credit, which has forced farmers to turn to private moneylenders and involved them once more in interlinked transactions to their substantial detriment.

It also has a negative impact on any medium term strategy of ensuring growth in particular sectors through directed credit, which has been the basis for the industrialisation process through much of the 20th century. In a large number of developing countries in the past, the financial structure was developed keeping in mind its developmental instrumentality. Financial structures were therefore created to deal with the difficulties associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low capacity utilisation during which they could find themselves a foothold in world markets. Not surprisingly, therefore, most late industrializing countries created strongly regulated and even predominantly state-controlled financial markets aimed at mobilising savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit, and low interest rates.

By dismantling these structures financial liberalization destroys an important instrument that historically evolved in late industrializers to deal with the difficulties of ensuring growth through the diversification of production structures that international inequality generates. This implies that financial liberalization is likely to have depressing effects on growth through means other than just the deflationary bias it introduces into countries opting for such liberalization.

Comments

Comments on two papers ‘Financial Crisis and the Economic Conditions of Women’ by Professor Jayati Ghosh and ‘Finance and Instability in Asia’ by Professor Chalapurath P. Chandrasekher

presented for a Symposium at Ochanomizu University (Institute for Gender Studies), 2016.4.11.

Makoto Itoh (Professor Emeritus of the University of Tokyo)

From two papers, I learned interesting problems on financial instability, its impact on employment, and women’s economic conditions in the contemporary world especially in Asia. Let me comment on each paper three issues mainly from a view of Japanese experiences, and add another separate point thereafter.

On the first paper by Professor Ghosh;

(1) The different effects of sub-prime financial crisis on men and women workers.

Women workers statistically seem affected less than men both in unemployment rates and in wage gender gaps. The author analyses that these facts originate from the socially gender biased structure of employment. Men were dominantly employed in financial and export-oriented industries with higher wages, whereas women were mainly in tertiary industries with lower wages. The financial crisis hit clearly the former than the latter. He also stress that women’s economic life was generally not improved but rather became unstable and harder as their jobs became more in the various forms of irregular employment, and also as their burden of unpaid work was added due to cuts of welfare policies.

This impressive analysis suggests that the different effects of financial crisis on men and women are deeply related to the background trend of socio-economic structural changes in our age of neo-liberal global capitalist development since the 1980s, which mobilized more and more of women to market labor beside their nom-market labor, especially in tertiary industries, with lowly paid unstable irregular wages. As such a trend is exactly working also in Japan, we have to reconsider together how to overcome such a series of trends in our age.

(2) The vulnerability of export-oriented growth and recovery in Asian economies.

The paper clarifies that the export-oriented recovery and growth trajectory in Asian economies after the Asian crisis of 1997-98 worked suppressive on domestic consumption, and resultantly made these economies vulnerable in the process of the subprime global crisis. This point is applicable also to Japanese economy. As its recovery depended on export for several years until 2007, with rather deflationary domestic demand, resulted in the worst macro-economic performance in a decline of real growth rate among the major economies, despite of its relative stability in the financial institutions. The point implies that much more domestic-oriented recovery strategies are surely necessary and desirable.

(3) What to think of the contents of Keynesian fiscal policies.

Thus the paper underlines the necessity of more positive Keynesian fiscal stimulus policies rather than the neo-liberal austerity policies in order to restore stable macro-economic balance. However it shows certain worries about Chinese fiscal stimulus spending mainly on public expenditure, allocating just less than 4% for health care and education. It appreciates more the case of Sweden and Argentina as models more desirable for treating women and younger generation such as educational and vocational guidance together with other social welfare measures.

We can add the case of Japanese unsuccessful decades of spending policies mainly for public expenditure by piling up huge amount of state debt more than twice of GDP, while cutting down budget for education and health care against need. Although Keynes himself believed in fiscal policy for public expenditure as an effective recovery measure, we have to doubt why it cannot work well in our age. Is it because the big business in general construction now using more of heavily automated machinery became less effective in generating employment by receiving demand for public expenditure? At least the initial phase of Japanese Democratic Party government born in 2009 after the subprime shock, following US Obama government, tried rather successfully a series of policies shifting 'form concrete-cement to human-being', including providing child-allowance without means-tests, and a sort of green-recovery policy in a form of eco-point system for purchasing eco-conscious electric appliances, cars, and houses, and managed to cause a wide recovery in 2010. However the government was pushed back in 2011, troubled deeply by the great earthquake, giant tsunami, and the disastrous accident at the Fukushima atomic power plant, and could not continue such policies..

On the second paper by Professor Chandrasekher;

(1) What did financial liberalization positively result in Asian countries?

This paper strongly demonstrates that financial liberalization in Asia since the 1980s resulted in mostly negative effects; such as increased vulnerability, difficulties to use the financial system for state-led development or industrial policies, and the increased susceptibility to the external financial shock like the subprime crisis. Although these effects must be true and serious, there must be also positive side of effects in relation with increased inflow of foreign capital especially in the form of direct foreign capital investment, promoting high economic growth with expanding employment in many Asian emerging countries.

Such positive effects as a trend in this period of neo-liberalism seems obvious from a view of the contrasting accelerated industrial hollowing out and stagnant trend in advanced economies including Japan.

(2) Why Japan did opt for financial liberalization?

This paper explains four sources of pressure on Japanese government to opt for financial liberalization; Japanese firms' multi-nationalization, lobbying by international financial institutions, these external agents' request to dilute the special relationship between the government, the financial system and the corporate circle, and fourthly together with Japanese financial institutions, these external agents demanded for greater flexibility in operation (p.4). Although these factors must actually have worked, I feel that US and other external pressures are overrated.

Behind the effects of these pressures from outside, there was also a fundamental internal shift in the functions of Japanese banking system since the end of high-economic growth period until 1973. In the high economic growth period, Japanese banks used to serve to industrial businesses by continuously supplying massive loans so as to promote their massive capital investment, forming a typical indirect over-loan by transmitting saving fund from households to industrial growth. After the end of high-economic growth, Japanese big industrial corporations became more and more self-financed, by reducing debt, and accumulated more of retained earnings, as real capital investment to plant and equipment reduced down. Thus Japanese banks had to find new operations to utilize idle fund more flexibly in capital market (to purchase directly or indirectly shares and public bonds), lending to smaller businesses, consumer credit and expanding multi-national financial operations, and thus moved for financial liberalization. The result was that the Japanese financial system also became much more speculative and insecure as the paper points out as a common tendency in contemporary Asian financial system.

We read in this paper (p.18-23) that in Asian emerging economies, the aggregate debt of non-financial sector is increasing including corporate debt. Comparison of statistical data on corporative debt between Japan and other Asian economies must be interesting if available.

(3) Financialization of labor-power?

In retrospect, the modern financial system in capitalist societies in general used to concentrate loans to business firms, leaving out consumer credit to the hands of more traditional old types of money-lenders and pawnshops the peripheral area of finance. However, it is interesting to observe in our age of neo-liberal globalization, modern banks began to expand consumer credit to promote markets for consumer durables, such as cars and houses. Such a trend started from advanced economies including Japan, and came into Asian emerging economies as well, as this paper analyses after p.23. In Korea, one every 10 households spends more than 40% of income on serving such a debt (p.27).

Upon the ground of commodification of labor-power, capitalism in our age expands financialization of labor-power so as to exploit workers of their wage income in addition to exploitation in the labor process. The subprime crisis well shows how this financialization of labor-power added to vulnerability or inner contradiction of capitalist financial system, as well as in mass of workers' economic life.

There is an interesting issue what impacts do this financialization of labor-power give women's economic life. Is there gender discrimination in treating housing loan? Did it promoted women to get jobs in market? In what ways did it deepen women's double burden both in market and outside of market?

Ideas for 21st century models of alternative paths

Let me add another point which may also worth discussing together concerning 21st century models of social democracy and socialism.

In my reading both authors are conscientious left Keynesian, taking care of issues how to improve economic difficulties among weaker people with warm heart. I am fully sympathetic to such a spirit, especially against neoliberal policies believing just in competitive market principles. Against neoliberalism, both papers suggests alternative desirable positive state policies of 21st century models of social democracy, such as a shift from mere public expenditure to social welfare, as a recovery strategy. We are witnessing increasing popularity of B. Sanders in USA, J. Corbyn in UK, and P. Iglesias in Spain, and expect a global sign for a new tide for socialism in a broad sense against neoliberalism containing such a renewed policy programs. Please let me hear if there is any information on this.

More specifically, in contrast to 20th century models of social democracy and socialism which expected nation state to work for redistribution in an egalitarian orientation, 21st century models of them must, in my view, have wider glass- roots often more localized various attempts to reconstruct social solidarity and mutual assistance from below. For instance, Mayor of Seoul Park Won-Soon initiated international Global Social Economy Forum (GSEF) in 2013 upon his practice in Seoul City, in order to promote social economy based on workers cooperative unions and other forms of non-profit regional organizations in cooperation with the local governments for the more humanistic future. Similar intention is found now in various local social movements to form local currencies, organization for local production and consumption, green-recovery strategies, sometimes liked with expectation for local administrations to act for recovery of local communities. Probably we should reconsider such ideas for the 21st models of social democracy and socialism, including various possibilities for more decentralized forms of micro-finance like Grameen banks.

I shall be happy if my comments can serve as suggestions for fruitful discussion in this symposium.