



RESHAPING FINANCIAL MARKETS AND ECONOMIC GROWTH IN ASIA

Master Recherche Relations Internationales Spécialité Économie

Autumn Semester, 2008-2009

Professor: Mr Kensuke Tanaka and Ms Margit Molnar

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Room: B 303

UP: 16989

1. Contacts

Kensuke Tanaka: kensuke.tanaka@oecd.org and Margit Molnar: margit.molnar@oecd.org

2. Objectives of the course

This course provides a theoretical and empirical overview of the causes of and responses to the crisis and recent economic growth including recent directions in policy reforms in Asia.

Economic landscapes in Asia have recently undergone enormous changes and in most countries this process is still under way. A major trigger of these changes was the 1997 Asian financial crisis which affected many East and Southeast Asian countries but even the countries that were spared by this crisis embarked on a path of reforms to make their financial systems more resilient.

Country examples of Thailand, Indonesia, etc. will illustrate the theoretical and empirical discussions of the crisis and responses to it and recovery process, while through the experiences of China and Japan - which were though not much affected by the 1997 crisis, but have vulnerable financial systems - possible ways to reshape financial system will be explored.

The course consists of four parts: (1) explaining the crisis through a theoretical (first-, second-, and third-generation models) and empirical framework; (2) reshaping financial systems in Asia after the crisis – example of Thailand and Indonesia, etc and growth (3) post-crisis growth and regional integration; and (4) reform of financial systems in China and Japan.

3. Methods

Mainly lectures by instructors and class discussions.

The approach of the course will be analytical, based on micro- and macro-economic theories and empirical methods. Through case studies of several countries, the course will help students develop analytical skills to examine economic phenomena.

4. Assessment

The course requirements are two short essays (30%) and a final paper (45%). Students will be requested to make a short presentation about their final paper (10%) during the course. Active class participation (15%) is encouraged. There will be no exam.

- The topics for the short essays will be distributed during the course and the essays are expected to be submitted the following class.
- The topic for the final paper should be selected from the ones covered by the lecture and should be approved by the instructors.

5. Course plan

Note: There may be minor changes in the course schedule. In that case, updated version will be distributed.

Two topics will be covered on each occasion.

Lecture 1: Introduction and Course Overview – Financial Crises in the 1990s and Recovery - Characteristics of Asian Financial Markets

Amid changes of the economic and the global capital markets environment, the past two decades have seen several financial crises occurring in various parts of the world, in countries of different levels of development such as the European ERM crisis, the Scandinavian crisis, the Mexican and Argentine crises, the Russian crisis, the LTCM crisis and the Asian crisis.

This lecture starts with the overview of recent financial crises around the world and then discusses the characteristics of Asian financial markets - (i) bank-based financial systems with relatively underdeveloped regulatory framework and capital markets, and (ii) sound macroeconomic fundamentals, buoyant economic activity and high savings. These characteristics make the Asian crisis different from other crises.

Part I. Theoretical and Empirical Framework for understanding financial crisis

Lecture 2: Traditional Theoretical Models – First and Second Generation Models

This lecture will summarise the major models existing prior to the Asian financial crisis, which are categorised into so-called first and second-generation models.

First generation models explain crises from the point of view of “fundamentals” and attribute the occurrence of crises to weak fundamentals. Representatives of this stream are Krugman and Flood and Garber and most such models focus on whether there is an adequate macro policy management in place, in particular, they address issues such as the amount of foreign reserves and the timing to move to a free float from a pegged regime.

Second generation models, pioneered by Obstfeld, on the other hand, focus on the self-fulfilling feature of crisis, irrespective of fundamentals. The public’s expectations with regard to the policy option of authorities are important factors in this context.

Lecture 3: The Asian Crisis and “Third Generation” Models

The inability of the existing literature to explain the Asian financial crisis lead to the emergence of a new stream of models - some of them are sometimes called “third generation models”.

These models attribute the crisis to a wide variety of reasons such as the simultaneous occurrence of currency and banking crises, the co-called “twin-crisis” view and the transmission of the crisis from one country to the other, i.e. the “contagion” view. Different from the previous two streams, these models also examine domestic financial and corporate weaknesses. This lecture covers the major theories and empirical literature and also touches upon recent directions for the analytical framework.

Part II. Policy Responses to the Asian Crisis and Reshaping Financial Markets – Selected Country Experiences

In this second group of lectures, the policy responses of countries affected by the crisis are discussed from the point of view of monetary and exchange rate policies and reforms of banking systems. In this context, the current debate about the reform of the international financial system will be touched upon.

Lecture 4: Reshaping of Banking Landscapes in Asia

Banks have traditionally been the major sources of financing for enterprises in Asia and lending has been the major activity for banks. After the crisis, however, this tight relation between banks and firms has loosened somewhat. The changing relations between banks and firms are manifest in declining bank lending growth and can be attributed to three major driving forces: cyclical factors, the fallout from the 1997 Asian crisis and structural factors affecting both the supply of and demand for bank credit. In response to declining lending growth and profits, banks have been diversifying their customer base and scope of activities.

Alternative strategies to restore profitability and stay afloat in the global competition arena are consolidation and branching overseas. The measures taken by banks to recover from the crisis and the 2001 downturn can be considered effective, but not sufficient to survive in the global arena.

Banks have not adequately addressed the non-performing loans (NPL) problem and have not restored profitability. At present, diversification may seem to be the solution, but given the limited possibilities of diversification, in the near-to-medium term banks and firms will remain highly dependent on each other.

Lecture 5: Inflation Targeting, Monetary and Exchange Rate Policy in Emerging Asia

Following the crisis, several Asian countries floated their exchange rates and at the same time introduced inflation targeting as anchor for monetary policy. Inflation targeting frameworks have largely contributed to the recovery of countries affected by the crisis and enhanced the transparency of monetary policy and the accountability of central banks.

There are, however still some issues to consider under inflation targeting systems, such as how to deal with large exchange rate fluctuation and capital outflows. This will be explained using the theory of optimal monetary policy based on the new Keynesian approach.

This lecture will also address two issues among future challenges for exchange rate policy- management of exchange rate regimes and the accumulation of foreign exchange reserves and reserve management. These countries have recently experienced a sharp rise in their foreign reserves imposing huge opportunity costs on them. There are several views explaining this trend such as the so-called “buffer-stock” view, which attributes the sharp accumulation of reserves to these countries’ desire to increase their resilience to possible future shocks. The lecture will summarise major studies on the optimal amount of foreign reserves and rules to determine such amounts.

Lecture 6: Post-crisis Economic Growth in Southeast Asia

This lecture will overview Southeast Asia’s dramatic economic growth including the discussion of the determinants of economic growth across countries, the role of government in economic growth, etc. Recent growth theories will be introduced if necessary.

Especially in Southeast Asia, the link between inequality and growth has been one of the hottest issues. This lecture also addresses the issue of growth cum equity in the context of Southeast Asia.

Lecture 7: Infrastructure Financing for Growth

Infrastructure development is key for growth in general and is very important for Southeast Asian countries in particular given their low level of stock of infrastructure capital and rapid economic growth that creates and ever increasing demand for infrastructure.

How to finance infrastructure is crucial. Since infrastructure development is a long term process, it is related to several economic issues including how to share the potential risks, etc. Risk-sharing schemes such as PPPs (public-private partnerships) and the relationship between infrastructure investment and the budgetary system will be addressed in this lecture.

This lecture also addresses multilateral attempts to develop infrastructure, the so called growth triangles in the region.

Lecture 8: Regional Integration in Southeast Asia

Regional integration in Southeast Asia has been strengthening both within ASEAN and in cooperation with neighboring countries under different guises such as ASEAN, ASEAN+3 and ASEAN +6.

Starting in the 1990s, owing to strengthening of production networks, market-driven economic integration among ASEAN members was reinforced through official initiatives such as the ASEAN Free Trade Area in 1992, the ASEAN Framework Agreement on Services in 1995 and the ASEAN Industrial Co-operation in 1996.

This lecture will discuss recent trends in regional integration in Southeast Asia and challenges ahead including institution building within ASEAN.

This lecture also touches upon the framework for bilateral swap agreements and attempts to develop an Asian bond market in order to secure long-term financing.

Lecture 9-10: Short presentations of the final papers by students

Part. III. Economic growth and financial markets in China and Japan

In the third part of the course, major issues related to the Chinese and Japanese financial system will be discussed. Although not particularly affected by the 1997 financial crisis, both countries' financial systems exhibit structural weaknesses.

Lecture 11: The Japanese Banking System and Economic growth

The miraculous post-war growth performance of Japan is often related to the so-called “main bank” and “convoy” systems which are said to achieve efficient monitoring and were effective to enhance bank management. Following the evolution of the international and domestic environments, such systems have increasingly become less adaptive to changes and therefore started to fade out in the 1990s. The 1990s witnessed the developing of the asset price bubble in Japan, which is often cited as the biggest of such in economic history and which resulted in the turning of large amounts of loans non-performing and causing the so-called “lost decade”, i.e. economic stagnation for over a decade. Theoretical aspect of cooperate finance will also be discussed.

The burst of the bubble implied a collapse of asset prices and the inability of banks to supply funds as they were saddled with non-performing loans. In an attempt to exit from such a deflationary environment, the Bank of Japan adopted unconventional monetary policy measures such as the zero interest rate policy and quantitative easing, i.e. the policy interest rate was set close to zero and large amounts of funds were released to the market to encourage lending and thus stimulate growth.

Such a policy has recently been abandoned as a result of the fading of deflation and recovery of domestic demand. This lecture explains the theoretical rationale for this policy and evaluates its effect in comparison with other policy options.

Lecture 12: Why Was China Not Affected by the Asian Financial Crisis? – The Macroeconomic Setting

Different from other Asian emerging economies, China was saved from the financial crisis of 1997. It is not that China had a more robust financial system or better prudential regulation in place, but mainly because it was less open than other economies, leaving less room for any trigger.

The exchange rate was (and is still) fixed, but China has long had large currency reserves, providing a buffer to possible shocks and has been much less “open” (measured as the ratio of trade to GDP or FDI to GDP) than other countries in Asia. At the time of the crisis, most items under the capital account were not liberalised, making the country less prone to sharp capital outflows. Moreover, most capital inflows took the form of foreign direct investment, which is said to be less likely to reverse.

Lecture 13: The Fragility of the Chinese Financial System, the Role of Informal Finance and Other Challenges for China

The Chinese financial system, similarly to those in other Asian countries, has long been bank based. Banks – until very recently—have almost exclusively been owned by the government and have mainly served the state-owned sector. With state-owned enterprises being the major customers, there was no need to develop monitoring skills and as the interest rate was determined, there was no room to price loans according to risk. This does not mean that lending was risk free; on the contrary, large amounts of loans turned sour, but banks still survived. Different indicators show that Chinese banks were not doing better than their East and Southeast Asian counterparts, but they were sheltered from foreign competition and had basically no foreign currency exposure.

This class will cover a wide range of topics including how to reform the banking system to serve a more dynamic economy and what would be the role for the informal financial sector. It will also discuss in some crucial problems of the economy such as public finances and growth prospects.

Lecture 14: Global Macroeconomic Issues and their Influence on Asia/Southeast Asia

This lecture discusses how the global economic environment affects regional economic trends in Southeast Asia. Recent oil price increases and the effect of US and Japanese economic performance on the region will be addressed. Different from other lectures, this will be conducted in a more interactive style and discuss some hot issues. Domestic regulatory challenges of selected ASEAN countries (Indonesia, Thailand, Vietnam, Malaysia, etc.) may be taken up depending on preferences.

6. General References

The following books may be useful to understand the discussions during the course, but are not required reading:

Obstfeld, M. and K. Rogoff (1996), *Foundation of International Macroeconomics*, MIT Press

Freixas, X. and J.C. Rochet (1997), *Microeconomics of Banking*, MIT Press

Barro, R.J. and X. Sala-i-Martin (2004) *Economic Growth*, second edition, MIT Press

Bordo, M. and B. Eichengreen (2002) "Crises Now and Then: What Lessons from the Last Era of Financial Globalisation?", *NBER Working Paper No. 8716*.

OECD Economic Outlook, OECD Economic Surveys (Japan and China) may be useful references to grasp the overall picture in these countries.

7. Detailed Reading List

Note: In case of any changes, an updated reading list will be distributed at the first lecture.

Lecture 1: Introduction and Course Overview – Financial Crises in the 1990s and Characteristics of Asian Financial Markets

Eichengreen, B. and Razo-Garcia, R. (2006) "The international monetary system in the last and next 20 years", *Economic Policy, July 2006*

Obstfeld, M. and Taylor, A. (2002) "Globalization and Capital Markets", *NBER Working Paper, No.8846*

Tirole, J. (2002) "Financial Crises, Liquidity and the International Monetary System", chapter 1, *Princeton University Press*

Lecture 2: Traditional Theoretical Models – First and Second Generation Models

Flood, R.P. and Garber, P.M. (1984) "Collapsing Exchange- rate regimes: Some Linear Examples", *Journal of International Economics, vol.17, pp 1-13*

Krugman, P.R. (1979) "Model of Balance of Payments Crisis", *Journal of Money, Credit and Banking, vol.11, No3, pp311-325*

Krugman, P.R. (1996) "Are currency crises Self-fulfilling?", *NBER Macroeconomic Annual 1996, pp 345-378*

Obstfeld, M. (1994) "Logic of Currency Crisis," *Banque de France Cahiers Economiques et Monetaires, No43, pp 189-213*

Obstfeld, M. (1996) "Models of Currency Crisis with Self-fulfilling Features," *European Economic Review, vol.40, No3-5, pp 1037-1047*

Bernanke, B and Gertler, M, (1995) "Inside the Black Box: The Credit Channel of Monetary Policy Transmission", *Journal of Economic Perspectives, Vol. 9, No. 4, pp. 27-48*

Diamond, D.W. and Dybvig, P.H, (1983) "Bank Runs, Deposit Insurance and Liquidity", *Journal of Political Economy 91, pp 401-419*

Lecture 3: The Asian Crisis and "Third Generation" Models

Aghion, P., Bacchetta, P. and Banerjee, A. (2001) "Currency Crises and Monetary Policy in an Economy with Credit Constraints," *European Economic Review, Vol.45, No.7, pp.1121-50*.

Allen, F. and Gale, D. (2000) "Financial Contagion", *Journal of Political Economy, vol.108, pp1-33*

Chang, R. and Velasco, A. (2001) "A Model of Financial Crisis in Emerging Markets," *Quarterly Journal of Economics, pp. 489-517*.

Corsetti, G., Pesenti, P. and Roubini, N. (1999) "What Caused the Asian Currency and Financial Crisis?", *Japan and the World Economy, 11, pp. 305-373*.

Kaminsky, G. and Reinhart, C. (1999) "The Twin Crises: The Cause of Banking and Balance of Payment Problems", *American Economic Review 89, pp 473- 500*

Radelet, S. and Sachs, J. (1998) "The Onset of the East Asian Financial Crisis," *NBER Working Paper No. 6680*

Lecture 4: Reshaping of Banking Landscapes in Asia

- Molnar, M. (2003) "Post-Crisis Changes in Banking and Corporate Landscapes in Dynamic Asia", *OECD working paper 362, OECD*
(downloadable: <http://ideas.repec.org/p/oec/ecoaaa/362-en.html>)
- Molnar, M. (2003) "Post-Crisis Changes in Banking and Corporate Landscapes, The Case of Thailand", *OECD working paper 363, OECD*
(downloadable: <http://ideas.repec.org/p/oec/ecoaaa/363-en.html>)

Lecture 5: Inflation Targeting, Monetary and Exchange rate policy in Emerging Asia

- Amato, J. and Gerlach, S. (2002) "Inflation targeting in emerging market and transition economies: Lessons after a decade," *European Economic Review* 46, 781–790.
- Bernanke, B. and Frederic S. M. (1997) "Inflation Targeting: A New Framework for Monetary Policy?" *Journal of Economic Perspectives* 11(2): 97-116.
- Mishkin, F. (2004) Can Inflation Targeting Work in Emerging Market Countries?, *NBER Working Paper No.10646*
- Taylor, J. (2001) "The role of the exchange rate in monetary policy rules," *American Economic Review* 91, 263–267
- Calvo, G. and Reinhart, C. (2002) "Fear of floating," *Quarterly Journal of Economics* 117, 379–408.
- De Beaufort Wijnholds, Onno, J., and Kapteyn, A. (2001) "Reserve Adequacy in Emerging Market Economies," *IMF Working Paper, WP/01/143*, International Monetary Fund
- Eichengreen, B and Hausmann, R. (1999) "Exchange Rates and Financial Fragility," in *New Challenges for Monetary Policy*, a symposium sponsored by the Federal Reserve Bank of Kansas City
- Levy-Yeyati, E. and Sturzenegger, F. (2005) "Classifying Exchange Rate Regimes: Deeds vs. Words," *European Economic Review* 49, pp1603-1635
- McKinnon, R. and Schnabl, G. (2004) "The East Asian Dollar Standard, Fear of Floating, and Original Sin", *Review of Development Economics*, 8(3), 331–360
- Fischer, S. (2001), "Exchange Rate Regimes: Is the Bipolar View Correct?," *Journal of Economic Perspectives*, 15 (2), pp. 3-24.

Lecture 6: Post-crisis Economic Growth in Southeast Asia

- World Bank (1993) *The East Asian Miracle*, Oxford University Press
- Young, A.(1994) "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," *The Quarterly Journal of Economics* Vol. CX, No. 3
- Evans, P. and J.U. Kim (2005) "Estimating Convergence for Asian Economies Using Dynamic Random Variable Models", *Economic Letters* 86
- Ghatak, M and N.N. Jiang (2002) "A Simple Model of Inequality, Occupational Choice and Development", *Journal of Development Economics* 69
- Cordoba, J.C. and G. Verdier (2007) "Lucas vs. Lucas: On inequality and growth", *IMF Working Paper 07/17*.

Lecture 7: Infrastructure Financing for Growth

- ADB- JBIC-WB (2005) "Connecting East Asia: A New Framework for Infrastructure", *ADB- JBIC-WB*
- Hall, D., V. Corral and S. Thomas (2004) "Electricity privatization and restructuring in Asia- Pacific"
www.psiu.org/reports/2004-12-E-Asia.doc
- Fay, Marianne and Tito Yepes (2003) "Investing in infrastructure: What is Needed from 2000- 2010?", *Policy Research Working Paper WPS 3102, World Bank*

Lecture 8: Regional Financial Integration in Emerging Asia

- OECD (2007) "Fostering Regional Integration: Peer Review in Southeast Asia", by Tanaka, K, *OECD Policy Brief*

- Tanaka, K (2008) "Economic Integration amid diversity and Peer Reviews in Southeast Asia", overview chapter in *"Shaping Policy Reform and Peer Review in Southeast Asia"*, OECD
- BIS (2006) "Developing corporate bond markets in Asia", *BIS Papers No. 26*, February 2006
- IMF (2000), "Recovery from the Asian Crisis and the role of IMF", *IMF*

Lecture 9-10: Short presentations of the final papers by students

Lecture 11: The Japanese Banking System and Economic Growth

- Aoki, M. and Patrick, H. (1994) "Japanese Main Bank System- Its relevance for Developing and Transition economies", Chapter 3-4 and 6, 1994, *Oxford University Press*
- Hart, O, (1995) "Firms, contracts and Financial structure", *Oxford Press*.
- Hanazaki, M. and Horiuchi, A. (2000) "Is Japan's Financial System Efficient?", *Oxford Review of Economic Policy*, 16 (2), 61-73.
- Hoshi, T. and Kashyap, A. (2004) "Solutions to the Japanese Banking Crisis: What might work and what definitely will fail?", *Hi – Stat Discussion Paper Series d04-35, Institute of Economic Research, Hitotsubashi University*
- Kawai, M. (2003) "Japan's Banking System: From the Bubble and Crisis to Reconstruction", *Institute of Social Science University of Tokyo, Japan*
- Bernanke, B. and Reinhart, R. (2004) "Conducting Monetary Policy at Very Low Short-Term Interest Rates", *American Economic Review*, Vol. 94, No. 2, May 2004
- Ito, T. and Mishkin, F. (2004) "Two Decades of Japanese Monetary Policy and the Deflation Problem", *NBER Working Paper No. 10878*
- Oda, K. and Nagahata (2005) "On the Function of the Zero Interest Rate Commitment: Monetary Policy Rules in the Presence of the Zero Lower Bound on Interest Rates", *Bank of Japan, Working paper series, No05-E-1*
- OECD (2008) "Economic Surveys: Japan", *OECD*

Lecture 12: Why Was China Not Affected by the Asian Financial Crisis? – The Macroeconomic Setting

- OECD (2005) "Economic Surveys: China", *OECD*
- OECD (2008) "Economic Outlook 2008", *OECD*
- Tyers, R. (2000) "China after the crisis: the elemental macroeconomics", Australian National University, Asia Pacific School of Economics and Management Working Papers

Lecture 13: The Fragility of the Chinese Financial System, the Role of Informal Finance and Other Challenges for China

- OECD (2006) "Challenges for China's Public Spending – Toward Effectiveness and Equity", by Molnar, M. and Pigott, C., *OECD*
- Allen, F., Qian, J. and Qian, M. (2006) "China's Financial System: Past, Present and Future", *Working Paper 05-17, Wharton Financial Institutions Center, University of Pennsylvania*
- Tanaka, K. and M, Molnar (2008) "What is different about informal finance? – Financing of private firms in China", revised version presented at the international conference *"Opening and Innovation on Financial Emerging Markets"* in China this March, 2007. (to be distributed by instructors)

Lecture 14: Global Macroeconomic Issues and their Influence on Asia/Southeast Asia

- OECD (2008) "Economic Outlook 2008", *OECD*
- ABD (2008) "Asian Development Outlook 2008", *ADB*
- IMF (2008) "World Economic Outlook 08", *IMF*