

This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Financial Sector Development in the Pacific Rim, East Asia Seminar on Economics, Volume 18

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Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38684-8

Volume URL: http://www.nber.org/books/ito_07-2

Conference Date: June 22-24, 2007

Publication Date: February 2009

Chapter Title: Comment on "East Asia and Global Imbalances: Saving, Investment, and Financial Development"

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Chapter URL: <http://www.nber.org/chapters/c0434>

Chapter pages in book: (156 - 160)

Comment Edward Robinson and Liew Yin Sze

Professors Chinn and Ito have done a careful empirical analysis of the determinants of current account balances over the past two decades. We think their study is a useful complement to the volumes of more conceptual papers that have been written on this subject.

We will first make a few comments on the chapter's empirical findings before providing some general points on financial development in the Asian region. We close with some tentative remarks on the global imbalances.

Empirical Results

The authors set up a panel equation specification with five-year non-overlapping data stretching from the mid-1980s. They include the usual set of conditioning variables, supplemented by a comprehensive list of other macroeconomic and institutional factors.

To begin with, there still appears to be a great deal of variation in current account balances that remained unexplained, especially for the emerging economies. In figure 4.10, the scatter plot for industrial countries shows a tighter relationship, while that for emerging economies displays a higher degree of "scatter" and more noticeable outliers.

However, the regressions do yield useful results. Allow us to comment on two of these.

Our first observation pertains to the evidence that fiscal balances do play a role in the determination of current account balances, particularly for the developed countries. Thus, the deterioration in the current account deficit in the United States in the early part of this decade coincided with a significant worsening of the fiscal position as well.

However, the relationship may not be an entirely strong one. It is noteworthy that the U.S. current account deficit continued to widen in recent years even though the fiscal shortfall has narrowed. In Asia, this "twin deficits" argument may also have been fairly weak. Many Asian governments had well-managed finances prior to the Asian crisis. The deterioration in the current account prior to the 1997 crisis was really driven by the saving-investment imbalance in the private sector, amid strong investments and capital inflows. Subsequently, although the fiscal position of many Asian nations deteriorated in the aftermath of the crisis, the current account has swung decisively into positive territory. Therefore, the fiscal bal-

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ance may not be the dominant factor in the current account dynamics for all countries all the time.

Second, the focus of the chapter is on what the data can reveal about the role of financial variables. In general, we believe that the results and inferences in tables 4.1 and 4.2 are reasonable.

The coefficients of the financial development variables are generally considerably smaller than those for the standard macroeconomic factors such as fiscal balance, net foreign assets, and relative incomes.

Although not entirely comparable, these findings are broadly in line with similar studies by Beck et al. (2001), which find that overall financial development is positively correlated with economic growth. It is interesting to note that in the Beck et al. type studies, the *size* of the financial sector is usually not statistically significant.¹ What comes strongly through as more distinguishing across countries is financial activity and efficiency. In this study as well, the information content of efficiency/activity variables is likewise confirmed.

We would like to make two minor comments that would suggest adopting a more careful or nuanced interpretation of some results.

First, it must be said that financial variables are difficult to define and measure, especially in Asia. Furthermore, there is the potential multicollinearity between financial development and openness measures that the authors allude to. This issue is likely to be important for Asia because financial development tends to be directly correlated with being tapped into global financial markets. More broadly in Asia, the growth development strategy is an outward, export-oriented one.

Second, it is important to appreciate that the Asian economies went through an extended period of cleaning up and reform after 1997 to 1998. Against this, we may not wish to take the estimated coefficients as some form of long-term structural (or deep) parameters. For example, national savings tended to rise after the 1997 crisis as corporates and households attempted to rebuild their balance sheets. It may not have very much to do with financial openness or other institutional measures. (In other words, the coefficients could be biased by the “precautionary-rebuild-of-reserves” phase in the sample set.) This “discontinuity” may have been an important reason for the overestimation of investment in Asia (or underestimation of the current account surplus) by the Chinn-Ito model for the postcrisis period.

Relatedly, China is highlighted as an example of a country that would tend to run large surpluses given its large but closed financial market and low index of institutional development. Large current account surpluses in China are in fact a relatively recent phenomenon. Actually, its average an-

1. In the Beck et al. (2001) study, *finance size* is defined as the log of the sum of private credit and market capitalization.

nual current account balance was close to 1 percent of gross domestic product (GDP) between 1982 and 2004. China's current account balance only swung into a large surplus of over 7 percent of GDP in the last two years. Nonetheless, we would agree that the combination of macroeconomic, financial, and institutional developments in China is likely to sustain its current account surpluses, going forward.

Despite the preceding caveats, we have no doubt that the variation in financial development lies behind the distribution of the current account outcomes we observe. A more developed financial system allows the link between domestic savings and investments to be broken, which permits a country to optimize consumption on an intertemporal basis.

Indeed, a validation of this point is readily available from studies that considered this from the capital flow perspective. Our colleague Chew (2006) utilized an "augmented" gravity model to analyze the effect of various factors on cross-border asset holdings. She made use of the bilateral data set on financial investment of over 200 countries in the International Monetary Fund's (IMF) Coordinated Portfolio Investment Survey (CPIS) over the period 2001 to 2005.²

The standard gravity model was "augmented" in order to account for financial development and institutional variables and estimated for various country blocs including Asia. Chew's analysis showed that the size of cross-border financial flows increases significantly with the financial development of the domestic and foreign financial markets. Her finding is consistent with the results of the Chinn-Ito chapter as greater financial development in emerging market economies reduces the constraint on domestic investment spending. This is reflected as an increase in the dispersion of current account balances across countries. Chew also found that institutional factors, such as regulatory standards and capital controls, are important determinants of cross-border capital flows. In addition, the degree of transparency and disclosure by financial institutions is seen to have a statistically significant role in augmenting cross-border financial flows by providing a boost to investor confidence.³

Future Financial Development in Asia and Implications for Capital Flows

We would classify this chapter as belonging to the genre of studies that seek to understand the role of financial development in the broader context of sustainable economic growth.

2. This data set provides a geographical breakdown of total portfolio investment assets in a bilateral matrix displaying stocks of cross-border holdings of assets measured at market prices.

3. Restricting the data set to Asian countries as destinations for international capital flows, the results remain that financial development and other institutional factors have a significant impact on the size of financial flows into Asia. Variables such as regulatory standards are important determinants of the sources, but not destinations, of financial flows into Asia.

We believe that Professors Chinn and Ito's focus on financial development and institutional factors is timely. The Asian financial crisis ten years ago vividly brought home the fact that in the race for growth, Asian governments, and even multilateral institutions, had neglected or downplayed the "software" aspect of economic development, that is, developing the institutions, systems, infrastructure and legal framework, and human resources required for a modern market-based economy. This aspect of development is perhaps the most difficult.

In Singapore, the development of deeper and more liquid financial markets has certainly helped in raising economic efficiency via improved allocation and deployment of capital. The deepening of the financial markets has also strengthened resilience to shocks and allowed a large current account surplus to be accommodated efficiently, in this case, through fairly sizeable capital outflows.

What about the rest of Asia? It has often been said that regional integration has thus far been a "real story," that is, Asian trade integration has proceeded rapidly, driven to a large extent by the outsourcing activities of multinational corporations and the development of a highly integrated regional production network. Indeed, it has become increasingly clear that financial development has not kept pace.

Asia's bond markets, for example, constitute only 113 percent of GDP, compared to 193 percent in the United States and 151 percent in the European Union. Excluding Japan, this percentage falls to just 49 percent.

At this juncture, we would like to bring together two pieces of research we have been interested in.

First, we have been doing some work at the MAS in estimating the likely profile of current account balances for some key Asian countries. Our estimates, which use as a starting point the simulations and projections from the IMF, show that the current account surpluses in Asia are likely to persist, led to a significant extent by the growing trade surpluses in China. For example, China's current account surplus is expected to reach some US\$275 billion (or 6.5 percent of GDP) or more in 2011.

Second, there have been a number of papers revisiting the Lucas Paradox. A recent IMF study examined the experience of Europe and found that with increasing financial integration, capital in Europe flowed in the correct direction, that is, "downhill" from rich to poor (or less rich) countries within the Union (Abiad, Leigh, and Mody 2007). Poorer countries that are financially integrated run larger current account deficits, whereas the richer countries run surpluses. Thus, financial integration in Europe was a force driving the increase in current account dispersion within the region.

So for Asia, taken together, these results point toward the need for increased collaborative efforts to accelerate the pace of financial deepening and integration. A well-developed financial sector in Asia will help to raise investment spending in the region and contribute to the reduction of the

saving glut. Increased financial integration could also nudge capital flow “downhill” from rich to less-rich countries within Asia itself.

Professors Chinn and Ito’s findings give us the basis for confidence that as financial deepening proceeds in the Asian economies, the dynamics of capital allocation are likely to improve and with it the sustainability of the current account path.

Conclusion

We conclude with some remarks on the global imbalances. It may be fair to say that, at best, the current state of affairs represents an “unholy truce” among diverse groups of financial participants, each having a vested interest in prolonging the status quo.

Indeed, at the moment, the global economy seems to be headed for an uneventful and gradual correction of the imbalances. While U.S. GDP growth has slowed, the expansion in Europe and Japan has picked up, and the growth of some of the key emerging economies, including the BRICs—namely Brazil, Russia, India, and China—has remained firm. This broadening of global growth would tend to error correct or at least stabilize the imbalances. The fall in the trade-weighted US\$ since early 2002 and relatively more stable oil prices will also help.

We, therefore, suspect that Bretton Woods II may well be a passing phase rather than a stable long-term equilibrium. Asian currencies have generally become more flexible in recent years, and this is an important development in view of projections of sustained saving-investment imbalances in the region. Adjustments in exchange rates would eventually manifest themselves to restore equilibriums. Over the longer term, the scope for greater exchange rate flexibility in Asia will likely increase along with efforts to further deepen the financial infrastructure and supporting institutions.

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