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Abstract

The paper applies the Feldstein-Horioka (FH) methodology to a large number of countries. By regressing the investment/GDP ratio over the saving/GDP ratio, the paper finds that the cross-section coefficient declined from around 0.5 during 1990-99 to a range of 0.22-0.35 during 2000-06 for different groups of Asian countries, suggesting that the region’s average financial openness increased across the two sub-periods. However, the FH coefficient during 2000-06 was generally higher for Asia than for other parts of the world. The paper concludes by arguing that countries in Asia must further liberalize cross-border financial transactions and make their financial systems deeper and more efficient, in order to promote financial integration in line with the region’s strengthening trade and macroeconomic interdependence.

JEL classification codes: F32; F41

Keywords: financial integration; saving-investment correlation; Feldstein-Horioka coefficient; Asian regional integration

I. Introduction

This paper assesses the degree of financial integration for different groups of Asian countries and identifies how it has changed in recent years as well as how it compares with the level of integration achieved in other parts of the world. In doing so, the paper uses saving-investment correlation (or the so-called Feldstein-Horioka coefficient when the investment/GDP ratio is regressed over the saving/GDP ratio) as an average measure of financial openness (which is a necessary condition for financial integration). It is well known that the Feldstein-Horioka (FH) coefficient is not free from conceptual problems, but it has the advantage of being obtainable for a large number of economies on a consistent basis. Moreover, recent research indicates that the measure contains useful information about the macroeconomic implications of financial integration.

Financial integration has been a topic of considerable interest in Asia, especially within the context

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‡ Japan Post Insurance (at the time the paper was prepared)
of the region’s ongoing economic integration process. Along with strengthening trade linkages among the region’s economies, there is now evidence that macroeconomic interdependence has also strengthened (ADB, 2008). In view of this, several initiatives have been underway to enhance macroeconomic policy cooperation in the region, including the Chiang Mai Initiative (and its multilateralization) and the ASEAN+3 policy dialogue process. There are natural expectations that financial integration has also strengthened in Asia, as trade promotes, and is accompanied by, financial transactions.

Financial integration, however, has a strong policy component—full financial integration requires explicit attempts on the part of policymakers to promote the development of domestic financial markets and to dismantle legal and regulatory restrictions on cross-border financial transactions. In this sense, financial integration in Asia remains an open question. Given the remaining capital controls and other restrictions on financial transactions, has Asia been as well integrated financially as in trade? Has the region’s financial integration increased in recent years? How does the region’s financial integration compare with the level achieved in other part of the world, such as the European Union (EU), Latin America, or Sub-Saharan Africa? These are the types of questions to which we are interested in providing answers.

The rest of the paper is organized as follows. Section II discusses alternative measures of financial integration proposed in the literature and the advantage of using the macroeconomic measure of saving-investment correlation. Section III qualifies the use of saving-investment correlation by discussing the associated conceptual and methodological problems. Section IV, the main section of the paper, estimates the investment-saving regression for different groups of countries and shows how Asia’s average financial openness (as a necessary condition for financial integration) has changed over time and how it compares with the level in other regions of the world. Section V presents a conclusion. Finally, Appendix I lists the composition of countries in each region or group.

II. Competing Measures of Financial Integration

Kenen (1976) defines financial integration as “the extent to which markets are connected” or “the degree to which participants in any market are enabled and obliged to take notice of events occurring in other markets” (p. 9). The concept may be straightforward, but it has multiple meanings in practice. Broadly, there are at least three ways in which the term financial integration has been operationally defined. First, financial integration can be a de jure measure. For example, two economies can be defined to be perfectly integrated if there are no legal or regulatory restrictions on cross-border financial transactions. However, the lack of restrictions does not guarantee that financial transactions actually take place freely. In the terminology of Le (2000), it may well be a measure of financial openness, but it is certainly not a sufficient condition for financial integration; it may not even be a necessary condition for a high degree of financial integration. In contrast, a de facto measure attempts to capture how two economies are actually linked financially.

Second, one set of de facto measures are based on price differentials, usually deviations from such no-arbitrage conditions as: covered interest parity, uncovered interest parity, and real interest parity,
which incorporates both financial and real integration (Frankel, 1992). The problem with price-based measures, however, is that it is often difficult to find financial instruments in two or more economies with comparable risk, liquidity and other characteristics. The prices of financial instruments, moreover, can be influenced by many factors, including exchange rate policy, governance concerns and risk premiums.

Third, another set of de facto measures relate to quantities, typically flows or stocks of financial instruments. Here, one must decide whether net or gross figures should be used. Stocks may be a better basis for measuring integration, to the extent that flows can be quite volatile from year to year, responding to various transitory shocks. But stock data are not easily available.¹ For both flows and stocks, measurements are often not accurate even when the data are available.

In sum, there is no single perfect measure of financial integration, either on feasibility or on conceptual grounds. Each measure has its own merits and limitations, and captures only one aspect of the totality of financial integration. One way to capture this multi-dimensionality of financial integration is to devise a composite concept. For example, Takagi and Hirose (2004) have suggested a methodology of using principal components analysis to obtain a univariate measure of financial integration from several competing ones.

Another way of addressing the multidimensionality is to use a macroeconomic measure, such as saving-investment or consumption correlation. The attractiveness of such a measure is that (i) unlike price-based measures, there is no need to deal with the problem of asset heterogeneity associated with individual financial instruments; and (ii) unlike quantity-based measures, data are readily available for a large sample of countries. Macroeconomic measures avoid the conceptual problems associated with directly measuring financial integration, by focusing indirectly on the macroeconomic implications of financial integration.

In what follows, we use saving-investment correlation as an average measure of financial openness, which is a necessary condition for financial integration, for a group of countries. In part, this is because correlation of consumption across countries is known to be a much noisier indicator of financial integration because (i) domestic consumption is cyclically correlated with domestic income and (ii) it is sensitive to exchange rate fluctuations as well as how nominal consumption is deflated.

The critical element of this investigation is to use consistent data for a large number of economies for comparison purposes, both across time and space.

### III. Saving-Investment Correlations

Saving-investment correlation, as a measure of financial integration, was first proposed by Feldstein and Horioka (1980), who estimated the following regression equation for member countries of the Organization for Economic Cooperation and Development (OECD):\[ (I/Y)_i = \alpha + \beta \frac{S}{Y}_i + \epsilon_i \]  

¹ The few available stock data sources include the Bank for International Settlements (BIS) for cross-border bank claims, and the Coordinated Portfolio Investment Survey (CPIS) conducted by the International Monetary Fund (IMF).
where I is domestic investment; S is domestic saving; Y is domestic income; α and β are coefficients to be estimated; ε is a random error term; and i is a country subscript. Feldstein and Horioka (1980) postulated that the coefficient (β)—henceforth referred to as the FH coefficient—would be unity in the complete absence of capital flows and zero under perfect capital mobility. The authors found the coefficient to range between 0.89 and 0.94 (depending on whether gross or net figures were used) by using period average data for 1960-74; the coefficient remained high and close to unity when the sample was divided into three 5-year periods. These results were termed the FH puzzle because they challenged the conventional view that capital mobility was high among industrial countries.

The FH approach to measuring financial integration has been challenged by a number of authors. Common to many criticisms is the notion that although zero capital mobility implies high saving-investment correlation, the converse may not be true if the two are correlated for reasons other than capital mobility (Harberger, 1980; Obstfeld, 1986). First, (I/Y) and (S/Y) may respond simultaneously to a third variable, notably a business cycle, a productivity shock, or demographic trend; Wong (1990) shows that the presence of non-traded goods could also cause the correlation to increase. Second, (I/Y) and (S/Y) are subject to an intertemporal budget constraint in the longer run. Third, saving-investment correlation increases as the unit of observation increases in size (i.e., from small to large countries). Ultimately, global saving must equal global investment. Finally, the government policy of limiting large current account imbalances may increase saving-investment correlation ex post (Bayoumi, 1990). All these considerations suggest that the FH coefficient when estimated especially in time-series data tends to be biased toward unity.

Two types of empirical work have been reported in the literature. One is to apply the original FH methodology to cross-sectional data or time-series panel data; the intent is to obtain an estimate of the FH coefficient for a region or a group of countries. Krol (1996) was among the first to use time-series panel data. Kim (2001), controlling for country size and business cycle shocks, still found that the order of magnitude of the FH coefficient for OECD countries remained essentially the same during 1960-92 as the original FH result. The other type of empirical work is to estimate the FH coefficient for individual countries using time-series data. Le (2000), for example, estimated the coefficients for 15 Asia-Pacific countries (excluding Japan, but including China, Australia, New Zealand, Myanmar, Nepal, Bangladesh, and India) during 1978-96 and found it to be low for Australia (-0.05) but high for New Zealand (1.28); the coefficient for East Asia was generally high, ranging between 0.2 (Korea and Malaysia) and 0.9 (China) and 1.0 (Indonesia).

A survey of the literature by Coakley et al. (1998), after noting that the FH results of implied

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2 Coiteux and Olivier (2000) and Jansen (2000) found that the short-run coefficient was smaller than the long-run coefficient.
3 Murphy (1984) found that the FH coefficient was smaller (less than 0.6) for smaller OECD countries than for larger countries (close to one) during 1960-80.
4 Krol (1996)’s major contribution was to find a much smaller FH coefficient for OECD countries during 1962-90 by using time-series panel data. The subsequent work by Coiteux and Olivier (2000) and Jansen (2000), however, challenged the result by showing that the reduction in the value of the FH coefficient was driven by the inclusion of Luxembourg, which Feldstein and Horioka (1980) had excluded from their sample. Ho (2002), using dynamic OLS or fully-modified OLS, showed that the estimation results were invariant to the inclusion or exclusion of Luxembourg.
low capital mobility among the OECD countries were robust, pointed to the emerging professional consensus that the FH methodology was not very informative because “a range of theoretical models” could “generate high saving-investment correlations even under perfect capital mobility.” Their assessment of the FH approach, however, appears premature in view of the fact that subsequent empirical work has yielded results that are more positive about the informational content of saving-investment correlations. First, with the financial globalization of the 1990s and 2000s, the FH approach applied to both industrial and emerging market economies has demonstrated that a substantial secular decline in saving-investment correlations occurred recently in many parts of the world. Taki (2008), for example, reports that the FH coefficient for OECD countries declined from 0.66 during 1975-79 to 0.10 during 2000-03.

Second, empirical work based on intra-national data has consistently shown that correlation, if any, between saving and investment across states, provinces or prefectures within a sovereign nation is small; often correlations are nearly zero and almost certainly smaller than those typically found in cross-country data. Again, Taki (2008) reports that the coefficient for Japanese prefectures was consistently small over 1975-2004; the coefficient could even be negative, indicating the impact of fiscal transfers within a sovereign nation. Other studies based on intra-national data indicate a similar result, with a coefficient estimate ranging between -0.11 for the United States and 0.15 for China (Sinn, 1992; Boyreau-Debray and Wei, 2002).

Thus, recent work suggests that saving-investment correlation does contain useful information about financial integration. It may not provide a precise metric of the degree of integration, and we must be careful not to ascribe too much to precise numerical estimates of the FH coefficient. However, the coefficient does seem to give a broad direction of change in financial linkage, thus allowing a rough comparison of financial integration across time and space when the methodology is applied to a consistent set of data.

IV. Measuring Regional Financial Integration by Saving-Investment Correlations

Relatively little work has been done to estimate the FH coefficient for Asia. To our knowledge, only four papers have estimated the cross-sectional coefficient for a group of Asian countries (see Table 1, including the choice of countries). Among the studies, Isaksson (2001) used monthly data to estimate the FH coefficient for several regions of the world during 1975-95, finding that capital mobility was generally low for most developing regions, including Asia (with the coefficient estimates of 0.82-1.35). The other studies, while confirming that the coefficient remained high for Asia, suggest that it had nonetheless declined substantially over time. For example, Kim et al. (2005) used a panel cointegration method to show that the estimated coefficient fell from 0.58-0.76 during 1960-1979 to 0.37-0.44 during 1980-98 for 11 Asian countries.

Additional studies based on Japanese data include Dekle (1996), who obtained a negative value for the coefficient during 1975-88; and Iwamoto and van Wincoop (2000), who found the coefficient to be 0.31 during 1975-90 after making appropriate adjustment for fiscal transfers (whereas the comparable estimate for OECD countries was 0.56).
Unfortunately, none of the studies address financial integration from the point of view of a relevant group of Asian countries, such as the Association of Southeast Asian Nations (ASEAN) or ASEAN+3. To provide useful inputs into the ongoing debate, we now estimate the FH coefficient for policy-relevant subgroups of Asian countries using more recent data, and compare the results with those from other parts of the world. All data are annual and come from the International Monetary Fund (IMF), *International Financial Statistics*; we estimate equation (1) by using period average, cross-section data for 1990-99 and 2000-06. We report in Table 2 the various estimates of $\beta$ obtained from using gross capital formation/gross domestic product for ($I/Y$) and gross domestic saving/gross domestic product for ($S/Y$).

Three observations are immediate from Table 2 (see Appendix I for the composition of different regions and country groups). First, there is a strong indication that financial openness increased in the Asia-Pacific region across the two sub-periods: the FH coefficient estimate declined for all three country groups. The decline is particularly substantial for the seven advanced members of ASEAN+3, for which the estimate fell from 0.470 during 1990-1999 to 0.223 during 2000-06. This latter estimate (0.223) is not statistically significant.

Second, looking at other parts of the world, we cannot say that financial openness increased consistently over the same period. This is true especially of Europe, which most likely mean that the

### Table 1: Selected Recent Estimates of the FH Coefficient in Cross-Section or Panel Regressions for Asia

<table>
<thead>
<tr>
<th>Study</th>
<th>Sample period</th>
<th>Sample countries</th>
<th>Methodology</th>
<th>Estimated coefficients</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Isaksson (2001)</td>
<td>1975-1995</td>
<td>Bangladesh, Bhutan, China, Fiji, Hong Kong, India, Indonesia, Korea, Malaysia, Myanmar, Nepal, Pakistan, Papua New Guinea, Philippines, Singapore, Sri Lanka, and Thailand</td>
<td>OLS/IV/panel regression</td>
<td>0.82-1.35</td>
<td>0.24-0.81 for Latin America; 0.08-0.33 for the Middle East; and 0.37-1.06 for Sub-Saharan Africa.</td>
</tr>
<tr>
<td>Kume and Ozeki (2003)</td>
<td>1970-2000</td>
<td>China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand</td>
<td>OLS</td>
<td>0.37 (1998-2000)/0.65-0.82 (1970-94)</td>
<td>-0.01 for EU-15 and 0.04 for OECD (1998-2000)</td>
</tr>
<tr>
<td>Kim, Oh and Jeong (2005)</td>
<td>1980-1998 (1960-1979)</td>
<td>India, Indonesia, Japan, Korea, Malaysia, Myanmar, Pakistan, Philippines, Singapore, Sri Lanka, and Thailand</td>
<td>Panel cointegration</td>
<td>0.37-0.44 (0.58-0.76)</td>
<td></td>
</tr>
<tr>
<td>Kim, Kim and Wang (2007)</td>
<td>1980-2002</td>
<td>China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand</td>
<td>Cross-section and panel time-series</td>
<td>Cross section: 0.85 (1980-1989); 0.53 (1988-2002) Panel: 0.88; 0.79; or 0.41</td>
<td></td>
</tr>
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</table>

Notes: ¹When estimated with the restriction that all coefficients are equal. ²Average of individual country coefficients when estimated without the equality restriction. ³Average of individual country coefficients after controlling for cyclical shocks.
The level of openness (and also presumably integration) was already high during 1990-99. The degree of financial openness appeared little changed among the Western Hemisphere countries, despite the fact that openness was not as high as in Europe to begin with. The extremely low estimates for Africa must be interpreted with care, because this could mean that the share of official development assistance in financing domestic investment is large (relative to GDP) in many countries (the coefficient for the CFA countries, however, is larger). If so, the low $\beta$ value does not necessarily reflect the outcome of financial openness.

Third, comparing the coefficient estimates across regions and country groups, we note that the degree of financial openness in the Asia-Pacific region, even for the later 2000-06 period, is not very high relative to Europe, the Middle East, or the OECD membership. Asia’s average financial openness (of 0.22-0.35) appears comparable to the degree observed in the Western Hemisphere (0.28-0.31). Although comparison with Africa is difficult, Asia remains among the least financially open and hence least financially integrated regions in the world, despite the great advances made in trade integration over the years.

The relatively low financial openness of Asia may correspond to the finding of Kim et al. (2006).
namely, that financial links in Asia during 1999-2003 were almost entirely explained by trade.\(^7\) Recent studies that are based on quantity measures of financial integration suggest that Asia is not well connected financially within the region. For example, Cowen et al. (2006), based on the IMF’s portfolio survey, show that Asia’s portfolio liabilities to other Asian countries amounted to only 2½ percent of regional GDP in 2004, less than one-third the liabilities to either North America or the EU. Pisani-Ferry and Cohen-Setton (2008) show that East Asia’s ratio of external financial assets and liabilities to GDP is considerably lower than the ratio in Europe or North America (see also Eichengreen and Park, 2004).\(^8\)

Financial integration cannot entirely be left to a market-driven process. There are at least three reasons for taking policy action. First, greater trade integration leads to greater macroeconomic interdependence. Financial integration presents a means of diversifying macroeconomic risks across the region in such an environment. Second, greater financial integration reduces the transactions costs of cross-border activities, thereby facilitating further trade integration. Third, greater financial integration, in the sense of more two-way capital flows within the region, reduces the adverse impact of global financial shocks that originate in international financial centers outside the region. The recent global financial crisis has demonstrated the danger of relying too much on outside financial centers to intermediate the region’s financial resources.

To promote further financial integration in Asia, policy measures are needed in two broad areas. First, the authorities must take explicit steps to liberalize restrictions on cross-border capital transactions. In terms of the IMF de jure measures of exchange and capital controls,\(^9\) Asia as a region has one of the most restrictive regimes in the world (Figure 1). Second, to further liberalize the capital account with confidence, the authorities must develop a deep and efficient financial system and establish a good system of prudential supervision. The experience of the 1990s has demonstrated that, in order to reap the benefits of international capital flows while minimizing the attendant risks, the financial system must be resilient to shocks and the private sector must be capable of managing currency and maturity risks effectively.

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\(^7\) By estimating a gravity model of bilateral financial asset holdings for 1999-2003, they found that the East Asia dummy had no additional explanatory power (indicating the lack of financial integration beyond what could be explained by trade).

\(^8\) East Asia is defined as ASEAN+3 and Europe as the EU + Switzerland.

\(^9\) The de jure index is based on 14 types of restrictions on foreign exchange and capital transactions.
V. Conclusion

The paper has applied the Feldstein-Horioka (FH) methodology to a large number of countries, in order to assess how financial integration progressed in Asia over time and how it compares with the degree achieved in other parts of the world. First, we found that the FH coefficient estimate declined for all three country groups within Asia, with the largest decline observed for the seven advanced members of ASEAN+3 (from 0.470 during 1990-1999 to 0.223 during 2000-06). Second, we noted that the degree of financial openness (as a prerequisite for financial integration) in the Asia-Pacific region, even for the later 2000-06 period, was not high relative to Europe, the Middle East, or the OECD membership; rather, Asia’s degree of financial openness was comparable to Western Hemisphere countries. While comparison with Africa is difficult, Asia remains among the world’s least financially open and hence least financially integrated regions.

The relatively large value of the FH coefficients estimated for Asia is consistent with other metrics of financial integration. For example, empirical studies show that financial integration in Asia has been predominantly driven by trade links, and that the volume of gross capital flows within Asia is only a fraction of the volumes seen in other regions as a percent of GDP. Moreover, in terms both of cross-border bank credits and of cross-border securities, Asian economies are more financially integrated with the global markets than with each other. Asia as a whole remains among the world’s most restrictive regions in terms of capital account openness.

In order to elevate the degree of financial integration in Asia to a level more commensurate with the degree already achieved in real integration, the authorities must take more explicit steps to liberalize restrictions on cross-border capital transactions. To do so with confidence, they must develop deep and efficient financial systems, establish a good system of prudential supervision, and pursue sound macroeconomic policies consistent with financial stability. A regional institution to provide peer pressure, mutual surveillance, and a crisis management facility may also be helpful in this context.
References


### Appendix 1. Composition of Regions and Country Groups

<table>
<thead>
<tr>
<th>Region</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN+3 (7)</td>
<td>Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, and Thailand</td>
</tr>
<tr>
<td>ASEAN+3 (10)</td>
<td>ASEAN+3 (7), Cambodia, China, and Vietnam</td>
</tr>
<tr>
<td>Asia-Pacific (19)</td>
<td>ASEAN+3 (10), Australia, Bangladesh, Bhutan, India, Mongolia, Nepal, New Zealand, Pakistan, and Sri Lanka</td>
</tr>
<tr>
<td>Original Euro Zone (11)</td>
<td>Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain</td>
</tr>
<tr>
<td>Euro Zone (15)</td>
<td>Original Euro Zone (11), Cyprus, Greece, Malta, and Slovenia</td>
</tr>
<tr>
<td>Original EU (15)</td>
<td>Original EU (11), Denmark, Greece, Sweden, and the United Kingdom</td>
</tr>
<tr>
<td>EU (27)</td>
<td>Original EU (15), Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, and Slovenia</td>
</tr>
<tr>
<td>Europe (34)</td>
<td>EU (27), Iceland, Israel, Norway, Russia, Switzerland, Turkey, and Ukraine</td>
</tr>
<tr>
<td>MERCOSUR (10)</td>
<td>Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela</td>
</tr>
<tr>
<td>Western Hemisphere (29)</td>
<td>MERCOSUR (10), Antigua and Barbuda, Belize, Canada, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, and the United States</td>
</tr>
<tr>
<td>Middle East and North Africa (11)</td>
<td>Algeria, Bahrain, Egypt, Jordan, Kuwait, Libya, Morocco, Qatar, Saudi Arabia, Tunisia, and Yemen</td>
</tr>
<tr>
<td>CFA Franc Zone (12)</td>
<td>Benin, Burkina Faso, Cameroon, Central African Republic, Republic of Congo, Cote d’Ivoire, Equatorial Guinea, Mali, Niger, Senegal, Togo, and Gabon</td>
</tr>
<tr>
<td>Sub-Saharan Africa (21)</td>
<td>CFA Franc Zone (12), Botswana, Burundi, Cape Verde, Democratic Republic of Congo, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mauritius, Mozambique, Namibia, Nigeria, Rwanda, Sierra Leone, South Africa, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe</td>
</tr>
<tr>
<td>G7 (7)</td>
<td>Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States</td>
</tr>
<tr>
<td>OECD (24)</td>
<td>G7, Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, and Turkey</td>
</tr>
</tbody>
</table>