Financial structures, regulation and interlinkages: Developing Asia in the context of global crises

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I. Introduction

The proliferation of financial crises from developing countries in the 1990s to developed countries in the new millennium has raised the question of the adequacy of financial regulation and supervision in both national and global financial markets. The financial crisis in the United States had global implications because of its impact on financial markets in a number of countries, but most importantly because the regulatory and supervisory systems of developed countries have provided the pattern for best practice regulation recommended to developing countries in order to strengthen the resilience of their financial systems and to increase financial stability.

Although the process of financial liberalisation began much later in Asia than it did in Latin America or the major developed countries, rapid liberalisation leading to a restructuring of domestic financial sectors has followed the same trajectory in the Asian region. An important consequence of this restructuring process has been the increasing integration of Asian developing country financial markets with those in the developed countries. In addition, the responses to financial crises in the region in 1997 and 1998 involved the introduction of developed country financial institutions and practices into the economies of the region. One result of this increasing financial integration and the adoption of developed country standards has been the growing presence in developing Asia of multinational financial firms originating in developed countries. This has further accelerated the domestic use of financial practices common to developed countries in local regulatory regimes that do not have the apparatus or personnel to manage these new markets, institutions and instruments.

While the banking systems of developing Asia have thus far been relatively less adversely affected than in some other parts of the world, the global crisis has shown that financial integration has made developing countries in Asia more vulnerable to financial developments in the developed countries and that this vulnerability can have consequences that are far more severe than those in the countries where the problems originate. Not surprisingly, despite early recovery from the effects of the global downturn, concern about

financial policies has been expressed not just by external analysts, but also by central banks and financial regulators in countries such as China, India, South Korea and Thailand.

In Section II of this paper we identify the impact of the Asian crisis of 1997-98 for financial restructuring in the region, and the consequent implications for financial fragility and contagion in the new global context. In Section III we consider financial policies in what has thus far been the great outlier in the region, the People's Republic of China, and newly emerging tendencies in that economy consequent upon changes in financial structure in the very recent past, with the growth of shadow banking activities. In Section IV we link trends and patterns in developing Asian financial markets with European financial markets. Two features are particularly noted: the exposure of European banks to financial markets in Asia, and the increasing role that may be played by sovereign wealth funds from Asia in the bond markets of "peripheral" countries of the eurozone.

II. The Asian financial crisis, financial restructuring and the problem of contagion

The Asian crisis of 1997-98 focused attention on the dangers for developing countries of a world dominated by fluid finance. It brought home the fact that financial liberalization can result in crises even in so-called 'miracle economies'. The crisis marked a major setback to the "East Asian miracle": more than a decade after that crisis, the affected economies have not really been able to recover their pre-crisis dynamism. And the more successful Asian economies in the subsequent period (such as China and to a lesser extent India) have since been much more cautious about extensive financial liberalization.

It is now quite obvious that currency and financial crises have devastating effects on the real economy. Even when crises are essentially financial in origin and in their unfolding, their effects unfortunately do not remain confined to the realm of finance. The ensuing liquidity crunch and wave of bankruptcies result in severe deflation, with attendant consequences for employment and the standard of living. The post-crisis adoption of conventional IMF stabilisation strategies tends to worsen the situation. Thereafter, governments become so sensitive to the possibility of future crises that they continue to adopt very restrictive macroeconomic policies and restrain public expenditure even in crucial social sectors. Finally, asset price deflation and devaluation pave the way for foreign capital inflows that finance a transfer of ownership of assets from domestic to foreign investors, thereby enabling a conquest by international capital of important domestic assets and resources.

In some ways all the economies that were deeply involved in the Asian crisis (Thailand, South Korea, Indonesia, Malaysia and the Philippines) have recovered, at least in terms of the eventual resumption of output growth. But the recovery has not meant a return to "miracle" status. Instead, it has been accompanied by significant acquisition, at

deflated prices, of productive assets in these economies by foreign firms. It has involved a substantial restructuring of the financial sector. It has altered the nature of engagement with the world system of these economies. And it has involved a setback to achievements on the human development front.

A key insight that emerges from an analysis of the Asian crisis is how market-oriented strategies to cope with the crisis created further financial fragility in many post-crisis economies, thereby rendering them extremely vulnerable to future contagion and volatility, exactly in the manner that has been experienced in 2008 and 2009. To that extent, the Asian crisis effectively predicted the severe impact on both the financial variables and the real economy that the global crisis of 2007-08 had upon developing countries in particular.

This is important not only for understanding the post-crisis trajectory of the affected Asian economies, but because it is now more than evident, more than a decade after the crisis, that the international financial system has still not evolved effective ways of preventing such crises among emerging economies and reducing their damaging effects. In this chapter, we examine the trajectory of the Asian crisis and consider how it has triggered changes in the financial structures of developing countries that in turn create new fragilities and exacerbate existing ones.

The trajectory of the Asian crisis

The pre-crisis development trajectories differed substantially across the countries most affected by the East Asian crisis. South Korea pursued a state-directed and highly regulated export-led growth strategy (Amsden 1992, Wade 2004), which gave way to a more liberalised regime much later. Malaysia and Thailand had much more recent histories of rapid economic growth, within relatively open economic regimes relying on foreign investment to deliver both export and output growth. In Indonesia, oil revenues and a strong state relying on internal and external clientelist relations (between the state and private capital internally, and between the American and Indonesian governments internationally) played an important role in the development path. The Philippines was never really much of a "tiger" except in the matter of export growth, and that did not translate into any major transformation of domestic productive structures.

The literature on the East Asian crisis (Chang, Palma and Whittaker 2008, Radelet and Sachs 2000) usually dates it from 2 July 1997, when the Thai currency, the *baht,* was allowed to float and promptly depreciated in value by around 40 per cent relative to the US dollar. Signs of impending problems had been evident in several economies for some months previously: in Thailand speculative attacks on the currency from around August 1996 were warded off only with great difficulty by the Thai government; and in South Korea several *chaebols* faced difficulties in servicing their loans from January 1997. But the sharp and sudden currency depreciations in the five “crisis” countries were the most

obvious symptoms of the crisis. They were triggered by three factors. First, a collapse in investor confidence resulted in a panic withdrawal of funds invested in equities and also prevented the roll-over of short term debt by multinational banks which had lent in the region. Second, there was a scramble for dollars on the part of domestic banks and corporations with imminent dollar commitments, the domestic currency costs of which were rising in the wake of depreciation. And finally, there was an increase in speculative operations by domestic and international traders cashing in on currency volatility.

While all of these factors operated in most Southeast Asian economies, their ability to withstand the crisis, by intervening in currency markets and combating speculation, was substantially different. Thailand, which faced speculative attacks on the *baht* in August 1996 and May 1997, was the first to succumb. Unable to prevent the flight of capital and denuded of foreign currency reserves, the country had to turn to the IMF for stand-by credit and help in working out a debt rescheduling package. As the contagion, mediated by the "confidence" of foreign investors and lenders, spread to other economies, Indonesia caved in quickly, whereas the South Korean government battled for months to stabilise the *won* without IMF assistance but failed. Others, notably Malaysia (and of course Taiwan China, which is rarely discussed even though it faced an equivalent decline in exports without experiencing a financial crisis) chose to go it alone and eventually achieved at least a basic stability of their currencies without recourse to IMF assistance or policy direction.

The real economic crisis appeared after this financial collapse, especially after the IMF was called in, but once it began, the real economic crunch soon threatened to outpace the financial crash. With a combination of a liquidity crunch, bankruptcies and IMF-sponsored deflation playing its role, not only did domestic manufacturing output and GDP contract massively in these countries, but unemployment rose sharply and standards of living fell dramatically in societies long accustomed to stability and high growth. Given the close integration through trade and investment of the economies of the region, this contraction affected even those that did not opt for the IMF route to stabilisation.

The crisis spawned a large variety of theories on its origins and extent. One argument heard frequently with respect to the East Asian crisis is that it was a crisis of "over-accumulation" such that markets could not absorb the output of additional investment (Erturk 2002). It is clear that capacity creation was in excess of demand growth, especially when assessed in the post-crisis context. But this was a symptom rather than a cause of the problem, which was that a very rapid rate of growth through high investment rates in these economies was based on substantial export penetration, such that international market shares in exports would have to continuously increase. Obviously, such a trajectory is not sustainable over long periods, and so the problems that emerged were inherent in the trade and industrialisation strategies that these countries were following. The region's excessive focus on exports as the engine of growth became

more difficult as competing developing country exporters (such as China) entered the scene, exemplified by the impact of the devaluation of the Chinese RenMinBi in 1994.

This was a more significant problem than the policy of maintaining fixed exchange rates, which has also been blamed for the crisis. In fact, real exchange rates were likely to have appreciated even more with large capital inflows if nominal rates were flexible. The existence of "crony capitalism" and opaque financial systems have also been cited as causes of the crisis (Hughes 1999), although these were always more controversial as explanations and have been rendered much less convincing after the outbreak of the US financial crisis in 2008.

Rather than these factors, it is now widely accepted that the most crucial proximate factor for the crisis was financial liberalization, specifically external or capital account liberalization. During the early 1990s, almost all East Asian countries liberalised their financial sectors and allowed local corporations, banks, and non-bank financial institutions to freely access international capital markets with little commitment to earn the foreign exchange needed to service the costs of such access. This allowed inflows of capital that enabled short-term borrowing for long-term projects and broke the link between domestic agents' ability to access foreign exchange and their need to earn it. This was associated with the use of new instruments, specifically derivatives contracts that were enabled by deregulation. As Kregel (1998, p. 67) has noted, the role of derivatives contracts can explain the existence of a number of puzzles associated with the Asian financial crisis. "The shift to short-term commercial bank lending in a region that traditionally relied on direct investment, the allocation of resources to low return uses in an area considered to be highly profitable, lax prudential supervision in systems that had introduced financial reforms early, and the co-movement of asset prices and exchange rates, which was to have been eliminated by direct equity investments, are all linked to the characteristics of derivative contracts used to provide lending to Asia."

The capital inflows into the region that increased as a result of the capital account liberalization and investor bullishness about export growth caused appreciation of the real exchange rate. This occurred irrespective of the exchange rate pegs that many economies in the region maintained with respect to the US dollar, as the capital inflows were associated not only with higher asset market values, but also with increased domestic activity that increased demand for domestic goods and services.[i] This shifted incentives for investment within the economy from tradables to non-tradables (specially real estate and domestic asset markets), and caused current account deficits to occur as exports effectively became more expensive and imports cheaper. As a result, the capital inflows were associated with current account deficits and deceleration of exports that laid the seed for the eventual reversal of investor confidence. Thus it was no accident that all these economies experienced property and real estate booms, as well as stock market booms, at some time in the years between 1993 and 1996. These booms in turn generated the incomes to keep

domestic demand and growth 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.

It was inevitable that this would eventually result in a collapse of investor confidence. When that did occur, capital was pulled out and currencies depreciated, those with dollar commitments in the offing rushed into the market to purchase dollars early and cut their losses. The spiral continued, generating a liquidity crunch and a wave of bankruptcy. Therefore, financial liberalization was associated with excessive dependence on foreign capital inflows, especially short term debt. This was probably the single most important explanatory factor for the nature and the severity of the crisis in East Asia.

The specific role of financial liberalization was further underlined by the fact that other economies in the region that also experienced export slowdown in 1996 and 1997 but had not liberalised finance and the capital account to the same extent (such as Taiwan China and Vietnam) did not experience a financial crisis. Mobile capital allowed for faster and more extreme appreciation of exchange rates and also more rapid reversals of capital flows in the crisis hit economies than in other less financially exposed economies of the region.

One very common conclusion that has been constantly repeated since the start of the Asian crisis in mid-997 is the importance of "sound" macroeconomic policies, once financial flows have been liberalised. It has been suggested that countries like Thailand, South Korea and Indonesia have faced such problems because they allowed their current account deficits to become too large, reflecting too great an excess of private domestic investment over private savings. However, with completely unbridled capital flows, it is no longer possible for a country to control the amount of capital inflow or outflow, and both movements can create consequences which are undesirable. If, for example, a country is suddenly chosen as a preferred site for foreign portfolio investment, it can lead to huge inflows which in turn cause the currency to appreciate, thus encouraging investment in non-tradeables rather than tradeables, and altering domestic relative prices and therefore incentives. Simultaneously, unless the inflows of capital are simply (and wastefully) stored up in the form of accumulated foreign exchange reserves, they must necessarily be associated with current account deficits.

This means that any country which does not exercise some sort of control or moderation over private capital inflows can be subject to very similar pressures. These then create the conditions for their own eventual reversal, when the current account deficits are suddenly perceived to be too large or unsustainable. In other words, what all this means is that once there are completely free capital flows and completely open access to external borrowing by private domestic agents, there can be no "prudent" macroeconomic policy; the overall domestic balances or imbalances will change according

to the behaviour of capital flows, which will themselves respond to the economic dynamics that they have set into motion.

Adjustment, recovery and after

The initial adjustment to the crisis varied significantly across countries, with an acceleration of liberalization in some (South Korea and Thailand) and greater intervention in others (Malaysia). The immediate response tended to be significantly affected by the extent of IMF intervention; indeed, the IMF has been strongly criticised (Stiglitz 2004, Chandrasekhar and Ghosh 1999) for its role in the Asian crisis because it responded in ways that may have intensified the crisis. In situations of asset deflation and associated collapse in economic activity in the crisis-hit countries, it imposed further deflationary pressure by demanding tight monetary policy and high interest rates (in order to reduce the capital outflows) and reductions in public expenditure (to generate more fiscal surpluses or reduce fiscal deficits). As a result, Thailand, Indonesia and South Korea experienced exceptionally sharp reductions in economic activity, and the subsequent recovery was essentially facilitated by a combination of devaluation-induced export increases and some fiscal expansion, including what was enabled by the Miyazawa Initiative.[ii] By contrast, Malaysia, which did not go to the IMF and also imposed temporary capital controls in order to prevent further capital flight during its fiscal stimulus, also recovered relatively quickly. In the event, while exports recovered quickly, it is also likely that the financial bailouts to domestic companies and banks along with the fiscal stimulus responses that were initiated in 1998 against IMF advice and in the teeth of criticism from the US and some European governments, also played positive roles in generating the recovery.

Over the subsequent decade, all these economies have recovered, albeit in different ways and to different degrees determined by the nature of the policy response in individual countries. But the recovery has not meant a return to "miracle" status. This is because the crisis did not lead to real changes in the export-led strategy of growth or to greater financial regulation that would have reduced financial fragility and enabled more inclusive growth (Ghosh and Chandrasekhar 2009a).

Export growth, which was seen as the key to the success of these five economies in the late eighties and the first half of the 1990s, is often cited as the best indication of the recovery as well. Pre-crisis export growth in the region was very high, between 10 and 20 % per year in US dollar terms. The deceleration of export growth in 1996 is widely recognised as one of the proximate causes of the crisis. The export recovery occurred within a couple of years: by 2000 all these five countries were showing sharp increases in rates of export growth. Subsequently, however, export growth has been very volatile in all five countries, and strongly influenced by global developments. GDP growth also recovered, but in general this involved growth rates that have been slightly lower, and definitely more

volatile, than the growth rates of the previous period. But the most startling change was the broad macroeconomic shift in terms of a large divergence between savings and investment rates. The East and Southeast Asian region generally had very high savings rates – between 30 and 45 % in these five countries. But the period subsequent to the financial crisis saw an increase in these already high rates, especially in the "crisis" countries. However, investment rates (that is the share of investment in GDP) plummeted in all these countries, with the sole exception of Thailand where it first fell and then rose again, albeit not reaching its earlier peak.

Therefore in all these five countries, the crisis years of 1997 and 1998 marked a clear break from the earlier trend, when typically domestic investment rates were higher than saving rates, and the balance was met by an inflow of foreign capital. The latter is in fact what one would expect in a developing country, since it is generally supposed that developing countries are characterised by a shortage of investible resources. Therefore economic openness, especially to foreign investment, is designed to allow foreign resources to add to domestic savings in order to generate a higher rate of investment than would be possible using only domestic resources. After the crisis, from 1998 onwards, these five economies actually became *more* "open" in policy terms, especially with respect to rules regarding foreign investment. Nevertheless, after 1998 all these five countries 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). This occurred despite the continuing need for more investment within these countries, since the development project is still not complete in these countries and especially in Indonesia, Thailand and the Philippines, where poverty and backwardness remain substantial.

This rather paradoxical situation, which is reflective of a broader international tendency whereby developing countries have been providing their resources to the developed world, and in particular to the United States, has been described by some as a "savings glut" (Bernanke 2005). Weak or inadequate financial intermediation and undeveloped financial institutions have been blamed for this outcome. But the evidence shows that as financial institutions became more sophisticated, and imitated the North Atlantic model, the divergence between domestic savings and investment actually grew (and was indeed the largest in economies with the most developed and sophisticated financial systems, such as Malaysia and Indonesia). In any case, it is apparent that the problem in these countries was not the rise in savings, so much as the collapse in investment, suggesting not a savings glut so much as *an investment famine*. True, savings

rates increased, affected also by crisis-induced shifts in income distribution that reduced workers' consumption and transferred more income to those in a better position to save. But the sharp collapse in investment rates came about because of other factors that then led to the emergence of this "savings surplus".

The growing savings surplus was partly – but only partly - the result of the decisions of private agents in these countries, and even these private decisions were strongly affected by official economic policies. For example, stringent monetary conditions, increasing real interest rates and an excess of very rigid and inflexible forms of prudential regulation caused bank credit to be less easily available for investment. A range of other post-crisis measures dampened private investment by directly and indirectly raising the costs of finance and reducing access to it. This obviously reduced investment by large corporate entities, and had even stronger detrimental effects upon small enterprises which found it more difficult to access credit. It is worth noting that the only economy that showed a different pattern in savings and investment – Thailand – is one where the government of Thaksin Shinawatra systematically made greater access to institutional credit to small enterprises and farmers a major plank of the post-crisis reconstruction strategy (Pasuk and Baker 2009).

But monetary and financial policies are only one part of the story. A very large role in the reduction of aggregate investment was played by fiscal policies of governments in these countries, who increased their own savings and cut down on fiscal deficits or increased fiscal surpluses across the region. Even though the financial crisis in these countries was essentially brought on by private profligacy in a financially liberalised environment, the aftermath of the financial crises created an environment of excessive caution on the part of governments. The pressure was on governments to keep budget deficits under control by reducing their spending. As a result, governments in these countries did not spend as much as could be easily sustained by the economy, to ensure better conditions for the people or to encourage more sustainable growth and generate more employment.

So the major cause for this apparent excess of capital, which was then exported to the US and other developed countries, was deflationary policies on the part of these governments, which suppressed domestic consumption and investment. One obvious reason for this was the fear of a repeat of the large and destabilising movements of speculative capital which were such a strong feature of the financial crisis of 1997-98. The idea was to guard against the possibility of such potentially damaging capital flight by building up substantial foreign exchange reserves, even when these may involve large fiscal losses. The other reason was that the economic strategy in these countries was still centred on the obsession with exports as the engine of growth, which combined with deflationary domestic policies that kept levels of aggregate domestic investment lower than savings.

This caused an “excess supply” of foreign exchange in the currency market, which would in turn involve an appreciation of currencies, thereby adversely affecting exports.

In a world of liberalised trade where exchange rates cannot be easily controlled, this meant that currencies had to be kept at “competitive” levels through market based means. And this in turn meant that foreign currency inflows – whether through more exports or remittances or through capital flows – had to be counteracted by central bank market intervention to purchase foreign currency, to prevent undesired appreciation of the currency. The macroeconomic counterpart – and cause - of the rising foreign exchange reserves held by the central banks of all these countries was therefore the excess of domestic savings over investment, which was actually a huge potential wasted for these economies. Financial liberalization effectively resulted in the choice of deflationary strategies by governments. This in turn contributed to the excess of domestic savings over investment, thereby threatening currency appreciation. This is what led to the accumulation of unutilised foreign exchange in the form of growing foreign exchange reserves that were invested in “safe” assets abroad such as US Treasury Bills.

Changes in financial structure

After a brief intermission in the immediate aftermath of the 1997 crisis, there was a revival of capital flows to developing countries. Triggered by the intensification of financial liberalization during and after the financial crisis, that revival turned into a veritable surge after 2003. Although the crisis of 2008 dampened flows briefly, subsequently the infusion of cheap liquidity into developed country markets has resulted in a new surge in capital flows. In sum, developing countries have continued to be recipients of foreign capital flows that in most cases are also far in excess of their current account deficits, if any (Ghosh and Chandrasekhar 2009a).

This long-term surge in capital flows to developing countries has also been associated with a transformation of their domestic financial structures. Over the years when developing countries, including developing countries in Asia, were attracting large financial flows from the developed countries, they were also attracting and accommodating in their financial systems the carriers of those flows, namely foreign financial firms. This required reforming their financial rules and reshaping their regulatory frameworks to create an environment conducive to the mode of functioning of these firms. The idea appears to have been that if you want to attract capital, you need to attract the carriers of capital. And if you want to attract the carriers of capital, you have to create for them an environment that they would find conducive. That environment is seen as defined by the model that was shaped in the US, not in 1934 by the Glass-Steagall Act, but by developments after the 1980s, which culminated in the Financial Services Modernisation Act. Thus, what financial liberalization and reform does is to recast financial structures and regulatory frameworks in developing countries to resemble those in the Anglo-Saxon

world; to replicate, despite the lower levels of per capita income or levels of development otherwise measured in these countries, the Anglo Saxon model of finance within their own borders (Chandrasekhar 2008). This phenomenon of "structural contagion" has been inadequately discussed in the literature on finance and development.

The resulting structural changes and entry of new institutions and instruments have been substantial. For example, despite the notoriety of hedge funds, gained from the role they are alleged to have played in the currency speculation that precipitated the 1997 crisis, hedge fund activity in developing countries has increased substantially in recent years. Encouraged by liberalization that ensures not only entry but the proliferation of instruments, the growth of derivatives markets, the emergence of futures, and the increase in shorting possibilities, these firms have devoted much attention to these markets. Portfolio diversification by financial investors in developed countries seeking new targets, higher returns and/or a hedge has also resulted in the entry of private equity firms. Private equity involves investment in equity linked to an asset that is not listed and therefore not publicly traded in stock markets. This broad definition includes a range of transactions and/or assets, such as venture capital investments, leveraged buyouts and mezzanine debt financing, where the creditor expects to gain from the appreciation in equity value by exploiting conversion features such as rights, warrants or options.

Given this tendency for Asian financial systems to increasingly resemble those in the Anglo-Saxon world, the question arises as to whether the financial sectors in Asian countries are characterised by vulnerabilities of the kind we saw in the developed countries in 2008 and after. This question remains valid even if the crisis in Asia has not taken the form it has in most developed countries. There has been no financial implosion in these countries. Asian banks are well capitalized. They are not overexposed to toxic assets such as collateralised debt obligations linked to the housing market in the developed countries. Nor are they engaged in risky profit seeking to the same degree. Even in terms of capital adequacy ratios, most banking systems in developing Asia are relatively sound.

But this does not mean that there has been no fallout of the restructuring of financial systems in Asia. In fact the process has been associated with similar tendencies of the socialization of risk, that are already evident in the US and Europe (Chandrasekhar 2004).

Consider, for example, the case of India. One consequence of financial liberalization is that there has been a rapid expansion of bank credit, which grew at more than double the rate of increase of nominal GDP in the five years before mid 2008. As a result, the ratio of outstanding bank credit to GDP (which had declined in the initial post-liberalization years from 30.2 per cent at the end of March 1991 to 27.3 per cent at the end of March 1997) doubled over the next decade to reach about 60 per cent by the end of March 2008. Thus, one consequence of financial liberalization was an increase in credit dependence in the

Indian economy, a characteristic imported from developed countries such as the USA. The growth in credit outperformed the growth in deposits, resulting in an increase in the overall credit-deposit ratio from 56 per cent at end March 2004 to 73 per cent at end March 2008. This increase was accompanied by a corresponding drop in the investment-deposit ratio, from 51.7 per cent to 36.2 per cent, which indicates that banks were shifting away from their earlier conservative preference to invest in safe government securities in excess of what was required under the statutory liquidity ratio (SLR) norm.[iii]

These changes were not primarily driven by an increase in the commercial banking sector's lending to the productive sectors of the economy. Instead, retail loans became the prime drivers of credit growth. The result was a sharp increase in the retail exposure of the banking system, with personal loans increasing from slightly more than 8 per cent of total bank credit in 1992-93 to more than 23 per cent by 2005-06. Within retail credit, the growth in housing loans was the highest in most years. The share of housing finance in total credit rose from 5 per cent in 2001-02 to 12 per cent in 2006-07 and was still at 10 per cent in 2009-10. The credit-financed boom in the housing market triggered a spiral in housing prices, which in turn fed the boom. Indeed, much of the recent rapid expansion of the Indian economy can be traced to such credit-fuelled demand for housing and consumer durables, even as mass consumption stagnated. Because of the leverage that these practices of finance permitted, debt financed private expenditure became a substitute for debt financed public expenditure, and helped sustain and raise real economy growth during the years of fiscal contraction (Ghosh and Chandrasekhar 2009b).

Even those in the Indian central bank took notice of this process: "Demand for housing finance has emerged as a key driver of bank credit in the past few years. As incomes grow further and the pace of urbanisation picks up, and, in view of the substantial backlog, demand for housing and housing finance can be expected to record continuous high growth over the next few years. In view of the expected high demand, pressure on real estate prices may continue. Moreover, real estate markets are characterised by opacity and other imperfections in developing countries, and certainly in India. Such developments can easily generate bubbles in the real estate market, because of problems in the elasticity of supply, and information asymmetries. Strong demand for housing and buoyancy in real estate prices in an environment of non-transparency, thus, could potentially pose risks to the banking system. In conjunction with interest rate cycles, the banking system as well as the regulator would need to be vigilant to future NPAs (non-performing assets) and the US-like sub-prime woes." (Mohan 2007, p. 2222)

This implies recognition of the possibility that the rapid increase in credit and retail exposure would have brought more tenuous borrowers into the bank credit universe in India as well. A significant (but as yet unknown) proportion of this could be "sub-prime" lending. To attract such borrowers, banks have been offering attractive interest rates below the benchmark prime lending rate. More recently, banks, including public sector banks

have been opting for the scheme of initial "teaser rates" on housing loans, which tends to attract borrowers of doubtful repayment capacity into the housing market. These are all tendencies reflective of the fragility that precipitated the 2008 crisis in many developed countries.

So, even though the conventional indicators of banking sector performance in India and other Asian countries suggest that they are safe, there are tendencies that indicate potential fragility. If these intensify and lead to financial failure, it could result in inadequate liquidity and credit stringency, especially if foreign capital exits these economies because of the uncertainties that arise.

It is in this context that we need to assess the "positive", recovery-inducing effects of the return of capital flows to Asia. The region has once again become the main attractor of equity capital from abroad, with flows far exceeding those to transition Europe and Latin America. Bank credit in Asia, which did not decline much even during the Global Recession, also seems to be turning around and regaining the rapid growth it recorded in the period since 2003. Thus, underlying the much-celebrated V-shaped growth trajectory, with its sharp recovery, is a return to precisely those tendencies that were temporarily stalled by the reversal of capital flows that magnified the effects of trade dependence on growth. In fact, it is not a substantial recovery in global trade flows that underlies the return to growth in these countries, but their ability to combine a fiscal stimulus with a return to a debt-financed, consumption- and housing-investment-led growth path. The idea seems to be that when required to exit from the fiscal stimulus, to whatever degree, credit-financed demand will continue to sustain growth in these countries.

III. The changing nature of finance in China

For a relatively long period, the People's Republic of China was known to have a highly regulated banking sector. Indeed, the ability of the Chinese authorities to control the four important commercial banks (Bank of China, Agricultural Bank of China, China Construction Bank and Industrial and Commercial Bank of China, which together were earlier estimated to control more than three quarters of total domestic credit) was seen as important macroeconomic tool in the hands of the state as well as an instrument of ensuring directed credit, both of which have been crucial to China's economic success.

Before the 1978 reform, the financial system of China was vastly different from that in most countries. Starting from 1951, banks and other financial institutions were taken over by the state and assimilated into a system dominated by the People's Bank of China (PBC). Until 1984 this system essentially implemented the cash and credit plans formulated by the central authorities, which supported the physical plan for mobilisation, allocation and utilisation of real resources. All public sector transactions, including those between various levels of government and the state enterprises, were through transfers on their

accounts with the PBC. These account transfers at the PBC accounted for an overwhelming share (of up to 95 per cent) of all transactions.

Moreover, cash (to serve the needs of households and non-state owned enterprises) was printed and issued by the PBC on demand by the central government and allocated according to instructions issued. The main elements of money in circulation were wage payments to workers and staff, the purchase of agricultural products by the government, other purchases of goods in the rural sector, and the withdrawing of savings deposits by individuals. The banking system was not responsible for provision of resources for fixed asset investments by the state owned enterprises (SOEs) and for much of their working capital requirements, which were made available free of charge by the Ministry of Finance. The banking system was merely responsible for providing additional working capital and some loans, for accepting deposits from households and other non-government entities and for settlement of transactions.

There was little role for monetary policy, since credit provision was centralized and strictly controlled. Enterprises and other economic entities received grants and loans directly from the PBC. Bank branches had to merely meet credit targets. And lower level banking entities had to hand over deposits that exceeded their credit provision targets to higher-level units. If the government felt the need for restricting economic activity, it did so directly through administrative means rather than using levers of monetary policy. To manage the supply of cash and its utilisation, the central authorities could adjust (administered) prices relative to money wages (using a turnover tax if necessary). However, since the objective was to keep prices mostly stable, excess cash in circulation was absorbed through rationing, when commodity supplies fell short of demand, and by encouraging savings.

Financial reform in the period starting from the 1980s and accelerating in the 1990s created a situation in which banks, financial institutions and enterprises at provincial and local levels had more flexibility in providing and accessing loans. A two-tiered banking system was established in 1984 by converting the PBC into the country's central bank and getting the specialized banks to undertake the commercial banking business. Further in 1986, reform of the non-bank financial sector resulted in the creation of a number of trust and investment companies, and financial intermediaries such as leasing companies, pension funds and insurance companies. Subsequently, foreign banks were allowed to begin business for the first time. However, even under the new arrangement it was in principle possible for the PBC to rein in overdrafts being run by these banks and prevent them from exceeding loan limits or quotas. Further, now the PBC could control the terms of its lending by charging lower rates of interest for loans within the credit plan and penalize unauthorised borrowing. Thus the ability of the PBC to realize its credit plan was strengthened by the reform.

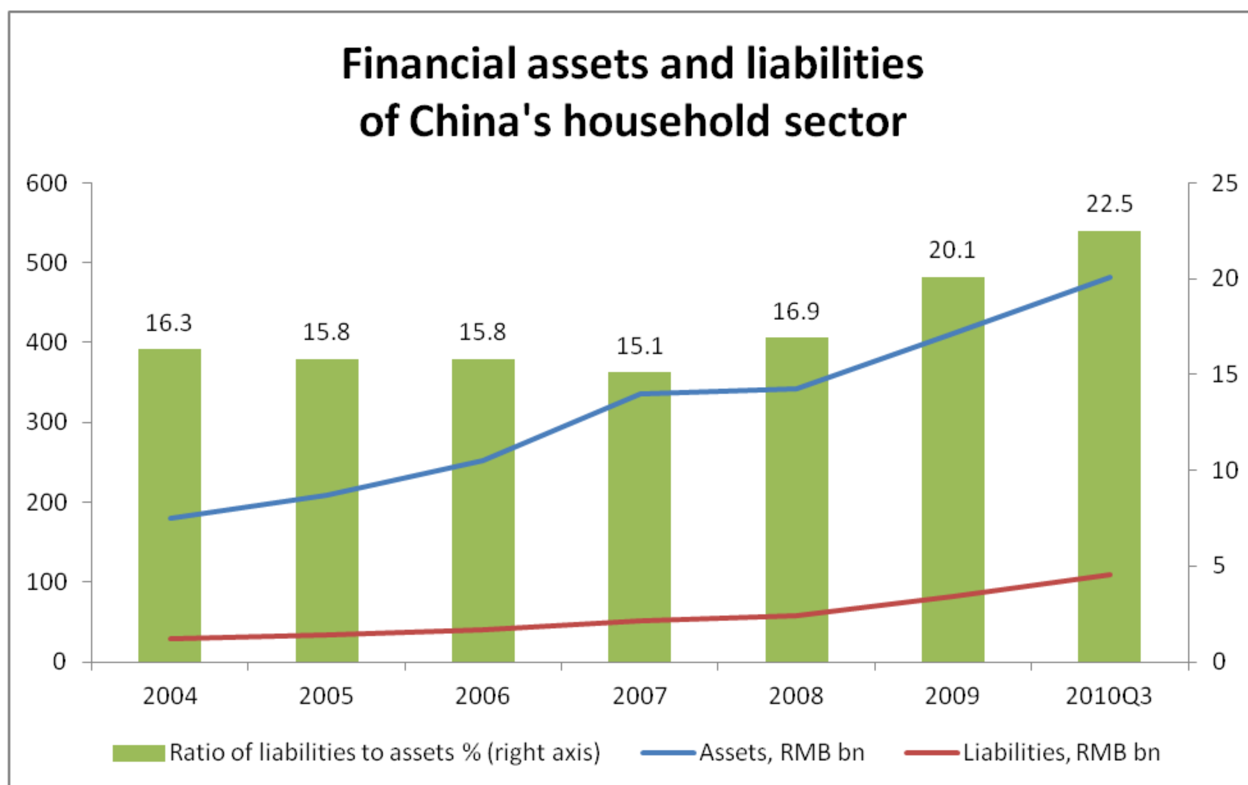
By the turn of the century, the ability of the government to control sharp increases in investment and consumption was to an extent reduced. So the government has increasingly relied more on countercyclical fiscal policy to correct for recessionary or inflationary tendencies. This was especially marked after the 2008 Great Recession. Meanwhile, price reform has meant that a growing number of commodities have been removed from the administered price category, so that excess demand can lead to inflation.

With a greater degree of decentralisation of financial activity and the ability of local officials to influence provincial and local appointments in the banks, it was possible for provincial and local government to easily obtain finance for special projects adding another element to the investment hunger determined by soft budget constraints in the SOE sector. Over time this problem has only increased, with an increase in number of financial entities, a change in property rights in the financial sector and a far greater degree of functional autonomy. In the process the capacity of the central bank to use monetary levers to control investment expenditures is weakened.

The changes in the financial system accelerated after 2008, when urge to provide more stimulus meant that the government allowed or encouraged more "informal" credit flows that went through new shadow banking intermediaries. As a result, the government's control over actual flows of domestic liquidity is weaker than it has been for more than half a century. In addition to trust companies and private banks, which are not regulated but at least are registered businesses with established offices, there has been a proliferation of underground operators, usually no better than loan sharks operating in a world of largely unsecured loans. Such has been the profitability of these operations that even large local state-owned firms whose main business was not finance are now expanding into operating guarantee companies, pawnshops and trusts, arbitraging their own access to cheap loans to lend out at many multiples of the official interest rates.

On the face of it, China's household sector appears to be not excessively leveraged at all – rather, they are substantial net financial savers, as evident from the chart below. Unfortunately, However, China's official financial statistics still do not cover shadow banking entities, though there are plans to reform the statistical system to being these under the purview of the data collection. But even without these, the data indicate that the ratio of liabilities to assets has been rising quite rapidly.

Chart 1.

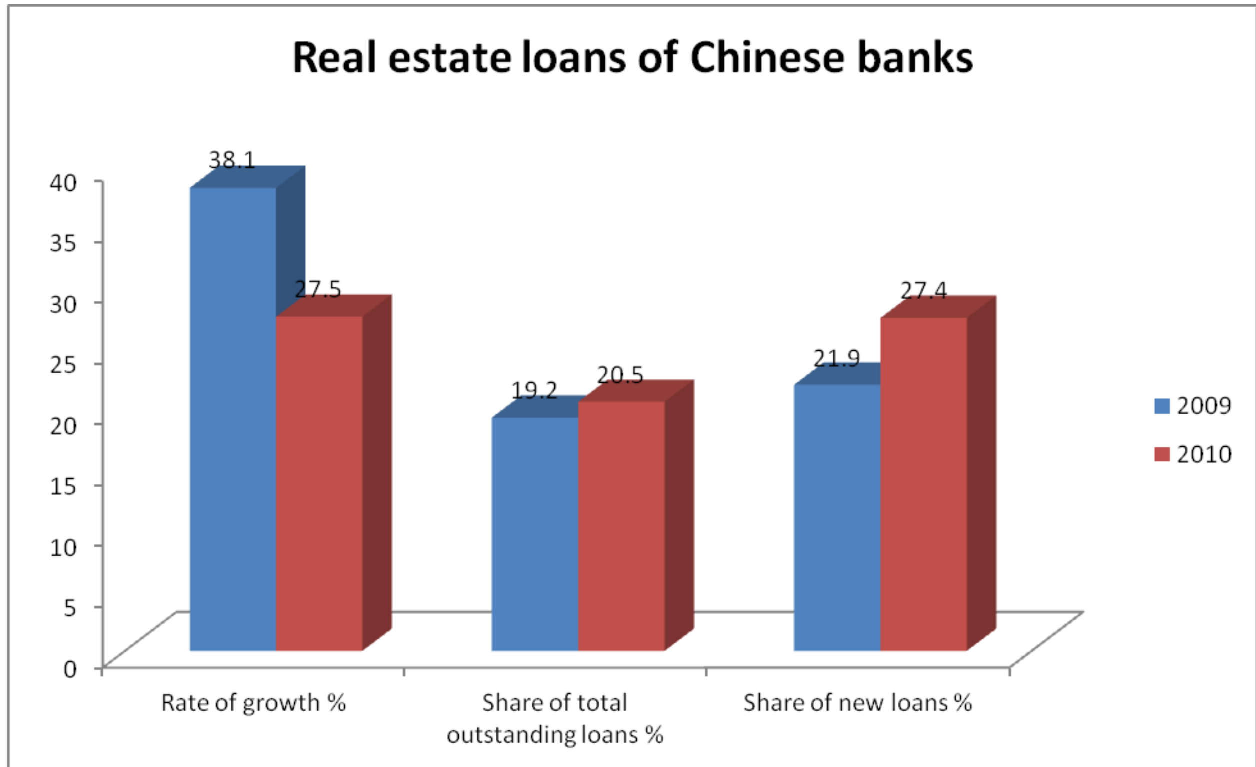


Source: China Financial Stability Report 2011, People's Bank of China, Beijing

The growing but opaque interlinkages between the formal credit system and the world of shadow banking are the real cause for concern. This is because the formal banks are also more attracted to indirect lending that generates at least double or triple the official 6.5 per cent one-year lending rate, and can even go up to 30-70 per cent in underground banks. In the first half of 2011, the most profitable activity of state-owned banks in the first half of this year was not lending to businesses but funding trusts and underground banks.

Much of that went into the overheated housing market, associated not just with a construction boom but with urban real estate prices that are now the highest in the world for cities like Shanghai and Beijing. Even formally, direct loans from Chinese banks for real estate and housing increased significantly in the previous two years.

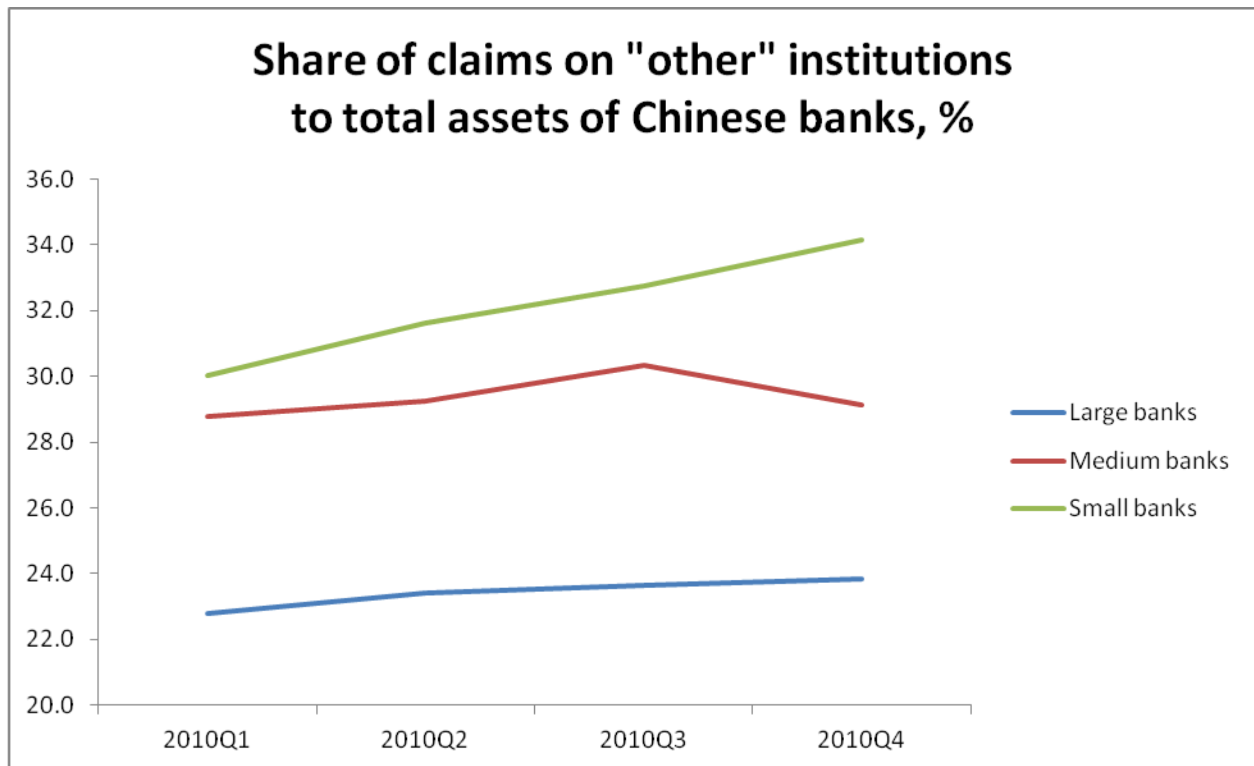
Chart 2.



Source: China Financial Stability Report 2011, People's Bank of China, Beijing

But these relate only to the direct lending by banks. Increasingly, commercial banks find it more profitable to lend to other agencies that then redirect the funds in this parallel or shadow banking activity that demands much higher interest rates. The chart below shows how this became a significant and even increasing share of banking assets especially for the small and medium sized Chinese banks. The chart takes claims on "other depository corporations", "other financial corporations" and "other resident sectors" (excluding non-financial corporations, government and central bank) as shares of total assets of banks according to size. This is only an approximate estimation of the shadow banking sector, since these categories also include other lending. But some analysts have already estimated that the value of China's shadow banking sector could amount to as much as RMB 14 to 15 trillion.

Chart 3.



Since official curbs on lending to this sector were tightened in early 2011, this parallel market expanded even further. However, the tighter interest rate policies and credit curbs have finally affected the real estate market. Recently the market has wobbled and real estate prices have finally started falling.

The bursting of this bubble could be painful. In an attempt to provide some protection, the government has encouraged the growth of credit guarantee companies – but many of these are also highly leveraged and themselves far from creditworthy. The growth of the shadow banking sector has also increased the correlation between lending curbs on formal banks, corporate bankruptcies and the occurrence of macroeconomic difficulties in China.

For a very long time, China's ability to control finance was an important (some would say essential) ingredient of its macroeconomic success. Of course the control still remains significant – well over half the commercial banking system is still under the direct control of the state, and currently the banks are well capitalised with low non-performing loan ratios and high capital adequacy ratios. Even if many of the new fly-by-night operators were to collapse with the pricking of the housing bubble, the contagion effects could well be contained by the actions of the state in further recapitalising the banks (as was done for

four major banks in October 2011). As long as the kerb operators are mainly lending institutions rather than deposit takers, the damage could still be contained. But clearly the Chinese financial system is significantly more fragile than it was in 2007, and this will affect both the conduct of monetary policy and the possibilities of quick recovery in the event of a macroeconomic slowdown occasioned by other factors like falling exports. Some attempts at bringing shadow banking also under the regulatory umbrella may well be required.

IV. Financial links between developing Asia and Europe

Banks in Europe are being forced to take a haircut to deal with the region's crisis. This raises concerns about the likely impact that the crisis would have on the financial systems in other regions of the world. Initially, the still-evolving crisis in Europe was read as being the result of excess public debt and poor public finances. Though this debt was owed to the banks, especially European banks, the latter were seen as protected. Default on debt owed to them would damage the financial system, worsen the real economy crisis, break the Eurozone and end the euro. Governments that had come together to constitute the Eurozone and adopt a common euro would hardly opt for this scenario stemming from a default by them that could damage bank profitability. Using that argument, the financial community worked overtime to call for action that would save the banks at the expense of the countries of the Eurozone and their populations.

It is now clear, however, that this strategy would not work. Governments seeking to "adjust" through austerity are finding their public finances worsening rather than improving, eroding further their ability to avoid a default on debt commitments. Thus, banks are being required to take a haircut, currently set at 50 per cent of loan value, up from 20 per cent a few months earlier. This could get even higher.

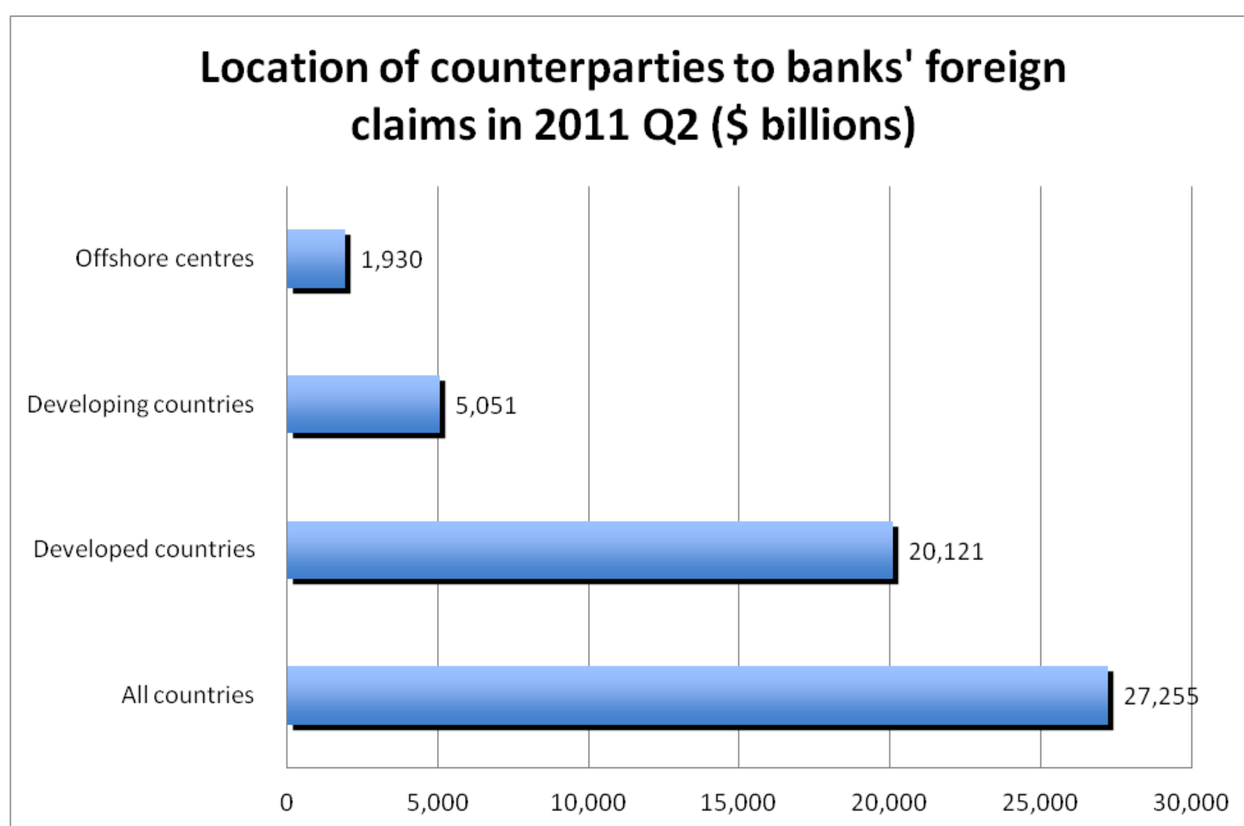
Given the damage that this would do to bank profits and balance sheets, a recapitalisation of European banks is imperative, with the current overly conservative estimate placing the funds required for that purpose at €106 billion. In addition, with European regulators set to agree on a revised core (tier one) capital ratio of 9 per cent for their banks, this figure could go up to €275 billion, according to Morgan Stanley. As of now, banks are required to dig into their global reserves (if any), approach the private markets for debt and equity, as well as take support from governments, through the European Financial Stability Facility (EFSF). But with most European governments unwilling or unable to provide funds, the EFSF's future strength is still uncertain. Thus, a significant retrenchment of still performing assets by European banks and persistent, possibly worsening, real economy crises seem unavoidable as of now.

This has led to much discussion on how a European banking crisis would affect the rest of the world. Our concern here is with the impact on developing countries, especially

the developing countries or the "emerging markets" in Asia exposed significantly to global banks.

It is now well accepted that one of the consequence of financial globalization has been the increased presence of global banks in developing countries and an increase in their role as lenders in these countries. This process has, of course unfolded to different degrees in different regions of the world. Between 1995 and 2005, the share of foreign banks in total bank assets rose from 25 to 58 per cent in Eastern Europe and from 18 to 38 per cent in Latin America, though even by that date the increase in East Asia and Oceania was much less (from 5 to 6 per cent). With this increase in presence, the share of foreign banks in lending to non-bank residents has been rising, as shown in Chart 4. Since the mid-1990s (and by 2009) the share of foreign banks in credit to non-bank residents rose from 30 to 50 per cent in Latin America, to nearly 90 per cent in emerging Europe, but is still at about 20 per cent in emerging Asia.

Chart 4.



As of the end of the second quarter of 2011, banks in countries reporting to the Bank of International Settlements (BIS) had foreign claims of $27.3 trillion outstanding.

Though a dominant share ($20.1 trillion) of these accumulated claims was in the developed countries, the developing country share ($5.1 trillion) was by no means meagre (Chart 4). What is particularly noteworthy is that the international banks involved are predominantly European. Around 70 per cent of the foreign claims of the global banking system is on account of European banks. Greater financial integration in Europe is one obvious reason. Of the $20.1 trillion claims on the developed countries, $12.3 trillion is in European developed countries, as compared with just $5.6 trillion in the US.

But another part of the reason is that European banks faced with increased competition at home are now seeking out developing countries to expand business and sustain profitability. Close to 20 per cent of the exposure of banks abroad is in developing countries, and this is true of European banks as well (Table 1). Given the greater role of European banks in total international funding and the importance of a few developing "emerging markets" as recipients of capital, this is of significance. The concentration of emerging market exposure in banks from one region increases the vulnerability of both these banks and their clients. But as discussed below, given the asymmetric nature of he relationship between foreign banks and their emerging market clients, this vulnerability is the greater for the latter, especially in the context of the current crisis in Europe.

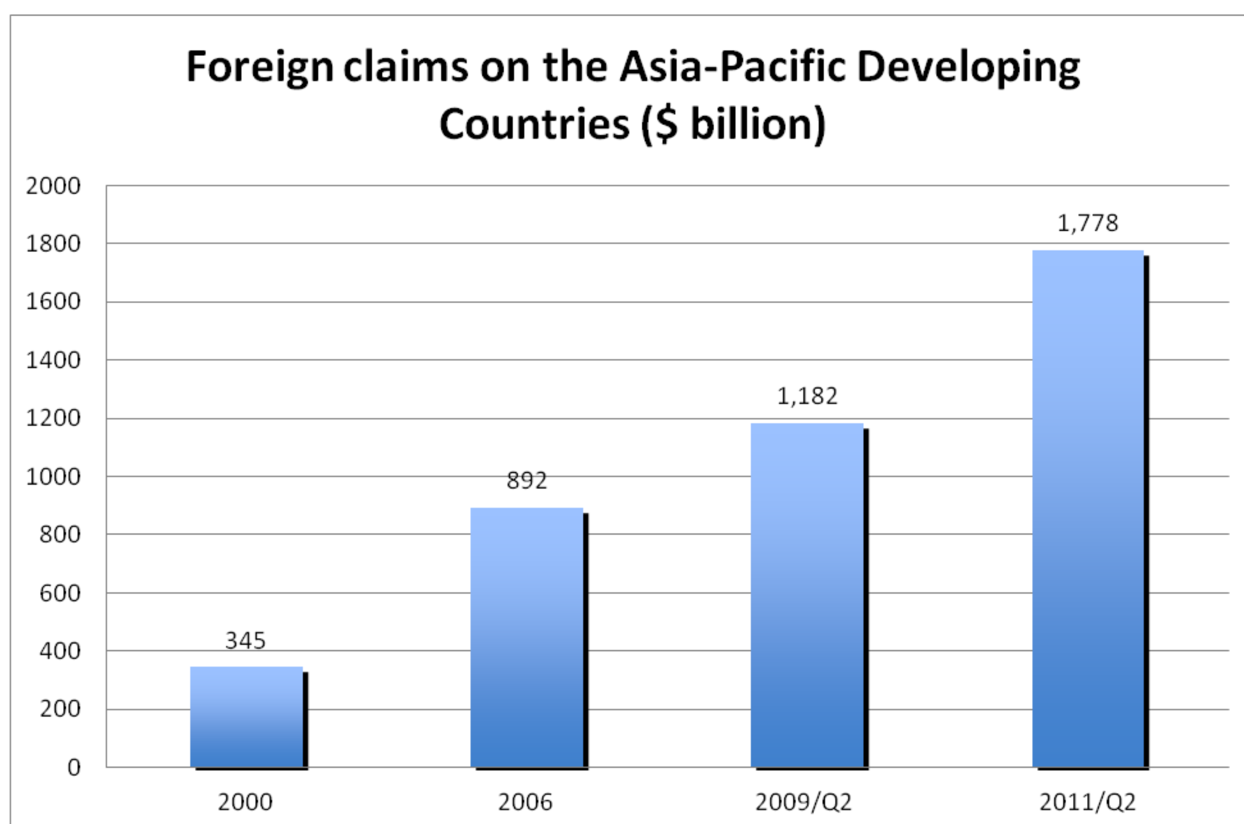
Table 1: Foreign exposure of banks by region (Per cent)

	All banks	European banks
Developed	73.8	74.7
European Developed	45.3	49.3
US	20.7	20.0
Offshore Centres	7.1	5.8
Developing Countries Of which:	18.5	18.9
Developing Africa & Middle East	2.2	2.6
Developing Asia & Pacific	6.5	4.9
Developing Europe	5.2	6.9
Developing Latin America & Caribbean	4.6	4.5

In the current context, the vulnerability of the developing countries, as demonstrated by the experience during the 2008-09 crisis, comes especially from one source. Having to cover losses at home, recapitalise themselves and improve the risk profile of their lending, European banks are likely to look to transferring profits and

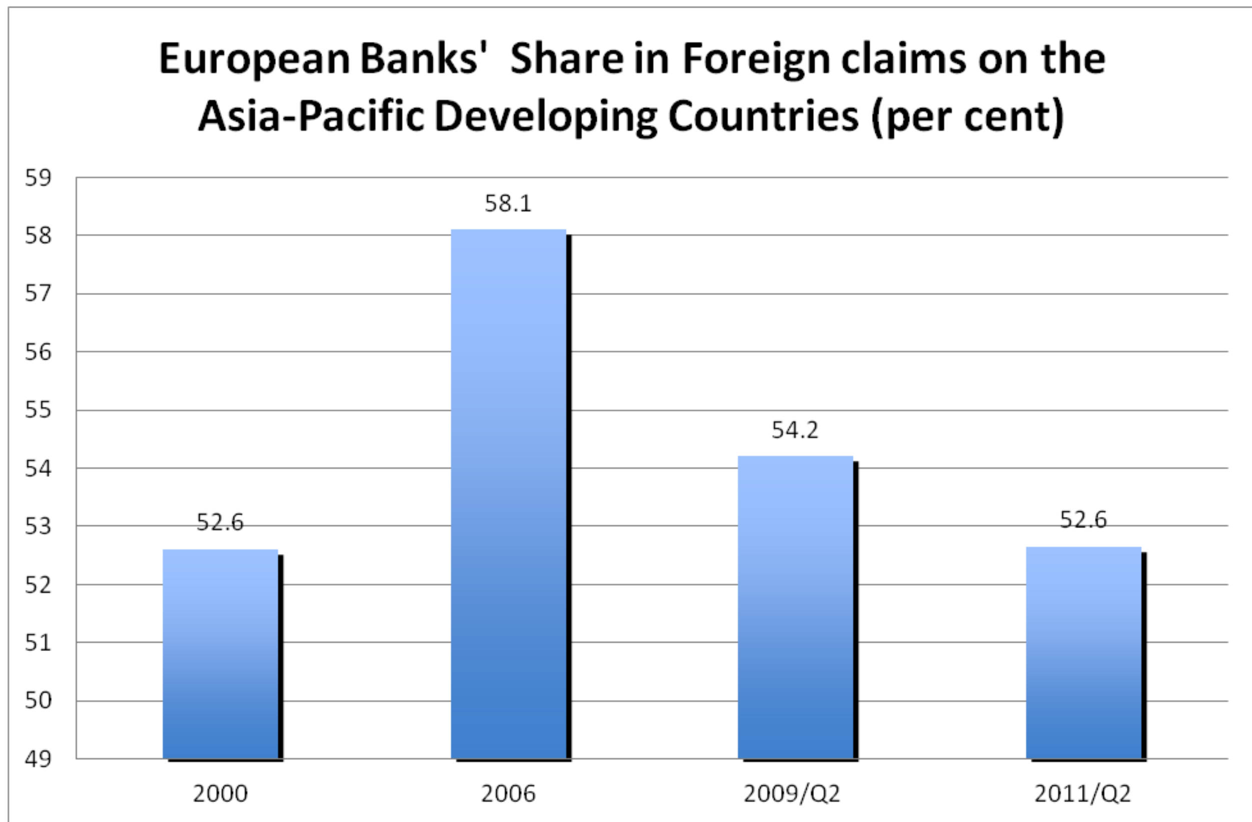
retrenching assets in their global operations. Emerging markets are bound to be affected by such moves. Among emerging markets, those in the Asia-Pacific, normally presented as relatively "decoupled" from the developed West, are just as vulnerable. As much as $1.8 trillion of the $5.1 trillion of global banking foreign claims located in developing countries are in the Asia-Pacific.

Chart 5.



The disconcerting feature of these claims is that they seem to have been driven to a substantial degree by short-term supply side developments in the developed countries. As Chart 5 shows, foreign claims on the Asia-Pacific developing countries rose by $547 billion during the period 2000-2006, when there was a supply side driven surge in capital flows across the globe. Even during the crisis period stretching from 2007 to the middle of 2009, foreign bank claims in the region increased by $290 billion. And when the post-crisis liquidity infusion made available cheap capital in large quantities to the banking system, the Asia-Pacific developing countries were the locations for an expansion of foreign bank claims to the tune of $596 billion in just two years. A capital surge of this kind, that provided additional grounds for the "decoupling" perspective, makes the region even more vulnerable to a capital outflow or a mere cutback in lending by foreign entities.

Chart 6.



Given what we noted earlier, this vulnerability is greater because of the importance of European banks in the region. The share of European banks in these claims in the developing Asia-Pacific rose from 53 to 58 per cent between 2000 and 2006, and has since fallen to 52.6 per cent (Chart 3). Part of the reason for that decline is the fact that the liquidity infusion into the banking system has been far more in the US than in Europe in the aftermath of the crisis. But it is also a reflection of the fact that European banks have been turning more cautious and possibly retrenching assets when they mature to transfer funds to their parent entities.

Table 2: Accumulated Foreign Bank Claims as a Percentage of GDP in Emerging Asia

	China	Indonesia	India	Korea	Malaysia	Thailand
2005	3.3	9.0	9.7	24.2	52.7	18.6
2006	4.7	9.3	12.3	27.1	54.1	20.1
2007	6.1	10.8	16.0	31.6	55.9	18.2
2008	3.9	9.4	15.1	29.3	44.5	17.1

2009	4.6	10.0	14.9	37.5	53.6	21.7
2010	6.1	10.5	15.3	31.4	52.6	22.9

That being said, how important are these foreign bank claims to these Asia-Pacific developing countries? It is indeed true that in many of them the annual flows of capital that those claims represent are small when compared to the aggregate annual flow of debt, equity and other claims. However, as accumulated claims these do constitute a significant amount relative to GDP in most Asian emerging markets, excluding China (Table 3). At 15-20 per cent in India and Thailand and as much as 30-50 per cent in Korea and Malaysia, these accumulated claims are a source for concern. Any sudden retrenchment can create liquidity as well as foreign exchange difficulties.

This vulnerability needs to be assessed in the context of the collateral damage that a banking crisis in Europe can result in. It would worsen the recession in Europe, which is an important destination for exports from Asia. The recession in Europe would in turn precipitate the double dip that can damage Asia's foreign exchange earnings and growth even more. And finally, the European banking crisis could trigger a global crisis, not just in banking but in the financial sector generally, given the multiple institutions and instruments through which financial markets are interlinked today. If that occurs, what matters is the aggregate exposure of the Asia-Pacific to global capital: and that is indeed substantial. Asia too needs to look to protecting itself in the near future.

This discussion suggests that the question of how to govern new forms of finance and monitor and deal with the effects of changes in financial structures (the combination of institutions, instruments and markets) induced by financial liberalisation is therefore emerging as a leading issue in economic management. Given that it is no longer taken for granted that adoption of best-practice regulatory regimes patterned on those of the developed countries will support financial stability, all countries now face the question of the most appropriate system of financial regulation within the context of the discussion of reregulation of developed country financial systems.

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[i] The recent experience of some eurozone countries like Ireland and Greece shows how such a process can occur not just with fixed exchange rates but even within a common currency area.

[ii] The Miyazawa Initiative launched in October 1998 aimed to create, in the context of the crisis, a short term fund financed by countries in the region holding excess foreign reserves. The fund was to provide loans at low interest rates to Asian countries facing balance of payments difficulties, a run on their reserves and a depreciation of their currencies. The initiative was seen by some as an attempt to set up the equivalent of an Asian Monetary Fund that would provide balance of payments financing at low interest rates and without the conditions associated with IMF lending. US objections are partly seen as responsible for an early end to the initiative, which provided less financing than it was initially expected to deliver.

[iii] Data in this and the subsequent paragraphs are from CFSA 2009.