Emerald

Volume 9

FRONTIERS
of ECONOMICS and GLOBALIZATION

The Evolving Role of Asia in Global Finance

EDITORS

Yin-Wong Cheung, Vikas Kakkar
and Guonan Ma

SERIES EDITORS

Hamid Beladi
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Hamid Beladi
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Series Editors

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About the volume

The process of Asia's rise to a position of eminence in global finance has accelerated in the wake of the international financial crisis, posing new opportunities and challenges to both the Asian economies and the global financial and trade systems. This volume represents a significant new endeavor to explore and understand the dynamics created by this process of transition. Specifically, it addresses the following four contemporary themes of the evolving role of Asia in global finance: (a) real and financial interactions among economies and across markets, both within Asia and beyond; (b) regional monetary cooperation in Asia; (c) the decoupling debate over Asia's evolving economic and financial ties with major industrial economies; and (d) the changing roles of domestic finance and capital flows in the developing Asian economies. It sheds light on various dimensions of Asia's economy and finance, ranging from business cycles, exchange rate movements, regional policy coordination, domestic financial development, capital flows, and financial market behavior. These analyses are pooled in a book that is a must read for market participants, policymakers, and academics alike.

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chapters on this theme, addressing the issues of macroeconomic similarities and differences, interactions among Asian stock markets and between them and the US equity market, as well as spillovers across various types of financial markets in the region in response to shocks.

In Chapter 1 Curtis and Mark identify how the Chinese macroeconomy differs from large developed economies, such as the United States or Canada, by applying a standard real business cycle model to China. Their main finding is that while the standard model fits China well along several dimensions, it predicts a consumption share in GDP that is significantly larger than that observed in the data. They then proceed to examine whether the relatively low consumption in China could be due to the lack of adequate risk-sharing across the provinces. They document that the degree of risk-sharing across Chinese provinces is strikingly low and constitutes one of the major differences between China and the industrialized countries, suggesting that low risk-sharing across provinces in China could be a key to its much lower observed consumption share in GDP. Their analysis raises questions about the possible causes behind the low interregional risk-sharing and has important implications for macroeconomic policy as the Chinese government moves away the export-led model and increases reliance on domestic demand as a more important engine of economic growth.

Candelon and Metiu focus on the linkages between stock market fluctuations and business cycles in several Asian economies in Chapter 2. The economies covered in their sample include China, Indonesia, Japan, South Korea, Malaysia, the Philippines, Taiwan, and Thailand. They use a recently developed band-pass filter to extract cycles from the data. Similar to what has been documented for developed economies, they find that stock markets lead business cycles by about 6 months on average for most Asian countries in their sample. The key exceptions to this stylized fact are China, Taiwan, and South Korea, for which the real business cycles are contemporaneously synchronized with the stock market cycles. They conjecture that this could be due these markets being less mature in terms of asset market capitalization and turnover. This interesting conjecture stands in sharp contrast to the prevailing market view that Taiwan and South Korea have deeper and more liquid stock markets than most other emerging Asian markets.

In the third Chapter Yoshida investigates and compares the linkages between the United States and 13 Asian stock markets during the Asian financial crisis of 1997–1998 and the more recent subprime crisis of 2007–2008 using a smooth-transition correlation VAR-GARCH model. He discovers significant differences in the dynamics of the two crises. During the Asian financial crisis, the volatility in Asian equity markets Granger-caused volatility in the U.S. stock market, whereas in the subprime crisis the volatility causality ran from the United States to Asia. This result makes sense, as the Asian crisis started in Asia while the subprime crisis originated in the United States. Also, during the Asian financial crisis, the correlation between Asian and U.S. stock markets decreased for several Asian economies, but a similar decline was not apparent during the subprime crisis. This finding suggests that relative market size matters, as spillover from smaller markets tends to be less pronounced than vice versa. Both crises also shared something in common – a transition in correlation took place well in advance of the largest drop in equity prices, suggesting that the market participants were, at least to some extent, anticipating the upcoming crash.

One of the interesting features of the subprime crisis was that, as market participants re-evaluated counterparty risk, the turbulence in money markets spilled over to the foreign exchange swap markets. In Chapter 4, Genberg, Hui, Wong, and Chung examine the links between foreign exchange swaps and currency strength during the subprime crisis of 2007–2008. Their main findings are that the currency risk premiums are positively correlated with the spreads of money market rates over their corresponding overnight index swap rates and negatively correlated with the strength of the spot rates of their respective currencies. These facts are consistent with the notion that the flow of funds during the credit crunch was guided by perceptions about the relative safety and soundness of different countries' banking systems, and had associated consequences for their currencies.

2. *Regional monetary cooperation in Asia*

The future of exchange rate cooperation among Asian economies has been a topic of intense research for several reasons. For one, relative stability among regional currencies may matter a lot, given a large trade sector and a high degree of openness for most Asian economies. Both concerns over competitiveness and risks associated with excessive exchange rate volatility favor some degree of intraregional currency stability. Yet, so far Asian policymakers find few feasible options of coordination in enhancing stable and yet flexible Asian currencies against each other. Section 2 is a collection of four papers from experts on this subject. Chapters 5 through 7 investigate exchange rate regimes in East Asian economies, and a unifying thread across them is the view that even in the absence of formal monetary or exchange rate agreements, currency stability may be achieved if each country manages its own currency against an appropriately defined currency basket. Chapter 8 discusses the possibility that competitive devaluation may be one of the factors behind the undervaluation of most Asian currencies since the Asian financial crisis.

In Chapter 5 Ma and McCauley investigate the recent evolution of the renminbi (RMB) since its unpegging from the US dollar in 2005. The authors discuss the implications of the basket management of the RMB for currency stability in Asia. The paper points to an important, but often overlooked, feature of the RMB's evolution – from mid-2006 through mid-2008 the RMB's *effective* exchange rate was confined to a narrow band of and trended along a gradual upward crawl against its trade-weighted basket of partner currencies. The conventional wisdom, by contrast, is that the RMB was no more than a dollar peg since 2005. This policy experiment was apparently interrupted by the intensification of the global financial crisis in 2008. Yet an important implication is that even without explicit and formal monetary cooperation, a policy of managing currencies against their own respective baskets by regional monetary authorities could lead to greater currency stability within Asia.

In Chapter 6, Volz considers the problem of the choice of an optimal exchange rate regime in the context of East Asian economies. He extends the literature on the optimal peg by taking into account considerations of international financial relations, and proposes a blend of real and financial exchange rate baskets. The key recommendation of the author is a gradual reduction of the East Asian economies' close linkage with the U.S. dollar, and a corresponding increase in the weights on the euro and the Japanese yen in their currency baskets. This would naturally lead to a relatively homogenous exchange rate policy for the region and could evolve into a more formal exchange rate arrangement at an appropriate stage.

In Chapter 7, Shimizu and Ogawa study during the recent subprime crisis the fluctuations in the nominal bilateral exchange rates and nominal effective exchange rates (NEERs) for East Asian economies and the Asian monetary unit (AMU), which is a weighted average of the East Asian currencies with weights based on purchasing-power-parity-measured GDP and trade volumes. Their key finding is that while the nominal exchange rates of East Asian economies become more volatile vis-à-vis the US dollar, the euro, and the Japanese yen in 2008, currencies that were pegged to a basket experienced relatively minor fluctuations. The AMU, in particular, was significantly more stable compared with the individual East Asian currencies in bilateral terms. They also reach similar conclusions as Chapters 5 and 6 and argue that stabilizing a currency against its NEER would result in a *de facto* coordinated exchange rate policy. In addition, they also emphasize the possibility of coordinated monetary policies in East Asia in the future.

One topic that has led to heated and intense debate in recent years is whether observed exchange rates in Asian economies, especially China, reflect their underlying equilibrium values. In Chapter 8 López-Villavicencio and Mignon provide estimates of the real exchange rate misalignment for a large set of countries based on a version of the behavioral equilibrium exchange rate model. They also study the dynamics of how real exchange rates converge to these long-run equilibrium values, allowing for the possibility of a nonlinear adjustment mechanism. A key finding is that while Asian real exchange rates were overvalued during most of the 1980s, they have since been significantly undervalued. They interpret these undervalued real exchange rates as being driven by competitive devaluations of Asian currencies given their reliance on export-led growth. This in turn highlights the potentials for some informal exchange rate coordination within Asia.

3. *The decoupling debate*

In the past decade or so, academics, analysts, and policy makers have vigorously debated whether emerging Asian economies have become decoupled from the developed western world. This debate has become all the more relevant with the outburst of the global financial crisis during 2007–2009 and the gradual but remarkable ascent of Asia. Section 3 explores the various dimensions of this ongoing debate and casts new light on it using novel techniques and data.

Chapter 9 by Willett, Liang, and Zhang provide an overview of the concept of decoupling and distinguishes the various notions and definitions associated with it. Decoupling could, for instance, be viewed as economic growth in one area occurring independently of another area. Alternatively, it could be defined in terms of a reduction in business cycle synchronization or lower stock return correlations. The authors demonstrate that the structure of correlations between advanced and emerging economies is susceptible to significant time variation, and caution against reading too much into these changes given their dependence on the patterns of underlying shocks. In particular, the authors argue that even for the more insulated economies like China and India, their slowdowns from trend growth have been similar to that of the United States. Thus, their decoupling has not been as great as many popular analyses have suggested.

In Chapter 10 Yetman focuses on the "business cycle synchronization" version of the decoupling concept and asks whether emerging Asia-Pacific economies have decoupled from the US economy. He shows that the variation in the business cycle correlations is related to the phase of the business cycle, with correlations being relatively high during recessions and low during other phases. He also constructs a measure of decoupling that adjusts for countries' long-run average growth rates and, based on this measure, shows that the evidence does not support decoupling of the Asia-Pacific economies with the US economy. On the contrary, the author contends that Asia has become less decoupled from the United States over time.

In Chapter 11 Pula and Peltonen analyze the sensitivity of emerging Asia's business cycle dynamics to intraregional demand and demands from the United States, the EU15, and Japan by using an Asian input–output table. They find that about one-third of the value added in the emerging Asian economies depends on external demand and that trade and production linkages between Asia and the rest of the world have strengthened in recent years, casting doubt on the decoupling hypothesis. At the same time, Asia itself has become more integrated in trade. Moreover, they caution that inference based on raw trade data alone can be misleading as it significantly overstates the Asian economies' actual dependence on exports when measured in value-added terms.

Leu and Sheen investigate the evolution of the association of the Australian business cycle vis-à-vis its trading partners in Europe, North America, and Asia using a dynamic latent factor model in Chapter 12. Their variance decomposition exercise for the Australian output growth variations shows that the most significant factors explaining the variation, in descending order of importance, were the global factor, the European factor, the Asian factor, and the North American factor. A striking finding is that the correlation between the Australian output growth rate and the Asian business cycle factor has, over the past eight years, become large and positive from an initially negative and small value. Other than during the global financial crisis period of 2007–2008, which was arguably an exceptional time period, the correlations of Australian output growth with the North American and European business cycle factors have been negative. This prompts the authors to conclude that Australia has indeed become more closely "coupled" with Asia in recent years.

4. Domestic finance and capital flows

Both internal and external financing have been an important factor influencing economic development and financial stability and will remain key to future high economic growth for the Asian economies. Nevertheless, the global financial crisis in 2008 reminds us that their relationships are far from straightforward. In the absence of appropriate regulation, the financial sector can become more self-serving, giving rise to unpleasant externalities. Cross-border capital flows can strengthen or destabilize an economy. Section 4 comprises four papers discussing the Asian experiences related to issues such as firm financing, capital flows, foreign direct investment (FDI), and international financial hubs.

The positive relationship between economic growth and the financial sector development is well established for many economies. Yet China has witnessed remarkable growth over the past couple of decades, far outpacing its relatively underdeveloped financial sector. Hale and Long investigate the various sources of financing for Chinese firms in Chapter 13. Utilizing a large database of firms, they find that state-owned enterprises (SOEs) in China enjoy significant advantages relative to other types of firms in obtaining external financing. In addition to SOE status, the size of a firm also plays an important role, with small private firms facing greater financial constraints relative to their larger counterparts. Most local Chinese private firms rely more on internal financing and more expensive external financing, though they seem to have gained improved access to formal external financing in recent years. The authors identify private firms' inability to obtain adequate long-term financing as the most severe financial constraint facing Chinese firms and argue that alleviating this constraint should be the focus of financial reforms in China.

One of the key ingredients in China's economic success has been the persistent and large inward flow of FDI into China ever since the opening up of the economy in 1979. In Chapter 14, Chen provides an overview of FDI in China and analyzes its sources and the regional and sectoral distribution of inflows. An important conclusion of the chapter is that FDI inflows have made a significant positive impact on China's economic prospects and have contributed to capital formation, export promotion, and integration of China in the world economy. Despite the recent slowdown in FDI inflows, attributable to the subprime crisis, China is expected to retain its position as one of the most attractive FDI destinations globally. The author also casts doubt over the view that the large inward FDI into China has taken place at the expense of its emerging market peers.

Cheung and Qian in Chapter 15 conduct an empirical assessment of the primary determinants of the Chinese renminbi's covered interest rate differential, which can be interpreted as a proxy for the effectiveness of capital controls. In addition to the usual macroeconomic variables, such as capital flight and various components of country risk, they also examine the impact of three China-specific regulatory and institutional factors. They find that the effects of the canonical macroeconomic variables on the RMB covered interest differential are largely consistent with *a priori* expectations and robust to the choice of onshore and offshore RMB forward rates. They also show that China-specific factors, such as the exchange rate reform program and capital control policy, affect the RMB covered differential, but political risk does not.

In Chapter 16 Treadway explores the future of Hong Kong as a major public securities market and argues persuasively that Hong Kong has the potential to become the world's pre-eminent equity market venue, if certain important conditions are met. These conditions include granting Chinese firms the freedom to list in Hong Kong and Chinese retail and institutional investors the option to invest in Hong Kong – events which would be facilitated by lifting capital controls on the renminbi. He also underscores the importance of remaining open to new technologies that reduce the cost of trading and enhance Hong Kong's competitiveness, maintaining Hong Kong's stable exchange rate regime with full capital mobility, and preserving Hong Kong's legal and economic structure as specified in the Basic Law.

In the coming decades, Asia is set to become an even more important leading force contributing to the global economic growth and driving global financial markets. This prospect is more than amply demonstrated by the rapid rise of both China and India, the two dynamic and most important emerging market giants on the world stage. During this process, there will be many new challenges to both Asia and the world and to business, market participants and policymakers alike. We all need to climb the learning curve quickly, in order to grasp the many new issues arising from a fast-changing Asia, as the storm of the global financial crisis gradually subsides. This edited volume represents an attempt to shed light on only a small set of such questions. Much more remains to be explored going forward.

This edited volume is a collective and collaborative effort by many. The authors of the 16 chapters undoubtedly deserve most of the credit, as it is their contributions, cooperation, and willingness to share their insights that have made the volume possible. The editors also wish to express their appreciation to the referees for their timely and quality services. Last, but certainly not least, we would also like to thank Kwan Choi of the Iowa State University, Hamid Beladi of the University of Texas, and Chris Hart, Emma Whitfield, and Sarah Baxter of the Emerald Group Publishing for their encouragement and professional support.

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Editors

INTRODUCTION: THE EVOLVING ROLE OF ASIA IN GLOBAL FINANCE

The rise of Asia in general and China in particular has markedly changed the landscape of the global economy and marketplace, especially after the global financial crisis of 2007–2009. The region has evolved from a sweatshop to a trading powerhouse and become a major growth engine globally today. Its economic rise will profoundly affect its relationship with the rest of the world, change the interactions among economies in the region, impact on an individual economy's domestic development pattern, and alter the linkages across various financial markets. Academics, policymakers, and market participants alike would like to have an enhanced understanding of this unfolding new world order. At the same time, the rapid rise of Asia has also prompted researchers to reexamine the conventional wisdom about the changing role of Asia in the global economy and different dimensions of its dynamic growth process.

This volume offers a timely collection of the latest research works that shed light on the evolving roles of a rising Asia in the global economic system. The contributors are experts on Asian economic issues. They are from the United States, Europe, and Asia, with diverse backgrounds ranging from academia, think tanks, monetary authorities, and international organizations, and of very different perspectives and styles. The volume consists of four main sections, with a total of 16 chapters. The four sections each address one of the following four broad themes: (a) real and financial interactions among economies and across markets, both within Asia and beyond; (b) regional monetary cooperation in Asia; (c) the decoupling debate over Asia's evolving economic and financial ties with major industrial economies; and (d) the changing roles of domestic finance and capital flows in the developing Asian economies.

1. Real and financial interactions

Asia's economic integration into the global system has many dimensions. It is part of the broader globalization process that has taken place over the past two decades and involves dynamics of convergence, integration, and interactions of both real and financial activities. Section 1 examines some of the recent trends in the real and financial interactions between Asia and the rest of the world and among different markets within Asia. It contains four