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โลกาภิวัตน์ใหม่: โอกาสและความเสี่ยงของไทยในทศวรรษหน้า

New Globalization: Risks and Opportunities for Thailand in the Next Decade

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บทคัดย่อ

ข้อคิดเห็นที่ปรากฏในบทความนี้เป็นความเห็นของผู้เขียน ซึ่งไม่จำเป็นต้องสอดคล้องกับความเห็นของธนาคารแห่งประเทศไทย

กระบวนการโลกาภิวัตน์เพื่อลดอุปสรรคทางการค้า การลงทุน และเคลื่อนย้ายแรงงานระหว่างประเทศ ซึ่งดำเนินต่อเนื่องมาหลายทศวรรษ ได้ถึงจุดหักเหจากวิกฤตเศรษฐกิจโลกในปี 2008-2009 โดยเศรษฐกิจของกลุ่ม G4 ที่อ่อนแอลงอย่างมาก นโยบายเศรษฐกิจมหภาคที่ได้ใช้ไปจนเต็มความสามารถจนอาจไม่เพียงพอที่จะกระตุ้นเศรษฐกิจต่อเนื่องในระยะถัดไปหากเกิดวิกฤตขึ้นอีก มีนัยว่ากลุ่มเอเซียจะพึ่งพาการส่งออกไปยังกลุ่ม G4 เป็นหลักไม่ได้มากอย่างในอดีต และทำให้ต้องพึ่งพิงการขยายตัวของอุปสงค์จากภายในกลุ่มเอเซียด้วยตนเอง

ในทศวรรษหน้าอุปสงค์จากภายในกลุ่มเอเซียจะทำให้เอเซียก้าวมาเป็นหัวจักรที่สองของการเติบโตของเศรษฐกิจโลก ซึ่งจะเกิดขึ้นจากการเปลี่ยนแปลงเชิงโครงสร้างจากการย้ายถิ่นฐานเข้าเมืองของแรงงานจำนวนมากจากภาคเกษตรมาสู่ภาคการผลิตและภาคบริการ ที่ทำให้รายได้และกำลังซื้อตลอดจนการบริโภคเพิ่มขึ้น ด้านอุปทาน ผลิตภาพการผลิตโดยรวม (TFP) จะเพิ่มขึ้นจากการขยายเครือข่ายการผลิตในภูมิภาคและการพัฒนาผลิตภัณฑ์รวมทั้งกระบวนการผลิต อีกทั้งการสะสมทุนยังมีแนวโน้มจะเพิ่มขึ้นจากการลงทุนในโครงสร้างพื้นฐานและการลงทุนโดยตรงภายในภูมิภาค (intra-regional FDI) แต่สิ่งสำคัญที่ต้องได้รับการดูแลคือ ประสิทธิภาพและความครอบคลุมของกระบวนการระดมทุนและจัดสรรทุน ตลอดจนความมั่นคงของระบบการเงินซึ่งจะเป็นปัจจัยสำคัญหากเศรษฐกิจเอเซียจะเจริญเติบโตได้เต็มศักยภาพ

\* ผู้วิจัยขอขอบคุณคุณณัฏฐิต นิจถาวร คุณไพบุลย์ กิตติศรีกังวาน คุณสุชาติ สักการโกศล และคุณทิตนันท์ มัลลิกะมาส สำหรับข้อชี้แนะ และความช่วยเหลือที่เป็นประโยชน์ยิ่ง ขอขอบคุณคุณจิรเทพ เสนิงค์ ณ อยุรยา ที่สอนให้ผู้วิจัยเรียนรู้ที่จะมีมุมมองที่แตกต่างและครอบคลุมยิ่งขึ้น รวมทั้งให้ความช่วยเหลืออย่างไม่เห็นเหน็ดเหนื่อย ขอขอบคุณคุณคุณสุพัฒน์พงษ์ นาวารัตน์ และคุณชัยพัฒน์ พูนพัฒน์พิบูลย์ สำหรับคำแนะนำ กำลังใจ และความช่วยเหลือที่ทำให้งานวิจัยนี้สำเร็จลุล่วงด้วยดี และขอขอบคุณคณะผู้บริหารและคณะเจ้าหน้าที่ในสายนโยบายการเงิน สายตลาดการเงิน และสายนโยบายสถาบันการเงิน โดยเฉพาะคุณเยาวนิจ มังคละระกุล คุณณัฐิกานต์ วรสง่าศิลป์ คุณดวงพร รอดเพ็งสังคะ คุณพลอย ธรรมาภิรานนท์ คุณวิศยา ลิ้มธรรมมหิศร คุณภาวณี จิตต์มงคลเสมอ คุณศรีฉวีพร อังคนาการ ทุกท่านในส่วนเศรษฐกิจระหว่างประเทศ และทีมสนับสนุนกิจการฯ สายนโยบายการเงิน สำหรับความช่วยเหลือในหลายส่วนตลอดช่วงการทำวิจัยในครั้งนี้

นอกจากนี้ผู้วิจัยขอขอบคุณ คุณนริศ อุณากร สำหรับบทวิเคราะห์เรื่องสกุลเงินสำรองระหว่างประเทศในทศวรรษหน้า และการลงทุนโดยตรงภายนอกของไทย (กล่อง 1 และ 2 ในบทที่ 4 และ 6 ตามลำดับ) และขอขอบคุณ ทีมเศรษฐกิจเอเซีย ฝ่ายเศรษฐกิจระหว่างประเทศ สำหรับบทวิเคราะห์แผนแม่บทการพัฒนาประเทศของประเทศไทยในภูมิภาคเอเซีย (กล่องที่ 3 ในบทที่ 6) และ คุณวัชรพันธ์ุ ธนประกอบ สำหรับบทวิเคราะห์แผนการพัฒนาประเทศของมาเลเซีย (กล่องที่ 4 ในบทที่ 6)

## บทสรุปผู้บริหาร

กว่า 30 ปีที่ผ่านมา กระแสโลกาภิวัตน์ได้นำไปสู่กระบวนการการเปิดเสรี การแปรรูปรัฐวิสาหกิจและการผ่อนคลายกฎระเบียบต่างๆ ตามแนวคิดที่ว่ากลไกตลาดจะทำให้เศรษฐกิจโลกมีประสิทธิภาพมากขึ้นและรายได้เพิ่มขึ้น อย่างไรก็ตามวิกฤตเศรษฐกิจโลกในช่วงปี 2551-2552 เป็นจุดหักเหของกระบวนการโลกาภิวัตน์ที่จะส่งผลให้แนวโน้มการเติบโตทางเศรษฐกิจในประเทศพัฒนาแล้วชะลอตัวลงเมื่อเทียบกับเศรษฐกิจเกิดใหม่ในเอเชียที่มีแนวโน้มการขยายตัวที่คาดว่าจะสูงและต่อเนื่อง ความอ่อนแอทางเศรษฐกิจของประเทศพัฒนาแล้วจะมาจากปัญหาภาระหนี้สาธารณะที่อยู่ในระดับสูง งบดุลของภาคธนาคารที่อ่อนแอ ตลอดจนนโยบายเศรษฐกิจมหภาคได้ใช้ไปเกือบเต็มความสามารถจนอาจไม่เพียงพอที่จะกระตุ้นเศรษฐกิจต่อเนื่องในระยะถัดไปหากเกิดวิกฤตขึ้นอีก ซึ่งปัญหาเหล่านี้สะท้อนถึงความล้มเหลวของฉันทามติแห่งกรุงวอชิงตัน (Washington Consensus) ที่เน้นการเปิดแข่งขันเสรีโดยไม่คำนึงถึงข้อบกพร่องของกลไกตลาดเท่าที่ควร ดังนั้น แม้ว่าการเปิดเสรีและการแปรรูปรัฐวิสาหกิจจะยังดำเนินต่อไป แต่คาดว่าภาครัฐจะมีบทบาทมากขึ้นในการเข้ามาแทรกแซงและกำกับดูแลกลไกตลาด

เพื่อความเข้าใจและเลือกดำเนินนโยบายตอบสนองการเปลี่ยนแปลงครั้งนี้ บทวิจยนี้ได้วิเคราะห์ปัจจัยสำคัญซึ่งจะสนับสนุนให้เอเชียเป็นกลจักรที่สองในการขับเคลื่อนเศรษฐกิจโลกในทศวรรษต่อไป โดยอาศัยกลไกการขับเคลื่อนเศรษฐกิจเอเชียแนวใหม่ (the new Asian growth model) ในอดีตที่ผ่านมา แรงขับเคลื่อนหลักของเศรษฐกิจในภูมิภาคเอเชียคือการส่งออกโดยพึ่งพาตลาดของประเทศพัฒนาแล้ว แต่ในระยะต่อไปคาดว่าจะมีอุปสงค์ภายในประเทศและภายในภูมิภาคเข้ามาเป็นแรงขับเคลื่อนเศรษฐกิจใหม่ที่สำคัญเพิ่มขึ้น โดยจะมีปัจจัยสนับสนุนจากการเปลี่ยนแปลงเชิงโครงสร้างโดยการเพิ่มบทบาทของภาคอุตสาหกรรมและภาคบริการขณะที่ภาคเกษตรมีความสำคัญลดลง ซึ่งจะส่งผลให้เกิดการย้ายถิ่นฐานของแรงงานเข้าเมืองเป็นจำนวนมาก และช่วยให้เกิดชนชั้นกลางที่มีรายได้และกำลังซื้อตลอดจนการบริโภคที่เพิ่มขึ้น สำหรับในด้านอุปทาน การสะสมทุนจะมีแนวโน้มเร่งขึ้นจากการลงทุนในโครงสร้างพื้นฐาน การลงทุนโดยตรงภายในภูมิภาค (intra-regional FDI) ประกอบกับผลิตภาพโดยรวมมีแนวโน้มที่จะเพิ่มขึ้นจากการเชื่อมโยงเครือข่ายการผลิตในภูมิภาค (regional production network) และการพัฒนาผลิตภัณฑ์และกระบวนการผลิตในลักษณะที่จะช่วยตอบสนองความต้องการของชนชั้นกลางที่ยังมีรายได้ไม่สูงนัก (frugal innovation) ปัจจัยเหล่านี้จะช่วยเพิ่มผลิตภาพให้กับแรงงานและสนับสนุนการเจริญเติบโตทางเศรษฐกิจของเอเชียต่อไป

ทั้งนี้ ความสามารถในการดูแลเสถียรภาพในภาวะที่เงินทุนเคลื่อนย้ายระหว่างประเทศจะเพิ่มขึ้นและผันผวนมากขึ้น ตลอดจนความสามารถในการจัดสรรทุนของภาคการเงินที่จะสนับสนุนกลไกการขับเคลื่อนเศรษฐกิจต่อไปในทศวรรษหน้า มีความสำคัญสูงต่อการเอื้อให้การเจริญเติบโตในภูมิภาคยั่งยืน โดยการไหลเข้าของเงินทุนมายังประเทศเอเชียน่าจะเพิ่มขึ้นจากสภาพคล่องในโลกและในภูมิภาคเอเชียที่อยู่ในระดับสูง ขณะที่แม้ความเสี่ยงในเศรษฐกิจของกลุ่ม G4 จะมีมากขึ้นแต่สินทรัพย์ของกลุ่ม G4 จะยังคงเป็นสินทรัพย์ที่นักลงทุนคิดว่ามีความปลอดภัยสูง (safe-haven assets) ที่ยังไม่มียุทธวิธีอื่นมาทดแทนได้ ซึ่งจะส่งผลต่อความผันผวนของเงินทุนไหลเข้ามายังเอเชียด้วยเช่นกัน

นอกจากเงินทุนไหลเข้าที่มีแนวโน้มเพิ่มขึ้นจะช่วยสนับสนุนกลไกการขับเคลื่อนเศรษฐกิจเอเชียแนวใหม่แล้ว เงินออมจำนวนมากในภูมิภาคเอเชียยังจะเป็นแหล่งทุนหลักที่มั่นคง แต่ปัญหาของการจัดสรรทุนเพื่อส่งเสริมการขยายตัวทางเศรษฐกิจยังมีอยู่ในด้านประสิทธิภาพของกระบวนการระดมทุนและจัดสรร

เงินทุนและความครอบคลุมของการให้บริการทางการเงิน ดังนั้นบทบาทที่เพิ่มขึ้นของตลาดทุน การทำงานที่ดีขึ้นของภาคธนาคาร (พฤติกรรมการณ์ให้กู้ การบริหารความเสี่ยง และระบบธรรมาภิบาล) และการเข้าถึงแหล่งเงินทุนที่ง่ายขึ้นของบุคคลธรรมดาและธุรกิจขนาดเล็กโดยเฉพาะอย่างยิ่งในพื้นที่ชนบท เป็นสิ่งจำเป็นต่อการส่งเสริมการเจริญเติบโตทางเศรษฐกิจในภูมิภาค ทั้งนี้ พบว่าหลายปัจจัยกำลังดำเนินไปในทิศทางที่ดีขึ้นจากการปฏิรูปทางการเงิน การแข่งขันที่เพิ่มขึ้น และความแข็งแกร่งและยืดหยุ่นของภาคธนาคารที่เพิ่มขึ้น

การเจริญเติบโตทางเศรษฐกิจของเอเชีย การเพิ่มขึ้นของเงินทุนเคลื่อนย้ายระหว่างประเทศอปรกับการลดข้อจำกัดในการเข้าถึงแหล่งเงินทุน จะช่วยเพิ่มโอกาสให้ไทยทั้งในด้านการค้าและการลงทุนภายในภูมิภาค แต่ความเสี่ยงก็จะเพิ่มขึ้นเช่นกัน ทั้งจากความร้อนแรงทางเศรษฐกิจจากเงินทุนไหลเข้าที่สูงขึ้นและการที่วิกฤตในภูมิภาคจะส่งผลกระทบต่อกันเร็วและง่ายขึ้น รวมถึงจากการตกขบวนรถไฟ (marginalization) ในการค้าและการลงทุน เพราะคู่แข่งใหม่ๆ ที่มีข้อได้เปรียบด้านต้นทุนและประสิทธิภาพ หรือ การสูญเสียความได้เปรียบจากการไม่สามารถบุกเบิกตลาดเป็นรายแรกๆ (first-mover advantage)

เมื่อประเมินว่าหลายประเทศในภูมิภาคเช่น มาเลเซีย จีน อินเดีย และ สิงคโปร์ ต่างมีแผนเชิงกลยุทธ์ที่ชัดเจนและครอบคลุมเพื่อยกระดับการพัฒนาเศรษฐกิจของตนภายใต้สภาวะแวดล้อมทางเศรษฐกิจที่เปลี่ยนแปลงไป ในการเตรียมพร้อมของประเทศไทยกับโอกาสและความเสี่ยงที่จะเกิดขึ้นในสิ่งแวดล้อมใหม่นี้ การจัดทำแผนพัฒนาเชิงกลยุทธ์ระยะยาวที่เป็นรูปธรรม ครอบคลุม และสามารถประเมินความก้าวหน้าในการดำเนินการตามแผนได้อย่างชัดเจนอาจเป็นเพียงก้าวแรกที่เราต้องดำเนินไป

## BOT Symposium 2010

## New Globalization: Risks and Opportunities for Thailand in the Next Decade

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## Abstract

*The views expressed in this paper are those of the authors  
and do not necessarily represent those of the Bank of Thailand*

The ongoing globalization process via the reduction and removal of obstacles to international trade and investment and international labor movement has come to an important inflection point due to the global Credit Crisis in 2008-2009. The Credit Crisis left G4 economies considerably weaker in light of the massive fiscal debt, fragile banking sector balance sheets, as well as the nearly maxed-out space for macroeconomic policies. Meanwhile, despite initial setbacks, EM Asia seemed to poise for robust growth going forward and is expected to become the second engine of global growth after the US.

In the next decade, EM Asia growth will likely be driven by the prospects of its own regional demand from burgeoning middle class as a result of fast transition from the primary sector to higher-paying manufacturing and service sectors. Additionally, supply side factors will provide significant support for EM Asia growth going forward through the improvement in TFP from intensifying regional production network and frugal innovation, as well as the rise in capital accumulation from greater infrastructure investment and intra-regional FDI. However, for the real sector growth to achieve its full potential, more effective financing that is efficient and inclusive will be needed. The resiliency of the financial system will also be a key factor that must be monitored closely and enhanced to ensure the sustainability of economic growth

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We also thank contributors to the analyses presented in the Boxes throughout various chapters. Norataj Unakul contributed analyses on the trend of major reserve currencies in the next decade, as well as those on Thailand's direct investment abroad (Box 1 and 2 in Chapters 4 and 6 respectively). Asia Economies Team contributed to the analysis on development plans of various emerging Asia economies (Box 3 in Chapter 6). Wacharaphan Tanaprakob analyzed Malaysia's New Economic Model (Box 4 in Chapter 6).

## Executive summary

Over the past 30 years, globalization has been mainly about the process of “liberalization, privatization, and deregulation”, trusting that the force of market and its invisible hand will lead the global economy to more efficiency and higher income. The emergence of global credit crisis in 2008-2009, however, can be regarded as the inflection point of this ongoing globalization. Compared with the rapid expansion in many emerging Asia economies (EM Asia), the crisis has resulted in slower growth in advanced economies due to massive fiscal debt, fragile banking sector balance sheets and nearly maxed-out space for macroeconomic policies. Besides, it has also exposed inevitable flaws of the dominant policy doctrine (the Washington Consensus), the problems of market failure. Going forward, although liberalization and privatization will continue, greater government intervention will play a more important role alongside market forces.

In response to this change, this paper first analyzes the underlying factors that support the new Asian growth model in the next decade. Looking back, export-led growth was an evident benefit of globalization for this region. This benefit is expected to continue into the next decade, however, with more significant roles played by internal and intra-regional demand. Demand-side factors that are expected to support this rising internal demand are migrations from the primary sector to manufacturing and services sectors, along with rapid urbanization, all of which will lead to higher income and greater consumer demand within EM Asia. On the supply side, higher growth in capital accumulation due to higher infrastructure needs and intra-regional FDI, together with higher total factor productivity (TFP) from the more integrated regional production network and “frugal innovations” amongst others are expected. Altogether, this will increase labor productivity and enhance robust EM Asian growth prospects.

The success of this new Asian growth model, nonetheless, depends on capacity to cope with the increasing dynamics of capital flows and ability of the financial sector to finance this growth model in the next decade. Analysis shows that growth differentials between G4 and EM Asia, and ample global and regional liquidity are expected to drive more capital towards EM Asia. Despite rising risks in G4 economies, however, their status as the ultimate safe-haven are expected to remain yet irreplaceable, and thus having implications on capital inflow volatility.

Whilst capital inflow will be an important source of funds to finance the new Asian growth model, this region also has an ample pool of savings that is

invaluable as a stable financing source. The problem of financing the upcoming economic expansion is rather in the efficiency and inclusiveness of intermediation by the financial sector in the region. Greater role of capital markets, better functioning in the banking sector (lending behavior, risk management and governance) and more financial access for individuals and small businesses, especially in rural areas will be needed to support growth. Against this, we find that there are many positive factors going forward such as financial reforms, changes in the banking sector landscape that will foster higher competition, and the greater emphasis on resiliency of banks to support growth even when in crisis.

Lastly, given the global shift in growth dynamics, changing pattern of capital flows, and potentially decreasing bottlenecks in the financial sector, Thailand will be presented with greater trade and investment opportunities in this region from higher demand and growth potential. But along with opportunities also come many risks that must be properly managed. Overheating could come from large capital inflows as well as regional contagion. Marginalization of our economy could come from new competitors with lower cost and better efficiency or by our failure to make an early strategic move in order to benefit from first-mover advantages.

Noting that our regional peers including Malaysia, China, India, and Singapore already have well-established strategic plans to step up their developmental stages, it seems that Thailand will need to gather our will and efforts to successfully take advantage of the upcoming opportunities while effectively mitigating possible risks. A long-term comprehensive plan, with measurable objectives might be just a small start of our long-term endeavor.

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## Introduction

Globalization, in terms of its economic aspects, involves the reduction and removal of cross-border barriers to international trade, production, investment, and labor. In the past 30 years, various factors including geopolitics, technological advances, and the dominance of market-led doctrines, have brought about the process of “liberalization, privatization, and deregulation” world-wide. Against this backdrop, various emerging economies, particularly those in Asia, have immensely benefited from greater access to global markets and capital of advanced economies. Indeed, the rapid growth of many emerging Asia economies (EM Asia) in the past three decades was largely enabled by rising exports to advanced economies, especially the G4 –US, euro area, Japan, and UK.

The emergence of global credit crisis in 2008-2009, however, can be looked upon as an important inflection point of the ongoing globalization process. The credit crisis left G4 economies much weaker in light of the massive fiscal debt, fragile banking sector balance sheets, as well as the nearly maxed-out space for macroeconomic policies. Meanwhile, the credit crisis left EM Asia relatively unscathed. Indeed, despite initial setbacks, EM Asia seemed to poise for stronger growth going forward. With the changes in global economic dynamics, global capital flows are also expected to change, together with increasing capital flow within EM Asia itself. Both growth differentials between G4 and EM Asia, and ample global and regional liquidity are expected to drive more capital towards EM Asia. However, G4 assets are expected to remain irreplaceable as the ultimate safe-haven assets despite weaknesses in G4 economies. As such, volatility of capital flows to EM Asia is expected to also surge in line with these developments.

Rapid EM Asia economic growth in recent years brought about fast transitions from the primary sector to higher-paying manufacturing and service sectors, and led to increasing urbanization of the vast population. Economic transitions and urbanization have created a fast growing middle class with greater income and purchasing power, as well higher-value consumption profile. The rise in domestic demand within EM Asia is thus expected. On the other hand, the supply factors have also been supportive of the rise of EM Asia going forward. Total factor productivity or TFP growth is expected to result from greater R&D, human capital, technological spillover as well as regional production network, and improvements in products and logistics such as those related to “frugal innovation”. Capital accumulation should also accelerate in line with infrastructure investment, greater intra-regional FDI, as well as accommodative financing environment.

While there are strong supporting factors for the growth of real sector on both the demand and supply sides, on the financing side, more efficient and “inclusive” intermediation will be necessary for the real sector growth to achieve its full potential. Greater role of the capital markets, greater competition, and



pertinent reforms will change the EM Asia financial landscape so that growth financing could be done more effectively. The resiliency of the financial system, however, will be a key factor that must be monitored closely so that instability or imbalance will not eventually undermine the sustainability of economic growth.

This paper aims to explore how Thailand can effectively position herself in this new global environment. To do so, the paper first examines the post-crisis trend, key features, and implications of “New Globalization”. The paper then explores why and how EM Asian internal demand can rise along with supporting supply-side factors, thereby propelling EM Asia as another important driver of global growth in the next decade. Subsequently the paper examines the prospects of EM Asia financial sector in financing growth and allocating capital in this high-saving region with specific considerations on effectiveness and inclusiveness. Lastly, the paper examines important opportunities and risks that the changes in global landscape could bring for Thailand, and how Thailand can effectively deal with them.

## **Part I: The New Globalization**

# Chapter 1: Legacies of the Credit Crisis and the weakening of G4

## I. What is the New Globalization?

### I.1 Prelude to the New Globalization: The Washington Consensus

Although the definition of globalization could be diverse, we took to the definition that globalization, at least in term of economic aspects, involves the reduction and removal of cross-border barriers to international trade, production, investment, and labor. Prior to the global crisis in 2008-2009, the past thirty years seem to have been another golden age of globalization. The end of the Cold War helped to integrate the eastern bloc countries into the global economic network. During this same period, the dominance of free market doctrines started in the Anglo-Saxon economies led to liberalization, deregulation, and privatization world-wide. Multilateral efforts that focused on freer international trade and investment including the EU, WTO, and regional free trade areas also proliferated. Meanwhile, great advances in information and telecommunication technology helped stimulate a more efficient economic and financial integration process across countries and regions.

One of the key features of this golden age of globalization was the rise of the so-called Washington Consensus, which in its original form described a set of specific economic policy prescriptions that should constitute the “standard” reform package promoted for emerging countries in crisis<sup>3</sup>. The prescriptions put emphases on greater fiscal discipline, lesser role of the state through deregulation, privatization, and market liberalization, as well as greater role of private sector competition. Indeed, a large number of emerging markets in Asia, Latin America, and other regions, have pursued reforms along these prescriptions to different degrees of success. By the early 2000s, as these prescriptions proved to be too traumatic for the crisis countries, the allure of Washington Consensus started to diminish although the dominance of free-market ideals remained yet untouched.

### I.2 The Credit Crisis as an inflection point of globalization

The Credit Crisis of 2008-2009 could be considered an inflection point of the pre-crisis or “old” globalization process. Ironically, two of the hardest hit countries in this crisis had been the most vocal advocates of the Washington Consensus, i.e. the US and the UK. Indeed, this global crisis forced the main beacons of the “liberalization, privatization, and deregulation” mantra to almost take a U-turn on these issues. Certain banks in the US and UK were effectively nationalized, while the governments intervened in markets that previously were supposed to be

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<sup>3</sup> Williamson, John: *What Washington Means by Policy Reform*, in: Williamson, John (ed.): *Latin American Readjustment: How Much has Happened*, Washington: Institute for International Economics 1989.

efficient, and took on vast public debt, violating the fiscal discipline prescription to pre-empt a deflationary spiral. Indeed, a *New Consensus* has already emerged to suggest that market-led economies might need more government intervention to correct inherent market failures. Despite the acceptance of a greater role of the state in market economies, the globalization process will continue, albeit differently from before. Indeed, we firmly believe that the global crisis will not reverse the process of reduction and removal of barriers to international trade and finance. Rather, it will bring changes into various aspects of the globalization process over the next decade.

Going forward, we expect that, the latest global crisis will bring forth a new stage of globalization. First, with New Globalization, the global economic dynamics would substantially change, whereby G4, the ultimate growth engine for past decades, would be markedly weakened, while the more dynamic EM Asia would continue to gain in importance. Second, a *New Consensus* on economic policy management would likely emerge, whereby it would be more acceptable that the state will take a greater role in market-led economies, since market failures may become more prevalent in the domestic as well as international economic and financial systems.

## **II. The shift of global growth centre: The weakening of G4 growth prospects**

In the aftermath of the Credit Crisis, a shift in global economic dynamics seems imminent. G4 economies suffered markedly by the Crisis, while EM Asia growth momentum continue to rise and gain strength after a temporary dip. In this new global context, the old model of global growth whereby consumers in the G4 economies (especially the US) were the ultimate source of final demand for the rest of the world, including EM Asia, may fade. Going forward, although still the world's number one economy with a dynamic and innovative population, the US economy would need to exert so much effort and adjustment just to overcome the strong economic headwinds. While the US status as the world's ultimate growth engine is likely to continue, that engine will be relatively weaker at least in the medium term.

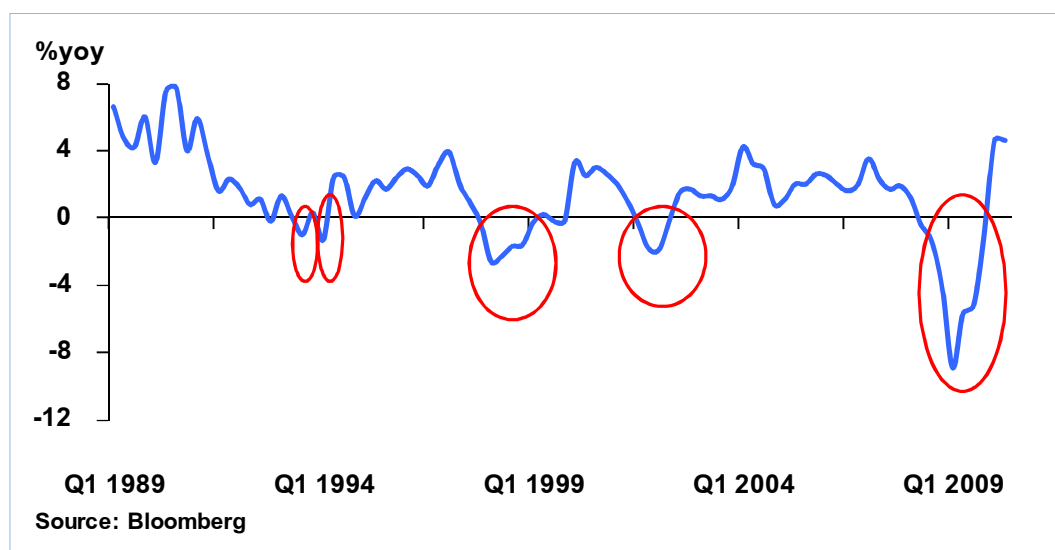
On hindsight, one cautionary tale is Japan after the burst of the bubbles in the early 1990's which experienced 5 recessions in two decades<sup>4</sup> along with long episodes of deflation that had yet to finish. In the Japanese case, the economy was seriously weighed down by debt overhang, whether the public or private sector. Taken together with nearly maxed out monetary and fiscal policies, the authorities no longer have much room to maneuver the limping economy out of

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<sup>4</sup> A recession is defined here as at least 2 consecutive quarters of negative year-on-year output growth.

stagnation. If anything, Japan's GDP became more volatile on the downside, as contraction became ever deeper over the past years.

**Figure 1.1: Japan real GDP growth rate**



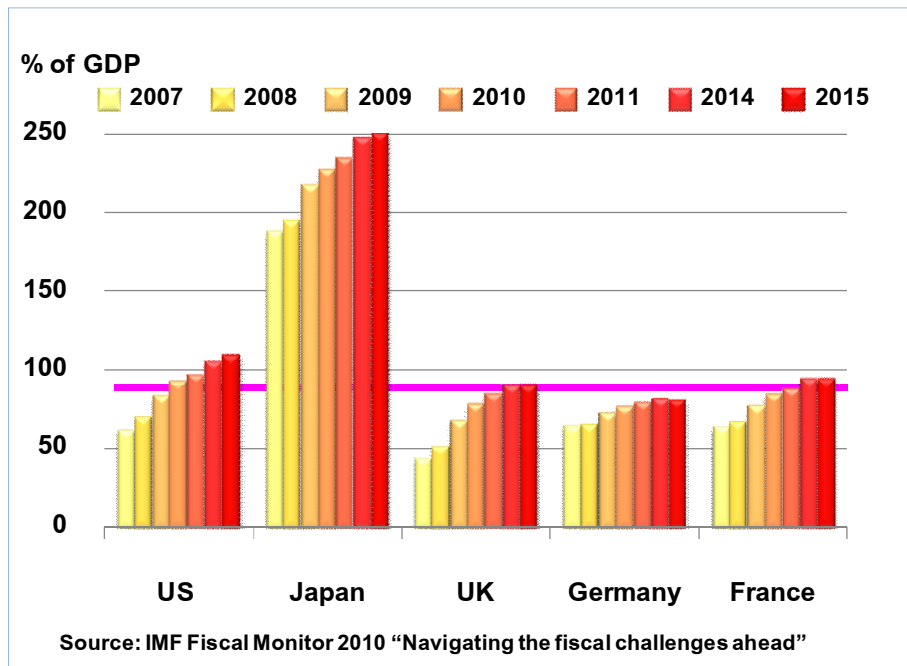
## II.1 Weakened G4 growth prospects

With the Credit Crisis, the prospects of G4 economies are likely to be weighed down by (1) public debt burdens, (2) weak banking system, as well as (3) constraints in macroeconomic policies.

### Public sector debt burden

The *Credit Crisis* demonstrated a repetition of the historical pattern noted by Reinhart and Rogoff (2008) whereby problems in the private sector (household and banking in this case) ultimately translated into fiscal sector debt burden. According to the IMF (2010c), gross public debt to GDP ratio in the US and the UK respectively jumped from 62.1 percent and 44.1 percent in 2007, to 83.2 and 68.2 percent in 2009. These figures are also respectively expected to rise to 92.6 percent and 78.2 percent in 2010 and 109.7 percent and 90.6 percent in 2015. Such jumps in public debt are expected to place heavy headwinds on growth. Among the main implications of the high debt overhang, Barro(1979) suggests that, assuming taxes ultimately need to be raised to achieve debt sustainability, one of the distortionary impact is the lower potential output. Large fiscal deficits and debts could also partially crowd out private-sector activity –see, for example Ford and Laxton (1999). Large fiscal deficits and public debt could also impact long-term bond yields, with non-linear effects (Baldacci and Kumar, 2010). Furthermore, there could be concerns on the monetization of debt, which may increase the inflation premia embedded in the nominal yields, as well as generate macroeconomic uncertainty leading to higher country risk premia and aggravating solvency concerns (Baldacci et al, 2008).

Figure 1.2: G4 public debt-to-GDP ratio



Going forward, with public debt-to-GDP expected to rise to more than 100 percent in the US in 2015, around 90 percent in the UK, and around 250 percent in Japan, G4 growth indeed could be seriously weighed down. Recent studies such as Caner, Grennes, and Koehler-Geib (2010), Reinhart and Rogoff (2009), establish that sovereign debt above a certain threshold will negatively affect economic growth. Using a yearly data set of 101 developing and developed economies spanning a time period from 1980 to 2008, Caner, Grennes and Koehler-Geib (2010) finds the threshold at 77 percent public debt to GDP. Above that threshold, each additional percentage point of debt costs 0.017 percentage points of annual real growth.<sup>5</sup>

### Weak banking system

The banking system in the US, UK and Europe was devastatingly affected by the Credit Crisis. According to the IMF's *Global Financial Stability Report* released in April 2010, banking sector write-downs that reflected banking losses on securities

<sup>5</sup> That same study also finds that the threshold is even more pronounced for emerging markets above the threshold of 64 percent public debt-to-GDP. Similarly, using data on forty-four countries spanning 200 years, Reinhart and Rogoff (2009) finds that the relationship between government debt and real GDP growth is weak for debt-to-GDP ratios below 90 percent of GDP. Above 90 percent, median growth rates fall by one percent, and average growth falls considerably more. Although Reinhart and Rogoff (2009) finds that the threshold for public debt is similar in advanced and emerging economies, emerging markets, however, do face lower threshold for external debt (public and private). When external debt reaches 60 percent of GDP, annual growth declines by about two percent; for higher levels, growth rates are roughly halved.

and loans between 2007 and 2010 were projected to be 885 billion US dollars for the US, 665 billion US dollars for the euro area, and 455 billion US dollars for the UK. Such losses reflect a great destruction of wealth and imply fragile banking sector balance sheets. Indeed, the intensity of the Credit Crisis was remarkable with many large US, UK and European global banks needed to be rescued by their respective governments or by stronger banks, while many local banks actually failed. In case of the US alone, Federal Deposit Insurance Corporation (FDIC) reported that the number of bank failures rose from 3 in 2007 to 25 in 2008, and 140 in 2009. For 2010, up to August 26, the number of US bank failures was already at 121, and likely to continue rising which will put pressures on the economy going forward owing to various reasons; (1) termination of productive investment (Diamond and Dybvig, 1983), (2) “flight to quality in lending” (Holstrom and Tirole, 1997), (3) the “financial accelerator” effect (Bernanke et al, 1996), (4) high level of indebtedness of borrowers (Pazarbasioglu, 1997), (5) debt minimization behavior of firms (Koo, 2008), and (6) deterioration of asset quality (Pazarbasioglu, 1997). As such, while acknowledging that a decline in lending could also owe to a decline in credit demand, given the recent G4 massive banking losses and bank failures, it is very likely that the impairment in the G4 banking sector balance sheets will be another headwind to G4 growth going forward.

### **Constraints on macroeconomic policies**

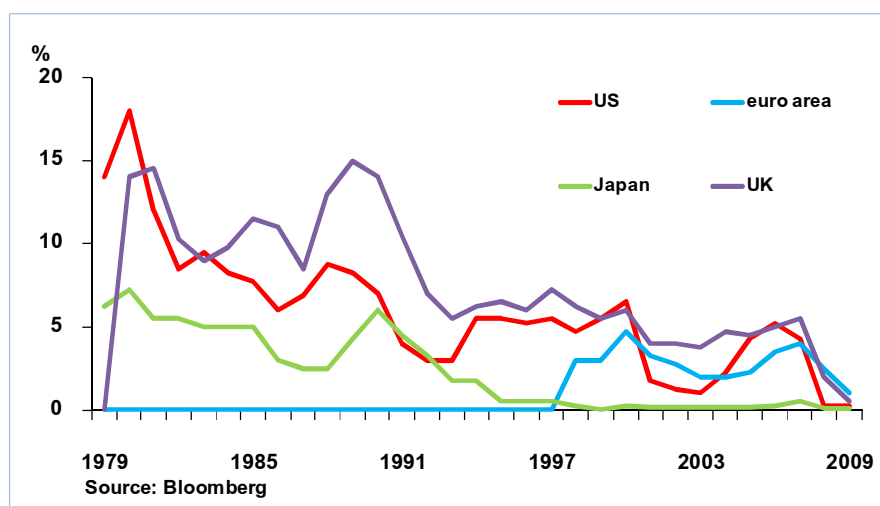
The Credit Crisis put so much pressure on both fiscal and monetary authorities of the G4 countries such that they will not have as much policy room to maneuver as before, and this is very worrisome should new shocks occur. To pre-empt systemic failures and deflation, central banks in the US, UK and the euro area all sharply cut down their interest rates. Similar to Japan, the US policy interest rate has approached the zero bound, while those of the euro area and the UK are exceptionally low at 1 percent and 0.5 percent respectively. Special liquidity facilities were also opened to the banking system to satisfy liquidity needs in the time of crisis. In addition, the US and UK central banks also resorted to securities purchases in the attempt to drive down longer-term interest rates (the so-called “credit easing” or “quantitative easing”). The liquidity injection and massive securities purchases bulged up G4 central banks’ balance sheets.

In case of the Fed, with liquidity provided to financial institutions and key credit markets, the balance sheet’s asset size rose from around 750 billion dollars in January 2008 to more than 2 trillion dollars at the end of the year. By mid 2010, however, with liquidity facilities maturing and securities purchases completed, the largest component in the Fed balance sheet became agency debt and mortgage-backed securities (MBS). Indeed, of the 2.27 trillion dollars worth of assets on the

Fed's balance sheet in August 2010, approximately 1.27 trillion were agency debt and MBS, and 332 billion were long-term US government bond purchases.<sup>6</sup>

As such, the ability of G4 monetary authorities to further stimulate the economy is highly constrained. Going forward, with the needs to rein in fiscal deficits, it seems that G4 authorities have less room to maneuver if another economic shock arises. Again, it is relevant to look at what happened to Japan after the bubble burst in the early 1990's. Despite massive fiscal stimulus by the government and rounds of quantitative easing by the Bank of Japan, the Japanese economy remained weak throughout the past two decades. Of course, in the case of the US, demographic factors, innovations and entrepreneurial drives, political and institutional structures as well as labor markets might be different from those of Japan, yet the point is that the G4 fiscal and monetary policies are somewhat tied up and might not be effective in countering any shock in the near future.

**Figure 1.3: G4 policy interest rates**

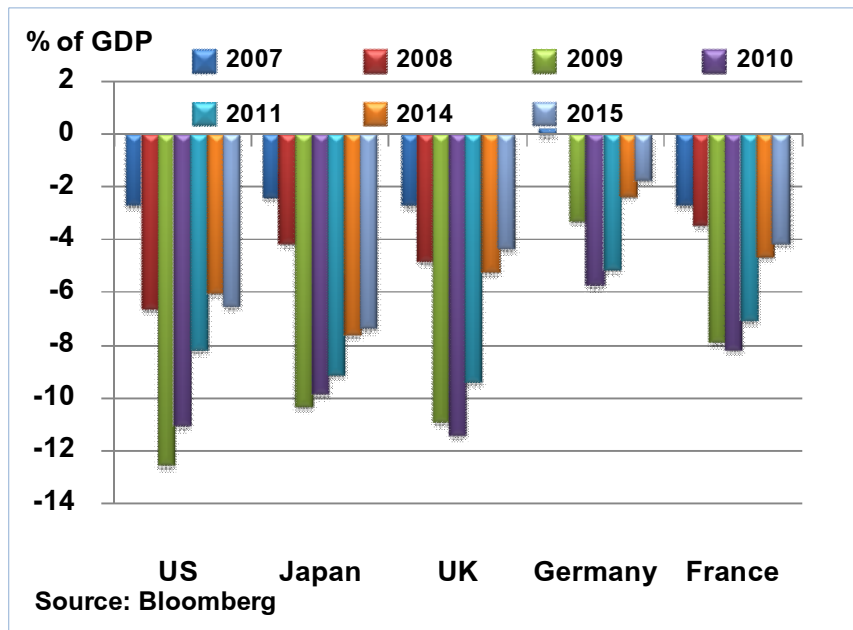


<sup>6</sup> For the Bank of England, the balance sheet's asset size rose from around 100 billion pounds in January 2008 to above 200 billion pounds by the end of the year, owing mainly to the rise in longer-term reverse repo. With the quantitative easing program announced in March 2009, however, by August 2010, the Bank of England's assets have grown to around 250 billion pounds, of which around 215 billion pounds being "other assets" which can be attributed mainly to securities purchases, particularly the UK government bonds.

Although the European Central Bank (ECB) did not formally embark on a quantitative easing program, the special liquidity facilities initiated during the Credit Crisis indeed also bulged up its balance sheet from around 1.25 trillion euro in January 2008 to around 2 trillion euro by 2009. Although the long-term refinancing operation (LTRO) matured by the middle of June 2010, the ECB's balance sheet still hovering around 2 trillion by August 2010.



Figure 1.4: G4 budget deficits



## II.2 Passing the baton: From G4 consumer to EM Asia consumer

With G4 growth prospects weakened by massive debt burdens, weak banking system, deleveraging, and constrained macroeconomic policies, one implication is that EM Asia reliance on G4 consumers as the ultimate source of final demand diminish in importance. Unlike G4, EM Asia emerged from the crisis relatively unscathed. Furthermore, both supply and demand factors seem to be favorable to support EM Asia growth going forward. As EM Asia's growth momentum continues, its income will also rise. EM Asia will be able to rely more on its internal demand for its growth. While it is very unlikely that EM Asia internal demand will entirely to replace G4 consumer demand in the next decade, both supply and demand factors seem to support the likelihood that EM Asia will emerge as another engine of global growth going forward. The next section discusses why this is likely to be the case.

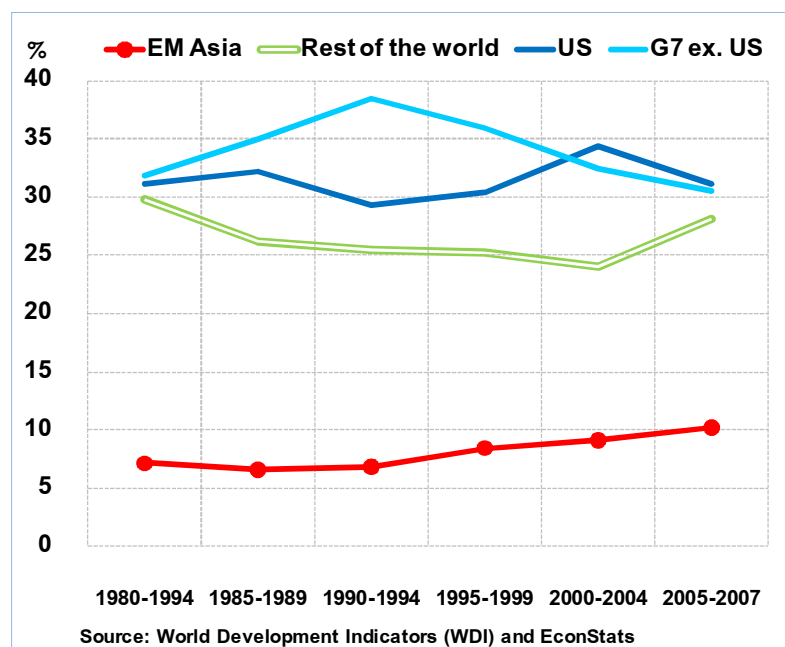
## **Part II: Emerging Asia as the next growth engine**

## Chapter 2: The rise of EM Asia domestic demand as a second engine of growth

For EM Asia economies, the globalization process has broadened access to advanced economies' markets, technology, and capital, as well as helped kick-start the robust export-led growth. With the support from favorable supply and demand side factors, the growth momentum would continue. On the demand side, migrations from the primary sector to manufacturing and services, along with rapid urbanization, will likely foster a fast growing middle class population with greater consumer demand within EM Asia. On the supply side (to be discussed in Chapter 3), the capital accumulation and TFP growth (from the more integrated regional production network and "frugal innovations", among others) are also likely to increase labor productivity and enhance robust EM Asian growth prospects.

The last decade saw a firm establishment of EM Asia as a global supplier of manufacturing goods for G7<sup>7</sup>. However, the recent global crisis is likely to reshape the landscape of world consumption with a slowdown in consumer demand growth in G7 as discussed in *Part I*. The relative share of world household consumption by the advanced economies has been declining since the mid 2000's (Figure 2.1), and this trend is expected to continue.

**Figure 2.1: Share in world household consumption**



<sup>7</sup> G7 countries are the world largest consumer markets including Canada, France, Germany, Italy, Japan, United Kingdom and United States.

## **I. Evolution of advanced economies consumption as an ultimate source of global final demand**

Up until the second half of the previous decade, 60 percent of global consumption belonged to only 11 percent of world population residing in the G7 economies. In contrast, EM Asian consumption accounted for only 10 percent notwithstanding its share of approximately half of world population. The major reason behind this disproportionate development is explained by higher G7 income per capita than in other groups. Nonetheless, relationship between income and consumption is not linear. Each income cohort has its own consumption behaviors which result in different spending patterns. Proportions of different income cohorts in an economy thus shape private consumption both in an aggregate value term and characteristics.

Development in social, political and economic structures allowed the G7 to become the first to witness the rise of middle class; UK in the eighteenth and nineteenth centuries (Landes, 1998 and Boot, 1999). Indeed, G7's private consumption expanded rapidly when middle income households reached a substantial size. The period of transitions from low to middle income of a large share of households is therefore a crucial point in changing consumption dynamics of an economy.

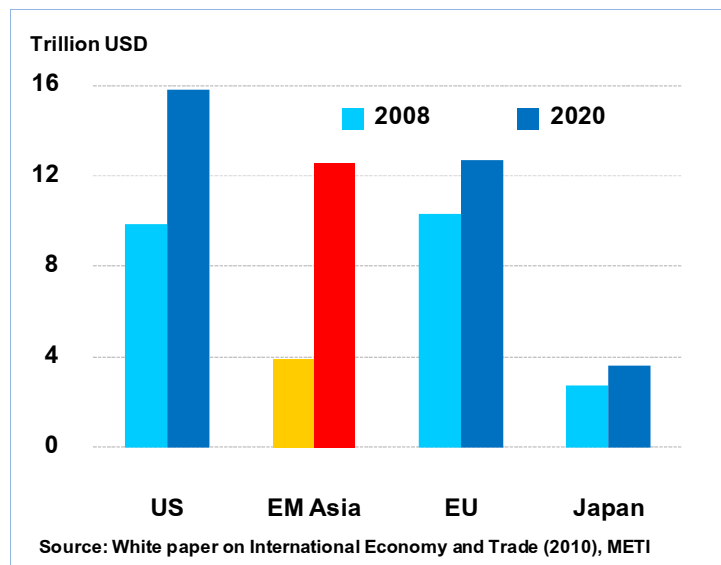
Among different groups of population, the middle class has a unique role in contributing to consumption growth. While the truly wealthy might consume much more per capita than the middle class, their number is very small. In contrast, the lower income group, while large in number, is often financially constrained to contribute much to consumption growth. Although there is no single definition of the middle class households, they could be characterized as those whose income/disposable income exceeds basic costs of living to a certain degree. This allows them to be capable of using their income for more discretionary spending.

Rising middle class contributes to demand growth for durable goods, services and high value added products. Meanwhile, shares of household budget devoted to food and other basic spending such as clothes decline in response to rising income. In an early stage, even though a burgeoning lower income group within the middle class may not have much impact on the overall consumption in an economy, its purchasing power could raise substantial demand for specific ranges of products that can rarely be reached by the poor such as tourism related services, small electronics devices and electrical appliances.

## II. The rise of EM Asian consumers

In the next decade, we believe that burgeoning middle class phenomenon, which was observed in several developed countries in the past, will recur in several EM Asian economies. With a significant number of new-entry middle class, demand within the region is expected to surge. According to the forecast by Euromonitor International<sup>8</sup>, by 2020, the EM Asian consumer market will grow threefold to about the same level as European market and second only to the US market (Figure 2.2).

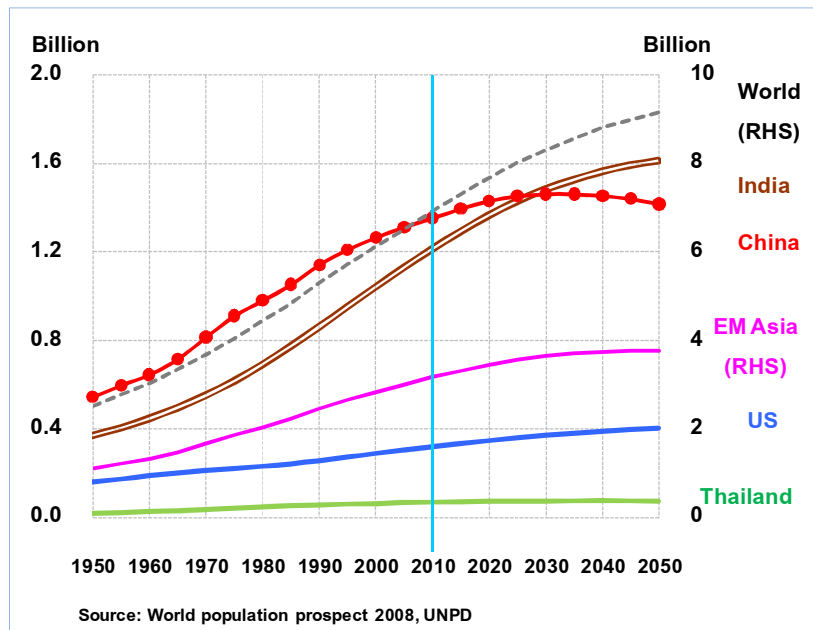
**Figure 2.2: G3 and EM Asian consumption projection**



One important feature of the emergence of middle class in EM Asia is its size. Of nearly the 7 billion current world population, EM Asian economies account for around 45 percent. China and India together share 80 percent, with 44 and 36 percent for each respectively. According to United Nation Population Division (UNPD) forecast in 2008, Indian population is expected to continue growing for the next several decades. In contrast, with a sharp decline of fertility rate in 1970s as a consequence of one-child policy, the Chinese population could reach its peak during 2025-2030 and decline thereafter. That said, within the next 10 years, the overall population of these two countries combined will grow noticeably and in 2020 will account for 45 percent of world population.

<sup>8</sup> Taken from the white paper on international economy and trade by Ministry of Economy, Trade and Industry (METI), Japan

**Figure 2.3: Population**



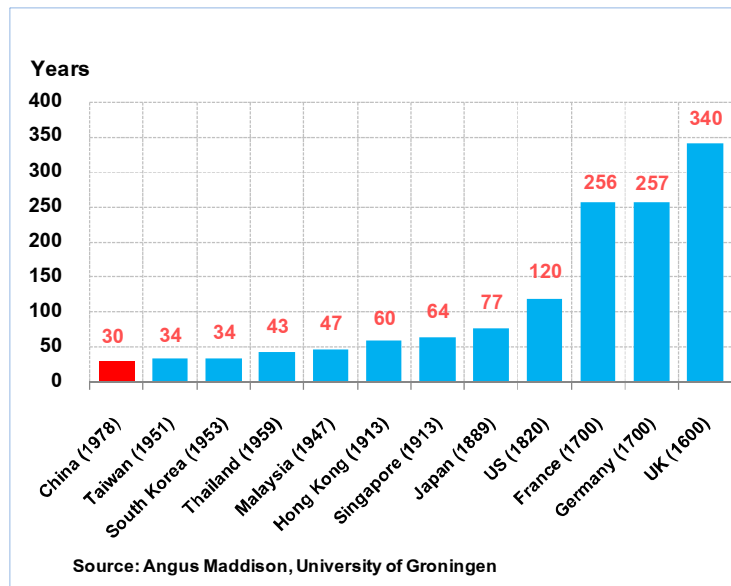
One key observation is, however, that the majority of the expanded middle class in China and India will likely be among the lower income range of the group. However, given its gigantic size, this is expected to create tremendous demand for goods and services for the region. Our following analysis will focus mainly on these two countries.

## II.1 Rising Chinese consumption

According to Angus Maddison’s world historical data, China took only 30 years after the 1978 reform to raise its income per capita (in Purchasing Power Parity: PPP) from USD 1,000 to 7,000<sup>9</sup>. For the UK, Germany, and the US, however, they respectively took 340, 257, and 120 years to make this same income increase (Figure 2.4). Moreover, China’s achievement was notable even when compared to other Asian Tigers during the latter half of the twentieth century.

<sup>9</sup> 1990 International Geary-Khamis dollars

Figure 2.4: Years to raise income per capita from 1,000 to 7,000 USD

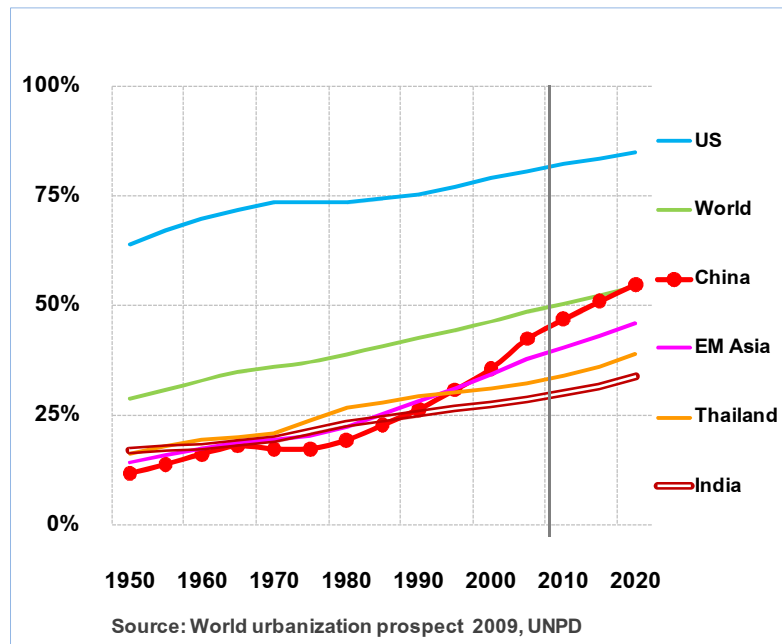


**Parallel to the ongoing economic development, the urbanization process has gained a continuous momentum in China.** With massive labor migration from rural areas to cities, the Chinese population residing in urban areas increased from 12 percent in 1950 to 47 percent in 2010 and is expected to reach 55 percent by 2020 with 786.8 million urbanites according to UNPD forecast in 2009. This “second wave of urbanization” has occurred at a faster pace and in far greater scale compared with the first wave during 1750 to 1950 in Europe and North America. This accelerating progress of urbanization in China has been driven by unprecedented growth in the past decades, attracting migrant labor into cities and catalyzing transitions of rural into urban areas as well as well planned city expansions.<sup>10</sup>

Like in other countries, the main benefit of dwelling and working in towns for rural migrants is in the form of opportunities to develop skills and earn better income as most have shifted from traditional sectors such as agriculture into manufacturing and services, allowing them the attain the middle class status.

<sup>10</sup> Since 1978, Chinese urbanization has been aided by gradual and orderly relaxation of household registration regulation called the “Hukou system” which had been formally in place since 1958 to prevent excessive growth of urban population. The step by step relaxation of Hukou restrictions in connection with infrastructure development and an attempt to help with job search have been part of the economic reform aiming to correction process of resource misallocation (Qiao, 2006).

Figure 2.5: Urban to total population ratio



The unique characteristic of the middle class in China is that the size of those in the rural area is comparable to the urban one. As noted by ADB (2010), “township and village enterprises (TVEs)<sup>11</sup>” incubated by government supports (at an early stage) in the rural areas that accounted for around 33 percent of rural employment in 2008 have had a major impact in providing non-agriculture job opportunities in the rural area and made it possible for the poor to break through the wealth ceiling in traditional sectors.

According to Euromonitor international forecasts, Chinese middle class<sup>12</sup> will double its current level of roughly 500 million to 970 million in 2020. This additional 470 million people with changing spending patterns will profoundly impact domestic as well as regional demand in the next decade.

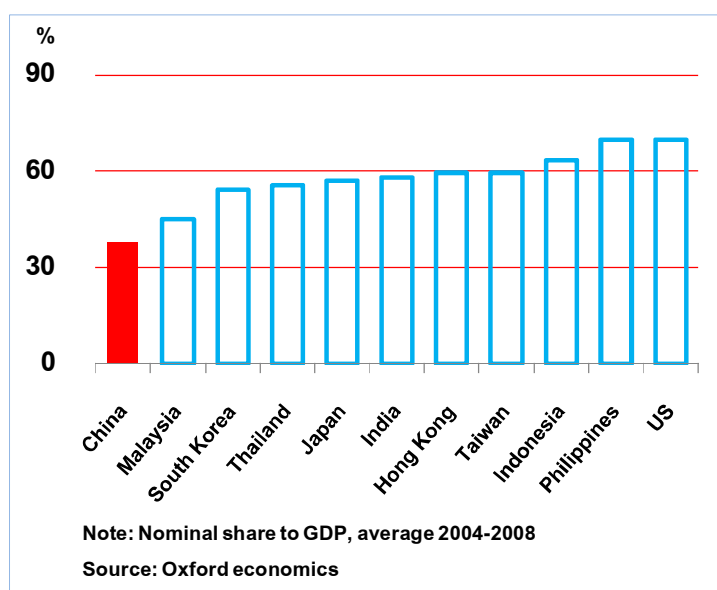
Despite the expected expansion in the middle class population and increasing aggregate consumption, the ratio of consumption to GDP in China is among the lowest in the world unless there is determined effort to solve problems associated with lack of social safety net, distortions stemming from government development strategies that bias toward investment, export oriented manufacturing sectors, and limited access to financial services of SMEs and consumers.

<sup>11</sup> This is also dubbed as “peasant entrepreneurs.” (Fan Y., 1996)

<sup>12</sup> Middle class, in this literature, is defined as household with disposable income falling between 5,000 and 35,000 USD.



**Figure 2.6: Share of household consumption in GDP**



However, there have been important signs of improvements in these areas. In 2006, the Chinese authorities announced a plan to improve social justice<sup>13</sup> with the aim to resolve widening income disparities by further expanding coverage of social safety net especially in the rural area, lowering taxes, and providing exemption for farm income. Moreover, improving income inequality is expected to be one of main goals for the next China's Five-Year Plan (2011-2015), which will be brainstormed in October 2010 and officially announced next year. Another important development in the social safety net area is health care. Since 2006 the Chinese government has actively attempted to improve the health care system with the National health reform blueprint announced in 2009. This plan targets to include all citizens under the coverage of basic health insurance by 2020. (WHO<sup>14</sup>)

Lastly, regarding the policy bias in favor of investment and the export sector, we take the view that China will tackle these issues whenever it is ready to do so, depending more on the domestic economic and social conditions than international political pressures.

## **II.2 India: a later start and slower growth pace than China but compensated by massive population**

On first impression, China and India economies appear to share numerous common features ranging from exhibiting magnificent growth to possessing abundant resources specifically vast pools of population. While China started to undergo a major economic reform in 1978 and gradually re-integrated itself with

<sup>13</sup> Resolution on Major Issues Regarding the Building of a Harmonious Socialist Society at the Sixth Plenary Session of the 16th Central Committee of the Communist Party of China (CPC)

<sup>14</sup> [www.wpro.who.int/countries/2009/chn](http://www.wpro.who.int/countries/2009/chn)

the global economy, India followed much later in 1991. On the economic structures<sup>15</sup>, the Chinese government chose to put more emphasis on export-oriented manufacturing sectors while India emphasized the roles of service sectors and domestic demand as sources of growth. Furthermore, India also substantially lacked behind China in terms of the investment to GDP ratio.

Indeed, underinvestment in India resulted in urban area being left underdeveloped. In 2007, in comparison to China with 362 US dollars per capita expenditure in urban services, India merely spends 50 US dollars per capita on urban services. (Dobbs et al, 2010)

Urbanization in India was also several steps behind China. In 1990, the rate of increase in urban to population ratio stood equally around 25 percent in both countries. Twenty years later, with China's rate soared up to 47 percent, India was left behind at 30 percent. Unfortunately, some government policies to support rural area also hindered the process of urbanization somewhat including the Rural Employment Guarantee Act which guaranteed jobs in rural area for 100 days each year and the absence of taxation on agricultural income.

On a positive note, despite a slow rate of urbanization growth in India, productivity gains from labor migration alone contribute to almost 1 percent of overall growth or approximately half of TFP growth. As estimated by Poddar and Yi (2007), labors in Indian manufacturing and service sectors were around 4 and 6 times respectively more productive than those in agricultural sectors.

In addition, according also to the estimation by Poddar and Yi (2007), the structural shift in GDP growth rate from average of 1990s at 6 percent to 8 percent between 2003 and 2008 was chiefly the result of surge in productivity particularly of manufacturing sectors, which benefited from a decade-long economic reform that has increased competition in the private sectors and required businesses to boost up their productivities.

With India still in the initial stage of urbanization as far greater proportion of labor still employed in agricultural sectors area, the urbanization progress in India has a long road ahead given its growing population which is expected to surpass Chinese population within the next two decades.

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<sup>15</sup> Share in GDP (Value added term)

%	China	India
Manufacturing	48	29
Service	40	53
Agriculture	12	18

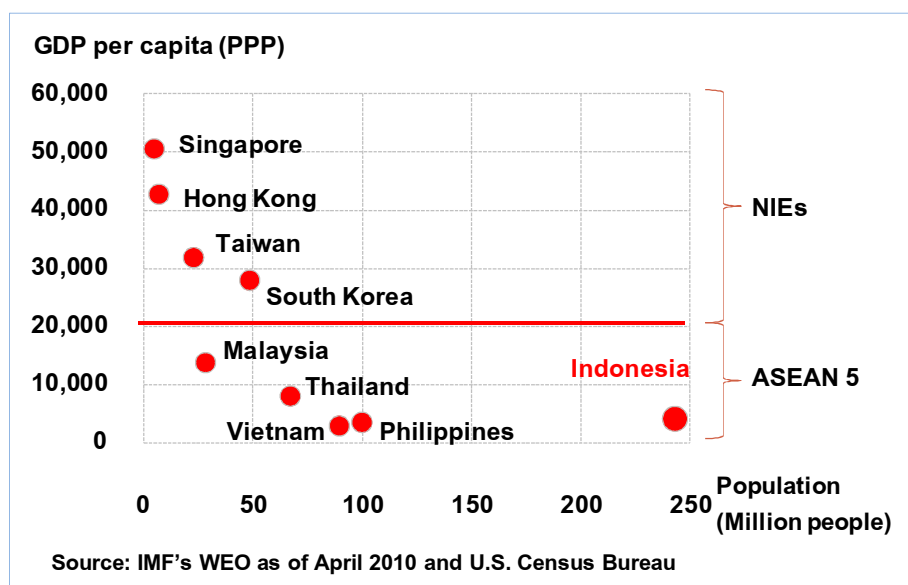
Note: average data between 2005 and 2008

Source: OECD.StatExtracts 2010

## II.3 EM Asian expanding role of consumers

As for the other 20 percent EM Asian population residing in NIEs and ASEAN5, their role as a consumer market is expected to be less substantial than China and India.

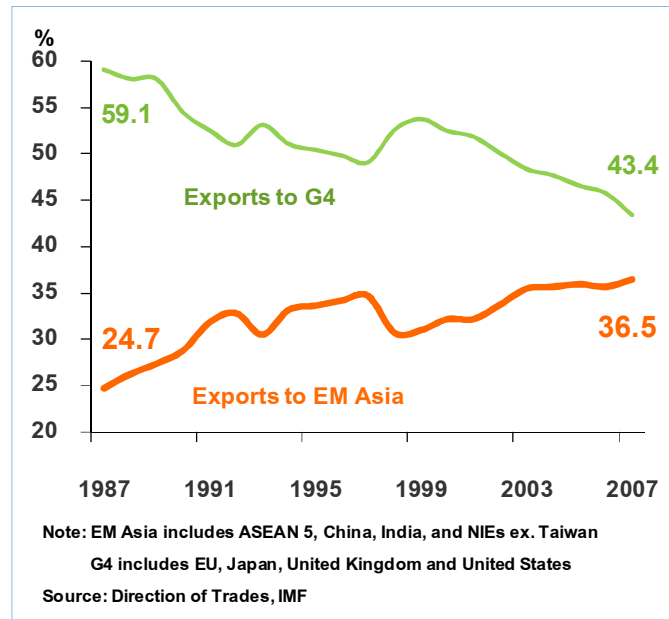
Figure 2.7: GDP per capita and Population



For the NIEs, with income and consumption already among the world highest, the growth prospect of consumption is unlikely to be as sizable as those of China and India. Even if increasing numbers of high income cohort may give extra opportunities for higher value-added and luxurious goods markets, but given their relatively tiny size of population which accounts for merely 2.7 percent of EM Asian population; impacts to the region as a whole are expected to be small. Importantly, the ageing population in the NIE's countries is expected to aggravate in the coming decade. As an increasing portion of consumers grow old and reach the retirement age, their consumption spending tends to contract. This is since the ageing group will mostly rely on their own savings or transfer payments from government and the younger generation.

For ASEAN5, considering the size of population and economic performance, Indonesia seems to have the best potential in term of both strong middle class and demand for goods and services. However, within the next decade, demand from Indonesia will still likely be quite small compared to those from China and India.

**Figure 2.8: Share of EM Asian export values**



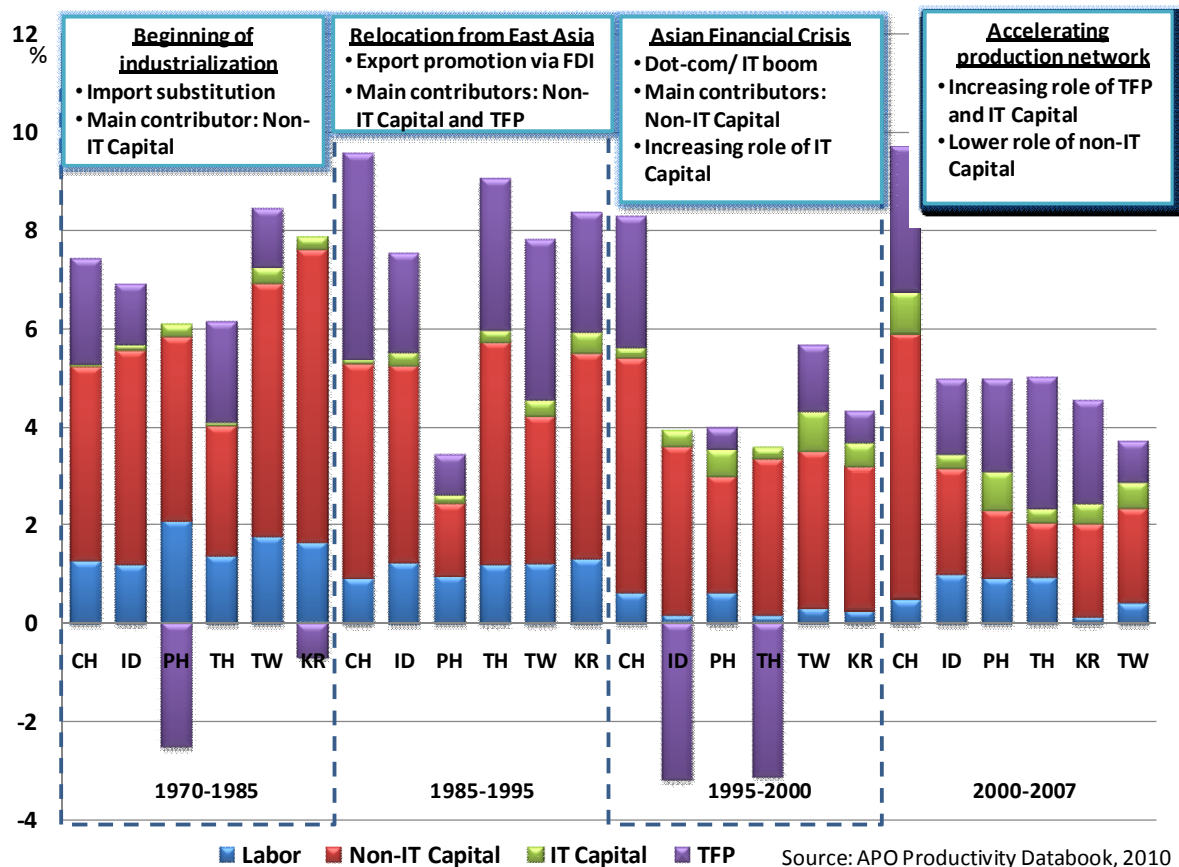
Surges in consumer demand within EM Asia imply that, in many of the countries, rebalancing of growth drivers toward domestic consumption will occur. However, a full transition to domestic demand-led economy still seems, at least in the next decade, to be unattainable. In the long run, for countries endowed with demographic advantages, especially China, the possibility that domestic demand will become main growth driver might be plausible. Somehow, for a small country with a tiny population, the possibility of creating domestic demand to replace external demand is still largely in doubt.

## Chapter 3: The supply-side growth drivers in EM Asia

Equally important to the rise of domestic demand within emerging Asia, the dynamics of Asia supply side factors will provide significant support for EM Asia growth going forward and this chapter examines why that should be the case.

### I. Asian economic growth model in the “old” globalization

Figure 3.1: Sources of Economic Growth (1970-2007)



For the past four decades, Asian economies have exhibited increasing dynamism and outstanding growth performances, though with increasing vulnerabilities to external shocks due to increasing trade and financial linkages. Rapid economic growth in emerging Asia has changed the notion about sources of economic growth prior to 1960s that focused mainly on capital deepening, industrialization, roles of governments and macroeconomic policies and lessening trade liberalization (Berhman, 2001). Since 1960s, trade and capital liberalization, the assimilation of advanced technologies through FDI, and rising exports through regional production network expansion have become crucial drivers of Asian growth.

According to the Asian Productivity Organization (APO) empirical evidence (2010), the evolution of the Asian growth model can be explained by three major

factors namely labor input, capital input (non-IT capital and IT capital<sup>16</sup>) and total factor productivity (TFP<sup>17</sup>) as shown in Figure 3.1.

**1970-1985: This period witnessed the beginning of industrialization in the Newly Industrial Economies (NIEs) in Asia (Korea, Taiwan, Hong Kong and Singapore).** Following the worldwide recession due to the 1973 oil crisis, import-substitution industrialization policies were adopted in NIEs and member countries of the Association of Southeast Asian Nations (ASEAN) (especially Malaysia, Indonesia and Thailand) to reduce reliance on imports and protect domestic industries from foreign competition. China also began reforming the economic restructure and pushing industrial policies, with an emphasis on expanding investment. Capital accumulation in both labor and capital intensive industries was the key contributor to favorable growth in Asia in this period.

**1985-1995: Realizing the limited size of their domestic demand, emerging Asian countries started to advance industrialization through export-promotion policies. Increasing liberalization of trade and capital, offering free-trade/export-processing zones with tax incentives, and subsidizing credit for investment capital for export activities attracted foreign capital into emerging Asia.** About this same time, the 1985 “Plaza Accord” prompted an increase in regional production network of manufacturing goods as Japanese and NIEs’ companies started to relocate its manufacturing production for exports to ASEAN countries, particularly Malaysia, Indonesia and Thailand to gain export competitiveness in terms of prices and labor costs (Abbott, 2003). NIEs also spread their investment in ASEAN countries to take advantage of cost reduction incentives (e. g. low wages, low taxes and attractive exchange rates). This relocation induced massive FDI into ASEAN countries and created cross border production networks of transnational corporations (TNCs) investment (Leelapornchai, 2007). Rising FDI was not only a crucial source of capital accumulation in ASEAN, but also of TFP growth through adopting and learning new technology. In addition, the development of microelectronics technology was an important factor behind the emerging of IT capital in accounting for growth in NIEs. Hence, during the period of 1985-1995, while capital accumulation remained the largest contributor for growth in emerging Asia, TFP growth also played a significant role in achieving respectable growth performance.

**1995-2000: TFP in most of the emerging Asian economies declined significantly after the Asian crisis** and recorded negative contribution to growth in the hardest-hit countries such as Thailand and Indonesia. Non-IT capital

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<sup>16</sup> IT capital is defined as a composite asset of IT hardware (computers and copying machines), communications equipment and computer software.

<sup>17</sup> TFP refers to the contribution to output growth, apart from contribution of factor inputs (i.e. labor and capital). It encompasses the contribution of advanced technical progress, improved human capital and skills, and efficient management techniques.

investment stayed below the pre-crisis levels as firms cut investment and rebuilt their balance sheets. However, IT capital accumulation contributed more significantly to growth as a result of the dot-com/ IT boom during this period. In the case of China, capital accumulation and TFP continued to have the significant role in driving the robust expansion as the Chinese economy was only marginally affected by the Asian crisis.

**2000-2007: This period saw a considerable decrease in non-IT capital contribution in most emerging Asian countries.** The decline in non-IT capital in Thailand, Korea, Philippines, Malaysia and Indonesia was a result of the sharp drop in investment rates after the Asian crisis which was driven by the decline in economic growth, domestic credit, rising prices of capital goods compared to export prices, and particularly public investments, especially in Thailand (Udomkerdmongkol et al, 2010).

### **The important role of TFP in sustaining Asian growth**

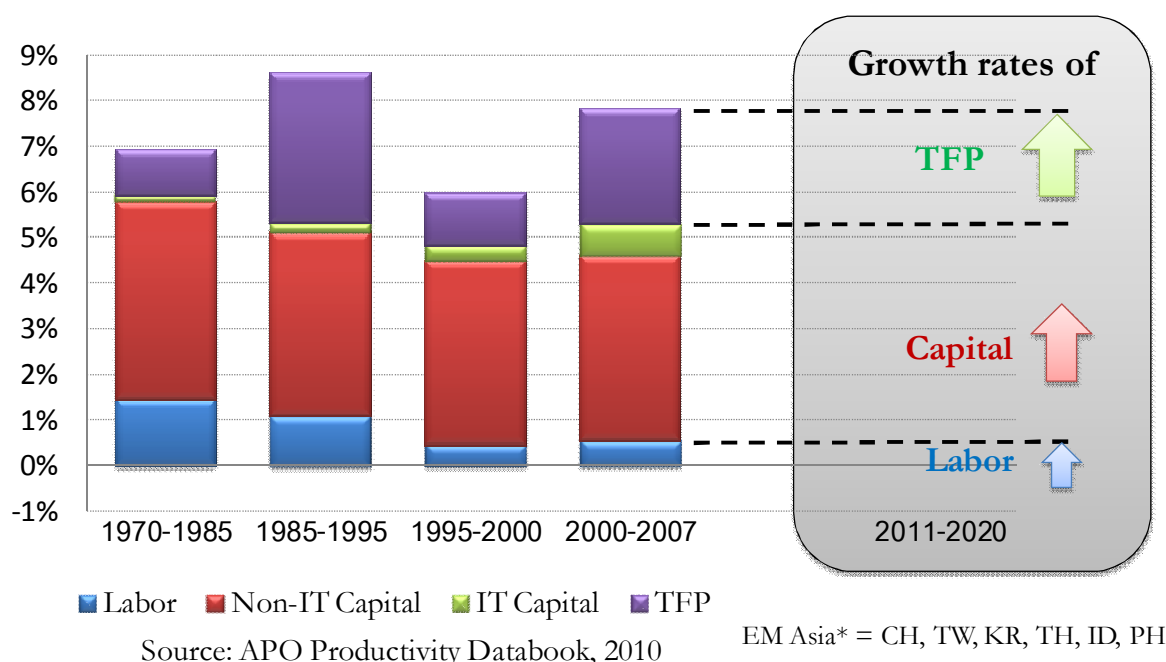
TFP played a relatively significant role in this period in most of the regional economies owing to accelerating production networks of TNCs across emerging Asia with an aim to exports to G4. The production networks across the region enhanced TFP growth by speeding up transfers of technology across the region and stimulating more efficient utilization of capital stock, and increasing economies of scale. Increasing TFP in the export sector in this period provided positive effects to the non-export sector through externalities in the forms of more efficient management, improved production techniques, and improved supply of inputs.

Similar to most countries in the world, contribution to growth from IT capital has continued to increase. The widespread use of IT and regional production networks save impetus to the trade creation process, allowing emerging Asia to become world major exporters of manufacturing goods and the most important electronic exporters.

Unlike other emerging Asia, during the period of 2000-2007, China's non-IT capital accumulation has increased and remained very significant in accounting for its solid growth as a result of its continued investment-driven policy and its increasing role as the chief assembly period for Asian exports since China's entry into the World Trade Organization (WTO) in 2001. The steady rise in IT capital accumulation and TFP also contributed significantly to the very high growth rate in China. Besides, the contribution of TFP has continued to be high due to both adoption and some creations of more advanced technologies, better education and training.

## II. New EM Asian economic growth model

Figure 3.2: Sources of Economic Growth (2011-2020)



**How will the Asian growth model evolve and deliver growth results in the next decade? Our answer is, that we expect that growth in emerging Asia will rely more on regional and domestic demand.** Specifically, the prospects of stronger regional and domestic demand will stimulate the processes of capital accumulation and the improvement in TFP. Moreover, we expect that (1) capital accumulation will continue to support growth through greater intra-Asian FDI, significant infrastructure investment, and conducive environment for private investment, (2) TFP growth will be enhanced through technological progress and gains in technical efficiency, and (3) the contribution to growth from labor input quantity will decelerate due to the slowdown in growth of labor force. With larger capital accumulation and the improvement in TFP growth, we believe that emerging Asia, particularly China and India will grow robustly over the next decade (Figure 3.2). Both capital accumulation and the improvement of TFP are expected to exhibit higher contributions to economic growth.

### II.1 Larger capital accumulation

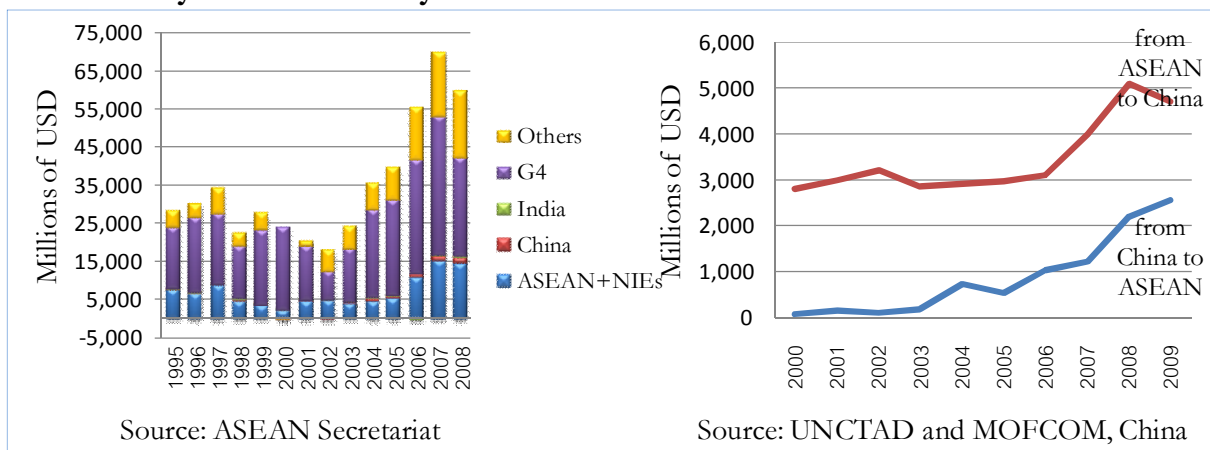
Over the next decade it is likely that capital accumulation (particularly IT) will continue to be a crucial mobilizer of growth in emerging Asia through (i) greater intra-Asian FDI, (ii) significant infrastructure investment and (iii) conducive environment for private investment.



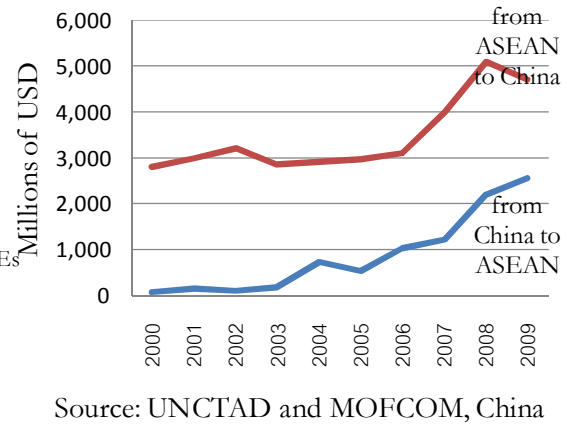
## Greater relative importance of intra-Asian FDI

Intra-Asian FDI has become more than just a source of external financing for capital accumulation but an important driver of improvement in technology and production efficiency. Over the next decade, we believe that intra-Asian FDI will continue more strongly as a driver of growth in this region. Although FDI inflows from G4 to ASEAN have started to decline recently, FDI inflows from intra-Asian countries (i.e., ASEAN, Asian NIEs, China and India) have been on a steady rising trend in line with rising exports. It also has not dropped despite the sharp GDP contraction during the global crisis in 2008 (Figure 3.3). Also, a trend of FDI flows between ASEAN and China has substantially increased since 2007, in parallel with growing trade links (Figure 3.4). According to World Investment Report (2010), intraregional investment in 2008 accounted for around 40 per cent of the total FDI stock of South, East and South-East Asia. Additionally, the services sector has attracted more FDI flows into ASEAN (Figure 3.5), especially in the finance and insurance and real estate sectors (Figure 3.6).

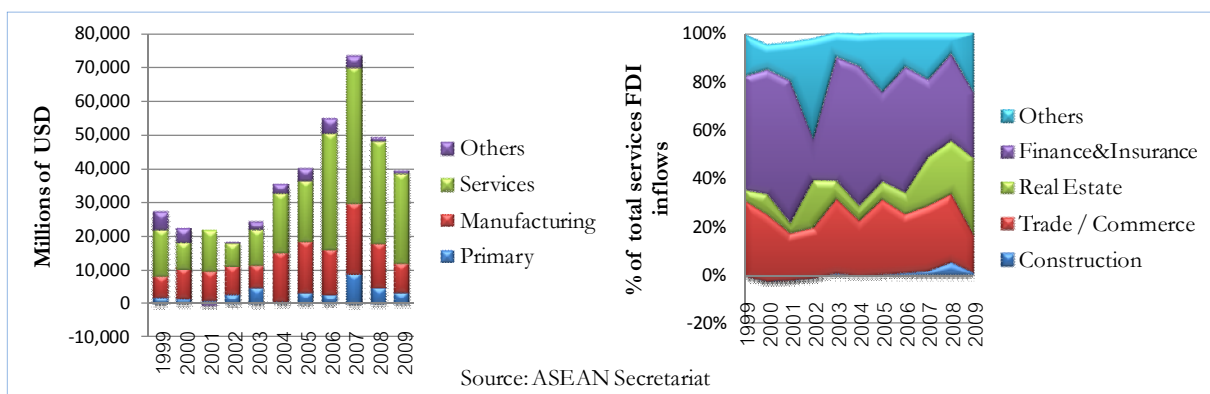
**Figure 3.3: FDI inflows to ASEAN by source country**



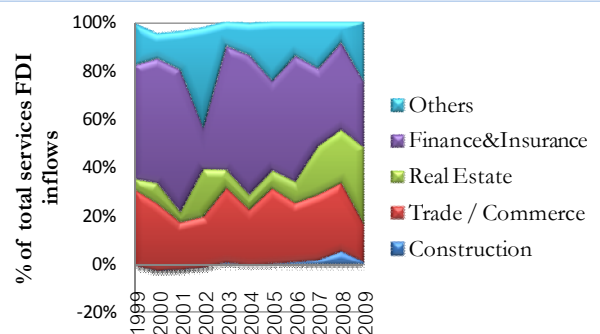
**Figure 3.4: FDI flows between ASEAN and China**



**Figure 3.5: FDI inflows to ASEAN by economic sector**



**Figure 3.6: FDI inflows to ASEAN in services sector**



Inward intra-Asian FDI is expected to continue to increase in the next decade due to Asian economic dynamism and regional integration efforts (e. g. in trade and investment, infrastructure and finance), while outward intra-Asian FDI would be driven by size and dynamic growth prospects of regional markets particular in China and India as well as growing competitive pressure at home countries.

Liberalization of trade in goods and services and investment through regional trade and investment agreements<sup>18</sup> will also be a catalyzing factor for increasing intra-Asian FDI flows. These efforts will help expand and deepen production networks in the region. For example, ASEAN Framework Agreement on Services (AFAS) will offer opportunities for ASEAN investors to access the regional services sectors, many of which are still relatively less developed, in the area of finance, transport, logistics and telecommunications. The rising prospects for intra-FDI in services sector will in turn increase IT capital accumulation. Moreover, the establishment of an ASEAN Economic Community (AEC) by 2015 will provide a wide range of opportunities for investors within the region in the manufacturing and services sectors.

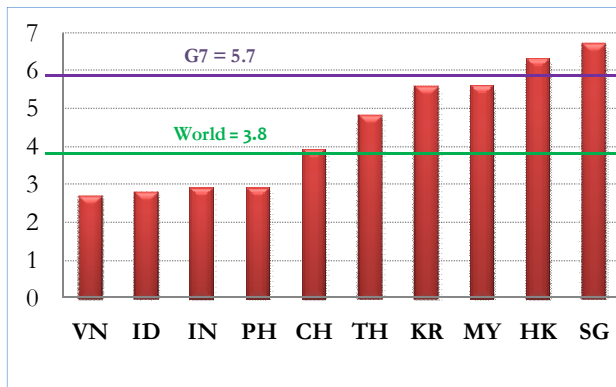
### **Significant infrastructure investment**

Emerging Asia's infrastructure investment is projected to significantly increase over the next decade as the dynamic growth prospects and increasing urbanization require increasing infrastructure especially in transport, energy and communications. Despite continued improvements in several emerging Asian economies, there is still much more to do especially for Vietnam, India, Indonesia, Philippines, China and Thailand to bring their quantity and quality up to meet the world standard (Figure 3.7). According to ADB-ADBI (2009), in order to relieve supply bottlenecks, connect the poor to markets, attract and keep FDI, generate new demand and boost potential output, Asia will need around \$8 trillion for investment in building new infrastructure as well as maintaining and replacing existing infrastructure. Electricity supply, transportation and telecommunication are estimated to account for 51%, 31% and 13% of this total, respectively (Figure 3.8).

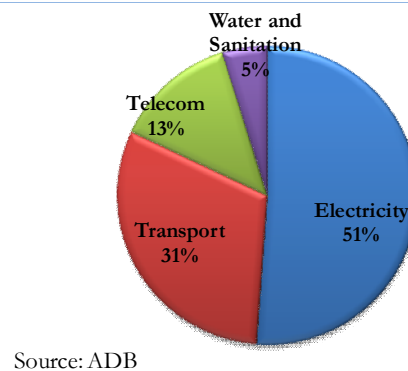
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<sup>18</sup> For example, ASEAN Comprehensive Investment Agreement (ACIA), AFAS, ASEAN-China FTA, ASEAN-Korea FTA, and ASEAN-India FTA (under negotiation on the investment provision)

**Figure 3.7: Overall Infrastructure Quality in 2008 (Transport & Electricity)**



**Figure 3.8: Asia's Total Infrastructure Investment Needs, 2010-20 (\$8 trillion)**



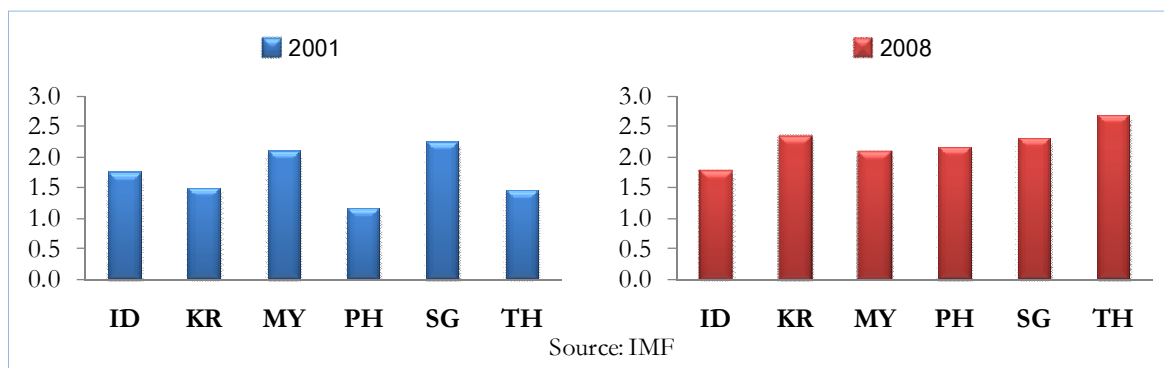
Source: ADB

Infrastructure investment is therefore a top priority in emerging Asia's national economic plans/ reforms such as those for India, China, Malaysia Singapore and South Korea (Box 3). Given the need for massive capital and the limited ability of the government budget to finance these infrastructure investments through a conventional route, the public-private partnership is expected to become an additional vehicle in future infrastructure investment in the region. As improving infrastructure is vital for generating new private investment, well-planned and feasible infrastructure will help bolster growth going forward.

**Conducive environment for private investment**

Economic environment has been conducive to investment in emerging Asia. Strong fundamentals, macroeconomic stability, favorable political conditions in most of the regional economies, improving corporate strength (Figure 3.9), and market-oriented policies have been the main factors that have fostered good investment climate (UNCTAD, 2010). Those favorable factors for investment have significantly been products of continued macroeconomic and financial reforms since the Asian crisis 1997.

**Figure 3.9: Indicators of Corporate Strength (Altman Z-score<sup>19</sup>)**



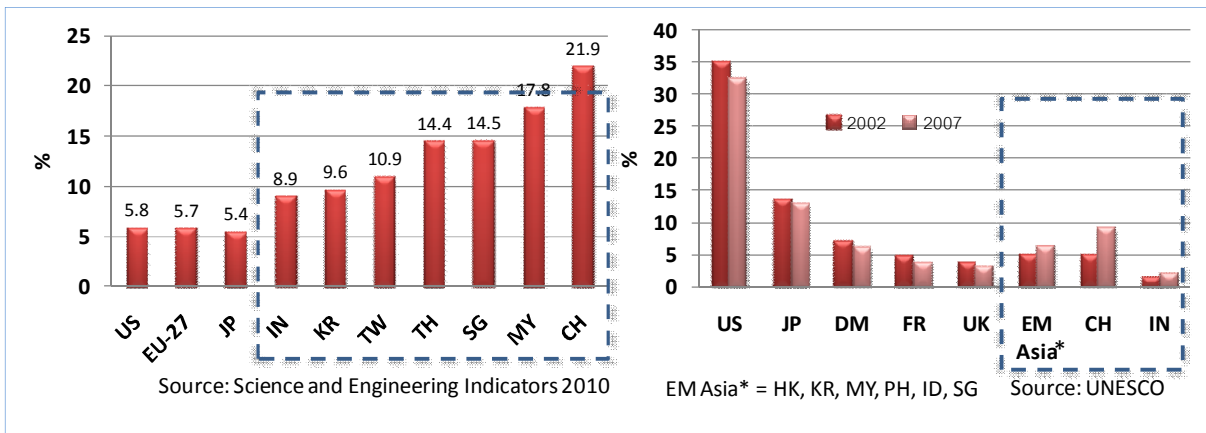
Source: IMF

<sup>19</sup> Altman Z-score is based on several financial ratios including leverage, profitability, and liquidity at the level of the individual firm.

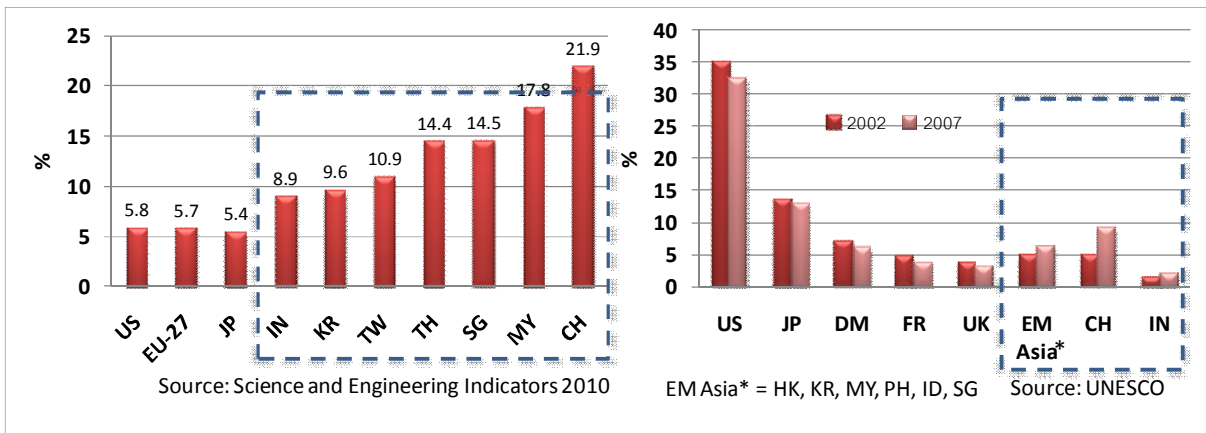
## II.2 Improvement in TFP growth

TFP growth is expected to continue as key factor sustaining the growth momentum in the next decade. The enhancement in TFP growth through technological progress will help to enhance efficiency and prevent the rate of returns on factor inputs from declining. We expect that technological progress in emerging Asia will be gradually elevated by rising technological innovation, better human capital, intensifying regional production network and “frugal” innovation. These factors will continue to create unique dynamism of TFP generation that is specific to this region of the world.

**Figure 3.10: Average annual growth of R&D expenditure, 1996-2007**

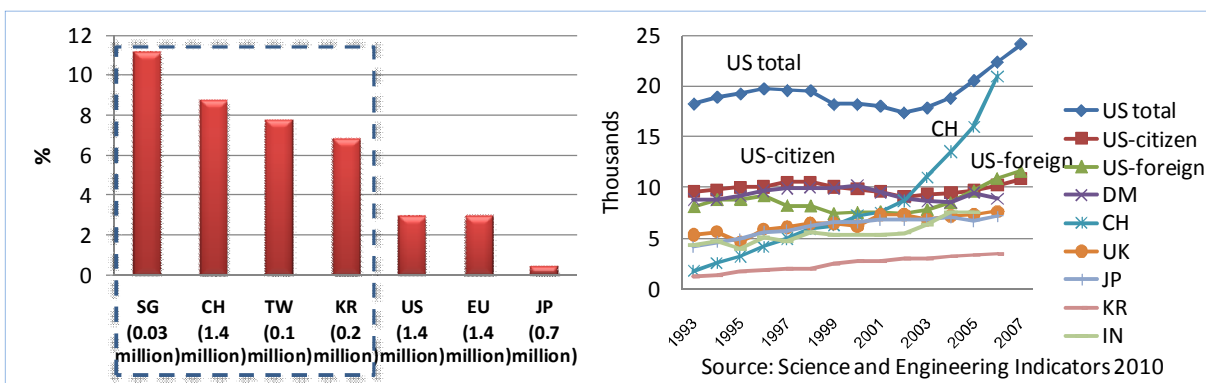


**Figure 3.11: Shares of world R&D expenditure**

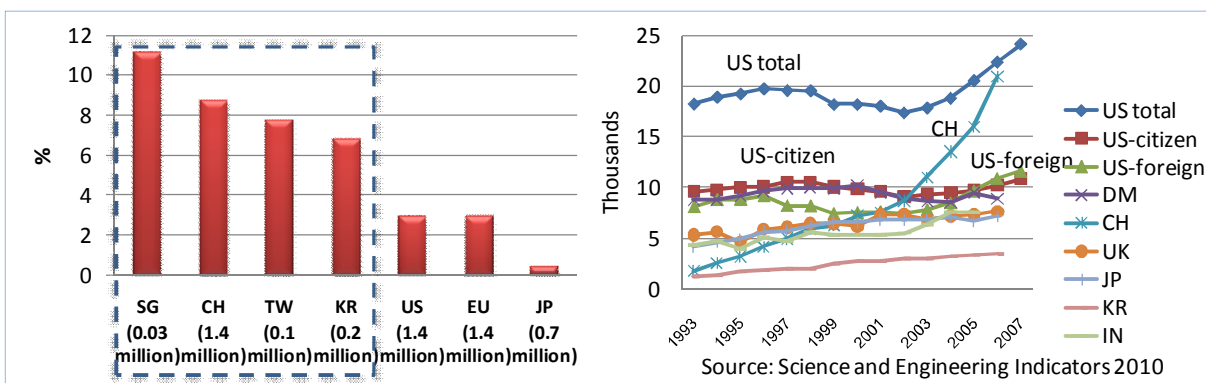


The rapidly growing focus on **technological innovation** in emerging Asia, particularly China, can be seen from the rising growth of R&D expenditure in the past decade (Figure 3.10) and the corresponding share rising share of emerging Asia in world R&D expenditure (Figure 3.11), a contrasting picture to R&D expenditure in developed countries. The trend of growing R&D spending in several emerging Asia is expected to continue in the next decade as regional governments (e. g. Malaysia, Singapore, South Korea, and Taiwan) have highlighted the need to increase R&D activities and focused on developing knowledge-intensive industries (Box 3).

**Figure 3.12: Average annual growth in number of researchers, 1996-2007**



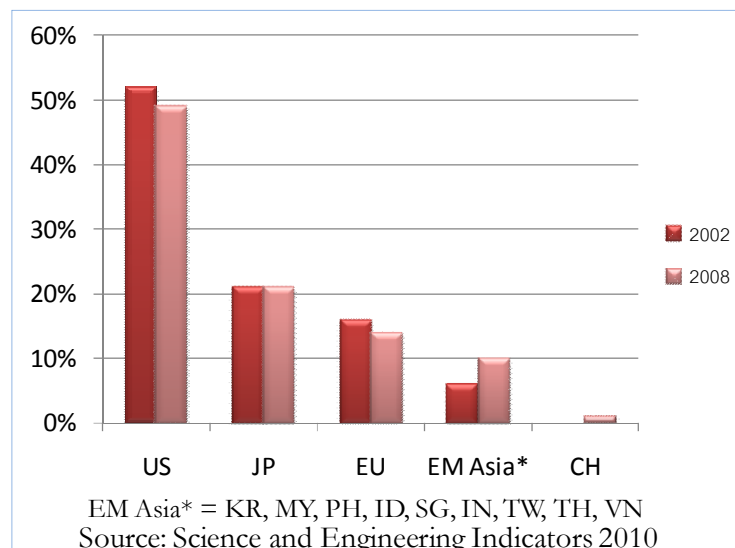
**Figure 3.13: Doctoral degrees in NS&E, 1993-2007**



**Human capital** is recognized as the most important growth driving factor especially as it determines the ability of workers to adapt and implement existing technology as well as to create new technological innovation. Despite being imperfect indicators of human capital, an increasing number of researchers and higher education at levels of population demonstrate positive prospects in higher income economies (i.e. Singapore, China, Taiwan and Korea) in the region. Though we cannot compare quality of researchers, as of 2007 the number of researchers in China was comparable to those in the US and the EU (Figure 3.12). The shares of world journal articles produced by emerging Asia have been increasing, while those of the US and the EU have decreased steadily (National Science Board, 2010). In addition, the number of NS&E doctorates awarded in China has increased rapidly, catching up with that of the US (Figure 3.13). Meanwhile, half of foreign doctorates who earned the degrees in the US were from East Asia, mostly from China, India and Korea. In the next decade, many of these foreign doctorates are expected to leave the US after receiving their degrees, as economic growth prospects at home look more favorable.

So far, emerging Asia-based inventors have gained an increasing share of patents in the US (Figure 3.14). Although the innovation gap between emerging Asian and developed economies will likely continue to be quite wide, the better prospects of technology catch-up through rising human capital will enhance TFP growth in emerging Asia in the next decade.

**Figure 3.14: Share of patents granted in the US**



Emerging Asia's **production network** will play an increasing crucial role in the improvement of TFP growth across the region over the next decade. This is because production network expansion will link up countries at different stages of development in the region to have new opportunities for industrial upgrading. For less developed neighbors, participation in TNCs' regional production networks will

help to enhance TFP growth through technology spillovers and economies of scale (UNCTAD, 2010).

In addition, there is a new trend of **“frugal” innovation** in emerging Asia, mostly led by India. Frugal innovation is a creative development of “new and improved” (i. e. simple and cheaper) products and services to serve huge markets of low- or lower middle-income consumers in emerging Asia more efficiently and effectively (The Economist, 2010a). For example, India’s “Nano car” sells for \$2,200 (by Tata Motors), India’s “the little cool” fridge that runs on batteries sells for \$70 (by Godrej & Boyce Manufacturing), or China’s lithium-ion battery retails for \$12 (by BYD Lithium Battery Co. ). Besides consumer goods, there are also various evidences of frugal innovation in personal care products, banking, insurance, health care products and services, and IT. For instance, Narayana Hrudayalaya Hospital, a flagship heart surgery hospital in India, can drastically reduce the cost of heart surgery to \$2,000, compared with \$20,000-100,000 in the US, and boost its customer base by combining mass-production techniques and specialization. The success of frugal innovation is rooted in a strong understanding of consumer needs. We strongly believe that frugal innovation will thrive in emerging Asia and increasingly help to boost economic growth, consumption and productivity through the next decade.

### **II.3 Slowing growth of labor input**

Over the next decade, the contribution to growth from labor input quantity will continue to be low due to the slowdown in growth of labor force, partly as a result of ageing population. Overall, labor force growth in emerging Asia is expected to grow more slowly than in the past decades (Figure 3.15) due to slowing population growth and diminishing shares of working-age population (Figure 3.16), as a result of the declines in fertility rates in China, NIEs and to lesser extent in AEAN4. The slowdown in labor force could be mitigated by an increase in labor force participation, such as increasing female participation. However, the extent to which labor participation rate in each country will increase over the next decade is difficult to predict. Hence, labor force participation and labor input will be important caveats to our conjecture. Notwithstanding this, we believe that labor participation will not unexpectedly jump over the next decade. Therefore, we assess that contribution of labor input to growth in emerging Asia will still be much lower than those from capital and TFP.

Figure 3.15: Labor Force Growth

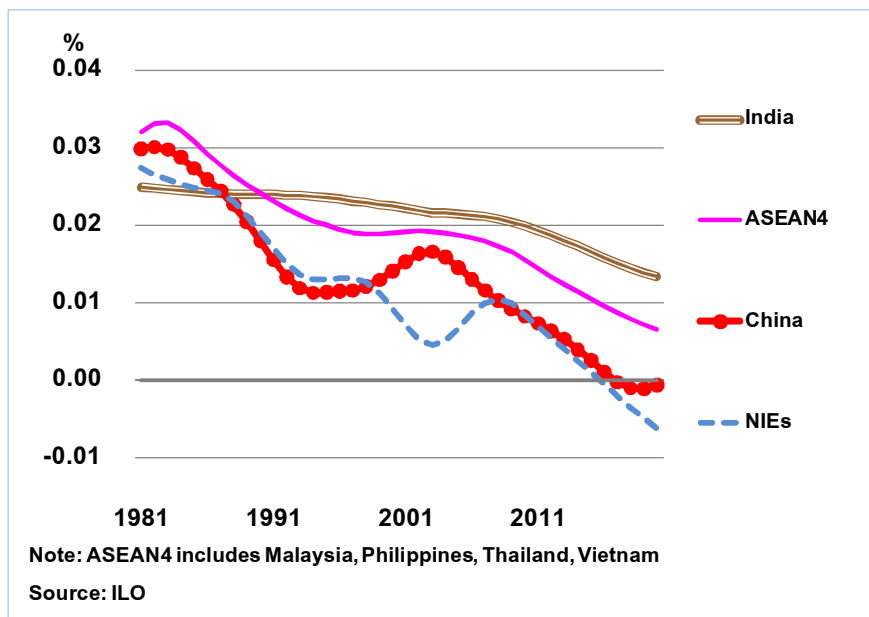
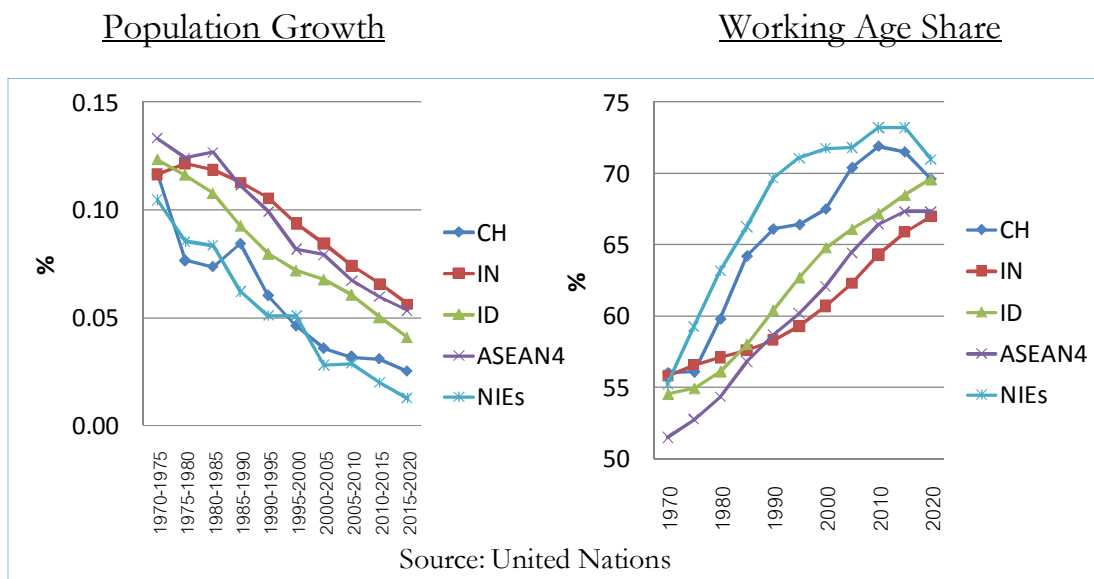


Figure 3.16: Population growth and working age population share



In conclusion, Asia’s economic growth in the next decade is expected to be driven by raising capital and TFP, through significant infrastructure investment, greater intra-Asian FDI, conducive environment for private investment, rising technological innovation, better human capital, intensifying regional production network and “frugal” innovation. Higher income will be derived from the higher capacity to produce in the model. If economic stability is ensured, this higher income in the region will in turn bolster its own domestic demand and regional demand, which would support further economic growth forward.

## **Part III: Financing EM Asian growth**



## **Chapter 4: Global financial flows post-crisis**

The altered global growth dynamics after the recent global crisis is likely to also affect the flows of global capital. While G4 is weighed down by the legacies of the credit crisis, EM Asia is poised for strong growth. As such, global growth differentials, ample global liquidity, and structural changes in G4 economies are likely to affect global financial flows in general, and with them, the volume and volatility of capital flows to EM Asia. The surges in capital flows imply that financing needs in EM Asia can be met without much difficulty.

It should be noted that global capital recycling will also occur, not the least because G4 assets are likely to remain the ultimate safe haven assets, and their currencies the dominant reserve currencies. The rising public debt burden in G4 as a result of the Credit Crisis as well as entitlement financing needs, however, also imply rising riskiness of the supposedly “risk-free” G4 assets. Rising risks and uncertainty of G4 assets also imply the likelihood that volatility of capital flows to EM Asia. Such surges in volume and the possible rise in volatility of capital flows could then affect stability of growth prospects of EM Asia in a significant way.

### **I. Surges in volume of capital flows: Growth differentials and higher expected total returns**

Going forward, there will be three major factors that would contribute to surges in volume of capital flows to EM Asia. One is the prospect of growth differential between G4 and EM Asia. Second is the ample global liquidity that is expected to continue. Third, is the increasing wealth and recycling of such wealth more within Asia, especially intraregional FDI.

#### **I.1 Growth differentials and global liquidity**

Studies on capital flows suggest that there are “push” and “pull” macroeconomic factors that are determinants of capital flows- see, for example, BIS (2009). Strong and economic performance and stable environment of the flow recipient countries are among the “pull” factors. Global liquidity and business cycles of the advanced economies, on the other hand, are among key factors that could “push” capital flows to emerging economies (EMEs). Indeed, in terms of capital flows to EMEs, Calvo, Leiderman, and Reinhart (1996) pointed out that during the early 1990’s economic downturns in most industrial countries helped encouraged capital flows to EMEs as their investment opportunities were deemed more profitable. Later on, this business cycle factor became a less important driver of flows into EMEs as economic conditions in the industrial countries improved. As such, the prospects of weakened G4 growth in the face of strong EM Asia growth dynamics imply that more capital would flow towards EM Asia as investment opportunities there would seem more profitable. At least until G4 economic prospects are improved to a more normal level, the weak G4 growth is likely to encourage more capital flows towards EM Asia.

Figure 4.1: IMF's growth forecast

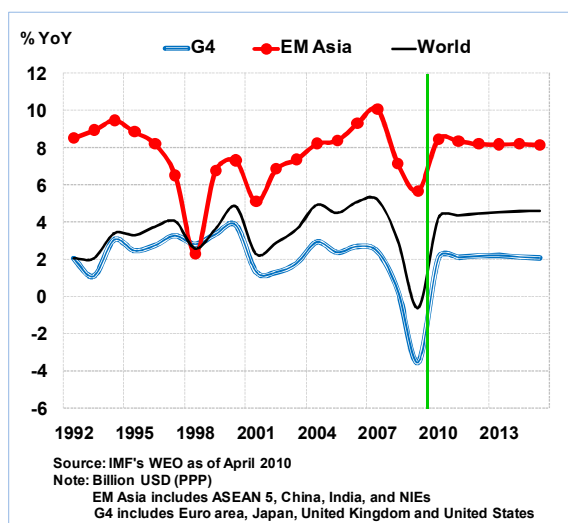
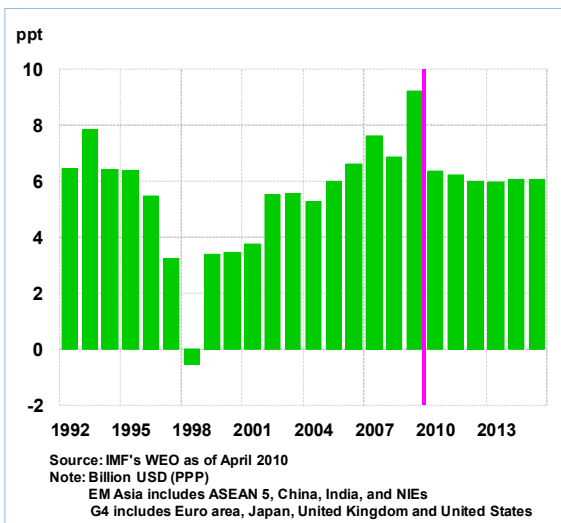
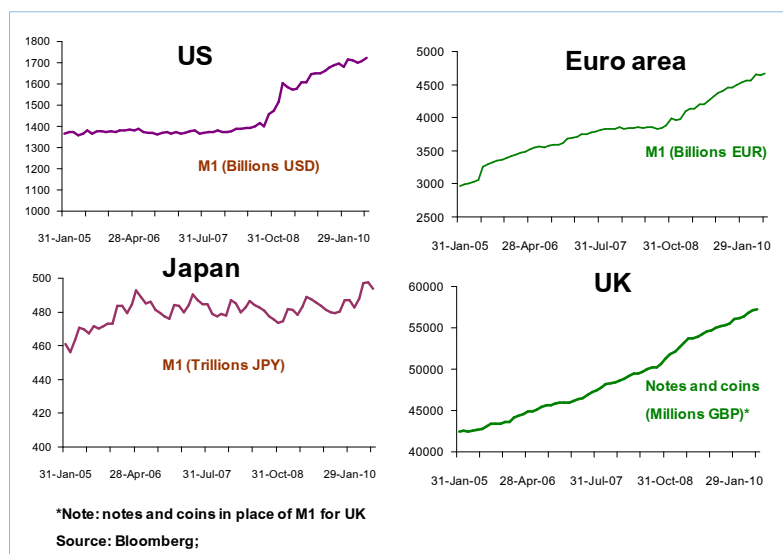


Figure 4.2: Expected growth differential between G4 and EM Asia



Going forward, we expect global liquidity to remain ample.<sup>20</sup> With G4 inflation risks on the downside, but with G4 growth limping, it is likely the case that G4 central banks will keep interest rates low and central bank balance sheets bloated with the assets purchased. Moreover, owing to demographic factors that imply greater saving rates in EME's (especially EM Asia) could also contribute to ample global liquidity going forward – see, for example Ekesen, Lueth, and Syed (2008) and Takats (2010). As such, the likelihood that ample global liquidity would remain also implies surges in capital flows towards EM Asia where future growth prospects are among the most favorable in the world.

Figure 4.3: G4 Liquidity



<sup>20</sup> While the exact definition of global liquidity can vary, it could be defined in terms of low global interest rate, strong money growth in developed countries, as well as the channeling of excess domestic saving in emerging market economies aboard – see, for example BIS (2009).

## I.2 Total return differentials

To assess how the weakened G4 growth and ample global liquidity might imply surges in volume of capital flows to EM Asia, one way is to examine the prospects of return differentials between these two groups of economies. In our case, return differentials can be assessed by comparing total returns from G4 assets versus total returns from EM Asia. Total returns comprise returns that would be earned from holding that asset (i.e. interests or yields), plus foreign exchange gains (if any).

To assess prospective benchmark yields, we would compare the forecasts of risk-free rates in G4 and EM Asia. Risk-free rates are typified by government bond yields and are often used as benchmarks in investment decisions. (For one thing, government bond yields are widely used as discount rates in investment projects.) Government bond yields themselves are partly determined by macroeconomic factors such as GDP growth and inflation prospects, public debt, fiscal balance, as well as policy interest rates and other substitutable assets.

To assess prospective foreign exchange gains, we would compare market exchange rates with those rates consistent with economic fundamentals using the Fundamental Equilibrium Exchange Rate (FEER)- see, Cline and Williamson (2010)- and Purchasing Power Parity (PPP) – see The Economist (2010b) - approaches.

**Table 4.1: 10-year government bond yields in G4 and selected EM Asia countries**

	10y government bond yield forecast*: Q4 2011 (1)	Inflation forecast**: 2011 (2)	10y Breakeven inflation (3)	Expected real yields (1)-(2)	Expected real yields (1)-(3)
US	4.06/3.51	1.67/1.60	1.80	2.39	2.26
Japan	1.49/1.32	-0.22/-0.20	-0.82***	1.71	2.31
Germany	3.65/3.12	1.30/1.30	1.60	2.35	2.05
UK	4.77/3.93	2.35/2.40	2.67	2.42	2.10
Philippines	8.50/8.40	4.00/4.30	-	-	4.50
Indonesia	8.91/8.59	5.78/5.88	-	-	3.13
South Korea	5.70/5.17	3.18/3.20	-	-	2.52
Malaysia	4.50/4.17	2.72/2.65	-	-	1.78
Thailand	3.76/3.72	3.35/3.50	-	-	0.41
China	3.60/3.52	3.25/3.50	-	-	0.35
India	8.22/8.12	8.05/8.00	-	-	0.17
Hong Kong	2.91/3.53	2.79/2.50	-	-	0.12

Note: \*Bloomberg Avg/ Implied forward yield, \*\* Bloomberg Wgt Avg/Median Bloomberg Survey, \*\*\* (8y Breakeven)

Source: Bloomberg, Aug 2, 2010

**Table 4.2: Exchange rate under/overvaluation of currencies against the US dollar**

	Implied PPP of the dollar	Actual dollar exchange rate @ 21/7/10	Under(-)/Over(+) valuation v. USD, @ 21/7/10, %	FEER-consistent dollar rates, May 2010	Market rate, May 2010
<b>US</b>	-	-	-	-	-
<b>Euro Area</b>	1.10	1.28	16	1.31	1.25
<b>Japan</b>	85.7	87.2	-2	84	92
<b>Britain</b>	1.63	1.52	-7	1.53	1.46
<b>China</b>	3.54	6.78	-48	5.50	6.83
<b>Hong Kong</b>	3.96	7.77	-49	6.30	7.79
<b>India</b>	-	-	-	42.6	45.9
<b>Indonesia</b>	6,102	9,063	-33	7,997	9,167
<b>Malaysia</b>	1.89	3.21	-41	2.52	3.25
<b>Philippines</b>	27.3	46.5	-41	40.8	45.6
<b>Singapore</b>	1.13	1.37	-18	0.96	1.39
<b>Taiwan</b>	20.1	32.1	-37	26.2	31.8
<b>Thailand</b>	18.8	32.3	-42	29.2	32.4

Sources: Cline and Williamson (2010)

Using median forecasts of Bloomberg survey for 2011Q4 (the longest forecast horizon available), we found that the expected real 10-year government bond yields in G4 were actually expected to be, on average, 70-100 basis points higher than those in EM Asia (Table 4.1). However, the EM Asia currencies were undervalued against the US dollar (on average, almost 20 percent on FEER term, and 38 percent on PPP term). Meanwhile, the euro, the Japanese yen, and the pound sterling were on average much more in line with the US dollar based on PPP and FEER (Table 4.2).

As such, the expected robust EM Asia growth together with the large undervaluation of EM Asia currencies imply that the room for EM Asia currencies' appreciation is rather large and could more than overwhelm the lower expected real risk-free yields. For completeness, we also compare market forecasts of equity earning yields<sup>21</sup> between G4 and selected EM Asia economies (Table 4.3).

<sup>21</sup> Equity earning yield is the inverse of the price-earning (P/E) ratio. Forecast of the P/E ratio can be derived from the Dividend Discount Model (DDM). The general form of the infinite period DDM is  $P_0 = D_1 / (k - g)$ . Divide both sides of the equation by next year's projected earnings,  $E_1 P_0 / E_1 = (D_1 / E_1) / (k - g)$ . ...cont'  
Whereby  $P_0$  = stock price in period 0,  $D_1$  = expected dividend in period 1,  $(D_1 / E_1)$  = the expected dividend payout ratio,  $k$  = the required rate of return on the stock =  $(1 + \text{risk-free rate})(1 + \text{inflation premium})(1 + \text{risk premium}) - 1$ ,  $g$  = the expected constant growth rate of dividends

Apparently, for 2011 (the longest forecast horizon available in Bloomberg), expected G4 and EM Asia equity earning yields are broadly similar. Going forward, we deem that growth differentials and total returns differentials (especially from expected currency gains rather than from risk-free or equity earning yield differentials) would indeed at least partly contribute to surges in volume of capital flows to EM Asia.

**Table 4.3: Expected equity P/E and earning yields in G4**

	P/E			Earning yields (%)		
	6 Aug 2010	Est. 2010	Est. 2011	6 Aug 2010	Est. 2010	Est. 2011
Dow Jones Industrial Avg.	13.89	12.81	11.37	7.2	7.8	8.8
S&P 500	14.93	13.45	11.66	6.7	7.4	8.6
NASDAQ Composite	24.76	17.18	13.93	4.0	5.8	7.2
DAX Index	13.77	11.52	10.23	7.3	8.7	9.8
Nikkei 225	24.55	17.46	15.69	4.1	5.7	6.4
FTSE 100	18.53	11.06	9.53	5.4	9.0	10.5
CSI 300 Index	19.05	16.29	13.32	5.2	6.1	7.5
Shanghai SE A Shares	19.69	15.75	13.07	5.1	6.3	7.7
Hang Seng	14.74	14.14	12.07	6.8	7.1	8.3
BSE SENSEX 30 Index	18.52	17.07	14.19	5.4	5.9	7.0
Jakarta Composite	31.32	15.15	12.63	3.1	6.6	7.9
FTSE Bursa Malay	17.36	15.17	13.54	5.8	6.6	7.4
PSEi –Philippines	11.78	13.12	12.26	8.5	7.6	8.2
Straits Times Index	12.06	14.60	13.37	8.3	6.8	7.5
Taiwan TAIEX Index	16.57	13.47	11.93	6.0	7.4	8.4
SET Index	13.44	12.64	10.82	7.4	7.9	9.2
Ho Chi Minh SEI	10.58	10.08	10.98	9.5	9.9	9.1

Sources: Bloomberg as of 6 August 2010

## II. Surges in volatility of capital flows: risks on “risk-free” assets, shorter business cycles, etc.

Going forward, it seems that there are various reasons to believe that volatility of capital flows to EM Asia will increase. First, the Credit Crisis has imposed risks and uncertainty on the supposedly “risk-free” G4 assets. Second, the possibility of shorter (and more volatile) G4 business cycles as a result of the Credit Crisis also implies greater volatility in capital flows. Third, despite its robust growth dynamics, EM Asia also has its own risks, from overheating to politics.

Fourth, the more intensified trade and financial linkages imply that shocks are more easily transmitted inter- or intra-region.

## II.1 Rising risks of “risk-free” assets

After the Credit Crisis, the issue of sovereign risks has taken on new dimensions. Although G4 -US, Germany, Japan, and UK in this case- are unlikely to default on their debt, their fast rising *debt burden* implies increasing risks of the *supposedly risk-free assets* –possibly through *the need to inflate their way* out of debt. Although their triple-A rating remained, the Credit Crisis had frontloaded more fiscal burdens on G4 which previously had already been on the trend towards mountains of contingent liabilities related to social security and healthcare of their aging populations. The heavy debt burdens that came with stimulus policies and banking sector bailouts in the US and the UK put questions on the status of the US dollar and the UK as the reserve currencies. Although Germany did not take on direct debt burdens as a result of the Credit Crisis, the possibility that she has to bail out other member states of the euro area that might run into financing troubles also put questions to the status of the euro as a reserve currency. As Japan is still coping with deflation and her fast-aging population, it seems uncertainty has increased over the longer run even for the supposedly risk-free G4 assets.

Despite rising sovereign risks, however, there is no clear alternative to G4 assets as the ultimate safe haven. Although there are advanced countries (e.g. the Nordic countries, or Australia and New Zealand) that have better combinations of debt level and debt dynamics than G4, their economies are much smaller and thus their assets are unlikely to replace G4 as the ultimate safe havens anytime soon. As for EM Asia powerhouses such as China and India, although their economies are likely to grow faster than those of G4 and the sizes of their economies are in the same league with GS, uncertainty regarding things like transparency, governance, or policy risks imply that their assets are unlikely to replace those of G4 as the ultimate safe haven assets anytime soon either. Such uncertainty surrounding the supposedly “risk-free” and safe-haven assets will indeed make global financial environment more volatile.

## Box 1: Major International Reserve Currencies in the Next Decade

The global debate regarding the future role of the U.S. Dollar has generated questions about its status as a major international reserve currency. One could point to the declining share of the U.S. Dollar in the world's foreign exchange reserves (FX reserves) as evidence of the currency's declining role. According to the IMF's Currency Composition of Foreign Exchange Reserves (COFER) data, the share of U.S. Dollar in advanced countries' FX reserves declined from 69.8 per cent to 64.7 per cent while emerging economies share of the U.S. Dollar declined from 74.8 per cent to 58.0 per cent between 2000 to the first quarter of 2010. On the other hand, the Euro saw its shares in FX reserves substantially rise since its inception from 18.4 per cent to 25.2 per cent in advanced countries and from 18.1 per cent to 29.5 per cent in emerging economies during the same period.

**Table B1: Currency Composition of FX Reserves**

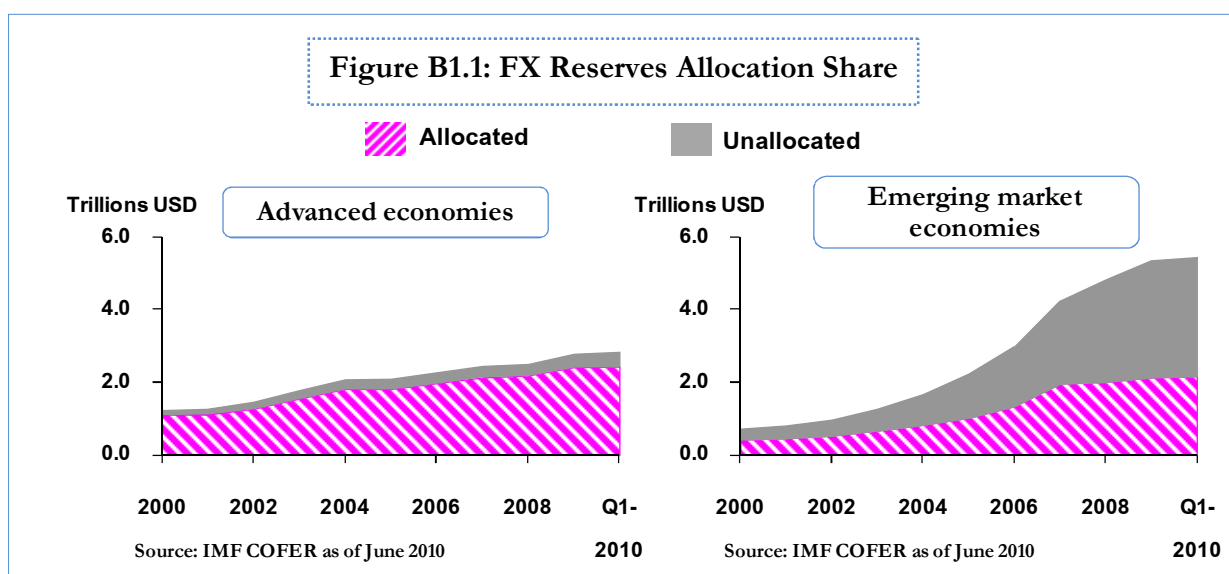
% of Allocation		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010
World	Dollars	71.1	71.5	67.1	65.9	65.9	66.9	65.5	64.1	64.1	62.2	61.5
	Pounds	2.8	2.7	2.8	2.8	3.4	3.6	4.4	4.7	4.0	4.3	4.3
	Euros	18.3	19.2	23.8	25.2	24.8	24.0	25.1	26.3	26.4	27.3	27.2
	Yen	6.1	5.0	4.4	3.9	3.8	3.6	3.1	2.9	3.1	3.0	3.1
	Others	1.8	1.6	2.0	2.2	2.0	1.9	2.0	2.0	2.3	3.2	3.8
Advanced	Dollars	69.8	70.6	66.5	67.2	67.3	69.3	68.2	66.1	67.2	65.4	64.7
	Pounds	2.8	2.7	2.8	2.3	2.7	2.7	3.3	3.5	2.7	2.8	2.8
	Euros	18.4	19.0	23.2	23.0	22.8	21.2	22.1	24.1	23.1	24.8	25.2
	Yen	7.3	6.1	5.4	5.2	5.0	4.7	4.3	4.0	4.3	4.1	4.3
	Others	1.8	1.7	2.1	2.3	2.3	2.1	2.2	2.3	2.7	2.9	3.1
Emerging	Dollars	74.8	73.8	68.6	63.1	63.0	62.7	61.5	62.0	60.7	58.5	58.0
	Pounds	2.6	2.8	2.8	3.8	4.9	5.1	6.0	5.9	5.4	5.9	6.1
	Euros	18.1	19.7	25.3	30.2	29.2	29.2	29.5	28.6	30.0	30.1	29.5
	Yen	2.7	2.4	1.7	1.1	1.3	1.5	1.3	1.8	1.9	1.8	1.9
	Others	1.7	1.2	1.7	1.9	1.5	1.5	1.7	1.6	2.0	3.6	4.5

Note: SDR Weight in 2005; US Dollars 44%, Euros 34%, Yen 11%, Pounds 11%

Source: IMF COFER as of June 2010

However, caution needs to be exercised in interpreting this data. One needs to take into account the mounting levels of unallocated reserves as well as the rise of Sovereign Wealth Funds (SWFs)

**Unallocated reserves** are part of the FX reserves that cannot be separated into currencies due mainly to the fact that some countries refuse to report their data. This share has been increasing and is mostly concentrated in emerging economies' FX reserves (Figure B1.1), giving rise to the possibility that U.S. dollar holdings may be underestimated.



**The value of assets under management of SWFs** has increased significantly since 2005 and its origin mainly from emerging economies. As of June 2010, the global value of SWFs is 3.89 trillion U.S. Dollars, rivaling the size of emerging economies' international reserves in Q1-2010 which was 5.50 trillion U.S. Dollars. Unfortunately, SWFs do not report their currency compositions.

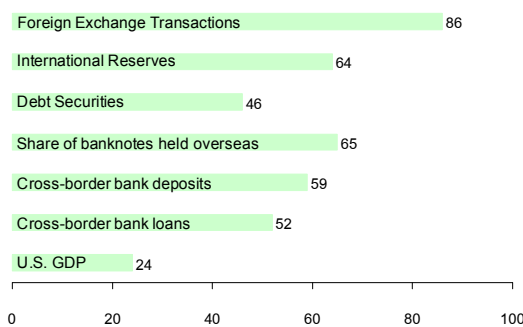
Nevertheless, the U.S. Dollar may still be a major reserve currency in the next decade due to the numerous factors as follows:

**Economic and Financial Market Size:** Currently, the U.S. is still the largest economy with the biggest financial market in the world (Figure B1.2). Although the Eurozone economy may only be slightly smaller, the recent sovereign debt crisis has undermined confidence in its currency. Some analysts have forecasted that China's economy may overtake the U.S. in the near future, but the fact that its financial market is still plagued with regulations and their currency still inconvertible makes the Renminbi an unlikely candidate. Moreover, neither United Kingdom's Pound Sterling and the Japanese Yen possess a financial market with an



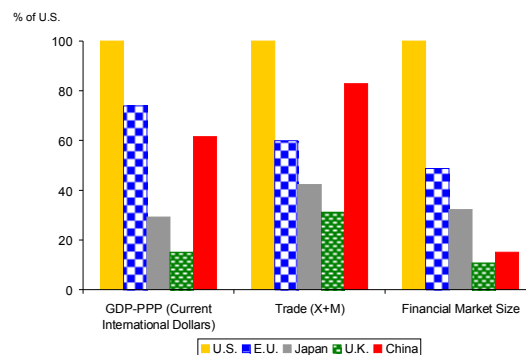
abundance of liquidity as the U.S. In lack of a clear alternative, the U.S. Dollar endows *network externalities*, a characteristic that helps maintain its wide usage throughout the world (Figure B1.3). From the U.S. Dollar’s widespread use, *inertia* becomes apparent as it becomes harder for market players to switch to a new currency because in doing so entails cost and time.

**Figure B1.2: Factors affecting International Reserve Currency**



Source: IMF (2010b)

**Figure B1.3: Share of US Dollar in Financial Transactions**



Source: International Trade Centre, Bloomberg, and EuroStat

**Geopolitics:** The U.S. has been able to retain its political role despite the recent global financial crisis, and this had preserved its allies “peg” to the U.S. Dollar.

**Special Drawing Rights (SDRs) as an alternative:** Discussions about a new reserve asset prominently brings the IMF’s SDRs to the spotlight. Its value is based on a basket of currency which some believe may serve as a better store of value than the U.S. Dollar. However, the SDRs have many limitations, including a lack of liquidity and its usage restricted only to member countries.

At least in the short-run, the U.S. dollar would still be a major reserve currency. It is still a viable possibility that the share of U.S. dollar in the world’s FX reserves may still be in decline, but no currencies would be able to overtake the U.S. as a major international reserve currency because no clear alternatives exist. Going forward, conditions that may cause changes to the current regime could be that the U.S. continues to implement unsustainable fiscal and monetary policies or other transformations of the monetary conditions occur, such as the liberalization of China’s capital account, measures to make the Renminbi more convertible, or developments on the SDRs market to increase its liquidity and access.

## **II.2 Shorter (and more volatile) G4 business cycles**

As capital flows have been found to also depend on business cycles of advanced economies, if G4 business cycles become shorter, then this could contribute to more volatility in capital flows. Post-bubbles Japan provided a tell-tale sign for G4 future economic prospects. For the past 20 years, after the equity and property bubbles burst in 1989-1991, Japan experienced 5 episodes of recessions, where a recession is defined as two-or-more consecutive quarters of real GDP contraction. Although various reasons including policy failures to prevent deflation from setting in, probably contributed also to vulnerability of the Japanese economy after the burst of the bubbles in the beginning of the 1990's, for other advanced economies there seem to be a number of risk factors that could make their business cycles going forward. Commentators are suggesting that business cycles in advanced economies could become shorter, owing to structural problems culminated in the Credit Crisis – see, for example Jen (2010). First, debt overhang in the public, banking, and household sectors are likely to weigh down on G4 growth with possibly a lower GDP-trend growth, an economy with impaired balance sheets is likely to be more recession prone, *ceteris paribus*. The household sector, for example, cannot embark on consumption binges based on leverages to support the economy forever. The household sector's fragile balance sheet also implies that consumption could be more constrained, going forward.

Second, with fiscal and monetary policies almost overly stretched, the authorities will have less room to maneuver their economies going forward. Third, given the above two factors, uncertainty surrounding policy decisions is also rising. High fiscal debts, low policy interest rates, and bloated central bank balance sheets imply that to pre-empt inflationary expectations, tightening of these policies should be done as soon as the authorities see fit. Too fast a withdrawal of stimulus policies, however, could derail the recovery process, especially when the private sector is still weakened. For Japan, there were a few instances where policies that had been earlier been tightened were later reversed, as economic growth slipped after the tightening.

## **II.3 Risks of EM Asia itself**

Despite the strong economic dynamics, risks inherent in EM Asia economies can also lead to volatility in capital flows. Among the more prominent “known-unknowns” are (1) the possibility of overheating and (2) uncertainty in policy and geopolitics.

The growth prospects of EM Asia are inducing more domestic investment as well as international capital flows. When an economy is growing fast, there is always a danger that an influx of capital inflows would find its ways to pockets of the economy prone to speculation such as the stock or property markets forming asset price bubbles. Indeed, with EM Asia becoming more integrated, a burst of bubbles in one of the larger economies could affect the region as a whole. Given

the possibility that such risks do really exist, as news of fast-rising stock and property markets have recently been coming from cities around EM Asia, it is very probable that when the risks become realized, fast capital flow reversals will occur.

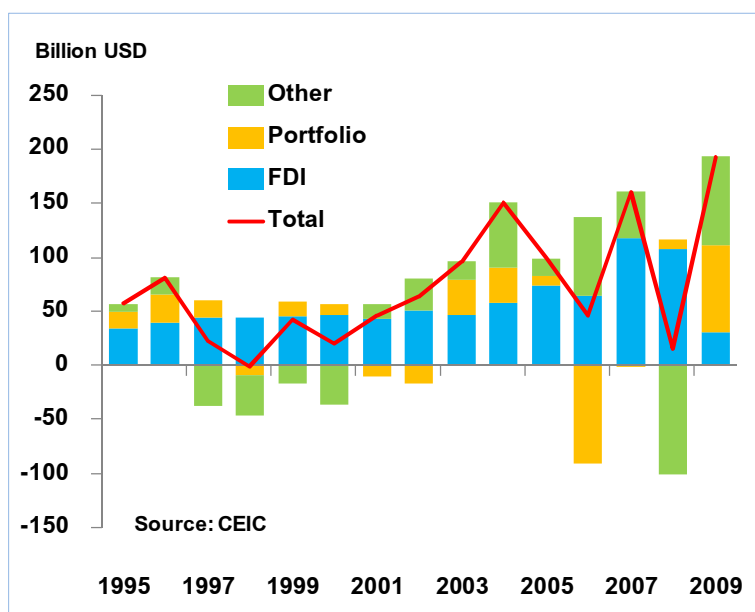
Apart from the possibility of overheating, policy and geopolitical uncertainty is also an inherent risk for investment in EM Asia. Unstable political regimes could imply more unpredictability and more uncertainty in public policies. Such unpredictability and uncertainty, in turn, affect prospects of investment returns and could lead to more volatile capital flows.

## Chapter 5: Financing the new Asian growth model

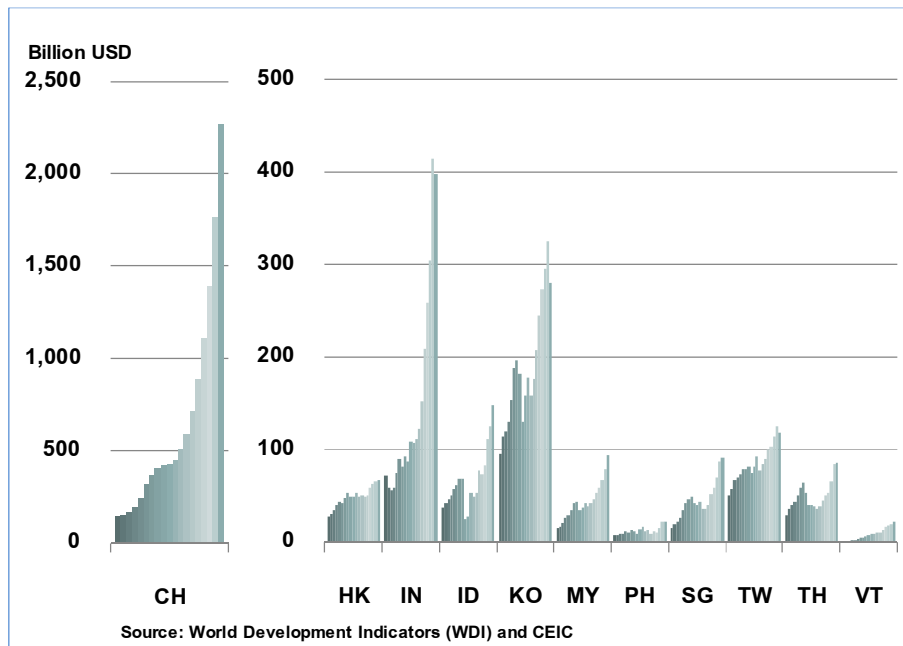
This chapter examines the overview of how the financial sector in EM Asia could effectively finance EM Asia growth going forward. Even though the concerns of financing are not in the limitation of funding source, due to the surge of capital inflows and large savings pool in Asia, obstacles to the success of the new Asian growth model could come from the process of channeling funds to the real economy – the effectiveness of capital allocation process.

Amidst the rising capital inflows both through portfolio and others (bank flows) channels, EM Asia economies also have abundant savings to fund regional economic activities. Capital flows into EM Asia has increased constantly, except 2005 and 2008. Savings that owe their significant size to fast export-led growth in the last few decades have also been on a rising trend and increased more than three-fold over the past 8 years from 2000 to 2008. The increase in savings has been most striking in China (five fold from the year 2000 to 2008) and contributed almost 70 per cent to regional total savings in 2008. Altogether, we deem EM Asia to have an ample source of funding, with caution that vigilance must be kept on the use of capital inflows risky activities.

**Figure 5.1: Net capital flows into EM Asia**



**Figure 5.2: Savings by country (1990-2008)**



Of greater concern than the adequacy of financing is the effectiveness of the capital allocation process by the financial sector in this region, both (1) “efficiency” and (2) “inclusiveness” where main issues are:

- (i.) The lack of breadth in regional equity and bond markets make them vulnerable to volatile capital inflows, aggravating uncertainty in the financial markets,
- (ii.) Underdeveloped risk culture amidst large credit supply and high growth prospect could send economies into bubbles, overheating and large losses, and
- (iii.) Limited financial access could lead to slower economic and income growth.

Further into this chapter, we will look at the evolution of financial intermediation in this region, both through capital market and banking system. Efficiency of capital allocation process and inclusiveness problem will be assessed. Various reforms relevant to each aspect of capital allocation process will also be discussed together with implications on the functioning of financial system going forward. Analysis carried out in this section will lead to a conclusion that there is much room for further improvement, an act that is crucial to support the new growth model of this region.

### **I. Efficiency – Intermediating resources to the projects with the highest risk-adjusted returns**

As put by Tobin (1989) and Wurgler (2000), the social purpose of the financial system is to allocate an economy’s savings to their highest value

**uses.** Efficiency of such process contributes to sustainable economic growth through awarding high value projects with appropriately-priced finance and thereby driving obsolete ones out of the market. Efficient intermediation process also limits systemic instability that might arise from inappropriate financing that normally lead to overheating, accumulation of non-performing loans (NPLs), failure of banking system and economic recession. Whilst banks in this region have gained strength over the past decade putting them in a better place to perform such role of intermediation, there are still various aspects that need improvements.

In this section we identify three areas that need improvements so that efficiency in EM Asia resource allocation will gain; (1) development of regional bond and equity markets, (2) introduction of risk-return decisions to complement relationship bank lending, and (3) improvements in risk management in banks and financial markets.

### **I.1 Bond market**

***Bond markets are mostly underdeveloped and hence fail to effectively complement banking sector in performing financial intermediary role***

Traditionally in EM Asia, banks are the main source of external financing for the real sector, both corporations and individuals. But as putting all eggs in one basket is excessively risky, relying solely on banks convey the same message. The 1997 financial crisis is one good example where bank failure amidst lack of alternative source of financing led most countries in this region into recession due to the shortage of funds to finance any growth potential. Fully developed bond market will also attract large corporations from banking sector, forcing banks to search for new customer base. Smaller corporations and individual who have more problems from asymmetric information and need to rely on financing from banks would as a result have more space for negotiation.

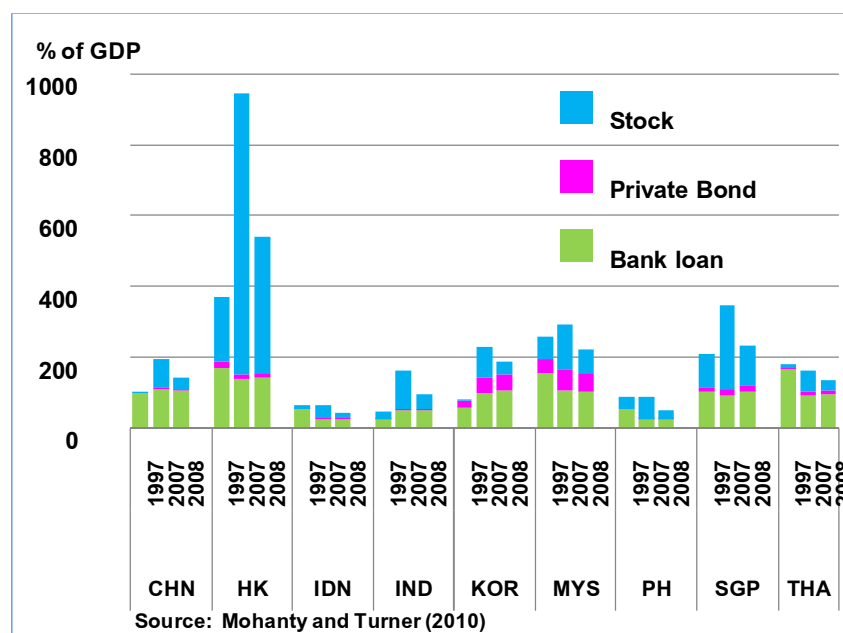
Since the 1997 financial crisis, various reforms and developmental plans have been put forward by countries in this region, both individually and collectively. Regional initiatives so far have tried to address problems from both supply – Asian Bond Market Initiatives (ABMI) – and demand – Asian Bond Funds (ABF) Initiative by EMEAP<sup>22</sup> – sides (Hyun et al, 2008). The aim altogether is to develop efficient and liquid bond markets in Asia through setting up favorable infrastructure to facilitate both local- and regional-currency bonds and establishing ABF to lead and catalyze investment in regional bonds. Removal of impediments

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<sup>22</sup> EMEAP: Executives' Meeting of East Asia Pacific Central Banks which is comprised of Reserve Bank of Australia, the People's Bank of China, the Hong Kong Monetary Authority, Bank Indonesia, the Bank of Japan, the Bank of Korea, Bank Negara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral Ng Pillipinas, the Monetary Authority of Singapore, and the Bank of Thailand

and market reforms so far include tax reforms, improved regional market infrastructure, and reduction of cross-border settlement risk<sup>23</sup>.

**Figure 5.3: Financial intermediation**



As a result of past reforms, the overall conditions in regional bond markets have improved, with some countries outperforming the others. To examine the role of different financing channels and its contribution of the economy, we look at market capitalization relative to GDP as illustrated in the diagram below. Ratio of bond markets to GDP is biggest in those countries that already have deeper bond market namely South Korea and Malaysia and continues to be bigger. Bond market development in Thailand is also evident with proportion relative to GDP rising from 2 percent in 1997 to 13 percent in 2008.

Going forward, with reforms showing their fruitful results in terms of better legal and institutional infrastructure and more credible yield curve due to higher secondary market activities, increasing capital inflows should lead to faster deepening and further expansion of bond market. Whilst a deep and well-functioning bond market is crucial for capital allocation, it is also very important for smooth operation in conducting monetary policy and for uncovering price (interest rates) to reflect the cost of funds at each maturity and for a given risk profile (Turner, 2002). Efficient regional bond market will also support recycling of domestic savings across countries within this region.

<sup>23</sup> By establishing a custodian net work covering all eight EMEAP markets and introducing a set of credible, representative and transparent bond indices in the form of the iBoxx ABF indices (EMEAP WGFM, 2006)

## **I.2 Banking system**

While development in bond market will continue to decrease the share of banking sector in providing external finance to the real sector, we believe that banking system will continue to dominate other financing channels in this region. The responsibility in carrying out effective intermediation then lies in the hand of the banking sector, within which there are many problems yet to be fully resolved, namely the lending behavior and risk management framework. Going forward, we see that increasing open up to foreign investors as well as the lessons from the recent financial crisis will foster higher efficiency of the financial sector in this region.

### **Key problems**

#### **a. Bank lending is largely influenced by relationship rather than risk-return profile**

Limiting business losses is one obvious way to ensure that funds received are put into most efficient use. Granting loans based on relationship rather than risk-return profile is therefore a clear impediment of efficient capital allocation process. Risk-return profile is the most fundamental concept of investment where returns received from investment must at least cover the losses that might occur over the course of transactions. Simple calculation of lending rates for example must at least cover (i) funding cost (deposit rates), (ii) operating cost such as loan documentation, loan monitoring and collateral valuation, and (iii) risk costs comprising expected loss and return on capital that must be maintained to absorb unexpected loss (loss conditional on economic recession that might occur in the future).

The 1997 financial crisis and the banking problem in China in 1990s are very good example of the lack of reliance on risk-return profile in doing business. Relationship lending during an economic upturn normally leads to overlending in certain sectors or certain groups. Such sector or group concentration, eg. real estate in 1997 and state-owned projects for Chinese case, is eventually translated into bad assets that put a drag on intermediary roles.

In solving this, awareness over significance of risk-return concept has been raised through fostering supervision on credit evaluation process. As relationship continues to be important in order to know your customer well, other factors such as ability to service debt and collateral evaluation to limit default losses must be thoroughly considered. What is left now is how rigorously such risk culture will be implemented in the region, the culture that is even more difficult to change amidst high growth prospect and increasing credit supply.

#### **b. Better risk management but further improvement is necessary**

Over the past decade, the concept of risk management has been at the core of financial reforms. In addition to the risk-return profile that should determine



which customers and at what price loans should go, comprehensive risk management framework needs to include risk identification, measurement, monitoring, hedging and reporting. Without these, excessive risk taking and insufficient risk oversight could easily lead to banking crisis.

One major change in regulation that put very high importance on risk management framework is the Basel capital guidelines, issued by the Basel Committee of Banking Supervision (BCBS), a committee under the roof of Bank of International Settlement (BIS). For large global banks, the Basel guidelines have allowed them to calculate capital requirement from their well-established internal rating systems.<sup>24</sup> For emerging economies on the other hand, the Basel guidelines introduce and put emphasis on developing the internal rating system and integrating the results into day-to-day banking business.

Over the past decade especially since the launch of the Basel II guideline in 2004, most of the large and well-established bank in this region have now had internal rating system in place and in the process of (some may have finished) integrating the results of the internal rating system into banking business and transaction pricing. But key obstacles in developing risk management framework in Asia is (i) the lack of sound internal control and oversight framework that could lead to incorrect information for risk management decisions, (ii) the lack of quality and quantity of data and (iii) the paucity of human and system resource (Choi, 2007). Further improvement in these areas is crucially needed both in terms of culture, technique and framework in order to well serve our economy going forward.

## **Supporting factors going forward**

### **a. The changing landscape in banking sector**

Whilst capital flows bring in foreign investors into capital market, favorable growth dynamics bring in foreign players into the banking sector. Looking around, having foreign players in the banking sector is not new. Selling shares to foreign investors is believed to bring in many benefits to the local economy. Flows of funds, knowledge, skills, resources and creation of positive externalities to the banking community such as efficiency and risk management are amongst many good aspects of foreign participation.

Over the past decade, higher foreign participation has been a result of banking crisis that expose vulnerabilities of this sector to the eyes of government and public. The financial crisis in 1997 for example allowed foreign investors to take up failing banks and become a fully foreign-owned bank with branching

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<sup>24</sup> Internal rating system is used to provide risk ranking and risk quantification, the tool that is very useful for internal management both in considering loan application, managing risk from already-granted loans and setting target customers. (Bank of Japan, 2005)

network already established. Privatizing various state-owned banks and expanding banking scope for foreign banks have also been the events over the past decade, especially the last few years.

The Chinese banking sector is one of the most important examples of financial open-up in this region. As banking opportunities increase, China Banking Regulatory Commission (CBRC) has also expanded business scope of some locally incorporated foreign banks to offer renmibi retail businesses, underwrite government bonds, issue bank cards and engage in derivatives trading. Minority shares of various Chinese banks have also been sold to foreign investors; as of end-2008 ICBC, BOC, CCB and BOCm<sup>25</sup> have attracted 9 foreign institutional investors, 24 small and medium-sized commercial banks formed partnership with 33 foreign institutional investors and 3 rural cooperative financial institutions also attracted 3 foreign institutional investors (CBRC, 2008).

Going forward, organic M&A or takeover will become increasingly intensified in order to reap the full benefits of abundant funding source and lending opportunities through already established branch network. Within this region, the crisis did intensely raise awareness of the critical need for well-functioning financial sector. Amidst an existence of many state-owned banks in this region, the arguments that foreign participation tends to increase competition and efficiency of the financial system will lead to further opening up of the financial sector.

**Figure 5.4: Changing landscape in banking sector**



Another outcome of this recent financial crisis is weakening global banks, leaving those that remain healthy, both global and regional, fighting vigorously to increase their coverage in this region. Examples are from both global banks like Standard chartered bank and Santander and regional banks like CIMB. Based on the Bankers top 1000 banks ranking for 2010, half of the profits are from China, confirming opportunities for bankers in this region. But since branch system is crucial in gaining business operations in this region especially to benefit from vast savings pool and lending opportunities, setting up local incorporation in the

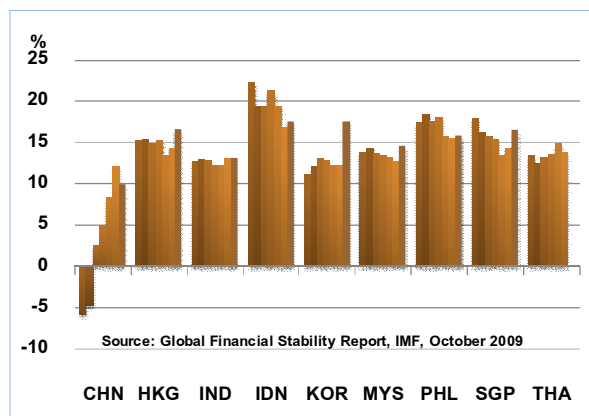
<sup>25</sup> ICBC: Industrial and Commercial Bank of China; BOC: Bank of China; CCB: China Construction Bank; BOCm: Bank of Communications

answer. This form of setting is also preferred by national authorities due to capital buffer set aside in host countries for any losses that might occur. The last crisis also showed that at times of financial difficulties, attention and financial support in home countries might not travel far enough to small host countries.

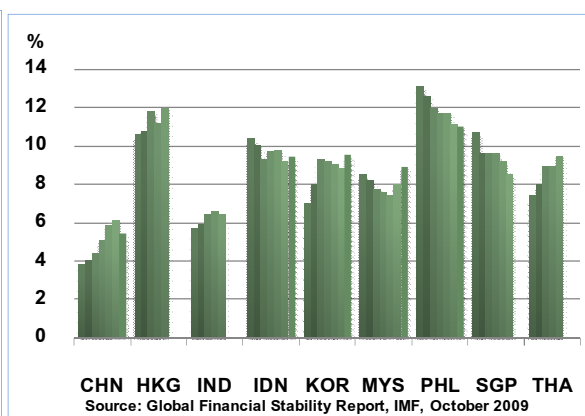
### b. Greater emphasis is now on resilience of the banking sector

As most structural ratios of banking strength are positive, the attention is now turned to the resilience of banking sector in face of systemic shock that might occur. Diagram.. shows that banks in this region have become stronger over the past decade. The quality of banks' assets improved dramatically with the ratio of non-performing loans to total loans trending downwards and provision coverage ratio increasing. The BIS ratios<sup>26</sup> are above minimum requirement with China improving dramatically from negative numbers to approximately 10 per cent whilst over-leverage is not the problem in this region.

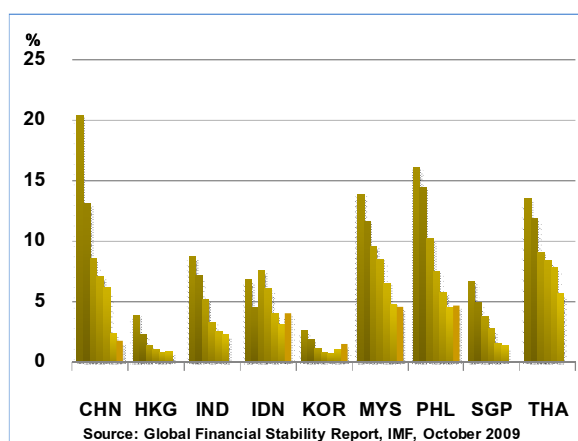
**Figure 5.5: Capital to risk-weighted assets (2003-2009)**



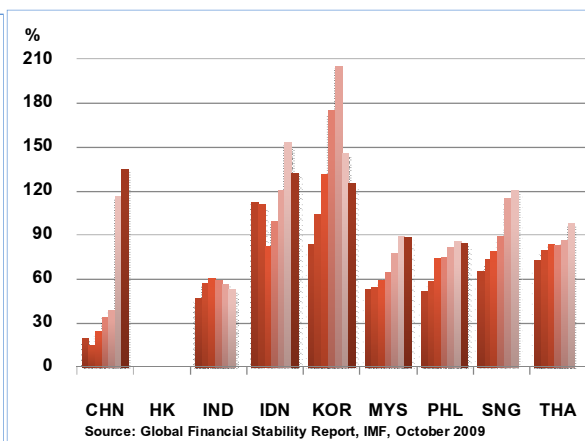
**Figure 5.6: Capital to assets (2003-2009)**



**Figure 5.7: Non-performing loans to total loans (2003-2009)**



**Figure 5.8: Provisions to non-performing loans (2003-2009)**



<sup>26</sup> The ratio of capital to risk-weighted assets which illustrates how much buffer banking sector has to absorb unexpected loss, either from more than expected market movement, more than expected default risks/losses and various operational losses

The key concern here however is whether these banks can be strong throughout an economic cycle. Possibly, the major cause of these good numbers can simply be the good economic environment in this region over the past decade and they have only been lucky so far. Resilience against potential shock to the system to keep the economy going forward is crucial.

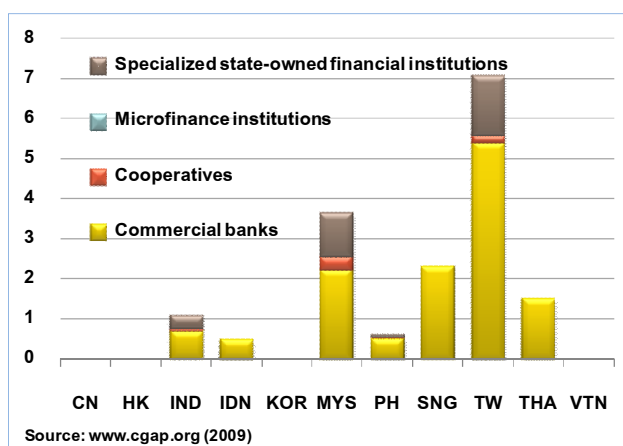
New regulatory initiations have been launched as a result of the recent financial crisis in advanced countries to ensure that banks can be viable in bad times. Important proposals include (i) having larger stock of good-quality capital to absorb unexpected losses, (ii) setting aside more provision in good times to reduce impacts of losses in bad times, (iii) introducing new liquidity ratios to ensure that banks maintain sufficient liquid assets to keep them out of insolvency in stress periods and (iv) higher recognition of stress testing to ensure enough conservatism is kept as banks and supervisors look into the future. Consequence of less pro-cyclicality and uncertainty should limit the problems of asymmetric information that inhibit economic agents from engaging in economic activities and render economic expansion more sustainable.

## II. Inclusion – Improvements can be made regarding access, especially for SME’s and microfinance

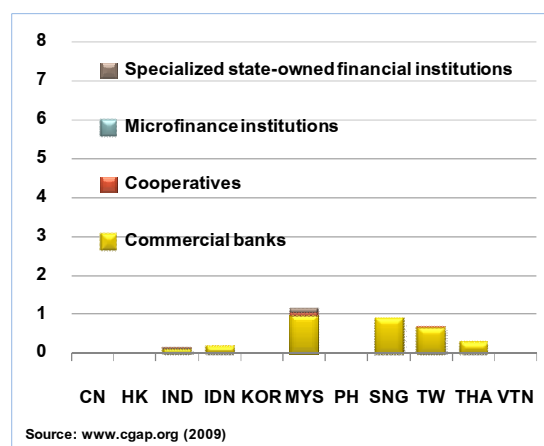
### Financial access to SMEs, low-income individual, customers in rural area is still limited

Financial inclusion of the financial sector is important in (i) gaining more savings to finance economic activities, (ii) supporting economic expansion through allowing new firms to start up and reducing risks to which such firms are exposed and (iii) reduce precautionary savings and thereby boosting domestic consumption by individuals.

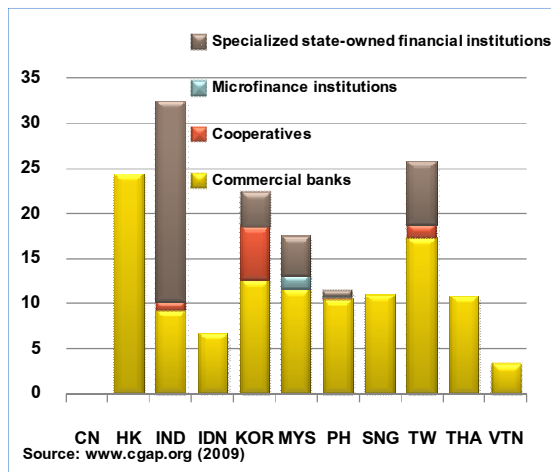
**Figure 5.9: Deposits accounts per 1 adult**



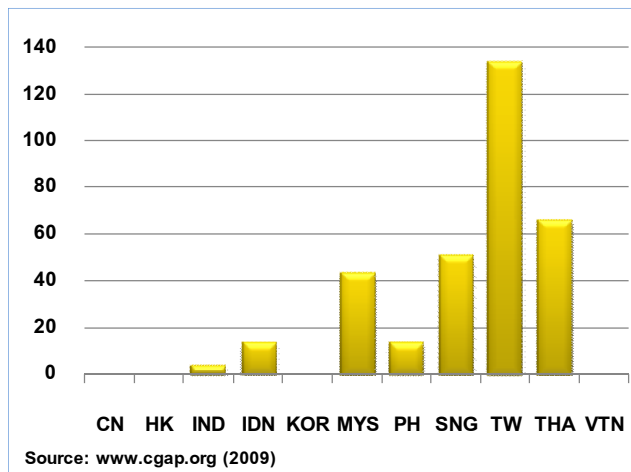
**Figure 5.10: Loan accounts per 1 adult**



**Figure 5.11: Branches per 100,000 adults**



**Figure 5.12: ATMs per 100,000 adults**



Data from survey conducted by Consultative Group to Assist the Poor (CGAP) show that financial access in this region is truly a problem, especially in India where its large saving pool has still far from being fully mobilized despite strong economic growth. Access to loan is also limited in Indonesia, India and Thailand. Problems in China are also acute with various counties not having any branches or ATMs to provide financial services. The important role of microfinance institutions and specialized state-owned financial institutions reflects the inapplicability of current business models employed by commercial banks to expand services to this segment.

Enhancing financial inclusion is now at the core of most countries' financial reform in this region. The Financial Sector Master Plan I & II by Thailand both put high emphasis on financial access of SMEs and rural area population by designing a retail bank license specifically offer services to SMEs and individuals. China also prioritizes the reforms of rural financial institutions at the top level together with reforms of large commercial banks. While also supporting SME lending, CBRC "accelerated the construction of financial service system in rural areas by adjusting and relaxing the market entry policy for banking institutions in the rural area under the principle of commercially viable strategy" (CBRC, 2008). India on the other hand is in the process of cleaning up weak rural co-operatives credit unions to enhance efficiency, self-reliance and quality of management, corresponding to their importance in the Indian social-economic system (RBI, 2009).

In sum, we see various positive factors inside the financial sector that has the ability to well finance the new Asian growth model going forward. Abundant funding source and various reforms and rigorous implementation to improve many hindrances within this sector are the most important in contributing to sustainable growth in this region. But risks do exist, especially amidst the fast growth prospect and surging yet volatile capital inflows. Financial development must be pushed

forward even further to ensure that any potential benefits that are arising in this region can be fully reaped especially when instability within the banking sector has been the usual cause of systemic risk to the overall economy historically.

## **Part IV: Risks and Opportunities and Positioning Thailand**

## Chapter 6: Risks and Opportunities and Positioning Thailand

### I. Opportunities

Discussions in the above sections suggested that the changing global landscape will provide opportunities for Thailand at least in two important areas. The first area involves intra-regional trade and production network. The second area involves access to inter and intra-regional capital.

As a matter of geography, Thailand is located right in the middle of dynamic EM Asia region. The increasingly interconnected intra-regional road and railway networks will enable more efficient production and distribution of goods as well as open Thailand to more tourists. With booming neighbors and greater access to more efficient intra-regional transportation networks, international trade and tourism will present vast opportunities for Thai exports.<sup>27</sup> Not only bilateral trade with our regional neighbors is expected to flourish, our position as a key player in the regional production network such as those in the automobile, computer parts or consumer goods derived from chemical products industries is also expected to gain from the more intensified connection within the region, not the least because production logistics could be done more seamlessly and and/or intra-regional distribution done more efficiently.

Apart from trade, discussions in the above sections also suggest that, going forward, Thailand is likely to enjoy ample access to capital. Dynamic EM Asia growth and ample global capital imply that inter-regional capital flows to the region, including Thailand, will continue to rise. On the other hand, with EM Asia savings expected to continue growing, while G4 growth prospects remain weak and saddled with uncertainty, intra-regional capital flows to Thailand are also expected. Going forward, if the Thai banking sector and financial markets can allocate capital more efficiently and more inclusively, Thai businesses and households will likely be gaining from better access to capital. Furthermore, with more relaxed rules related to outward direct investment, Thai corporate will also be able to invest more abroad, access more resources and more markets, as well as exploring new opportunities, whether intra or inter-regionally.

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<sup>27</sup> Analyses such as those from the traditional “gravity model of international trade”, suggest that trade with our booming regional neighbors are likely to soar. See, for example (Pootrakul et al, 2003)



## BOX 2: Thailand's Direct Investment: Overview and Outlook

### Overview of Thailand's Direct Investment

In 2008, according to the survey conducted by the *International Investment Position Team*, Bank of Thailand the value of Thailand's Direct Investment (TDI) abroad is 304,082 Million Baht, representing an increase from 2007 by 20.96 per cent. When classified by sectors, most of the investment undertaken has been into the Finance sector, followed by the High-Tech Manufacturing sector, Resource-based Manufacturing sector, Mining, and Wholesale and Retail Trade sector, respectively as shown on Table B2.1:

Table B2.1: TDI by Sector\*

units: Million Baht	2007	2008
<b>Services: Finance</b>	94,983	99,892
<b>Manufacturing: High-Tech</b>	45,975	55,165
<b>Manufacturing: Resource</b>	29,624	34,205
<b>Mining</b>	12,992	31,369
<b>Services: Trade, Sale</b>	24,192	27,469
<b>Services: Transport, Telecommunications</b>	17,569	19,654
<b>Manufacturing: Labor</b>	6,920	11,553
<b>Services: Real Estate, IT, Law</b>	9,586	10,507
<b>Services: Construction</b>	4,765	5,163
<b>Services: Energy</b>	1,096	4,935
<b>Services: Hotel, Restaurant</b>	2,486	3,177
<b>Services: Social Work</b>	639	691
<b>Services: Other</b>	367	302
<b>Manufacturing: Other</b>	196	
<b>Grand Total</b>	<b>251,389</b>	<b>304,082</b>

\*Note: classification by sector has the survey limitations of being conducted only in Thailand  
Source: International Investment Position Survey, BOT

If divided by countries, the majority of Thai direct investments abroad were concentrated in ASEAN countries (most notably in CLMV nations), followed by China, United States, Virgin Islands, and Hong Kong, respectively as shown on Table B2.2:

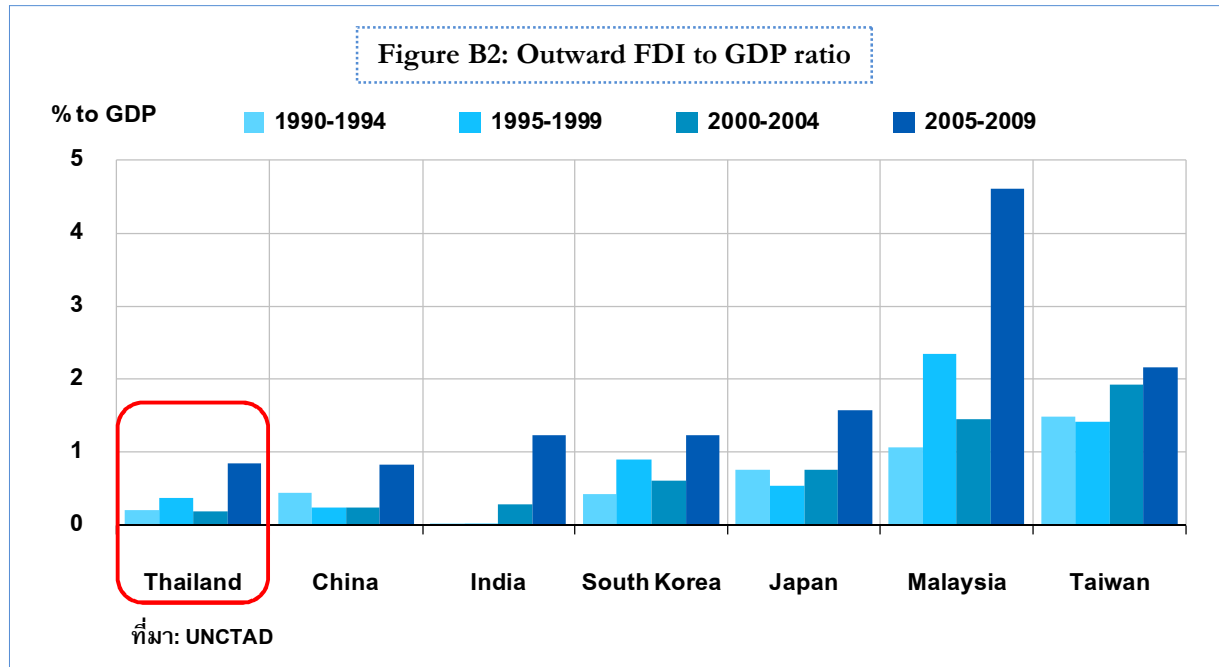
**Table B2.2: TDI by Country\*\***

units: Million Baht	2007	2008	Share in 2007	Share in 2008
<b>ASEAN</b>	141,686	164,290	56.36%	54.03%
CLMV	88,051	103,038	35.03%	33.88%
ASEAN-6**	53,634	61,252	21.34%	20.14%
<b>China</b>	28,567	31,399	11.36%	10.33%
<b>USA</b>	6,312	23,702	2.51%	7.79%
<b>Virgin Islands</b>	19,519	19,878	7.76%	6.54%
<b>Hong Kong</b>	15,781	16,429	6.28%	5.40%
<b>Other</b>	39,525	48,384	15.72%	15.91%
<b>Grand Total</b>	251,389	304,082	100%	100%

\*\*Note: does not include Brunei Darussalam and Thailand  
 Source: International Investment Position Survey, BOT

Thailand's level of investment abroad to GDP, albeit increasing steadily since the 1990s, is considered quite low when compared to other countries in the region. In this measure, Malaysia has the highest level of investment abroad to GDP averaging at 4.6 percent, followed by Taiwan at 2.2 percent, South Korea at 1.2 percent and India at 1.2 percent between the years 2005-2009, as shown on Figure B2:

**Figure B2: Outward FDI to GDP ratio**



## **Objectives of outward Foreign Direct Investment**

From the research conducted by Dunning (1993), Eiteman et al. (2001) and UNCTAD (2006), there are four objectives that underline foreign direct investments. They are:

1. **Resource seeking objective:** When the host country is endowed with an abundance of natural resources, it may be beneficial for the home country's firms to invest there in order to acquire those resources at a lower price.
2. **Market seeking objective:** An investment by the home country's firms in the host country that used to be their export market. This may be due to a wide variety of reasons, namely from new obstacles that have emerged in trade or that the export market has increased relative to the host market.
3. **Efficiency seeking objective:** Investments in search of more efficient production factors, ranging from labor costs, tax incentives, to government stimulus measures.
4. **Created Asset seeking objective:** The objective of this is for firms to invest in ways that could increase their competitive advantage, such as in new technologies.

Judging from Thailand's direct investment data, it could be concluded that firms have above objectives in mind when investing abroad.

## **Opportunities to invest abroad for Thailand**

Going forward, it seems that now is a good time to undertake long-term investments for many Thai firms because of these reasons:

1. The recent financial crisis has had an impact on asset prices. Although the economic recovery is in progress, some asset prices are still low when compared to where they were during the pre-crisis period. For Thai investors with long-term objectives, prices are indeed favorable.
2. Since Thailand and most other emerging countries run both current account and capital account surpluses, the Thai baht along with regional currencies has appreciated considerably since the recovery process. Together with low global asset prices, Thai investors could probably get good assets with favorable baht terms.
3. Although the global economic recovery has shown some signs of vulnerabilities, there are several countries and sectors that are back on their growth trajectory. Therefore, attractive options exist for foreign investors that do their research.

## **II. Risks and challenges**

Along with opportunities, the changes in global economic and financial environment discussed above will likely also bring forth risks and challenges for Thailand. Here we identify three of the major risks and challenges that could hamper our country's success in this new global environment namely (1) overheating and increasing reliance on EM Asia and (2) marginalization.

### **II.1 Overheating and increasing reliance on EM Asia**

Although EM Asia is poised for another decade of dynamic growth, there is certainly an inherent risk that it might become overheated, especially when surges in capital flows are expected. In the 1990's, Thailand, along with many of our regional neighbors' impressive growth was halted, and actually reverted by Asian financial crisis that came together with the burst of the bubbles in the property and stock markets. Going forward, without a close monitor and appropriate policy responses, it is not implausible that bubbles may again recur. Although our exchange rate regime has been changed to be more flexible since after the Asian crisis, surges in capital flows could still mean that money could rush to certain pockets of the economy and drive up asset prices. Recently, across EM Asia many cities are experiencing fast rising property prices. If bubbles do emerge and are not properly managed, their burst could entail large losses to the banking sector, the government, as well as households and businesses. With the more intensified intra-regional trade and financial linkages, the impact of a negative shock such as overheating could be profound and rapidly and directly transmit across the region.

### **II.2 Marginalization**

With EM Asia gaining fast both in terms of demand and supply-side factors, there is a risk that Thailand will be marginalized in the New Asian Growth Model. Such marginalization can occur in at least three ways.

First, rising demand from the growing middle class in EM Asia will clearly benefit a number of industries that Thailand enjoys comparative advantage. These industries include those such as food (e.g. rice, shrimps, canned-fish, and poultry), tourism, cassava, rubber, as well as petrochemical and plastic products. However, there are a number of competitors with comparable or better costs and productivity. Hence, creating high value added products based on comparative advantage such as ready-to-eat and processed food that fit EM Asia demand is crucial in gaining significant benefits.

Second, if we fail to rightly penetrate the burgeoning EM Asian markets (China and India in particular) or make strategic direct investment to capture these markets up front, we will fail to capture the first-mover advantage. Such

advantage will be crucial, given that many other regional countries do have similar (or better) production capabilities to ours.

Third, although we are currently a key player in the regional production network, our role has largely been that of a low-wage assembler of manufacturing products particularly electronics and electrical appliances. Unless something is done, going forward, facing with other newcomers who are wage-competitive as well as those who are already up the value chain, Thailand's role in the burgeoning regional production network could easily be marginalized. Indeed, it is not so difficult for MNC's to pull out their production bases out of Thailand when other countries are offering competitive workforce with lower wages.

### **III. Positioning Thailand for the Next Decade**

While there seems to be vast opportunities going forward, for Thailand to successfully take advantage of those opportunities, we deem that a careful planning, and well conceived strategies must be done along side effective execution. Indeed, on the matter of long-term planning, it seems that many of the regional countries have already set up long-term comprehensive plans to position themselves in this new global environment. Many of the goals that these countries are determined to achieve are indeed set up such that progresses could be easily measured against. For example, Malaysia had the aim of achieving an advanced economy status by 2020. India aimed to double per capita income by 2016-2017. China aimed to increase per-capita GNP to the level of the medium-developed countries by the mid-21<sup>st</sup> century. Singapore, meanwhile aimed to achieve 2 to 3 percent of productivity growth to enable 3 to 5 percent GDP growth over the next decades. To achieve such goals, the plans are often designed comprehensively. Details could range from the strengthening of the private and public sectors in Malaysia, creating a globally competitive manufacturing sector at 20-25% of the economy with emphasis on knowledge-intensive manufacturing in Singapore (making it a Global-Asia hub), or increasing agricultural GDP growth to 4% per year to ensure a wider spread of benefits in India. A summary of such plans is presented in Box 4 below.

### Box 3: National Economic Development Plans of Asian Economies for the Next Decade

Country	Ultimate Goals	Objectives	Details
China	<p>Rebalance economy toward a consumption-driven for sustainable growth</p> <p>Reduce poverty and improve quality of life</p>	<ul style="list-style-type: none"> <li>Promote domestic consumption and urbanization</li> <li>Increase per-capita GNP to the level of the medium-developed countries by the mid-21st century</li> </ul>	<ul style="list-style-type: none"> <li>Raise household income and reduce household saving by increasing public spending on healthcare, education and improving the pension system</li> <li>Establish the finance companies to support consumer's expenditures</li> <li>Invest in urban infrastructure and relax the household registration system (hukou) to facilitate labor mobility from rural to urban areas</li> <li>Encourage state-owned companies to pay more dividends</li> <li>Increase minimum wages, and continue to support development in western region</li> </ul>
India	<p>Reduce poverty and improve quality of life</p>	<ul style="list-style-type: none"> <li>Double per capital income by 2016-17</li> <li>Create new work opportunities</li> <li>Connect every habitation with electricity, all-weather road, on-line communication, etc.</li> </ul>	<ul style="list-style-type: none"> <li>Increase GDP growth to 10% in 2012</li> <li>Increase agricultural GDP growth to 4% per year to ensure a wider spread of benefits.</li> <li>Create 70 million new work opportunities.</li> <li>Augment minimum standards of education in primary school.</li> <li>Reduce infant mortality rate to 28 and malnutrition among children of age group 0-3 to half of its present level.</li> <li>Ensure electricity connection to all villages and increase forest and tree cover by five percentage points.</li> </ul>
Hong Kong		<ul style="list-style-type: none"> <li>International centre for finance, trade, tourism, and logistics</li> <li>Major offshore centre for facilitating RMB transactions</li> <li>Shipping centre and free port</li> </ul>	<ul style="list-style-type: none"> <li>Develop closer cooperation with the stock exchanges in Shanghai and Shenzhen</li> <li>Promote the gradual internationalization of the RMB</li> </ul>
Singapore	<p>Create high-skilled people, innovative economy, and distinctive global city</p>	<ul style="list-style-type: none"> <li>2 to 3 percent of productivity growth to enable 3 to 5 GDP growth per year in the next decade</li> </ul>	<p><b>Growing through skills and innovation</b></p> <ul style="list-style-type: none"> <li>Establish high-level national council to oversee and drive efforts to boost productivity and expand CET (Continuing Education and Training)</li> <li>Encourage enterprise innovation and investment in technology and training</li> </ul>

Country	Ultimate Goals	Objectives	Details
			<ul style="list-style-type: none"> <li>• Upskill workers at all levels through enhanced CET system</li> <li>• Strengthen support for low-wage workers</li> <li>• Manage our dependence on the foreign workforce</li> </ul> <p><b>Anchor Singapore as a Global-Asia hub</b></p> <ul style="list-style-type: none"> <li>• Establish Global-Asia hub for manufacturers across the glob</li> <li>• Develop globally competitive manufacturing sector at 20-25% of the economy with emphasis on knowledge-intensive manufacturing (e.g. bio-electronics), and take advantage of the convergence of manufacturing and services (e.g. headquarter operations, clinical trials for new drugs and IP management services)</li> <li>• Create trusted financial and modern service hub</li> <li>• Create leading consumer business centre</li> <li>• Achieve location of choice to test-bed ‘Future ready’ urban solution</li> </ul> <p><b>Build a vibrant and diverse corporate ecosystem</b></p> <ul style="list-style-type: none"> <li>• Develop a deeper base of globally competitive Singapore enterprises to grow 1,000 Singapore enterprises with revenues over \$100million by 2020</li> <li>• Establish Singapore as premier location in Asia for MNCs, global mid-sized companies, and Asian enterprises seeking to internationalize</li> <li>• Support strengthened alliances between MNCs and local SMEs</li> </ul> <p><b>Make innovation pervasive and strengthen commercialization of R&amp;D</b></p> <ul style="list-style-type: none"> <li>• Increase Singapore’s total expenditure on R&amp;D to 3.5% of GDP by 2015</li> <li>• Strengthen emphasis on commercialization of R&amp;D through new innovation platforms and developing talent in downstream commercialization</li> <li>• Emphasis design-driven innovation through incentives for capabilities such as in product and industrial design, provisions for affordable spaces for industry collaboration</li> </ul>

Country	Ultimate Goals	Objectives	Details
			<p><b>Become a smart energy economy</b></p> <ul style="list-style-type: none"> <li>• Improve energy security and resilience with through the diversification of energy sources</li> <li>• Invest in critical economy-wide energy infrastructure such as establishing Intelligent Energy System (IES) and Jurong Island.</li> <li>• Step up measures to promote energy efficiency</li> <li>• Improve pricing energy to reflect real costs and constraints</li> </ul> <p><b>Enhance land productivity to secure future growth</b></p> <ul style="list-style-type: none"> <li>• Plan ahead of a new, vibrant waterfront city, size comparable to Marina Bay</li> <li>• Study, under the Concept Plan 2011, the feasibility of a consolidated port at Tuas in the long term</li> <li>• Increase land productivity and inject greater land use flexibility</li> <li>• Enhance diversity of business location to support a range of enterprise needs</li> <li>• Invest ahead to create new underground spaces</li> </ul> <p><b>Build a distinctive global city and an endearing home</b></p> <ul style="list-style-type: none"> <li>• Attract and nurture a diverse pool of talent and develop thought and practice leadership</li> <li>• Transform Singapore to be a leading cultural capital</li> <li>• Provide the best quality of life in Asia</li> </ul>
Taiwan	Augment the economy's added value and promote green society	<ul style="list-style-type: none"> <li>• Target 5.0% of GDP growth in 2009-2012</li> </ul>	<ul style="list-style-type: none"> <li>• Revitalize private investment by helping private sector removing investment obstacles and encouraging private participation in public works</li> <li>• Reshape the industry by promoting six key emerging industries, speed up the development of budding ICT industries, promote service industry development, and bring about industrial upgrading and transformation</li> <li>• Enhance global linkage by promoting the normalization of cross-strait economic and trade relation, responding to the adjustment of cross-strait economic and trade policy, actively participate in global economic and trade integration, and promote the diversification of export market</li> </ul>



Country	Ultimate Goals	Objectives	Details
			<ul style="list-style-type: none"> <li>• Improve business environment by loosening financial and economic regulation and improving the investment environment</li> <li>• Expand employment opportunities by strengthening employment creation and amplifying industrial manpower</li> </ul>
<b>South Korea</b>	Create dynamic economy and transparency society	<ul style="list-style-type: none"> <li>• Business-friendly economy</li> <li>• Economic hub of Northeast Asia</li> <li>• Strength in science &amp; technology, human resources</li> <li>• Top quality of life and economic opportunities for all</li> </ul>	<ul style="list-style-type: none"> <li>• Designate three free economic zones</li> <li>• Develop World-class airports and seaports Recruit high-tech research institutions</li> <li>• Strengthen market monitoring function</li> <li>• Gradually open of service and agricultural sectors</li> <li>• Implement Minimal land-use regulations governing factory construction and expansion of the Seoul metropolitan area</li> <li>• Enact a special law to expand the social safety net in rural areas</li> </ul>
<b>Malaysia</b>	Create high-income economy	<ul style="list-style-type: none"> <li>• Double per capital income by 2010</li> <li>• Achieve an advance economy status</li> </ul>	<ul style="list-style-type: none"> <li>• Reenergize the private sector, including by creating an entrepreneurship ecosystem, remove barriers and costs to doing business, and encourage competition</li> <li>• Develop a quality workforce and reducing dependency on unskilled foreign labour</li> <li>• Create a competitive domestic economy, including removing price controls and subsidies that distort market behavior</li> <li>• Strengthen the public sector, by creating a leaner, customer-focused government while widening the tax base and streamlining public finance management</li> <li>• Implement transparent and market-friendly affirmative action, which will transition from ethnic considerations to emphasize the lower income 40% of households</li> <li>• Build the knowledge base and infrastructure, including an environment for innovation</li> <li>• Enhance the sources of growth, of which 12 national key economic areas have been identified with high growth potential</li> <li>• Ensure sustainability of growth, including environmental sustainability</li> </ul>

While a plan might not guarantee success (unless, among others, followed by effective execution), it could help the country identify its priorities, given limited resources and the presence of challenges. Here, while not offering a comprehensive solution, at the most fundamental level, we deem that for Thailand to successfully take advantage of the opportunities that are opening up, the countries must at least effectively address the risks and challenges discussed in the previous section. Specifically, we deem that (1) to mitigate overheating risk and providing economic environment conducive to growth, macro-economic stability must be ensured, (2) to avoid being marginalized, our competitiveness must be enhanced, and our middle class expanded. Indeed, a long-term comprehensive national plan might be needed so that our actions could be made in a prioritized, consistent, and holistic manner.

### **III.1 Mitigating the risk of overheating**

#### **Over-indebtedness in all sectors must be carefully monitored**

With EM Asia growth expected to be very dynamic in the next decade, there is always a risk that the region, which includes Thailand, could experience overheating. When the economy is booming, high growth projection could lead economic agents to be over-optimistic and pile in more debt to take advantage of more leverage. Some of the debt might be used to finance non-durable consumption or high-risk speculative projects that promise high returns. Such over-optimism could backfire when debts were taken on but returns prospects were not backed by solid fundamentals.

#### **Judicious use of macro-prudential tools will be necessary**

To mitigate the risk of overheating, the authorities need to be vigilant in debt positions of the various economic agents whether the household sector, the corporate sector, the banking sector, or the government sector. For the central bank, this means a close monitoring of the balance sheets of these sectors as well as developments in asset markets, be it stock or property. In this sense the debate of whether the central bank should “lean against a bubble” while it’s still developing or “clean up” after the bubble burst seem to have died down after the Credit Crisis. By allowing the housing bubble to go full blown the US and the UK suffered immensely when it burst. Going forward, although the identification of a bubble might remain difficult, the central bank is likely to be more on the cautious side. Macro-prudential measures such as a lower loan-to-value ratio or a higher reserve requirement will likely become important tools to rein markets from possible overheating.

#### **Capital inflows, bubbles, and exchange rate volatility**

As EM Asia is well aware, an influx of capital flows can contribute to asset price bubbles, which when burst, can set back the economy for a considerably long

time. As discussed above, going forward, the dynamic growth of EM Asia is likely to draw more capital inflows. Apart from helping finance normal economic activities, these flows could indeed find their way into asset price speculation. Also, as discussed above, the possibility that G4 business cycles could be more volatile going forward means that volatility of capital flows is also likely to rise. While the rise in volume of capital inflows could contribute to asset price bubble, the rise in volatility of the flows also have implications on the domestic economy, not the least via the possible more volatile exchange rate.

The literature is filled with various ways to deal with the surges in volume and volatility of capital flows. Among the suggested options often include (1) having a more flexible exchange rate policy, (2) reserve accumulation, (3) the use of prudential measures, (4) liberalization of capital outflows, and (5) develop a deeper and more resilient domestic financial market. Note that these options are not cost-free. While the more flexible exchange rate could help lessen valuation pressures on domestic assets, a fast appreciation or a more volatile currency could adversely affect the export (and import) sector. While reserve accumulation could help as an insurance against fast flow reversals, there are also costs to reserve accumulation, including yield differentials, and sterilization costs. On the other hand, although prudential measures including capital controls are receiving less bad press, post-Credit Crisis, such measures could be perceived as a reversal of the liberalization process. Meanwhile, although the liberalization would help partly balancing out the inflows, as with any liberalization, it should be done in proper sequence, as capital flights during desperate times are not at all impossible. The last option, creating a deeper and more resilient domestic financial market, seems to have mainly benefits, yet are not easily done in the short-term.

### **III.2 Overcoming over-reliance on exports**

#### **Building up domestic demand**

As a complement to our export promoting strategy, for our growth to be more resilient and sustainable even in the face of a regional slowdown, Thailand might need to build up its own domestic demand in order to achieve a more balanced growth. As discussed in the above sections, the fast creation of middle class in China and India has been credited as an important factor behind the rise of domestic demand in these two powers. Although, the sizes of the economy is not large enough for most capital-intensive industries to achieve economy of scale, Thailand might still need to enlarge and strengthen her middle class so that we can rely more on domestic demand and achieve a more organic and sustainable growth. Section IV.3.c below discusses various strategies to expand and strengthen our middle class population in more details.

## **Macro-prudential is again every important**

While the more intensified intra-regional trade and financial linkages should provide immense market opportunities for Thailand, they can also mean that Thailand would be more susceptible to intra-regional shocks. While it is almost impossible to avoid such risk, the fact that we are more susceptible to contagion means that we should keep ourselves in good shape. As in case of the euro area where fiscal concerns in one periphery country raised alarms on others, to keep ourselves immune from serious effects of contagion, we must constantly monitor our country's balance sheets. Apart from private sector debt, where macro-prudential measures could be judiciously used, fiscal debt also needs to be kept in check. Although a regional shock could imply a Thai economic slowdown, with enough prudence beforehand, however, we should be spared the worst of the contagion effects.

### **III.3 Overcoming marginalization**

#### **A two-pronged strategy: Enhancing competitiveness and building up internal demand**

There are two complementary approaches that should be considered when trying to overcome the marginalization problem. First, in addition to the traditional G4 markets, we could try to jump onto the EM Asia growth wagon by trying to gain market shares in trade and investment with our booming regional neighbors. Second, we could try to grow more organically through building up internal demand via expansion and solidification of our own middle class. As discussed earlier, much of the current Thai exports were those from the “hi-tech” sector, particularly vehicle and electronics & electrical appliances, which did not necessarily provide much value-added for Thailand and were mainly owned by MNC's. To effectively reap the most benefits from exports, our competitiveness must be enhanced, so that we could capture more value-added, from both climbing up a technological ladder in the “hi-tech” sector, as well as reaping benefit from the resource-based and agricultural sectors which are mainly Thai-owned and employ a large number of Thai workers. On the other hand, to rely more on domestic demand, it is necessary that Thai purchasing power should overall increase with an expansion and increasing strength of the Thai middle class.

Interestingly enough, we find that the underlying fundamental factors that support these two approaches (enhancing competitiveness and expanding the middle class) are not mutually exclusive and are in many ways similar. Indeed, to enhance competitiveness and expand our middle class population, we deem that thorough long-term planning and well-executed strategies in the following areas (1) human capital (2) infrastructure, (3) capital allocation (4), financial access, and (5) social safety net, will help.

With greater human capital (education as well as skills), there is a greater chance that we will be able to master and internalize new technology and management as well as achieve more innovations. With greater human capital our lower income workers are also likely to be able to join the middle class through better jobs and more steady income. Better infrastructure will help enhance competitiveness in our production and distribution of goods and services, as well as help facilitating a smoother urbanization process and/or transition to manufacturing and service sectors. A greater financial access will help promote the capacity to put new ideas and innovations into use. Also, a greater financial access and a better social safety net should help promote capital accumulation by the lower income so that they can become middle class as well as preventing some of the middle class from falling into lower income group.

As importantly, in addition to the above factors, we deem that, macro-stability will be necessary in promoting competitiveness and expansion of the middle class. On the one hand macro-stability will provide a stable environment conducive to growth. On the other hand, macro-stability will prevent any reversal of growth and reduction of the middle class population that might come with an economic crisis.

To conclude, we would like to present an example of a comprehensive long-term national plan of a country that broadly faces a similar hurdle to us, i.e. Malaysia's New Economic Model. This New Economic Model encompasses various key features that the Malaysian authorities deem essential to address in order for the country to achieve its goal of avoiding the middle income trap and becoming a high-income country.

## Box 4: Malaysia's Road towards High-income Economy

This box analyzes the past developments of Malaysia and its future direction as an important example of the national plan to escape from the middle-income trap. Malaysia has been able to elevate from a low income to an upper middle income within just a few decades. Nevertheless, the past economic reforms and institutional buildings have been deemed insufficient for reaching its goal of becoming a high-income economy. Thus, a clearly defined strategic roadmap to address weaknesses in its economic structure was laid out and the New Economic Model (NEM) under 10<sup>th</sup> plan was introduced in June 2010 with the target of transforming Malaysia into high-income economy by 2020.

### Key Challenges

In addition to doubling the current income per capita of 6,634 US dollars to 12,196 US dollars to be high income economy, according to World Bank definition\* by 2020, a number of key structural concerns that have kept Malaysia in the slow pace of growth in the past decade are

1) Declining investment in the past few decades. Investment declined from 33 percent of GDP in 1990 to 21 percent of GDP in 2007. Private investment has fallen from 22 percent of GDP in 1990 to 12 percent of GDP in 2007 partly due to changing economic structure in the aftermath of 1997 financial crisis combined with high investment cost as a result of lengthy bureaucratic procedures.

2) Reliance on exports of manufacturing goods and slow productivity improvement. Manufacturing export has been the main growth engine of Malaysian economy for the past two decades. The lack of innovation and unskilled labor have undermined productivity growth and resulted in continued reliance on low-valued added exports. The high degree of openness has also made the economy vulnerable to external shocks. Therefore, Malaysia plans to stimulate the role of domestic demand while keeping the pace of manufacturing export towards higher value added products.

3) Income inequality and inclusiveness remain a key challenge for the Malaysian economy. The affirmative action policies including the minimum requirement of 30 percent equity holdings by ethnic Malays have adversely affected the cost of doing business and supported rent-seeking behavior. The bottom 40 percent of households have so far experienced the slowest growth of average income.

4) Market distortions including subsidies and inefficient affirmative actions have obstructed transformation process to a private sector led economy, highlighting the need for structural reforms.

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\*According to World Bank definition, economies are divided according to 2009 GNI per capita, calculated using *the World Bank Atlas method*. The groups are: low income, \$995 or less; lower middle income, \$996 - \$3,945; upper middle income, \$3,946 - \$12,195; and high income, \$12,196 or more.

## New Economic Model (NEM)

The NEM will focus on achieving the goals of high income, inclusiveness, and sustainability. The key strategic reform initiatives include re-energizing the private sector by developing quality workforce, creating competitive domestic economy, building knowledge-base infrastructure, and enhancing the sources of growth, which highlights the need to improve 5 key areas.

### Sources of growth

Malaysia will leverage on the existing strong manufacturing base by moving towards higher value chain of existing industries. Some potential areas include advanced electronics, solar panel manufacturing, medical equipment and downstream palm oil which would be complemented by services sub-sectors such as information and communication technology (ICT), health and education, and entertainment. To enhance these new sources of growth, a competitive private-sector led economy will be created. While, multinational and large domestic companies will remain important, SMEs are expected to play a more crucial role in the new high income Malaysian economy. Market distortions including price controls and subsidies such as fuel subsidies will be removed. The government also plans to create a transformation fund to assist distressed firms during the reform period.

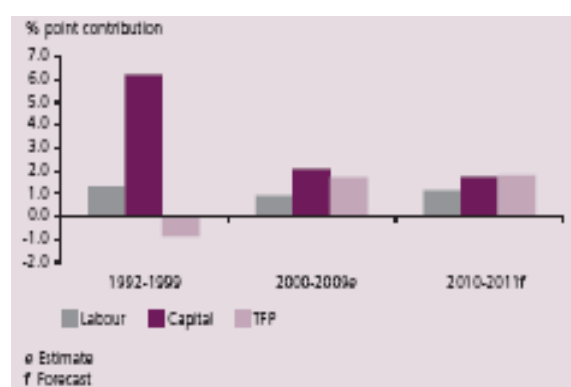
### Productivity

Productivity will be enhanced through upskilling and automation in manufacturing sector to achieve the goal of knowledge-based and innovation-intensive economy. At present, 80 % of manufacturing workforce is low to mid-skilled, and less than half of the workers have received formal training. Improvement of quality workforce will enhance value creation necessary in a high income economy. The reforms of the education system as well as technical education will focus on producing skilled talents for advanced manufacturing and services sectors. In addition, several initiatives and flexibility will be put in place to attract global flows of talents and reduce brain drain. Moreover, R&D activity, a crucial fundamental to move up the value chain in manufacturing sectors, will be supported through easing the application process.

### Role of government

The government will become a key facilitator of competitive environment for the private sector by focusing on provision of infrastructures including transportation, internet-related infrastructure, and health and education with close collaboration with the private sector. It will play a residual role for safety nets to stabilize and correct periods only upon instances of market failure. Government

**Figure B4: Factor contributions to growth**



decision making processes will be improved, including greater transparency to provide appropriate incentives. Fiscal management will be improved through broadening revenue base and better utilization of revenue. Fiscal deficit will be reduced from 7 percent of GDP in 2009 to 2.8 percent by 2015 with lowering public debt ratio. Goods and Services Tax (GST) will be implemented to broaden government revenue base and administrative spending will be made more efficient to achieve the target.

#### Regional integration

Given existing trade linkages, Malaysia plans to take advantage of such demand by foster deeper integration with the regional economies, in particular the ASEAN-FTA. An increase in foreign players (currently accounting for approximately 20% of market share in the banking sector and 33% of the insurance sector) is expected to help facilitate the flows of trade and investment and act as catalysts for economic growth. The financial liberalization plan announced in 2009 aims to reinforce Malaysia's position as an Islamic financial center and emphasize three broad strategies, namely, 1) issuing of new licenses to qualified foreign players that can bring significant value propositions to the financial sector, 2) increasing foreign equity limits in domestic financial institutions to provide greater flexibility in forming stronger strategic partnerships and 3) Providing greater operational flexibility to existing locally-incorporated financial institutions as well as promoting financial inclusion.

#### Sustainability and inclusiveness

The NEM also extends the target to inclusiveness and sustainability. In this regard, the introduction of new measures to assist to the bottom income of 40 percent households will strike a balance between the special position of Bumiputra (ethnic Malays) and legitimate interests of different groups in order to ensure fair opportunities through transparent processes and strong institutional framework. Investment and policy decisions will be made with consideration of long-term impact on the society, the economy as a whole, and the environment.

While Malaysia has successfully introduced NEM to address key concerns and initiate reform agenda in becoming the high income economy, implementations of all key issues and more tangible processes are the next crucial step for getting out of the middle income trap that other regional economies need to keep an eye on.



## Chapter 7: Conclusion

The Credit Crisis is likely to alter the course of globalization process that has been taking place rapidly world-wide for the past 30 years. In the New Globalization, global growth dynamics is expected to change as G4, the ultimate source of final demand, will have to cope with various burdens from the Crisis. The role of the state is also expected to be greater, as market failures proved more prevalent than expected, and early government intervention in some cases might be better than allowing large losses that would be shouldered by the public.

Meanwhile, EM Asia is expected to rise from more reliance on internal demand that comes with rising middle class, rapid urbanization, and transition to manufacturing and services sector. EM Asia growth is also expected to be supported by various supply-side factors, including TFP growth that comes with regional production network production, R&D, and frugal innovation, as well capital accumulation from investment in infrastructures and intra-regional R&D.

Along with altered global economic dynamics, flows of international capital are expected to be affected. Return differentials and ample global liquidity would likely induce surges of capital inflows to EM Asia. Although G4 economies are becoming riskier, their assets will remain irreplaceable as the ultimate safe-haven assets. As such, increased volatility of capital flows is also expected.

With continued capital inflows, and ample regional savings, EM Asia does not seem to have problem with financing its real sector growth. To really achieve its full potential, however, more effective financing will be needed. In particular, efficiency and inclusiveness of the intermediation process will be needed. Furthermore, stability and resiliency of the financial system will be of utmost importance.

Going forward, the New Globalization will bring many risks and opportunities for Thailand. Intra-regional trade and finance will present opportunities for Thailand's trade and investment prospects. Risks, however, could come in many forms, whether from overheating, easier transmissions of shocks from within the region. The country also faces the possibility of marginalization from the lack of competitiveness in high-value added production and meanwhile we can no longer rely on cost advantages in terms of being a player in the regional production network.

To move Thailand forward in the Next Decade, it seems that a long-term, comprehensive planning will be needed, similar to what others in the region have already laid out. Here we identify that (1) human capital, (2) infrastructures, (3) access to capital, and (4) social safety net are among the factors that are very important both in improving our global competitiveness and generating domestic demand that will sustain our long-term growth.

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