ASIA’S JOURNEY TO PROSPERITY
Policy, Market, and Technology over 50 Years
Chapter 7: Investment, Savings, and Finance
Asia’s rapid capital accumulation

Domestic savings financed most of investment

External financing complemented domestic savings

Asia’s financial system

Looking ahead

Questions and further readings
1. Asia’s rapid capital accumulation

- Rapidly rising investment rate led to a significant expansion of Asia’s capital stock, contributing to economic growth.
- In many countries, investment was propelled by a strong push for industrialization. In the 1960s and 1970s, industrialization was often led by governments, emphasizing heavy industries with a large role of state-owned enterprises.
- Since the 1980s and 1990s, market-oriented reform has led to a surge in investment by the private sector and foreign direct investments (FDI).

### Stock and Growth of Physical Capital Stocks, 1960, 1990, 2017

(constant 2011 $ trillion)

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... = data not available.

2. Domestic savings financed most of investment

- Asia’s high investment was financed mainly through domestic savings by households, corporations, and governments.

- In the 1960s, developing Asia’s gross domestic savings rate was the lowest among regions globally and was also lower than the investment rate, resulting in a current account deficit.

- Over time, the region’s savings rate increased significantly, and, from the 1990s, exceeded the domestic investment rate, resulting in current account surpluses).

- To a large extent the rising domestic savings in Asia was driven by the People’s Republic of China (PRC).

### Gross Domestic Savings and Savings–Investment Gaps (% of GDP)

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... = data not available, GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development.
Notes: Data on savings–investment gaps are in parentheses. Data for Taipei, China refer to gross national savings.
2. Domestic savings financed most of investment (cont.)

  - Household savings are part of the disposable income that is not consumed.
  - Gross corporate savings mainly comprise retained earnings (after corporate tax and dividend payments, but before investment).
  - Government savings are the excess of government revenues over current expenditures of central and local governments.

Notes: Sector and gross domestic savings are period averages based on available official estimates. Economies may follow different approaches in classifying savings by sector. For the Philippines, sector data are based on 1968/1993 System of National Accounts framework. Data for the PRC and Thailand are from flow of funds accounts. For India, for 2012 onward, data correspond to new base year 2011/12; before 2012, data correspond to old base year 2004/05.
Numerous studies have tried to explain high and/or rising household savings rates in some developing Asian countries, although the reasons likely differ from country to country.

One is rapid economic growth, which leads to higher savings rates. This can be explained by either the so-called “habit persistence” or “permanent income” hypothesis.

The second relates to demographic factors based on the “life-cycle hypothesis.”

- Individuals want to smooth consumption over their lifetime—they take on debt (or save less) when they are young, anticipating that future income streams will allow them to pay off debt; save (or save more) during middle age to maintain their consumption level when they retire; and after retirement, draw down on previous savings. The past 50 years have seen a rapid rise in the share of the working-age population in many Asian countries. This has likely contributed to rising household savings rates.

The third set of explanations relates to financial sector development, including a mild level of financial repression, access to savings facilities, and household borrowing constraints.

- Mild financial repression (partly due to low inflation and tax-free interest earnings) kept real interest rates positive.
- Many Asian economies have well-established voluntary household savings mobilization programs.
- Less-developed consumer credit markets may have contributed to high household savings as well.

The fourth set of explanations relates to precautionary savings, largely due to underdeveloped social security systems, such as the lack of universal health coverage and inadequate pension provisions.
In many Asian economies, corporate savings account for a large part of domestic savings, and the corporate savings rate has increased in the past 2-3 decades.

Growing corporate savings rates are a global phenomenon, and many developed countries have also seen them increase significantly over the past 3-4 decades.

Several factors have been suggested for rising corporate savings rates globally:
- Declining labor income shares associated with technological progress, globalization, and diminished bargaining power of trade unions;
- Falling prices of investment goods, possibly associated with technological progress;
- Lower dividend payouts in some countries to retain greater income for investment;
- Reductions in corporate income tax rates;
- Low interest rates which increased corporate profits; and
- Emergence of highly profitable platform companies that do not need to make huge investments in physical capital.

Many of these factors apply to Asia.
In recent years, fiscal reforms to increase tax revenues or cut subsidies in several Asian economies—such as India, Indonesia, and the Philippines—increased government savings and enabled larger public infrastructure spending.

- Government savings is important to gross domestic savings in Indonesia; the PRC; the Republic of Korea; Taipei, China; and Thailand. India’s government savings rate, however, continued to be negative, meaning government revenues fell short of current expenditures.

- High government savings rates often go hand in hand with fiscal prudence. Many studies have documented the role fiscal prudence played in Southeast Asian economies—such as Indonesia, Malaysia, and Singapore—in augmenting government savings.

- In recent years, fiscal reforms to increase tax revenues or cut subsidies in several Asian economies—such as India, Indonesia, and the Philippines—increased government savings and enabled larger public infrastructure spending.
2. Domestic savings financed most of investment (cont.)

- **The debate on Asian savings and global imbalances**
  - There was building-up of large global current account imbalances before the 2008 global financial crisis. A set of countries in East and Southeast Asia and Europe and oil exporters had high current account surpluses (excess savings over investment); while the United States (US) had high current account deficits (excess investment over savings).
  - Some considered this one of the sources of financial vulnerability that led to the crisis. It was argued that some emerging markets and oil exporters saved too much with excess savings largely invested in US assets, keeping US interest rates low and leading to excessive risk-taking by financial institutions in US markets. This view was popularly dubbed the “global savings glut.”
  - Others disputed that global imbalances arose more from low household savings and high fiscal deficits in the US, and the excessive risk-taking by its financial institutions. They also argued that the excessive risk-taking was mainly due to the lack of adequate regulation and supervision over complex securitization products.
  - While the debate has continued, emerging Asian countries (especially the PRC) have seen their current account surpluses declining after the global financial crisis.

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World Current Account Balance, 1997-2018 (% of world GDP)

GDP = gross domestic product.
3. External financing complemented domestic savings

Developing Asia’s gross domestic investment rate was higher than its gross domestic savings rate during the 1960s, 1970s, and 1980s. This excess investment was financed by foreign savings from nonresident capital inflows such as official flows, FDI, bank lending and bonds, and portfolio equity.

Since the 1990s, savings rates have exceeded investment rates.

The domestic savings–investment gap equals the current account balance. A positive gap indicates a surplus, while a negative gap shows a deficit. The deficit requires external financing.

However, even if a country runs a current account surplus, there can still be net capital inflows by nonresidents.

In such a case, the current account surplus and net capital inflows by nonresidents will offset investment by residents abroad (including FDI) and increase foreign exchange reserves.
3. External financing complemented domestic savings (cont.)

- Before 1990, net official flows (bilateral and multilateral) were the largest source of external financing for developing Asia, but these declined significantly as a share of gross domestic investment since 1990, although they continued to increase in levels.

- Since the early 1990s, inward FDI flows have become the largest source of external financing, as Asian economies introduced measures to liberalize trade and investment.

Net Capital Inflows by Nonresidents to Developing Asia, 1970-2017
(% of gross domestic investment)

Net FDI Inflows • Net Official Flows • Net Bank Lending and Bonds • Net Portfolio Equity Inflows

FDI = foreign direct investment.

Notes: Bonds are securities issued with a fixed rate of interest for a period of more than 1 year. They include net flows through cross-border public and publicly guaranteed and private nonguaranteed bond issues. Data are in current United States dollars.

3. External financing complemented domestic savings (cont.)

- The importance and composition of external financing differ from subregion to subregion.

- The Pacific had the largest external financing as a ratio to gross domestic investment. Their largest source has been net official flows.

- East Asia had the smallest external financing as a ratio to gross domestic investment, with the largest source being net official flows in the 1970s and net FDI since the 1980s.

**Net Capital Inflows by Nonresidents to Developing Asia by Subregion, 1970s to 2010s**

(% of gross domestic investment)

FDI = foreign direct investment.
3. External financing complemented domestic savings (cont.)

• **The role of financial systems.** A well-functioning financial system supports growth by
  - Mobilizing and pooling savings;
  - Facilitating payments, and financing trade of goods and services;
  - Promoting efficient financial resource allocation; and
  - Finding new entrepreneurs, diversifying and managing risks, monitoring investments, and applying corporate governance.

• Empirical studies find financial sector development leads to greater capital accumulation, faster productivity growth, and better economic performance.
  - The positive impact of financial development on growth is found to be more pronounced in emerging economies than in advanced economies as financial constraints are more binding in the former.
4. Asia’s financial system

- **Bank-based versus market-based financial system.** While the initial structure of a country’s financial system is often determined by historical, institutional, economic, legal, and political factors, there is now a consensus that an effective financial system requires both banks and capital markets.

- Some argue that banks have an advantage, particularly during the early stage of development. This is because banks can mobilize large sums of savings from small savers into medium- to long-term corporate investment. Banks can also monitor these investments on behalf of a large number of savers because they can extract critical information through their long-term relationships with borrowers, such as the “main bank system” in Japan.

- On the other hand, bonds and equity markets have the advantage of better spreading risk across a large number of investors with diverse risk profiles. Market-based financial systems are usually better at financing riskier investments—such as technological innovations—and providing long-term finance.

- Also, a market-based system can promote strong market discipline and better corporate governance through disclosure requirements, price signals, and the functions of boards representing equity holders. Capital markets offer investment opportunities for institutional investors—such as pension funds and life insurance companies.

- The market-based system is also considered better able to prevent financial crises, as losses incurred during financial distress can be absorbed by bond and equity holders instead of impairing bank balance sheets—thus avoiding bank runs and protecting payment systems. However, as the global financial crisis in 2008–2009 made clear, financial crises can occur regardless of financial structure—the crisis started in the US, where capital markets were considered most developed.
• **How the 2008 global financial crisis happened.** Since the 1990s, with the rapid development of structured finance, banks in many advanced countries, especially US, have invested heavily in market-linked products such as mortgage- and asset-backed securities through special purpose vehicles. Banks were also increasingly involved in derivatives markets (such as currency and credit-default swaps) and exposed to broader market risks.

• This created a channel through which distress in mortgage-backed securities (reinforced by more sophisticated securitization such as collateralized debt obligations) quickly spilled over to the banking system and impacted the entire financial system. Lack of effective financial regulation was at the core.

• After the global financial crisis, there have been serious efforts to reduce systemic risk, including through addressing the “too-big-to-fail” problems—and strengthening firewalls between banking and other investment services.

• But the boundary remains less clear-cut than what regulations intended. In many ways, the banking sector and capital markets are complements rather than substitutes in providing financial services, and risks can spill over between them. Regulators and the financial industry should remain vigilant and respond to any sign of possible irregularities.
4. Asia’s financial system (cont.)

- Before the 1997 Asian financial crisis, finance across most of developing Asia was bank-based, with bank loans accounting for 80-95% of corporate financing.
- Fast-growing Asian economies (newly industrialized economies) were quite successful in channeling domestic savings into investment using the banking system, partly due to several selective policy interventions.
- After the crisis, Asian policy makers prioritized capital market development—especially local currency bond markets and nonbank financial institutions—as a more diverse long-term financing alternative to banks.

### Measures of Financial Sector Development, 1990-2017

(amount outstanding as % of GDP)

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Notes: Regional averages are weighted by GDP. Economic regions follow the composition provided by the Asian Development Bank. Developing Asia includes Hong Kong, China; India; Indonesia; Malaysia; the Philippines; the PRC; the Republic of Korea; Singapore; Thailand; and Viet Nam. Sub-Saharan Africa domestic private debt securities figures refer to South Africa only.

4. Asia’s financial system (cont.)

- There has been a significant expansion in debt markets in many Asian economies in the past 2-3 decades, providing stable sources of long-term financing.

Outstanding Domestic Debt Securities, Selected Asian Economies, 1990-2017 (% of GDP)

ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product, NIEs = newly industrialized economies, PRC = People’s Republic of China.

Notes: ASEAN4 includes Indonesia, Malaysia, the Philippines, and Thailand. For India, 2010–2017 average refers to 2010–2011 data.

While capital market size has grown, much more needs to be done to make them deeper and more liquid.

One priority is to expand the institutional investor base, such as pension funds and insurance companies, as long-term investors.

Compared with advanced countries, institutional investor participation in capital markets in developing Asia remains limited.

**Domestic Savings, Pensions, and Insurance Assets, 2017**

(% of GDP)

- Developing Asia: Domestic Savings (40.1%), Pension (6.2%), Insurance (25.3%)
- OECD: Domestic Savings (22.4%), Pension (83.0%), Insurance (50.4%)

GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development.
Promoting small and medium-sized enterprise (SME) access to finance

- Broadening access to finance by SMEs is key to boosting inclusive economic growth. SMEs are the backbone of most Asian economies. They create jobs, promote competition, and stimulate domestic demand. However, poor access to finance is often a critical constraint to their growth in developing Asia.

- A recent Asian Development Bank report on SME finance (covering 20 developing Asian economies) states that, while SMEs made up an average 96% of registered firms, employed 62% of the labor force, and contributed 42% of economic output, they only received 19% of total bank loans in 2014.

- Limited access to bank credit is a structural problem for SMEs, mainly because of the asymmetric information between banks and borrowers. This leads to high collateral and guarantee requirements and adds to transaction costs.

- Developing Asian countries have taken various measures in recent years to promote SME access to finance, by making it easier to borrow using movable assets as collateral, expanding the guarantee of SME loans, introducing mandatory bank lending quotas for SMEs, supporting SME finance through fintech and digital solutions as part of national strategies for financial inclusion.
5. Looking ahead

• Future **policy challenges** regarding investment and savings for Asian economies are multifaceted and depend on **country situations**—such as demographics, resource endowment, policies, and institutions.

**01** Countries with **high investment and savings rates**, such as the PRC, need to **increase domestic consumption**. Policy measures may include promoting **consumer credit** and strengthening **social protection**.

**02** For countries with **low savings rates, low investment rates, and persistent current account deficits**—often with low per capita income—governments should introduce policies to **increase domestic savings**, including government savings through raising **tax revenues**. They can also more effectively use **external financing** from FDI, remittances, and bilateral and multilateral development finance.

**03** Regarding **financial systems**, future **priorities** include:

- developing and **deepening capital markets** and supporting greater participation by institutional investors;
- increasing **financial sector efficiency** by allowing greater competition;
- promoting **financial inclusion** by improving access to underserved groups such as SMEs, women, and low-income households;
- strengthening **financial regulation** to safeguard the financial system, protect consumers, and address money laundering; and
- embracing financial **innovation**.
6. Questions and further readings

- Questions

01 How does economic theory model the role of investment and savings in generating economic growth? What are the empirical findings?

02 What have been the key drivers of high investment and savings rates in Asian economies?

03 What were the causes of the 2008 global financial crisis?

04 What has been the role of financial systems in supporting Asian growth?

05 What are the pros and cons of bank-based and market-based financial systems?
6. Questions and further readings (cont.)

- Further readings

6. Questions and further readings (cont.)

Further readings


• Further readings


Thank you!

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