

## Comment on: The influence of China and US financial markets on Asia-Pacific

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China is playing an increasingly important role in the Asia-Pacific region's financial markets; this much seems obvious. The paper, however, sets out to document and most importantly quantify this increasing impact by comparing it to the long-dominant financial position of the United States in the region. Their empirical investigation allows the authors to distinguish between the impact of the United States and China on the small jurisdictions of Hong Kong SAR and Singapore, on the much larger Southeast Asian countries of Indonesia, Malaysia, Philippines, and Thailand, on the high-income, commodity-reliant countries of Australia and New Zealand, on the manufacturing powerhouses of Korea and Japan, and on India.

The links of some of these countries to China are already strong, and growing stronger. This is true for Australia and New Zealand and their trade exports (dairy products from New Zealand, and coal from Australia), of the Southeast Asian countries and their assimilation into China's supply chains and vertical integration, and of the Chinese-speaking Hong Kong and Singapore. The financial links, however, have not been as intensely scrutinised, and the authors are right to emphasise it.

Three possible markets and channels of impact are posited: sovereign bond, equity, and currency markets. It is the various channels of influence from one type of market in China or the United States to another in one of the Asia-Pacific countries that is investigated. The authors employ structural vector auto regressions (SVAR) with identification obtained by sign-restrictions motivated by theory. The main impact the authors locate is between the equity markets, whereby the Shanghai stock exchange has an impact on the other stock exchanges of similar magnitude to that observed from the NYSE. Remarkably, the impact is almost identical across countries, with all of the countries investigated associated with a 40–50% spillover from fluctuations originating in either the Chinese or the US stock markets.

The main empirical difficulty is the trade-off between the theoretical credibility of the assumed sign restrictions on the SVAR, and the larger admissible parameter space that arises when not enough structure (in the form of sign restrictions) is imposed on the VAR. The authors choose to impose relatively few sign restrictions – those they feel are most theoretically palatable – but are paying a cost in terms of the accuracy of their estimated impacts.

The paper focuses on a short-term horizon of five days. If we are to believe the efficient market hypothesis, one should not look for any longer-term impact. But much research has cast doubt on this hypothesis, and it may be that some of the long-term trends in these markets (for example the almost continuous appreciation

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of the Chinese currency) also have an impact that is otherwise unidentifiable in the SVAR framework.

Another caveat that is worth keeping in mind, especially for regulators and policymakers, is that any VAR estimation is based on a linear model. As is true of the dynamic stochastic general equilibrium models that are frequently used by central banks, and which failed so spectacularly to predict the 2008 global financial crisis, these VARs are also not good indicators for either the direction or the magnitude of the impact that will result in periods of extreme volatility.

Whether this extreme volatility arises in the region, or elsewhere, is not necessarily of any importance. The main qualifier is that the impacts may be much larger in periods of high volatility. This problem will potentially be more severe if the crisis engenders multiple shocks that are not orthogonal to each other.

Finally, one should ask what implications the findings described in this paper have for long-term financial stability. In the aftermath of the global financial crisis, the issue of financial stability has moved to the forefront of public attention and will, it is to be hoped, remain there. Is the rising impact of China on the local currency, bond and equity markets of the Asia-Pacific region a force for stability, or is it another source of imported instability? Especially worrying, in this context, is the relative opacity of the securities traded in Shanghai, and the consequent large volatility in this market. The run-up in the Shanghai SE composite in 2006 and the equally precipitous decline in 2007 should serve as a cautionary note about the possible volatility that an increased role for China will create in the region.

China's stock markets may be somewhat developed, but China's domestic bond markets are clearly at an earlier stage of development. We are led to expect, given the results presented here, that their impact on the region will in the future increase as well. What form will this causal channel take, and whether it will also create a new source of instability in the region, is not yet clear. The 30 year-old lesson from the Latin American debt crisis again sounds a cautionary note as it illustrates the type of bond market spillover that is observed when investors panic.

Related to that question is the possible macroprudential policy toolkit that should be adopted and adapted to deal with this new type of exposure in the region. Should, for example, capital controls continue to be used as part of the macroprudential toolkit as was recently done in the aftermath of the crisis, and as is now advocated by the IMF? Will capital controls be an effective tool in dealing with the liquidity and volatility now coming out of China?

And last, but from an American perspective not least, is the increasing role of China a harbinger of a diminished role for US financial markets in the region? Is this really a zero-sum game?