



FEDERAL RESERVE BANK OF SAN FRANCISCO ASIA PROGRAMS

Because of the strong ties between the Twelfth District and Asia, the Federal Reserve Bank of San Francisco has a strategic interest in following and analyzing economic and financial developments in Asia. This contributes to a better understanding of the District's economy and developments that shape the implementation of the Federal Reserve's monetary policy and supervision and regulation of banks. Two programs within the Bank monitor Asia: the Economic Research department's Center for Pacific Basin Studies and Banking Supervision and Regulation's Country Analysis Unit.

CENTER FOR PACIFIC BASIN STUDIES

The Center for Pacific Basin Studies was established within the Federal Reserve Bank of San Francisco's Economic Research department in 1990; it is the oldest such regional research center in the Federal Reserve System. Its origins date back to 1974, when the Bank initiated its Pacific Basin Program to concentrate on economic issues related to this important international region with close ties to the Twelfth District. The center's mission is to promote cooperation among central banks in the region and enhance public understanding of major Pacific Basin monetary and economic policy issues. The center's staff members conduct basic research and support the Bank's president in the conduct of policy by providing briefings on international economic conditions.

In addition to providing policy support and conducting scholarly conferences in 2005, the center pursued a number of other activities. These included the annual Senior Policymaker Seminar, which the center organizes jointly with the World Bank for leading policymakers from emerging nations in the Pacific Basin and beyond. The center also maintained an extensive visiting scholar program, bringing in economists from the San Francisco Bay Area and other regions to work on Pacific Basin policy issues. In 2006, the center will inaugurate an "Asian visiting scholar" program, aimed at bringing in top visiting scholars from Asia to conduct Pacific Basin research at the Federal Reserve Bank of San Francisco. Information about the center and its research can be found at www.frbsf.org/economics/pbc/index.html.



CENTER FOR PACIFIC BASIN STUDIES

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CENTER FOR PACIFIC BASIN STUDIES TAKES ON THE U.S. CURRENT ACCOUNT DEFICIT

The U.S. current account balance, which reflects its balance on trade in goods and services, investment income, and unilateral transfers, has deteriorated significantly over the last 15 years. In 1991, it was in surplus. Since then, the current account balance has swelled to a deficit that in 2005 equaled more than 6 percent of GDP, the highest such ratio in at least 40 years. In 2005, the Center for Pacific Basin Studies took on the controversial issue of the large and growing U.S. current account deficit in two scholarly conferences. Exploring this topic was of particular interest both because of its implications for the U.S. economy and because of the important role Asia plays in it, as the United States has traditionally run a large bilateral current account deficit with countries in that region. For example, the bilateral trade deficit with Asia in 2004 accounted for roughly 44 percent of the overall U.S. trade deficit.

In the past, other countries faced worsening borrowing terms, in the form of either reduced borrowing opportunities or increased interest charges, when their current account deficit reached around 5 percent of GDP. By that standard, some would argue that the United States is overdue for such adjustments, which may be accompanied by a fall in the value of the dollar.

This position has been contested by a group of economists who argue that the current pattern is caused by unique conditions, and that continued large U.S. trade deficits need not necessarily lead to a large dollar devaluation. Instead, they envision an environment where the large U.S. current account deficit can continue to be financed by an accumulation of dollar reserves by foreign governments, particularly those in Asia, where a number of national governments have accumulated large stocks of U.S. Treasuries. These economists assert

that Asian nations will be willing to accumulate ever-increasing stocks of U.S. assets to maintain export growth in an informal arrangement that mirrors the Bretton Woods system of fixed exchange rates that prevailed internationally in the mid-twentieth century.

Two of the leading proponents of this argument, Michael Dooley of U.C. Santa Cruz and Peter Garber of Deutsche Bank, presented their viewpoints at a symposium sponsored by the Center for Pacific Basin Studies and U.C. Berkeley's Clausen Center for International Business and Policy entitled, "Revived Bretton Woods System: A New Paradigm for Asian Development?" in February 2005. The symposium provided an opportunity for Dooley and Garber to discuss these issues with other experts in the field, a number of whom contended that the U.S. current account deficit is unsustainable for an extended period.¹

The question of the U.S. current account deficit was revisited in the Center for Pacific Basin Studies annual conference, "External Imbalances and Adjustment in the Pacific Basin," held in September 2005. The conference included a number of scholarly papers examining the U.S. current account deficit and its implications for the U.S. economy going forward, with special attention placed on the prominent role of Asian nations in both the trade and financial issues associated with the large U.S. external imbalances. In one paper, Maurice Obstfeld of U.C. Berkeley and Kenneth Rogoff of Harvard University argued that a major devaluation of the dollar would be required to bring the U.S. current account into balance. In another, H el ene Rey of Princeton University and Pierre-Olivier

Gourinchas of U.C. Berkeley argued that the United States would accumulate capital gains in its net international investment position as a result of dollar devaluation, which would mitigate the magnitude of devaluation necessary to achieve current account balance. Other papers also considered issues raised by the continued U.S. current account deficits.²

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Going forward, the Center for Pacific Basin Studies will continue to serve as an international resource for research on issues relevant to the Pacific Basin, even potentially controversial topics, such as the role of Asian nations in the U.S. current account deficit. Such topics are crucial to the center's long-standing mission of promoting the understanding of major monetary and economic policy issues in the region.

1. For the symposium agenda and copies of papers presented, see www.frbsf.org/economics/conferences/0502/index.html.

2. For the conference agenda and copies of papers presented, see www.frbsf.org/economics/conferences/0509/agenda.pdf.

BANKING SUPERVISION AND REGULATION: COUNTRY ANALYSIS UNIT

The Banking Supervision and Regulation department's Country Analysis Unit closely analyzes Asian financial sector developments to support the Reserve Bank's oversight of the U.S. branches and subsidiaries of 22 Asian banks. Because conditions in home markets can affect these banks' abilities to support their U.S. operations, Reserve Bank staff monitor not only the financial strength of Asian parent banks, but also the quality of Asian bank regulatory systems and the potential impact of broader economic, political, and social trends.

Although much of this research is used internally for supervisory purposes, the unit conducts some activities to benefit the public, in recognition of the

tremendous interest in Asian economic and financial developments. The unit's staff deliver presentations to local conferences, and the unit sponsors a speaker series—"The Asia Financial Forum"—that allows local bankers, businesspeople, and regulators to meet specialists outside of the Federal Reserve who focus on Asia. In addition, the unit's *Asia Focus* publication offers concise analyses of selected issues of importance to Asian banks. In 2005, *Asia Focus* examined consumer finance in Japan, foreign investment in Chinese banks, bank reforms in India, and China's housing market. Past and current issues of *Asia Focus* can be found at www.frbsf.org/publications/banking.



COUNTRY ANALYSIS UNIT

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2005: A BIG YEAR FOR ASIAN BANKS

This past year saw momentous changes in Asia's banking sector. In China, there was an unprecedented number of investments in local banks by foreign firms. In India, the state-dominated financial sector recognized the potential of the country's vast middle class and sparked a consumer credit expansion. In Japan, seven years of contracting credit ended as bank loans finally started expanding. Across the region, 2005 also will be remembered for the enthusiasm of the consumer, with retail banking driving growth broadly across many Asian banking sectors.

China Gold Rush

China's banking sector saw the most dramatic developments in the region. Before last year, Chinese banks attracted relatively little international attention. The government had been trying to find foreign buyers for minority stakes in the so-called Big Four state-owned commercial banks,¹ but global banks showed little interest given the high risk of purchasing noncontrolling shares in highly troubled lenders.

In 2005, foreign banks began to acquire sizeable stakes in large Chinese banks as a more favorable regulatory environment took hold and investors increasingly recognized the potential of the Chinese banking market. In June, Bank of America agreed to pay \$3 billion for 9 percent of the third-largest lender, China Construction Bank, and in August, Royal Bank of Scotland struck a deal to buy 10 percent of second-ranked Bank of China for \$3 billion. Over the summer, Goldman Sachs and other investors began negotiations to take a 10 percent stake in top lender Industrial and Commercial Bank of China. The consortium eventually agreed to pay \$3.8 billion.

Encouraged by the successful sale of large strategic stakes, two of the top five mainland banks successfully listed in Hong Kong. In June, China's

fifth-largest bank, the Bank of Communications, launched a \$2 billion initial public offering (IPO) on the Hong Kong stock market, and in October, China Construction Bank conducted one of the ten largest IPOs in world history for over \$9 billion. By then, foreigners had struck deals worth \$16.5 billion for buying stakes in Chinese banks, or close to 95 percent of the market value of all five mainland banks listed at the end of 2004.

The share sales are of great importance for both the buyers and the sellers. On the Chinese side, the capital injections are shoring up weak balance sheets and providing the funds for future growth. More importantly, buyers are expected to provide the technical expertise to improve lending practices, risk management, and corporate governance. For foreign banks, the acquisitions provide access to the fast-growing Chinese banking market and with it, Chinese consumers. Residential mortgage lending to individual households has grown by over 30 percent in each of the past two years, but represented a relatively low 12 percent of China's GDP as of year-end 2004. There is potential for further growth in this area as per capita income in China rises.

India's Emergence

A rapid increase in bank lending has paralleled India's emergence as a regional economic power. Traditionally, Indian banks have kept 40 percent or more of their total assets in low-risk government bonds and lent relatively little, largely to well-connected corporate borrowers. Over the past year, some Indian banks began shifting their preferences for both bonds and corporate lending. India's large middle class is experiencing rapid income growth as the economy expands, and banks are looking to tap that underserved market. Total credit growth reached 33 percent by the middle of 2005, with consumer lending growing

especially rapidly. Outstanding credit card receivables increased an estimated 49 percent in the fiscal year to March 2005, and mortgages, car lending, and personal loans grew as well. Although the pace of lending has raised asset quality concerns, India's consumer lending market looks set for continued strong growth.

Japan's Revival

As Japan's economy rebounded from recession in 2005, its banks also recovered from a decade of poor performance. After several years of writing off bad loans from the real estate and stock market bubbles of the 1980s, a number of banks finally started lending again. In August 2005, the banking system achieved positive year-on-year lending growth for the first month since early 1999. In the late 1990s, the government provided banks tens of billions of dollars in capital injections. Bolstered by stronger balance sheets and rising profitability, the banks now are repaying those public funds. If the trends of the past year continue, banks could reemerge as an engine of economic growth and help Japan's revival deepen and mature.

The Rise of Retail Banking

Throughout Asia, banks in 2005 increased their focus on consumer lending and retail banking. In part, the trend arose from a reaction to the years preceding the financial crisis when banks lent excessively to corporate customers and neglected individual consumers. But the shift also highlights the growing maturity and sophistication of the region's financial institutions. Asian banks face challenges in realigning lending practices and risk management systems with the new retail emphasis, but the best growth opportunities clearly lie with the Asian consumer, and increased consumer lending should help lead to more sustainable and better balanced economic growth.

1. China's Big Four banks are the Agricultural Bank of China, the Bank of China, China Construction Bank, and the Industrial and Commercial Bank of China, which together held 53 percent of total Chinese banking assets as of December 2005.

