CAPITAL MARKETS IN ASIA:

CHANGING ROLES FOR ECONOMIC DEVELOPMENT

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FOREWORD

The AT10 co-operative research program for 2000-01 showed how the economies in East Asia are striving to achieve more indigenously driven development by upgrading their industrial sectors. In many economies in the region, financing start-up firms in dynamic industries such as ICT has become a major issue. The banking system, which dominates financing in East Asia, is not well suited to this task, and in some economies it is also plagued with massive non-performing loans.

In many ways, capital market financing meets the needs of East Asian economies to support their future industrial development. It offers a substitute for the ailing banking system. In addition, greater reliance by East Asian firms on capital markets may strengthen their competitiveness by stabilising access to funds for growth and improving corporate governance. And, since capital markets provide start-up as well as growth financing, a greater role for capital markets in the region will support the emergence of indigenous firms. Finally the increased requirements for financial information that emerge with the development of capital markets will drive the formation of an information infrastructure in the region.

To date, the spread of global capital markets has had both positive and negative impacts on East Asia. It has increased capital inflows, created pressure to improve corporate governance and to develop institutions that meet international standards, and introduced technological and managerial know-how from international financial institutions. On the other hand, it has exposed the region to financial volatility and it may encourage corporate management to take a shorter-term perspective.

The Tokyo Club Foundation for Global Studies asked researchers from the leading think tanks in ten East Asian economies (the AT10) to examine the status of capital markets in their home economies, considering the places of capital markets and banks as sources of financing, institutional changes intended to support the development of the capital market, the role of global capital markets and financial institutions, and the impact of capital market development on the local economy. The researchers were asked to prepare a paper on the aspect of capital market development that they saw as most significant to their home economy.

In March 2002, the AT10 researchers met in Tokyo to present and discuss these papers under the theme "The Role of Capital Markets in Asian Economic Development". I am pleased that the Tokyo Club, in co-operation with ISEAS and NRI, can share the results of their work.

Junichi Ujiie
President
Tokyo Club Foundation for Global Studies

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CHAPTER 1

CAPITAL MARKETS IN ASIA: FOUNDATION FOR CONTINUING ECONOMIC DEVELOPMENT

Donna Vandenbrink

Capital markets contribute to growth by mobilizing an economy's savings and allocating them to productive investments in the corporate sector. To carry out these functions effectively, capital markets draw on a wide variety of systems and actors, from exchanges and settlement systems for trading to legal systems for enforcing contracts, from providers and analysts of information about corporate performance to corporate managers that act in shareholders' interests. Given these requirements, capital markets tend to emerge as significant sources of corporate financing only after an economy has reached a certain level of development, and the notion of the sequential development of financial systems from banking to bill trading to sophisticated financial instruments is well established. Today, though, with investment capital able to flow relatively freely across national borders, developing countries may be subjected to the demands of capital market investors whether or not they have in place the requisite infrastructure to support arm's length, market-based financing.

The East Asia region has experienced the positive and the negative sides of the globalization of capital markets. During the early 1990s it benefited through the increased inflows of funds, the pressure to improve corporate governance and to develop institutions that meet international standards, and the technological and managerial know-how of international financial institutions. On the other hand, the region became exposed to external financial shocks, notably the Crisis of 1997-98.

That Crisis highlighted the need for Asian economies to develop domestic sources of finance and to diversify their bank-dominated financial systems. Over-reliance on foreign financing and term mismatch by banking institutions were factors precipitating the crisis, and as the crisis played out in some economies, banks with massive holdings of non-performing loans could not carry out their role as financial intermediaries. East Asian firms need to be able to draw on capital market financing as well as bank loans.

By creating a broader, more stable financial base, robust domestic capital markets would provide a stronger foundation for further economic development in the region. For the most part, economies in East Asia are recognizing the need to encourage local entrepreneurs and SMEs to replace foreign direct investment in driving their development. Active local equity markets could be not only a source of capital for domestic firms but also a source of control on management practices. Improved corporate governance would raise the international competitiveness of Asian firms and Asian economies. The emergence of a local venture capital industry and markets for financing start-up firms would provide stimulus for indigenous firms in industries such as ICT that are critical in the transformation to knowledge-based economies. Expansion of domestic bond markets would relieve the local banking industry from the burden of providing long-term financing and facilitate recycling the region's accumulated foreign currency reserves into the development of indigenous firms. The requirements of capital markets for financial information would spur the formation of a local information infrastructure.

Status of Capital Markets in East Asia

What is the current status of domestic capital markets in East Asian countries? How do they contribute to the local economy? Are reliable support institutions and infrastructure in place? Can they compete in the environment of globalized capital markets? In 2002, the Tokyo Club Foundation for Global Studies funded researchers from ten East Asian countries to take stock of the status and direction of capital market development in their home economies. The papers in this volume comprise their analyses of the most significant aspects of domestic capital market development in each economy.

According to the priority issues identified in these papers the economies of East Asia fall into five groups. First, Indonesia, the Philippines and, to some extent, Thailand, are focused on the problems of building an active capital market as a counterweight to bank financing. Next, mainland China is utilizing domestic stock markets to support the transformation of state enterprises and the development of private ones, while Hong Kong is supporting this transformation by attracting the listing of mainland firms on its stock markets. Third, Singapore is trying to maintain its status as a regional financial centre by accelerating reforms and liberalization, while Malaysia is targeting the same objective in a more phased manner in view of its fragile securities industry. For Korea and Taiwan, which are eager to transform to knowledge-based economies, the focus is to provide growth equity markets and venture capital financing for high-tech and knowledge-intensive firms. Finally, Japanese equity investment in Asian firms has potential diversify risk and increase returns for Japanese investors and to support indigenous businesses and develop local capital markets in the rest of Asia, provided obstacles in both Japan and recipient countries are overcome. In this Introduction we highlight the key findings on each of the ten economies.

Diversifying from Bank Financing: Indonesia, Philippines, and Thailand

The chapter on Indonesia focuses on the role of the country's capital markets in stabilising economic activity as well as funding growth and development. While improper financing techniques—reliance on short-term bank loans for long-term financing and failure to hedge foreign exchange liabilities—caused the financial crisis in 1997 Indonesia's capital market proved to be a reliable financial institution during the crisis, maintaining the volume of transactions (p. 17). In the present circumstances the capital market is a crucial source of funds for restoring the country's good macroeconomic prospects. Government funds for development spending are limited by competing demands to re-capitalize banks and by changes in the central government's control over revenues. Repayment obligations on foreign borrowing are becoming an increasing fiscal burden, while restructuring in the banking sector is delaying resumption of its normal function as financial intermediary. The private business sector began to tap the capital market for long-term financing during the crisis, and the value of bond and share issues began to approach the volume of bank lending from 1997.

According to the author, at the time of the crisis, Indonesia had made "substantial progress in creating the complex set of laws and rules on which the capital market depends" (p. 12). Indonesia began to develop its capital market from the late 1970s and three deregulation packages adopted in the late 1980s reformed the institutional structure of the market. Enactment of the 1995 Capital Market Law made full-disclosure by companies, self-regulation by exchanges and supporting institutions, and government supervision of market performance, the operating principles for the market and stimulated strong investor interest in the market.

The task now is for Indonesia to ensure adequate financing to restore the economy to a sustainable long run-growth path. In addition to drawing foreign investors back, it needs to increase the participation of domestic investors in the local capital market and improve the functioning and scale of the market. Looming on the horizon is the pressure on the economy and the markets when the government must repay the bonds it issued to recapitalize the banking sector in the 1997 crisis.

Factors favoring continued development of Indonesia's capital market include investor interest in the privatization of state-owned enterprises, presence of foreign brokers and managers, attractive earnings opportunities created by the rupiah's decline, the pools of SMEs as potential new issuers and of individuals and institutions as potential new investors, and the improved professionalism of capital market players. On the other hand, small scale, uneven distribution of ownership and illiquidity, and lack of familiarity and unprofessional behavior among market participants may constrain market development.

The government should encourage capital market development by instituting a regulatory system to control issuance and a strong supervisory system to monitor day-to-day activities, all with the objective of good corporate governance and transparency. (An appendix highlights the activities of the regulatory authorities since 1998.) In addition, Indonesia must achieve macro-economic stability and improve the political environment to create a climate conducive to local investment (p. 20).

In contrast to Indonesia's relatively steady progress in capital market development since the late 1970s, the Philippines failed to maintain the position it held in 1966 at the forefront of the region's capital markets. The authors of the chapter on the Philippines limit their attention to three components of the country's capital market—the pension system, the equities market, and the fixed income market—to explain this disappointing development trajectory and to suggest future prospects.

The Philippines has not yet tapped the potential of contractual pension savings as a catalyst to developing the country's capital market. Regression results showing pension contributions comprising a rising share of household savings as national income rises suggest that pension savings could be a significant source of long-term capital in the future. According to the authors, one of the few domestic sources of such capital at present is the privately managed voluntary pension plans of large private companies. The public pension system suffers from a lack of professional investment policies and practices, regulatory restrictions on the allocation of assets to long-term securities, and suspicion of political influence over investments. The flow of savings from the pension system to the capital markets should increase with recent changes in coverage and compliance by the public pension system as well as by addressing the issues of over-pensioning, benefit portability, and privatization.

Although the Philippine equities market was founded in 1927, it has remained small with only a few actively traded and investment-grade issues. The authors' regression of equity market capitalization and per capita GNP suggests that the equities market will increase in importance as economic development raises income levels. Moreover, a structural change during the 1990s implies that "equities markets have grown in importance for economies at all levels of development" (p. 18). Historically, the Philippine equity market has depended on foreign participation, which subjects it to the risk of fleeing foreign funds. Two other problems holding back market development are high transactions costs due to taxes on transfers and commissions and the loss of investor trust due to scandals and political involvement. The latest scandal led to significant reform of securities regulation providing for full-disclosure, de-mutualization, protection of minority shareholders, and prohibitions on insider-trading and affiliated transactions. Availability of information and perception of fairness are issues that remain to be addressed.

Turning to the fixed-income securities market, the authors blame structural and demand-related problems for the lack of market development. They attribute inefficiency in the primary market for government securities to the power of banks, which are able to corner some issues, and to the auction rules, which accept too high a proportion of non-competitive bids. The secondary market for government securities could become more active by: 1) changing regulations that encourage banks and insurance companies to hold these securities; 2) adopting a public, on-line quoting and trading system that would allow two-way information exchange and impersonal matching; 3) unwinding the universal bank model to make investment houses more competitive and removing impediments to participation of public pension funds and non-bank financial institutions; and 4) removing the tax on transactions. These structural problems combined with uncertainty over the economy's prospects and lack of market knowledge to discourage investor interest and limit market liquidity. Addressing these issues, the authors suggest, would deprive commercial banks of the economic rents they currently enjoy and bring the yield curve for Philippine government securities in line with inflation and with those of other developing countries.

Turning to the fixed-income securities market, the authors blame structural and demand-related problems for the lack of market development. Structural factors, including the power of banks, regulations on pension funds, banks, and non-bank financial institutions, the auction, quoting and trading systems, and taxation combine with uncertainty over the economy's prospects and lack of market knowledge to discourage investor interest and limit liquidity in the primary and secondary markets for government securities. Addressing these issues, the authors suggest, would deprive commercial banks of the economic rents they currently enjoy and bring the yield curve for Philippine government securities in line with inflation and with those of other developing countries. Additional structural problems noted in the market for private fixed-income securities are the lack of credible credit ratings, inadequate accounting standards, and a lack of corporate governance standards. Overall, the authors believe that recently adopted and proposed structural reforms address most of the obstacles to putting the Philippine capital market back on track to contribute to the country's sustained economic growth.

The starting point for the chapter on Thailand is the boom in the country's stock and bond markets that followed the 1997 crisis. The author puts this surge in market activity into perspective by looking both at the path of capital market development and the characteristics of Thailand's business and financial environment. While some see the post-crisis performance as the sign of a well-developing market, the author argues that the boom of the late 1990s must be examined more closely before interpreting it as an indicator of the general trend of the Thai capital market. The number of issues, volume of transactions and turnover in the Thai market increased along with the evolution of instruments, institutions, and participants. However, the government securities issues that were the dominant source of expansion at the end of the 1990s were a one-time phenomenon caused by the need to recapitalize financial institutions and revive the economy. Under the more normal pre-crisis conditions, legal constraints on government borrowing and the government fiscal balance restricted the supply of government securities. Moreover, the increase in private debt and equity issues in the late 1990s was also a one-off, post-crisis phenomenon, the author argues, reflecting corporations' need to refinance foreign obligations in the face of the decline in bank credit and local interest rates as well as fluctuating exchange rates. He points to the fact that corporate bond issues fell by half from 1999 to 2000 as these pressures eased.

The characteristics of Thailand's business and financial environment present some potential obstacles to the future development of the market, the author argues. Observing the apparent preference of Thai business for indirect financing through banks over direct financing through capital markets, he suggests that reluctance to be subjected to the governance and transparency requirements of public listing may be inherent to Thai business culture. Other potential stumbling blocks are the reliance on equity-related rather than debt-related instruments, due to later opening of bond markets and restrictions on the supply of government bonds; the lack of participation by households and non-bank institutional investors, the latter due to prudential restrictions; and the heavy reliance foreign investors, which subjects the market to interest and exchange rate fluctuations that discourage local investors.

At the end of the 1990s, Thai policymakers adopted measures to improve the functioning of the market; they included steps to cultivate investors with rating information, education, training, and investor protection as well as with new instruments such as retirement mutual funds, steps to encourage listing, by creating a market aimed at SMEs and modifying listing requirements, for example, and steps to raise market performance through internet trading and facilitating payment and settlement.

Overall, the author is guarded about the prospects for Thailand's capital market. Limitations on public and private sector participation in the market could be offset with foreign investment and liberalization of the domestic securities business to accelerate the pace of development. But this requires appropriate regulation to preserve the stability of the market and needs to take into account the unique aspects of Thai corporate culture, in particular the nature of SMEs. Thai authorities must find a middle ground between too much emphasis on safety, which will hamper market development by deterring SMEs and foreign investors, and too little control, which could lead to failures of domestic firms and market instability.

Using Stock Markets to Transform State-Owned Enterprises: China and Hong Kong

Counting from the launch of the Shanghai and Shenzhen exchanges in 1990, China's modern securities market is barely ten years old. While the development of this market was initially aimed at providing capital for troubled state-owned enterprises (SOEs), the author of the chapter on China notes a critical change in the official philosophy, exemplified by the reorganization of the China Securities Regulatory Commission in 1998 and the promulgation of the Securities Law in 1999, to give private companies greater access to this funding as well. Development of

China's capital markets not only provided funds, but also contributed to the development of domestic enterprises. For SOEs, it diversified ownership, reduced the influence of the government in enterprise affairs, and, as a result, improved enterprise governance; and listing on the markets has had a positive influence on governance of private enterprises as well.

The author identifies two issues that Chinese authorities must address to keep the country's capital markets on their path to development. One is the generally poor quality of SOEs' assets and the financial strain of their social welfare obligations which motivates their spinning-off good assets into new enterprises that can generate funds through IPOs and engaging in self-dealing and transferring profits to access those funds. The other is the continuing inadequacy of financing for private, especially start-up, firms because they cannot meet the listing conditions under the Company Law.

As well as listing on China's markets, an alternative route to funds for SOEs and an additional impetus for upgrading some Chinese enterprises is listing in Hong Kong. That is the contention of the authors of the chapter on Hong Kong. They argue that Hong Kong's equity market has served the development of Chinese enterprises both financially, by channeling international capital to Chinese enterprises, and educationally, by serving as a training ground where Chinese enterprises gain familiarity with internal capital market standards. They illustrate this argument with a case study of the Zhejiang Expressway, which is a concrete example of how listing induces improvements in corporate governance. To list its H-shares and comply with the laws of Hong Kong and regulations of the SEHK, Zhejian Expressway had to seriously address the issue of insider trading and to adopt international standards of information disclosure and transparency.

Hong Kong is able to play these roles for Chinese enterprises because its financial sector is at an advanced level, comparable to that in developed economies. In particular, the authors describe the recent organizational, technological, and regulatory improvements in the equity market that have kept Hong Kong at the forefront of global capital markets. The overview also reveals the continuing importance of banks and the relative insignificance of debt markets as sources of corporate finance in Hong Kong, a situation also found in other economies in the region. Unlike with less developed economies, however, the weakness of Hong Kong's debt market is not due to a lack of institutional infrastructure. Rather, as in Thailand, development of the debt market suffered because of the long-standing strong fiscal position of the government. In addition, according to the authors, easy access to bank and equity financing in Hong Kong means issuing debt incurs higher transactions costs. They also point to a lack of large-scale pension funds as potential buyers of domestic debt.

Orderly Upgrading and Deregulating to Maintain Competitiveness: Singapore and Malaysia

From the 1960s Singapore embarked on a deliberate program to develop as a center of financial market activity for the Southeast Asia region. Through its outward-looking financial development strategy it has achieved a high concentration of financial institutions and capital markets and has become a central location for transacting the region's financial business. Its banking system, through offshore units of foreign banks known as Asian Currency Units, is a center for international banking and foreign exchange trading. With the merger of the securities and derivative exchanges into the Singapore Exchange, Singapore's capital market has gained the financial capability and vibrancy to undertake heavy capital investments and financial innovation and strategic alliances with foreign exchanges will increase efficiency and attract global players.

Current targets for improvement are: domestic banks, which need to expand to compete with foreign banks at home as liberalization continues and to overcome the limits of their small domestic market; the bond market which, though more liquid than markets in Thailand, Indonesia, and even Hong Kong, still needs to grow in depth and breadth; and the fund management industry, which is well behind Hong Kong in the amount of funds it manages.

In the years ahead Singapore faces a number of challenges to its position as a regional financial center including the emergence of other competitors such as Malaysia and the Hong-

Kong-Shanghai combination as well as technological advances that erode its comparative advantages, structural changes, and consolidation of global financial activity. It will have to “continue to plan, invest, and anticipate changes” to maintain its leading position as a financial center for the Southeast Asia region.

As with Singapore, upgrading the domestic capital market is a central part of Malaysia’s overall economic strategy. At the end of the 1990s Malaysia’s capital market was more highly developed than the markets in many other emerging markets. Over the previous 30 years, capital market financing grew at twice the rate of the Malaysian economy as a whole. During the 1990s in particular, the market changed and developed substantially, assuming a more prominent place in the financial system. The authors describe how the variety of products and services offered expanded to serve private-sector firms as well as government and the steps Malaysia took to modernize its exchanges, consolidate capital market regulation, and develop intermediary market services. As the market increased in scale and liquidity it attracted more international players and helped Malaysian firms gain access to international capital.

The central concern of the chapter, though, is what Malaysia must do to develop the capital market to the next level. Upgrading the domestic capital market is necessary to ensure the country can mobilize sufficient financial resources to meet its development goals, accommodate structural change in the financial sector, and meet the pressure of international competition. The Capital Market Masterplan lays out the country’s comprehensive strategy for accelerating development of the capital market to 2010. The plan aims to make the capital market the preferred source of fundraising, improve the investment management industry; the market institutions, intermediation services, and the regulatory regime and to promote Malaysia as a center for Islamic banking. It is to be implemented in three stages to ensure the readiness of market participants to face increased competition and liberalization. The authors stress that the orderly, sequenced introduction of change is necessary to maintain the stability and integrity of Malaysia’s capital markets in the course of liberalization and deregulation.

Addressing Financing Needs of New, Innovative Firms: Korea and Taiwan

To fill a gap in early-stage financing left by financial institutions and to stimulate financial activity, Korea established the KOSDAQ market in 1997 to cater to venture businesses. The market grew dramatically, particularly in the early years after the Asian Crisis. The author establishes that this growth was based on fundamentals, not simply speculation and identifies three important factors in the market's growth: the demand for financing from the booming IT industry; the fall of the *chaebol* which led investors to re-evaluate and redirect resources to different risk categories; and most importantly the Korean government, which acted as owner and governor, provider of subsidies to market participants, investor, and certifier of venture businesses.

While accepting the benefit of such strong government intervention in the early days of the market, the author argues that now the government should shift from market-creation to investor-protection as the policy goal and it should adopt the new policy paradigm of maximizing the market mechanism/minimizing government presence, which is the operative paradigm in advanced countries. Realizing this new paradigm requires determining the structure of private ownership, governance, and regulation and establishing an appropriate role for financial institutions in the market. Unlike similar markets in advanced economies, individual investors, not financial institutions such as venture capitals and investment banks, dominate the KOSDAQ. The author advocates policies aimed at establishing well-functioning venture capitals with sufficient reputation to enhance market efficiency and changing regulatory requirements to enhance the market-making role of investment banks.

As another Asian NIE, Taiwan is in a similar position to Korea—it does not yet offer the range of financial institutions and variety of financial instruments and sources of funds found in the most advanced economies. The particular concern of the Taiwan chapter is how well the financial environment in Taiwan serves the needs of high-tech knowledge-intensive enterprises through all stages of their development. During the 1990s, private market allocation began to take the place of policy-directed subsidies for high-tech industries, and new types of financial instruments and institutions, including venture capital businesses and stock market peripheral institutions, started to appear as Taiwan liberalized its financial system. Nevertheless, the author finds that the financing needs of high-tech enterprises that are in the initial start-up phases are not well served in Taiwan (p. 6). Given their inherently high levels of risk, such firms are typically not candidates for traditional indirect (bank) financing. Moreover, the capital markets, including the stock markets and venture capital businesses, in Taiwan have not yet developed to serve this segment of the market.

Both the Taiwan Stock Exchange and the OTC market have relaxed listing requirements for high-tech firms and non-traditional industries appear to be attractive to their investors, but most SMEs still lack the scale to list on one of the exchanges. One development that may facilitate equity financing for high-tech start-ups is the market for unlisted shares established in 2002 by the OTC with very loose registration requirements.

Turning to venture capital, which is an appropriate source of financing for newly established enterprises, the author finds that the emergence of this industry strongly supported Taiwan's growing high-tech sector during the 1990s. But looking more closely, she also finds that the preponderance of venture capital funding went to enterprises in the establishment stage rather than those in the seed stage. Recent changes in tax incentives may decrease investment in venture capital.

Role of Japanese Investment in East Asia's Development

Rather that focusing on the capital market in Japan, the authors of the paper from that country examine the role of investors from Japan in the capital markets of other Asian economies. Japan is the second largest economy in the world with an abundance of household wealth, but Japanese investors have heretofore been relatively insignificant players in regional stock markets.

The authors argue that increasing investment in Asian stocks from Japan would bring mutual benefit to both Japanese investors and recipient economies. It would afford Japanese investors the opportunity to diversify risk and increase returns and it would offer Asian economies access to additional capital to finance local companies to drive economic development without relying on FDI. In addition to lack of absorptive capacity on the part of Asian economies, the authors attribute the small amount of Japanese investment in Asian stocks to the risk appetite of Japanese individual investors, the underdevelopment of the Japanese fund management industry, the domestic orientation of Japanese investors and the non-Asian orientation of the same. While some of these conditions may change over time, the authors provide an agenda of items for Asian economies and Japanese investors to address in order to increase the flow of investment from Japan to other capital markets in the region. Increasing the flow of stock investment from Japan to other Asian economies would appear to be a win-win proposition, with benefits to Japanese savers, Asian firms, and the capital market infrastructure on both sides.

CHAPTER 2

THE CAPITAL MARKET IN INDONESIA'S ECONOMY: DEVELOPMENT AND PROSPECTS

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INTRODUCTION

Alongside distribution of income and resources and price stabilisation, the growth rate of an economy is an important macro indicator of economic development. Economic growth usually requires a proportional increase in investment. At the same time, because higher economic growth indicates improving macroeconomic performance it will encourage investment. Indonesia's economy should have grown without many obstacles in the environment of economic globalisation and flourishing domestic business activity during the 1990s. But the economic crisis that hit in the middle of 1997 obliterated this expectation. The improved macroeconomic performance achieved by Indonesia (which the World Bank listed among the countries with the most rapid economic growth) collapsed since the crisis. One factor impeding the revival of the business sector was its excessive dependence on bank funding. The relative under utilisation of the capital market for financing Indonesian business delayed the recovery of the national economy from the crisis.

This chapter describes capital market development in Indonesia and the role of capital market financing in Indonesia's economic development.

INDONESIA'S ECONOMIC DEVELOPMENT IN BRIEF

Indonesia made good macroeconomic progress, growing more than seven percent per year on average for the five years before the economic crisis in struck 1997 (Table 2.1). This was one of the highest rates of growth in the emerging economies in Asia. Monetary policy was directed to maintaining

1. The author expresses appreciation for their kind help on this paper to Ir. Heny and Mr. Fatah Arafat SE, who contributed research assistance, and to Mrs. Rietje Koentjoro.

internal and external stability, and inflation had subsided to a safe level. During that period, prudent government policy planning to control expenditures generated continual fiscal surpluses. On the external side, current account deficits were below four percent of GDP, the lowest ratio in Southeast Asia. The current account deficit resulted from the growth of imports, particularly investment goods, tied to the high level of economic activity. Until mid 1997 it seemed possible that Indonesia would be able to reduce the current account deficit in the coming years since exports, especially non-oil and gas exports, were increasing. This favourable outlook was due to the government's integrated macroeconomic policies that had been undertaken to maintain stability and to support high economic growth.

TABLE 2.1
Growth Rate of Real GDP by Industry at Constant 1993 Prices, 1993-2001
Percent

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Agriculture, livestock, forestry and fisheries	1.7	0.6	4.4	0.1	1.0	-1.3	2.7	1.7	0.6
Mining and quarrying	3.4	5.6	6.7	6.3	2.1	-2.8	-2.4	2.3	-0.6
Manufacturing	11.4	12.5	10.9	11.6	5.3	-11.4	3.8	6.2	4.3
Electricity, gas and water supply	10.1	12.7	15.9	13.6	12.4	3.0	8.3	8.8	8.4
Construction	14.5	14.9	12.9	12.8	7.4	-36.4	-0.8	6.7	4.0
Trade, hotels and restaurants	8.8	7.3	7.9	8.2	5.8	-18.2	0.1	5.7	5.1
Transport and communication	9.9	7.8	8.5	8.7	7.0	-15.1	-0.8	9.4	7.5
Financial and leasing and business	10.3	10.2	11.0	6.0	5.9	-26.6	-7.5	4.7	3.0
Services	4.3	2.8	3.3	3.4	3.6	-3.8	1.9	2.2	2.0
GDP	7.3	7.5	8.2	7.8	4.7	-13.1	0.8	4.8	3.3

Source: Central Bureau of Statistics.

The outlook changed significantly as the speculative attack that started in Thailand in July 1997 quickly hit other Asian currencies, including Indonesia's rupiah. The exchange rate fell from 2,410 rupiah to the U.S. dollar on 11 July 1997 to around 8,550 on 8 April 1998. This drastic weakening of the rupiah showed the negative response of the markets to the government's efforts to restore currency stability. The weakness of the rupiah was closely related to speculation by certain foreign financial institutions aimed at destabilising regional economic performance, particularly the reform commitment undertaken by Indonesia, which was actively supported by international agencies, namely the IMF (International Monetary Fund), the World Bank, and the ADB (Asian Development Bank).

The government of Indonesia undertook a number of measures to stabilise the exchange rate and economic conditions. However, the excesses of the national general election campaign in 1999 obstructed production and investor expectations. Rising nationalism together with various distorted, non-transparent policies caused many investors to cancel their plans to invest in Indonesia. Increased scepticism about changes in political and economic policy cut into the realisation of investment plans and, eventually, economic growth. These uncertainties in addition to unsolved bureaucratic problems and the problematic banking system undermined the sustainability of long-term economic growth.

Indonesia's economy started to recover and strengthen with more balanced growth in 2000 (Table 2.1). GDP grew 4.8 percent compared to 0.8 percent the previous year and to -13.1 percent in 1998. All sectors in the economy recorded positive growth. The processing industry still represents the main engine of growth, followed by the trading and transportation sector. The financial sector, which contracted in 1998 and 1999, also recorded positive growth. On the demand side, economic recovery is being sustained by investment spending. In 2000 the generator of economic growth shifted from consumption to exports and investment, both of which contributed significantly and positively to GDP growth (Table 2.2).

TABLE 2.2
Growth of Real GDP by Expenditure at Constant 1993 Prices, 1993-2001
Percent

	Real GDP	Consumption	Investment	Exports	Imports
1993	7.3	8.3	6.6	6.1	4.2
1994	7.5	10.1	13.8	9.1	14.5
1995	8.2	8.6	14.0	8.6	15.8
1996	7.8	8.9	14.5	7.6	6.9
1997	4.7	5.9	8.6	7.8	14.7
1998	-13.1	-7.1	-33.0	11.2	-5.3
1999	0.8	4.3	-9.4	-31.6	-40.7
2000	4.8	3.9	17.9	16.1	18.2
2001	3.3	6.2	4.0	1.9	8.1

Source: Central Bureau of Statistics.

Investment spending increased seventeen percent in 2000, a significant development considering that it was still contracting the previous year. The increase in investment performance indicates that the economic recovery is already on the appropriate path, and continuing and increasing investment spending should push up the rate of economic growth. Investment is especially attractive in view of the fact that at current share prices (which are quite low in U.S. dollar terms) companies would not lose substantially even if the most disastrous political chaos should occur. Moreover, there is great potential for profits to multiply when political conditions improve in the future.

Nevertheless, Indonesia's economy slowed in 2001. GDP managed only 3.3 percent growth, compared to the targeted rate of 5.0 percent. This deceleration was attributable to unfavourable internal developments as well as to the global economic slowdown. Domestically, debt and corporate sector restructuring progressed slowly, banks were consolidating, and the government had a heavy financial burden. The demand-side sources of economic growth, investment and exports, did not develop as expected in 2001 because of continuing risk and uncertainty related to the rising social and political tension and to weak law enforcement. Economic growth mainly depended on consumption by the household and government sectors.

For 2002, Indonesia expects GDP to grow 3.5 percent. Although progress has been made in the settlement process for the government's foreign loans and on bank re-capitalisation, several fundamental economic problems continue to obstruct the recovery. These are mainly the many constraints against acceleration of private investment, the delayed restructuring of private enterprises and foreign debt, the non-recovery of financial intermediation by banks, and the government's limited capacity for fiscal stimulus because of substantial expenditures for loan interest and subsidies.

The economy's continuing structural problems and uncertainty have caused increased inflationary pressure. Such structural problems as the obstruction in bank intermediation keep aggregate supply from increasing sufficiently to satisfy the strong aggregate demand. The government policy to reduce subsidies, the weakening rupiah exchange rate, and high inflationary expectations add to the pressure on prices. The inflation rate climbed to 9.35 percent in 2000 compared to 2.01 percent in 1999, and it reached double digits in 2001 (Table 2.3).

TABLE 2.3
Annual Inflation Rate, 1991-2001

	CPI Inflation Rate %
1991	9.54
1992	4.93
1993	9.77
1994	9.25
1995	8.65
1996	6.47
1997	11.05
1998	77.63
1999	2.01
2000	9.35
2001	12.55

Source: Central Bank of Indonesia

This current combination of economic conditions makes it difficult for Bank Indonesia (BI, the central bank) to formulate and implement monetary policy. On one hand, the increasing inflationary pressure demands tight monetary policy, while on the other hand, tightening monetary policy too drastically would threaten the banking recovery and the restructuring of still unstable companies. The failure of these companies in turn would destroy public confidence in the economic recovery, which would eventually cause inflation to accelerate further.

SOURCES OF FUNDS FOR INDONESIA'S ECONOMIC DEVELOPMENT

An economy's pace of development is generally influenced by both external and internal factors. The internal factors include the direction of economic policy, the degree of economic development activities, and the availability of funds to finance economic development. The four main sources of public and private sector funds for Indonesia's economic development are the State Budget (APBN), foreign loans, bank loans, and the capital market (Table 2.4).

TABLE 2.4
Sources of Funds for Indonesia's Economic Development, 1991-2001

	State Budget (APBN) Rp trillion	Foreign Loans US$ billion	Bank Loans Rp trillion	Bond and Share Issues Rp trillion
1991	22.0	65.7	113.6	11.2
1992	25.9	73.4	123.7	15.0
1993	27.3	80.6	148.3	21.8
1994	27.6	67.6	188.9	33.2
1995	28.3	106.4	234.6	44.1
1996	33.1	109.3	293.0	61.5
1997	39.0	136.1	378.1	89.6
1998	71.6	150.9	545.4	94.8
1999	61.8	148.1	277.3	229.9
2000	41.6	141.7	320.4	254.8
2001	43.1	131.2	358.6	263.0

Source: Central Bank of Indonesia

State Budget (APBN)

Originally, APBN was an instrument for allocating resources, distributing revenues and resources, and stabilising the macro-economy. Now, however, none of those functions is operating effectively. In 2001 the State Budget ran a deficit of 54.3 trillion rupiah. Out of Rp286 trillion in total revenues and grants, Rp89.6 trillion went to interest payments and Rp54 trillion to petroleum subsidies, leaving only Rp45.5 for development expenditures. Moreover, the amount of State Budget expenditures going to local governments increased more than one hundred percent in 2001 as a result of Law No. 25/1999 which went into effect in January 2001. As part of a program to decentralise government authority, Law 25 shifted government revenues (as well as service delivery) to local regions according to specified formulas. In the APBN the so-called Balance Fund represents the central government revenues transferred to local governments and consists of designated portions of revenues from certain taxes, a general allocation fund, and a special allocation fund. In 2001 the Balance Fund amounted to Rp81.5 trillion, or 5.5 percent of GDP, compared to only Rp35.6 trillion of State Budget expenditures that went to local and regional governments in the 1999/2000 budget. At the same time, the privatisation program for state-owned enterprises did not reach the APBN target of Rp6.5 trillion for 2001. This failure was due more to political conflict of interest than to economic factors.

Most significantly, the rescue measures to re-capitalise distressed banks that the government “was compelled” to undertake in the 1997-98 crisis are imposing a heavy burden on the APBN. The government took over bank assets that had been financed by loans and in turn gave the banks specially issued government bonds. While the interest on these bonds generates income for banks, the interest payments are State Budget expenditures. Based on the original APBN, domestic interest payments amounted to Rp59.6 trillion, or 18 percent of total expenditures, in budget year 2001 compared to Rp15 trillion and Rp18 trillion respectively in 1998-99 and 1999-2000.[2] By comparison, budget expenditures for civil servants’ salaries amounted to only Rp40 trillion in 2001. In other words, if the government did not have to make the interest payments on re-capitalisation bonds, it could have increased civil servants’ salaries by more than 100 percent. Based on APBN, foreign interest expenditures in 2001 totalled Rp27.4 trillion, or 8.2 percent of total expenditures. The interest payments on government bonds and notes issued to finance the bank rescue will be a burden on the budget for many years to come.

Among other efforts, the government is trying to cover the fiscal deficit through the sale of assets managed by the National Banking Recovery Board (BPPN). The BPPN is the organisation managing the assets of distressed banks before reselling them. This effort is now considered a success. Before expenses, BPPN had cash deposits of Rp27 trillion and Rp10 trillion in bonds. BPPN’s target for asset

2. See *Financial Note and State Budget Plan* 1999/2000.

sales in 2002 is yet higher, Rp35.3 trillion, but even the targeted amount does not cover the expected APBN deficit of Rp43 trillion.

Foreign Loans

Indonesia cannot count on foreign loans to finance its future economic growth. On the contrary, its current foreign borrowing is a growing fiscal burden, with interest payments comprising 8 percent of total State Budget expenditures. As of 2001 Indonesia carries US$131.2 billion in foreign loans, of which US$71.4 billion represents government borrowing and US$59.8 billion is private debt (Table 4). The interest and principle repayment obligations on foreign loans reduce the amount of state savings that are available for the development budget and all other routine budget components. To meet the interest payments on its foreign loans the government has had to increase tax revenues, obtain new foreign loans, sell assets managed under BPPN, reduce subsidies, and sell state-owned enterprises (BUMN). To overcome the fiscal drag and enable it to start pushing domestic economic activity, the government approached creditor countries requesting debt rescheduling, haircuts, dispensations, and grants. So far, creditor countries have only agreed to delay for 20 years the repayment of principal that was due in 2000-03. But Indonesia must still pay the interest on these foreign loans every year. Thus, rescheduling is not a long-term solution, since the government needs to undertake new borrowing to repay old loans and interest.

Bank Loans

To reduce Indonesia's dependence on foreign borrowing the government earlier took steps to increase the role of domestic financial institutions, such as banks. During the 1980s it implemented various policies (June 1983 Package, October 1988 Package) to improve bank efficiency. Those policies helped banks mobilise domestic funds and increase the volume of bank loans. The mobilisation of savings through banks moved too rapidly, however, outpacing private sector demand for loans, even more so because of high interest rates.

The upheaval of the rupiah exchange rate and the decline in public confidence at the time of the 1997 economic crisis sent the banking industry into crisis. The weakening currency generated a liquidity problem for banks, which compounded the sector's internal problems, including weak management systems, excessive credit concentration, lack of transparency of financial information, and still ineffective supervision by Bank Indonesia. Bank lending fell in half from Rp545 trillion in 1998 to Rp277 trillion in 1999 (Table 2.4).

The banking sector did not start to recover until the end of 1999 because of delays in restructuring and re-capitalisation, which depended on the success of the government bond issues. The bank re-capitalisation program was completed in 2000 and bank capital rose from negative territory in 1999 to reach Rp53.5 trillion in December 2000. Banks' capital adequacy ratio (CAR) increased, loan distribution and fund mobilisation improved, and net interest margin turned positive (BI *Annual Report* 2000). Nevertheless, banks did not resume their normal financial intermediary function because of continued risk and uncertainty and because the restructuring was not yet completed. Similarly in 2001, financial intermediation by banks failed to achieve the expected level because banks were focused on meeting the eight-percent CAR requirement and striving to lower their total non-performing loan ratios (NPLs) to five percent.

Capital Market

The capital market became an alternative source of relatively low-cost, long-term funding from the 1980s. However, even though the capital market can meet the requirements of the private sector, government, and state-owned enterprises, Indonesian entrepreneurs did not readily tap this source of funds. Before the crisis, bank financing dwarfed financing through the capital market. For example, in 1991 the value of bank loans was ten times the value of equity issues (Table 2.4).

Since July 1997, though, bank lending has been declining and capital market financing has become more important for the business sector. In 2001, the value of bond and share issues reached almost three-fourths the value of bank lending (Table 2.4). It is recognised that excessive dependence on bank borrowing by Indonesian businesses resulted in a "mismatch," with long-term investments being financed with short-term bank loans. Such a risky situation contributed to the protracted economic crisis. To reduce this mismatch, the role of the dominant supplier of funds for business should shift from the banking sector to the capital market.

CAPITAL MARKET DEVELOPMENT BEFORE AND AFTER THE ECONOMIC CRISIS

The existence of a capital market in Indonesia dates at least from 1912 when the Dutch Colonial government established a stock exchange. Since then, the government has issued various policies on the capital market. In particular it imposed a number of requirements on share trading. Eventually the capital market stagnated because of lack of investor interest and the stock exchange was closed in 1956. In addition, regulations were disadvantageous to entrepreneurs and the public lacked understanding of the capital market as a means of investment.

Development of the Capital Market before the Crisis

The real development of the capital market in Indonesia started in 1977 when the Jakarta Stock Exchange was re-opened under the newly created Capital Market Operation Board (BAPEPAM) of the Ministry of Finance. Corporate bonds began to play a role as capital market instruments in 1983. Jasa Marga (the state-owned highway construction and maintenance corporation) issued the first bonds, using the proceeds to finance construction of toll highways, among other things. Bond issues by Jasa Marga were followed by ones from Bank Bappindo, a state-owned bank, and Bank Papan Sejahte, a private bank. The bond market grew slowly at first. From 1983 to 1988 there were a total of only twenty-four issues, twelve by Jasa Marga, four each by Bappindo and Papan Sejahtera, and one issue each IBJ Leasing, Astra Internasional, UPPINDO, and BPD East Java, which are private enterprises. The total overall value of bonds issued in these first five years was only Rp855.72 billion.

During the 1980s, the government started to reform regulations that had obstructed investor interest in the Bourse in order to create a climate conducive to business. The Pakdes package of 1987 (effective 24 December 1987) relaxed government regulation of the market and licensing and had a major effect on the market's development. This package reduced the role of the government in the stock exchange, allowed share values to fluctuate according to market forces, introduced over-the-counter (OTC) trading, and allowed foreigners to purchase shares on the stock exchange. It also simplified certain procedures for issuing securities, including the application for sight draft share issues and the licensing of supporting institutions (securities brokers, securities traders, the securities administration bureau, trustees, and guarantors). The Pakdes package was expected to encourage firms to offer their shares on the stock market.

In December 1988, government undertook further deregulation focused on the capital market and non-bank financial institutions (NBFIs) with the Pakdes package of 1988. This package permitted privately owned stock exchanges, supplementing the existing government-operated exchange and paving the way for new exchanges to open in major cities outside Jakarta. It also expanded securities trading on JSE (Jakarta Stock Exchange) by allowing companies that had already listed shares to list all their remaining previously issued shares without further underwriting.

The Pakdes package adopted in December 1990 (effective 2 January 1991) reformed the institutional structure of the capital market. This package provided for conversion of the Capital Market Operations Board into the Capital Market Supervisory Agency (under the same acronym, BAPEPAM), privatisation of the JSE, and over-the-counter trading, and it changed the capitalisation requirements for securities companies including brokers, issuers and underwriters.

Indonesia's capital market made significant progress following these three deregulation packages of the late 1980s. The Surabaya Stock Exchange was established in 1989. From 1991 to 1997 the number of companies issuing shares rose from 145 to 306 and the value of equity issues outstanding went from just under Rp9 trillion to almost Rp71 trillion (Table 2.5). Foreign capital drove the market during the early 1990s, with 70 percent of transactions in 1994 involving foreign investors (Table 2.6). Foreign investors increased their presence through joint ventures with domestic brokers, but the number of domestic broker-dealers did not increase.

TABLE 2.5
Bond and Share Issues by Listed Companies, 1991-2001

	Number of Issuers		Number of Outstanding Issues		Value of Outstanding Issues Rp billion	
	Bonds	**Shares**	**Bonds**	**Shares**	**Bonds**	**Shares**
1991	24	145	384,032	1,178,465,725	2,215.2	8,976.1
1992	34	162	653,788	1,761,393,686	3,856.8	11,161.8
1993	43	181	725,047	3,338,513,735	5,761.8	16,065.0
1994	46	231	763,448	6,401,933,047	6,691.3	26,528.0
1995	50	248	788,264	11,110,964,641	8,694.4	35,395.0
1996	55	267	805,474	25,343,423,026	11,535.5	49,981.4
1997	70	306	848,077	51,459,413,729	18,740.5	70,879.6
1998	43	309	848,507	62,719,348,831	18,890.5	75,947.0
1999	46	321	857,590	714,460,834,556	23,174.4	206,686.8
2000	50	347	1,014,445	811,675,983,545	28,787.4	226,057.3
2001	55	379	1,067,695	826,770,663,455	31,662.4	231,342.1

Source: Indonesia Capital Market Supervisory Agency.

TABLE 2.6
Stock Market Transactions by Foreign and Domestic Investors, 1992-2001

	Foreign Investors		Domestic Investors		Total
	Rp billion	**%**	**Rp billion**	**%**	**Rp billion**
1992	1,237.8	59.08	857.5	41.02	2,095.2
1993	11,547.6	60.50	7,538.6	39.50	19,086.2
1994	17,881.1	70.17	7,601.7	29.83	25,482.8
1995	21,690.5	67.03	10,667.0	32.97	32,357.5
1996	45,693.6	60.34	30,036.3	39.66	75,729.9
1997	62,801.1	52.18	57,584.0	47.82	120,385.2
1998	41,556.6	41.69	58,128.1	58.31	99,684.7
1999	51,727.4	34.98	96,152.6	65.02	147,880.0
2000	24,684.0	20.11	98,090.7	79.89	122,774.8
2001	10,517.0	10.78	87,005.8	89.22	97,522.8

Note: Data refer to Jakarta Stock Exchange only.
Source: Indonesia Capital Market Supervisory Agency.

The bond market developed slowly during the 1980s because

- Most bond purchasers were pension fund institutions, which tended hold the bonds until maturity rather than resell them in the secondary market. This limited the liquidity on the bond market.
- Low liquidity in the secondary market made it difficult for holders to cash-in their bonds.
- High interest rates made time deposits more attractive than bonds as an investment alternative.
- With the takeoff of the stock market in 1989 investors were attracted to shares, hoping to gain high dividends.

In 1992 investors became more interested in bonds as the interest rate on time deposits began to decline and as the equity market had become bearish. From 1992 to 1997 the number of companies issuing bonds doubled, from 34 to 70, and the value of bond issues outstanding more than quadrupled, from Rp3.9 to Rp18.7 trillion (Table 5).

Enactment of Law No. 8 of 1995 was another milestone in the development of Indonesia's capital market. This legislation made full disclosure, self-regulation, and supervision the three fundamental principles of the capital market. With full disclosure, issuing companies and other parties involved in the capital market must do business with transparency, openness, and honesty. Self-regulation by the stock exchange, bourse, and other supporting institutions facilitates market supervision while government supervision ensures proper performance of the market. This law also permitted the sale of open-end mutual funds.

With the enactment of the 1995 Capital Market Law and other regulations, the capital market entered a stage of rapid development driven by strong investor interest. Investments in the capital and money markets increased significantly after 1995 (Table 2.7). Both internal and external factors contributed to a climate conducive to portfolio investment. Significant internal factors included Indonesia's diverse natural resources; domestic market potential; abundant, relatively low-cost labour; political, and economic stability; investment policies consistent with global economic development and free flow of foreign exchange; and strategic location. External factors attracting investment to Indonesia included decreasing communication costs, increasing competition, and rising business costs in the industrial countries.

TABLE 2.7
Real and Financial Sector Investment, 1991-2001

	Real Sector		Financial Sector	
	Domestic Investment Rp billion	Foreign Direct Investment US $ million	Outstanding Share Issues Rp billion	Inter-bank Call Money Rp billion
1991	41,078	8,778	8,976.1	48,420
1992	29,342	10,340	11,161.8	57,808
1993	39,450	8,143	16,065.0	90,107
1994	53,289	27,353	26,528.0	110,990
1995	69,853	39,945	35,395.0	189,259
1996	100,715	29,929	49,981.4	447,564
1997	119,873	33,827	70,879.6	784,368
1998	60,741	13,598	75,947.0	2,104,924
1999	53,168	10,892	206,686.8	595,362
2000	92,410	15,412	226,057.3	279,263
2001-1h	37,668	4,965	231,342.1	216,899

Note: FDI amount refers to approvals.
Source: Indonesia Capital Market Supervisory Agency and Central Bank of Indonesia.

Impact of the Crisis on the Capital Market

In barely a decade up to 1997, Indonesia made substantial progress in creating the complex set of laws and rules on which the capital market depends. The stock exchanges were privatised and computerised. The foundation was laid for scripless trading and book-entry settlement to become operational in 2000. Prudent rules for internal controls of custodians and broker-dealers were promulgated. But when the monetary crisis broke out in August 1997, the government was unable to continue to support the rupiah in the foreign exchange market. The resulting sharp devaluation of the rupiah against the U.S. dollar eventually affected the capital market, as most issuers had liabilities or loans in foreign currencies. In addition, Indonesia's rapid economic growth had been backed by foreign loans to a few large enterprises that were protected by government policies (including prohibition of new investors from entering certain business sectors). Moreover, "mark-up" practices on bank loans had paralysed the national banking system, which had a domino effect on the economy. The monetary crisis exposed economic malpractice. Many Indonesian banks and private companies had un-hedged foreign exchange liabilities, and within six months the devaluation caused many businesses to become insolvent.

The currency crisis generated a crisis of confidence among foreign as well as domestic investors, making them reluctant to invest directly in Indonesia because of the social, political, and security risks. The value of approved domestic and foreign investment plunged immediately after 1997 (Table 2.7). The sharp decline in investment in the real sector was partly due to the increased risk of national stability brought on by the riots that followed the change in government. Investment approvals increased during 2000 in response to the election of a new president and vice presidents by the People's Consultative Council (MPR), although approvals were below the levels in the years before the crisis. Investors remained cautious because Indonesia was included among the high investment-risk countries. This risk worsened with the declining political support for the government.

Financial investment also suffered as a result of the economic and currency crisis. The total value of stock market transactions fell from Rp120 trillion in 1997 to Rp99 trillion the next year. The share of transactions by foreign investors declined from 52 percent to 42 percent (Table 2.6). Continuing political instability and national security concerns dampened foreigners' interest and their share of transactions fell to just under eleven percent by 2001.

The succession of political developments and such fundamental factors as political conflict, the weakening of the rupiah, the need to meet with the IMF, the budget deficit, and other domestic problem hit the stock market. Share prices recovered after the General Meeting of the People's Consultative Assembly (MPR) in 2000 in response to the plan to reshuffle the cabinet, but they fell again with the formation of the new cabinet, which did not meet the expectations of market participants. Anxiety over national political developments, demonstrations, and the impending impeachment which drove down the prices of large company shares leading up to the 2001 Special Meeting of the MPR (Table 2.8). The government's discussions with the IMF were expected to resolve the immediate problem and to cover the 2001 fiscal deficit, which would improve the value of the rupiah against the U.S. dollar. The crisis apparently also affected the bond market. In the four years after 1997, there were 24 new bond issuers, but the value of issues outstanding increased by only Rp12.9 trillion (Table 2.5).

TABLE 2.8
Composite Share Price Index, 1991-2001

	Composite Share Price Index
1991	247.4
1992	274.3
1993	588.8
1994	469.6
1995	513.8
1996	637.4
1997	401.7
1998	398.1
1999	676.9
2000	416.3
2001	392.0

Source: Indonesia Capital Market Supervisory Agency.

In 2001 Indonesia's capital market faced continued uncertainty on a number of fronts. National political stability and security was one threat, in addition to the possibility of a soft or hard landing for the U.S. economy. Those uncertainties made investors modify their strategy and endeavour to decrease risk to a minimum level.

Improper financing techniques caused this crisis. Indonesia would have avoided economic collapse if corporations had used equity financing and long-term bonds and if foreign exchange liabilities had been hedged. The lesson is that a capital market is essential for economic stability.

Equity and bond financing are the basis for stable growth. The crisis increased Indonesia's awareness of the importance of the capital market and its role in the economy. Concrete steps have been taken to improve disclosure in international loan syndication, especially with regard to risks of un-hedged or non-self-liquidating loans. In addition, fiscal and other incentives are being used to encourage corporations to raise funds by selling equities on the domestic market. The number of underwriters and investment management companies (especially domestic companies) increased from 1999-2000 (Table 2.9).

TABLE 2.9
Recent Development of the Securities Industry, 1999-2000

	Number of Companies	
	1999	**2000**
Broker–dealers	100	93
Foreign joint venture	5	4
Domestic	95	89
Underwriters	7	13
Foreign Joint venture	3	5
Domestic	4	8
Investment managers	65	70
Foreign Joint venture	27	27
Domestic	38	43

Source: Indonesia Capital Market Supervisory Agency.

Impact of Bank Re-capitalisation

The government's rescue of the banking sector by replacing banks' equity with specially issued bonds may create new problems for the capital market and the economy when these bonds begin to mature. The first re-capitalisation bonds were SU-001 bonds with a nominal value of Rp80 trillion to mature on 1 October 2017 issued on 28 September 1998 by the Reform Cabinet of President Habibie. By May 1999, the government had issued three more bonds: Rp53 trillion in 20-year bonds with an interest rate of 3 percent above inflation; Rp95 trillion worth of government bonds with 3- to 10-year maturities at a floating interest rate and yield related to 3-month SBIs; and Rp8.6 trillion with 5- or 10-year maturities at interest rates between 12 and 14 percent. In addition, the government also issued Rp103 trillion worth of bonds to re-capitalise PT Bank Mandiri (a state-owned bank). By 2001, bank-re-capitalisation obligations represented 65 percent of the value of government bonds outstanding (Table 2.10).

TABLE 2.10
Government Bonds Outstanding by Program, 1999-2002
(Rp trillion)

	Amount Outstanding as of 31 December			
	1999	2000	2001	2002
Guarantee program	218.31	218.31	218.31	218.31
Credit program	9.97	9.97	9.97	9.97
Bank re-capitalisation program	281.83	425.54	430.74	422.42
Total	510.11	653.82	659.02	680.70

Source: Ministry of Finance.

Many of these bonds will mature between 2004 and 2009. If the maturity structure is not re-balanced and there is no surplus in the primary budget, the government will have to conduct a large-scale refinancing (increase debt) to meet these repayment obligations. This could have a negative impact on the economy. Rising market interest rates may crowd the private sector out of the financial market and cutbacks in APBN expenditures for other development programs could suppress economic growth. Even with a surplus in the APBN primary balance (revenues minus non-interest related expenditures), if the maturity profile of government bonds is not re-structured, the fiscal pressure generated by the repayment of maturing bonds will cause economic turbulence during the period 2004 to 2009. For the government to refinance these bonds by issuing new bonds on the domestic market it would have to pay high interest. A vicious cycle will occur, with increasing total government debt pushing up the market rate of interest, and eventually causing deeper complications and pushing economic activity towards crisis.

CAPITAL MARKET PROSPECTS FOR FINANCING ECONOMIC DEVELOPMENT

Indonesia needs to work on many fronts to ensure adequate financing to restore the economy and return to sustained long-run growth. It needs to bring back the foreign investment that fled in the 1997 crisis and to build the domestic capital market into a significant source of long-term financing for domestic companies. With these steps and additional measures to stabilise the macro economy, the future prospects for the capital market are good.

Attract FDI

With a scarcity of funds from other sources, Indonesia needs to restore inflows of foreign direct investment (FDI), but this is becoming more difficult as competition among countries for FDI has intensified. Since the crisis, Indonesia has been liberalising investment policy, simplifying procedures, and intensifying promotional activities to attract foreign financing.

Measures to make licensing procedures for FDI projects faster, easier, and more transparent and to improve opportunities for investing in Indonesia include:

- Allowing the Minister of Investment/Chairman of Investment Co-ordinating Board (BKPM), rather than the president, approve FDI projects up to US$100 million. Indonesian ambassadors overseas should soon be given full authority to approve foreign investments.
- Transferring approval for domestic investments up to Rp10 billion to provincial government authorities.
- Delegating authority from the Minister of Investment/Chairman of Investment Co-ordinating Board (BKPM) to the Management Agency of the Integrated Economic Development Area (KAPET) to accept and evaluate applications for foreign investments in the KAPET.
- Eliminating principal approvals that were normally issued by governors.
- Eliminating, for all but four sectors, the requirement for investment applications to be recommended by technical/sectoral departments before approval by the Minister of Investment/Chairman of Investment Co-ordinating Board. The recommendation requirement may also be eliminated for the four remaining sectors (mining, energy, palm oil plantations, and fisheries).
- Requiring investment approvals to be processed within 10 to 20 working days. "Same day service" is being planned.
- Encouraging the growth of small-scale businesses.
- Enacting an Anti-Monopoly and Unfair Business Practices Law.
- Allowing FDI companies to enter retail and wholesale/distribution trade business and establish holding companies in Indonesia.

In addition to these steps to improve the business climate, steps to improve the political environment are essential to restoring investors' confidence about doing business in Indonesia.

Encourage Domestic Investment through the Capital Market

The reforms of the 1980s spurred the development of the capital market, but participation by domestic investors did not grow along with other measures of market progress. Foreign investors still dominated stock exchange transactions up to 1997 (Table 2.6). Indonesia's population constitutes a potentially large customer base and comparative advantage for the capital market that should be exploited, but previous efforts to encourage Indonesians to participate in the capital market have not been fruitful.

Now, Indonesia needs a breakthrough to encourage domestic investment through the capital market. Increased participation by investors in outlying regions through regional securities companies and long-distance trading would lead to wider distribution of share ownership among domestic investors. To this end, domestic businesses need to offer positive incentives for investors through good business practices and competitive profit levels and they need to establish more extensive networks. Furthermore, the capital market infrastructure should be updated and enhanced with sophisticated, secure systems. At the same time, the market must develop the operational and marketing capability required to serve large-scale domestic capitalists.

Improve the Functioning and Scale of the Capital Market

According to the World Bank, in the era of investment liberalisation, investment through bank loans has declined while portfolio investment and FDI have increased. This trend in global financial markets presents Indonesia with the opportunity to increase the efficiency of its capital market. It also raises the question of whether that capital market is capable to take over the strategic role of banks as a source of funds. In fact, the capital market demonstrated its reliability as a financial institution even in the crisis. Although the value of stock market transactions decreased from 1997 to 1998 and again in 2000, the volume of transactions has increased every year except 2000 (Table 2.11). The capital market's role as a source of funds for the business sector and as an investment alternative for the public became even more important as a result of the IMF agreement, which stressed increased supervision of the banking sector, but did not constrain efforts to utilise the national stock exchange.

TABLE 2.11
Transaction Volume and Value on the Jakarta Stock Exchange, 1991-2001

	Number of shares transacted		Value of shares transacted	
	million shares	% change	Rp billion	% change
1993	3,844.0	252.84	19,086.2	810.94
1994	5,292.5	37.68	25,482.8	33.51
1995	10,646.4	101.16	32,357.5	26.98
1996	29,527.7	177.35	75,729.9	134.04
1997	76,599.1	159.41	120,385.2	58.97
1998	90,620.5	18.30	99,684.7	-17.20
1999	178,486.6	92.55	147,880.0	48.35
2000	134,531.3	-22.90	122,774.8	-16.98
2001	148,381.3	10.29	97,522.8	-20.57

Source: Indonesia Capital Market Supervisory Agency.

Indonesia needs to exert continuous effort to enhance the capacity of the capital market to generate long-term funding through a variety of alternatives including obligations as well as stocks or equities—and also to increase the government's funding options. Furthermore, since Indonesia is far behind its neighbours in utilising the capital market, it should also focus on increasing the volume of transactions in the market. This requires altering the behaviour patterns of entrepreneurs as well as of the government. If a wider variety of capital market instruments becomes available, direct investment should begin to become a more important means of financing for Indonesian firms. Requiring companies to form pension funds that not only hold time deposits and other bank investments but also purchase stocks and other obligations would increase competition in the capital market and reduce the possibility of capital flight to international capital markets.

To reduce the risk of capital market transactions, investors must be adequately protected through appropriate regulation by the stock exchange as well as the government supervisory agency and other means. The recent increase in capital and money market transactions indicates that Indonesian businesses view favourably the support of the political circle and the armed forces under the present government.

Future Prospects and Problems for the Capital Market

A number of current indicators suggest that the prospects for the future development of the capital market are good. These include:

- The declining role of banking institutions as a source of funds since the 1997 economic crisis (Table 2.7). One lesson from the economic crisis of 1997 was the need to make greater use of the capital market to prevent a recurrence of the mismatch by which long-term investment was financed by a short-term bank funding.
- The privatisation of BUMN (state-owned enterprises) and the growing number of BUMN shares available in the capital market. Since most BUMN are in strategic, upstream industries they are quite attractive, and the entrance of PT Telkom, PT Indosat, PT Tambang Timah, PT Semen Gresik, PT Aneka Tambang, and PT Bank BNI has stimulated local investor interest in the capital market.
- The presence of international brokers and investment managers. Foreign investors have been participating actively in Indonesia's capital market for a long time and they have been encouraged by the change in the political climate, the determination to eliminate KKN (corruption, collusion, and nepotism), and the commitment to enforce the law. Improvements in economic and security conditions are expected to attract foreign investors back to the Indonesian market.
- The potential for high earnings growth. Indonesia's stock market offers attractive opportunities to foreign investors because of the decline in the exchange rate of the rupiah against the dollar and the correction in the prices of leading stocks.
- The many medium- and small-scale enterprises with listing potential. So far, companies participating in the capital market have been mainly large, strong capitalists, whereas most of Indonesia's medium- and small-scale entrepreneurs are also eligible to participate.
- The potential for broader domestic participation. In 1998 only around five-hundred

thousand individuals or institutions participated in the capital market compared to Indonesia's total population of 200 million people (Ary Suta 2000).

- The growth of professionalism. The improved quality of the manpower in the capital market has increased investor enthusiasm.

The good prospects of the capital market should be used to promote Indonesia as an attractive destination for foreign investment.

Against these optimistic conditions, there stand a number of factors that constrain the development of the national stock exchange. These include:

- Its relatively small capitalisation compared to competitors.
- The unfamiliarity and reluctance on the part of institutional investors whose participation is strategic.
- The uneven distribution of stock ownership in the domestic market.
- The illiquidity of stocks.
- Extensive and unchecked collusion and unprofessional behaviour among market participants.
- The need to carry out privatisation of the BUMN slowly, so as not to destroy them.
- The close connections between ownership and management, as well as cross-ownership between companies.

CONCLUSION

The capital market is important not only to finance growth but also to provide economic stability. Since the financial crisis of 1997, the collapse of Indonesia's banking sector and the fall off in government expenditures and foreign loans have turned the focus on the capital market as a source of long-term financing. Based on several indicators, Indonesia's capital market appears to have good prospects and a good opportunity to develop efficiently. This is especially true since capital market utilisation is still well below an optimal level.

For the capital market to serve the future needs of Indonesia's economy, share ownership must be more widely distributed, companies must offer investors a positive stimulus in the form of competitive profit rates and expanded business networks, and the market infrastructure must develop by adopting more sophisticated systems and improving operational and marketing capability. Those steps will make the domestic market more competitive and reduce the possibility of capital flight to international capital markets. In order for the domestic capital market to be a stable source of funds for Indonesian business, the average level of risk needs to be reduced. If investors have greater confidence in the capital market, they will be inclined not only to invest more but also to hold their investments for longer periods. The government should encourage capital market development by instituting a regulatory system to control issuance and a strong supervisory system to monitor day-to-day activities, all with the objective of good corporate governance and transparency.

In addition to these efforts to improve the capital market, Indonesia must solve several other problems that challenge the capital market. It must achieve macro-economic stability, assurance of the rule of law, harmonisation of rules and policies, improvement of securities industry infrastructure, and good corporate governance. It is possible that the climate in Indonesia will once again be conducive to investment and that Indonesia's capital market will take a competitive position in the global market.

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APPENDIX
DEVELOPMENTS IN CAPITAL MARKET REGULATION SINCE THE FINANCIAL CRISIS

Activities of Bapepam (Capital Market Supervisory Agency) in 1998

Issued new rules:

- Rule V.D.4, Control and Protection of Securities Deposited with a Securities Company
- Rule V.D.5, Maintenance and Reporting of Net Adjusted Working Capital
- Rule V.D.7, Main Points of Subordinate Loan Agreement
- Rule IX.D.4, Capital Increases without Pre-emptive Rights
- Rule X.K.5, Disclosure of Information by Issuers or Public Companies Regarding Bankruptcy
- Rule XI.B.2, Repurchases of Shares that Have Been Issued by an Issuer or Public Company
- Rule XI.C.1, Insider Securities Transactions that are Not Prohibited

Activities of Bapepam in 1999

Revised rules:

- Rule III.A.3. regarding Commissioners and Directors of Stock Exchanges, intended to encourage professional, effective and efficient management of the stock exchanges. The rule specifies the method for recruiting and selecting commissioners and directors, nominating procedures for candidates, and duties of directors.
- Rule V.D.4. regarding Control and Protection of Securities Kept by Securities Companies, relates to the obligations of securities companies in accounting for segregation of clients' securities in custody.
- Rule V.D.5, regarding Maintenance and Reporting of Net Adjusted Working Capital. Rule V.D. 5 main revised to form V.D. 5-3 and V.D. 5-4 and postponed implementation until April 2000.

Issued new rules:

- Rule XIV.B.1, regarding Procedures for Collecting Administrative Fines specified procedures for imposing fines for violation of capital market regulations and to improve collection of fines, requiring that fines be paid within 30 days.
- Rule V.D.7, regarding Guidelines for Subordinated Loan Agreement of Securities Companies established standards for subordinated loans that are applicable in the assessment of net adjusted working capital of securities companies.

Activities of Bapepam in 2000

Revised existing regulations:

- Rule VIII.G, regarding Guidelines for the Preparation of Financial Statements, revising decision No.Kep-97/PM/1996, 28 May 1996
- Rule IX.A.2, Registration Procedures for a Public Offering, revising decision No. Kep-43/PM/1996, 17 January 1996
- Rule IX.A.7, Responsibilities of Underwriters with Respect to Subscriptions and Allotments of Securities in a Public Offering, revising decision No. Kep-48/PM/1996, 17 January 1996

- Rule IX.A.8, Preliminary Prospectus and Information Memorandum, revising decision No. Kep-113/PM/1996, 24 December 1996
- Rule IX.C.1, Form and Content of a Registration Statement for a Public Offering, revising decision No. Kep-113/PM/1996, 24 December 1996
- Rule IX.C.3, Guidelines concerning the Form and Content of a Prospectus for a Public Offering, revising decision No. Kep-51/PM/1996, 17 January 1996
- Rule IX.D.1, Pre-emptive Rights, revising decision No. Kep-41/PM/1998, August 14, 1998
- Rule IX.D.2, Guidelines Concerning the Form and Content of a Registration Statement for Issuing Pre-emptive Rights, revising decision No. Kep-42/PM/1998, 14 August 1998
- Rule IX.D.3, Guidelines Concerning the Form and Content of a Prospectus for Issuing Pre-emptive Rights, revising decision No. Kep-43/PM/1998, 14 August 1998
- Rule IX.E.1, Conflict of Interest on Certain Transactions (to accelerate the restructuring of the company), revising decision No. Kep-12/PM/1997, 30 April 1997
- Rule IX.E.2, Material Transactions and Changes of Main Business Activity, revising Letter No. S-456/PM/1991
- Rule IX.F.1, Tender Offers, revising decision No. Kep-85/PM/1998, 24 January 1998

Issued new rules:

- Rule III.B.6. Guarantee of Securities Transaction Settlement
- Rule III.B.7. Guarantee-Fund
- Rule V.D.8. Activities of Securities Company on several location
- Rule V.D.9. Guidelines Concerning Contract of Securities Company Agent as Member of Securities Exchange
- Rule IX.H.1. Take Over the Public Company

Prepared a draft amendment to Capital Market Law No. 8, 1995. In addition to providing for de-mutualisation of the stock exchange and issuing of shares without par value this amendment made Bapepam an independent state institution free from government intervention.

Activities of Bapepam in 2001

Publicised the draft amendment to the Capital Market Law designed to harmonise Indonesian law with international capital market practices and standards, to respond to fundamental shifts in the global financial services industry, and to accommodate the interests of market participants.

Initiated discussions with the Directorate General of Financial Institutions, the Ministry of Finance, and the Bank of Indonesia regarding integrating the supervision of the financial services industry under one agency.

Revised:

- Rule No.III.A.3, concerning Commissioners and Directors of Stock Exchange. The revision aimed to improve the integrity and quality of stock exchange management to prepare the exchange to confront global competition. The revised rule also intended to push stock exchange management to encourage capital market participants to implement management practices in accordance with good corporate governance principles.
- Rule No.IX.A.6, concerning Restrictions on Shares Issued Prior to an Initial Public Offering
- Rule No.IX.E.2, concerning Material Transactions and Change of Main Business Activity
- Rule No.IX.D.1, concerning Pre-emptive Rights, increased investment alternatives by allowing corporations to issue warrants for up to 30 percent of paid-in-capital.

Represented Bapepam in 2 separate court cases

Imposed sanctions on 28 securities companies, 2 securities company representatives, 8 securities administration agencies, 1 custodian bank, and 130 issuers.

Appeared as expert witness for the National Police in 5 court cases and for the Attorney's Office in 3 cases.

CHAPTER 3

CAPITAL MARKET DEVELOPMENT IN THE PHILIPPINES: PROBLEMS AND PROSPECTS

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At the end of World War II, the Philippines was one of the more promising developing countries in Asia, but that promise has remained unfulfilled until the present time. The same may be said of the capital market. In 1966 the Philippines was the first country in Asia to introduce Treasury Bills and to organise a formal association of money market dealers, but since then its capital market has developed at no more than a snail's pace.

Some underlying trends in the financial sector of the Philippines since 1980 provide background for examining the development of the capital market. First, the importance of the financial sector in the economy is virtually unchanged over these two decades (Table 3.1). The ratio of financial sector assets to GNP, at 102.8 percent in 2001, is barely one percentage point higher than it was in 1980. The ratio climbed to 133.3 percent in 1997, but subsequently dropped, apparently reflecting the disintermediation effect of the 1997 Asian crisis.

TABLE 3.1
Amount and Composition of Financial Assets by Type of Institution, year-end 1980-2001

	1980		1985		1990		1995		2000		2001	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
	bil. pesos	%	bil. pesos	%	bil. pesos	%	bil. pesos	%	bil. pesos	%	bil. pesos	%
Banking system	188.8	76.2	395.2	78.6	609.5	76.1	1,595.6	78.6	3,326.8	80.4	3,259.3	79.7
Commercial banks	138.4	55.9	283.3	56.4	539.7	67.4	1,347.4	66.4	3,013.6	72.8	3,070.5	75.1
Thrift banks	10.6	4.3	15.1	3.0	37.6	4.7	143.3	7.1	245.8	5.9	259.0	6.3
Specialised gov't banks	34.2	13.8	88.0	17.5	18.5	2.3	68.2	3.4	--	--	--	--
Rural banks	5.6	2.3	8.8	1.8	13.7	1.7	36.7	1.8	67.4	1.6	73.8	1.8
Non-bank financial institutions	58.9	23.8	107.3	21.4	191.8	23.9	434.4	21.4	810.3	19.6	829.2	20.3
Government	20.1	8.1	60.6	12.1	107.8	13.5	277.2	13.7	473.4	11.4	506.7	12.4
Private	38.8	15.7	46.7	9.3	84.0	10.5	157.2	7.7	336.9	8.1	322.5	7.9
Total	247.7	100.0	502.5	100.0	801.3	100.0	2,030.0	100.0	4,137.1	100.0	4,088.5	100.0
Total Assets/GNP	101.6%		90.4%		74.3%		103.6%		117.3%		103.3%	

Notes: For non-bank financial institutions data for 2001 are projections and data for 2000 are 1999 estimate.
Source: BSP *Statistical Bulletin*, *Selected Philippine Economic Indicators*.

Second, the banking sector has gained in importance. In particular, commercial banks increased their share of financial system assets sharply from 55.9 percent in 1980 to 75.1 percent in 2001 (Table 3.1). The concentration of financial assets in commercial banks, which deal in government securities, have stock broking, investment bank, and thrift bank subsidiaries, and manage unit trust or mutual fund accounts, means that the diversity of institutions and instruments narrowed and that the market power of commercial banks increased.[1] The Bankers Association of the Philippines (BAP), the formal association of the commercial banking sector, was one of the most powerful lobbies in the country and was instrumental in limiting the entry of foreign banks, which was liberalised in 1994.

The other side of the picture is that non-bank financial institutions (NBFIs) decreased in importance over this period. More than banks, NBFIs tend to be the main buyers and sellers in the capital market. While NBFIs represented 23.8 percent of the financial system's resources in 1980, their share was estimated at only 20.3 percent in 2001.

Pension funds are the most important non-bank financial institution, with government pension funds accounting for 45.1 percent of the sector's assets in 1999 (Table 3.2). Pension funds are followed by insurance companies (19.6 percent) and then by investment houses and finance companies which together account for 17.3 percent of NBFI assets. Securities dealers and brokers account for only 1.6 percent of NBFI assets. (Nevertheless, the stock market is a growing component of the capital market, with market capitalisation of 55.5 percent of GNP, up from only 2.8 percent in 1984.) The Philippines' other, small, non-bank financial institutions together constituted only two percent of the total resources of the system in 1999 (Table 3.2).

One type of financial institution does not appear in these tables, that is pre-need companies. Unique to the Philippines, the pre-need industry started during the 1960s. Like insurance companies, pre-need companies promise to cover the cost of a future service (typically, education, pension, death-related services, or memorials) for a fixed premium during a person's lifetime. Pre-need plans are categorised as securities and regulated and supervised by the Securities and Exchange Commission (SEC), but there is little public data available.[2] The pre-need industry’s assets grew rapidly during the 1990s from P27.7 billion in 1993 to an estimated P150 billion by 2001, nearly the same as the insurance industry. This dramatic growth has put pressure on insurance companies to put up their own pre-need subsidiaries.

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1. Trust accounts of commercial banks are kept off-book, and are not reflected in Table 1.
2. The minimum capital required to set up a pre-need company was P50 million at the end of 2000. The SEC licenses each company for an annual volume of sales for pre-need plans and imposes penalties for exceeding the approved volume. Pre-need companies are required to set-up a trust fund and make deposits according to a schedule issued by the SEC. The choice of trustee and trust agreement must be submitted to the SEC for approval. Currently, there are no rules on disclosure to plan participants nor are there clear investment rules apart from a 10-percent liquidity requirement and a 20-percent limit on investments in real estate.

TABLE 3.2
Amount and Composition of Non-bank Financial Institution Assets, 1991-99

	1991		1995		1999	
	Amount billion pesos	**Share %**	**Amount billion pesos**	**Share %**	**Amount billion pesos**	**Share %**
Government	133.7	55.2	250.3	55.2	389.8	54.4
Pension funds	106.1	43.8	186.7	41.1	322.8	45.1
Others	27.6	11.4	63.6	14.0	67.0	9.4
Private	108.3	44.8	203.4	44.8	326.4	45.6
Investment houses	31.2	12.9	40.7	9.0	93.3	13.0
Finance companies	14.8	6.1	27.6	6.1	30.6	4.3
Securities dealers/brokers	2.9	1.2	8.4	1.9	11.2	1.6
Insurance companies	45.2	18.7	100.3	22. 1	140.2	19.6
Non-bank thrift institutions	5.2	2.1	13.5	3.0	33.4	4.7
Others	9.0	3.7	12.9	2.8	17.7	2.5
Total	242.0		453.8		716.2	
Total Assets/GNP	19.2%		23.2%		22.8%	

Notes: Other private NBFIs include pawnshops, lending investors, venture capital corporation and fund managers.
Source: BSP *Statistical Bulletin*, *Selected Philippine Economic Indicators*.

This chapter focuses on three components of the capital market--pension funds, the equities market and the fixed-income securities market. We highlight these components because pension funds mobilise savings that could be a source of demand for capital market instruments and equities and fixed-income securities markets must function efficiently to channel domestic savings and foreign investment to further economic growth and development. The remainder of the chapter analyses problems in each of these sectors that have slowed the development of the capital market, describes recent reforms, and suggests changes that still need to occur.

THE PENSION SYSTEM

Contractual Savings for Capital Market Development

Overall, the Philippine financial sector is rather underdeveloped. The primary sources of long-term domestic financing are the stock market and the contractual savings sector, which includes pension funds and the insurance industry.[3] With increased participation, the contractual savings

3. The insurance industry accounts for one-fourth of contractual savings assets, and almost 60 percent of insurance industry assets are in life insurance companies. Life insurance companies are subject to a

sector has the potential to become a vehicle to support capital market development. The resources available to the contractual savings sector can provide an effective primary and secondary market for government and private securities, expand the capital market, and generate demand for professional investment and fund managers which will help establish a fund management industry (World Bank 1992).

The contractual savings sector in the Philippines has grown significantly. Total contractual savings increased at an average annual rate of 17.3 percent during the period 1985-2000 (Table 3.3). Nevertheless, this sector is less important in the Philippines that in many other developing economies. Contractual savings has hovered around 17 percent of GDP since 1998. This is about the same ratio as in Brazil, but it is far below the ratio in Chile, Singapore, and Malaysia, where contractual savings surpasses 50 percent of GDP.

Pension funds are the primary players in the contractual savings sector in the Philippines, with over 75 percent of contractual savings assets (Table 3.3).[4] Total assets in public sector pension funds were estimated at P473.4 billion in 2000. This is a sizeable pool of long-term resources, equal to 58.1 percent of the assets of non-bank financial institutions and 10.6 percent of the assets of the entire financial system. The generation of savings by the pension systems can be measured in terms of gross contributions and net income, which is investment income less the costs of running the system and benefits paid. In the Philippines, savings through pension contributions (public and private systems) reached an all-time high of 2.6 percent of GDP in 2000 (Table 3.4) and net income of the public pension system increased from P11.8 billion in 1989 to P35.6 billion in 2001 (Table 3.5).

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documentary stamp tax (DST) of 0.25 percent of the face value of each policy (Sunley et al 1997). The Financial Taxation Reform Program is seeking to reduce this tax to encourage efficient allocation of life insurance assets and equalize the DST on forms of savings instruments to level the playing field. Control by local, small family-owned businesses, which are often undercapitalised and have low retention capacity, hampers the non-life insurance segment.

4. This does not count the assets of the pre-need industry, which have been growing considerably but have no public data.

TABLE 3.3
Contractual Savings by Type of Asset, 1985-2000
(Billion pesos)

	1985	1990	1995	1998	1999	2000	2001	Avg. annual growth 1985-2000 (%)
Pension funds total assets	43.1	183.5	272.1	442.1	518.6	563.4	601.6	13.9
% of nominal GDP	7.5	17.1	14.3	16.6	17.4	17.1	16.5	
Public plan assets								
SSS investment funds	26.3	62.5	114.4	136.0	163.0	165.0	164.4	11.7
GSIS investment funds	16.8	36.1	72.2	131.6	163.7	181.1	205.5	16.4
Pag-IBIG assets	na	19.9	85.5	83.6	97.4	113.8	123.2	
AFP-RSBS assets	na	na	na	15.9	14.5	13.5	13.6	
Private plan assets	na	20.0	40.0	75.0	80.0	90.0	95.0	
Insurance assets	18.1	45.5	70.0	126.0	148.2	169.0	173.0	15.2
Total contractual savings	61.2	164.0	342.1	568.1	666.8	732.4	774.6	17.3
% of nominal GDP	10.7	15.3	18.0	21.3	22.4	22.2	21.3	

Note: These figures were obtained directly from each institution and may differ from Table 1 because of delays or omissions in information reported to the BSP.
Source: SSS, GSIS, Pag-IBIG, RSBS, Insurance Commission, WB, NSCB, UA&P.

TABLE 3.4
Pension Fund Contributions as a Share of GDP 1989-2000
(Percent)

	Public Sector Employer-Employee Contributions	Private Sector Employer-Employee Contributions	Total Public and Private Sector Contributions
1989	1.20	0.07	1.27
1990	1.42	0.11	1.53
1991	1.47	0.19	1.66
1992	1.48	0.15	1.77
1993	1.61	0.42	2.03
1994	1.71	0.56	2.27
1995	1.75	0.63	2.38
1996	1.71	0.48	2.19
1997	2.02	0.49	2.51
1998	1.81	0.54	2.35
1999	1.89	0.54	2.42
2000	1.98	0.58	2.55

Notes: Public member contributions came from annual reports of SSS and GSIS. Total income of private occupational funds was obtained from a survey by the Strategic Business and Economic Consultancy Group and company statements filed with the SEC. Total contributions are the sum of public contributions and the generated private member contributions
Source: Calculated by authors based on *SSS, GSIS, WB, NSCB, UA&P.*

TABLE 3.5
Net Income of Public Pension Funds, 1989-2001
(Million pesos)

	SSS	GSIS	Total
1989	8,237	3,545	11,782
1990	10,557	6,331	16,888
1991	13,598	7,013	20,611
1992	12,657	7,016	19,673
1993	12,555	8,738	21,293
1994	12,182	11,608	23,790
1995	13,898	14,113	28,011
1996	14,649	16,168	30,817
1997	16,829	18,515	35,344
1998	14,978	20,945	35,923
1999	13,397	30,568	43,965
2000	12,340	20,568	32,908
2001	9,793	25,813	35,606

Source: SSS and GSIS.

Pension savings can be significant sources of long-term capital because of their assured cash flows and long-term liabilities. Our ordinary least squares regression estimate indicates that the ratio of employee pension contributions to household savings is positively related to GDP (Appendix A). Thus, we can expect that the Philippines will have a growing pool of pension savings as economic development proceeds. In principle, by mobilising long-term savings, social security institutions can make non-inflationary long-term financing available to sectors that can use it most efficiently. The long-term maturity structure of their liabilities also creates a demand for matching financial assets, in the nature of equities and fixed income securities. The process of accumulation and investment of retirement reserves can stimulate creation of new financial institutions and more efficient mechanisms for allocating capital. In this way, the pension system itself can serve as an engine for increasing future earnings.

At present, however, only a small fraction of pension fund assets in the Philippines supports capital market development, because the investments are allocated primarily to loans and to non-traded government securities. The Philippine pension fund industry has a long way to go to match its neighbours. For instance, public pension spending in the Philippines was 0.6 percent of GDP, way less than Malaysia's 1.9 percent and Singapore's 2.5 percent (World Bank, 1985). Also, the pension system suffers from the absence of a pool of investment professionals, underdeveloped long-term financial markets, and a still-evolving relationship between pre-need companies and savers. Moreover, structural changes in the economy and society will increase the funding requirements of the formal social security system. Recently, the Philippines has begun to seriously consider reforms to strengthen the pension system.

Structure of the Public Pension System

As in most Southeast Asian economies, Filipinos relied more on extended families or informal, community-based support than on formal public pensions to provide for their social security needs. Strong ties among members of the extended family are a part of traditional Filipino culture and they provide a continuous and significant mechanism for assuring economic security into old age. Nevertheless, the Philippines introduced a formal public pension system for government employees as early as 1936.

Now, the formal social security system has two tiers (Asher 1998). The first tier comprises the mandatory, publicly managed system, including the Government Service Insurance System (GSIS), the Social Security System (SSS), the Armed Forces of the Philippines-Retirement and Separation Benefit System (AFP-RSBS), and the Home Development Mutual Fund (Pag-IBIG) (See Box 1). The GSIS primarily administers the social security program, including pension, workman's' compensation, and medical programs, for public-sector employees. The SSS, started in 1957, is responsible for employees of private companies and self-employed persons. The AFP–RSBS is to provide Filipino soldiers and their beneficiaries with living pensions and complementary welfare benefits, but it is still building up its fund and has yet to pay out any pension benefits. These three public systems are defined-benefit programs. The Pag-IBIG is the only defined contribution pension system in the Philippines.

The second tier is comprised of privately managed voluntary occupation pension plans of large private-sector companies. Unlike the first tier formal social security system, there is little published information on the private pension plans. Most employer-sponsored retirement plans have tailored their benefit schemes to satisfy the minimum requirements established by the

Employee Compensation Act of 1972. Typically, they pay a lump sum, calculated at 1.5 times the member's final salary times years of service with the company (Asher 1998). The private pension sector, while relatively young, is becoming an important source of retirement benefits for Philippine workers and one of the very few sources of long-term domestic capital.

Box 1

Basic Elements of the Retirement System

Pension funds are provided through both formal and informal planning. The formal retirement income support system includes five major elements:

- The Social Security System (SSS) provides retirement, survivor and disability benefits to workers in the private sector financed by employer and employee contributions totalling 8.4 percent of the first P11,000 of monthly earnings. Monthly retirement benefits are calculated by multiplying the average of the workers' most recent 60 monthly salary credits by 2 percent for each year of credited service and adding P300 to the total. Full retirement benefits are available at the age of 60.
- The Government Service Insurance System (GSIS) provides public sector workers with similar, though somewhat more generous, protections and is financed by employer and employee contributions totalling 21 percent of the first P16,000 in monthly earnings and 14 percent of earnings above this ceiling. GSIS, retirement benefits are calculated by multiplying the average of the workers' most recent 36 months of salary credits (with certain adjustments) by 2.5 percent per year of credited service. Benefits are available at the age 60.
- Pag-IBIG is a mandatory savings program financed by contributions totalling 4 percent for monthly earnings between P4,000 and P5,000. Accumulated funds are used primarily to finance housing loans. Accounts balances are available to participating workers at death, disability, retirement, or after 20 years of contributions. Participation is voluntary for low earners.
- Mandatory Retirement Pay (RA 7641) requires private sector employers to pay a lump sum equal to one-half month's pay for each year of service upon the retirement of an employee with more than five years of service. RA 7641 also provides for involuntary separation and disability benefits. Small employers in services, agriculture, and retail trade are exempt. This benefit does not have to be pre-funded. We estimate that pre-funding would cost employers about 2.5 percent of their cash wage bill if the average worker retired with tenure of 15 years and 6 percent of their cash wage bill if the provision were fully portable and average tenure at retirement were 35 years.
- Voluntary occupational pensions have tax preferences but their vesting, funding and benefit provisions are unregulated.

Source: SSS, GSIS, Pag-IBIG and World Bank.

At the end of 2001, the two main public social security programs (SSS and GSIS) had combined assets of P369.8 billion or 10 percent of GDP and accounted for almost 50 percent of contractual savings. Almost three-fourths of the combined total net income of these two schemes was in the GSIS system (Table 3.5). The surge in GSIS assets, which grew at an average annual rate of 16.4 percent from 1985 to 2000, was a major factor in the growth in contractual savings over the same period.

Problems

Three emerging trends in the economic landscape of the Philippines are creating the need to restructure the formal social security system and make it more efficient (Asher 1998). First, with increased urbanisation and industrialisation of rural areas, fewer people will be able to rely on informal, community arrangements to support their retirement, placing greater demands on the formal system to provide adequate benefits. Second, stronger purchasing power brought about by economic recovery will increase demand for economic security. Last, the size of the retiree population relative to the size of the workforce is projected to rise significantly in the next 30 years. A confidential World Bank report cited in the newspaper projects the possibility that SSS benefit payments will exceed its income by the year 2020. Heavy investment losses incurred during the Estrada administration and the low percentage of member contributions may put the SSS in this situation a decade sooner than the World Bank projected. These trends represent structural changes to which the formal pension system must adapt.

Although both the SSS and GSIS programs are partially funded, their investment policies and practices have serious shortcomings. For example, the reserves are not earning market returns, they are, for the most part, not held in liquid securities, and they are not managed in a way that encourages the growth of financial markets. A solution to hire a professional fund manager has been proposed but it is still very much in the conceptual stage.

Moreover, regulatory constraints on the allocation of pension fund assets to long-term securities have kept the public social security institutions from playing a significant role in developing the capital market. In 2000 long-term investments represented only 23 percent of total assets for the SSS and 32 percent for GSIS. This can be explained by the previous volatility of interest rates, which made even the private pension system maintain a fairly short-term investment profile, and to lean toward avoiding risk.

One negative aspect of public-sector controlled pension funds is the high probability of politically motivated (therefore, inefficient) investments. Indeed, there are allegations that investment of public sector pension assets in the Philippines has fallen under political influence. The former heads of the SSS and GSIS admitted that former President Estrada benefited from transactions involving the gaming firm, Belle Corp., and there are suspicions that he also profited from other deals such as the 1999 merger of Philippine Commercial International Bank (PCIBank) and Equitable Banking Corp. Equitable, then the country's tenth largest lender, was able to acquire 72 percent of PCIBank, the third largest bank, because the SSS and GSIS each contributed P7.5 billion to the P31.9 billion deal. While it was unusual for one bank to gobble up another bank more than twice its size, what was truly questionable was that this transaction was financed with the pension and other retirement contributions of private and state employees. Had the SSS and GSIS profited they could have defended the investment by pointing to the boost it gave to fund earnings, but in fact the merged bank has run into one financial problem after another, especially since the owners' connection with Estrada was exposed during the former president's impeachment trial.

Reforms

Reforming the pension institutions can improve retirement benefits and make the pension system more equitable. At the same time, if structured carefully, reform of the current retirement income system can raise the prospects for economic growth and development in the Philippines through improvements in the capital and financial markets.

The regional financial crisis stimulated the government to undertake some changes in the public pension system. Over-reliance on foreign financing along with excessive term transformation by financial institutions and excessive dependence of enterprises on short-term debt papers as opposed to long-term debt and equity finance were factors in the regional financial crisis. Recognition of these factors highlighted the need for the Philippines to develop domestic sources of financing. To this end, the government enacted two major pieces of legislation soon after the onset of the crisis to strengthen the public pension institutions. These and subsequent reforms have expanded their coverage and compliance and attempted to halt investment malpractice of public pension funds.

Both the Government Service Insurance System Act of 1997 (RA 8291) and the Social Securities Act of 1997 (RA 8282) raised the maximum amount of earnings on which pension contributions are based. This will increase the amount of money that pension funds could potentially put into the capital market. The Social Security Act of 1997 also gave the SSS new administrative authority. Before the act was passed, companies that complied with the pension funding requirements accounted for less than one-third of the employees who should have been covered by the program. Moreover, there is evidence that the contributions reported for a given worker in a given year often did not reflect the worker's full annual earnings. These compliance problems created financial difficulties for the SSS. They can be traced to the combination of economic incentives and administrative weaknesses to evade the law. The 1997 law gave the SSS greater powers to enforce compliance. For example, since the 1997 Act, the SSS can cross-check local business license applications with its own employer lists, making a more transparent environment. Compliance is an important challenge to the retirement income system. Without greater compliance, the system may never generate the adequate level of retirement income for beneficiaries that it should be able to provide. The main thrust of reforms seems to be compliance, i.e., actually collecting a greater proportion of the contributions that are legally required. This would have a positive impact on the pension saving rate in the long run.

Pending Issues

A number of problems and issues remain to be addressed to strengthen the public pension system as a social security institution and as a contributor to the capital market.

Over-pensioning

Under the GSIS benefit formula, many workers with long service may enjoy pensions that equal or exceed their pre-retirement net pay, given the current tax treatment. The GSIS is undertaking an analysis of benefits to long career workers. Administrators are presently comparing the combined total of pension benefits to pre-retirement earnings and they will recommend appropriate adjustments in the total compensation package for government employees.

Portability of Benefits

Workers moving from public to private sector employment are likely to suffer losses because benefits are not adequately portable between the GSIS and SSS programs. Several strategies could be adopted to remove the barriers to job mobility produced by the employer mandates under RA 7641. One approach is to require the previous employer to provide retirement pay and to adjust the benefit amount to reflect any increase in wages from the time the worker left each employer until retirement. A second approach is to require employers to set aside the potential benefits for workers who depart prior to retirement age. These funds would accrue interest in an investment account from the date of separation to the date of retirement. GSIS and SSS still need arrangements that allow workers to combine credits under the two schemes to establish their eligibility for benefits. Effecting this will require legislation, but GSIS and SSS are conducting preparatory discussions.

Privatisation

Some countries have responded to political and demographic pressures threatening the financial stability of their public pension systems by privatising them. A handful of countries have converted their pension systems from pay-as-you-go to partial- or full-funding and at the same time they have transferred management of contributions, in part, to the private sector. In the Philippines, discussion of privatising the SSS and the GSIS has been initiated either by the institutions themselves or by established fund managers. These discussions link privatisation to the objective of trimming the size of the government bureaucracy and improving investment returns. Conflicting political interests, however, may make it infeasible to accomplish privatisation of the Philippine pension system in a single step. If privatisation is to succeed, it is likely that it would only cover contributions in addition to present plan contributions.

THE EQUITIES MARKET

Besides improving the pension system, development of the capital market is a means to increase domestic savings to support long-term and sustainable development. Savings mobilisation requires a capital market that provides accessible instruments—both equities and fixed-income securities—to encourage savings and lower the cost of financial transactions. As intermediaries of such savings, efficient capital market institutions will improve the allocation of funds to alternative productive investments in the corporate sector. In the current global environment, with rapid development in information technology, innovations in financial products and services, integration of markets, and liberalisation of capital flows every economic player has to be competitive in order to survive. To compete for investors and channel investments properly in the rapidly changing global environment, the Philippine capital market needs technical and financial assistance to improve its analytic capability, to adopt international best practices, to build institutional capacity, and to upgrade infrastructure, particularly through IT-enabled support systems. The Philippines also needs to build a larger pool of investment capital by broadening public participation and attracting foreign investors to its equities and securities markets.

The Philippine equities market is one of the oldest in Asia. The Manila Stock Exchange (MSE) was founded in August 1927. The Makati Stock Exchange (MkSE) was established in May 1963. To consolidate logistics and hasten development, these two bourses agreed in principle to unify their operations under the Philippine Stock Exchange (PSE), which was incorporated on 14 July 1992. They continued to operate separately, however, until 4 March 1994, when the SEC granted the PSE a license to operate as a securities exchange and simultaneously cancelled the licenses of MSE and MkSE, making the PSE the sole exchange operating in the Philippines.

The PSE has remained relatively small since its formation. At the end of 2001, it listed only 230 companies and only a little over 300 issues. Of these, only 120 to 140 are actively traded issues. More importantly, most analysts consider only 30 to 50 of these issues to be investment grade. The 50 largest issues on the PSE account for almost 90 percent of its total capitalisation of $51.6 billion and the 50 most-traded securities account for over 80 percent of the total turnover value.

Moreover, the growth of the PSE seems to have stalled since the Asian financial crisis. In 1997, the year the crisis began, only six companies listed securities on the PSE, in 1998 four companies were listed, and in 2001 only a single company was listed. Total value turnover also dropped dramatically from a high of P669 billion (US$17 billion) in 1996 to only P357 billion (US$8 billion) in 2000 and to P160 billion (US$3 billion) in 2001. This post-crisis trend contrasts with the bright outlook for the PSE in the first two years after its formation, when IPOs boomed and market capitalisation was increasing.

The year 1994 was the busiest ever for IPOs in the Philippines, with 21 new issues generating gross proceeds of 37 billion pesos (Table 3.6). Between 1994 and 1996 there were 50 new company listings raising P95 billion. The 1994-96 surge in IPOs is probably attributable to the foreign exchange liberalisation in 1992, which paved the way for better a macroeconomic environment and the deregulation of the banking industry in 1994. Also, economic stability and political confidence during the administration of President Ramos meant that newly listed issues could realise average gains of 100 to 200 percent in one month's time. The rapid rise in prices of new issues might also suggest that underwriters under priced IPOs to guarantee success and to minimise their risk.

TABLE 3.6
Number and Proceeds of New Listings, 1987-2001

	Number of IPOs	Gross Proceeds million pesos
1987	2	156.5
1988	3	952.3
1989	6	3,702.2
1990	10	4,134.3
1991	10	5,658.3
1992	9	5,660.6
1993	11	8,713.9
1994	21	37,415.0
1995	16	31,028.5
1996	13	27,049.5
1997	6	10,073.6
1998	4	1,016.8
1999	5	756.5
2000	7	560.7
2001	3	242.0
Total	126	137,120.7

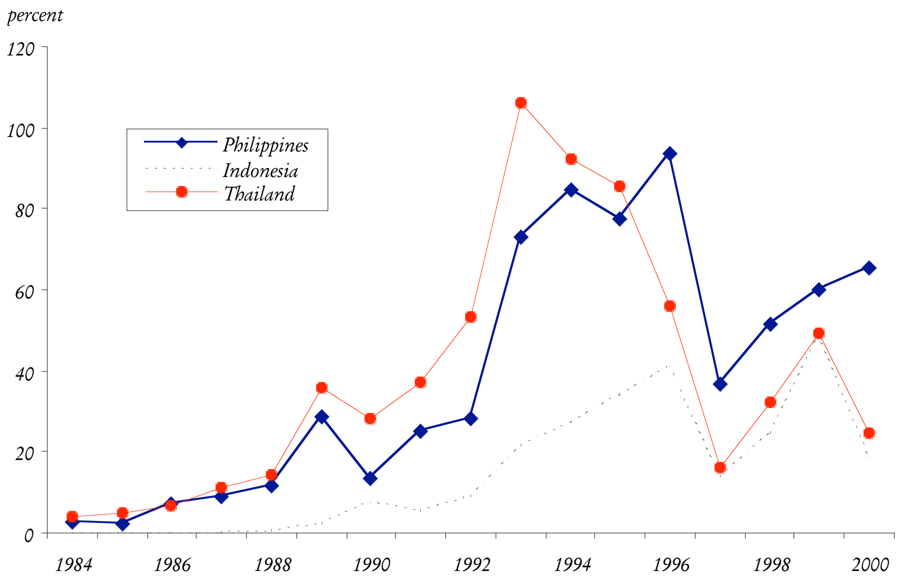
Notes: Number of IPOs is the number of firms that issued IPOs. Issues with A/B share classification are counted as one IPO. Gross Proceeds equals offer price times the number of shares offered to the public including both A and B shares.
Source: Philippine Stock Exchange

In 1994, stock market capitalisation in the Philippines reached 84.5 percent of GNP, compared to only 13.4 percent in 1990 (Figure 3.1). Market capitalisation peaked at 93.5 percent of GNP in 1996 before it fell drastically with subsequent external (the Asian financial crisis) and internal (political uncertainty) problems. Although it began to recover, in 2001 the market capitalisation-to-GNP ratio was still down by one-third from its peak. However, market capitalisation in the Philippines is larger in relation to GNP than in Thailand and Indonesia (Figure 3.2).

FIGURE 3.1
Ratio of Market Capitalisation to GNP, 1984-2000

Source: Emerging Stock Markets Factbook.

FIGURE 3.2
Market Capitalisation to GNP Ratios of Selected Asian Economies, 1984-2000



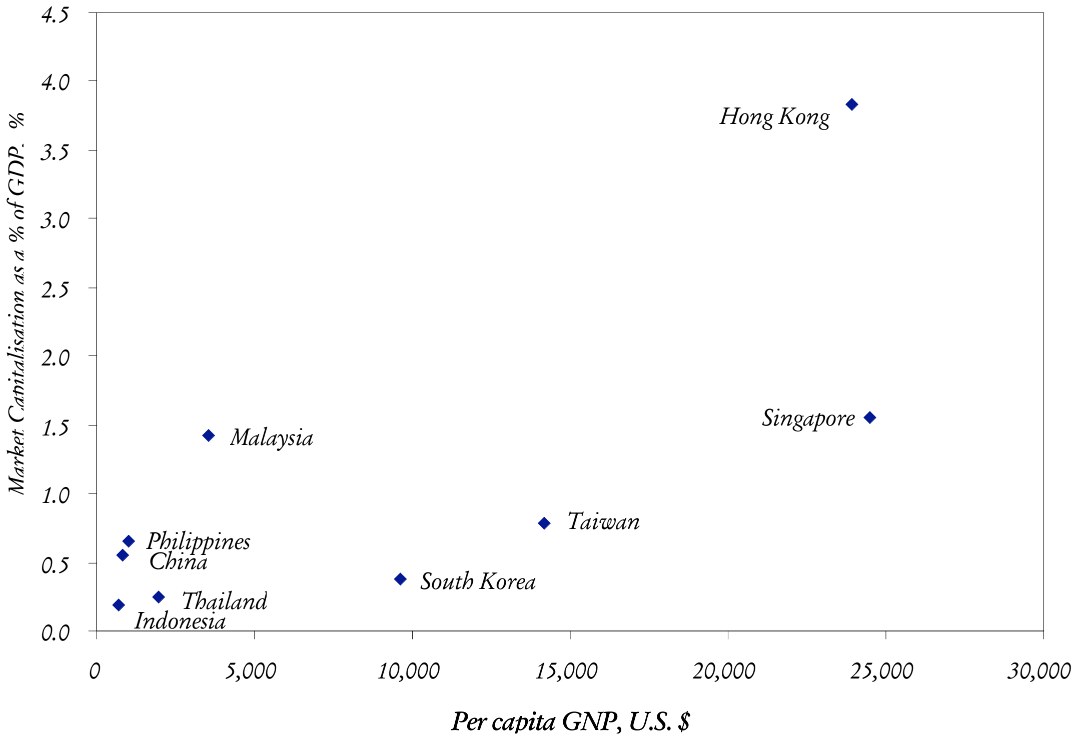
Source: Emerging Stock Markets Factbook.

Comparison with Other Asian Markets

This raises the question of how the size of the equities market in the Philippines relates to the economy's overall level of development. We answer this question by comparing the Philippines with neighbouring economies.

Figure 3.3 plots GNP per capita against the ratio of market capitalisation to GNP for nine Asian economies in 2000. It suggests a positive relationship between per capita income, or level of development, and the size of the stock market. For developed economies with high per capita incomes, like Hong Kong and Singapore, the value of stock markets is equal to or greater than total output, so the market capitalisation ratio is 1 or above. On the other hand, for emerging markets like the Philippines, China, Thailand, and Indonesia, that have lower levels of GNP per capita, the value of stock markets is generally less than the value of output. Malaysia is the exception among the emerging Asian economies with market capitalisation almost 1.5 times GNP.

FIGURE 3.3
Per capita GNP vs. Market Capitalisation as a Percentage of GNP, 2000



Source: Emerging Stock Markets Factbook.

We examined this relationship more closely by means of OLS regression of per capita GNP on the market capitalisation ratio for these nine economies using data for 1991 and 2000 (Appendix B). We found that there was a structural change in the relationship during the 1990s.

Specifically we found that for a given level of per capita income the market capitalisation ratio was higher in the more recent period. In other words, equities markets have grown in importance for economies at all levels of development. Besides, this has meant that despite the Asian crisis, stock market capitalisation in the Philippines is above average in relation to per capita GNP.

Problems

Dependence on Foreign Capital

Historically the Philippine stock market has not had a bull run without strong foreign participation. This was demonstrated quite clearly during the years between 1994 and 1996. Furthermore, in 1997 it was foreign funds fleeing the local market that caused its collapse. Strict monitoring of foreign capital, like the Malaysian model, can be a solution to the problem of volatile flow of funds.

High Transactions Costs

Another factor holding the equity market back is costs. The Philippine stock market has the second highest transaction costs among Asian equities markets (Table 3.7). In fact, at over US$2 billion commissions, fees, and taxes in the Philippines are significantly higher than in other Asian markets. The most significant contributor to these costs is taxes, specifically taxes on transfers, closely followed by commissions. If not for the very high market impact cost in South Korea, the Philippines would have the highest total cost among Asian equity markets.

TABLE 3.7
Equities Market Transaction Costs in Selected Economies, 1997 Q4
(US$ billions)

	Commissions, Fees and Taxes	Market Impact	Total Cost
Hong Kong	1.16	0.24	1.40
India	0.52	1.24	1.76
Indonesia	1.95	0.58	2.53
South Korea	1.52	3.97	5.49
Malaysia	1.78	0.41	2.19
Philippines	2.60	0.17	2.77
Singapore	1.38	0.42	1.80
Taiwan	1.31	0.53	1.84
Thailand	1.67	0.52	2.19
Asia Average	1.54	0.90	2.44
New York Stock Exchange	0.31	0.55	0.86
World	1.11	0.68	1.79

Notes: Market Impact compares the trade price to the "underlying price," and indicates execution skill and market liquidity. Normally, the larger the trade, the more the impact. Here, the underlying price is estimated by averaging the daily high, low, open, and close.
Source: Ekins/McSherry Co., Inc.

High taxes on transactions are almost certainly restricting volume and liquidity in the Philippine market. Low liquidity reduces the attraction of the stock market for investors and issuers. Experience elsewhere suggests that cutting very high transaction taxes leads to substantial increases in trading and tax revenue (Wells 1998). However, given the tight fiscal situation, Philippine tax authorities should study the likely impact that reducing transactions taxes would have on overall volume and on tax revenue.

Loss of Credibility

Finally, the Philippine equity market has suffered because the PSE and the SEC, as the final watchdog, lost public investor credibility, particularly during the Estrada Administration (1998 - 2001). One example, was the Best World Resources (BW) scam, the biggest fraud in Philippine stock market history. BW's stock price rose to a record level in October 1999 with an announcement that Macao casino tycoon, Stanley Ho, was to invest heavily and become Chairman of BW. This did not materialise and the price plunged a week later. The exhaustive Investigation Report of the PSE's Compliance and Surveillance Group concluded that Dante Tan, who controlled BW, and other brokers were manipulating BW stock through fraudulent "wash sales," in which the seller and buyer are one and the same person. The objective is to create the illusion of an active market in a particular stock.

Former President Estrada also allegedly played a role in the dramatic changes in BW's stock price. Tan was a friend of the President, and in July 1999 through the government Philippine Gaming Corporation (PAGCOR) the Office of the President gave the nationwide on-line bingo franchise to Best World Gaming and Entertainment Corp., a wholly owned subsidiary of BW. Under the Constitution, only Congress can grant a franchise to operate a gambling activity; without a congressional franchise, a gambling activity is a criminal act.

The BW scam was so massive and so glaring that it scared away all investors, foreigners and locals alike. This uncertainty caused the stock market to fall in late 1999 and 2000. Despite evidence presented during Estrada's impeachment trial in late 2000, the criminal cases against the parties involved have hardly moved.

Reforms

A positive offshoot of the BW scandal was the passage of the Securities Regulation Code (RA 8799), or the Securities Act of 2000, in July 2000. The enactment of the Code sends a clear signal to both local and foreign investors that the Philippine government is firmly committed to developing the local capital market and protecting investors. The reforms in the Code aim to develop the capital market, promote self-regulation in the securities industry, ensure protection for all investors, encourage full and fair disclosure, and eliminate fraud and manipulation which create market distortions.

Significant features of the Code include:

- *Reorganisation of the SEC into an effective market regulator.* The Code allows the SEC to completely reorganise, including paying higher salaries, which will enable it to attract the better trained staff that it needs to restore credibility as an effective market regulator. The Act also gives the SEC additional powers to enforce the law and address market abuses.
- *Full-disclosure approach to regulation of the securities market.* The law codifies a new approach to regulation, which aims to ensure that investors are provided with material information to enable them to make informed investment decisions. The SEC's role in public offerings is to review disclosure documents to make sure that they comply with disclosure requirements. The issuer, corporate secretary, persons who sign the registration statement, underwriters, and directors are liable for the accuracy the disclosure documents.
- *Credibility of the securities market.* The law requires the Philippine Stock Exchange to de-

mutualise and become a publicly held corporation with diverse ownership within one year, to immediately be governed by a majority of non-broker members, and to be managed by an independent and professional group. De-mutualisation is a way to restore investors' perception that the stock market is fair and transparent. The Code also gives the SEC power to regulate other types of markets, including "innovative trading" markets to reflect new market realities.

- *Protection of minority shareholders*. The law provides better protection to minority shareholders. Such protection is essential to attract new investors to the stock market where ownership is highly concentrated. Under the Code, mandatory tender offers are required if any person or group of persons intends to acquire 15 percent of the equity securities of a listed or other public company, or intends to acquire at least 30 percent of such equity over a period of 12 months.
- *Prevention of market abuses*. The law contains new prohibitions on insider trading and affiliated transactions by brokers and dealers, and it generally segregates the broker and dealer functions to prevent market abuse and fraud. Moreover, the Code provides the SEC with a flexible framework to regulate such markets, to enable it to resolve cases more expeditiously during an investigation.

There are two major items on the reform agenda that have yet to be carried out. The first is to remove the stamp tax on secondary transactions. This item had been given priority on the legislative agenda. The government is willing to reduce the DST on secondary transactions, but it wants to raise the DST on other items to compensate for the loss in revenue.

The second item is to achieve convictions in the BW scandal. The SEC does not appear to be seriously pressing the criminal cases on this issue. Achieving convictions will go a long way to restoring credibility in the integrity of equities market institutions among investors and the general public.

Future reform of the equity market should address the issues of information availability, profitability, and fairness. Investors put their capital where they believe it will yield the highest returns. The confidence of investors to go into the stock market depends both on the availability of information to guide their decisions and manage risks and on their perception of market profitability and fairness.

Lastly, the SEC must take very concrete steps to improve the credibility and image of the institution and its employees and to establish procedures and systems that remove, where possible, discretion on the part of SEC personnel over decisions and transactions. Among these are transparent rules and procedures, automation of some processes, closer monitoring of cases to determine delays and backlogs, and transferring discretion to parties that have a greater stake in the outcome, particularly in corporate recovery cases. These are some of the administrative reforms that remain to be carried out to complement the recent legislative reforms.

THE MARKET FOR FIXED-INCOME SECURITIES

The fixed-income securities market is the largest part of the capital market in the Philippines. Debt instruments are issued by the government and private companies and they are held by banks, insurance companies, pension funds, and pre-need companies. The government securities market is much larger and more highly developed than the private debt market.

Market for Government Securities

The market for Philippine Treasury bills is one of the oldest active securities markets in Asia, having been established in 1966 concurrent with the formation of the Money Market Accredited Dealers Association (MART) to handle its transactions. Despite its age, it has not fully developed, and much-needed improvements remain to be effected.

The national government regularly issues two kinds of securities, Treasury Bills (which mature in less than one year) and longer term Treasury Bonds. Prior to 1990, the maximum maturity of securities issued by the national government was only one year. Gradually as inflation and interest rates declined, the government began to issue instruments with longer maturity. Beginning in 1986 it issued longer-term Floating Rate Treasury Notes (FRTNs). It discontinued these in 1994 and replaced them with fixed-rate semi-annual coupon bonds, called Treasury bonds (Table 3.8). Treasury bonds (T-bonds) are issued in a range of maturities, and by 2001 they accounted for 69.2 percent of outstanding government securities (regular issues only).

In addition to these regular government issues there are special issues, both short and long term, by the national government and other securities issued by local governments or government corporations. One long-term special issue was the Retail 10-Year Treasury bond issued in 2001 and 2002.

TABLE 3.8
Outstanding Value of Regular Issue Government Securities, 1995-2001
(Billion pesos)

	1995	1996	1997	1998	1999	2000	2001
Treasury bills	216.7	218.2	214.6	264.4	290.2	275.5	250.8
Fixed-rate Treasury bonds	59	186.4	227.6	253.5	330.5	434.3	563.3
2-year	29	76.6	85.8	72.9	84.4	104.1	159.8
5-year	30	62.5	69.8	90.9	110.2	116.6	146.1
7-year	0	37.7	45.8	53.2	68.9	99.6	132.4
10-year	0	9.6	23.8	32.4	61.9	98.4	107
20-year	0	0	2.4	4.1	5.1	9.8	9.8
25-year	0	0	0	0	0	5.8	8.2
Total	275.7	404.6	442.2	517.9	620.7	709.8	814.1
in US$ billions	10.72	15.43	15.00	12.66	15.88	16.06	15.96
% of GNP	14.1	17.9	17.5	18.5	19.8	20.3	20.2

Source: Bureau of Treasury.

Origins and Systems

The Treasury bill (T-bill) market was born because of persistent government deficits and ceilings on deposit interest rates. The Central Bank originally carried out weekly auctions, but this regime ended with the clearer dichotomisation of monetary and fiscal policy in 1993. The Bangko Sentral ng Pilipinas (BSP) was established to replace the bankrupt Central Bank and the auctions were to be transferred to the Department of Finance, Bureau of Treasury (BTr) within five years. The BTr actually started handling the auctions in 1995. A representative of the BSP occupies one seat on the new Auction Committee.

When the BTr took over the primary auction of T-bills and T-bonds, it adopted the privately developed Automated Debt Auction Processing System (ADAPS). The ADAPS is an electronic system for the auctioning government securities to a network of authorised government securities dealers (GSEDs) linked electronically to the BTr. As of March 2001, there were 38 GSEDs, only five of which were non-banks. Introduction of ADAPS raised confidence in government issues by dramatically speeding up the auction process, making it real-time.[5]

5. Leonor Magtolis Briones and Catherine Bool Nunez, E-Government and Information Technology. *Asian Review of Public Administration*, 13(1), Jan-June 2001. Downloaded from http://unpan1.un.org/intradoc/groups/public/ documents/eropa/unpan004145.pdf.

Longer-term T-bonds are sold in a competitive, uniform price Dutch auction while T-bills are sold in an English auction, where successful bidders pay the price that they have bid. For T-bills, the Auction Committee decides a cut-off yield below which it makes awards, based on the amount of securities to be auctioned. First, however, 40 percent of the T-bills in the auction are awarded to non-competitive bidders (i.e., those that do not specify any price or yield, but only an amount), at the weighted average of the accepted bids. Bidders may enter as many bids as they wish and also participate in the non-competitive bids. The Committee can reject all bids that are way off current market rates or award less than previously announced.

Clearing and settlement are done on-line through the BTr's Registry of Scripless Securities (RoSS) system. RoSS is a central electronic clearinghouse that monitors and officially records the sale and registration of all government securities. Secondary trading is carried out by GSEDs on a limited, over-the-counter basis. There are no two-way price quotes for market players to see, so trading is based on direct one-on-one contact between dealers.

Problems with the Government Securities Market

The two fundamental weaknesses of the government securities market in the Philippines are inefficiency in the primary auction market and underdevelopment of a secondary market.

Despite electronic bidding and award posting, the primary auction market is still inefficient in several respects. This is illustrated by the fact that the rate is higher on T-bills than on similar period time deposits. One source of the high yields is market imperfection on the buyers' side. Banks, especially the big banks, have too much market power. In the past, a single bank has been able to corner the entire issue of a given tenor, especially of 364-day T-bills. This problem was pointed out in the 1992 World Bank study of Philippine Capital Markets:

> "…in normal circumstances, a demand for T-bills larger than the available supply should depress the yields on T-bills. The commercial banks in the Philippines, however, hold a monopsonist position in the market for T-bills. At the end of 1989, commercial bank holdings on their own account and private investors of T-bills amounted to 81 percent of total T-bills outstanding." (World Bank 1992)

Although more up-to-date information on ultimate holders is not available, the situation is not likely to have changed, since banks' share of financial resources increased during the 1990s (Table 3.1).

Another source of high yields is the auction rules. Using linear programming on actual bids for 16 auctions, Leonor found that the government could lower yields on primary auctions by changing the rules. Specifically, she proposed adjusting the percentage of accepted non-competitive bids according to a formula that considers tenders for both competitive and non-competitive bids and awarding risk-averse non-competitive bids at a rate equal to the highest accepted bid (Leonor 2000, p. 56).

The government proposed a new set of regulations and bidding system and submitted it for comment by market players in late 2001. One part of the proposal was to switch from the English to the Dutch system for auctioning T-bills, which would promote competition. It is likely that the change can be effected before the end of 2003.

The second fundamental problem is the practical non-existence of a secondary market, even for much-sought-after government securities. There are at least six reasons for the illiquidity and lack of development in the secondary market. They are: (1) a propensity for primary auction dealers to hold on to securities for their own account; (2) the inefficiency of the trading system; (3) the absence of market makers, (4) prohibitive taxation of securities transactions; and (5) lack of investor interest.

Propensity to Hold on to Existing Issues

Rather than serving as intermediaries, primary buyers of T-bills and T-bonds tend to hold on to these instruments until maturity, making the market illiquid. On one hand, primary auction dealers appear to be extremely risk-averse, preferring to put a large portion of their portfolios into government securities rather than loans. This behaviour has been especially apparent after BOP and/or banking crises and it continued after the Asian crisis of 1997. At the same time, the central monetary authority's regulations on bank lending compound the propensity for primary buyers to hold on. Banks that fail to meet the required loan allocation to agriculture can comply by purchasing certain government securities.

To solve the holding-on problem and create liquidity in the secondary market, Abola (1998) suggests lowering, or removing altogether, mandated lending to agriculture and limiting the government securities holdings of banks and insurance companies to a reasonable percentage of either total assets or total earning assets.

Inefficient Trading System

Presently, dealers carry out secondary market transactions on actual buy/sell requests, which they seek to fill from their own accounts or among other dealers on a personal basis. This one-on-one, barter-like system is inefficient, resulting in high transaction costs that discourage trading.

To be more efficient, the system for secondary trading in government securities should allow public, two-way exchange of information on bids and quotes and impersonal matching and execution of trades. A public-access, on-line quoting and trading system would accomplish these goals. The Bankers Association of the Philippines has plans to add such a system to its electronic trading system for foreign exchange, while the PSE has its own plan to include it alongside its stock trading system. Regardless of which entity (or a joint entity as is also being considered) succeeds, these plans, together with the determination of the Bureau of Treasury to develop a secondary market, bode well for the realisation of this long-awaited development to become operational before the end of 2003.

Lack of Market Makers

A viable secondary market needs large financial intermediaries to act as market makers, taking up the slack in the market and feeding the public perception that their presence assures liquidity. At present, the Philippines lacks any significant market makers. There are many Philippine investment houses, but they are either owned by banks or are poorly capitalised; the former cannot really compete with their parent's banking business, while the latter have little muscle to become market makers. This situation developed out of the introduction of universal banking in the 1980s, which stymied the development of the capital market by allowing banks to gain such dominance over other financial institutions. Neither are the SSS and GSIS pension funds able to function as market makers. Because their T-bill holdings are tax-exempt, these big institutional investors are constrained to trade only with the BSP (Bernardo 1999, p. 14). Not only is this tax exemption distorting but also it is unfair to other holders of government securities.

The existing wide spreads between loan and deposit rates at banks present a window of opportunity for active trading in government securities. In the first place, the amount of outstanding government indebtedness is large enough to supply the market with tradable instruments. Secondly, the private sector needs more efficient intermediation to maintain the momentum of the present recovery. Realising an active secondary market, however, also requires removing the impediments to participation by public pension funds and non-bank financial institutions, but that is unlikely to happen any time soon. Politicians are not apt to go against popular sentiment to legislate an end to the tax-exempt status of public pension fund holdings of fixed-income securities. Moreover, the powerful BAP is sure to mount stiff opposition to any attempts to unwind the universal bank model.

Heavy Taxation of Secondary Market Transactions

Every transfer of bonds and debentures is subject to a documentary stamp tax (DST) of 0.75 percent of the face value of the instrument. Since this tax is based on face value, it adds significantly to the cost of transactions in the secondary market, especially when interest rates are low as they have been trending in recent years. The high transactions cost discourages holders from unloading their securities to obtain liquidity or realise capital gains.

Both the private sector and the Department of Finance (DOF) have proposed removing the stamp tax for all secondary market transactions (including equities). Indeed, removal of the tax is part of DOF’s Financial Sector Tax Reform program, but it requires legislative approval. Passage of this and other financial sector reforms appear to be a priority of President Arroyo's administration.

Lack of Investor Interest

Finally, the secondary market for Philippine government securities suffers from a general lack of investor interest due to interest rate fluctuations and lack of market liquidity and market knowledge. Recent macroeconomic uncertainty and the resulting interest rate volatility have tended to make investors wary of long-term commitments such as bonds and government securities. Market illiquidity created by the structural problems cited above has discouraged retail investors from buying government securities. Moreover, Filipino investors and even finance professionals lack knowledge about the workings of such markets precisely because they are virtually non-existent in the Philippines. Past government policy did not help to encourage investors, either. For example, at one time Bancom was a pioneer in capital market development in East Asia and it actively promoted commercial papers and repurchase agreements for government securities, but the government allowed this large investment bank to collapse because of non-payment by a major paper issuer, Dewey Dee.

Except for the lack of liquidity in the market, the factors that have kept investors away from the secondary market for government securities seem to have been weakening. Evidence of this is the government's successful special issue of Retail Treasury bills/bonds in 2000 and 2001. These issues were sold directly to the public and in smaller denominations than regular issues of T-bills and T-bonds. The success of this special issue encouraged the government to repeat with another such issue in 2002. Retail investors would find such issues even more attractive if there were a secondary market to provide liquidity.

Overall Comments

The shortcomings of the primary auction market and the lack of a normal secondary market have meant that commercial banks can obtain economic rent in both markets. Evidence of this is the steep yield curve for government securities, which is unjustified by present or expected rates of inflation. Yields on Philippine government securities are also way out of line with yields in other developing countries such as India (Table 3.9).

TABLE 3.9
Yield on Long-term Government Bonds in Philippines, Australia, and India, September 2002
(Percent)

	Philippines	Australia	India
1-year	7.17	4.89	5.94
2-year	9.20	5.01	5.94
5-year	11.78	5.31	6.34
10-year	12.58	5.56	7.18

Source: *Asian Wall Street Journal.*

Indeed, the existence of these large yield spreads may also provide the solution to the inefficiencies of the primary and secondary markets for government securities in the Philippines. Such spreads create the incentive for other institutions and players to get into the act and to make substantial profits in the process.

Market for Private Fixed-income Securities

The fact that in 1996 domestic issues of commercial paper amounted to only half the volume of bonds floated on the international market by Philippine companies illustrates the weak state of the domestic market for private debt (Bernardo, p. 12). The market for private fixed-income securities in the Philippines is essentially a market for commercial paper. To issue bonds, corporations must prepare a prospectus and disclose much information, while to issue CP they simply need SEC approval. Prior to 1975, the issuance of commercial papers was unregulated. Financial disclosure started in 1975 and Registration and Eligibility Rules were adopted in 1981. Even prior to the banking crisis of 1984, the only private debt issues were short-term or commercial papers.

The market for commercial papers (CPs) was primarily short-term until 1991 when three-year commercial papers were first issued. These longer-term CP issues peaked in 1996, at P20.3 billion, and declined sharply from then until the present (Table 3.10). The market for short-term CPs followed a similar pattern, except that the fall has been precipitous since 1999. The Asian crisis severely impacted the private debt market in the Philippines. Due to a flight to quality, new issues of commercial paper fell from P24.6 billion in 1997 to only P8 billion in 1998 (Table

10). New issues for 2001 were practically nil (only P2 billion).

TABLE 3.10
Issues of Commercial Paper, 1995-2001
(Billion pesos)

	1995	1996	1997	1998	1999	2000	2001
Short term CP	18.8	15.1	13.2	7.3	2.0	1.8	1.0
Long term CP	12.1	20.3	11.4	0.7	6.7	7.0	1.0
Total	30.9	35.4	24.6	8.0	8.7	8.8	2.0
in US$ billions	1.20	1.35	0.83	0.20	0.22	0.20	0.04
% of GNP	1.6	1.6	1.0	0.3	0.3	0.3	0.0

Source: SEC.

Most outstanding private debt securities in the Philippines are long-term (Table 3.11). This is because recent tax changes partially or totally exempted long-term (5-year) issues on the part of the investor. Besides, with banks charging high lending rates when they are willing to lend, retail investors and corporate users would both benefit by issuing bonds. With inflation under control, there is promise for the corporate bond market to flourish during the coming decade.

TABLE 3.11
Commercial Paper Outstanding Year-end 1995-2000
(Billion pesos)

	1995	1996	1997	1998	1999	2000
Short term	3.9	5.9	4.7	3.4	2.0	1.6
Long term	25.0	46.0	50.2	44.3	45.5	43.0
Total	28.9	51.9	54.9	47.7	47.5	44.6
in US$ billions	1.12	1.98	1.86	1.17	1.22	1.01
% of GNP	1.5	2.3	2.2	1.7	1.5	1.3

Note: Data for 2000 are January to May only.
Source: SEC.

The private securities market suffers from most of the same problems discussed above with reference to the government securities market. At the same time, three additional factors specifically affect the development of the market for private fixed-income securities. These are (1) lack of mandatory ratings and credible credit rating agencies, (2) misalignment of accounting and auditing standards to international standards, and (3) lack of standards for good corporate governance.

Credit Rating Agencies

The private securities market in the Philippines would benefit from a more effective credit rating infrastructure to provide investors with objective, impartial information on the quality of debt issues. The need for credible rating agencies and mandatory rating of bonds is even greater since the Securities Act of 2000 gave the SEC a more regulatory role and the PSE has yet to prove its effectiveness as a self-regulating body.

The first credit rating agency in the Philippines, the Credit Information Bureau Inc, was set up in 1982 by the Central Bank, the SEC, and the Financial Executives Institute. Perhaps in response to criticisms in a 1997 study by the Asian Development Bank, the Credit Investigation Bureau was reorganised in 1998 with technical assistance from Standard and Poor’s and renamed the Philippine Ratings Services Corporation, or PhilRatings (Saldana 2001). Thomson Watch and the International Finance Corporation (IFC) helped to establish a second agency, Thomson Ratings Philippines, in 1999 (Saldana 2001). These agencies maintain fairly good databases and they also gather information from other sources as well as from financial statements.

The revitalisation of the existing agency with foreign help and the entry of a second rating agency are welcome changes that will improve the quality of information and ratings in the Philippines. But, as in other developing countries, investors in the Philippines must pay special attention to obtain information not covered by financial statements and disclosures required by the SEC. A further step toward improving the private securities market by providing information essential for investors would be to make the rating of CP and bond issues mandatory.

Accounting and Auditing Standards

At one time, accounting and auditing standards in the Philippines were rated on a par with the rest of the region (Merrill Lynch 1998 cited in Abola et al. 2000, pp. 58-59). During the 1990s the Philippines moved away from strict adherence to the Generally Accepted Accounting Principles (U.S. GAAP) used in the United States by updating local accounting standards in accordance with the framework of the International Accounting Standards Committee (IASC).

As a result, the Philippines now has a mixed set of standards. While the U.S. GAAP is generally recognised as the more stringent standard, the Enron fiasco highlighted some of its deficiencies. Nevertheless, having a mixed set of standards is inefficient. It means that companies' financial statements are not readily comparable. Adherence to a single set of standards should be the norm. Since the Philippines followed U.S. GAAP in the past, it should continue to do so, and hope that U.S. GAAP and IASC will work out their differences in the future.

Not only are accounting standards in the Philippines now inconsistent, but also auditors are not held accountable. For example, a leading local auditing firm with ties to one of the top five U.S. auditing firms failed to detect the true state of insolvency of at least two listed companies. Neither the Board of Accountancy nor the Philippine Institute of Certified Public Accountants imposed sanctions on the auditors in these incidents or other cases.

The Philippines also needs to ensure that securities accounting is based on mark-to-market principles. BSP has mandated that banks follow mark-to-market, but the SEC has not imposed such a requirement on listed companies in general. There is great pressure for the SEC to issue such a directive and it should occur in due time.

Lack of Corporate Governance Standards

The Asian financial crisis of 1997 highlighted the lack of good corporate governance standards in the Philippines as elsewhere in the region. According to industry sources, before the crisis some Philippine banks were granting loans first and checking credit later, if at all. These banks continue to be saddled with high rates of non-performing loans, which stood at around 18 percent of total bank loans as of December 2001. The reckless lending to the real estate sector in 1994-97 could have been avoided if the Philippines had established norms for good corporate governance and sanctions for their violation.

Dr. Jesus P. Estanislao, former Secretary of Finance and President of the ADB Institute, spearheaded the establishment of the Institute of Corporate Directors in the Philippines. The

Institute worked with the World Bank and the Asian Development Bank to identify the key governance issues common to East Asian economies and to research and promote best practices in corporate governance. Workshops held in Manila in February, May, and November 2000 came up with a set of best practices in corporate governance and duties and responsibilities of corporate directors to recommend to the Pacific Economic Co-operation Council in the fall of 2001 (Institute of Corporate Directors 2000). The Philippines' group adopted these general principles.

In addition, through the SEC, the BSP, and public consultation, the Institute of Corporate Directors in the Philippines adopted a set of guidelines on Corporate Governance Reform. These guidelines cover rights and equitable treatment of shareholders, role of stakeholders in corporate governance, disclosure and transparency, responsibilities of board of directors, and appointment of two independent board members. The BSP requires all banks to follow these guidelines, while the SEC recommends that listed firms should follow them. At the end of May 2002, President Arroyo signed an Executive Order giving more teeth to the policy thrust. The BSP has been tough in implementing reforms and has mandated that members of banks' boards of directors take an accredited course on corporate directorship. The SEC is still working out final arrangements with the Philippine Stock Exchange to establish a similar requirement for directors of listed companies. Adoption of these guidelines and accompanying sanctions will mark a major step in realising a true private bond market. As is often the case in the Philippines, there is no shortage of laws or regulations on good governance—standards for best practice, duties, and responsibilities of directors are now in place—but what we need now is implementation and effective sanctions.

The Philippines is in the process of developing the necessary institutional framework for a bond market, but much work still has to be done soon to enable the financial system to be a contributor, rather than a deterrent, to sustained economic growth in the post-Asian crisis era.

CONCLUDING REMARKS

The capital market in the Philippines had a head start over the rest of East Asia, but it failed to develop. Recent structural reforms have improved the chances for the market to move ahead once more. We pinpointed the main obstacles in the way of developing the capital market, but we also showed that most of these obstacles have been or are in the process of being tackled. Reforms are being pursued to remedy imperfections in the primary market for government securities, and developing a liquid, electronically based (payments and settlement, and registry) secondary market is crucial.

With the recent trends of lower inflation, lower interest rates, and greater economic stability, the macroeconomic conditions are ripe for major development of the Philippine capital markets in this first decade of the new millennium.

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APPENDIX A
REGRESSION ANALYSIS OF PENSION FUND CONTRIBUTIONS

To show that pension contributions will be growing source of private savings for the Philippines in the future, we estimated a simple model of the determinants of pension fund contributions as a share of household savings during the 1990s. Pension contributions are a form of savings. Theoretically, when prices of goods and services are increasing very fast, households tend to decrease savings, while the other hand, when incomes are rising their savings increase. Furthermore, households are likely to reduce their current level of savings in the wake of natural disasters, wars, or financial upheavals, which make the future less certain. So like other savings, pension contributions should depend on the price level, income, and unforeseen shocks. As incomes rise, more enterprises join the formal sector of the economy and become subject to the pension scheme and as consumer prices move up, self-employed persons have less incentive to join the scheme. In recent years contributions from self-employed persons (which include overseas contract workers) have risen, because of the desire of these workers to take advantage of the housing loan benefit.

As independent variables we included the consumer price index (CPI) to reflect the price level; real gross domestic product (GDP) to proxy for household income; a dummy variable to capture the effect of natural calamities and the Gulf War in 1991; and a dummy variable to incorporate the impact of the aftermath of the Asian financial crisis in 1998. The data are annual for 1989 to 2000. The OLS regression results are:

Dependent variable: RATIO		
Variable	**Coefficient**	**t-statistic**
Constant	3.24190800	
CPI	-0.02498900	-7.582
GDP	0.00000653	6.026
DUM91	-0.30376600	-3.370
DUM98	-0.37293100	-4.128

R^2 = 93.4 ; Durbin Watson = 1.827

where:

RATIO	=	total member contributions / household savings
CPI	=	consumer price index (1994=100)
GDP	=	gross domestic product, at 1985 constant prices (in millions of pesos)
DUM91	=	dummy variable with value of 1 in 1991
DUM98	=	dummy variable with value of 1 in 1998

As expected, the consumer price index is negatively related to the pension savings ratio and higher gross domestic product means pension contributions are a larger share of savings. The uncertainties of 1991 and 1998 did dampen the rate of contribution to pensions out of savings. Other things equal, we can conclude that as the Philippines continues to develop and the general level of incomes rises, the pool of pension savings will also rise.

APPENDIX B
POOLED TIME SERIES ANALYSIS OF THE EQUITIES MARKET

To find out how economic development affects stock market capitalisation we estimated a simple regression of GNP per capita (PCY) on the ratio of market capitalisation to GNP (MKY) for the nine Asian economies, Philippines, Indonesia, Thailand, Malaysia, South Korea, Taiwan, China, Hong Kong, and Singapore. Analysis of the pooled data for 1991 and 2000 shows a positive relationship between PCY and MKY:

MKY	= 0.231	+ 0.000083 PCY	R^2 =	0.552
	(0.000019)		S_1 =	6.132
	t = 4.44		df =	16

In other words, market capitalisation rises along with an economy's per capita income and its level of development.

We used the Chow Test (Gujarati 1995) to test whether the relationship between MKY and PCY changed from 1991 to 2000. This test involves calculating a test statistic based on the sum of the squared residuals for the regression on the pooled time periods (S_1 above) and the sum of the squared residuals from regressions on each time period separately (S_2 and S_3 below):

1991					
	MKY	= 0.229	+ 0.000067 PCY	R^2 =	0.538
		(0.000024)		S_2 =	1.040
		t = 2.86		df =	7
2000					
	MKY	= 0.306	+ 0.000085 PCY	R^2 =	0.536
		(0.00003)		S_3 =	4.861
		t = 2.84		df =	7

Calculation of the test statistic:

$$F = \frac{S_5 / k}{S_4/(n_1 + n_2 - 2k)} = \frac{(12.033)/2}{(5.901)/[9 + 9 - 2(2)]} = \frac{6.0165}{(5.901)/14} = \frac{6.0165}{0.4215} = 14.3$$

where $S_4 = (S_2 + S_3) = 5.901$

$S_5 = (S_1 + S_4) = 12.033$

At the 5 percent level, the critical $F_{2,14} = 3.74$. Since the observed F value of 14.3 exceeds this critical value, we reject the hypothesis that the MKY function is the same in 1991 and 2000. In other words, we find that the structural relationship between MKY and PCY changed between 1991 and 2000. Two conclusions are worth noting. First, market capitalization is positively related to a country's development level as measured by per capita GNP. Second, despite the

Asian crisis, reliance on equity financing increased among the Asian countries in the sample.

CHAPTER 4

CAPITAL MARKET DEVELOPMENT IN THAILAND

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INTRODUCTION

After the Thai economy sparked off the Asian financial crisis in 1997, Thailand's stock and bond markets seem to have experienced unprecedented growth by most measures, including issuance and turnover of securities. This chapter investigates the actual path of capital market development in Thailand, examines its fundamental shortcomings as well as its potential, and analyses the factors and regulations that pertain to the development of the capital market. The next section introduces the instruments and regulations in the debt market. The third section summarises the market's growth and evolution to include equity and secondary market trading and interprets the recent surge in the securities market. The next section discusses particular characteristics of the Thai capital market, some of which may be stumbling blocks to continued development. The fifth section covers the government's latest policy actions, and the concluding section summarises the weaknesses in the market and presents some suggestions for policy approaches to improve the Thai capital market's potential for future development.

MARKET FOR DEBT SECURITIES

Debt securities, specifically government debt securities were the original instrument of Thailand's capital market. Public authorities in Thailand may issue several types of debt securities including government bonds, state enterprise bonds, Bank of Thailand bonds, Financial Institution Development Fund bonds, Property Loan Management Organisation bonds, Treasury bills, and promissory notes. Bank of Thailand bonds were meant to handle domestic liquidity or monetary policy, while Financial Institution Development Fund bonds and

Property Loan Management Organisation bonds were intended to help resolve particular crises and are no longer issued. In their stead, the government occasionally resorts to issuing government or Bank of Thailand bonds, and state enterprises issue state enterprise bonds.

In accordance with the Budgetary Act of 1959, the Thai government can borrow by issuing securities only in case of budget deficit or when expenditures exceed revenues. Those borrowings cannot exceed the sum of 20 percent of total fiscal spending and 80 percent of the expenses allocated to debt amortisation. Each state enterprise has its own regulation on borrowing, but government guarantees are subject to certain conditions. If the state enterprise is a company, the government guarantee limit is four times capital for a financial state enterprise company and six times capital for a non-financial state enterprise company. If the borrowing state enterprise is not a company there is no limit on the government guarantee. Treasury bills are short-term securities issued under discount for the purpose of administering the Treasury balance and fiscal policy. The borrowing public entity is free to select any pattern of maturity, timing, and auctioning method that it deems suitable for its status and/or market conditions.

Most private entities (except financial institutions) are not subject to constraints on borrowing from the capital market. They can issue several types of short-term commercial paper including bills of exchange, bankers' acceptances, promissory notes, negotiable certificates of deposit. As for longer maturity securities, before 1992 only public and exchange-listed companies were eligible to issue bonds. With enactment of the Securities and Exchange Act in 1992 limited companies, which constitute the majority of Thai business entities, became able to issue corporate bonds.

EVOLUTION AND GROWTH OF THE CAPITAL MARKET

Recognising investors' need for liquidity, over the last quarter century the central authorities established a number of secondary markets and undertook measures to facilitate trading different types of securities. First, the Stock Exchange of Thailand (SET) was originated in 1974 for trading common shares. Then, in 1979 the Bank of Thailand initiated the repurchase market to accommodate financial institutions' temporary liquidity shortages and simultaneously implement monetary policy.

The capital market saw many more institutional changes and experienced significant growth from the mid 1990s. In 1993 the first credit rating agency, the Thai Rating Information Service Co., Ltd. (TRIS), was founded to help investors evaluate bond and share issuers. The Bond Dealers' Club (BDC) was put into action in 1994 to entertain secondary trading of public securities and corporate bonds. Banks were permitted to engage in bond underwriting in 1993. Since then, banks' role in underwriting has grown remarkably, from 4 percent of the total value of bonds registered at BDC in 1995 to 46 percent in 2000. Banks also became major dealers in the secondary bond markets between 1998 and 2000.

The growing volume of transactions and responsibilities led to upgrading the BDC to become the Thai Bond Dealing Centre (TBDC) in 1997. From that time, secondary trading of securities rose impressively. Trading value jumped from 72 billion baht in 1998 to 1,592 billion baht in 2001 (Table 4.1). The turnover ratio surged from 9 percent in 1998 to 105 percent in 2001 (Table 4.2). Nevertheless, in 2001 corporate bonds still constituted only 5 percent of trading value, compared with government bonds, which accounted for 57 percent of turnover, and state enterprise bonds, which represented 8 percent (Table 1).

Table 4.1
Trading and Outstanding Value of Thai Bond Dealing Centre, 1995-2001
(Millions of baht)

	1995		1996		1997		1998		1999		2000		2001	
	Trading value	**Out-standing**	**Trading value**	**Out-standing**	**Trading value**	**Out-standing**	**Trading value**	**Out-standing**	**Trading value**	**Out-standing**	**Trading value**	**Out-standing**	**Trading value**	**Out-standing**
All government debt	931	8,500	4,833	18,500	15,235	36,500	63,202	637,904	398,378	905,216	1,283,722	1,059,684	1,500,926	1,254,961
Government	-	-	-	-	-	-	43,090	330,446	341,084	538,846	1,027,781	586,261	916,473	618,176
State enterprises	-	-	-	-	-	-	7,533	286,458	50,784	356,370	207,864	407,347	140,383	414,448
Guaranteed	-	-	-	-	-	-	6,636	253,696	42,535	309,091	191,688	345,340	123,871	357,278
Non-guaranteed			-	-	-	-	897	32,762	8,249	47,279	16,176	62,007	16,512	57,170
Treasury bills	-	-	-	-	-	-	-	-	3,777	-	47,414	62,000	350,837	110,000
BoT/FIDF/PLMO	931	8,500	4,833	18,500	15,235	36,500	12,579	21,000	2,732	10,000	662	4,076	93,233	112,337
Corporate debt	50,597	89,228	195,775	130,189	90,955	132,591	8,896	125,841	32,819	179,387	73,400	209,883	91,294	251,720
Total	51,528	97,728	200,608	148,689	106,190	169,091	72,098	763,745	431,197	1,084,602	1,357,121	1,269,567	1,592,219	1,506,682

Note: The Bond Dealers' Club, BDC, was established in November 1994. It was upgraded to a Bond Exchange and renamed Thai Bond Dealing Centre (BDC) in April 1998. At that time it registered government and state enterprise bonds. In 1999, T-bills were registered for information purposes only; they are not included in the outstanding value of registered bonds. Since 1 October 2000 the outstanding value of total registered bonds includes T-bills.
Source: Thai Bond Dealing Centre.

Table 4.2
Turnover Ratios of Bonds in the Thai Bond Dealing Centre
(Percent)

	1995	1996	1997	1998	1999	2000	2001
All government debt	10.96	26.12	41.74	9.91	44.01	121.14	119.60
Government	-	-	-	13.04	63.30	175.31	148.25
State enterprise	-	-	-	2.63	14.25	51.03	33.87
Guaranteed	-	-	-	2.62	13.76	55.51	34.67
Non-guaranteed	-	-	-	2.74	17.45	26.09	28.88
Treasury bills	-	-	-	-	-	76.47	318.94
BoT/FIDF/PLMO	10.96	26.12	41.74	59.90	27.32	16.25	82.99
Corporate debt	56.71	150.38	68.60	7.07	18.30	34.97	36.27
Total	52.73	134.92	62.80	9.44	39.76	106.90	105.68

Note: Turnover ratio = yearly trading value/outstanding value
Source: calculated from Table 1.

Long-term Trend or Post-crisis Blip?

The growth in secondary market turnover in the late 1990s could be taken as a sign of the Thai capital market's development, likewise, the increased issuance of securities by both the government and the private sector. For example, total annual issues of debt securities increased from 81.5 billion baht in 1993 to 866.9 billion baht in 2001 (Table 4.3). However, such statistics must be qualified in light of the aftermath of the 1997 crisis, before interpreting them as indicators of the general trend of the Thai capital market.

Table 4.3
Issuance of Thai Debt Securities, 1993-2001
(Billions of baht)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Government bonds	0	0	0	0	0	400	333.7	94.1	149.2
Treasury bills	0	0	0	0	0	0	77	240.9	441.4
State enterprise bonds	60.4	57.1	55.2	57.4	49.3	46.7	95.3	111.7	57.6
Guaranteed	0	50.8	55.2	43.1	41.3	46.7	90.1	90.4	57.5
Non-guaranteed	0	6.3	0	14.3	8	0	5.1	21.3	0.1
FIDF/PLMO bonds	0	0	29.5	139.9	191.5	55	0	0	112
Corporate bonds	21.1	59.8	47.5	36.2	40.9	37.8	289.3	151.2	106.7
Total	81.5	116.9	132.2	232.4	281.7	539.5	795.3	597.9	866.9

Source: Thai Bond Dealing Centre

First, consider the surge in government securities issues in the late 1990s. The Thai government was unable to issue any debt securities at all for nine consecutive years from 1988 to 1996 because the cash balance was in surplus (Table 4.4). Then, after the financial turmoil in 1997, the government offered massive assistance to ailing financial institutions in many formats such as re-capitalisation through the Bank of Thailand’s Financial Institution Development Fund. All of the government bond issues in 1998 and almost 90 percent of the issues in 1999 were such re-capitalisation bonds (Table 4.5). Another reason for substantial public borrowing at the end of the 1990s was the government’s intention to revive the economy from the pervasive downturn. Thus, while government securities issues were the dominant source of capital market expansion in the late 1990s, this phenomenon may not be long lasting, especially because of the legal constraints on the amount of securities the government may issue.

Table 4.4
Thai Government Cash Balance
(Millions of baht)

	Cash Balance	GDP	Cash Balance/GDP (%)
1985	-38,966	1,056,496	-3.69
1986	-34,150	1,133,397	-3.01
1987	-8,861	1,299,913	-0.68
1988	36,098	1,559,804	2.31
1989	65,335	1,856,992	3.52
1990	107,046	2,183,545	4.90
1991	107,707	2,506,635	4.30
1992	72,811	2,830,914	2.57
1993	59,713	3,170,259	1.88
1994	97,651	3,634,500	2.69
1995	126,117	4,192,697	3.01
1996	43,303	4,622,832	0.94
1997	-71,051	4,740,249	-1.50
1998	-129,292	4,628,431	-2.79
1999	-154,362	4,615,388	-3.34
2000	-109,869	4,900,330	-2.24

Source: Bank of Thailand and National Economic and Social Development Board.

Table 4.5
Government Bonds Issued for Re-capitalisation by Type, 1998-2000

	1998		1999		2000	
	Billion baht	% gov't bonds	Billion baht	% gov't bonds	Billion baht	% gov't bonds
Re-capitalisation bonds	400.0	100.0	297.8	89.5	25.0	45.4
FIDF	400.0	100.0	100.0	30.0	0.0	0.0
Reopened FIDF	0.0	0.0	149.0	44.8	0.0	0.0
Tiers 1 & 2						
Banks	0.0	0.0	39.0	11.7	24.7	44.8
Finance companies	0.0	0.0	9.7	2.9	0.3	0.6
Government bonds total	400.0	100.0	332.8	100.0	55.0	100.0

Source: Bank of Thailand.

Moreover, the increase in capital market issues in the late 1990s also reflected the severe adjustment of the private sector to the 1997 crisis. After Thailand accepted assistance from the IMF the central bank subjected commercial banks to tighter rules on loan classification and provisioning as well as write-offs. Commercial banks became cautious about extending credit, and bank credit contracted in each year from 1998 to 2000 (Table 4.6). In order to re-capitalise, banks either had to issue more shares or merge with foreign partners. At the same time, some large non-bank private corporations tapped domestic capital markets both because bank credit was less accessible and because local interest rates declined markedly while exchange rates fluctuated. New equity issues reached all time highs in 1998 and 1999 (Table 4.7). And new debt issues increased in 1999-2000 as private companies issued domestic bonds in order to refinance their foreign debt obligations (Table 4.7). But, while corporations issued almost ten times more bonds in 1999 than in 1998, in 2000 corporate bond issues were only half what they were in the previous year (Table 4.8). This raises the question of whether Thailand's capital market will continue to develop once commercial banks have re-capitalised and once large corporations have refinanced their debt. In other words, the capital market boom may not be sustainable.

Table 4.6
Capital Market Mobilisation and Changes in Commercial Bank Credit, 1993-2000

	1993	1994	1995	1996	1997	1998	1999	2000
Funds raised in capital market								
Current prices (billion baht)	122.55	250.49	255.82	242.23	90.54	232.03	599.62	242.66
1988 prices (billion baht)	95.64	185.77	158.39	163.43	58.55	137.44	351.14	141.41
Share of gross investment (%)	9.78	17.27	13.16	12.79	5.74	22.57	61.14	22.20
Change in commercial bank credit								
Current prices (billion baht)	512.59	762.76	793.12	604.86	1204.3	-821.3	-105.9	-526.5
1988 prices (billion baht)	400.01	565.68	556.21	408.10	778.76	-486.49	-65.59	-320.71
Share of gross investment (%)	40.91	52.60	46.22	31.94	76.40	-79.90	-11.42	-50.35

Source: Securities and Exchange Commission.

Table 4.7
Newly Issued Securities by Type of Instrument, 1993-2000

	1993	1994	1995	1996	1997	1998	1999	2000
				Billion baht				
Equities	60.23	138.00	138.65	106.43	49.62	194.25	277.23	72.30
Debt instruments	21.46	82.54	0.60	92.33	38.15	31.06	313.30	112.89
Equity-linked instruments	39.99	27.51	16.10	40.53	2.77	6.72	7.69	7.45
Warrants	0.88	2.44	0.47	2.95	0.00	0.00	1.40	0.00
Total	122.56	250.49	255.82	242.24	90.54	232.03	599.62	242.66
				% share				
Equities	49.1	55.0	61.4	43.9	54.8	83.7	46.2	29.8
Debt instruments	17.5	33.0	31.3	38.1	42.1	13.4	52.2	67.1
Equity-linked instruments	32.3	11.0	7.1	16.7	3.1	2.9	1.3	3.1
Warrants	0.7	1.0	0.2	1.2	0.0	0.0	0.2	0.0

Source: Securities and Exchange Commission.

Table 4.8
Corporate Bond Offerings by Type, 1995-2001

	1995	1996	1997	1998	1999	2000	2001
				Billion baht			
Straight issues	70.60	92.33	38.15	30.05	308.17	146.92	106.67
Convertible issues	16.13	40.53	2.77	6.20	7.69	7.45	0.01
Total	86.73	132.86	40.92	36.25	315.86	154.37	106.68
				% share			
Straight issues	81.40	69.49	93.23	82.90	97.57	95.17	99.99
Convertible issues	18.60	30.51	6.77	17.1	2.43	4.83	0.01

Source: Securities and Exchange Commission.

CHARACTERISTICS OF THE BUSINESS AND FINANCIAL ENVIRONMENT AND THE CONTINUED DEVELOPMENT OF THAILAND'S CAPITAL MARKET

Several characteristics of Thailand's business and financial environment may pose stumbling blocks to the continued development of the capital market.

First, Thai private businesses continue to rely heavily on financing from banks rather than the capital market. Private business mobilised far fewer funds from the capital market than they obtained from commercial banks. Overall from 1988 and 2000 funds raised in the Thai capital markets averaged 118 billion baht per year, roughly half the 242 billion baht per year raised through bank credit (Table 4.9). Thai businesses' preference for bank financing contrasts with preferences in other economies. From 1988 to 2000 51 percent of gross fixed capital formation in the United States was funded by capital markets, and the figure was 43 percent in the U.K. (Table 4.10). In Thailand, capital markets contributed only 11 percent. The picture is reversed for commercial bank credit. Bank credit financed 26 percent of investment spending in Thailand compared to only 15 percent in the United States. The fact that Thai businesses lag behind in direct financing through the capital markets suggests that owners tend not to have sufficient knowledge or understanding about the role, responsibility, and working mechanism of capital markets and regulations. Consequently, they depend on borrowings from financial institutions, especially commercial banks, for most of their fund-raising.

Table 4.9
Business's Fund Mobilisation in Thailand's Capital and Money Markets

	Annual average		
	1988-1992	**1993-2000**	**1988-2000**
Capital market funds			
Funds raised (billion baht)	49.08	161.47	118.24
Share of total private investment (%)	6.73	17.52	13.95
Commercial bank credit			
Funds raised (billion baht)	262.66	229.50	242.25
Share of total private investment (%)	36.03	24.90	28.58
Capital market funds/commercial bank credit (%)	18.69	70.36	48.81

Note: calculated from 1988 price.
Sources: NESDB, BOT, SEC, and SET.

Table 4.10
Comparison of Capital and Money Market Fund Raising in Selected Economies, 1988-2000

	Capital Market Fund Raising		Commercial Bank Credit	
	% of GDP	**% of GFCF**	**% of GDP**	**% of GFCF**
Japan	4.32	14.57	3.73	12.57
South Korea	8.80	25.23	8.41	24.10
Singapore	6.07	17.52	11.24	32.45
Thailand	3.87	11.68	8.62	26.01
U.K.	7.26	43.59	0.01	0.05
United States	9.64	51.74	2.93	15.72

Notes: GDP is gross domestic product and GFCF is gross fixed capital formation. U.S. data for 1990-99; U.K. for 1994-98; and Japan for 1988-97.
Sources: U.S. Census Bureau, *Statistical Abstract of the United States: 1998;* London Stock Exchange; Tokyo Stock Exchange, *Annual Securities Statistics: 1997;* Financial Supervisory Board of South Korea; Monetary Authority of Singapore; NESDB, BOT, SEC and SET.

Moreover, although Thai businesses relied on the domestic market to a growing extent after 1997, capital market utilisation was not well diversified across sectors. A total of thirty business sectors tapped the capital market, but the great majority of funds raised were clustered in only a few sectors. From 1988-2000 only three sectors, financial institutions, construction, and real estate, commanded 67 percent of capital market funds, far more than their 12 percent share of GDP (Table 4.11). At the same time, industry, imports, and exports accounted for only 16 percent of funds, roughly one half their combined 31 percent value added to GDP. The distribution of commercial bank credit did not show such a bias toward the finance, construction, and real estate sectors, but instead showed a profile that corresponded well to GDP composition.

Table 4.11
Allocation of Capital Market Funds and Bank Credit by Sector
(Percent of total funds raised 1998-2000)

	Share of GDP	Capital Market Funds	Bank Credit
Industries, exports, and imports	31.58	16.85	36.65
Services, consumption, and public utilities	19.96	10.38	22.42
Wholesale and retail trade	16.54	1.98	16.71
Finance, construction, and real estate	12.06	67.34	21.09
Agriculture	10.22	0.00	2.50
Mining	4.12	3.45	0.62
Administration and defence	3.01	0.00	0.00
Housing rental	2.51	0.00	0.00
Total	100.00	100.00	100.00

Note: Composition of GDP at constant prices.
Source: NESDB, SEC, BOT.

Another characteristic is the small number of private companies in Thailand that appear willing to spread their ownership and minimise their cost of funds by financing directly through the capital markets. As of mid-2000 the Stock Exchange of Thailand (SET) listed 383 firms. These listed firms accounted for slightly more than one-fourth of the total capital of Thai companies but only 0.17 percent of the total number of companies (Table 4.12). The vast majority of Thai companies still seem to prefer more expensive indirect financing through financial intermediaries. That was true even among large firms that were eligible to for listing. Of the 3,261 public and limited companies in Thailand that met SET listing requirements—at least 200 million baht paid-up capital and a history of satisfactory profits—only 10 percent were actually listed in the stock market (Table 4.12). The paid-in capital of large listed firms comprised only 40 percent of the total capital of firms eligible for listing (Table 4.12). Most eligible unlisted firms were in manufacturing (22 percent) and property, construction, renting, and business services (24 percent) sectors (Table 4.13).

Table 4.12
Listing Ratios among All Companies and Eligible Companies, by Number and Paid-in Capital, end 1999

	All Public and Limited Companies	Listing-Eligible Companies
Total number of companies	226,060	3,261
Listed on SET	383	346
Listed companies share of total	0.17%	10.6%
Total capital (million baht)	4,982,221.63	3,567,889.2
Listed on SET	1,321,490.96	1,356,470.8
Listed companies share of total	26.52%	38.0%

Note: Companies listed on SET as of 30 June 2000. Listing-eligible companies are companies with at least 200 million baht paid-up capital as of June 2000.
Source: Ministry of Commerce and SET.

Table 13
Number and Capital of Companies Eligible for SET Listing by Sector, end 1999

	Eligible Companies		Capital of Eligible Companies	
	number	%	million baht	%
Manufacturing	668	22.9	571,482	25.8
Property, construction, renting, business services	700	24.0	459,550	20.8
Wholesale, retail trade, auto and motorcycle repair	474	16.3	372,500	16.8
Financial institutions	192	6.6	205,708	9.3
Communication, transportation, storage	73	2.5	77,979	3.5
Hotels and restaurants	99	3.4	48,624	2.2
Entertainment, personal services	49	1.7	42,914	1.9
Energy	30	1.0	36,238	1.6
Healthcare services	70	2.4	29,400	1.3
Agriculture	49	1.7	22,942	1.0
Education	18	0.6	6,916	0.3
Other	493	16.9	337,164	15.2
Total	2,915	100.0	2,211,418	100.0

A crucial unresolved issue among private firms in Thailand concerns corporate governance and transparency. Although proper corporate governance procedures and transparency cannot be implemented or spelled out through explicit rules because they are moral issues, these issues acutely affect the performance of both listed firms and potential listing candidates. Poor governance and inadequate transparency, which can easily generate negative repercussions, are prevalent in Thai businesses, even among some listed companies. They are, to some extent, part of the business culture and they are difficult to rectify by government regulation or supervision, especially in the midst of economic difficulties because unlike money markets, capital markets involve numerous parties.

In terms of capital market instruments, Thailand still relies considerably on equity-related instruments to mobilise funds, in contrast to fund-raising in developed economies which is predominantly through debt. Only 43 percent of funds raised in Thailand's capital market from 1988 to 2000 were debt-related compared to over 80 percent in the United States and Japan and 75 percent in Korea (Table 4.14). That is primarily because Thai bond markets were opened up later than the stock market. Also, the supply of government bonds is limited since the government may only issue them to finance a budget deficit. The debt portion gained momentum in Thailand after the SEC Act went into effect in 1992 and private corporations increased their offerings of straight and convertible bond issues (Table 4.15).

Table 4.14
Equity versus Debt Composition of Capital Market Funds Raised in Selected Economies, 1988-2000
(Percent of total capital mobilised)

	Equity-related	Debt-related
Japan	11.27	88.73
Singapore	49.19	50.81
South Korea	24.91	75.09
Thailand	56.14	43.86
United States	17.72	82.28

Note: US refers to 1990-99; Japan refers to 1988-97. Thailand equity-related funds include common shares, preferred shares, and warrants and debt-related funds include debentures and convertible debentures.
Source: U.S. Census Bureau, *Statistical Abstract of the United States: 1998,* Tokyo Stock Exchange, *Annual Securities Statistics: 1997*, Financial Supervisory Board of South Korea. Monetary Authority of Singapore, BOT, SEC, SET.

Table 4.15
Amount and Share of Funds Tapped in Capital Markets by Type of Instrument, 1988-2000

	1988-1992		1993-1997		1998-2000	
	billion baht	%	billion baht	%	billion baht	%
Equity-related	51.32	90.68	99.93	53.63	168.18	48.94
Debt-related	5.27	9.32	86.40	46.37	175.49	51.06
Total	56.60	100.00	186.33	100.00	343.67	100.00

Source: BOT, SEC and SET.

On the investor side, institutional and high net-worth investors are the overwhelmingly predominant players in the Thai market, commanding over 95 percent of newly issued corporate bonds (Table 4.16). Commercial banks hold over one-third of all government securities, as investments or to satisfy reserve requirements (Table 4.17). The household sector, in contrast, shows less confidence and/or little knowledge about capital market instruments. According to 1993 and 1998 surveys by the central bank, the savings of Thai households went mostly and increasingly to bank deposits, not to equity or to other financial institutions (Table 4.18). The lack of participation by non-institutional investors is a significant factor holding back capital market development in Thailand.

Table 4.16
Investors in Newly Issued Corporate Bonds, 1995 and 1999

	1995		1999	
	Millions of baht	%	Millions of baht	%
Institutional and high net-worth investors	84,103	96.97	314,652	99.62
Domestic	27,214	31.38	287,801	91.12
Foreign	56,889	65.59	26,851	8.50
Retail investors	2,627	3.03	1,206	0.38
Domestic	1,619	1.87	1,201	0.38
Foreign	1,008	1.16	5	0.00
Total	86,730	100.00	315,858	100.00

Source: Securities and Exchange Commission

Table 4.17
Amount and Distribution of Investment in Government Debt Securities by Type of Investor, 1995-2001
(Millions of baht)

	1995	1996	1997	1998	1999	2000	2001
	Million baht						
Bank of Thailand	12,301	20,608	75,232	214,942	153,120	129,101	146,296
Commercial banks	166,303	157,795	136,949	282,475	414,498	446,999	457,466
Government Savings Bank	14,184	24,460	21,838	47,748	148,129	187,761	169,999
Financial institutions	70,763	75,402	41,680	72,023	61,791	60,456	53,368
Insurance companies	6,785	6,511	14,632	31,040	62,198	93,768	126,767
Others	10,909	11,646	17,692	64,805	124,914	201,142	268,208
Total	281,245	296,422	308,024	713,034	964,650	1,119,227	1,222,104
	% of Total Investment in Government Securities						
Bank of Thailand	4.37	6.95	24.42	30.14	15.87	11.53	11.97
Commercial banks	59.13	53.23	44.46	39.62	42.97	39.94	37.43
Government Savings Bank	5.04	8.25	7.09	6.70	15.36	16.78	13.91
Financial institutions	25.16	25.44	13.53	10.10	6.41	5.40	4.37
Insurance companies	2.41	2.20	4.75	4.35	6.45	8.38	10.37
Others	3.88	3.93	5.74	9.09	12.95	17.97	21.95
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Bank of Thailand and calculated by author.

Table 4.18
Composition of Household Savings, 1993 and 1998
(Percent share)

	1993	1998
Deposits	74.9	94.5
Life insurance	18.9	1.4
Equity	1.3	0.3
Provident funds	0.3	2.1
Other	4.6	1.7
Total	100.0	100.0

Source: Survey of the Bank of Thailand, 1993 and 1998.

Furthermore, regulations restrict the capital market activity of some institutional investors. In particular, prudential regulations on non-bank institutional investors affect these institutions' trading activity in the secondary bond market. For example, insurance companies may not hold more than 10 percent of any single company's bonds by value, and their holdings may not exceed 10 percent of their total assets for insurance company bonds and 30 percent of total assets for non-insurance company bonds. Provident funds are limited to investing no more than 5 percent of total funds in a single company's corporate bonds. Finally, mutual funds may not invest more than 5 percent of their total net asset value in any company's corporate bonds and they may invest at most 15 percent of total net asset value in corporate bonds rated lower than the top four rating agency rankings.

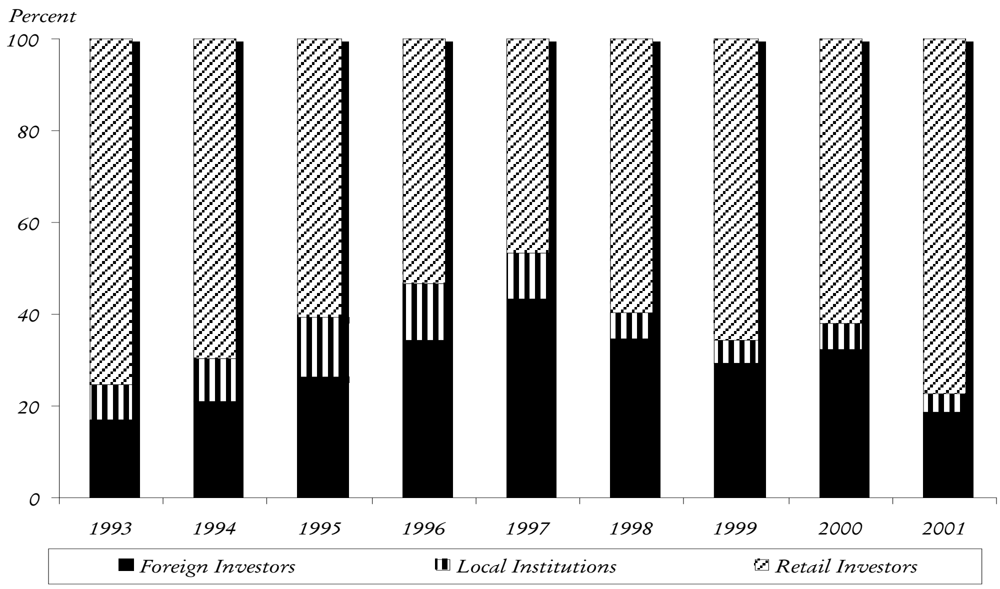
A final characteristic of the Thai capital market is the heavy reliance of the equity market on foreign investors. Foreign investors were responsible for roughly one-third of the turnover value in the Thai stock exchange during the 1990s (Table 4.19 and Figure 4.1). Ever since Thailand opened the capital account in the early 1990s, portfolio moves by foreigners have been a primary determinant of the SET index. The large presence of foreign investors meant that interest rate differentials became a significant stimulant to market activity and so did exchange rate fluctuations together with related factors such as current account status, and foreign exchange reserves. A strong adverse repercussion from such a situation is that it discourages or scares off most local investors, except speculators. Fluctuations of stock market indices in foreign countries had more influence as well. Movements of huge amounts of foreign investment funds also affected the baht exchange rate after the currency was floated in 1997 and fluctuations in the exchange rate in turn affected the real sector. In short, though foreign capital may have strengthened the growth path of Thailand's capital market, it also increased the market's vulnerability to external conditions and shocks.

Table 4.19
Amount and Composition of SET Turnover by Type of Investor, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
	Millions of baht								
Net turnover value									
Foreign investors	52,419	-41,737	47,302	13,377	55,437	30,227	-3,134	-33,068	-6,426
Local institutions	23,928	13,405	-756	-17,056	-22,453	-3,239	-2,872	-948	-538
Retail investors	-76,346	28,332	-46,546	3,680	-32,984	-26,987	6,006	34,016	6,963
	%								
Share of total turnover									
Foreign investors	16.97	20.94	26.33	34.25	43.25	34.62	29.41	32.19	18.62
Local institutions	7.77	9.55	13.07	12.41	9.94	5.64	4.90	5.69	3.95
Retail investors	75.27	69.51	60.60	53.34	46.81	59.75	65.69	62.12	77.43

Note: Data for 2001 are preliminary. Net turnover value = value of purchases - value of sales.
Share of total turnover = (value of purchases + value of sales for investor type/total turnover) * 100.
Source: SET.

Figure 4.1
Composition of SET Turnover Value by Type of Investor



RECENT POLICY MOVES

Towards the end of the 1990s the government began to accept the principle of market discipline. According to this way of thinking, if market forces function efficiently, movements of securities prices will reflect the most relevant data and status of firms. Hence, government should allow and encourage market forces to function freely, so that securities prices can promptly signal any emerging problems to both regulators and firm owners.

Based on this new point of view Thai authorities took a number of policy actions to improve the functioning of the capital market. From 1997, the SEC allowed investors to conduct short selling and securities lending. Short selling provides investors an opportunity to make profits when the market goes down, whereas securities lending is meant to support short selling activities. In June 1999, recognising the fact that many Thai businesses are small, the SET established the “Market for Alternative Investment,” or MAI, to attract small- and medium-sized enterprises (SMEs). The MAI follows the same trading and settlement procedures and trading hours as the main market, but the minimum paid-up capital to list on the MAI is only 40 million baht compared to 200 million baht for listing on the main market. As further incentive for SMEs to utilise the capital market, the corporate income tax rate for companies listed on the MAI is only 20 percent, compared to 25 percent for firms listed on SET, and 30 percent for non-listed companies.

Among the actions taken since 1999 are the following:

- The government authorised the organisation of inter-dealer brokers in 2000 in order to enhance liquidity and facilitate transactions in the secondary debt market.
- The SET modified the listing criteria in June 2000 to make them more flexible. In place of the requirement that a prospective company have no accumulated losses, it allowed prospective companies to qualify under one of three criteria: net profit of at least 30 million baht in the pre-listing year, sales revenues of at least 2 million baht in the pre-listing year, or market capitalisation of at least 1.5 billion baht.
- SET replaced its cheque payment and electronic book entry delivery and clearing system with a delivery-versus-payment system in September 2000. Under the new system clearing members, which are custodian banks, can make or receive payments directly to Thailand Securities Depository through the Bank of Thailand’s BAHTNET system.
- Brokerage commission fees were liberalised in October 2000 to stimulate competition and provide investors with more alternatives, with commission rates varying in accordance with the services provided.
- The authorities co-ordinated efforts to expedite privatisation of some state enterprises such as electricity power plants, the petroleum authority, and Thai

Airways in order to upgrade the quality of securities available to investors in the market. At the end of 2000 Ratchaburi Electric Power Plant became the first such privatised enterprise to list on the SET.

- To cultivate investors, in 2000, the SEC set up a capital market information centre where investors can gather information before making their investment decisions. The SEC promotes various activities to provide information access, education and training, and investor protection. The agency has also developed a capital market information website.
- In January 2001 the SET launched regulations for Internet trading, under which securities companies with computer support and information security systems may be permitted to offer Internet trading services to their customers. Afterwards, the SET organised a new company called SETTRADE.COM, which provides Internet trading services for securities companies in order to promote Internet trading and to reduce risk and investment expenses for securities houses.
- Fitch Ratings was approved in February 2001 as the country's second credit rating agency. This addition addresses investors' need for credit rating information to help them assess risks and returns with greater accuracy and confidence.
- Commencing March 2001, the SEC began easing the application process for companies that have won promotion from the Office of the Board of Investment In order to encourage listing of private companies.
- Along with other liberalisation measures, in March 2001 the SEC permitted securities companies to expand their scope of businesses to include life insurance broking, back office service provision, computer vending, and mutual fund business via subsidiaries.
- Some mutual funds such as the Thai Trust Fund were established in 1997 to enable foreigners to invest in companies that had reached the allowable limit on foreign shareholding. Similarly, in mid-2001 a non-voting depository receipt (NVDR) was introduced as a new type of security. Holders of NVDRs have all the same rights as shareholders except the vote.
- Foreseeing the importance of long-term savings as a shock absorber for the economy, in the last quarter of 2001 the SEC established retirement mutual funds (RMFs) as a vehicle to encourage long-term savings for retirement. RMFs are eligible for tax privileges similar to those for provident funds if savers satisfy certain conditions such as a five-year investment history and no redemption until the owner reaches age 55.

CONCLUDING REMARKS

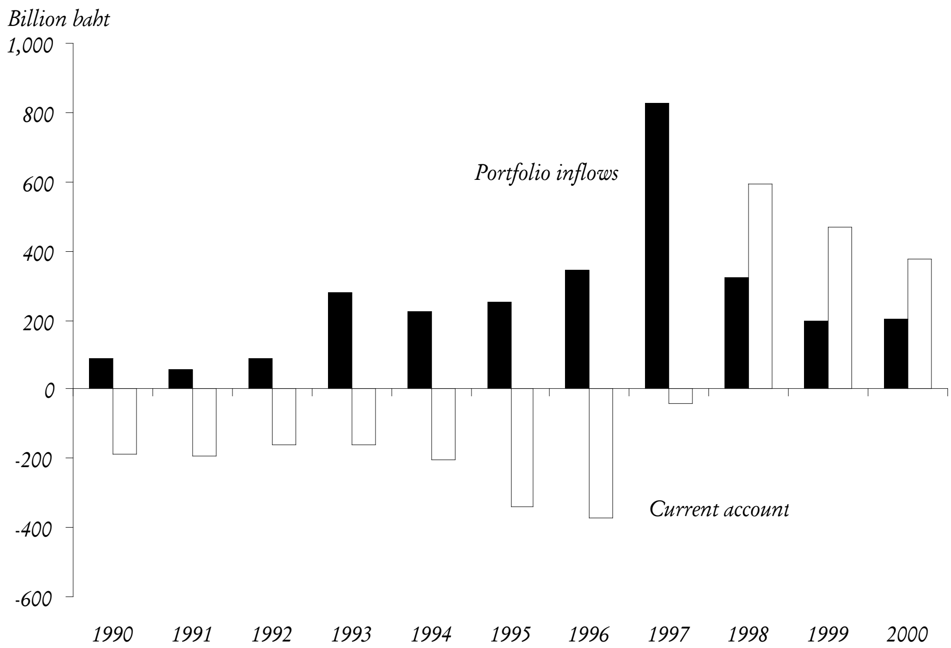
Statistics and stories from the decade of the 1990s suggest that Thailand's capital markets performed satisfactorily. The volume of debt securities issued by the public and private sectors (Table 3), the turnover value of foreign investment (Table 19), and the recent series of liberalisation measures all point in the direction of a well-developing capital market. Upon closer scrutiny, however, several factors appear that may limit or constrain the future development of the capital market.

In the public sector, stringent rules on government borrowing create uncertainties in bond issuance, debt rollover, maturity profile, benchmark yield curve, and actual use of funds. The government cannot issue bonds for purposes such as allocating, channelling, or lubricating capital flows, only for financing a deficit. Moreover, the reserve requirements that the government imposes on financial institutions leave lenders and investors in the general public and the secondary markets with fewer government securities to trade. Worse yet, the implementation of monetary policy in the official repurchase market further distorts genuine market forces.

In the private sector, there are several areas of concern as well. First, even though the SEC Act of 1992 allows limited and not necessarily public companies to issue corporate bonds, only large, leading firms actually did so. One reason is probably that corporate bonds tend to be a costly source of funds unless the size of the issue is large enough. In addition, to issue bonds a company also needs an adequate credit rating, which excludes the more than 90 percent of Thai businesses that are SMEs from becoming issuers. At the same time, very few SMEs utilised MAI, the market set up exclusively for smaller firms. This carries the worrying implication that perhaps Thai corporate culture does not favour listing or public ownership, or that family connections are too strong. Another concern is the prudential restrictions imposed on corporate bond investment and trading in the secondary market by insurance companies, provident funds, and mutual funds. Institutional investors such as these play a far larger role than households do in furthering the development of an economy's capital markets.

While foreign capital is an alternative source of stimulus in the market, it could make the market excessively volatile for several reasons. First, foreign investors bring an additional and unnecessary degree of market fluctuation because they tend to diversify their portfolios among various countries and when a shock occurs in one country, they move investments to other countries to cover their losses or positions. Second, foreigners tend to be naive and sensitive because ordinarily they are less well acquainted with domestic corporations and the local situation. Most threatening to Thailand is the large volume of transactions by foreign investors. For example, aggregate portfolio investment inflows to Thailand are quite large compared with the current account balance (Figure 4.2). Hence, in the current flexible exchange rate regime, foreigners' investment decisions affect both stock market sentiment and the exchange rate, which have powerful repercussions on both the real and financial sectors of Thailand's economy.

Figure 4.2
Portfolio Investment Inflows vs. Current Account, 1990-2000



Like foreign investment capital, financial liberalisation can be a double-edged sword. On one hand, greater freedom to undertake new businesses may mean more income and growth for domestic securities firms and banks and improved consumer welfare through heightened competition. On the other hand, liberalisation may threaten domestic firms that are not prepared to handle the higher level of risk that it brings. Securities firms and commercial banks need adequate experience and expertise to handle large, volatile transactions without becoming over-exposed. The experience of financial bubble and ultimately crisis following Thailand's liberalisation of the early 1990s is a sorrowful lesson about the need for proper timing of liberalisation of immature commercial banks and finance companies. Altogether, foreign investment in and liberalisation of domestic securities business may accelerate the pace of capital market development in Thailand. Nevertheless, we must be mindful that they also increase the market's vulnerability or susceptibility to dangers or shocks, especially when local agents are not well prepared.

Liberalisation immediately leads to controversial issues about regulation. Different sectors deserve different rules, and so do different objectives. Before authorities implement any rule they should explicitly spell out and rank its target sectors and objectives. Moreover, a sector or objective that has top priority at one time may not deserve the top rank at another time. That is, authorities should also take the time dimension into consideration. Regulations of different sectors and agents should also be optimally co-ordinated so that neither loopholes nor biases arise with respect to certain groups or agencies.

Corporate culture is another consideration in the development of Thailand's capital market. Rules or regulations acceptable in some cultures or countries may not be compatible with conditions in other cultures or countries. The authorities cannot simply adopt rules and regulations from other places wholesale: they need to modify them to suit domestic business and corporate culture. For example, SMEs, which typify Southeast Asian businesses, are reluctant to use capital market financing because they hesitate to publicise their ownership and debts in order to tap needed funds. To accommodate SMEs' preference to work within a narrow circle in the same profession or community, Thai authorities might encourage SMEs to form a kind of co-operative that would gain a capital market listing based on the aggregate performance of the individual members. By designing listing or issuance criteria appropriately, it should be possible to recycle funds to SMEs via the domestic capital market in a way that would be compatible with SMEs preferences and at the same time be sufficiently productive and stable to satisfy investors.

In summary, the prevalence of SMEs, the large volume of foreign portfolio investment, and the liberalisation of the domestic securities business constrain Thai central authorities in regulating the capital market. Imposing stringent entry rules to protect the stability and safety of the capital market will deter participation by SMEs and foreign investors, which would severely limit the future development of the capital market. On the other hand, making entry rules too loose could give rise to securities company failures and rapid, wild market fluctuations. Therefore, the government has to be extremely careful in choosing the optimal blend of regulations along the path of capital market development.

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CHAPTER 5
THE ROLE OF CHINA'S SECURITIES MARKET IN SOE REFORM AND PRIVATE SECTOR DEVELOPMENT

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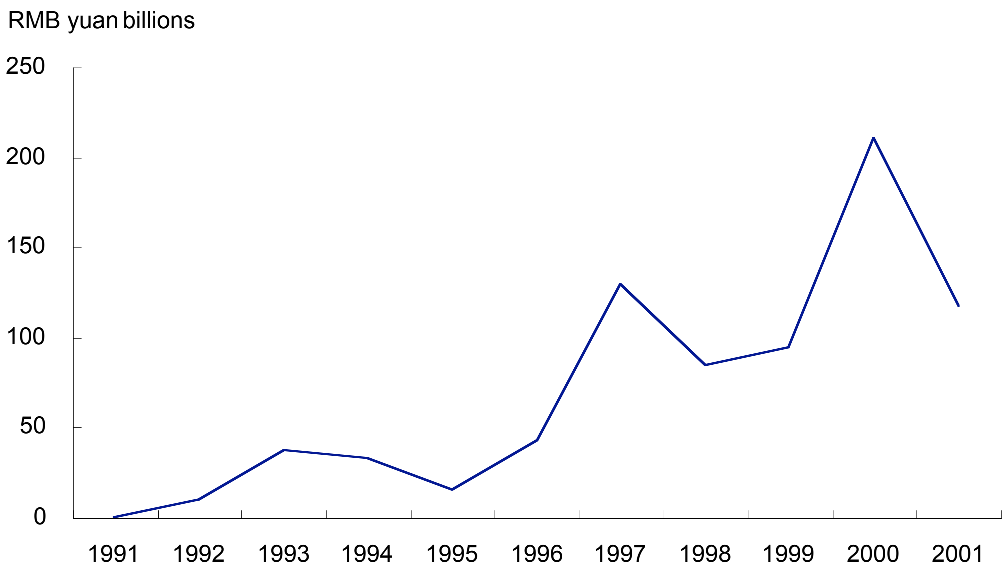
China's securities market took off after the early 1990s when exchanges were established in Shanghai and Shenzhen. During most of the 1990s, the dominant philosophy was that securities markets are supposed to serve large state-owned enterprises (SOEs). As a result, most companies listed on exchanges in China are SOEs. Moreover, the state owns more than fifty percent of the shares of these enterprises and these shares are not tradable. Since the late 1990s, however, more and more private companies have entered the securities market. As of the end of April 2001 private firms or individuals controlled 10.5 percent of the companies listed on the Shanghai and Shenzhen exchanges.

The securities market in China is plagued with corporate governance problems. Self-dealing between listed companies and their state-owned parent companies is quite common as a way to transfer profits to the parent. Many companies fall into financial distress as a result of this practice two or three years after they are listed. China must improve corporate governance in order to contain the risk of the growing reliance on the securities market to finance economic development.

HISTORY AND OVERVIEW OF CHINA'S SECURITIES MARKET

The securities market in China has a very brief history. Some enterprises issued stocks and bonds to obtain funds for business expansion in the late 1980s, but these issues were odd and irregular and there was no legal market for secondary trading. The modern securities market began with the launching of exchanges in Shanghai and Shenzhen in 1990. Since then, the securities market has played an increasing role in the financing of enterprises in China, with stocks the main instrument traded in the securities market. For the eleven years from 1991 through 2001 China's enterprises raised a total of 772.7 billion RMB yuan on the two markets through IPOs, additional flotation by listed companies, and convertible bond issues by listed and non-listed companies. Since 1997 enterprises raised between 84.2 billion and 210.4 billion RMB yuan a year in the securities markets (Figure 5.1).

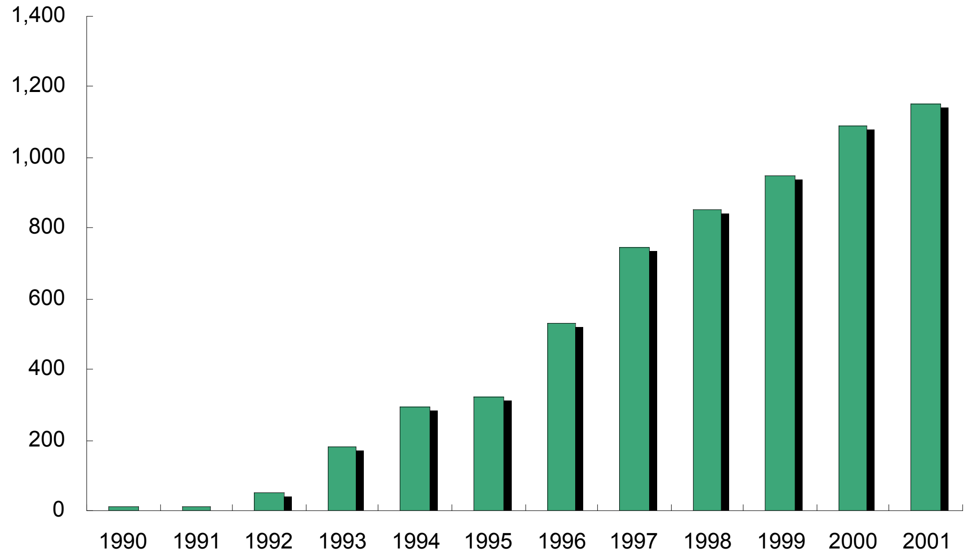
FIGURE 5.1
Funds Raised in the Shanghai and Shenzhen Markets, 1991-2001



Source: Yearbook of People's Bank of China (2000) and http://drcnet.com.cn. 1991-96 from *China Statistical Yearbook* 2001. Table 19-13.

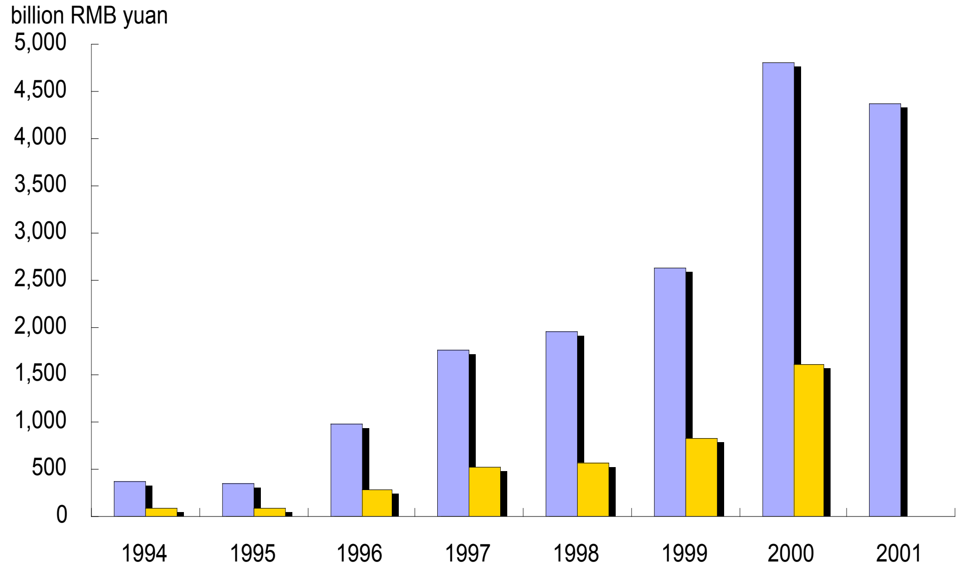
The number of enterprises listed on the Shanghai and Shenzhen exchanges increased rapidly, from only 10 in 1990 to 1,153 at the end of 2001 (Figure 5.2). The number of registered stockholders reached about 65 million in 2001. Market value also increased enormously. The total capitalisation of the Shanghai and Shenzhen markets rose from 35.3 billion RMB yuan in 1993 to 4,376.3 billion at the end of 2001 (Figure 5.3). Securities market capitalisation exceeded fifty percent of GDP for the first time in 2000, and China's stock market is now the second largest in Asia after Japan's.

FIGURE 5.2
Number of Enterprises Listed on the Shanghai and Shenzhen Securities Exchanges, 1990-2001



Source: Yearbook of People's Bank of China (2000) and http://drcnet.com.cn.

FIGURE 5.3
Total and Negotiable Capitalisation of the Shanghai and Shenzhen Markets, 1994-2001



Source: Yearbook of People's Bank of China 2000 and http://drcnet.com.cn. 1994-96 from *China Statistical Yearbook*, 2001 Table 19-14.

With the adoption of the corporatisation or 'modern enterprise system' policy in 1995 many SOEs were reorganised into shareholding corporations and in consequence the majority of companies listed on China's stock exchanges are SOEs. Most companies that transformed from pure state-ownership to shareholding enterprises have three types of shares, state shares which are non-negotiable (that is, they cannot be sold in the market), shares held by employees, and shares held by legal entities including other companies and financial institutions. Usually, the non-negotiable state shares comprise the majority of a listed company's shares, and thus the state retains control of these listed enterprises.[1]

During most of the 1990s, regulators and government and enterprise officials viewed the securities market mainly as an instrument to serve SOEs and even to rescue them from financial difficulty. Since the late 1990s, though, the situation has changed. More and more listed companies have been restructured, with private companies purchasing their shares and becoming controlling shareholders. Furthermore, the underlying philosophy changed since the China Securities Regulatory Commission (CSRC) was reorganised in 1998 and the Securities Law took effect in 1999. The examination and approval system and the quota systems for issuing securities, which tended to favour SOEs and give government agencies a large say, were replaced. Under the new verification system for public offerings, private companies have more equal access with SOEs to funding from the securities market. More private companies have been listed and the securities market is playing an increasing role in the development of private companies.

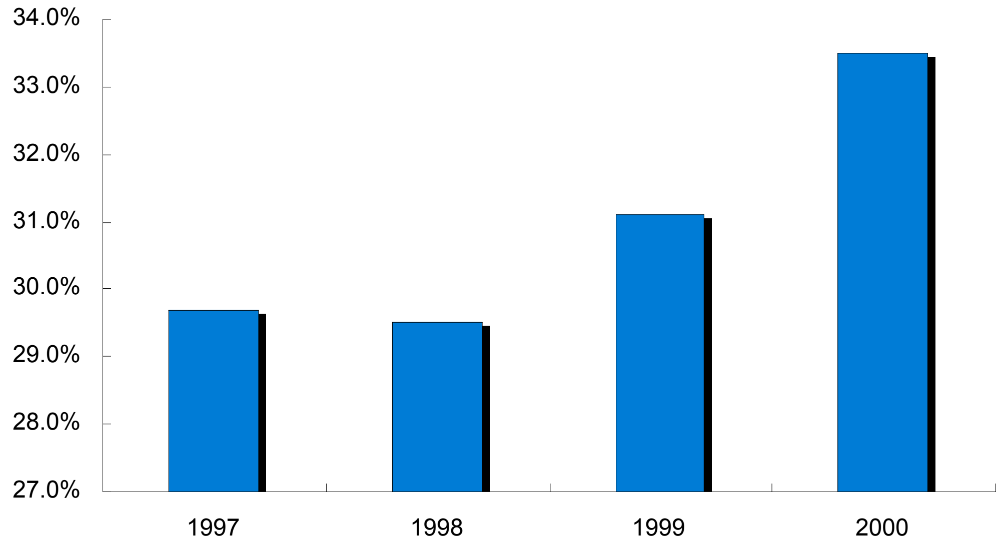
IMPACT ON THE SHAREHOLDING STRUCTURE AND CORPORATE GOVERNANCE OF SOEs

It is fair to say that at the beginning, the securities market was developed essentially as a means to transform traditional large and medium-sized SOEs from enterprises solely owned by the government into enterprises with hybrid ownership. As these enterprises listed and sold some shares in the securities market non-state shareholders, including the general public, were

1. Although state shares are not negotiable on the Shanghai or Shenzhen markets, they may be transferred in negotiated purchases with government approval.

introduced. From 1997 to 2000 the proportion of public shareholding on the Shanghai and Shenzhen markets rose from 29.7 percent to 33.5 percent (Figure 5.4).

FIGURE 5.4
Public Shareholding of Listed Companies, 1997-2000



Source: Yearbook of People's Bank of China (2000) and http://drcnet.com.cn.

A more significant impact of the development of the securities market has been to diversify the ownership of companies after they have been listed. When SOEs have been corporatised and their shares listed in the securities market, it becomes easier to reduce the extent of state ownership. In fact, since 1997 other firms, including private firms have even acquired control of some of the state shares of listed SOEs. In particular, the government has allowed ownership of the (previously non-negotiable) state shares of so-called "shell" companies, which are listed companies that have essentially no net assets, to be transferred to other enterprises. At the end of 2001, for example, the CSRC approved a plan for transferring the state shares of financially troubled retailer, Zhengzhou Baiwen, to a private enterprise, the Sanlian Group, in exchange for Sanlian's taking over Baiwen's debt. Baiwen, which had three successive years of losses, became a shell company when the Sanlian Group took over its capital, debts, and staff. (This transaction also brought Sailian a "backdoor listing" on the exchange and hence access to securities market financing.)[2]

In addition, the development of the securities market has made possible a new type of transaction, a management buy-out (MBO), which has started to attract a lot of attention as a way to diversify ownership of SOEs. In such a transaction, the managers of a listed SOE set up a private firm which then acquires some of the state shares of the listed company. For example, in 2001 state shares of vehicle manufacturer, Yutong Ke Che, in Henan Province were sold to a private investment company that had been established especially for the deal. Since an MBO usually means the managers of a listed SOE can become owners at a discounted cost, many more such deals are expected to take place.

Diversification in the ownership of SOEs has a positive impact on their governance. For most listed companies in which the state share is still the majority, boards of directors are controlled by the government, and nomination of directors and appointment of officers as well as significant business decisions are subject to statutory procedures. For listed companies in which non-state ownership predominates, on the other hand, government interference is more restrained. Thus, development of the securities market in China has promoted the reduction of government influence over enterprise activities. Disclosure and auditing requirements for listing on the securities market also helped to improve corporate governance to some extent. In 2001, for example, regulators punished Yin Guang Xia and its auditing firm for making false disclosures.

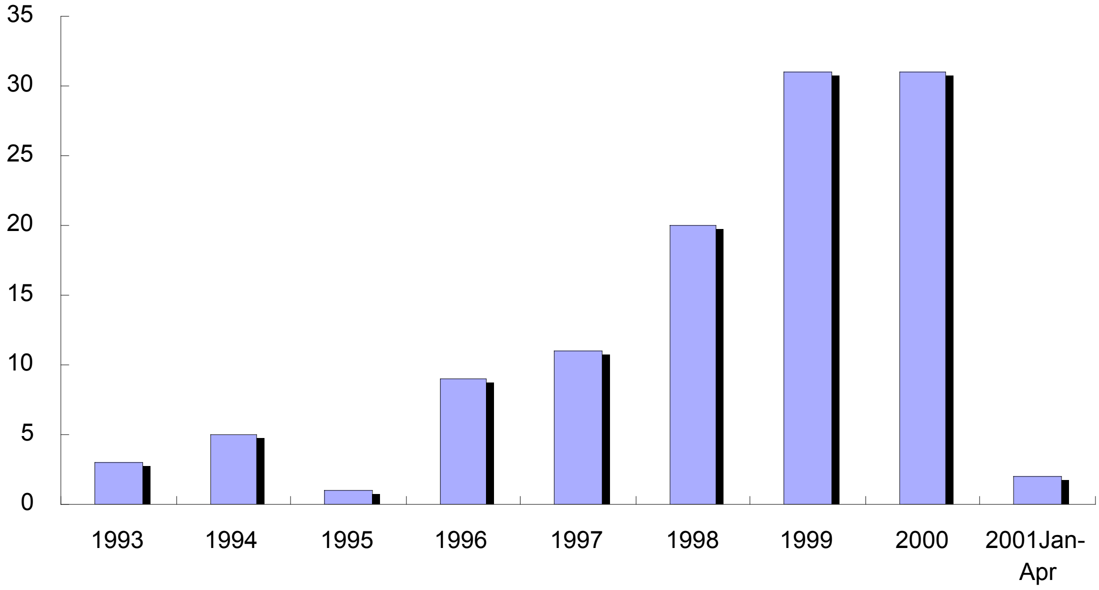
THE PRIVATE SECTOR AND THE SECURITIES MARKET

In the early 1990s, China had very few listed private enterprises because of the listing policies of the exchanges, and listing quotas favoured SOEs. The number of listed private firms increased since 1998 with the reform of the CSRC and the adoption of the Securities Law. From only three in 1993 the number of new listings of private enterprises increased to over 30 in 1999 and 2000 (Figure 5.5). As of the end of April 2001, 10.5 percent of the companies

2. http://english.peopledaily.com.cn/200012/07/eng20001207_57156.html.

listed on the Shanghai and Shenzhen exchanges, a total of 118 companies, were controlled by 113 private enterprises. Fifty-two of these private enterprises were listed in Shenzhen and sixty-six in Shanghai.

FIGURE 5.5
Number of Private Enterprises Entering Securities Markets, 1993-2001

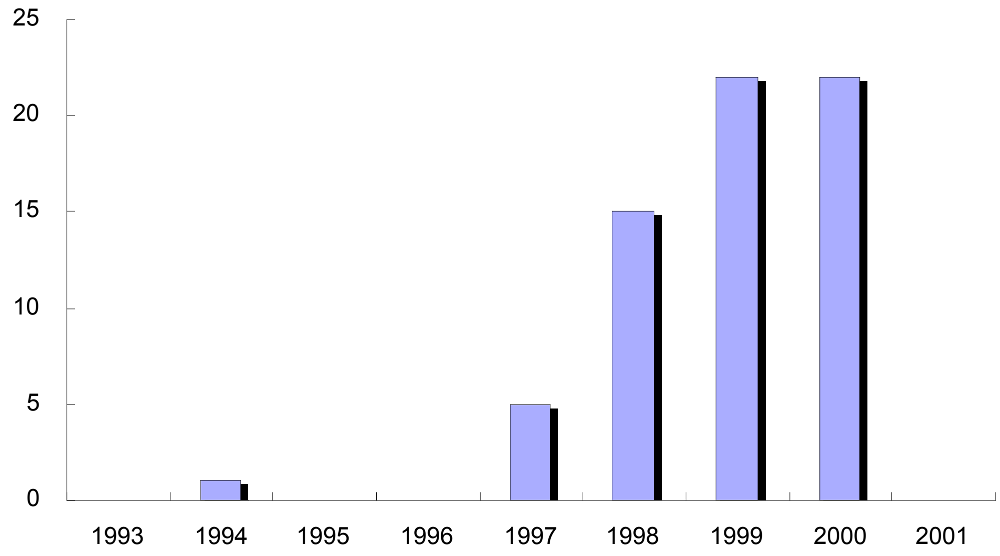


Source: Anhui Securities Corporation.

Milestones in the development of China's securities market were the listing of the first private enterprise, New Hope Group, in 1998 and the first listing of a private bank, MinSheng Bank in 2000. In 2001, the Shanghai exchange became the first to list a company promoted and controlled by a "natural person" (as opposed to a "legal person").

There are two ways in which a private enterprise to can have its shares traded. One is to go through an IPO and then have the shares listed on an exchange. The other, and most common way, is to acquire a shell company which is already listed on one of the exchanges. Of the 113 private companies listed on the two exchanges in 2001, 48 had gone through IPOs and 65 had acquired a shell company. Acquisitions of shell companies became more frequent in 1998 (15 firms acquired), 1999 (22 firms acquired), and 2000 (22 firms acquired) because of the intensified restructuring of listed SOEs (Figure 5.6). (There were no such acquisitions during the first four months of 2001, however.)

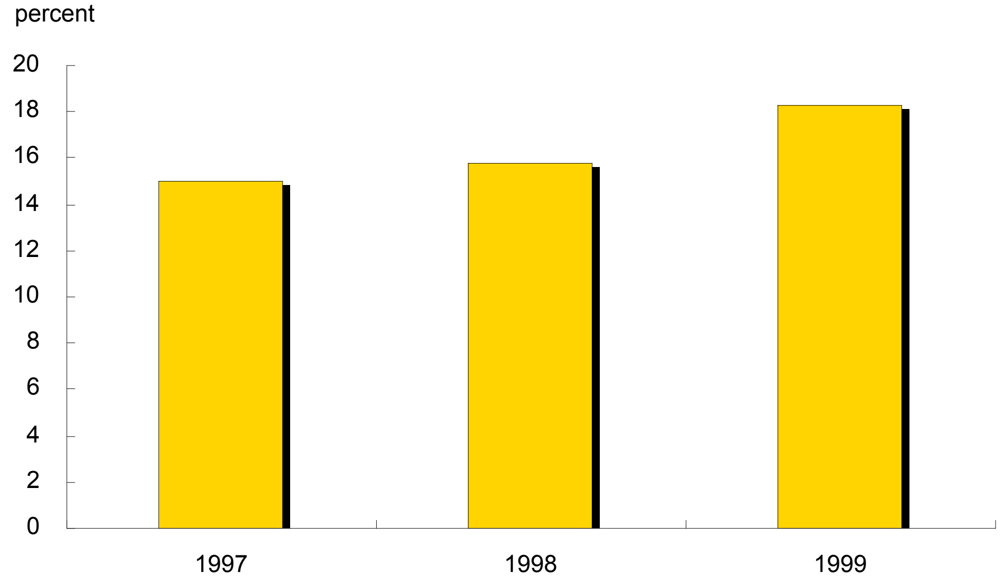
FIGURE 5.6
Acquisitions of Shell Companies by Private Enterprises, 1997-2001



Source: Anhui Securities Corporation.

The listing of private enterprises has had a positive impact on the development of both the securities market and enterprises. Private enterprises make more attractive investments than SOEs because they do not have the same burden of social welfare expenses and they are less subject to government interference. Thus, with the listing of private enterprises investors became more interested in trading in China's securities markets than when only SOE stocks were available. At the same time, listing on the securities market gave private enterprises access to a new source of funds, which was conducive to their own further development. Although the private sector contributed 20 percent of GDP in 2000, up from 15 percent in 1997, (Figure 5.7) only 0.6 percent of bank loans went private sector firms that year. Thus, to some extent, being able to access the securities market made up for a shortage of bank funds for business development in this growing sector. Some private listed companies are growing rapidly and becoming large conglomerates. For example, Delong Group, a well-known private conglomerate, expanded quickly after entering the securities market in 1999 and it now owns three other listed companies. The Dong Fang Group, which is a listed private enterprise, also controls another listed company, Xinjiang Tun He.

FIGURE 5.7
Private Sector's Share of GDP, 1997-1999



Source: China State Statistics Bureau.

For private enterprises, having shares traded in the securities market also improves their governance. In China most private enterprises are family-controlled and their shareholdings and operations are usually closed. Becoming listed introduces public stockholders and transparent accounting to these enterprises, and both of these governance factors will have a good influence on business in the long run.

SELF-DEALING AND TRANSFERRING PROFITS: A BIG PROBLEM WITH CHINA'S LISTED COMPANIES

Although listing on the securities market has a positive effect on governance both for SOEs and for private enterprises, listed companies in China still have very serious problems and the number of listed companies involved in scandals has increased in recent years. In fact, quite a few companies have fallen into financial difficulty two or three years after becoming listed. The main cause of their financial downturn is self-dealing and the transfer of profits, which are common practices among listed companies.

For the SOEs that make up the majority of listed companies self-dealing and profit transfer are almost a necessity, since they cannot raise funds by issuing their own shares through an IPO because of the poor quality of their assets and their heavy social welfare obligations. Thus, they are motivated to put their good assets in a newly established corporation, which then does an IPO. The bad assets remain in the old SOE, which is the parent of the newly listed company. Unlike its parent, the listed spin-off has both profit potential and access to funds from the securities market. Since the parent usually holds 50 or 60 percent of the spun-off company, giving it control, it naturally tends to extend its hands to the funds of the newly listed company. Furthermore, business relations between parent companies and spin-offs facilitate the transfer of funds. Usually, a parent company is engaged in supporting business for the listed spin-off, which uses the tangible and intangible assets of the parent. So, self-dealing transactions between parent companies and listed spin-offs occur each and every day. With such transactions made at non-market prices profits tend to be transferred from the listed company to the parent.

Private companies listed on the securities market are also interested in this trick of self-dealing and profit transfer. A private entrepreneur may set up a group of firms and manage to list one while the others remain unlisted. Arranging self-dealing transactions among these firms will convey profits and funnel funds from the securities market to the unlisted firms in the group. Private enterprises do not engage in transferring profits to the same extent as SOEs because they do not have as large a burden of welfare expenses to distribute among related companies.

Self-dealing and profit transfer between parent SOEs and listed companies is gaining attention as a serious problem in China, with listed companies often referred to as "ATMs" — automated teller machines. One way to address this problem is to restructure the SOEs to give them direct access to funds from the securities market. In 2001 some parent SOEs were transformed into shareholding corporations or even privatised. Yutong Ke Che, which was mentioned previously, underwent an MBO. This trend is expected to continue over the next few years.

Although the CSRC is relaxing restrictions on the entry of private firms to the securities market, some obstacles will exist for a while longer. One of these is the statutory conditions for listing under the Company Law. These conditions include minimum capital of RMB50 million and three consecutive years of profitable operation. It is not possible for new start-ups to meet these conditions. For this reason, many economists are calling for the establishment of a second board for growth enterprises in order to give new private firms in China access to securities market financing.

CHAPTER 6
THE ROLE OF HONG KONG CAPITAL MARKETS IN FINANCING CHINESE MAINLAND ENTERPRISES

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INTRODUCTION

The Hong Kong equity market was the tenth largest in the world and the second largest in Asia by market capitalization as of September 2000 (HKEx 2001b).[3] The Hong Kong securities market was the most active in Asia and the fourth most active in the world by the amount of new capital raised during 2000 (HKTDC 2001a). The Hong Kong capital markets play a key role in financing Chinese enterprises in the Chinese mainland (China hereafter), which helps the reform of inefficient state-owned enterprises (SOEs), numerous infrastructure development projects, as well as newly emerging growth enterprises in China.

This paper reviews recent developments in the Hong Kong capital market and examines the significance of that market in supporting the development of enterprises in China (Chinese enterprises, hereafter). We first present an overview of the financial markets in Hong Kong as well as a description of the regulatory framework of the capital market. Then we discuss the listing of Chinese enterprises in the Hong Kong equity market not only as a source of additional capital but also as a training ground for their participation in global capital markets, using the case of Zhejiang Expressway Company, Ltd. to illustrate.

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3. Japan was the largest Asian equity market in 2000.

OVERVIEW OF THE FINANCIAL MARKETS IN HONG KONG

This section reviews recent developments in the banking industry and the bond market as well as the equities market in Hong Kong and compares the relative importance of the banking industry and the capital market.

The Banking Industry

The banking industry in Hong Kong has gone through a number of significant reforms since the early 1960s, moving from laissez-faire to world-class prudential supervision. This was a result of the government's timely and determined responses to the banking crises that occurred in the early 1960s, the mid-1980s, and the early 1990s. In 2000, about 64 percent of banks' liabilities in Hong Kong dollars were deposits from customers, while their dominant types of assets during the period 1995 to 2000 were loans and advances to customers. The amount due to banks outside of Hong Kong has the highest percentage of liabilities in foreign currency, but this category gradually declined from 72.81 percent in 1995 to 42.49 percent in 2000. On the other hand, the amount due from banks outside of Hong Kong has the highest percentage of assets in foreign currency from 1998 to 2000. This category has increased gradually from 48.15 percent in 1998 to 60.37 percent in 2000. Loans and advances to customers occupy the highest percentages of assets in foreign currency from 1995 to 1997 and in total assets (both Hong Kong dollars and foreign currency) from 1995 to 2000. The composition of liabilities changes slightly after 1997. From 1995 to 1997 the amount due to banks outside of Hong Kong dominated total liabilities, and from 1998 to 2000 deposits from customers had the largest share of total liabilities (HKC&S, 2000; and HKMA, 2001a).

Bank lending, equity finance, and bond issuance are the major sources of corporate financing. It has been well established that financial development is a prerequisite for economic growth; all the sectors of the financial market (banking, equity, and debt) must grow and become more sophisticated. A more interesting question is how the relative importance of these three sources of corporate financing changes over the course of economic development.

In the case of Hong Kong, bank finance has continued to be important. Even in 2000 (after the Asian financial crisis), domestic credit provided by the banking sector was 158 percent of GDP (compared with 100 percent in Singapore, 109 percent in Japan, 128 percent in the UK, and 73 percent in the United States). Bank credit is so significant perhaps because Hong Kong has long had a modern and advanced banking system under extremely prudent government regulation and supervision. Corporate governance regulations have also been elaborate. In accordance with Diamond (1984), bank finance can be as effective as other sources of financing if it is possible for banks to minimize the agency problems arising from information asymmetry. The stock market has played an increasingly important role in corporate financing in Hong Kong in line with the theory of economic development. In 2000, the capitalisation of Hong Kong's stock market was 377 percent of GDP (c.f. Singapore's 247 percent, Japan's 71 percent, UK's 185 percent, and the United States' 157 percent). On the other hand, Hong Kong corporations' use of the debt markets as a source of financing remains relatively insignificant. The reasons for this are discussed in the next section.

Development of the Bond Market

Unlike the equity market, the debt market in Hong Kong is relatively small and the bond market appears inactive when compared to the markets in other developed economies. From 1994 to 2000 the bond market grew from 8 percent of GDP to only 37 percent (HKTDC 2001b).

Following the classification of the International Federation of Stock Exchanges (IFSE), the Hong Kong bond market consists of domestic public, domestic private, and foreign bonds. Domestic public bonds are Exchange Fund Bills and Notes, which are issued and managed by the Hong Kong Monetary Authority (HKMA). Domestic private bonds are mainly issued by commercial banks and large corporations such as the Mass Transit Railway Corporation (MTR) and the Kowloon Canton Railway Corporation (KCR) (HKTDC 2001b). The foreign bonds listed on the SEHK are issued by non-resident institutions, including foreign companies, foreign governments, international banks, and supranational organisations such as the World Bank group and the Asian Development Bank.

Foreign bonds comprised from 83 to 93 percent of the market value of all bonds listed in Hong Kong from 1997 to 2000, while domestic private bonds represented less than 3 percent of the market (Table 6.1). In contrast, foreign bonds comprised only around 3 percent of the market value of the bonds listed on the New York Stock Exchange. While the great preponderance of the value of the NYSE bond market was public issues, private domestic bonds still represented around ten percent of the market value. Thus, we can see that the domestic bond market in Hong Kong is inactive compared with the markets for domestic bonds in highly developed economies.

TABLE 6.1
Market Value of Bonds Listed in Hong Kong and New York, 1997-2000

	Domestic Private Bonds		Domestic Public Bonds		Foreign Bonds		All Listed Bonds	
	US$ million	% of all bonds	US$ million	% of all bonds	US$ million	% of all bonds	US$ million	% Change from 1997
Stock Exchange of Hong Kong								
1997	2,588	2.46	3,889	3.70	98,519	**93.83**	104,995	-
1998	1,955	1.77	4,805	4.35	103,679	**93.88**	110,438	5.18
1999	2,935	2.97	11,563	11.69	84,412	**85.34**	98,910	-10.44
2000	2,650	2.96	12,449	13.92	74,302	**83.11**	89,401	-9.61
New York Stock Exchange								
1997	249,988	9.52	2,321,270	**88.42**	54,099	2.06	2,625,357	-
1998	242,080	9.48	2,256,892	**88.36**	55,150	2.16	2,554,122	-2.71
1999	230,840	9.61	2,108,845	**87.81**	61,920	2.58	2,401,605	-5.97
2000	232,678	10.95	1,827,994	**86.03**	64,117	3.02	2,124,789	-11.53

Note: Private domestic bonds are issued by domestic private companies. Domestic public bonds include government and municipal bonds. Foreign bonds are ones listed on the stock exchange and issued by non-resident institutions (i.e., foreign companies, foreign governments, and international banks) or by supranational issuers such as the World Bank group and the Asian Development Bank. Bold typeface indicates the type of bond comprising the largest percentage of total market value in each year.
Source: International Federation of Stock Exchanges 1997-2000.

The Hong Kong bond market is much smaller than the U.S. bond market overall. The year-end market value of bonds listed in Hong Kong amounted to only about four percent of the value of bonds listed on the New York Stock Exchange from 1997 to 2000 (Table 6.1). Moreover, generally speaking the value of the bond market in Hong Kong is smaller relative to the equity market than is the case in the United States. In 1998, in the aftermath of the Asian crisis, the value of the bond market in Hong Kong reached 32 percent of equity market capitalisation, which was well above the 24 percent in the United States (Table 6.2). In the more normal years of 1997, 1999, and 2000, however, the bond market in the United States was larger relative to the equity market than it was in Hong Kong. For both the United States and Hong Kong, the bond market declined relative to the equity market after 1997. Furthermo, debt markets appear to have shrunk in both countries during recent years. The rate of growth in the value of the bond market was negative in 1999 and 2000 for both Hong Kong and the United States (Table 6.1).

TABLE 6.2
Market Value of Bonds versus Equity Market Capitalisation in Hong Kong and New York, 1997-2000

	Domestic Private Bonds		Domestic Public Bonds		Foreign Bonds		Total Market Value of Bonds		Equity Market Capitalisation
	US$ million	% equity mkt. cap.	US$ million	% equity mkt. cap.	US$ million	% equity mkt. cap.	US$ million	% equity mkt. cap.	US$ million
	Stock Exchange of Hong Kong								
1997	2,588	0.63	3,889	0.94	98,519	23.84	104,995	25.40	413,323
1998	1,955	0.57	4,805	1.40	103,679	30.18	110,438	32.14	343,567
1999	2,935	0.48	11,563	1.90	84,412	13.86	98,910	16.24	609,090
2000	2,650	0.43	12,449	2.00	74,302	11.92	89,401	14.34	623,398
	New York Stock Exchange								
1997	249,988	2.82	2,321,270	26.14	54,099	0.61	2,625,357	29.57	8,879,631
1998	242,080	2.36	2,256,892	21.97	55,150	0.54	2,554,122	24.87	10,271,900
1999	230,840	2.02	2,108,845	18.44	61,920	0.54	2,401,605	21.00	11,437,597
2000	232,678	2.02	1,827,994	15.85	64,117	0.56	2,124,789	18.42	11,534,613

Note: Private domestic bonds are those that are issued by domestic private companies. Domestic public bonds include government and municipal bonds. Foreign bonds are those that are listed on the stock exchange and issued by non-resident institutions (i.e., foreign companies, foreign governments, and international banks); they also include supranational issuers such as the World Bank group and the Asian Development Bank.
Source: International Federation of Stock Exchange 1997-2000, *Market Statistics Annual*.

Within the region, Hong Kong's bond market is relatively large. The SEHK ranked fifth among the eleven Asia-Pacific stock exchanges from 1997 to 2000 in the market value of listed bonds (Table 6.3). The two largest bond markets in the Asia-Pacific region in terms of market value were in Japan (Tokyo and Osaka), while the smallest regional bond market in these four years was in the Philippines.

TABLE 6.3
Ranking of Asian Pacific Bonds Markets by Market Value of Listed Bonds

	1997		**1998**		**1999**		**2000**	
	Rank	**US$ million**	**Rank**	**US$ million**	**Rank**	**US$ million**	**Rank**	**US$ million**
Australia	6	76,107.6	6	68,329.2	6	76,697.4	6	59,101.0
Colombo	10	5.3	10	46.6	9	64.4	9	70.2
Hong Kong	5	104,995.4	5	110,438.3	5	98,910.0	5	89,401.0
Jakarta	9	109.2	9	50.3	10	21.3	10	15.5
Korea	4	132,222.2	3	277,785.5	3	321,706.1	3	335,718.3
Kuala	8		8		8		8	
Lumpur		1,836.9		1,310.5		1,752.6		1,563.2
Osaka	2	1,785,308.4	1	2,253,635.7	2	2,624,293.4	2	2,535,507.1
Philippines	11	3.7	11	0.0	11	0.0	11	0.0
Singapore	3	171,625.9	4	182,946.2	4	198,938.9	4	218,791.5
Taiwan	7	32,807.0	7	36,577.9	7	44,370.0	7	48,455.4
Tokyo	1	1,814,982.4	2	2,219,012.0	1	2,639,619.2	1	2,548,332.0

Source: International Federation of Stock Exchanges. 1997-2000.

Three factors usually affect the development of debt markets. The first, on the supply side, is the presence of reputable firms that are creditworthy potential bond issuers. The second, on the demand side, is the existence of potential buyers with adequate spare funds. The third is the institutional framework (corporate governance, accounting standards, law enforcement, and judicial system) that helps protect investors. Many developing economies lack all three factors and, hence, their debt markets are underdeveloped.

Hong Kong is somewhat different from other developing economies. On the supply side Hong Kong certainly has many reputable firms, which are potential bond issuers, but the government has not been an issuer for a long time because of its strong fiscal position. In consequence, there was no benchmark against which private bond prices could be set. Only recently has it become possible to construct a yield curve, as a result of the issuance, first, of 2- to 3-year government paper and, then, of 5- to 10-year paper. In addition, for reputable firms in Hong Kong, issuing bonds incurs higher transactions cost than other sources of financing because of firms' easy access to bank finance and the equity market. On the demand side, although Hong Kong has a high savings rate, investors are risk-preferred and there are relatively few large-scale pension funds. Hong Kong's institutional framework is not an obstacle because for a long time it has had a credible legal and judicial system and well-established schemes to protect investors. Since the Asian financial crisis, the Hong Kong government has undertaken various measures to promote the development of the debt market (SFC 2001c).

The Equity Market

In the past, Hong Kong's equity market had a relatively simple structure. It was comprised of two major platforms, the Stock Exchange of Hong Kong Limited in the cash market and the Hong Kong Futures Exchange (HKFE) in the derivatives market, as well as three associated clearing houses: the Hong Kong Securities Clearing Co. Ltd. (HKSCC), the Stock Exchange Options Clearing House (SEOCH), and the HKFE Clearing Corporation Ltd. (McGuinness 1999).

To increase its competitiveness and meet the challenges of the increasingly globalised capital market, the Hong Kong equity market went through several major changes in recent years. These included the demutualisation of the two exchanges (SEHK and HKFE), the merger of their clearing houses, the launch of the Growth Enterprise Market (GEM) and the Pilot Program for trading U.S. securities, and the introduction of the Third-Generation Automatic Order Matching and Execution System (AMS/3) and the upgraded version of Central Clearing and Settlement System (CCASS/3) (HKEx 2001b). Hong Kong Exchanges and Clearing Limited (HKEx), the holding company of the SEHK, the HKFE, and the integrated HKSCC, was established on 6 March 2000 and subsequently listed on its own exchange on 27 June 2000. To meet the financing needs of smaller and high growth companies that do not qualify for listing on the main board (i.e., the SEHK), the GEM was launched on 15 November 1999. The GEM was considered a designated offshore securities market by the U.S. Securities and Exchange Commission (SEC) in 2000 (HKEx 2001a and 2001b).

During May 2000 in conjunction with NASDAQ, the SEHK introduced the Pilot Program to globalise Hong Kong's equity market. Under this Program initially seven established NASDAQ stocks were quoted and traded, but not listed, on the SEHK. As these trades were settled and cleared in Hong Kong dollars through HKSCC, they followed the standard trading and clearing procedures with T+2 settlement period. To increase market efficiency through the formation of electronic linkages among investors around the world, the SEHK launched an AMS/3 trading system in 2000. The three important features of this modernised trading system are its multi-workstation, its open gateways, and its order routing system (ORS). The ORS allows investors to trade Hong Kong stocks by computer or mobile phone from anywhere in the world over the Internet.

Characteristics of Listed Companies and Investors

As of May 2001 the main board of the SEHK listed 741 companies with a total market capitalisation of US$575 billion. In comparison, the GEM listed 75 companies with a total market capitalisation of approximately US$9 billion (HKTDC 2001a).

The SEHK classifies listed companies into one of seven industry categories: finance, utilities, properties, consolidated enterprises, industrials, hotels, and miscellaneous (HKEx 2001b). From 1991 to 2000 the three most important industries in the Hong Kong equity market were consolidated enterprises, finance, and properties (Table 6.4). Consolidated enterprises' share of total market capitalisation was the largest of the seven industry categories in 1991, 1992, 1994, 1995, and 2000, while the finance industry had the largest share, about one-fourth, from 1997 to 1999. The property industry had a significant presence in the Hong Kong equity market before the Asian financial crisis of 1997, claiming the largest share of market capitalization in 1993 and 1996 and the second largest share in 1994 and 1995. On the whole, similar to other Asian financial markets, the equity market in Hong Kong was sluggish with negative growth rates in 1997 and 1998. It recovered in 1999 with a growth rate of about 77 percent, but slowed again in 2000.

TABLE 6.4
Market Capitalisation of the Stock Exchange of Hong Kong by Industry, 1991-2000

	Industry Classification														**SEHK Total Capitalisation**	
	Finance		**Utilities**		**Properties**		**Consolidated Enterprises**		**Industrials**		**Hotels**		**Miscellaneous**			
	HK$ billion	**% of market cap.**	**HK$ billion**	**% of market cap.**	**HK$ billion**	**% of market cap.**	**HK$ billion**	**% of market cap.**	**HK$ billion**	**% of market cap.**	**HK$ billion**	**% of market cap.**	**HK$ billion**	**% of market cap.**	**HK$ billion**	**% change from prev. year**
1991	154.0	16.23	175.7	18.51	255.6	26.93	270.7	**28.52**	65.9	6.94	20.8	2.19	6.3	0.67	949.2	-
1992	297.9	22.36	222.8	16.72	332.7	24.98	352.3	**26.45**	92.6	6.95	28.1	2.11	5.8	0.43	1,332.2	40.35
1993	599.7	20.16	420.7	14.14	856.6	**28.79**	828.8	27.86	186.7	6.27	73.6	2.47	9.1	0.31	2,975.4	123.35
1994	452.4	21.70	321.7	15.43	533.3	25.58	581.4	**27.88**	128.7	6.17	59.1	2.83	8.6	0.41	2,085.2	-29.92
1995	570.0	24.27	328.0	13.97	621.1	26.45	634.9	**27.04**	137.3	5.85	52.1	2.22	5.0	0.21	2,348.3	12.62
1996	805.5	23.17	357.5	10.28	1,079.3	**31.05**	903.2	25.98	252.0	7.25	68.8	1.98	9.6	0.27	3,476.0	48.02
1997	864.0	**26.98**	598.9	18.70	679.3	21.21	674.8	21.07	320.0	9.99	48.2	1.51	17.4	0.54	3,202.6	-7.86
1998	787.4	**29.58**	527.7	19.83	562.6	21.14	528.0	19.84	217.0	8.15	31.6	1.19	7.5	0.28	2,661.7	-16.89
1999	1,224.2	**25.89**	1,132.5	23.96	773.5	16.36	1,170.7	24.76	377.5	7.99	40.0	0.85	9.2	0.19	4,727.5	77.61
2000	1,441.1	30.05	290.0	6.05	698.4	14.56	1,968.4	**41.05**	333.8	6.96	34.6	0.72	28.8	0.60	4,795.2	1.43

Note: Bold typeface indicates the industry with the largest percentage share of total market capitalization in each year.
Source: HKEx 1997 and 2001b.

TABLE 6.5
Distribution of Listed Companies by Market Value of Ordinary Shares, 1996-2000

	Market Value of Ordinary Shares:																Total number of listed companies
	10 - 100 HK$ million		101 - 200 HK$ million		201 - 300 HK$ million		301 - 500 HK$ million		501 - 1,000 HK$ million		1,001 - 3,000 HK$ million		3,001 - 10,000 HK$ million		10,001 HK$ million & over		
	Number	%	Number	%	Number	%	Number	%	Number	%	Number	%	Number	%	Number	%	
1996	25	4.69	57	10.69	55	10.32	79	4.82	107	**20.08**	107	**20.08**	58	10.88	45	8.44	533
1997	23	3.75	96	15.66	72	11.75	93	15.17	113	18.43	114	**18.60**	61	9.95	41	6.69	613
1998	131	**20.34**	130	20.19	73	11.34	77	11.96	93	14.44	70	10.87	39	6.06	31	4.81	644
1999	72	10.68	113	16.77	85	12.61	83	12.31	116	**17.21**	114	16.91	47	6.97	44	6.53	674
2000	83	11.58	142	19.80	91	12.69	102	14.23	117	**16.32**	102	14.23	38	5.30	42	5.86	717

Note: Bold typeface indicates the market value category with the most companies in each year.
Source: DataStream-All ordinary index. The Transaction Survey 2000 conducted by HKEx provides some indication of the characteristics of market participants (HKEx 2001d). From 1991 to 2000, most activity on the SEHK was on behalf of clients (agency trading) with principal trading, for the trader's own account never amounting to more than 8 percent of trades, and usually much less than this (Table 6). Trading on behalf of individual and institutional clients in Hong Kong comprised from two-thirds to almost three-fourths of activity during the decade. Most such local agency trading is for individual rather than institutional investors. After 1997, institutional trading on behalf of overseas clients surpassed institutional trading for local clients.

According to the market value of their ordinary shares, in 1996 and 1997, over half of the companies listed on the SEHK were capitalised at HK$501 million or more and less that twenty percent were capitalised at under HK$201 million (Table 6.5). This distribution shifted downward after 1997. In 1998 only 35 percent of companies were capitalised at HK$501 million or more, while for approximately 40 percent market values were below HK$201 million. From 1996 to 2000, under 10 percent of companies had market values exceeding HK$10 billion.

TABLE 6.6
Distribution of Hong Kong Investors by Type of Trade, 1991-2000
(Percent Share of Total market Turnover)

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Principal trading	2.60	2.33	1.43	2.70	4.43	8.43	4.77	5.06	5.38	2.90
Overseas agency trading	25.04	22.84	29.43	25.15	30.02	31.84	21.85	32.12	31.53	30.19
Individual trading	2.36	2.05	1.96	1.85	2.08	2.35	2.49	1.54	1.30	2.13
Institutional trading	22.68	20.79	27.47	23.3	27.94	29.49	19.36	30.58	30.23	28.06
Local agency trading	72.36	74.83	69.14	72.15	65.54	59.73	73.38	62.83	63.09	66.91
Individual trading	**47.24**	**52.80**	**42.40**	**45.75**	**32.73**	**33.76**	**52.94**	**41.16**	**44.87**	**49.38**
Institutional trading	25.12	22.03	26.74	26.4	32.81	25.97	20.44	21.67	18.22	17.53
Total trading	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: Principal trading refers to trading in the participant firm's own account. Individual trading refers to trading on behalf of individual clients. Institutional trading refers to trading on behalf of institutional clients. All percentages are based on the Transaction Survey by the Stock Exchange of Hong Kong, Limited.
Bold typeface indicates type of trading that had the largest share of total market turnover in each year.
Source: HKEx 2001d.

Regulatory Framework

The HKMA and the Securities and Futures Commission (SFC) are the two major regulatory bodies for the capital market, with the SFC being the principal regulator of the securities and futures markets. The HKMA was founded on 1 April 1993 by merging the Office of Exchange Fund with the Office of the Commissioner of Banking. As the government's monetary authority, the HKMA is responsible for maintaining monetary and banking stability by keeping the Hong Kong dollar stable, managing the Exchange Fund (Hong Kong's official reserves) effectively, promoting the safety of Hong Kong's banking system, and developing sound financial infrastructure for Hong Kong (HKMA 2001b).

The SFC was established on 1 May 1989 under the Securities and Futures Commission Ordinance. It is an independent non-governmental statutory body that is responsible not only for the regulation of the securities and futures markets, takeovers, merger activity, and offers of investment products in Hong Kong, but also for the enforcement of laws regarding market malpractice (SFC 2001b). To avoid potential conflict of interest, HKEx and its subsidiaries (the SEHK, HKFE, and HKSCC) are also directly regulated by the SFC as listed issuers (SFC 2001a).

THE ROLE OF HONG KONG CAPITAL MARKETS IN FINANCING CHINESE MAINLAND ENTERPRISES

The Hong Kong equity market supports the development of Chinese enterprises in two ways. The first is financial: the equity market channels international capital to firms in China. The second is educational: Hong Kong serves as a training ground where Chinese enterprises gain experience in the corporate standards and practices expected by international capital markets.

Financing Mainland Enterprises through H-shares and Red Chips

In recent years, investors in the Hong Kong equity market have been financing enterprises in mainland China through purchases of China-related securities that are listed on the SEHK, the so-called 'H shares' and 'red chips'. Red chips, also referred to as 'China-affiliated corporations', are "Hong Kong-listed companies which are at least 35 percent-owned, directly or indirectly, by state institutions, provincial or municipal organisations in the mainland" (HKEx 2001c). Whereas H shares are issued by companies incorporated in mainland China, red chips are issued by China-affiliated companies that are incorporated in Hong Kong (or other overseas countries). Therefore, red chips are subject to the same securities regulations and disclosure requirements as all Hong Kong incorporated companies. The SEHK has no additional listing and disclosure requirements for red chips.

In 2000, the Hang Seng China-Affiliated Corporations Index (HSCCI) covered 45 red chips compared to 24 in 1993 (Table 6.7). Prior to 1998, about one-third of the red chips were consolidated enterprises and a slightly smaller share were industrials, but from 1998 to 2000 red chips that were industrial companies outnumbered those in all other categories. There are no red chips in the utility sector and a few in the finance and hotel sectors. (A list of these red chips and their market values as of December 2000 is provided in Appendix 1).

TABLE 6.7
Industry Composition of the Hang Seng China-affiliated Corporations Index (HSCCI), 1993-2000

	Finance		Utilities		Properties		Consolidated Enterprises		Industrials		Hotels		Misc.		Total Number of Companies
	#	%	#	%	#	%	#	%	#	%	#	%	#	%	
1993	3	12.50	0	**-**	**7**	**29.17**	6	25.00	6	25.00	0	-	2	8.33	24
1994	3	10.34	0	-	7	24.14	9	**31.03**	8	27.59	0	-	2	6.90	29
1995	3	9.68	0	-	7	22.58	10	**32.26**	9	29.03	0	-	2	6.45	31
1996	3	9.38	0	-	7	21.88	10	**31.25**	10	**31.25**	0	-	2	6.25	32
1997	4	11.11	0	-	7	19.44	12	**33.33**	11	30.56	0	-	2	5.56	36
1998	4	8.51	0	-	9	19.15	14	29.79	17	**36.17**	0	-	3	6.38	47
1999	3	7.14	0	-	6	14.29	10	23.81	20	**47.62**	0	-	3	7.14	42
2000	5	11.11	0	-	5	11.11	13	28.89	18	**40.00**	1	2.22	3	6.67	45

Note: Boldface type indicates the industry with the largest percentage of HSCCI companies in each year.
Source: HKEx 1995-2000 and 2001b and HSI Service Ltd., 2001b.

H shares are shares of companies "incorporated in the People's Republic of China (PRC) and approved by the China Securities Regulatory Commission (CSRC) for a listing in Hong Kong" (HKEx 2001b). The CSRC, the SEHK, the SFC, and the Shanghai and Shenzhen Stock Exchanges signed a Memorandum of Regulatory Co-operation on 19 June 1993 for listing mainland-registered enterprises in Hong Kong. H shares are subscribed for and traded in Hong Kong dollars; their par value is denominated in Renminbi (RMB). In addition to listing H shares, some Chinese enterprises also list on the New York Stock Exchange (N shares), the London Stock Exchange (L shares), and the Singapore Stock Exchange (S shares). (The H-share, N-share, L-share, and S-share companies are shown in Appendix 2 along with their market values and listing dates.)

The first mainland enterprise to list H-shares on the SEHK was Tsingtao Brewery Company on 15 July 1993. By 2000 there were 50 H-share companies, 47 listed on the main board and 3, Beijing Beida Jade Bird, Tong Ren Tang, and Shanghai Fudan, listed on the GEM

(Table 6.8). The majority of these mainland issuers are categorised as industrial companies and there are none in the hotel or finance sectors.

TABLE 6.8
Number and Distribution of H Shares on Growth Enterprise Market (GEM) and on Stock Exchange of Hong Kong Main Board by Industry, 1993-2000

	Total H shares	GEM		Main Board													
				Finance		Utilities		Properties		Consolidated Enterprises		Industrials		Hotels		Misc.	
	#	#	%	#	%	#	%	#	%	#	%	#	%	#	%	#	%
1993	6	0	-	0	-	0	-	0	-	0	-	**6**	**100.0**	0	-	0	-
1994	15	0	-	0	-	0	-	0	-	0	-	**14**	**93.3**	0	-	1	6.67
1995	16	0	-	0	-	0	-	0	-	0	-	**15**	**93.7**	0	-	1	6.25
1996	23	0	-	0	-	1	4.30	0	-	1	4.35	**20**	**86.9**	0	-	1	4.35
1997	39	0	-	0	-	2	5.13	1	2.56	2	5.13	**33**	**84.6**	0	-	1	2.56
1998	41	0	-	0	-	3	7.32	1	2.44	2	4.88	**34**	**82.9**	0	-	1	2.44
1999	44	0	-	0	-	5	11.36	1	2.27	2	4.55	**35**	**79.5**	0	-	1	2.27
2000	50	3	6.00	0	-	5	10.00	1	2.00	3	6.00	**36**	**72.0**	0	-	2	4.00

Note: Bold typeface indicates the industry with the largest percentage of H-shares on the main board each year.
Source: HKEx 1996-2000 and 2001b; CSRC 1997, HSI 2001b.

Development of Overseas Listing by Chinese Enterprises

Hong Kong is the major overseas equities market for China-incorporated companies, although the other markets are rising in importance. Of the fifty-three Chinese enterprises listed overseas in December 2000, fifty were listed on the SEHK, compared to only ten on the NYSE, five on the LSE, and two on the SSE (Table 6.9). Moreover, in 2000, H-shares accounted for 50 percent of the market value of the Chinese enterprises listed on all four overseas markets (Table 6.10). This was down from 70 percent in the years 1993 to 1999. The importance of the London and New York markets increased significantly from 1999 to 2000, with the market value of L-shares growing 850 percent and that of N-shares growing 353 percent. At the same time, the market value of H-shares rose a comparatively modest 103 percent.

TABLE 6.9
China-domiciled Companies Cross-listed in New York, London, Singapore, and Hong Kong, 1993-2000

	New York	London	Singapore	Hong Kong	Total
1993	1	-	-	6	6
1994	2	-	-	15	16
1995	3	-	1	16	18
1996	4	-	1	23	25
1997	7	3	2	39	43
1998	8	3	2	41	44
1999	8	3	2	44	47
2000	10	5	2	50	53

Note: Entries under New York were listed both in New York and Hong Kong. Note that Huaneng Power International, Inc. was listed only in New York in 1994 and in both Hong Kong and New York from 1998. Zhejiang Southeast Electric Power was listed in London from 1997. Zhejiang Expressway Co. was listed in Hong Kong from 1997 and in both London and Hong Kong in 2000. Entries for Singapore indicate companies listed in Singapore only.
Source: HKEx 1996-2000 and 2001b; CSRC2001a; NYSE 2001; LSE 2001; and SGX 2001.

TABLE 6.10
Market Capitalisation of Chinese Enterprises Listed in Overseas and Domestic Markets, 1993-2000

	Overseas Markets									Domestic Market			
	Overseas Markets Total	New York		London		Singapore		Hong Kong		Domestic Market Total	A Shares	B Shares	Red Chips
	US$ mil.	US$ mil.	%	US$ mil.	%	US$ mil.	%	US$ mil.	%	US$ mil.	US$ mil.	US$ mil.	US$ mil.
1993	3,069	710	23.1	0		0		2,359	76.9	60,769	57,121	3,649	9,775
1994	3,528	946	26.8	0		0		2,582	73.1	43,700	41,628	2,072	6,109
1995	3,057	928	30.4	0		0		2,129	69.7	41,757	39,798	1,971	6,973
1996	5,855	1,710	29.2	0		68	1.2	4,077	69.6	118,174	113,455	4,731	21,276
1997	9,034	1,865	20.7	780	8.7	114	1.3	6,275	69.5	210,939	206,426	4,513	24,794
1998	6,156	1,264	20.5	495	8.0	68	1.1	4,329	70.3	235,605	233,105	2,488	16,446
1999	7,485	1,613	21.6	359	4.8	125	1.7	5,389	72.0	319,717	316,058	3,672	25,192
2000	21,765	7,312	33.6	3,411	15.7	126	0.6	10,916	50.2	580,992	573,320	7,671	21,719

Note: % indicates the individual exchange's percentage share of the total capitalisation of China-incorporated enterprises in the four overseas exchanges. Red chips are China-affiliated corporations incorporated and listed in Hong Kong.
Source: Data on overseas companies listed in New York, London and Singapore were obtained from *Datastream*. Data on overseas companies listed in Hong Kong were obtained from HKEx 2001b. Data on companies listed in the Chinese mainland (i.e. A and B shares listed on the Shanghai and Shenzhen Stock Exchanges) were obtained from State Statistical Bureau 2001. Data on China-affiliated corporations were obtained from *Datastream* for those listed in Hong Kong from 1993 to 1996; and from HKEx 2001b for those listed in Hong Kong from 1997 to 2000.

The H-share market has a larger capitalisation than the domestic B-share market.[4]

4. China has two major stock exchanges: the Shanghai Stock Exchange and the Shenzhen Stock Exchange. Both offer Class A shares (A shares) and Class B shares (B shares) of common stocks that are issued by China-domiciled companies. B share listings carry the same rights as A share listings. For all intents, B shares are identical to A shares except for who can buy them. A shares are restricted to PRC citizens while B shares were restricted to non-PRC citizens in the past but became available to both PRC

Moreover, the H-share market is much more liquid than the B-share market (Table 6.11). The trading volume of H shares significantly exceeded the trading volume of B shares in every year from 1993 to 2000 except 1996. In 2000, the trading volume of H shares was more than three times the B-share volume. Prior to 2001, only foreign investors (i.e., non-PRC citizens) were allowed to purchase B shares listed on the SHSE and the SZSE.

TABLE 6.11
Trading Volume of Equities Listed in Hong Kong and in Mainland China, 1993-2000
(US$ million)

	Listed in Hong Kong		Listed in Mainland China	
	Ordinary Shares	**H Shares**	**A Shares**	**B Shares**
1993	158,254.61	4,031.35	61,302.81	1,807.07
1994	146,990.70	4,274.06	94,752.67	1,479.96
1995	106,932.31	2,183.93	51,914.18	937.56
1996	182,590.00	3,218.08	252,773.64	3,361.99
1997	488,961.13	38,426.84	364,560.77	5,138.39
1998	219,586.16	9,492.66	282,856.83	1,533.98
1999	246,470.78	13,222.94	375,022.65	3,261.07
2000	390,728.53	21,066.15	728,235.92	6,620.44

Source: HKEx 1997 and 2001b and State Statistical Bureau 2000 and 2001.

The relative importance of all overseas listing by Chinese enterprises increased significantly since the Asian financial turmoil of 1997. From 1999 to 2000 the market value of overseas shares rose 191 percent, while the value of the Chinese domestic market increased by only 82 percent (Table 10). The PRC's new Securities Law, effective 1 July 1999, requires that a Chinese enterprise, which offers securities overseas and is listed on the secondary market is still subject to approval by the domestic securities regulatory authorities (CSRC 2001b).

According to CSRC (2001b), overseas listing can make a significant contribution to the reform and opening-up of Chinese enterprises to international markets. Overseas listing benefits China in several ways. First, it provides additional outlets for raising capital for the construction and growth of the Chinese economy. Second, it can facilitate the privatisation of SOEs. That is, it can promote the segregation of SOEs from government control. Third, it can strengthen China's relationship and exchanges with the international capital market. Lastly, it can enable Chinese enterprises to learn about management methods, accounting systems, laws

citizens as well in 2001.

and regulations, and regulatory measures in other well-established markets.

This last advantage of overseas listing is particularly associated with listing in Hong Kong. The CSRC has recognised the need to improve transparency and reduce regulatory suppression of Chinese enterprises to attract foreign investors (CSRC 2001b). To promote voluntary disclosure of information, the CSRC held training workshops for board chairmen, CEOs, and other key personnel of overseas-listed companies. The CSRC also invited staff from the Hong Kong Securities and Futures Commission and the SEHK to lecture on listing rules and mergers and acquisitions in order to gain government officials' support for disclosing information on foreign listings.

The SEHK added a separate chapter to its Listing Rules relating to issuers incorporated in the PRC after 25 June 1993 (i.e., for H-share issuers, SEHK 1989-2002; Poon and Fung 2000). For example, H-share companies are required to disclose performance results to the public on a timely basis and to prepare interim and year-end financial statements using internationally accepted accounting systems (IAS). The SEHK also published a guidebook for listing Chinese companies in Hong Kong (SEHK 1998). Thus, in preparing for H-share listing, managers of China-incorporated enterprises gain practical experience for listing in larger or more sophisticated capital markets such as the New York Stock Exchange (NYSE).

Literature on China’s Equity Markets

The China equity markets are still in an early stage of development. It is of interest and significance to examine the financial characteristics of China’s equity markets in the context of the existing literature. The following survey examines China’s A- and B-share markets and the role of the H shares and red chips in Hong Kong’s capital markets as a substitute for B shares. This review would throw light on the role of Hong Kong’s capital markets in the development of China’s equity markets.

Beginning with the preliminary empirical evidence of Bailey (1994), researchers have taken a notable interest in studying the financial characteristics of China’s equity markets. Most of the recent literature on China's equity market is interested in segmentation and information transmission, whereas some papers concern the under-pricing of Chinese initial public offerings (IPOs) (Su and Fleisher, 1999a) or the relationship between the shareholding structure and the corporate performance of listed Chinese companies (Qi et al. 2000).

Bailey (1994) studied the early evolutionary stage of both the Shanghai and Shenzhen stock markets and found that B-share returns display little or no correlation with international equity index returns. Bailey's study implies that B shares can be considered good diversification investments for foreign investors and confirms the effectiveness of market segmentation in A- and B-share markets. Poon et al. (1998) examined the impact of the initial listing of B-share issues on the prices of already listed A shares. They found that the abnormal returns on A-share companies that also offer B shares are significantly negative, and these A-share firms seem to experience a decline in investor base and a decline in liquidity.

Qi et al. (2000) investigated whether and how the shareholding structure affects the corporate performance of Chinese companies listed on the SHSE from 1991 to 1996. Their results indicate that firm performance, measured by the return on equity, is positively related to the fraction of legal-person (LP) shares and negatively related to the fraction of shares owned by the state (state-owned shares). They also found that firm performance increases with the degree of relative dominance of LP shares over state shares.

Some researchers examine whether there is any difference in prices between A and B shares in China, while others attempt to explain the price difference (Chakravarty et al. 1998; Su, 1999; Su and Fleisher (1999b), Sun and Tong, 2000; and Chen et al., 2001). As documented in the recent studies, B shares trade at a significant discount relative to A shares in China, which is contrary to the evidence from other markets with a similar segmented structure. Incorporating both information asymmetry and market segmentation in their model, Chakravarty et al. (1998) derived a relative pricing equation for A and B shares. They show that the B-share discount is significantly related to their proxies for information asymmetry. Similarly, Su and Fleisher (1999b) conclude that information asymmetry constitutes stock-price and return volatility differentials between A- and B-share markets in China.

Employing a one-period capital asset pricing model (CAPM) under share ownership restrictions, Su (1999) also attempted to explain differences in prices and expected returns between Chinese A and B shares for the period April 1994 to September 1996. The results of the study indicate that the price differentials and return spread between the two share groups can be explained by the CAPM's beta.

In contrast to these explanations, Sun and Tong (2000) suggest that B-share discounts over the period April 1994 to February 1998 can simply be explained by basic economic principles. They consider that the H-share and the red-chip markets in Hong Kong provide good substitutes for the B-share market, and thus foreign investors' demand for B shares could be quite elastic. They found that the B-share discount increases with the number of H shares and red chips listed in Hong Kong. On the other hand, Chen et al. (2001) attribute the B-share discount to the liquidity problem in the B-share market for the sample period 1992 to 1997. They explain that relatively illiquid B shares are priced lower and have higher expected returns to compensate investors for increased trading costs due to lower liquidity in the B-share market.

Long et al. (1999), Fung et al. (2000), and Sjoo and Zhang (2000) empirically examine the information transmission between the A- and B-share markets, while Poon and Fung (2000) extend the scope of study by including H shares and red chips in the sample. Long et al. (1999) investigate market efficiency and the price-volume relation in A and B shares on the SHSE relative to the U.S. stock market over a 100-week period from February 21, 1992 to January 14, 1994. Consistent with the evidence from U.S. stock markets, their results show a significant positive relationship between changes in volume and absolute price returns in both A and B shares. In addition, their market efficiency tests support that the A- and B-share markets in Shanghai follow a random walk.

Sjoo and Zhang (2000) demonstrate information flows from foreign to domestic investors in the Shanghai market but this information diffusion process goes in the opposite way in the smaller Shenzhen market during the study period July 1993 through June 1997. Their results imply that the direction of the information flow is determined by the choice of stock exchange. Interestingly, Fung et al. (2000) provide additional evidence to illustrate that the Shanghai stock market responds to information less quickly than the Shenzhen stock market for the period May 1993 to June 1997. Recently, using daily data for the period 4 August 1994 to 27 June 1997, Poon and Fung (2000) study the information flow between China-backed securities comprising H shares, red chips, and Shanghai-and Shenzhen-listed common shares. They indicate that there are significant return and volatility spillover effects among the China-backed securities. In addition, the results suggest that the red chip market processes information faster than the other markets.

CASE STUDY: ZHEJIANG EXPRESSWAY CO., LTD.

The experience of Zhejiang Expressway Co., Ltd (ZE) illustrates the many ways in which listing in Hong Kong facilitates the development of Chinese enterprises. ZE was incorporated in China as a joint stock limited company on 1 March 1997. It is mainly engaged in investing in, constructing, and managing toll roads and other infrastructure projects in Zhejiang Province. Its ancillary businesses include automobile servicing, operating petrol stations, and billboard advertising along toll roads. The company has a majority interest in the Shanghai-Hangzhou-Ningbo Expressway and the Shangsan Expressway (ZE 2000a). An Australian group expressed interested in acquiring a majority stake, but the company chose instead to list in Hong Kong to open the door to future financing (Lancher 1997). The retail portion of ZE's US$449 million offering of H shares on 15 May 1997 was 118 times over subscribed. The over-subscription attracted a lot of attention among China infrastructure companies (Gailey 1997). Three years later, on 5 May 2000, ZE listed L shares on the LSE. This was different from other Chinese enterprises listing in London or New York as well as Hong Kong, which did so simultaneously (Appendix 2).

We look first at ZE's financial performance and corporate activity after listing in Hong Kong and then at how ZE adapted to the standards of international capital markets.

Post-listing Financial Performance and Corporate Development

As of 31 December 2000, H shares comprised approximately 33 percent of ZE's issued share capital (ZE 2000b). The financial performance of the company improved considerably after it listed. Return on equity (ROE) gradually increased from 3.61 percent in 1997 to 6.5 percent in 1999 and net profit grew by 85 percent from RMB296 million in 1997 to RMB548 million in 1999 (ZE 2000b). The H-share listing also broadened the company's shareholder base and raised its profile among international investors. For example, in 1999 an analyst at U.S. stockbrokerage Warburg Read recommended ZE as one of the best-valued infrastructure stocks in the market (Leung 1999).

The additional capital raised from the 1997 H-share offering enabled ZE to undertake several acquisitions. The company invested HK$194.4 million initial capital in a joint-venture project known as Zhejiang Expressway Petroleum Development. About HK$160 million of this investment came from internal resources with the balance financed by proceeds of the Hong Kong IPO (SCMP 1998). ZE also acquired 30 percent ownership in JoinHands Technology on 6 April 2000 (ZE 2000b).

Moreover, by enabling ZE to fund additional projects the H-share offering contributed indirectly to the restructuring of state enterprises and the development of infrastructure in China. For example, in June 1999, ZE acquired an additional 4 percent ownership interest in Shangsan Co., the holding company of the Shangsan Expressway, from Xinchang Transport, a state enterprise wholly owned by the Xinchang County Transport Bureau. This RMB114.1 million acquisition increased ZE’s ownership share from 51 to 55 percent and reduced the state's (i.e., Xinchang Transport's) share from 6 to 2 percent (ZE 1999). In addition, ZE completed construction of the Shangsan Expressway on 26 December 2000. ZE also completed the Shanghai-Hangzhou-Ningbo Expressway, which is the only direct highway link between these three major cities along China's East Coast (ZE 2000b).

Beyond improving corporate performance and contributing to China's development, ZE's listing on the SEHK led the company's management to modify many practices, initiating it to the behaviours and requirements of participating in global capital markets.

Corporate Governance and Compliance

Becoming listed on the SEHK apparently provided the impetus for ZE to improve corporate governance. Appendix 14 of the *Rules Governing the Listing of Securities on the SEHK* (Listing Rules) lays out a "Code of Best Practice" for corporations listed in the Hong Kong market (SEHK 1989-2002). The Code is intended as a framework to guide each company in devising its own governance structure, not as a rigid set of rules. According to the Code all listed companies should appoint "non-executive" directors. If the independent non-executive directors hold views contrary to those of the executive directors in the board meeting, their views should be clearly reflected in the board minutes. In addition, companies listing on the SEHK must establish an audit committee comprising at least two non-executive directors to supervise the company's financial reporting process and internal controls (Salomon 2001).

After listing its H shares ZE made several changes to bring its corporate structure into line with the SEHK's Code of Best Practice. In 2000, it increased the number of non-executive directors to two and the number of independent non-executive directors to three. Moreover, on 28 February 2000 it formed an Audit Committee consisting of five non-executive directors to enhance internal control. In its *2001 Interim Report* ZE specifically pointed out that the company operates in compliance with the Code of Best Practice of the Listing Rules (ZE 2001).

These changes brought ZE partway to meeting the stricter corporate governance standards of the London Stock Exchange. The LSE requires listed companies to state in their annual reports not only whether or not they have complied with the 1998 Combined Code on Corporate Governance throughout the accounting period, but also how they have applied the Code's principles of good governance (Salomon 2001).[5]

5. The NYSE does not require a non-U.S. company to modify its corporate governance policies to conform to those of U.S. companies, but it does always encourage foreign issuers to comply with U.S. corporate governance policies and audit committee requirements (NYSE 2002).

Insider Trading and Shareholder Protection

Listing in Hong Kong brought ZE under the jurisdiction of Hong Kong laws regarding securities trading and forced the company to adopt new practices in order to comply with these laws. For example, companies listing in Hong Kong must obey the Disclosure of Interests Ordinance (Chapter 396 Cap. 396 of the Laws of Hong Kong), which requires disclosure of beneficial interests of directors and chief executives in securities of a listed company and its associated companies as well as its substantial shareholders. A substantial shareholder is defined as one "who is holding over 10 percent of the voting share capital of a listed company". ZE's recent *Interim Report* (ZE 2001) included a listing of the interests of the chief executive, the directors, and the supervisors as well as their associates.

In addition, Hong Kong's Insider Dealing Ordinance (Chapter 395 Cap. 395 Laws of Hong Kong, HKSAR 1991-2002) indicates that a person who is connected with a listed company and is in possession of price-sensitive information not available to the general public should not be involved in the securities trading of that company or any affiliated company. So, because of its listing H shares, ZE had to seriously address the issue of insider trading by disclosing interests of the chief executive and directors to ensure that the company complied with the Laws of Hong Kong. Shareholder protection codes are even stricter in the UK and in the United States than in Hong Kong. For example, while insider trading is not a crime in Hong Kong it has been a criminal offence in the UK since 1980. Section 16 of the U.S. Securities Exchange Act 1934 discourages insider trading and requires insiders to file public reports of their stock ownership and trading activities in equity securities. Both civil remedies and criminal penalties can be used to enforce Section 16, although criminal action for a reporting violation is unlikely (Salomon 2001).

Information Disclosure and Transparency

Listing in Hong Kong also required ZE to adopt certain international standards of information disclosure and transparency. In preparation for listing on the SEHK, a company must present an accountant's report of its financial history and assets and liabilities that conforms with accounting standards approved by the Hong Kong Society of Accountants or with the International Accounting Standards (IAS) (SEHK, 1989-2002).[6] ZE appointed one of the top accountancy firms in Hong Kong, Ernst and Young Certified Public Accountants, as its auditor and reporting accountant (ZE 2000b and 2001). The SEHK also requires listed companies to release audited interim and year-end financial reports including the minimum financial information (i.e., balance sheet, income statement, and cash flow statement) described in Appendix 16 Disclosure of Financial Information of the Listing Rules (SEHK 1989-2002). Thus, after listing its H shares, ZE must continue to maintain its accounts and periodically disclose its financial information in a manner that meets the standards of the exchange.

According to the 2000 Reuters Survey of Global Emerging Markets, brokerage analysts ranked ZE second in transparency and quality of reporting and disclosure among listed issuers in Asian emerging markets (ZE 2000b). To list on other overseas exchanges, however, ZE must further improve information disclosure and transparency. The registration and periodic reporting requirements of the U.S. securities laws are regarded as the most stringent among major international markets. Companies signing the NYSE listing agreement are bound to notify the exchange of specific facts, such as any change in the general character or nature of their business, and any change of officers or directors that will materially affect the financial position of the company (Salomon 2001).

CONCLUSION

The financial sector in Hong Kong developed rapidly and it is now at an advanced level, comparable to that in developed economies. Corporate financing through the stock market is of primary importance while the debt markets are relatively underdeveloped, as in most developing economies. Bank finance has continued to be important because of its efficiency and prudent

6. According to SEHK (1989-2002), “an overseas issuer, which has a secondary listing on the Exchange, may prepare annual accounts drawn up in conformity with Generally Accepted Accounting Principles in the United States of America (US GAAP)”.

government supervision.

The Hong Kong stock market has expectedly played a vital role in the modernisation and internationalisation of financing of Chinese mainland enterprises. Hong Kong served Chinese enterprises in two ways. First, the Hong Kong stock market provided a venue for the Chinese enterprises to be listed and to have access to international capital. As of December 2000, there were 50 H-share and 45 red chip Chinese enterprises listed in the Hong Kong Stock Exchange. The amount of capital they have raised is tremendous and significant for the financing of China's economic development.

Second and even more important, preparation for listing in Hong Kong provided a practical learning experience in which Chinese enterprises acquired knowledge of modern corporate finance and how to comply with international regulatory standards and systems. The Hong Kong Securities and Futures Commission and Stock Exchange of Hong Kong played an instrumental role in the various aspects of this learning process for Chinese enterprises. The experience of Hong Kong and the cultural affinity make Hong Kong's contribution unique and irreplaceable. The preparation work for overseas listing (with the assistance of relevant Hong Kong organisations) was often so well done that listing was able to take place simultaneously in Hong Kong and in other capital markets such as New York and London, which have extremely stringent listing conditions.

Third, the cross-listing of these Chinese enterprises in domestic and overseas markets has had an impact on China's domestic capital markets. These overseas-listed Chinese enterprises have become drivers in the modernization and rationalization of the domestic-listed enterprises. Hong Kong's SFC and SEHK have consistently and continuously been providing advice and support to these Chinese enterprises.

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APPENDIX 1

CHINA-AFFILIATED CORPORATIONS (RED CHIPS) LISTED IN HONG KONG, IN DESCENDING ORDER OF MARKET CAPITALISATION, DECEMBER 2000

	Market Value (HK$ million)	Listing Date
Legend Holdings	36,625.01	14/2/1994
China Resources Enterprise	19,766.37	N.A.
COSCO Pacific	12,942.33	19/12/1994
Shanghai Industrial Holdings	12,749.56	30/5/1996
China Everbright	12,419.30	26/2/1973
China Merchants Holdings	11,582.63	15/7/1992
CITIC Ka Wah Bank	6,941.25	17/7/1980
China Overseas Land	5,490.87	20/8/1992
Beijing Enterprises	4,419.75	29/5/1997
China National Aviation	4,205.74	17/12/1997
Denway Motors	4,011.66	22/2/1993
China Travel	3,186.09	11/11/1992
ICBC (Asia)	3,020.84	14/3/1973
Founder Holdings	2,444.26	21/12/1995
China Resources Beijing Land	2,439.23	8/11/1996
CNPC (Hong Kong)	2,426.78	13/3/1973
Guangdong Investment	2,310.87	N.A.
Guangzhou Investment	2,283.17	15/12/1992
Shum Yip Investment	1,554.48	7/3/1997
China Aerospace Int'l	1,499.69	25/8/1981
Tianjin Development	1,263.68	10/12/1997
Top Glory Int'l Holdings	1,257.31	N.A.
Stone Electronic Technology	1,256.06	16/8/1993
GZI Transport	1,213.88	30/1/1997
COSCO Int'l	1,188.48	11/2/1992
China Foods Holdings	1,129.23	7/10/1988
Guangnan (Holdings)	1,010.92	9/12/1994
China Pharmaceutical	955.14	21/6/1994
Logic Int'l Holdings	950.56	7/11/1994
Continental Mariner		30/8/1973
Investment	921.11	
China Everbright Int'l	751.75	N.A.
China Everbright Technology	647.49	10/12/1991
Sinopec Kantons	611.73	25/6/1999
HK Construction	543.40	29/5/1987
Chu Kong Shipping	480.00	23/5/1997
Shougang Concord Int'l	436.05	30/4/1991
CASIL Telecom Holdings	353.60	11/8/1997
Oriental Metals (Holdings)	336.53	15/12/1994
Guangdong Brewery Holdings	331.25	8/8/1997
Poly Investments Holdings	302.31	6/4/1988
Zhu Kuan Development	279.65	26/5/1998
Min Xin Holdings	248.09	28/6/1982
Shougang Concord Technology	235.51	23/12/1988
ONFEM Holdings	204.63	20/12/1991
Shenyin Wanguo (HK)	176.58	N.A.
Total	169,404.86	

Source: HKEx 2001b and 2001a.

APPENDIX 2

CHINESE ENTERPRISES ON HONG KONG, NEW YORK, LONDON, AND SINGAPORE STOCK EXCHANGES, DECEMBER 2000

	Hong Kong Listing	Overseas Cross-listing	Market Value (US$ million)	Listing Date
Hong Kong (H shares) subtotal			**10,915.75**	
PetroChina Co	main board	with N shares	2,930.40	7/4/2000
Sinopec Corp	main board		2,667.66	19/10/2000
Huaneng Power Int'l	main board	with N shares	725.96	21/1/1998
Beijing Datang Power	main board	with L shares	371.42	21/3/1997
China Southern Airlines	main board	with N shares	357.52	31/7/1997
Beijing Capital Int'l Airport	main board		302.02	1/2/2000
Yizheng Chemical	main board		262.05	29/3/1994
China Eastern Airlines	main board	with N shares	247.09	5/2/1997
Yanzhou Coal Mining	main board	with N shares	234.29	1/4/1998
Sinopec Shanghai Petrochem	main board	with N shares	233.00	26/7/1993
Zhejiang Expressway	main board	with L shares	227.94	15/5/1997
Shandong Int'l Power Dev	main board		225.66	30/6/1999
China Shipping Dev	main board		196.06	11/11/1994
Jiangsu Expressway	main board		192.70	27/6/1997
Guangshen Railway	main board	with N shares	177.99	14/5/1996
Great Wall Technology	main board		148.38	5/8/1999
Qingling Motors	main board		123.42	17/8/1994
Jiangxi Copper	main board	with L shares	102.30	12/6/1997
Beijing Yanhua	main board	with N shares	101.20	25/6/1997
Sinopec Zhenhai Refining	main board		98.35	2/12/1994
Shenzhen Expressway	main board		92.00	12/3/1997
Maanshan Iron & Steel	main board		82.20	3/11/1993
Angang New Steel	main board		81.01	24/7/1997
Beijing Beida Jade Bird	GEM		77.00	27/7/2000
Guangdong Kelon Elect	main board		76.00	23/7/1996
Tsingtao Brewery	main board		72.48	15/7/1993
Beijing North Star	main board		70.70	14/5/1997
Shenyang Public Utility	main board		56.05	16/12/1999
NJ Panda Electronics	main board		53.36	2/5/1996
Sichuan Expressway	main board		52.80	7/10/1997
Jilin Chemical	main board	with N shares	50.71	23/5/1995
Anhui Expressway	main board		44.87	13/11/1996
Tianjin Bohai Chemical	main board		30.07	17/5/1994
Tong Ren Tang	GEM		29.86	31/10/2000
Anhui Conch Cement	main board		25.45	21/10/1997
Guangzhou Phar	main board		23.96	30/10/1997
Jingwei Textile	main board		23.17	2/2/1996
Harbin Power	main board		20.75	16/12/1994
Shanghai Fudan	GEM		20.27	3/8/2000
First Tractor	main board		19.75	23/6/1997

Chongqing Iron & Steel	main board		16.18	17/10/1997
Shandong Xinhua	main board		15.96	31/12/1996
Luoyang Glass	main board		15.70	8/7/1994
CATIC Shenzhen	main board		12.41	29/9/1997
Northeast Electrical	main board		10.91	6/7/1995
Chengdu PTIC	main board		9.84	13/12/1994
Beiren Printing	main board		9.61	6/8/1993
Guangzhou Shipyard	main board		9.18	6/8/1993
Kunming Machine Tool	main board		7.33	7/12/1993
Dongfang Electrical	main board		7.30	6/6/1994
New York (N shares) subtotal			**7,311.84**	
Petrochina Company Ltd.		with H shares	2,912.08	6/4/2000
China Petroleum & Chemical Co.		with L shares	2,559.02	18/10/2000
Huaneng Power International		with H shares	707.81	6/10/1994
China Southern Airlines Co Ltd.		with H shares	349.32	30/7/1997
China Eastern Airlines Co Ltd.		with H shares	237.98	4/2/1997
Sinopec Shanghai Petrochemical Co Ltd.		with H shares	224.26	26/7/1993
Guangshen Railway Co Ltd.		with H shares	173.55	13/5/1996
Beijing Yanhua Petrochemical Co Ltd.		with H shares	98.97	24/6/1997
Jilin Chemical Industrial Co Ltd.		with H shares	48.84	22/5/1995
Yanzhou Coal Mining Co Ltd.		with H shares	0.01	31/3/1998
London (L shares) sub-total			**3,411.36**	
China Petroleum & Chemical Co.		with N shares	2,642.92	18/10/2000
Beijing Datang Power Generation		with H shares	371.44	20/3/1997
Zhejiang Expressway Co.		with H shares	227.95	5/5/2000
Jiangxi Copper Co.		with H shares	169.03	12/6/1997
Zhejiang Southeast Electric Power [c]			0.02	23/9/1997
Singapore (S shares) sub-total			**125.96**	
China Merchants Shekou Holdings Co Ltd.			94.46	7/24/1995
Tianjin Zhong Xin Pharm Group Co Ltd.			31.50	6/27/1997
Grand total			**21,764.92**	

Notes: Huaneng Power International, Inc. was listed in New York in 1994 but it was only listed in both New York and Hong Kong from 1998. Zhejiang Expressway Co. was listed only in Hong Kong from 1997 but in both Hong Kong and London from 2000. Zhejiang Southeast Electric Power was listed in London in 1997.
Source: HKEx 2001b; NYSE 2001; LSE 2001; and SGX 2001.

CHAPTER 7
SINGAPORE AS A REGIONAL FINANCIAL CENTRE

Denis Hew

INTRODUCTION

A regional financial centre can be defined as a central location where there is a high concentration of financial institutions and capital markets that allow financial transactions in the region to take place efficiently. Singapore has been a remarkable success as a regional financial centre. In just over three decades, the city-state has become one of the world's leading financial centres. The Singapore government has been actively undertaking financial liberalisation and reforms since the 1960s. As a result of its endeavours, Singapore has become a leading financial centre serving the domestic economy as well as **neighbouring economies in Southeast Asia**. As a financial centre, Singapore has facilitated greater financial intermediation in the region, contributing to capital market development and cross-border trade and business investment.

Singapore was the economy in Southeast Asia least affected by the Asian financial crisis. Nevertheless, the crisis exposed Singapore's vulnerability to external shocks and financial contagion. Rather than become more inward looking (as did some crisis-affected countries), the Singapore government hastened financial liberalisation with the aim of creating a more resilient financial sector that could compete in an increasingly globalised environment. The liberalisation has involved strengthening domestic banks through consolidation and increasing foreign participation in the financial sector.

This chapter describes Singapore's development as a regional financial centre and the coming challenges. The next section describes in detail Singapore's financial sector development since the 1960s and the government's efforts to develop the capital markets. **The third section provides some background on central banking activities and regulatory framework in Singapore as well as recent developments in corporate governance and regulatory reform.** The fourth section reviews recent financial liberalisation measures enacted by the government, particularly the opening-up of the banking sector to foreign financial institutions. The next section discusses the challenges Singapore faces as a regional financial centre, including global financial restructuring and the emergence of new competitors. The chapter **concludes by evaluating** Singapore's prospects as a regional financial centre.

FINANCIAL SECTOR DEVELOPMENT

In the 1960s, Singapore chose a different route from many of its Southeast Asian neighbours by adopting an outward-looking financial development strategy, with the aim of transforming into a regional financial centre. Over the next 30 years, the Singapore government implemented financial sector reforms, opened new financial markets, and enacted regulatory and fiscal incentives to attract foreign financial institutions to Singapore. This strategy has proven to be very successful. The number of foreign financial institutions as well as offshore and non-banking financial institutions increased significantly during this period. Ariff and Khalid (2000) found that the number of institutions in the financial sector increased from less than 100 in the mid-1970s to almost 450 in the 1990s. In the banking sector, the increase in the number of competitors has forced local banks to upgrade their financial products and services as well as management expertise. Successful financial centres such as Singapore also attract highly skilled foreign workers as well as other services such as accountancy, law, management consultancy, and information technology.

As of March 2003, Singapore's financial sector had 117 commercial banks (5 local and 112 foreign), 164 Asian Currency Units, 5 finance companies, 53 merchant banks, 143 insurance companies, 57 insurance brokers, 51 bank representative offices, 59 stockbroking companies, 90 fund management companies, and 8 international money brokers.

ACUs, DBUs and the Asian Dollar Market

Singapore's banking system is unique as it consists of two types of financial institutions–commercial banks**, or Domestic Banking Units (DBUs),** and Asian Currency Units (ACUs). Only commercial banks can undertake transactions in Singapore dollars, while ACUs, which can deal in any currency except the Singapore dollar, are involved in international financial transactions. This two-tier banking sector was designed in the early 1970s to partition domestic and international banking activities. The main rationale was to promote Singapore as a base for international financial activities, while at the same time protecting domestic banks from larger and more sophisticated foreign financial institutions.

DBUs deal mainly with deposits and loans denominated in Singapore dollars and are subject to stricter liquidity and reserve requirements and higher tax rates than ACUs. DBUs must hold a minimum cash balance of 3 percent of their liabilities with the Monetary Authority of Singapore (MAS) and hold 18 percent of their liabilities in liquid assets (**at least 10 percent of which** must be in the form of Singapore government debt securities). Over the twenty years from 1971 to 1990, assets of DBUs grew at an average annual rate of 19 percent, in tandem with the economy's growth during this period (Figure 7.1).

Bank of America set up the first ACU in Singapore in 1968 to accept deposits in U.S. dollars and other major foreign currencies from non-residents. The withholding tax on interest paid on such deposits was **waived**. ACUs **were licensed** to deal in the Asian Dollar Market, which is essentially an international money and capital market dealing in foreign currencies.[1] Singapore was the first economy in the region to allow foreign banks to operate off-shore banking units such as ACUs, and the success of the Asian Dollar Market has undoubtedly contributed to Singapore's becoming a regional, if not international, financial centre.

Although ACUs are subject to Singapore banking laws and regulation, they are exempted from several provisions of the Banking Act in order to attract foreign financial institutions. For example, they are not subject to reserve requirements or minimum liquidity ratios, and the concessionary tax rate on transactions with non-residents and approved foreign institutions **is just** 10 percent. Although an ACU is an integral part of a bank, it maintains separate accounting records for its financial transactions to ensure that they do not disrupt domestic monetary

1 It was called the Asian Dollar Market because most transactions were denominated in U.S. dollars.

management.

ACUs grew spectacularly, **both in numbers and in assets,** since their inception. ACU assets grew at a rate of 22 percent per annum during the 1980s, but the rate of growth slowed to about 3.7 percent per annum in the 1990s. By 1993, ACUs accounted for 66.2 percent of all the assets of Singapore's **banks**, **a vast increase over the 0.1 perce**nt of bank assets accounted for by the first ACU (Bank of America) in its initial year of operation **(Figure 7.2)**. **The growth of international financial operations outpaced expansion of the domestic banking sector.** ACU assets climbed from 28 percent of DBU assets in 1970 to a peak of 596 percent in 1987 before declining to 239 percent in 2001. ACU assets reached 11 times Singapore's GDP in 1987, and total ACU assets were 5 to 10 times GDP throughout the 1990s .

The success of the Asian Dollar Market—which made Singapore the fourth largest foreign exchange market after London, New York, and Tokyo—globalised Singapore's financial sector and contributed in transforming the city-state into a leading financial centre. The Asian Dollar Market grew rapidly during the 1970s and 1980s as it provided a channel for investing savings from the United States, Europe, and Japan in the expanding economies of East Asia. In addition, Singapore's geographic location and time zone allow dealers to engage in foreign exchange transactions with financial centres around the globe 24-hours a day. The Asian Dollar Market also attracted multinational corporations to set-up regional treasury and financing operations in Singapore. These currently number about 5,000.

Bank Consolidation

Since 1998, when Development Bank of Singapore (DBS) acquired the Post Office Savings Bank (POSB) and Keppel Bank merged with Tat Lee Bank, the Singapore government has been encouraging domestic banks to consolidate to prepare them for stiffer competition from foreign banks. In fact, for Singaporean banks to compete successfully in the new era of globalisation, the government would like to see them eventually merge into two "super banks".

Merger and acquisition activity among Singaporean banks increased during 2001:

- In April 2001 DBS acquired Hong Kong's fourth largest bank, Dao Heng Bank, for US$5.7 billion as part of its regional expansion plans.

- On 12 June 2001, Singapore's third largest bank, Overseas-Chinese Banking Corporation (OCBC) announced a S$4.8 billion bid (voluntary general offer) for Keppel Capital Holdings (KCH), which owns Singapore's smallest Bank, Keppel TatLee Bank.
- Two weeks later, on 22 June 2001, DBS Holdings Group (which owns Singapore's largest bank, DBS) made an unsolicited bid of S$9.4 billion for Overseas Union Bank (OUB), the fourth largest bank.
- On 29 June 2001, second largest United Overseas Bank (UOB) made a competing bid for OUB, consisting of a cash and stock offer. UOB's bid succeeded in August 2001 and the merger will form Singapore's largest bank in terms of assets.

Despite this merger activity, Singaporean banks are still relatively small compared to foreign banks such as Citibank and Hong Kong Shanghai Banking Corporation (HSBC), which are global players in the banking business **(Table 7.1)**. Moreover, with limited growth prospects in the small domestic market, Singaporean banks need to expand activity in the region. For example, DBS's acquisition of Hong Kong's Dao Heng Bank reflects its ambition to become a regional player. To date, Singapore's regional expansion in banking has had some limited success. Tschoegl (2002) found that overseas assets represented about 22 percent of the total assets of Singapore's top four banks (DBS, OCBC, OUB, and UOB) in 1999 (**Table 7.2**).

Singapore Exchange

The Stock Exchange of Singapore (SES) was incorporated in 1973, after the Stock Exchange of Malaysia and Singapore (SEMS) was split into two separate exchanges. Since then, the SES has become one of East Asia's largest and most developed stock exchanges. In December 1999 the SES merged with the Singapore International Monetary Exchange (SIMEX) to form the Singapore Exchange (SGX). Under the new arrangement, the SES and SIMEX were integrated into a single, privately held stock company, which was officially listed on 23 November 2000.

Market capitalisation of the Singapore equity market increased significantly when secondary foreign listing was allowed in the 1980s **(Figure 7.3)**. Since 1987 the SES increased foreign participation by liberalising foreign ownership restrictions on member firms and relaxing listing requirements for foreign companies. The SES also introduced international memberships, which allow members to trade freely in SES-quoted securities with non-residents. In 2001 foreign companies contributed about one-third of total market capitalisation in the SGX

Securities Trading Mainboard.

The authorities set up the Stock Exchange of Singapore Dealing and Automated Quotation (SESDAQ) in 1987 to enable smaller companies, particularly high-technology companies, with a shorter track record of profits to tap the stock market for capital. Market capitalisation of SESDAQ rose from S$235 million at end-1987 to S$6.1 billion in 2003 (Figure 7.4).

The securities trading division of SGX, which includes both the Mainboard and SESDAQ, recorded initial public offering (IPO) listings of 55 companies that raised S$1.7 billion in 2003. Including the 55 IPOs, the Singapore stock exchange listed a total of 431 companies on the Mainboard and 138 companies on SESDAQ with a total market capitalisation of S$390 billion.

Brokerage commissions were fully liberalised in October 2000, giving the SGX a more diversified shareholding structure. Commission rates have fallen to an average of 0.4 to 0.5 percent for retail dealers and 0.2 percent for institutional dealers. Meanwhile, trading and settlement systems are being improved to match international best practices. For example, the SGX reduced the settlement period from trade-day-plus-five market days (T+5) to T+3 in March 2000. The SGX also plans to implement straight-through processing of stock trades by the end of 2002.

In June 2000, SGX entered a joint venture with the American Stock Exchange (AMEX) to trade and list AMEX-listed exchange traded funds (ETFs) and structured products. In May 2001, five AMEX-listed ETFs were listed on the SGX-Securities Trading (SGX-ST) trading board. In December 2001, SGX and the Australian Stock Exchange (ASX) launched the world's first co-trading linkage for securities which allowed for 50 SGX stocks and 51 ASX stocks to be traded across this linkage.

The formation of the Singapore Exchange (SGX) **was intended to exploit the** synergies between the securities and derivative business and to increase the financial capability to undertake heavy capital investments and financial innovation. **De-mutualisation made the market more vibrant by including non-brokers and shareholders.** The merger between SES and SIMEX as well as strategic alliances with foreign stock exchanges should attract global investors by opening access to international brokers and other market players. It will also mean lower transaction costs, through greater competition and provide more efficient and flexible funding from the capital markets. The Singapore government envisages that these measures will contribute to elevating Singapore to the status of international financial centre—the ultimate goal of its financial development strategy.

Singapore's Derivatives Exchange

The government launched the Singapore International Monetary Exchange (SIMEX) in 1984. **Now called SGX-DT (Singapore Exchange Derivatives Trading Limited) since the 1999 merger with SES, the exchange** has become one of Asia's largest derivatives exchanges trading the widest range of Asian derivatives in the world and the widest range of international derivatives in the Asia Pacific region. The exchange trades seventeen instruments in all comprising interest rate futures (especially Eurodollar futures); currency futures; stock index futures; and commodity futures (such as Brent Crude Petroleum futures).

The derivatives exchange operates with an open outcry system, which ensures that prices of futures contracts respond sensitively to relevant new information, and an Electronic Trading System that complements the open outcry system. Both systems provide extended trading hours that span different time zones, increasing investment opportunities and flexibility.

The Singapore derivatives exchange started off with its doors wide open to foreign participation. In fact, **now** most futures companies, corporate clearing members, and non-members are foreign-owned. Furthermore, customers from outside Singapore originate a significant proportion of the trades transacted on the derivatives exchange.

Financial derivatives trading volume in Singapore grew from about half a million contracts in 1985 to 35.6 billion in 2003 (**Figure 7.5**). Over the past decade, **Singapore's derivatives exchange** has built a reputation as a successful regional risk management centre for investors.

Bond Market

The development of bond markets has become a key priority in many crisis-affected countries in the region since the Asian financial crisis. Debt securities are increasingly seen as an alternative source of capital that may help businesses reduce their over-dependence on commercial bank intermediated financing and avoid resorting to short-term capital to finance long-term development projects.

In Singapore, domestic private companies and government/statutory organisations have been tapping the domestic bond market more and more to fund development projects. In recent years, the Singapore government has been actively promoting the city-state as a regional hub for arranging and trading debt securities. Key initiatives taken by the government to deepen and broaden the domestic bond market include:

- The September 2001 announcement of plans to issue a 15-year bond to extend the benchmark yield curve beyond the current 10-year maturity. The first 10-year Government bond issue was successfully auctioned in July 1998.
- Announcement in May 2000 that the size of benchmark issues would be raised from S$1.5 billion to at least S$2 to 2.5 billion to create more liquid and substantial benchmark issues
- The MAS Notice no. 757 revision in December 2000 making it easier for foreigners to issue Singapore dollar bonds, subject to certain financial safeguards. In particular, banks can now lend any amount to non-residents provided the proceeds are for investment purposes in Singapore assets (financial assets and real assets).
- Enactment of a number of attractive tax incentives since 1998 to boost the bond market. For example, until February 2003, primary dealers are exempted from paying tax on profits generated from trading in the Singapore bond market. Meanwhile, financial institutions in Singapore that are involved in the arrangement, underwriting, and distribution of Qualifying Debt Securities (QDS) are exempted from paying tax on their fee income.[2]
- SGX's launching a 5-Year Singapore Government Bond Futures contract on 29 June 2001 to complement the 3-Month Singapore Dollar Interest Rate Futures **contract** and provide investors with risk management tools to cover the short- and medium-end of the benchmark yield curve.
- The re-opening of an existing 5-year bond issue as a new 2-year benchmark in November 2000 to decrease the number of illiquid off-the-run issues and re-channel them into larger and more liquid benchmark bonds.

The Singapore bond market appears to be attaining the liquidity required to achieve critical mass. From 1999 to 2003, the amount of corporate debt issuance increased by almost 245 percent from S$19.5 billion to S$67.2 billion (**Figure 7.6**). Outstanding debt in 2003 stood at S$49.5 billion, which represents 31.1 percent of GDP. Moreover, the inclusion of SGS in the JP Morgan Government Bond Index Global Broad index November 2000 will likely give the

2 According to MAS, QDS are basically debt securities that are substantially arranged by financial institutions in Singapore.

Singapore bond market an additional boost.[3]

Fund Management Industry

Over the past ten years, the Government has been increasingly focussed on making Singapore a leading international fund management centre. The domestic fund management industry has seen assets under management ballooned to **S$465** billion in **2003**, more than a thirty-eight-fold increase compared to S$11.8 billion in 1989 (**Figure 7.7**). The number of fund management companies increased from 191 in 1999 to 230 in 2003. However, Singapore still lags significantly behind Hong Kong, which is the largest fund management centre within Asia (excluding Japan).[4]**.** Nevertheless, Singapore's high savings rate (over 40 per cent of GDP) and the opportunity to manage funds from the country's extensive national pension scheme (i.e. The Central Provident Fund) have attracted many global fund managers to set-up shop in Singapore.

There has also been growing calls to use Singapore's huge foreign reserves to help boost the domestic fund management industry. With that in mind, the Government of Singapore Investment Corporation (GIC) and MAS announced in February 1998 that they would place out S$25 billion and S$10 billion respectively to external fund managers within three to five years. At end-2001 GIC had placed out S$21 billion of the S$25 billion to external fund managers.[5] GIC has given 54 fund managers (including five boutique fund management firms) a total of 144 mandates. In 2000, MAS reached the final stage of its funds outplacement exercise and has selected most of the external fund managers for the fund.

The government also liberalised the CPF Investment Scheme (CPFIS) over the past

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3 The J.P. Morgan Government Bond Indices are tools for measuring performance and quantifying risk across international fixed income markets. The Government Bond Index Global Broad includes government bonds from G-7 countries, Spain, Netherlands, Belgium, Denmark, Sweden, Australia, Finland, Ireland, New Zealand, Portugal, South Africa, Switzerland, Austria, and Singapore.

4 According to the Hong Kong Investment Fund Association, there were 1,872 authorised funds in Hong Kong, with total net asset value of US$534.4 billion (as at 31 March 2004).

5 The GIC manages Singapore's huge foreign reserves (estimated to be above US$100 billion) and has over 200 investment managers.

couple of years. CPF members were allowed to invest all their Special Account and Ordinary Account balances in approved retirement-related financial instruments. This consequently freed up a substantial amount of CPF funds, raising the funds available for investment to S$41 billion. Since September 1998, revised investment guidelines have provided CPF members access to a wider pool of fund managers and unit trusts, as well as better information on investment risk and fund performance. To enhance the returns from CPF savings, the Government has also raised the investment limit of professional managed financial products to 100 per cent from the current 80 percent in September 1999. As at end-2001, 155 out of a total of 319 unit trusts in Singapore are under the CPFIS.

In the Economic Review Committee Report entitled, “Positioning Singapore as a Pre-eminent Financial Centre in Asia” (September 2002), the committee recommended the following policy recommendations to develop Singapore’s fund managements industry:

- Develop start-ups and small and medium sized fund managers
- Extend fund management mandates (i.e. other than Asia ex-Japan) granted by GIC and MAS
- Provide funds to attract private equity players such as venture capitalists
- Grant tax exemptions to: domestic source investment income and foreign source remitted to Singapore; and management fee income earned by fund mangers from managing funds sourced overseas.

REGULATION AND GOVERNANCE OF FINANCIAL INSTITUTIONS

Central Banking and Regulatory Framework

The Monetary Authority of Singapore (MAS) was established as a statutory board in 1971 by virtue of the Monetary Authority of Singapore Act. MAS functions as the de facto central bank for Singapore. It is responsible for the formulation and implementation of monetary policies and supervises and regulates the activities of commercial banks, finance companies, insurance companies, stock and future exchanges. It acts as banker and financial agent to the Singapore Government, and hence, serves as the lender of last resort to the banking system.

The issue and redemption of currency notes and coins, which is not entrusted to MAS, is the responsibility of the Board of Commissioners of Currency of Singapore (BCCS). Under the currency board system, the BCCS stands ready to exchange domestic currency for the foreign reserve currency at a specified fixed rate. The currency must be backed at least 100 percent. The Singapore government has announced that BCCS will be merged with MAS by March 2003 in order to improve organisational efficiency by streamlining overlapping functions. But the currency board system under the Currency Act will remain intact and there will be no change in the issuance of currency.

The ultra conservative approach adopted by MAS sets Singapore clearly apart from other financial regulators in the region. MAS has given top priority to maintaining the soundness and resilience of Singapore's financial system as well as the protection of depositors' and investors' interests. Moreover, MAS has endeavoured to minimise risks, banking failures, and financial scandals so as not to undermine Singapore's credibility as a regional financial centre.

The regulatory framework consists of a set of laws including the Banking Act, the Finance Companies Act, the Insurance Act, the Securities Industry Act, the Futures Trading Act, the Development Loan Act, and the Local Treasury Bill Act. MAS has some regulatory role under each of these laws. For example, the Banking Act (enacted in 1970 and revised in 1993) called for all Singapore-incorporated banks to maintain the minimum capital adequacy ratio (CAR) recommended by the Bank of International Settlements (BIS), which is 8 percent. This has led to a financially sound banking sector where most domestic banks maintain minimum CAR of 12 percent.

Since the listing of SGX in November 2000, the regulatory relationship between MAS and SGX has become more clearly defined. MAS will administer statutory laws regulating the capital markets and have oversight of SGX's regulatory functions. Meanwhile, SGX will retain the frontline responsibility of regulating market participants and ensuring compliance.

MAS's stringent system of prudential regulation and supervision certainly prevented a banking crisis from breaking out in Singapore as it did in neighbouring Southeast Asian countries during the Asian financial crisis of 1997. MAS's strict regulatory approach can become a double-edge sword, however. Because it makes the financial sector appear inflexible and over-regulated compared to its more laissez faire rival, Hong Kong, it could possibly impede Singapore's development as a regional financial centre in the current global environment, which is both dynamic and unpredictable.

Corporate Governance

The Ministry of Finance, MAS and the Attorney-General's Chambers established the Corporate Regulation and Governance Policy Committee in December 1999. Three private sector-led committees under its wing were responsible to review the corporate regulatory framework, disclosure standards, and corporate governance.

In March 2001 the first review committee, the corporate governance committee, issued a Code of Corporate Governance that sets out recommended principles and practices for listed companies in Singapore. The second review committee, the Disclosure and Accounting Standards Committee, completed a draft report reviewing the processes by which accounting standards are set, maintained, and regulated in Singapore. This draft report is currently posted on the Internet to solicit public comments. The third review committee, the Company Legislation and Regulatory Framework Committee, which was given the mandate to recommend revisions to the Companies Act, have organised a public consultation.

Over the past few years, there has been significant improvement in bank disclosure and corporate governance practices. In the May 1998 report by the Committee on Banking Disclosure, banks are required to disclose details relating to principal sources of income, loan-loss provisions, and off-balance sheet items. They are also required to provide information regarding their non-performing loans as well as the market value of their investments and properties. In order to strengthen corporate governance in the banking sector, all local banks are required to appoint a five-member Nominating Committee within their board and key management positions. Under the Banking Act, MAS will retain its powers to approve appointments. It will also extend the vetting process to re-appointments in order to ensure that candidates who were appointed some time ago continue to meet the criteria for re-appointment.

In February 2003, MAS came out with a consultative paper on proposed guidelines and regulations to enhance the corporate governance framework for locally incorporated banks and direct insurers. The consultative paper provides a set of principles of corporate governance and the proposed guidelines build on the existing Code of Corporate Governance. In essence, the consultative paper clearly defines what is meant by an independent director and sets out the requirements for the composition of the board of directors and board committees. The proposed regulations also require the clear separation of the roles of Chairman and Chief Operating Officer and outline the application of this rule. MAS is currently seeking public feedback and comments on the consultative paper.

Regulatory Reforms

Recognising the concerns about over-regulation, MAS has shifted progressively from "one-size-fits-all" regulation to a risk-focused supervisory approach. As such, MAS is moving away from relying on extensive regulation as a means to protect investors and customers. Consequently, this new role will promote adequate disclosure and greater transparency in the market. Better disclosure and market scrutiny will sharpen the competitive edge of financial institutions by putting pressure on them to operate efficiently. The new approach will entail monitoring and examining institutions for compliance with guidelines and assessing the adequacy of internal controls and risk management systems.

Furthermore, the focus of supervision is on systemic risk rather than the risks of individual institutions or transactions. MAS is developing internal rating systems for financial institutions, which will allow Singapore to move towards performance-based regulation by giving greater leeway to stronger and better managed financial institutions.

MAS is also considering instituting financial safeguards in an increasingly liberalised financial environment. In particular, a proposed deposit insurance scheme to protect Singaporean depositors during periods of financial crisis. In August 2002, MAS released a consultative paper on the proposed features of a deposit insurance scheme in Singapore. The deposit insurance scheme will cover all Singapore dollar deposits held by individuals up to a limit of S$20,000 and will be backed by a fund targeted to reach 0.3 per cent of insured deposits (or an estimated S$120 million). This fund will be built up over a span of ten years, based on premium contributions from banks and finance companies that offer retail deposit facilities.

Another important financial safeguard that MAS is considering is the requirement that foreign banks with a large retail presence have to subsidiaries their operations in Singapore. Subsidiarisation would involve foreign banks having to incorporate in Singapore and meet MAS' minimum paid-up capital requirement of S$1.5 billion and capital adequacy ratio requirements (8 per cent Tier I capital and 12 per cent Tier 1 and Tier II capital). This would also allow for better supervision of the subsidiary and greater flexibility in containing any potential financial contagion arising from problems in the foreign bank's home market or global operations.

RECENT FINANCIAL LIBERALISATION MEASURES

On 17 May 1999, MAS introduced a five-year programme to liberalise Singapore's banking sector and expedite the development of local banks. The main objective of this programme is to create a stronger and more competitive banking environment in the face of globalisation trends and rapid developments in electronic delivery channels. It also means that the previously coddled local banking sector will face intense competition from foreign banks, which will have greater access to the domestic market.

The liberalisation programme regarding foreign banks has two key elements: granting foreign banks new licences and more access to the domestic market and lifting foreign ownership restrictions on local banks. **In the first phase,** MAS plans **to introduce** a new category of full banking licence known as a Qualifying Full Bank (QFB) **and to issue QFB licenses** to up to six foreign banks by 2001. Each QFB will be allowed additional branches, off-premise automatic teller machines (ATMs), and ATM-sharing privileges. It had already issued QFB licenses had already been issued to four foreign banks, namely ABN Amro Bank, Banque Nationale de Paris, Citibank, and Standard Chartered Bank by the end of 2000 (see **Table 7.3**).

MAS has renamed the Restricted Bank licence to the Wholesale Banking licence to better reflect the wide range of financial activities that they are now undertaking. This would include increasing their lending limits and reducing restrictions on Singapore dollar swaps Unlike a QFB, a Restricted Bank can have only one branch and is not allowed to accept Singapore dollar savings accounts or fixed deposits of less than $250,000 from non-bank customers. Fifteen banks were awarded wholesale banking licences in December 2001 and an additional five licences were made available in 2002.

The 40-percent aggregate foreign shareholding limits imposed on local banks were lifted in July 1999 and local banks are allowed to merge their local and foreign share tranches. The elimination of the 40-percent limit was intended to increase the liquidity of local banks' shares, which would make it easier for them to forge strategic partnerships with foreign banks. In turn, this would mean foreign banks could potentially own significant stakes in local banks (although the authorities are unlikely to allow a foreign take-over of a local bank, for the time being). **An individual shareholder still requires approval before increasing domestic bank holdings above the 5-percent and 20-percent level, as well as a new intermediate 12 percent shareholding threshold**.

On 29 June 2001, MAS announced the second phase of financial liberalisation.[6] Compared to the 1999 package of financial reforms, the second package of measures represents a more substantial opening up of the financial sector to foreign banks which will intensify competition in the hitherto protected domestic wholesale and retail markets. Furthermore, the latest version of MAS Notice No. 757 (issued in December 2000) has removed most obstacles against non-residents accessing Singapore dollar credit facilities for economic and financial activities in Singapore, including to undertake trading activities in Singapore dollars. This sets the stage for deeper and broader capital markets—expediting the government's plans to transform Singapore into an international financial centre.

Foreign participation in the domestic wholesale market will broaden. MAS will move away from the multi-tiered licensing regime of Full, Restricted, and Offshore Banks towards a licensing agreement that differentiates between retail and wholesale banks. The existing Restricted Bank licence will be renamed the "Wholesale Banking" licence and Qualifying

6 "Consolidation and Liberalisation: Building World-Class Banks", speech by DPM Lee Hsien Loong, Chairman of MAS, at the Association of Banks Annual Dinner, 29 June 2001.

Offshore Bank (QOB) and Offshore Bank (OB) licences will be phased out. Meanwhile, existing QOBs and OBs will be upgraded to Wholesale Bank status. This upgrading will allow these foreign banks to accept Singapore dollar fixed deposits above S$250,000 and operate Singapore dollar current accounts. MAS plans to grant twenty Wholesale Banking licences over the next two years.

In December 2001, MAS awarded the remaining two QFBs to Malaysia's Maybank and HSBC. Moreover, MAS plans to the allow QFBs to:

- establish up to 15 locations of which up to 10 (previously 5) can operate as branches with the rest off-site ATMs.
- provide debit services on an electronic point of sale payment service network (such as the Network for Electronic Transfers (S) Pte. Ltd. (NETS), Visa, or Mastercard), from 1 July 2002. Issuing debit cards that can access such a network will enhance QFBs' delivery capabilities in the retail market.
- offer Supplementary Scheme accounts, accept CPF fixed deposits, and offer agent bank accounts under CPF Investment and Minimum Sum Schemes, also from 1 July 2002.

The liberalisation of the ATM network presents a challenge to local banks as it broadens the scope for foreign bank expansion in the retail market. If all six QFBs **join in** a network, they will have ATMs in 90 locations around Singapore. Even more challenging for local banks is the possibility that MAS will grant more QFBs licenses and that these foreign banks might eventually gain access to the extensive ATM networks of local banks (just over 1,700 ATMs).

FUTURE CHALLENGES FACING SINGAPORE'S FINANCIAL CENTRE

According to Tan and Chen (1999), a successful financial centre should have a politically stable environment with an effective government, strong economic fundamentals, state-of-the-art physical and financial infrastructure, good geographic and time zone location, internationally recognised accounting standards and regulatory laws, and a skilled labour force with high levels of English proficiency. Singapore clearly meets most if not all of these requirements for success. Besides being a politically stable country with little corruption, Singapore's key strengths as a regional financial centre include its:

- Highly successful and sophisticated offshore market. It is also an important centre for loan syndication (i.e., syndicated offshore loans arranged in Singapore).

- Active and liquid foreign exchange market, which is the fourth largest in the world.
- Well-regarded and pro-active financial regulator.
- Financially sound and resilient banking sector.
- Well-developed infrastructure including state-of-the-art information and communication technology (ICT) infrastructure, an established legal and accounting framework, high corporate governance and compliance standards, and professional management.
- The first integrated stock and derivatives exchange in Asia, SGX, which offers such advantages **over local exchanges** as greater access for global investors, lower transaction costs, more efficient and flexible funding from capital markets.
- Highly developed and vibrant derivatives market which has made it a major risk management centre.
- Multi-lingual population, proficient in English, Mandarin, Bahasa Melayu, and Tamil, making it an ideal financial services hub for East Asia and the Indian sub-continent.

Singapore's financial centre will face numerous challenges in the coming decade, however. While Singapore is strong in international banking and foreign exchange, its bond and fund management industries remain relatively underdeveloped. Singapore will also face rising competition from neighbouring countries as they liberalise and develop their own financial sectors. For example, Malaysia is actively carving out a niche as an international centre for Islamic banking and finance. Advances in technology may make Singapore's advantages, such as a developed infrastructure and a favourable time zone, less essential requirements for a major financial centre.

Trends in global finance raise other concerns about Singapore's future role as a financial centre. IMF (2000) found that financial restructuring in Europe in the 1980s, which spread to East Asia since the 1997 crisis, may result in the consolidation of financial activity into fewer centres. This may make it harder for Singapore to find and sustain a niche as a financial centre. For example, SGX is already facing stiff competition for global funds from consolidated stock exchanges such as the Euronext, which is a merger between the Paris, Amsterdam, and Brussels bourses. Also, global consolidation of fund management companies and the rising trend for new offices to be set-up in Northeast Asia may affect Singapore's efforts in developing its domestic fund management industry.

Singapore is situated in a region of increasing economical and political uncertainty since the 1997 financial crisis. Certainly, the 11 September terrorist attacks on the United States and the Bali bombing incident in October 2002 have raised the risk premium in terms of foreign investments into the region.

Singapore's rival, Hong Kong, is next door to economically powerful China. Rapid economic growth and rising foreign direct investment in China in recent years will benefit Hong Kong's financial centre possibly at the expense of Singapore. China's growing appetite for capital to finance its development will certainly lead to greater demand for Hong Kong's financial services, giving the latter a vital boost as a regional financial centre. Furthermore, the Chinese government has been aggressively investing and promoting Shanghai as a future financial centre. The Hong-Kong-Shanghai combination could potentially be a formidable competitor to Singapore.

CONCLUSION

In the new millennium, Singapore's role as a regional financial centre faces challenges from global financial trends and new competitors such as China and Singapore will need to re-position itself within this new environment. With world-class infrastructure, institutions, and capital markets, Singapore is well placed to be the financial centre for an integrated ASEAN market. With a total population of more than 500 million, ASEAN is a potentially lucrative market for trade and investment, which could generate substantial demand for capital and financial services. The recent ASEAN initiative to form an ASEAN Economic Community could pave the way for such an integrated market within the region[7] At the ASEAN Summit meeting in Cambodia in November 2002, ASEAN leaders have agreed to explore the possibility of forming an ASEAN Economic Community. Although, the concept of such as economic community was not elaborated on during the Summit, this would undoubtedly involve deeper

7 At the Ninth ASEAN Summit in Bali in October 2003, ASEAN leaders have agreed to establish an ASEAN Economic Community (AEC) by 2020. It is envisaged that the AEC will be a single market and production base with free flow of goods, services, investments, capital and skilled labour.

economic integration within the ASEAN region.

Singapore is strengthening its position as a regional capital centre for Southeast Asia through recent financial liberalisation measures that allow equity listing and bond issues in Singapore dollars for non-residents. Singapore could mobilise funds from its equity and bond markets for Southeast Asian countries as they revitalise their economies. In particular, Singapore's bond market could potentially become an important supplier of capital to Southeast Asia as well as the expanding economies of China and India. Singapore is also building a niche as a private banking centre, attracting capital from high net worth individuals across Asia.

Singapore will also need to leverage on China's expanding economy by positioning itself within its slipstream. Besides Hong Kong, the spillover effects of China's growing need for funds could be sourced from Singapore. Hence, the Singapore government should continue to forge a close economic relationship with China. The China-ASEAN free trade agreement (FTA) which is expected to be realised by 2010 will undoubtedly benefit Singapore.[8] Moreover, there are still untapped opportunities outside Asia. For example, the adoption of the euro currency by the European Union will create new business opportunities that could consolidate Singapore's position as a premier foreign exchange centre.

At the same time, Singapore should continue financial liberalisation, which has so far been a gradual and cautious "big bang". Financial restructuring, strategic alliances, heavy investments in ICT, and skilled human resources will be crucial to keep Singapore competitive in this globalised financial environment. In short, Singapore needs to continue to plan, invest, and anticipate changes to stay ahead as a regional financial centre.

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8 ASEAN signed a framework agreement on comprehensive economic co-operation with China on 4 November 2002. This agreement would pave the way towards realising an FTA with China for the ASEAN-6 member countries (i.e. Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand) by 2010 and for the newer member countries (i.e. Cambodia, Laos, Myanmar and Vietnam) by 2015.

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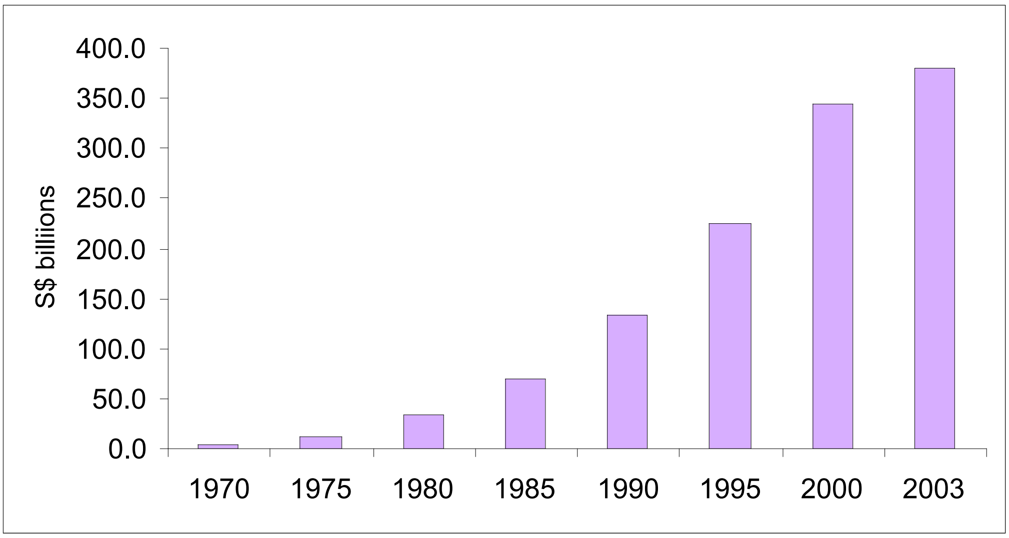
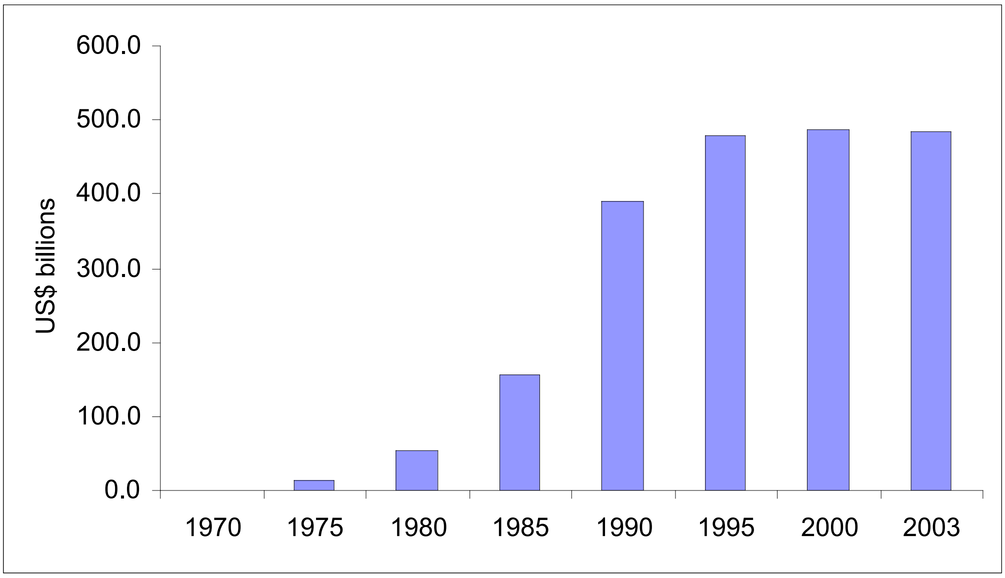
FIGURE 7.1
Total Assets of DCUs (Commercial Banks), 1970-2003



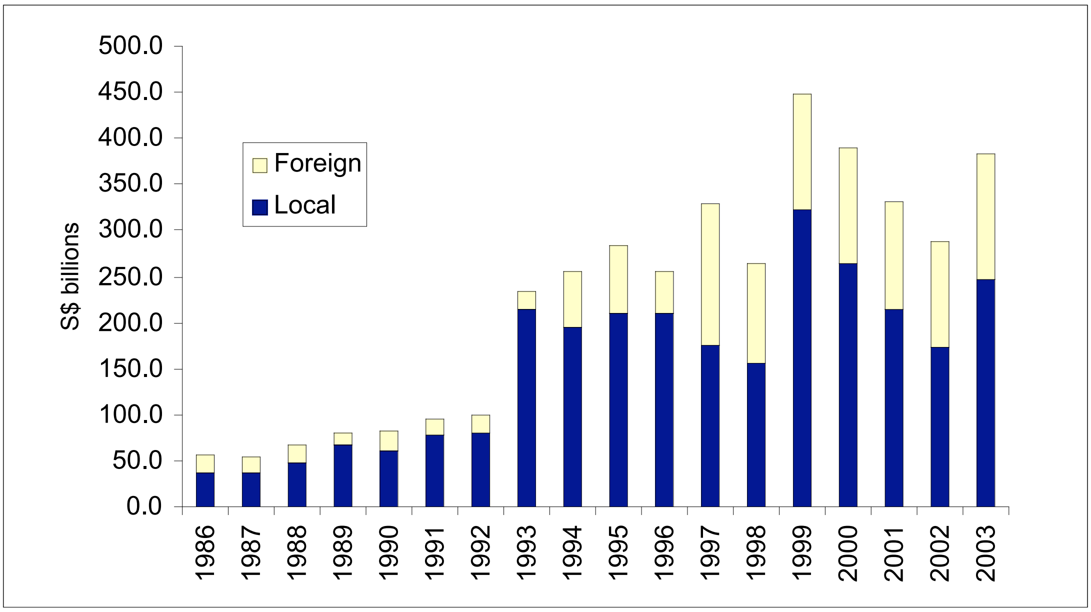
Source: Monetary Authority of Singapore.

FIGURE 7.2
Total Assets of DCUs, 1970-2003



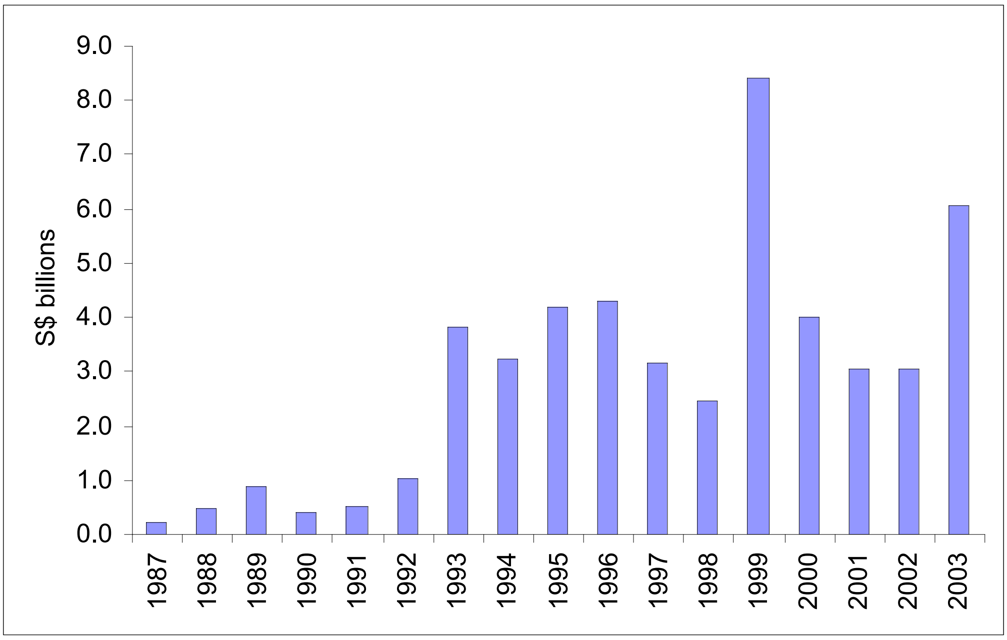
Source: Monetary Authority of Singapore.

FIGURE 7.3
Market Capitalisation of Singapore Equity Market
1986-2003



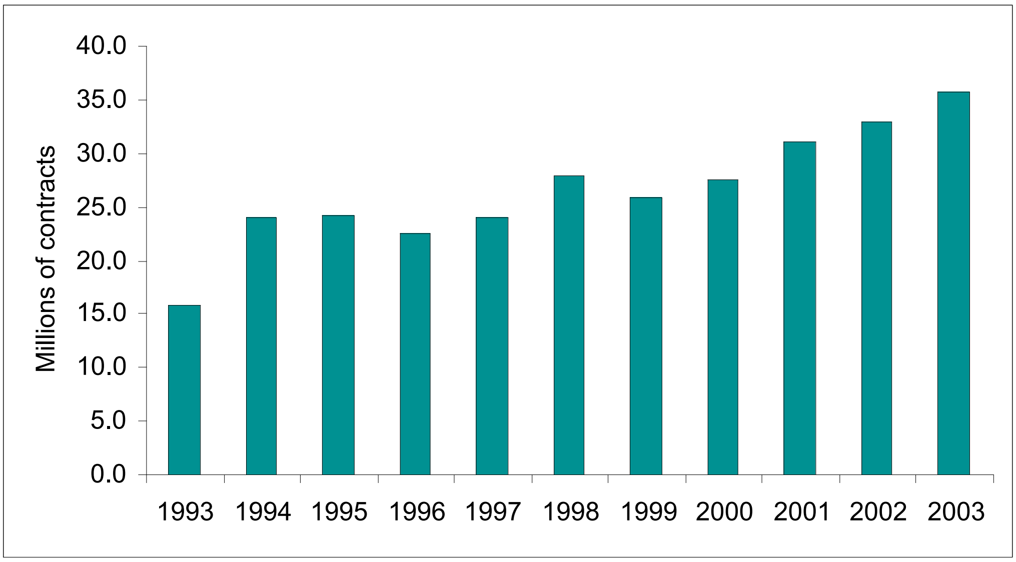
Source: CEIC Data.

FIGURE 7.4
Market Capitalisation of SESDAQ
1987-2003



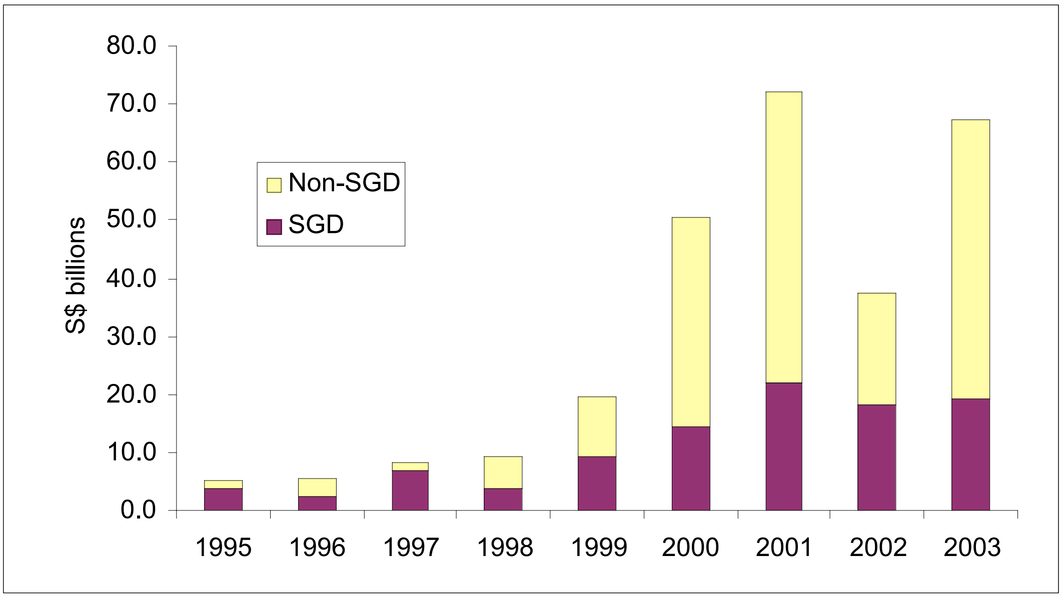
Source: CEIC Data.

FIGURE 7.5
Annual Turnover of SIMEX/SGX-DT Futures and Options
1993-2003



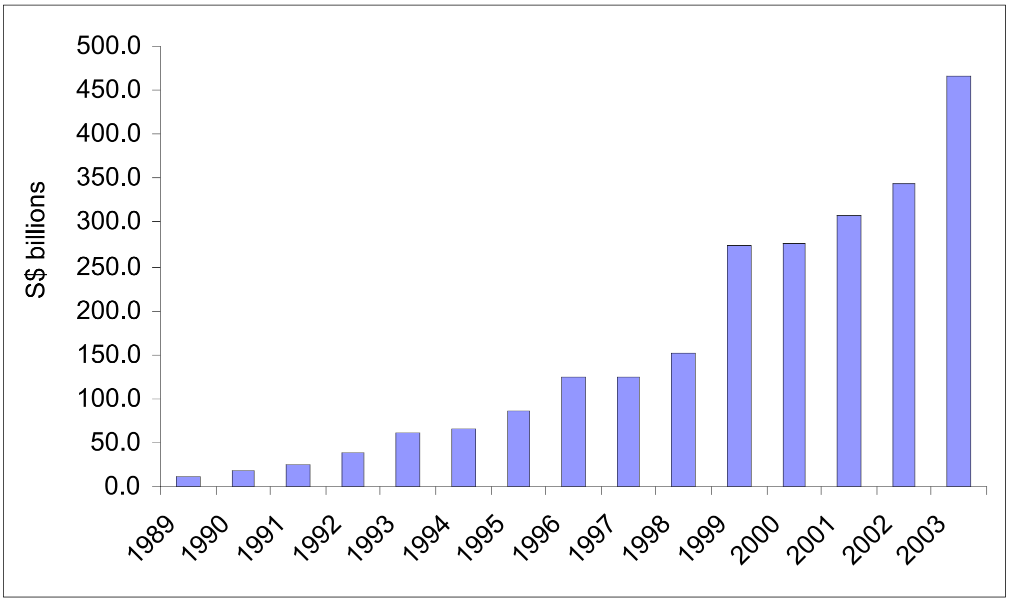
Source: CEIC Data.

FIGURE 7.6
Issuance of Corporate Bond in Singapore Dollars and Other Denominations,
1995-2003



Source: CEIC Data.

FIGURE 7.7
Total Assets under Management
1989-2003



Source: Monetary Authority of Singapore (MAS).

TABLE 7.1
Characteristics of Singapore's Largest Banks after M& As in 2001

	DBS	UOB + OUB	OCBC + KCH
Total Assets (S$ billion)	111.0	113.7	83.0
Total Loans (S$ billion)	54.2	61.5	50.4
Total Deposits (S$ billion)	92.8	96.6	71.1
Total S/H funds ($S billion)	8.4	13.1	8.3
Number of branches	107	93	74
Number of ATMs	900	426	381

Note: DBS is the Development Bank of Singapore; UOB is the United Overseas Bank; OUB is the Overseas Union Bank; OCBC is the Overseas-Chinese Banking Corporation; and KCH is the Keppel Capital Holdings (which owns Keppel Tat Lee Bank). Data for DBS exclude Dao Heng Bank.
Source: Singapore Exchange Web, Bank Annual Reports.

TABLE 7.2
Domestic and Overseas Assets of Singapore's Largest Banks, 1999

	Domestic Assets (S$000)	Overseas Assets (S$000)	Total Assets (S$000)	Overseas Assets as % of Total
DBS (Development Bank of Singapore)	86,241	20,224	106,465	19
OCBC (Overseas-Chinese Banking Corp.)	40,734	13,555	54,290	25
OUB (Overseas Union Bank)	30,582	8,790	39,372	22
UOB (United Overseas Bank)	43,154	13,346	56,499	24

Source: Tschoegl 2002.

TABLE 7.3
Foreign Banks in Singapore as of September 2002

Bank	Origin	Granted QFB	Operates an ACU
ABN Amro	Netherlands	Yes	Yes
Citibank	USA	Yes	Yes
HSBC	Hong Kong	Yes	Yes
Standard Chartered Bank	UK	Yes	Yes
Malayan Banking	Malaysia	Yes	Yes
BNP Paribas	France	Yes	Yes
Bank of America	US	No	Yes
Bank of China	China	No	Yes
Bank of Tokyo-Mitsubishi	Japan	No	Yes
Credit Agricole Indosuez	France	No	Yes
JP Morgan Chase	USA	No	Yes
RHB Bank	Malaysia	No	Yes
Bangkok Bank	Thailand	No	Yes
Bank of East Asia	Hong Kong	No	Yes
Bank of India	India	No	Yes
Bank Negara Indonesia	Indonesia	No	Yes
HL Bank	Malaysia	No	Yes
Sumitomo Mitsui Banking	Japan	No	Yes
Indian Bank	India	No	No
Indian Overseas Bank	India	No	No
Southern Bank	Malaysia	No	No
UCO Bank	India	No	No

Source: EIU Country Finance: Singapore, September 2002.

CHAPTER 8

DEVELOPMENT OF THE CAPITAL MARKET IN MALAYSIA

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INTRODUCTION

The effective mobilisation of financial resources is a critical prerequisite for economic growth and an efficient and competitive capital market is an important pre-condition for the mobilisation of financial resources. Financial resources can be tapped from domestic as well as international sources. Emerging markets in Asia have been attracting foreign capital flows for quite some time. The growth and development of capital markets in emerging countries, therefore, have been proceeding to a large extent under the influence of foreign capital flows. At the same time, national authorities in emerging markets have made efforts to strengthen and develop their indigenous capital markets. The Asian financial crisis was a major setback for these efforts, however.

Malaysia's capital market is more highly developed than many other emerging markets, but it has much to do to develop to the next phase. Growth, structural change, and the pressure of competition have made it imperative to further accelerate the development of the capital market. The implementation of the government's Capital Market Master Plan covering the period 2000-2010 will be a major factor in shaping the future development of Malaysia's capital market.

This paper addresses the development of the capital market in Malaysia with a focus on consolidation, restructuring, and governance. The first section deals with the links between

1. The authors are grateful for the substantial research input provided by Ms Tang Kar Mei from the Securities Commission. The views expressed in this paper are entirely the writers' own and should not be taken as bearing institutional support.

economic growth, development, and structural change in the capital market. This is followed by a description of the institutional regime for the capital market, including the modernisation of exchanges, regulation, and intermediation services. A separate section takes up the international dimensions of the capital market. A final section looks into the future changes to the capital market as the Capital Market Master Plan is implemented.

ECONOMIC GROWTH AND DEVELOPMENTS IN THE CAPITAL MARKET

Financing Past Economic Growth

The World Bank classified Malaysia, which had a per capita income of US$3,516 (RM13,361) in 2000, as a middle-income country. Malaysia's economy has a more than satisfactory growth record, growing at 6.7 percent per annum from 1971 to 1990 and at 7 percent per annum from 1991 to 2000. The economy contracted by 7.4 percent in 1998 following the financial crisis, but it commenced recovery in 1999 and grew by 8.5 percent in 2000. The current global economic slowdown has adversely affected the economy, with marginal growth of 0.4 percent recorded in 2001 and growth of 3.5 percent anticipated for 2002.

The structure of the economy has changed as it has grown. Agriculture's contribution to GDP, export earnings, and employment has declined while manufacturing has risen in importance. The manufacturing sector accounted for about a third of GDP in 2000 compared to about 27 percent in 1995. Non-resource based industries, such as electronics and electrical machinery, account for more than half (55 percent) of the value-added in manufacturing. Manufactured export's share of total exports reached about 85 percent in 2000. The service sector accounted for 52.4 percent of GDP in 2000. Malaysia has a high savings rate. Savings grew at a rate of 10.2 percent per annum over the period 1996-2000. Investment declined from 45.8 percent of GNP in 1995 to 29 percent in 2000.

Capital market financing has grown along with Malaysia's economy. Reflecting rising income, savings, and public and private sector demand, the amount of funds raised in the capital market over the thirty years 1962-92 increased RM7.5 billion per annum. This 16 percent annual rate of growth was roughly double the growth rate for the economy as a whole. Nevertheless, the banking system was still the main provider of funds, extending RM10.2 billion per year over the same period. Net new funds raised in the capital market in 1961 amounted to just RM140 million, but increased to RM405 million in 1970, and multiplied to RM2.5 billion in 1980. In 1992, for the first time, funds raised in the capital market (RM13.8 billion) slightly exceeded the amount of financing provided by the banking system (RM13.7 billion net new lending). In 2000, total net funds raised in the capital market reached RM40.4 billion, up from RM26.2 billion in 1999 (Table 8.1).

The private sector has increased fund-raising through the capital market at a faster rate than the public sector. In 2000, the private sector raised about RM26.8 billion, which was about double the RM13.6 billion raised by the public sector. Public sector borrowings from the capital market have been declining since 1990, because of the strategy to downsize the operations of the public sector and the increasing emphasis on the role of the private sector in the economy.

TABLE 8.1
Funds Raised in Malaysia's Capital Market
(RM million)

	1991	1992	1993	1994	1998	1999	2000
Public Sector							
Government Securities, gross	3,500	3,800	1,600	2,500	14,950	10,000	16,413
Less Redemptions	343	2,420	2,225	3,549	6,200	6,676	5,286
Less Government holdings	0	0	50	-97	0	0	0
Equals Net Federal receipts	3,157	1,380	-675	-952	8,750	3,324	11,128
Khazanah Bonds (net)					2,732	2,598	551
Govt. Investments Issues (net)		100	1,000	2,800	-750	0	2,000
Malaysia Savings Bond (net)			855	-70	-928	375	-19
Net funds raised by public sector	3,157	1,480	1,180	1,778	9,804	6,297	13,659
Private Sector							
Shares	4,392	9,181	3,245	8,159	1,788	6,096	6,004
Debt securities	1,966	4,123	4,934	10,294	14,152	26,558	31,097
Less Redemptions	125	991	1,369	1,297	7,977	12,750	10,331
Equals Net issues	1,841	3,132	3,565	8,997	6,175	13,808	20,766
Net funds raised by private sector	6,233	12,313	6,810	17,156	7,963	19,804	26,770
Total Net Funds Raised	**9,390**	**13,973**	**7,990**	**18,934**	**17,767**	**26,202**	**40,429**
Short-term papers and Notes (net)			4,400	19,092	185	-720	-1,626
Total	9,390	13,793	9,908	20,943	17,951	25,481	38,803

Notes: Debt securities excludes issues by banking institutions. Short-term papers and notes refers to Commercial Papers and Cagamas Notes only. Data for 2000 are preliminary.
Source: Bank Negara Malaysia Annual Report. Various years.

Capital Market Development

The capital market refers to markets for medium- to long-term financial assets. For our purposes the capital market encompasses corporate stocks, public and private debt securities with maturity exceeding one year, and shares with no fixed maturity period that are traded in the stock market, the government bond market, and the market for private debt securities. Government securities through issues of Malaysian Government Securities (MGS) account for the bulk of the funds raised by the public sector. Private debt securities (PDS) are the main source of capital market funding for the private sector, with the equity market also providing a sizeable portion through rights issues and initial public offerings (IPOs). The domestic currency (ringgit) bond market has expanded since the financial crisis, supplying some RM34.4 billion in 2000, about 85 percent, of the total net funds raised (Table 8.1). Low interest rates, financing for expansion, and corporate debt restructuring all contributed to the increase in public and private debt securities. The total value of outstanding bonds reached RM242 billion in 2000 compared to RM202.5 billion in 1999, with PDS comprising 58 percent of outstanding bonds in 2000.

The variety of capital market products and services as well as fund-raising capacity expanded significantly, particularly during the 1990s. Up to the late 1980s the government's funding needs dominated fund-raising in the capital market. As much as three-quarters of funds raised were to finance public sector investments. Privatisation in the late 1980s and 1990s resulted in increased financing needs among private sector firms. The capital market expanded to meet this demand. During the 1980s and 1990s improving trading and clearing and settlement systems strengthened the equity market. At the end of September 2000 stock market capitalisation reached RM489 billion with 788 listed companies. Exchange-traded derivatives were introduced in 1980 with crude palm oil futures and later warrants/transferable subscription rights (TSRs) and call warrants were introduced. Stock index futures were introduced in 1995 and a three-month financial futures contract was launched in 1996. Venture capital financing was encouraged during the 1990s, and by the end of 1999 the government had a stake in nineteen venture capital companies. A new equity exchange (MESDAQ) was established in late 1997 to promote high-growth and technology companies.

The other services and products that support these markets also expanded, including activities of investment management funds, stockbrokerages, and advisory services. By September 2000 Malaysia had 62 licensed stock brokerages, 32 futures broking companies, and 735 licensed futures brokers' representatives. The unit trust industry grew with the addition of various schemes, the entry of new firms, and regulatory reforms in the 1980s and 1990s.

Various Islamic products and services have been developed and promoted since the first Islamic bank, Bank Islam, was established in 1983. Islamic securities have been growing and some of the leading corporations have issued long-term corporate debt utilising Islamic-based instruments. The first Islamic unit trust was set up in 1993, and in 1996 the Securities Commission (SC) established the Syariah Advisory Council (SAC) to advise it on Islamic capital market operations.

In 2000, the government introduced a number of new measures to further develop the capital market. These measures included: strengthening the stockbrokerage industry through consolidation, promoting the bond market with new guidelines and regulations, relaxing rules on the use of proceeds from issuance of PDS, enhancing the market mechanism and competitiveness, improving corporate governance and the protection of minority shareholders, and promoting the fund management industry.

Capital Market Development and Future Capital Requirements

In the past, banks played the major role in mobilising financial resources for Malaysia, but the financial system must diversify to avoid over-burdening the banking system as the economy grows and changes structure. While the banking system will continue to be an important part of Malaysia's financial system, the insurance industry and other specialised institutions and the capital market must play a more prominent role. With the increased importance of the capital market will come increasing disintermediation, i.e., a shift from bank lending to direct financing through the capital market. Corporations will also consider listing their shares on foreign stock exchanges to gain access to the global equity market. Within the capital market there is a need to develop the bond market. The value of outstanding bonds was only 67 percent of GDP in 1999, compared with 157 percent of GDP for outstanding bank loans.

Moreover, the capital market must expand its financing capacity in order for Malaysia to meet its development goals. Mobilising sufficient financial resources is one of the primary requirements for development. Furthermore, resource mobilisation will be more efficient if markets are more competitive. Thus, required financial investment is a key quantum in the Malaysian government's overall development policy, the Outline Perspective Plan 3 (OPP3), and in its master plans for the capital market and the financial sector.

The OPP3, which lays out the general vision for Malaysia's economic development to 2010, targets a growth rate of 7.5 percent, which is to be accomplished primarily by improving productivity. The plan envisions that, of this growth, total factor productivity (TFP) will contribute 42.4 percent, up from 25.5 percent in the previous plan period, while capital will contribute 36.6 percent (down from 50.2 percent) and labour will contribute 20.9 percent (down from 24.3 percent). These assumptions imply that Malaysia will need total private investment of RM1,052 billion during the plan period (12.7 percent per year real growth). But, if TFP growth falls below the OPP3's optimistic assumption, then capital will need to make a larger contribution, and the amount of investment required will be larger.

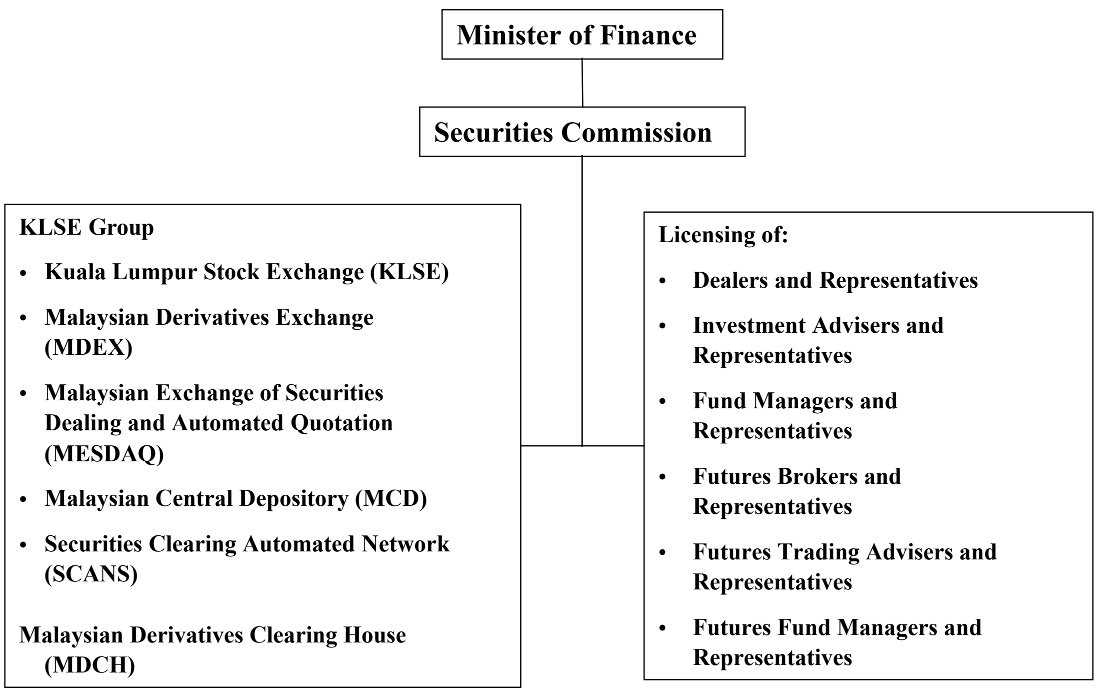
The Capital Market Master Plan (CMP) projects the economy will require RM930 billion in new capital expenditures (investment) over the 2001-2010 period to increase output by 7.3 percent. This assumes a relatively efficient incremental capital-output ratio (ICOR) of 2.74. But if capital is less productive, an ICOR of 4.9 for example, Malaysia would require RM1.5 trillion in new investment (30 percent of GDP) to achieve this same rate of growth. Assuming 30 percent of the required funds are sourced from the capital market, then the markets would have to make available some RM500 billion over the next 10 years, or about RM50 billion per year.

The Financial Sector Master Plan (FSMP) anticipates public investment to grow by 5.4 percent per year and private investment to grow by 17.5 percent per year over decade from 2001 to 2010. At these rates, total investment will amount to RM2,231 billion. This is three times the RM790.9 billion invested during the previous plan, from 1991 to 2000.

INSTITUTIONAL REGIME OF MALAYSIA'S CAPITAL MARKET

The current institutional regime of the capital market in Malaysia is depicted in Figure 8.1. Under the authority of the Minister of Finance, the Securities Commission licenses capital market players and oversees the activities of the several exchanges and institutions that comprise the Kuala Lumpur Stock Exchange (KLSE) Group. This institutional organisation is the culmination of a period of new product introduction and subsequent consolidation of exchanges and the concomitant consolidation of regulatory control over the capital market.

FIGURE 8.1
Overview of the Institutional Structure of the Malaysian Capital Market



Modernisation of the Exchanges

Although the KLSE traces its history to the 1930s, the present exchange was formally established in 1973. At that time, many Malaysia-incorporated companies were also listed and traded through the Stock Exchange of Singapore (SES) and vice-versa for Singapore-incorporated companies. A significant milestone for the KLSE occurred in 1990 with the de-listing of Singapore-incorporated companies and the de-listing of Malaysian companies listed on the SES. This move paved the way for the KLSE to carve out a position as a stock exchange with a truly Malaysian identity.

The KLSE is an order-driven market. Trading was completely computerised in 1992 with the full implementation of the System on Computerised Order Routing and Execution (SCORE) automated trading system, which effectively eliminated the need for a physical trading floor by facilitating trading through member stockbrokerages located all over the country. In 1993, the Central Depository System (CDS), an automated clearing and settlement system replaced the practice of holding and moving physical scrip of quoted shares with a safe and dependable computerised book entry system. Companies are listed either on the Main Board or the Second Board of the KLSE and are classified into sectors based on their core businesses.

The Malaysian Exchange for Securities Dealing and Automated Quotation (MESDAQ) was approved in October 1997 as a separate stock exchange to promote the development of high-growth and technology companies in Malaysia. It was intended to be a mechanism to facilitate capital raising by technology-intensive industries with strong growth prospects which lacked a track record of profits and to develop a strong science and technology base through indigenous research and development efforts, including the development of the Multimedia Super Corridor (MSC). Trading on MESDAQ commenced in April 1999, but by the end of 2000 the exchange had listed only three companies.

The range of capital market products expanded when the Kuala Lumpur Commodity Exchange (KLCE) was established in July 1980 as the first futures exchange in Southeast Asia. The range widened further when the Kuala Lumpur Options and Financial Futures Exchange Bhd (KLOFFE) and the Malaysian Derivatives Clearing House Bhd (MDCH) were established. The introduction of KLOFFE's stock index futures contract in December 1995 was a significant event in the development of the capital market, as it made Malaysia the third Asian economy after Hong Kong and Japan to offer domestic equity derivatives products. The Malaysian Monetary Exchange (MME) was set up in May 1996 to provide fixed income derivatives, namely the three-month KLIBOR (Kuala Lumpur Interbank Offer Rate) futures contract.

The KLCE merged with the MME in December 1998 and became the Commodity and Monetary Exchange of Malaysia (COMMEX) to reflect the diversity of its products. Then KLOFFE became a subsidiary of the KLSE Group in January 1999. Continuing the earlier wave of consolidation, in June 2001 KLOFFE and COMMEX merged to become Malaysia Derivatives Exchange Berhad (MDEX). In 2002 MESDAQ joined the KLSE Group, ceased business as an exchange, and was re-launched as a new MESDAQ Market on the KLSE. This means that virtually all of Malaysia's capital market institutions have been brought under the umbrella of the KLSE.

Consolidation of Capital Market Regulation

The regulatory infrastructure of Malaysia’s capital market has undergone major enhancements in the last decade—including streamlining, deregulation along with appropriate re-regulation, and increased regulatory and enforcement capacity—aimed at developing a fairer and more efficient capital market and facilitating market innovation. Before 1993, responsibility for overseeing the Malaysian securities industry fell variously on the Registrar of Companies (ROC), Capital Issues Committee (CIC), Panel on Take-overs and Mergers (TOP), Foreign Investment Committee (FIC), Bank Negara Malaysia (BNM), Ministry of Trade and Industry (MITI), and Kuala Lumpur Stock Exchange (KLSE). The need for a more streamlined regulatory framework and, in particular, a single regulatory body with a broad overview of capital markets became apparent as the market expanded and matured and it was identified explicitly in the Sixth Malaysia Plan for 1991–1995.

The Securities Commission Act 1993 established the Securities Commission (SC) on 1 March 1993. The new SC's main roles were to act as a single regulatory body to promote the development of the capital market and to take responsibility for streamlining the regulations of the securities market and for speeding up the processing and approval of corporate transactions.[2] Since its establishment, the SC has undertaken a substantial programme of law reform in recognition of the important influence of the regulatory framework on the growth and development of the capital market. Legislation governing the securities industry consists of the Securities Industry Act 1983 (SIA), the Securities Industry (Central Depository) Act 1993 (SICDA), the Companies Act 1965 (CA), the Securities Commission Act 1993 (SCA) and the Futures Industry Act 1993 (FIA).

With regulatory consolidation, the SC has the primary responsibility for oversight of the securities industry, with BNM, FIC, and the ROC involved to some extent as well. The SC's regulatory and supervisory purview includes the supervision of the exchanges, clearing houses, and central depositories; the issue of securities; takeovers and mergers; unit trust schemes; the designation of futures contracts; and the registration of securities markets participants. Other functions include advising the Minister of Finance on all matters relating to the securities industry; safeguarding the interests of investors; promoting proper market conduct; suppressing illegal market practice; considering and suggesting legal and regulatory reforms in relation to the securities industry; and encouraging the development of the securities industry in Malaysia.

Development of Capital Market Intermediation Services

In tandem with the development of institutions and regulatory infrastructure, capital market services have also developed significantly over the years. Managed investment funds in Malaysia consist broadly of funds managed by provident and pension funds, unit trust management companies, asset management companies, insurance companies, and others. At the end of 1999, these institutions collectively deployed about RM280 billion, just half the amount managed by the banking sector

2. The SC is responsible to the Minister of Finance and tables its annual report and accounts to parliament. It is empowered to investigate breaches of securities regulation, enforce rules and regulation, and prosecute securities offences. The CIC and TOP were dissolved and their functions absorbed by the SC. A number of functions pertaining to the capital markets previously undertaken by other authorities were also transferred to the SC gradually over the ensuing years.

(RM560 billion).

Malaysia introduced unit trusts relatively early on compared with other markets in the region. The first unit trust was established in 1959, but only five new unit trust companies, with a total of 18 funds, were established over the next twenty years. More focused efforts to develop the industry came in the decade from 1980 to 1990. In 1981 Amanah Saham Nasional Bhd launched Skim Amanah Saham Nasional (ASN) to promote savings in the Bumiputera community and encourage Bumiputera ownership in the corporate sector. Property trusts were added to the list of products available to investors in 1989. In 1990, the Bumiputera Trust Fund (ASB) was launched to replace ASN.

The 1990s was the decade of fastest growth for the Malaysian unit trust industry in terms of the number of new companies established and funds under management. The centralisation of regulation of the industry with the formation of the SC in 1993 and extensive marketing strategies adopted by the ASN and ASB were influential in making unit trusts household products during this period. The total net asset value of unit trusts grew more than four-fold from RM11.7 billion at the end of 1990 to RM60.0 billion at the end of 1996.[3] Although growth of these funds has moderated since the financial crisis of 1997–98, the number of units in circulation and the number of unit holders have nevertheless continued to increase. From February 2000 Registered Institutional Unit Trust Agents were allowed to market the unit trust products of third parties, a move that was positively received by market participants. The asset management industry has grown in line with the growth of the unit trust industry as well. In February 2002 there were 76 licensed fund management companies and 229 licensed fund managers' representatives.

As the capital market developed, so too did the scope, quality, and penetration of intermediation services offered by securities brokers. Stockbrokerages, which are members of the KLSE, typically carry out a range of activities. These include trading in KLSE-listed instruments and other securities, offering investment advice, and providing authorised nominee/custodian services. Some qualified stockbrokerages also participate in underwriting new securities issues. Stock broking services are fairly widely dispersed throughout the country, due mainly to government policy during the developmental years of the capital market which limited the concentration of stockbrokerages by geographic location.

Although the market downturn in 1997–98 had an adverse impact on the industry—particularly on brokerages with lower capitalisation, weak risk management, and poor internal controls—comprehensive measures have been introduced since then to substantially strengthen the industry as a whole. In addition, the SC introduced a number of measures to instil a greater sense of financial discipline in brokers and to enhance the strength of the stock brokering industry as a whole. Prudential measures were implemented based on international best practice, including the introduction of new risk-based capital adequacy requirements and new rules to enhance the protection of client assets.

While the number of market participants in the futures broking industry has fallen somewhat since the onset of the 1997–98 regional financial crisis, the representation of futures intermediaries in the capital market is still relatively strong given the current market size. At the end of January 2002, Malaysia had 25 futures broking companies and 11 futures fund managers.

Corporate finance advisers include merchant banks, approved stock broking companies, public accountancy firms, law firms, and such other parties that advise companies submitting applications to the SC. At present only merchant banks and approved stock broking companies are permitted to submit to the SC proposals on behalf of listed companies for its consideration.[4]

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3. Federation of Malaysian Unit Trust Managers.
4. The current regulation also stipulates that unlisted companies, with the exception of those applying for flotation on the stock exchange, may do so through either a merchant bank, approved stockbroking company or an approved public accounting firm. Companies can also submit a proposal through a discount house or a commercial bank but only for issues involving non-equity-linked debt securities.

INTERNATIONAL DIMENSIONS OF THE CAPITAL MARKET—CAPITAL FLOWS AND FOREIGN INVESTMENT

As outlined in the previous section, the capital market changed and developed significantly during the 1990s and rapidly assumed a more prominent place in Malaysia's financial sector. The gradual internationalisation of the capital market has played an important role in this development, as well as raising new issues concomitant with increased global integration. The internationalisation of the equity market depended on achieving a combination of sufficient scale and liquidity and attractive valuations, among other conditions. The international bond market has also become an important source of long-term funding for larger Malaysian corporations. In particular, offshore bond issues increased in the mid-1990s reflecting in part the relatively more attractive cost of overseas funds due to the upward shift in the term structure of domestic interest rates during 1995 and increased foreign demand.[5]

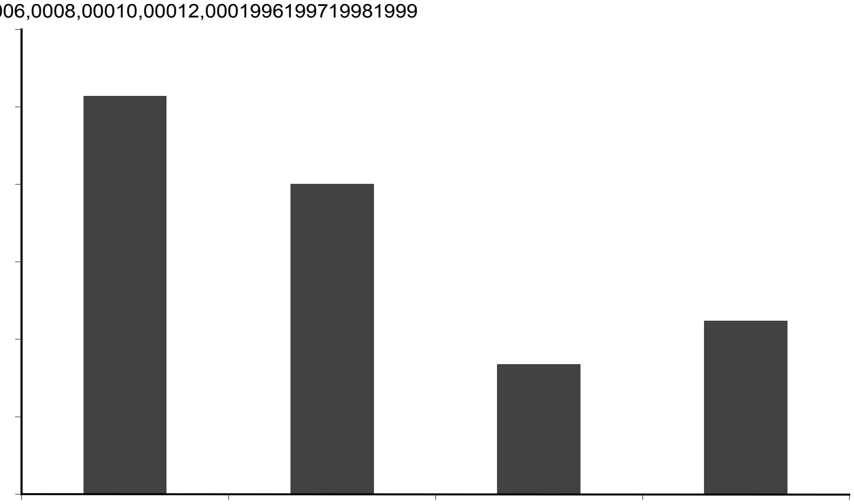
The onset of the Asian crisis in 1997–98 adversely affected offshore fund-raising activities by Malaysian corporations, however. With the crisis, a spate of credit-rating downgrades across emerging market issuers and a significant increase in the credit risk premium demanded by global investors led to a significant increase in the international cost of funds for Malaysian companies. As the cost of overseas funds increased the amount of funds raised by Malaysian companies through international bond issues declined (Figure 2).

Similarly, foreign activity in Malaysia's equity and derivatives markets declined following the regional financial crisis. Annual foreign net portfolio investment in Malaysian securities fell sharply from its 1993 peak to negative levels in 1997–98 before recovering gradually (Figure 3). As of mid 2001, foreigners accounted for 10.7 percent of shareholders but held 15.9 percent of the

5. In 1995, four companies—Petronas, Telekom Malaysia, Malayan Banking and Tenaga Nasional—raised nearly US$1.7 billion (RM4.3 billion) in total. In 1996, given the continued availability of cheaper credits, facilitated by their enhanced credit ratings in the international markets, several companies again tapped the offshore market with a total of 15 issues worth almost US$4.1 billion (RM10.3 billion).

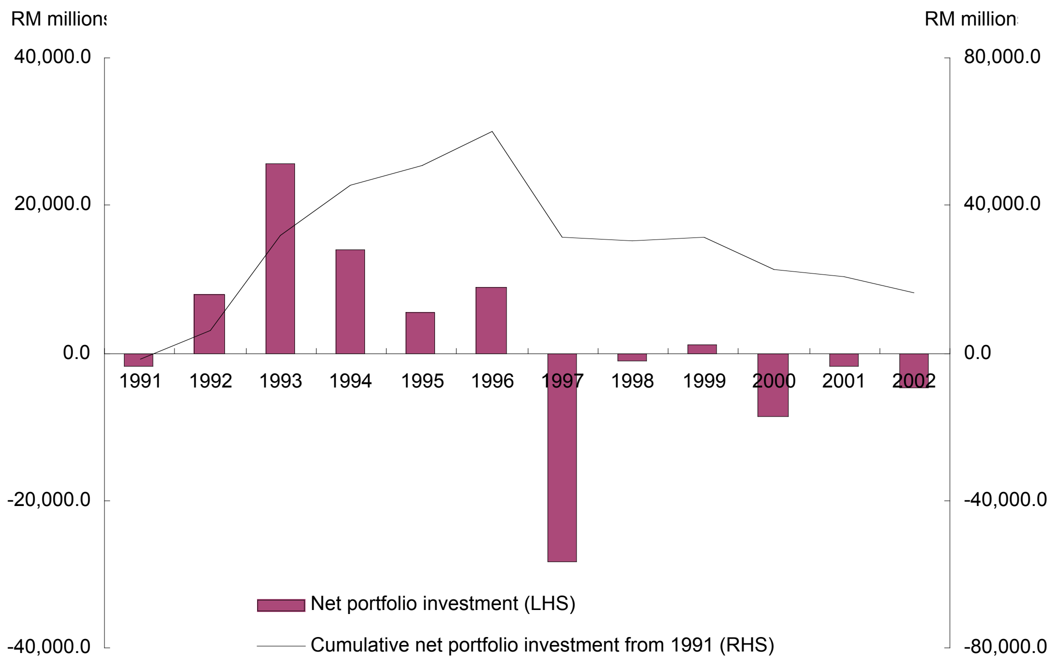
total value of equity on the KLSE.

FIGURE 8.2
International Bonds Raised by Malaysian Companies
(RM million)



Source: Bank Negara Malaysia.

FIGURE 8.3
Annual and Cumulative Foreign Net Portfolio Investment into Malaysia, 1991-2002

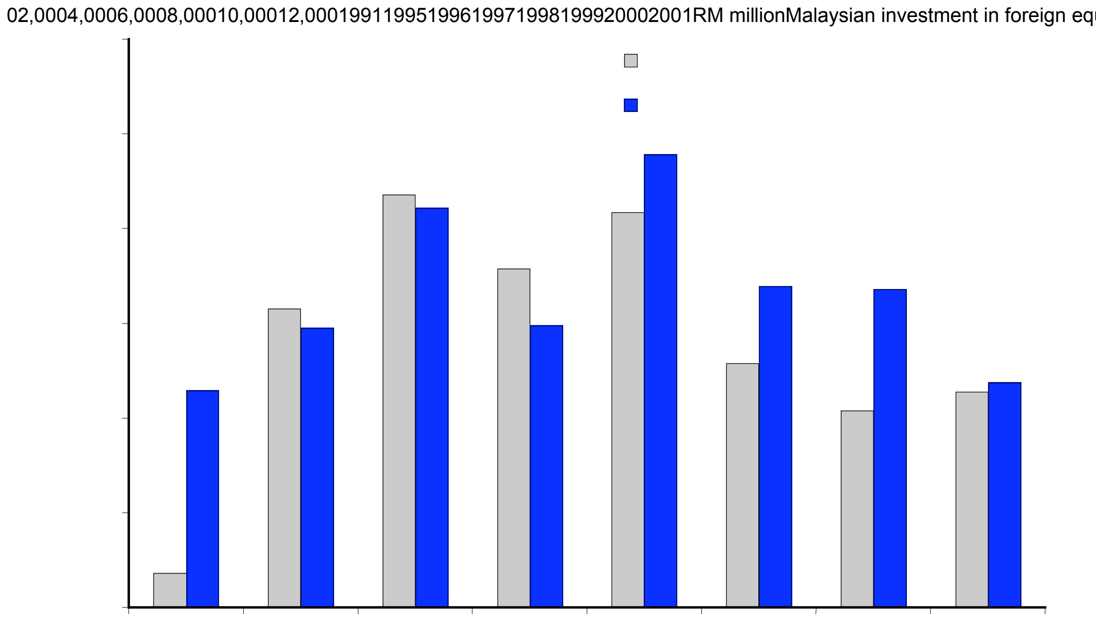


Source: Bank Negara Malaysia.

Malaysian investment in foreign businesses increased sharply over the 1990s. While gross foreign equity investment in Malaysian businesses rose by only 3.7 percent over the period 1991-2001, Malaysian ownership of foreign businesses surged by 519.5 percent (Figure 4). This surge in investment abroad reflects to some extent government policy to encourage reverse investment to create synergistic relationships with foreign markets. Another thrust of this policy was the disaggregation of production processes to retain the high value-added operations in Malaysia and create supporting production ventures offshore appropriate to the local skill and technology levels.[6]

6. Seventh Malaysia Plan, 1996–2000.

FIGURE 8.4
Gross Equity Investment in Business Activities to and from Malaysia, 1991-2001



Note: Refers to equity participation through the setting up or expansion of businesses, including joint venture projects, where the investor has an effective voice in the management of the business. This excludes the purchase/sale of listed securities (which are classified as portfolio investment under BNM's Cash Balance of Payments Reporting System) unless such acquisition results in a degree of management control in the company.
Source: Bank Negara Malaysia.

As Malaysia's economy has become more open and more intertwined with the global environment through international trade, so too has the capital market. Malaysia's involvement in various global multilateral negotiations to liberalise access to the financial services sector reflects the government's recognition of the importance of liberalisation in furthering Malaysian economic interests. In the 1994 Uruguay Round of Multilateral Trade Negotiations of the General Agreement on Trade in Services (GATS), Malaysia's commitments included measures to raise limits on foreign equity ownership in stock broking companies and measures relating to the entry of managers, specialists, experts and professionals, and commercial presence. In December 1995, Malaysia also entered into the ASEAN Framework Agreement on Services, one aspect of which was to develop commitments on financial services liberalisation.

Foreign involvement in Malaysia's capital market services sector is already evident. At the end of February 2002, foreign equity ownership was above 40-percent (but less than 50 percent) at three licensed stock broking companies and it was above 20-percent at six more firms. Also, eleven licensed futures broking companies had some degree of foreign ownership and two were wholly foreign–owned. In August 1995, the SC introduced Guidelines on the Establishment of Foreign Fund Management Companies (FFMCs) as part of its efforts to promote and develop the fund management industry.[7] As of the end of February 2002, 16 fund management companies had some degree of foreign ownership. Of these, eleven had joint ventures with majority local ownership, two were wholly foreign-owned, and three were joint ventures with majority foreign ownership. Four of these fund management companies also held futures fund manager licenses.

CONSOLIDATION, RESTRUCTURING, AND GOVERNANCE OF THE CAPITAL MARKET

Framework for Consolidation

International financial systems are becoming more and more interdependent and markets for various assets are becoming increasingly integrated. The resulting blurring of the distinction between institutional arrangements and financial activities in turn challenges the ability and capacity of regulatory authorities to ensure seamless regulation. Changing demands on the regulatory framework and authorities are compelling a shift towards a more market-based regulatory approach that fosters innovation and competition by allowing market participants to react swiftly and respond appropriately to changes in the marketplace.

To claim a position within the rapidly changing domestic and international environment a national capital market must have a clear strategy. In August 1999 the Minister of Finance announced a mandate for the Capital Market Master Plan (CMP) to provide such a comprehensive

7. The Guidelines were revised in July 2000.

and cohesive strategy for Malaysia. The CMP, which was completed and released in February 2001, set out the vision and objectives for the capital market for the coming 10-year period. It identified a host of wide-ranging measures to promote the market's growth and to develop an internationally competitive, highly efficient capital market supported by a strong and facilitative regulatory framework. The broad objectives of the CMP are:

- To develop the capital market as the preferred fund raising centre for Malaysian companies.
- To promote an effective investment management industry and a more conducive environment for investors.
- To enhance the competitive position and efficiency of market institutions.
- To develop a strong and competitive environment for intermediation services.
- To ensure a stronger and more facilitating regulatory regime.
- To establish Malaysia as an international Islamic capital market centre.

These objectives are linked to 24 strategic initiatives and 152 recommendations in the areas of market institutions, the stock broking industry, the derivatives market, investment management, the equity and bond markets, the Islamic capital market, technology and e-commerce, training and education, corporate governance, and the regulatory framework. A pragmatic programme for further deregulation and liberalisation was also formulated to facilitate greater competition in various capital market sectors and industries in an orderly and sequenced manner.

The CMP is being implemented in three phases:

Phase I (2001-03):

- Strengthen domestic capacity and develop strategic and nascent sectors.

Phase II (2004-05):

- Further strengthen key sectors and gradually liberalise market access

Phase III (2006-10):

- Further expand and strengthen market processes and infrastructure to become a fully developed capital market.
- Enhance international positioning in areas of comparative and competitive advantage.

Some of the major initiatives and developments in the consolidating, restructuring, repositioning, and enhancing capital market governance are discussed in detail below.

Demutualisation of the Consolidated Exchange

Globalisation, innovation, and technology have brought profound challenges to the traditional role, influence, and position of market institutions. Malaysian exchanges and clearing houses must strengthen, and where necessary redefine, their value proposition to their users in light of the changing operational environment. To carve out a place in the global market, Malaysia's market institutions must be able to adapt promptly and appropriately to these challenges. Fundamentally they need to offer investors a liquid, efficient, secure, and transparent trading environment at competitive cost. They also need to offer competitive listing and fund raising costs, as well as sufficient international visibility, so that issuers can obtain appropriate value recognition of their securities. The CMP recommended that the exchanges should consolidate, demutualise, and list in order to be able to accomplish these goals.

One key to the future development of the capital market is the creation of a single exchange with the consolidation of all the existing exchanges under the KLSE Group, which is largely accomplished. Consolidation will enhance the collective efficiency of the various market institutions, enabling them to tap into economies of scale and scope by sharing market infrastructure and integrating common operational functions across the merged institutions. An integrated environment will also give them greater capacity to introduce new products and services and allow them to use their combined financial strength to meet external competition. This is particularly relevant to developing market segments that do not presently have sufficient depth to support separate exchanges. A single combined exchange would be in a stronger competitive position than separate exchanges acting individually to pursue strategic alliances and other international business strategies.

The next step is the demutualisation of the exchange and listing on the stock market, which is planned for 2003. Demutualisation will allow the consolidated exchange to adopt the structures and strategies needed in a competitive and dynamic business environment. With more professional management and streamlined organisational structure, a demutualised exchange will be able to respond to these challenges in a timely and focused way with commercially oriented strategies and practices. Under a demutualised structure, the exchange should be more customer-driven and market-orientated because commercial decisions will take account the collective interests of many stakeholders, including issuers and investors, and not simply reflect the majority vote among different sized broker members.

Listing of the demutualised exchange’s shares will encourage wider dispersion of ownership, increase public representation in the governance of the exchange, promote transparency and accountability, and provide incentive structures to align the interests of management with commercial interests of the exchange. Moreover, it would broaden the base of capital on which to expand and further develop the exchange's operations. Finally, as a listed company, the exchange would be held to high standards of transparency and accountability, which would benefit its stakeholders.

The details and procedures for the demutualisation of the exchange by the target date of 2003 are still being worked out. Experience in other countries will need to be considered and adapted to conditions in Malaysia. Important considerations for policy makers and regulators as they change the governance structure will be to minimise conflicts of interest and to safeguard the public interest. Such conflicts arise with for-profit exchanges because resources also need to be allocated for regulatory activities. Senior executives may face conflicts in allocating their time between profit-making and regulation. There could also be conflicts between the exchange's listing and supervisory functions and its broker and supervisory functions. The extent of ownership by the current members of the exchange will also have to be determined. Demutualisation will probably require a suitable legislative framework. Although the shareholding of the demutualised exchange could be more widely dispersed, institutional shareholders could play a more prominent role. In Singapore, for example, the demutualised Singapore Exchange Limited (SG) had 11,877 shareholders at the end of December 2001, compared to only 33 members at the time the Stock Exchange of Singapore (SES) merged with the Singapore International Monetary Exchange, Limited.

Corporate Restructuring and Fund-raising

In the wake of the 1997 regional financial crisis, Malaysian authorities have been actively involved in facilitating and, where possible, expediting corporate workouts and debt recovery. The Corporate Debt Restructuring Committee (CDRC) was established in August 1998 to facilitate debtor-creditor negotiation in debt settlement.[8] The SC has also been occupied with debt restructuring and corporate workouts and with facilitating capital raising to spur the revitalisation of economic activity. It has tried to ease the burden of financial obligations on local firms and market participants without compromising investor protection or market integrity.[9]

Improving the fund-raising environment is a top priority for the future. Malaysia needs an efficient and competitive market to support capital formation for ongoing economic development. A well-functioning capital market is crucial to financing corporate restructuring and economic growth and to further diversifying the sources of funds within the financial system.

The SC's programme to shift from merit-based regulation to disclosure-based regulation (DBR), which was recommended by the CMP, is one key to making fund-raising more efficient. By

8. Since its inception until end-2001, 37 cases with debts amounting to RM34.5 billion have already been resolved. As at that date, 12 cases with debts amounting to RM18.0 billion remained outstanding and are targeted for resolution by 31 July 2002.
9. Effective 30 September 1999 the SC allowed greater variations of profit guarantee agreements, subject to strict investor protection conditions, in cases where the guarantors could demonstrate that they did not have the financial capability to fulfil the profit guarantee obligation. Apart from this, new guidelines announced on 3 September 2001 included a reduction in the post-restructuring net-tangible-asset position requirement for distressed listed companies, thus allowing a wider pool of viable assets to be injected into distressed

adopting DBR the SC's aims to reduce its involvement in assessing the merits of investment opportunities and to enhance the role of issuers and their advisers and investors in capital allocation and decision-making. DBR places emphasis on transparency, due diligence, corporate governance, and the promotion of accountability and self-regulation.

The SC is making the change in three phases with full DBR now targeted for 2003. It is gradually shifting the onus for assessing the merits of investment onto investors through due diligence while requiring companies to adopt higher standards of information disclosure and governance. From 1996 to 2000 the SC made significant steps toward a more disclosure-based environment and improved disclosure standards. It introduced major changes to the SCA and adopted new guidelines for public offerings that incorporate elements of DBR. Phase 2 is a partial implementation of DBR. The SC continues to examine corporate proposals relating to the issue or offer of securities, but it does not intervene as long a proposal complies with the "Policies and Guidelines on Issue/Offer of Securities". The SC is evaluating the preparedness of capital market players before moving to full DBR. Phase 3 will emphasise information quality, compliance, and enforcement.

Higher standards of accounting are important for improving governance and transparency. (The Enron debacle is a timely reminder of the consequences of lax accounting practices and inadequate governance standards.) The development of financial markets and new products will make stringent demands on the practice and standards of valuing assets. In particular, an historical cost approach to accounting and valuation can have limitations. Where markets are absent or underdeveloped the treatment of "fair value" for new financial instruments, such as derivatives, can be problematic. The prices of derivatives tend to be volatile and unpredictable and can lead to severe losses.

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companies as part of their restructuring schemes.

Many actions have been taken to develop the corporate bond market as a competitive source of financing. In 1999 the National Bond Market Committee was formed and the SC became the sole regulator of the corporate bond market. Following the recommendation of the CMP, the SC introduced guidelines to facilitate the offering of asset backed securities (ABS) in April 2000. By the end of February 2002, the SC had approved a total of RM2.14 billion in ABS proposals. Other initiatives include efforts to further streamline the bond issuance process and lower the associated costs and to encourage secondary bond market activity by improving accessibility and efficiency of the bond-trading infrastructure.

Developing a market for risk capital is an important facet of Malaysia's thrust to become a knowledge economy and build a production base that adds more value. Risk capital encompasses informal investment by business angels, venture capital, and stock markets specialising in SMEs and high-growth companies. The CMP identified a range of capital market-related measures to promote the development of high-growth and technology companies. It focused in particular on ways to enhance MESDAQ's role as an effective exit mechanism for venture capitalists. Another step in spearheading the development of the risk capital industry was the formation of a central co-ordinating agency for venture capital development under the Ministry of Finance as announced in the 2001 Federal Budget.

Consolidation of the Stock Broking Industry and Reduction of Transaction Costs

The domestic stock broking industry operated in a relatively sheltered environment. Barriers to entry included stringent licensing and domestic ownership requirements, limitations on geographic concentration, and fixed brokerage commissions. Although these conditions supported the past development of the industry, they might become a drag in the future, particularly because they have potential ramifications for the quality and scope of services for users of the capital market.

The domestic capital market grew and the increasingly competitive global market environment made it necessary for Malaysia to undertake a thorough review of the stock broking industry and develop a cohesive strategy. For one thing, the presence of a large number of small players competing with a few dominant firms pointed to the need for industry consolidation. Consolidation would increase economies of scale and scope, create of larger, better-capitalised and better-managed institutions, and ultimately provide investors with higher quality services at reasonable cost. At the same time, the increasing conglomeration of financial services is blurring traditional boundaries between banks, fund management companies, insurance companies, and securities brokers. Technological applications such as online broking, for example, have also revolutionised intermediation in many jurisdictions, providing end-users with faster, cheaper, and more direct access to the market.

The stock broking industry must develop a stronger and more competitive environment for intermediation services and the CMP identified several measures to increase the industry's financial strength and its capacity to offer a wide range of high-quality, cost-effective, and integrated services and products. These measures include a strategy for progressive domestic deregulation, which entails allowing firms to expand the range of services and products they offer as well as to branch out geographically.

Specifically, the CMP recommended developing a core group of full-service domestic intermediaries, known as Universal Brokers (UBs), which would form a competitive market for integrated financial services and which could maintain strong market positions under the challenges of liberalisation and globalisation. To become a UB an existing stockbrokerage must merge with three other brokerages.[10] As an added incentive to industry restructuring, in August 2001 the SC issued guidelines to assist UBs in setting up electronic access facilities. UBs are now also allowed to give certain discounts for trades executed through the electronic access facilities.

10. Given the need to further rationalise the industry, stock broking companies that do not aspire to become UBs are also required to merge with at least one other stockbroking company.

The fixed-fee structures that have controlled the pricing of intermediation service are also being deregulated. For example, various fees in the derivatives industry—including futures broking and clearing commission rates, the commission-sharing structure between futures brokers and their representatives, and the shared commission rates between trading members and institutions—were made fully negotiable in December 2001. Liberalisation of brokerage commission rates for retail trades was deferred due to difficult economic conditions, but other trading costs have been reduced as planned. For example, in July 2001 KLSE reduced its fees for SCORE and clearing and the SC reduced its levy.

Enhancement of Corporate Governance Standards and Practices

Two issues that gained prominence following the Asian financial crisis—liberalisation and governance and transparency—have special relevance and importance to financial markets. All the Asian economies in one way or another are grappling with these two issues and the underlying theme or issue is the effect of short-term capital flows on emerging markets. Most Asian economies are addressing the need for liberalisation, although they are opening up at different speeds and they made different commitments to the World Trade Organisation (WTO). Malaysia's Financial Sector Master Plan and Capital Market Plan laid out a plan for the nature and speed of banking and capital market opening over the 2001-10 period. Malaysia had been making efforts to enhance corporate governance prior to the regional financial crisis of 1997–98, but the aftermath of the crisis sharpened the impetus for comprehensive and co-ordinated reforms. Prodded by the fallout from the crisis, in 1998 the Minister of Finance announced the formation of a high level committee to review the framework for corporate governance in Malaysia. The Finance Committee on Corporate Governance was charged to "undertake a review of the legal and regulatory infrastructure to evaluate its effectiveness in promoting sound corporate governance standards", to develop a code of best practices in corporate governance, and to identify the training and education needs of directors and other key corporate participants and investors. The committee, with the SC acting as secretariat, released a report in March 1999 setting out over 70 recommendations for improving corporate governance through three specific areas: the Malaysian Code on Corporate Governance; reform of laws, regulations, and rules; and training and education.[11]

The Report proposed a “prescriptive approach” to the Code of Best Practices with principles and practices for good governance similar to those recommended by the Hampel Committee in the UK. The Code aims at the boards of listed companies to improve their composition and to increase their efficiency and accountability. The Report's recommendations regarding corporate participants recognise that good corporate governance rests firmly with the board of directors. More attention and concern are now paid to the position of minority shareholders and to ensuring that their rights are not ignored or overridden. Laws and regulations will need to be updated.

The Finance Committee on Corporate Governance made several recommendations to improve disclosure and transparency. Disclosure preserves the integrity of the market by giving all investors equal and timely access to information. The Committee's recommendations include a rationalised regime for prospectus regulation, introduction of civil actions for insufficient disclosure, and additional reporting by directors on the state of internal controls and the going-concern status of the company.

Legal changes recommended by the Committee, involving comprehensive streamlining of the regulatory structure to rationalise the regulation of fund-raising and bond market activities, are being put in place. Since the Report Malaysia has amended the securities laws and the Companies Act 1965, requiring auditors to report suspected breaches of securities laws, codified the duties of directors, and introduced curbs on a controlling shareholder’s right to vote in related-party transactions.

11. An Implementation Project Team leads and oversees the implementation of the broad-ranging recommendations contained in this report.

The Working Group on Best Practices in Corporate Governance, comprised of representatives from the private sector, developed the Malaysian Code on Corporate Governance, which was subsequently approved by the Finance Committee on Corporate Governance. While adoption of these standards is voluntary, amendments to the KLSE's Listing Requirements announced in January 2001 brought the Code into effect by requiring companies to disclose in their annual reports the extent to which they have complied with the principles and best practices set out in the Code.

The Capital Market Master Plan builds upon the foundation laid by the Finance Committee's Report with measures to further enhance the enforcement of minority shareholders' rights, to improve continuous disclosure by listed companies, and to enhance auditors' responsibilities. The formation of the Minority Shareholder Watchdog Group, which appointed its first Chief Executive Officer in July 2001, was also an important step in promoting greater shareholder activism.[12] The Committee will monitor and combat abuses by company insiders against minority shareholders and encourage and support shareholders' interests. At the same time, the SC continues to focus on promoting investors' awareness of their rights and responsibilities.

Importantly, the authorities have made a committed effort at enforcement along with promoting good corporate governance. Actions undertaken between 1999 and 2001 have placed increased emphasis on the need for accountability and transparency by the principal officers and persons controlling listed companies in the discharge of their duties. For example, Malaysia successfully prosecuted its first case of insider trading and the courts imposed substantial fines on the directors of several public listed companies for submitting false or misleading information.

On the international front, the SC has been actively involved in the Asia Pacific Economic Cooperation (APEC) Collaborative Initiative on Corporate Governance. Malaysia is the leader of the Initiative's Core Group, which also includes comprised Australia, the United States, the World

12. The MSWG is founded by several of Malaysia's major institutional investors: the Employees Provident Fund, Lembaga Tabung Angkatan Tentera, Lembaga Tabung Haji and the Social Security Organisation.

Bank Group, and the Asian Development Bank. The APEC Finance Ministers endorsed the Initiative's report, *Strengthening Corporate Governance in the APEC Region*, in May 1999. The report essentially identified leading features or patterns in corporate governance practices in Asian economies, recommended means of addressing the problems and issues identified, and discussed areas in which further co-operative international efforts could accelerate the strengthening of corporate governance in these economies.

At the same time, broad-ranging measures have been undertaken to improve transparency and disclosure standards within the corporate sector. The imposition of quarterly reporting by KLSE-listed companies, enhanced disclosures in prospectuses, and a reduced timeframe for reporting changes in substantial shareholdings have been among the enhancements introduced.

Another key development was the establishment of the Malaysian Accounting Standards Board (MASB) and the Financial Reporting Foundation (FRF) in 1997. The former has statutory responsibility for setting national accounting standard under the Financial Reporting Act 1997, while the latter oversees the operations of MASB. MASB formulates standards with reference to the International Accounting Standards Committee and other national standard setters in order to align them with international best practices.

With the establishment of the FRF and MASB, Malaysia became the first country in Asia to set up an independent, statutorily incorporated body to set accounting standards. A framework to ensure compliance and enforcement of the standards set by MASB has been introduced under the purview of the SC for public-listed companies, BNM for financial institutions, and the ROC for all other companies.

Moving Forward

A key priority in moving forward is to implement the recommendations in the Capital Market Master Plan effectively according to schedule. In the process, implementation must balance the need to increase competition, innovation, and liquidity in the capital markets with the overarching priorities of maintaining fair, orderly, and efficient markets with high standards of supervision, enforcement, and investor protection. The urgency for change needs to be continuously weighed against the potential implications for market stability and integrity. Thus, the implementation schedule and ongoing periodic assessments take into account the readiness of market participants to respond to market changes as well as the prevailing market conditions and the stage of market development.

Pragmatic sequencing is particularly essential in the deregulation and liberalisation of various segments of the capital market. Appropriate preparatory measures must precede the facilitation of competition within the domestic market in order to enhance the resilience of market participants beforehand and to avoid severe economic displacement from a sharp increase in competition. The implementation schedule for the CMP identifies certain areas of the capital market where action should be taken early on. These include certain strategic and nascent sectors—such as the investment management industry, venture capital industry, the Islamic capital market, and the derivatives market—where the immediate priority is to introduce greater competition and skills transfer to raise the level and quality of services and products offered in Malaysia's capital market. In addition, recommendations that carry broad-based implications affecting other recommendations or a broad spectrum of market participants will be implemented sooner rather than later.

While pursuing deregulation and liberalisation, the regulatory authorities will maintain an active dialogue with market participants, international counterparts, and international bodies such as the International Organisation of Securities Commissions (IOSCO) to facilitate consistency with appropriate international standards and to closely monitor international developments. This is expected to foster the development of Malaysia's capital market.

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APPENDIX

APPENDIX TABLE A.1
Ranking of Major Bourses by Domestic Market Capitalisation

Rank	Country	End-1999 (US$ billion)	Country	End-1996 (US$ billion)
1	United States	16,642	United States	10,215
2	Japan	4,555	Japan	3,106
3	Great Britain	2,855	Great Britain	1,643
4	France	1,503	Canada	890
5	Germany	1,432	Germany	665
6	Canada	801	France	587
7	Italy	728	Hong Kong	449
8	Netherlands	695	Switzerland	400
9	Switzerland	693	Netherlands	375
10	Hong Kong	609	Australia	312
11	Spain	432	**Malaysia**	**306**
12	Australia	428	Taiwan	274
13	Taiwan	377	Italy	257
14	Sweden	373	Spain	241
15	Finland	349	Sweden	240
16	Korea	306	South Africa	240
17	Brazil	228	Brazil	217
18	Singapore	198	Singapore	153
19	Greece	197	Korea	139
20	South Africa	193	Belgium	119
21	Belgium	184	Mexico	107
22	Mexico	154	Thailand	96
23	**Malaysia**	**140**	Indonesia	91
24	Turkey	113	Philippines	80
25	Denmark	105	Denmark	71
26	Ireland	69	Chile	66
27	Chile	68	Finland	63
28	Portugal	68	Norway	57
29	Indonesia	64	Argentina	45
30	Norway	64	New Zealand	37
31	Israel	63	Ireland	35
32	Thailand	57	Israel	34
33	Argentina	56	Austria	34
34	Philippines	42	Luxembourg	32
35	Luxembourg	36	Turkey	30
36	Austria	33	Portugal	24
37	Poland	30	Greece	24
38	New Zealand	28	Iran	13
39	Iran	17	Peru	13
40	Peru	12	Poland	8

Notes: Based on information on exchanges in 40 countries compiled by Federation Internationale des Bourses de Valeus. The figure for Germany in 1999 is the market capitalisation of the Deutsche Borse.
Source: Securities Commission *Capital Market Master Plan*

APPENDIX TABLE A.2
Consolidation and Integration of Market Institutions in Malaysia and Selected International Markets

<table>
<tr><th>Exchange / clearing house</th><th>Date</th><th>Form</th></tr>
<tr><td>London International Financial Futures and Options Exchange (LIFFE) and London Clearing House</td><td>March 1999 joint venture announced</td><td>Vertical integration of trading and settlement functions.</td></tr>
<tr><td>Brussels Stock Exchange, Belgian Futures and Options Exchange (BELFOX) and National Depository</td><td>March 1999 merged to form Brussels Exchange.</td><td>Consolidation of stock and derivative exchanges.

Vertical integration of functional lines.</td></tr>
<tr><td>National Association of Securities Dealers Automated Quotation (Nasdaq), American and Philadelphia Stock Exchanges</td><td>June 1998 Nasdaq-AMEX-Philadelphia merger.</td><td rowspan="8">Consolidation of stock and derivatives exchanges.</td></tr>
<tr><td>Stockholm Stock Exchange and Swedish Derivatives Exchange</td><td>Early 1998 merged to form OM Stockholm Exchange.</td></tr>
<tr><td>Lisbon Stock Exchange and Oporto Derivatives Exchange</td><td>November 1999 Portuguese government approved merger.</td></tr>
<tr><td>Stock Exchange of Hong Kong (SEHK) and Hong Kong Futures Exchange (HKFE)</td><td>December 1999 merged.</td></tr>
<tr><td>Stock Exchange of Singapore (SES) and Singapore International Monetary Exchange (SIMEX)</td><td>December 1999 merged to form Singapore Exchange (SGX).</td></tr>
<tr><td>KLSE and KLOFFE</td><td>January 1999 KLSE acquired KLOFFE.</td></tr>
<tr><td>KLSE and COMMEX</td><td>March 2000 signed Memorandum of Understanding (MOU) allowing COMMEX to join the KLSE Group.</td></tr>
<tr><td>KLCE and MME</td><td>December 1998 merged to form COMMEX.</td><td>Consolidation of financial and commodity derivative exchanges.</td></tr>
</table>

Source: Securities Commission *Capital Market Master Plan.*

APPENDIX TABLE A.3
Amount and Share of Malaysian Government Securities Outstanding by Original Maturity

	2-3 years	4- 5 years	6-10 years	11-15 years	More than 15 years	Total
			Amount outstanding (RM billion)			
1990	-	2	11	12	37	62
1991	-	3	12	13	38	65
1992	-	2	14	14	37	67
1993	-	3	13	13	37	66
1994	-	2	12	14	37	65
1995	1	2	11	14	37	65
1996	1	4	14	13	35	67
1997	1	6	12	13	35	66
1998	2	7	15	15	37	75
1999	4	9	16	15	36	78
2000	7	12	24	12	34	89
			Share of total (%)			
1990	-	3.6	17.8	19.6	59.0	100
1991	-	4.2	17.8	20.3	57.7	100
1992	-	2.8	20.9	20.9	55.4	100
1993	-	5.3	20.2	19.1	55.4	100
1994	-	3.2	19.0	21.5	56.3	100
1995	1.5	3.3	17.7	21.0	56.5	100
1996	1.5	5.3	21.1	19.3	52.8	100
1997	1.5	8.5	18.8	19.0	52.2	100
1998	2.7	8.7	20.1	19.7	48.8	100
1999	5.1	10.8	19.9	18.6	45.6	100
2000	8.3	12.9	26.4	13.8	38.6	100

Note: 2000 figures are end-September. Data for 1999 and 2000 are preliminary.
Source: Securities Commission. 2001. *Capital Market Master Plan.*

APPENDIX TABLE A.4
Malaysian Government Securities Issuance Since 1990
(RM million)

Year	Gross Issue	Redemptions	Net Issue
1990	5,140	399	4,741
1991	3,500	343	3,157
1992	3,800	2,421	1,380
1993	1,600	2,225	(625)
1994	2,229	3,549	(1,320)
1995	2,000	2,250	(250)
1996	6,000	3,809	2,191
1997	3,000	3,648	(648)
1998	14,950	6,200	8,750
1999	10,000	6,676	3,324

Note: Data for 1999 are preliminary.
Source: Securities Commission 2001 *Capital Market Master Plan.*

CHAPTER 9
EVOLUTION OF THE KOSDAQ STOCK MARKET: EVALUATION AND POLICY ISSUES

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INTRODUCTION

Since the economic crisis of 1997, the Korean economy has been experiencing fundamental structural changes. Though the on-going changes touched essentially all areas of the economy, the most visible changes are the innovations in financial markets. Chronologically, the first change was the opening of domestic financial markets to foreign investors. This led to a surge of foreign investment in Korean financial markets, particularly the stock market. As a result, foreign holdings hovered close to forty percent of market capitalization of the Korea Stock Exchange in early 2002. The next change was the appearance of a government bond market in the genuine sense of the word 'market'. Before the crisis, all government-related bonds were digested through forced allocation mechanisms with issuing prices above market levels. Consequently, there was minimal secondary market activity, a *de facto* absence of a market for government bonds. Reforms implemented since the 1997 crisis subsequently yielded a large-scale and active government bond market. The third and final change was the creation of new securities markets, which include the KOSDAQ stock market and derivatives markets such as options and futures markets.

While noting all of these changes under way in Korean financial markets, this paper focuses on the development of the KOSDAQ stock market. The KOSDAQ stock market exhibited dazzling growth during the post-crisis years. Primary and secondary market activity increased dramatically, raising the market's status from practical non-existence to one comparable with the Korea Stock Exchange on some measures. This paper describes the KOSDAQ market and suggests how such dramatic growth was possible. It also discusses the likely future policy issues facing KOSDAQ.

It is widely accepted that a well-developed stock market for venture companies encourages early-stage private equity investment in venture businesses by allowing efficient exiting of private capital investment through IPOs.[1] As an IPO market for venture companies, the KOSDAQ market is closely related to the venture capital cycle in Korea. In this sense, the present chapter may be read as a description the formation of Korea's venture capital cycle, albeit one limited in scope because it does not discuss venture capital fund-raising or investing.

The remainder of the chapter begins by explaining the history and the basic institutional structure of the KOSDAQ stock market. This is followed by a description of the market's recent growth, an analysis of the factors responsible for that growth, and a discussion of future policy issues.

OVERVIEW OF THE KOSDAQ STOCK MARKET

'KOSDAQ' stands for Korea Association of Securities Dealers Automated Quotation. The similarity of the name to 'Nasdaq,' which is an acronym for National Securities Association of Securities Dealers Automated Quotation, gives the impression that the KOSDAQ stock market is similar to the Nasdaq market. This impression is both true and false. Comparison with the Nasdaq stock market serves to highlight the institutional characteristics of the KOSDAQ market.

As a new equity market the KOSDAQ market shares a common economic purpose with the Nasdaq. The KOSDAQ market is self-regulated by the Korean Stock Dealers Association (KASD), while being owned by number of stock market related institutions (Table 9.1 and Figure 9.1). Regardless of its outer institutional structure, however, in reality it is closely governed and controlled by the government. Therefore, although the KOSDAQ market resembles the Nasdaq, in the sense that both markets are self-regulated by the Stock Dealers Association and both exist outside of the traditional exchange, the KOSDAQ differs from the Nasdaq in that the government plays a much greater role.

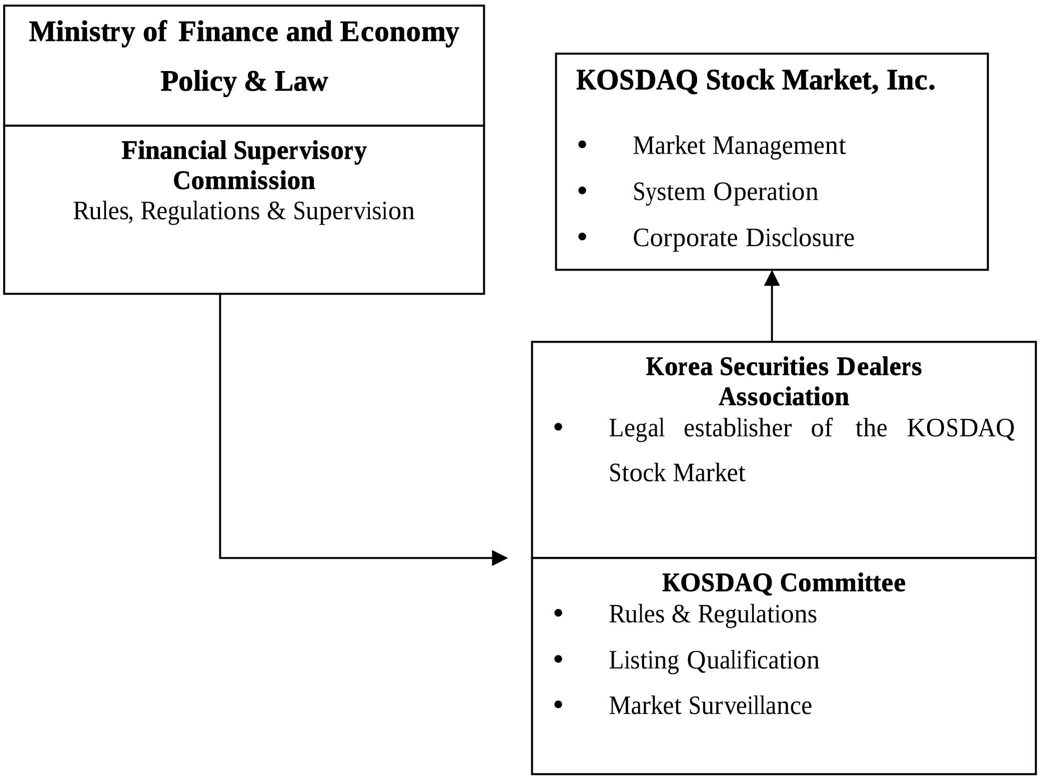
[1]. For example, Gompers and Lerner (1999) posit that the venture capital cycle consists of the three stages of venture capital fundraising, venture capital investing, and exiting venture capital investments, and they appreciate the importance of the final stage.

TABLE 9.1
Ownership Structure of the KOSDAQ Stock Market, Inc.
(Percent)

	Small Business Corp.	Korea Securities Finance Corp.	Korea Association of Securities Dealers	Korea Securities Depositary	Korea Stock Co.	Securities Companies	Total
Ownership share	23.77	16.64	10.37	9.51	7.13	32.58	100.0

Note: Securities companies include Daewoo Security Co., LG Security Co. and twenty-eight others.

FIGURE 9.1
Regulatory Structure of the KOSDAQ Market



Besides, the KOSDAQ differs from the Nasdaq in internal market structure. The Nasdaq is a quote-driven market and, as its full name indicates, it is structured around securities dealers.[2] But, strictly speaking, 'KOSDAQ' is a misnomer since dealers have no role in the KOSDAQ market. KOSDAQ is an auction, or an order-driven market where trading is fully automated via the KOSDAQ Electronic Trading (KETRA) System. More specifically, regular trading, which takes place from 9

2. As part of reforms in 1997, dealers in the Nasdaq market are required to integrate customer limit orders into their proprietary quotes, giving precedence to customer limit orders. As a result, the Nasdaq market has taken on a characteristic of an order-driven market though it still remains fundamentally a dealer market. For the reforms and their impacts, see Weston (2000).

a.m. to 3 p.m. Monday through Friday, is through continuous auction (multi-price auction) with the principles of price and time. In contrast to regular trading, the opening and closing trades of the day are settled by a call, or single-price, auction. Customer orders placed one hour before the beginning of regular trading (8 to 9 a.m.) and ten minutes before closing (2:50 to 3 p.m.) are considered simultaneous orders and are settled by a single price which matches both parties' limit orders. There is no market maker or designated liquidity provider in the KOSDAQ market. Limit orders by public traders are the only source of market liquidity.

The OTC Market: Forerunner of KOSDAQ

The Korea Stock Exchange (KSE) was established as the country's first regulated stock market in 1953 after the Korean War. Until 1987 Korea had one regulated stock market, the KSE, and one unregulated market, the Over-the-Counter or OTC market. While the KSE grew steadily since the take-off of the economy in the 1970s, activity in the unregulated OTC market remained negligible.

In an attempt to invigorate market activity the Korean government introduced an 'organized OTC market' in 1987. The government established certain registration criteria and designated the KASD as the operator. KASD collected and made public trading information on registered stocks. The government's effort to stimulate activity in the OTC market continued in 1991, as it established an OTC intermediary office in KASD and introduced an automated trading information collection system (Table 9.2).

TABLE 9.2
KOSDAQ Historical Highlights

1987	April	OTC (Over-the-Counter) market systematized under sponsorship of the Korea Association of Securities Dealers (KASD)
1991	October	OTC Securities Trading Intermediary floor began operations
1996	May	KOSDAQ Securities Co. Established
1997	January	KOSDAQ Stock Market opened
	April	KOSDAQ Price Index announced (Base date: 1 July 1996; Base index: 100)
	April	KOSDAQ Stock Market legislation passed
1998	October	KOSDAQ Committee established
1999	June	KOSDAQ Securities Co. renamed KOSDAQ Stock Market, Inc.

The number of listed companies increased steadily after the organized OTC market was established in 1987. In particular, from 1992 to 1994 new listing surged, and the total number of listed companies reached 310 at the end of 1994 (Table 9.3). The pace of new listing slowed from 1995, however, and the total number of listed companies stagnated as de-listing suddenly increased, mostly because companies transferred to the KSE.

TABLE 9.3
Listing and De-listing on the KOSDAQ Market, by Type of Business, 1987-2001
(Number and Percent)

	New listings			De-listings			Total Listed Companies: Ordinary Business	Total Listed Companies: Venture		Total Listed Companies: KOSDAQ Total	
	Ordinary Business	Venture	Total	Ordinary Business	Venture	Total	Number	Number	% of KOSDAQ	Number	% of KSE listed companies
1987	18	3	21	2	-	2	16	3	16	19	5
1988	8	4	12	4	-	4	20	7	26	27	5
1989	19	5	24	4	-	4	35	12	26	47	8
1990	12	10	22	3	-	3	44	22	33	66	10
1991	16	5	21	5	5	10	55	22	29	77	11
1992	42	13	55	2	4	6	95	31	25	126	18
1993	79	10	89	5	1	6	169	40	19	209	30
1994	106	12	118	15	2	17	260	50	16	310	44
1995	-	-	48	-	-	18	293	47	14	340	47
1996	-	-	31	-	-	39	279	52	16	331	44
1997	-	-	83	-	-	55	273	86	24	359	46
1998	4	4	8	-	-	36	217	114	34	331	44
1999	42	58	100	37	-1	36	222	173	44	395	54
2000	62	116	178	-12	45	33	296	244	45	540	77
2001	41	137	178	8	1	9	356	357	50	713	103

Note: Excludes mutual funds.
Source: KOSDAQ Stock Market, Inc.

In 1996, the government restructured the organized OTC market and re-launched it as the KOSDAQ market in January of 1997. The most notable change was in the trading system; the OTC trading system was abandoned and an auction trading system introduced. This brought an end to the organised OTC market as a trading system.

KOSDAQ Stock Market, Inc. was established as manager of the auction market, although the initial name of the company was different (Table 9.2). Policymakers seem to have chosen the name KOSDAQ in order to emphasize the intended economic function of the new market. The policy goal of reforming the organized OTC market was to grow a 'venture business oriented stock market' and the Nasdaq stock market was often mentioned as the benchmark for the new market. Reflecting the policy intention, policymakers imported the name.

GROWTH AND DEVELOPMENT OF THE KOSDAQ MARKET

Primary Market

Listing Trends

Initially, total listings on the new KOSDAQ market did not increase much over the total under the organized OTC market. De-listings continued and new listings were not always sufficient to offset them. Since 1999, however, new listing activity grew at an unprecedented rate and the total number of listed companies increased significantly. Altogether, 456 companies were newly listed in the three years from 1999 to 2001, more than doubling the total number of listed companies. By the end of 2001, the number of companies listed on the KOSDAQ market slightly exceeded that on the KSE (Table 3).

What distinguishes the growth in new listings after 1998 from that in the early 1990s is the type of companies. In the earlier period, most newly listed companies were ordinary businesses. Among 118 newly listed companies in 1994, 106 were classified as ordinary businesses, while only 12 were ventures (Table 9.3). In contrast, venture businesses have been driving the recent surge in listing, significantly outpacing listing by ordinary businesses. Moreover, the predominance of ventures in new listing activity seems to be increasing. In 1999, there were 58 venture listings against 42 listings by ordinary businesses. But in 2000 venture business claimed 116 new listings versus 62 for ordinary businesses, and in 2001 ventures outnumbered ordinary businesses in new listings, 137 to 14. Due to the rapid increase in listing by venture businesses, their share of all listed companies reached 50 percent at the end of 2001, up from 16 percent in 1996 and 34 percent in 1998.

Capital Raising

Data on capital raising during the organized OTC market era are hard to come by, but activity was known to be minimal compared to the KSE. The stagnant state continued in the early years of the KOSDAQ market, which was dwarfed by the KSE. Capital raised on the KOSDAQ amounted to a mere 3 percent of the fundraising on the KSE in 1996 and to only 7 percent of funds raised on the KSE in 1997 (Table 9.4).

TABLE 9.4
Capital Raising in the KOSDAQ Market, 1996-2001

	Rights Issues		Pubic Offerings		Total Capital Raised	
	Billion won	Number	Billion won	Number	Billion won	KOSDAQ % of KSE
1996	123.7	80	27.1	26	150.8	3
1997	86.8	50	129.4	69	216.1	7
1998	1,873.2	40	6.3	3	1,879.5	14
1999	3,084.4	136	2,125.4	110	5,209.8	15
2000	5,627.9	202	2,568.6	182	8,196.6	142
2001	1,584.5	149	1,142.0	144	2,726.5	52

Source: KOSDAQ Stock Market, Inc.

Capital raising in the KOSDAQ market began gaining strength in 1998. The absolute amount of capital raised in that year was almost nine times the amount in the previous year and the ratio of capital raised on KOSDAQ to capital raised on the KSE doubled to 14 percent. The ratio remained the same for 1999, but because of the extraordinary boom in primary market activity on the KSE in that year, a stable ratio implies that the absolute amount of capital raised in the KOSDAQ was, in fact, triple the amount raised in 1998.

In 2000, capital raising in the KOSDAQ market recorded unprecedented growth, considerably outpacing the KSE, and the total amount of capital raised in the KOSDAQ market exceeded that of the KSE for the first time. This expansion slowed a bit in 2001 and as the Korean economy fell into recession in late 2000, overall stock market activity was sluggish in 2001. This slowdown had a greater negative impact on the KOSDAQ market than on the KSE. In 2001, capital raising in the KOSDAQ market shrank relative to the KSE as well as in absolute terms. Even so, the KOSDAQ still raised just over half (52 percent) as much capital as the KSE raised.

Individual Korean investors, not institutional investors and not foreign investors, were largely responsible for the emergence of the KOSDAQ market. In 2000, individuals held 58 percent of the outstanding KOSDAQ stocks, followed by institutional investors who held 37 percent (Table 9.5). The percentage of shares held by individuals is much higher for the KOSDAQ than for the KSE. On the other hand, foreigners hold less than 5 percent of the stocks listed in the KOSDAQ market compared to almost 15 percent of the stocks listed on the KSE.

TABLE 9.5
Composition of Ownership of Outstanding Shares on the KSE and KOSDAQ by Type of Investor, 1999 and 2000
Percent

	1999		2000	
	KSE	**KOSDAQ**	**KSE**	**KOSDAQ**
Institutions	48.65	40.27	48.45	37.14
Foreigners	12.37	4.18	13.80	4.79
Individuals	38.98	55.55	37.74	58.06

Source: KOSDAQ Stock Market, Inc.

Secondary Market

Market Activity and Turnover Rate

Secondary market activity in KOSDAQ-listed stocks reflects the trends in the primary market. The secondary market was dormant through 1998, when activity on the KOSDAQ market was only 6 percent that of the KSE, based on the turnover rate in each market (Table 9.6). After this year, however, a dramatic boom occurred just as it did in the primary market. Turnover in the KOSDAQ market skyrocketed from 17.62 percent of outstanding stocks in 1998 to 212.09 percent in 1999. Turnover on the KOSDAQ market climbed to 45 percent compared to activity on the KSE. The trading boom accelerated in 2000. In that year, as with capital raising in the primary market, trading activity on the KOSDAQ market surpassed that on the KSE. In 2001, trading in the KOSDAQ market maintained its dynamism although capital raising on the primary market weakened, so the turnover rate actually rose further to 1,121.85 percent from 724.24 percent the year before.

TABLE 9.6
Trading Volume and Turnover Rates on the KOSDAQ Market, 1997-2001

	Ordinary Businesses		Venture Businesses		KOSDAQ Total		KOSDAQ Turnover Rate / KSE Turnover Rate
	Trading Volume (billion shares)	Turnover Rate (%)	Trading Volume (billion shares)	Turnover Rate (%)	Trading Volume (billion shares)	Turnover Rate (%)	
1997	-	-	-	-	0.5	6.56	0.05
1998	0.9	9.57	1.1	59.55	2.1	17.62	0.06
1999	26.1	92.24	60.6	481.22	86.7	212.09	0.45
2000	227.0	497.49	283.5	1,140.63	510.5	724.24	1.87
2001	469.0	961.47	474.9	1,343.10	943.9	1,121.85	1.87

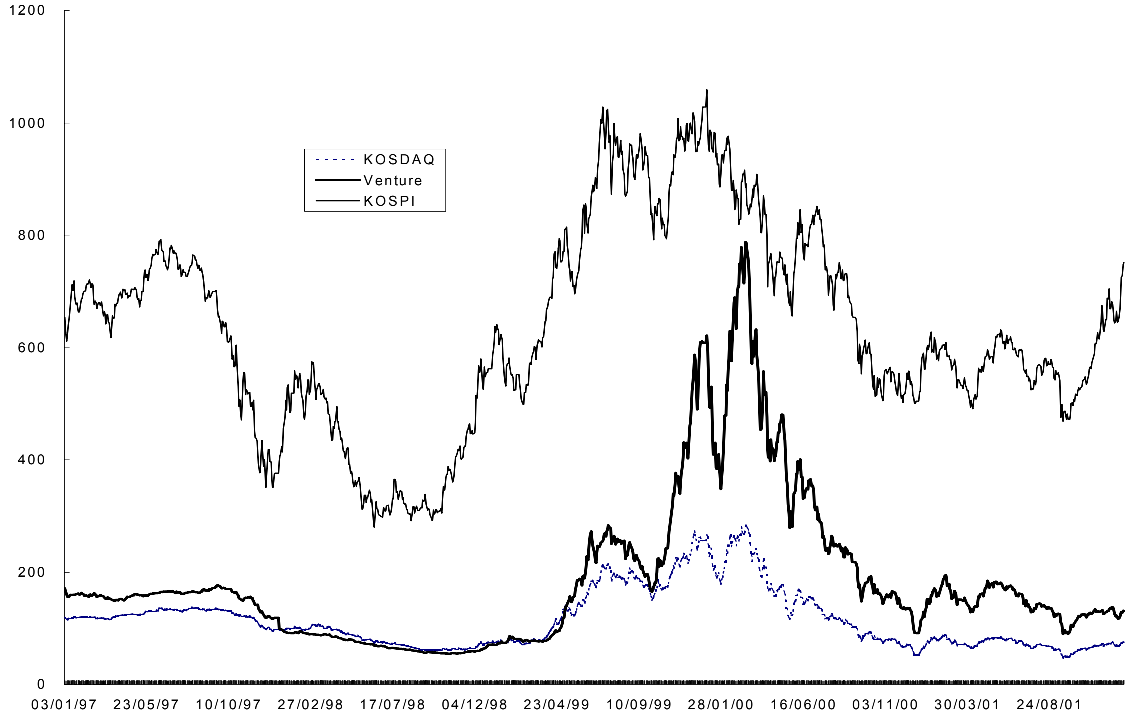
Note: Turnover rate = Trading volume / Total stock outstanding.
Source: KOSDAQ Stock Market, Inc.

The liquidity and high turnover rates on the KOSDAQ market were driven by speculation in venture stocks. The recent explosion of trading in the KOSDAQ market has centered on venture stocks, which turned over up to five times more often than the stocks of ordinary businesses during the past four years (Table 9.6).

Price Behavior

The roaring growth in liquidity of the KOSDAQ market was accompanied by sharp fluctuations in the KOSDAQ index. As market activity increased, the KOSDAQ composite index began a vertical rise in April 1999 that continued until February 2000 (Figure 9.2). Over those eleven months the index more than tripled from 79.79 to 266.37. Subsequently, however, downward adjustment occurred, and eventually the index ended the year 2001 back down at 72.21. Thus, two years from the beginning of the boom, the KOSDAQ index had fallen back to its pre-boom level.

FIGURE 9.2
Trends in KOSDAQ Index, Venture Index and KOSPI KSE Index

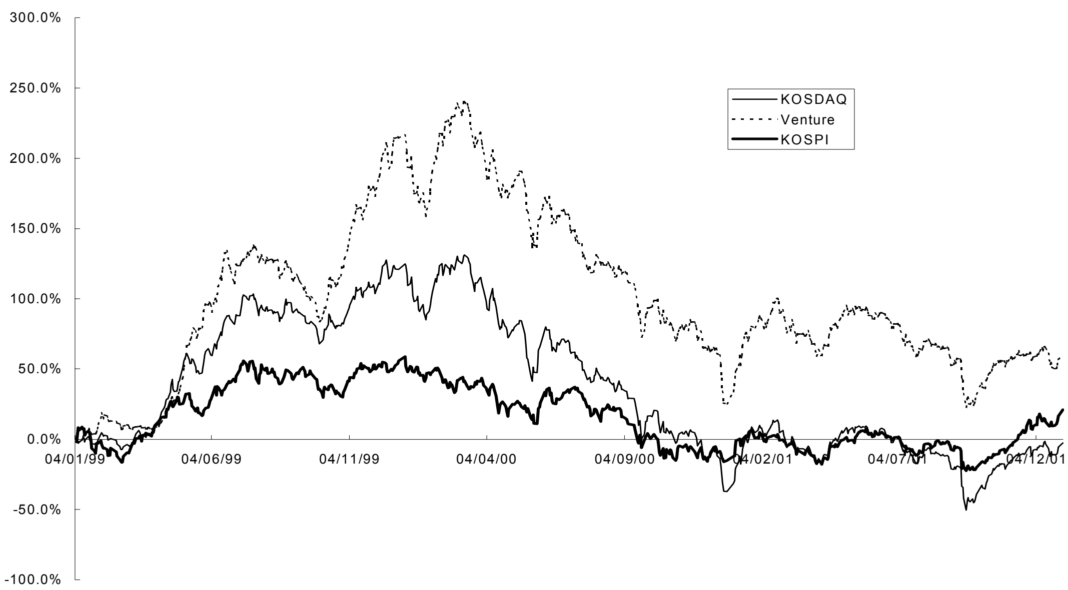


Source: KOSDAQ Stock Market, Inc.

The movement of the composite KOSDAQ index masks differences between venture and ordinary businesses, however. KOSDAQ's Venture Index (index of venture stocks) showed the pattern of boom and adjustment found in the Composite Index. Even though movement of the two indices was qualitatively similar, however, the Venture Index did not fall as much as the Composite Index and the Venture Index remains significantly above its pre-boom level, unlike the KOSDAQ Composite Index (Figure 9.2).

The disparity between the Venture Index and other indices is easier to notice in cumulative daily stock returns. Two points about cumulative daily stock returns from the beginning of 1999 to the end of 2001 are noteworthy. First, cumulative returns of venture stocks outpaced returns of the KOSDAQ Composite Index and the KOSPI Index throughout this period (Figure 9.3). Second, for the last half of 2001, cumulative returns for the KOSDAQ and the KOSPI indices were virtually zero, while venture stocks still showed a positive cumulative return of about fifty percent.

FIGURE 9.3
Cumulative Daily Stock Returns 1999.1-2001.12



Source: KOSDAQ Stock Market, Inc.

Individuals dominated trading in the KOSDAQ market. Their share of trading rose steeply from 54.96 percent in 1998 to 91.87 percent in 1999 and it reached 95.7 percent in 2001 (Table 9.7). The fact that trading by individuals rose simultaneously with the turnover rate suggests that individual traders have been the main actors in the market recently. Although individuals are also responsible for most of the trading activity on the KSE, the extent of individual participation differs between the KOSDAQ and the KSE (Table 9.7). Individuals accounted for roughly three-fourths of the trading value in the KSE, but this relatively large share pales in comparison to their 95 percent share of trading value in the KOSDAQ market.

TABLE 9.7
Share of KOSDAQ Trading Value by Type of Investor, 1999-2001
Percent

	1999		2000		2001	
	KSE	**KOSDAQ**	**KSE**	**KOSDAQ**	**KSE**	**KOSDAQ**
Institutions	16.47	4.51	16.75	3.52	14.36	2.18
Foreigners	5.29	1.23	9.39	1.04	10.69	1.17
Individuals	78.09	91.87	73.67	94.37	74.68	95.70

Source: KOSDAQ Stock Market, Inc.

EVALUATION OF KOSDAQ MARKET DEVELOPMENT

Successful Identity Positioning

The most significant consequence of the development of the KOSDAQ market since 1998 was for the identity of the market. Before 1998, not only was the KOSDAQ market negligible in size, but also it did not have a clearly identified economic function independent of the KSE. The KSE and the KOSDAQ market (and the organized OTC market up to 1996) listed the same types of companies, but the companies listed on KOSDAQ were generally inferior to those listed on the KSE. In other words, before 1998 the KOSDAQ market served as a second-class KSE. But the spurt in activity at the end of the 1990s transformed the KOSDAQ market into a genuine 'New Equity Market' that caters to venture businesses. For the past several years, new listings in the KOSDAQ were mainly venture businesses, and now the number of venture businesses exceeds the number of ordinary businesses. Market participants today perceive the KOSDAQ market as a venture-oriented equity market, and the market has established its own clear identity.

Real Growth: More than a Bubble

Despite the impression given by price behavior, there are at least two indications that the explosive growth in the KOSDAQ during 1999 and early 2000 was not simply a bubble that was unsubstantiated by fundamentals. First, although the KOSDAQ Composite Index is still below its 2000 peak, the prices of venture stocks remain well above their levels of late 1998 and early 1999 (Figure 9.2). In other words, as far as venture businesses are concerned, the price increase appears to have been supported by improved fundamentals. Second, as new listings and capital raising continue, capitalization of the KOSDAQ market in 2001, at 51 trillion won, was six times that in 1998 (Table 9.8). Also, in terms of market capitalization, in 2001, the size of the KOSDAQ market relative to the KSE (20.3 percent) was double what it was in 1997 (Table 9.8). Thus, venture business was a driving force of real growth in the KOSDAQ market.

TABLE 9.8
Market Capitalization of KSE and KOSDAQ, 1997-2001
Billion won

	1997	1998	1999	2000	2001
KSE	70,988.9	137,798.5	349,504.0	188,041.5	255,850.1
KOSDAQ	7,068.5	7,892.2	106,280.5	29,015.8	51,818.1
KOSDAQ/KSE (%)	10.0	5.7	30.4	15.4	20.3

Source: KSE, *Stock* and KOSDAQ Stock Market, Inc.

Constraints on Continued Market Development

Two characteristics—heavy reliance on individuals and high turnover rates—indicate that the KOSDAQ market may not be mature enough to achieve efficiency and stable growth. Although there is no theoretical or empirical consensus on the optimal share for individuals among stock market participants, individual investors are generally presumed to be noisy or uninformed traders. A predominance of individual traders, then, and an absence of institutional structure to enhance information processing make a market vulnerable to unwarranted price volatility and illiquidity. When a fad captures such a market, mounting speculative trading increases price volatility but does not contribute to price discovery. When the market becomes sensitive to information asymmetry, liquidity will disappear and the market will shrink. The extraordinarily high turnover rates in the KOSDAQ market may be a sign of information asymmetry. If so, someday liquidity may dry up and the market may shrink. Thus, the current structure of the KOSDAQ market, relying heavily on individual traders, makes it fragile, and the market's recent unprecedented growth may be just another aspect of this fragility.

Growth Factors: Changes in Industrial Structure, Risk Profile, and Government Policies

One factor behind the growth of the KOSDAQ market in the late 1990s was likely the so-called IT revolution. The majority of companies listed on the KOSDAQ are information-related businesses, with 35.6 percent of listed companies directly involved in IT business (Table 9.9).[3] Although interaction between the KOSDAQ market and the IT revolution must run in two directions, at least at the beginning, the causality likely ran from the IT industry to the KOSDAQ market. In line with the trend in other economies around the world, during the late 1990s the IT industry in Korea grew faster

[3]. These sectors are video, audio, and communication device manufacturing, computer and office appliance manufacturing, information processing, computer management services, and communication services.

than other industries (Table 9.10). Since the growth of the IT sector began before the boom in the KOSDAQ market, it is probable that this spark in the real sector generated financial demand and provided a 'fundamental' basis for development of the KOSDAQ market.

TABLE9. 9
Composition of KOSDAQ-listed Companies by Industry

	Venture Businesses		Ordinary Businesses		All Listed Companies	
	Number	**%**	**Number**	**%**	**Number**	**%**
Manufacturing	244	72.2	223	63.2	467	67.6
Video, audio, communication devices	91	26.9	38	10.8	129	18.7
Computers and office appliances	18	5.3	2	0.6	20	2.9
Medical, optical devices	17	5.0	3	0.8	20	2.9
Other electric machinery	18	5.3	13	3.7	31	4.5
Other machinery	45	13.3	21	5.9	66	9.6
Chemical products	18	5.3	23	6.5	41	5.9
Traditional manufacturing	37	10.9	123	34.8	160	23.1
Services	94	27.8	130	36.8	224	32.4
Information processing, computer management	67	19.8	18	5.1	85	12.3
Communication	2	0.6	10	2.8	12	1.7
R&D, expert science, and technology services	5	1.5	5	1.4	10	1.4
Financial services	0	0	21	5.9	21	3.0
Entertainment	3	0.9	10	2.8	13	1.9
Construction	0	0	15	4.2	15	2.2
Other Services	17	5.0	51	14.4	68	9.8
Total	338		353		691	

Source: KOSDAQ Stock Market, Inc.

TABLE 9.10
Growth Contribution of the IT Industry, 1998-2001
(Percent)

		Growth rate			Contribution of IT Industry to GDP Growth
		Real GDP	**IT industry**	**Non-IT Industries**	
1998		-6.7	20.7	-9.0	1.6
	Q1	-4.6	25.2	-7.0	1.8
	Q2	-8.0	15.5	-9.9	1.2
	Q3	-8.1	16.0	-10.2	1.3
	Q4	-5.9	26.6	-8.6	2.0
1999		10.9	36.0	8.1	3.6
	Q1	5.8	29.5	3.3	2.8
	Q2	11.2	37.0	8.4	3.6
	Q3	13.0	36.0	10.4	3.6
	Q4	13.0	40.3	9.9	4.1
2000		8.8	36.5	5.0	4.4
	Q1	12.6	41.9	8.8	4.9
	Q2	9.7	40.2	5.5	4.9
	Q3	9.2	42.9	4.6	5.2
	Q4	4.6	23.9	1.8	3.0
2001					
	Q1	3.7	17.7	1.3	2.6
	Q2	2.7	3.4	2.6	0.5
	Q3	1.8	0.9	2.3	-0.1

Note: Contribution = increase in real value-added in IT industry / increase in real GDP.
Source: Bank of Korea.

Another factor in KOSDAQ's development, we argue, is the change in the risk-profile of the economy following the unprecedented failures of the *chaebol*. For the past several decades, the competitive structure of the Korean economy has been characterized by the existence of large conglomerates or *chaebol*. For various socio-economic reasons, the *chaebol* were believed to be 'too big to fail'. Taking advantage of that perception, the *chaebol* claimed a disproportionately large amount of financial resources, as reflected in their higher debt-equity ratios before the 1997 crisis.[4] The economic crisis undermined this belief, or more accurately, initiated fundamental changes in the underlying economic structure that had supported the 'too big to fail' belief. These fundamental changes include liberalization, opening, and growth itself of the Korean economy. When medium-sized *chaebol* went bankrupt in 1997 and 1998 market participants began to question their old belief. And when Daewoo, the third largest *chaebol*, failed in mid 1999, the belief finally faded out all together.

From the point of view of investors, correction of the 'too big to fail' belief implies a noteworthy change in the risk-profile of the Korean economy: formerly safe investment opportunities became fallen angels. Given the changed risk-profile, investors needed to reshuffle their portfolios and redirect some resources into different risk categories. Many of those resources seem to have flowed into government bonds as a way of finding safer assets. At the same time, investment opportunities that had once appeared too risky compared to *chaebol* became relatively less risky and could attract some of these resources. This argument is largely speculation because of the difficulty of measuring the impact of the failure of the *chaebol* on the perception of risk. But to the extent that the speculation is correct, the change in the risk-profile of the Korean economy that resulted from the failures of the *chaebol* was a factor spurring growth of the KOSDAQ market.

Such phenomena as the IT revolution and the change in the risk-profile of the economy are manifest as permanent shocks on the quantitative levels of market activity. In other words, they represent changes in market fundamentals. Thus, whatever impact these two factors had must be seen as a permanent shift in the long-run path of the market. Hence, neither the change in industrial structure nor the change in the risk- profile is sufficient to explain the sudden, sharp expansion of the

[4]. For a detailed discussion on the financial structure of *chaebol* see Joh (1999).

KOSDAQ market in 1999 and 2000. For this, we need to find some factors that gave a temporary boost to the market. Government policies seem to be the likely candidate.

After the 1997 economic crisis, the Korean government adopted various policies aimed at fostering the KOSDAQ market in order to facilitate development of small and medium-sized high-tech companies. These policies were comprehensive as they covered all market agents and they were all similar in nature to providing tax favors. First, in 1999 the government encouraged companies to list in the KOSDAQ by exempting KOSDAQ-listed companies from taxes on income set aside as a loss provision, up to a maximum of 50 percent of their total annual income. Second, in 1999, as an incentive to underwriters, the government loosened the legal standards for due diligence and relaxed the penalties for failure to comply with the regulation. Third, it provided for favorable treatment of dividend and capital income for shareholders in venture capitals and investors in venture funds as incentives for investment in venture businesses.

Fourth, and most important, the government itself participated in the KOSDAQ market as an investor in venture businesses and as an intermediary evaluating the eligibility of firms to benefit from the relaxed listing requirements for venture businesses (Table 9.11). The government established public funds specializing in venture investment and also set up publicly funded loan programs for venture businesses. In addition to these programs, which provided public funds to stimulate the market, the most interesting government intervention was the 'venture certification program'. This program established a procedure for identifying venture-type businesses—companies that satisfy certain conditions or pass evaluation of a government-recognized institution. Otherwise, the only companies that are eligible for favorable treatment in the listing requirements are those selected by the market—that is, companies that have already attracted venture capital investors. Although the venture certification program was established in November 1997, it seems to have been actively utilized only since 1999. Its significance in the development of the KOSDAQ market is seen in the increased proportion of 'certified ventures' among ventures listed in the KOSDAQ after 1999. In 1999, certified ventures comprised 42.8 percent of all listed ventures, with venture capital-invested ventures comprising the remaining, larger, proportion. By 2000, though, certified ventures were in the majority with 63.0 percent of all listed ventures.

TABLE 9.11
KOSDAQ Market Listing Requirements for Ordinary and Venture Businesses

	Ordinary Business		
	Option 1	**Option 2**	**Venture Company**
Trading Record	3 years	-	-
Paid-in Capital	500 million won	-	-
Shareholders' Equity	-	10 billion won	
Total Asset	-	50 billion won	-
Debt-to-equity ratio	Less than 150% of the industry mean	Less than 100% of the industry mean	-
Earnings	Positive ordinary income	-	-
Capital Impairment	No capital impairment during the most recent business year	No capital impairment during the most recent business year	No capital impairment during the most recent business year
Auditor's Opinion	Qualified or Qualified with reservation	Qualified or Qualified with reservation	Qualified or Qualified with reservation
Share Distribution	More than 30% of shares, or more than 10% and no less than 1 million shares, should be placed to the public	More than 30% of shares, or more than 10% and no less than 1 million shares, should be placed to the public	More than 30% of shares, or more than 10% and no less than 1 million shares, should be placed to the public
	More than 500 minority shareholders	More than 500 minority shareholders	More than 500 minority shareholders

FUTURE POLICY ISSUES FOR KOSDAQ

As a result of its development since 1998, the KOSDAQ market is now reckoned as a stock market by any measure. But given its short history, the market must still address a number of significant policy issues.

Reforming the Policy Paradigm

The government of Korea has been an essential component in the growth of the KOSDAQ market. It is the effective owner and governor of the market. Furthermore, it fostered the market by providing tax subsidies to market participants and it directly participated in the market as investor and venture certifier. In short, the interface between the government and the market so far is characterized by strong intervention, which presumably resulted from the policy goal of market-creation or market-fostering.

Now that the KOSDAQ market has successfully established its identity, at least as far as its external aspects are concerned, the government needs to adopt a new policy goal and a new policy paradigm. An appropriate goal in the changed environment would be 'investor protection', which is a policy goal in advanced countries. In economic jargon, investor protection is expressed as ‘resolution of market failure due to information asymmetry’. The new policy paradigm based on such a policy goal would be maximization of the market mechanism/minimization of government presence.

Configuring Regulatory, Governance, and Ownership Structure

In order to implement this new policy goal and paradigm, the government needs to determine how to configure the regulatory, governance, and ownership structure of the KOSDAQ. It may be easy to get a consensus on the necessity to replace the government ownership structure by a private one, but deciding who should and should not be among the private owners is more difficult. In particular, the role of the KASD could be controversial, given that the NASD, its U.S. counterpart, recently divested its holdings in Nasdaq Stock Market, Inc. The Korean government is likely to confront the same broad issue that advanced economies face: how to arrange the regulatory and governance structure of a privately owned exchange. Another unresolved issue is the relationship between KOSDAQ and the Korea Stock Exchange. In such European countries as Germany and France, new equity markets are under the umbrella of the traditional exchange, in contrast to the situation in the United States where, as is well known, the Nasdaq market competes with the NYSE. Whether to allow multiple exchanges and competition among them is a question Korea has yet to address.

Improving the Role of Financial Institutions

While ‘investor protection’ or ‘resolution of market failure due to information asymmetry’ is an often mentioned policy goal in advanced countries, it should be remembered that the raison d’être of financial institutions is, in fact, to lessen problems of information asymmetry. Further, the Korean government drove the development of the KOSDAQ market because it desired faster growth when development of financial institutions lagged. Following this line of argument, transforming the former intervention paradigm into a market-based one seems to require establishing an appropriate role for financial institutions in the KOSDAQ market.

Experience in advanced economies suggests that two kinds of financial institutions may be essential players in a KOSDAQ-type stock market: venture capitals and investment banks. Venture capitals are said to reduce information asymmetry problems during the IPO process. Specifically, the economics literature reports that the ‘under-pricing’ problems of newly issued stocks are reduced when highly regarded venture capitals are involved.[5] The performance of IPO stocks and, in conjunction with this, the role of venture capitals gained attention in Korea as the KOSDAQ market stalled in late 2000. So far, the general view is that venture capitals have not yet built up sufficient reputation to enhance market efficiency, which is not surprising since most Korean venture capitals are less than five years old. Hence, establishing well functioning venture capitals remains a policy issue for Korea.

Besides venture capitals, the other type of financial institution with a role in stock markets is the investment bank. The importance of investment banks in the development of stock markets is well accepted.[6] In particular, investment banks are said to 'make markets'. As underwriters in the primary market, investment banks determine offering prices and their reputation convinces the public of the fairness of these prices. Thus, transactions take place and the market is made due to the certifying role of investment banks. In addition, as dealers in the secondary market, investment banks provide liquidity or service of immediacy to the market and so sustain the stability and reliability of trading. An interesting feature of the KOSDAQ market, and in some sense what makes its growth mystifying, is the limited role that investment banks have.

Investment banks do not play a market-making role in either the primary or the secondary KOSDAQ market. They cannot act freely as market makers in the primary market because they do not have full responsibility for determining offering prices. Under the so-called demand prediction system large institutional investors also participate in the price determination procedure. Whenever there is a public offering of a stock, demand revelations from institutional investors automatically determine a range for the offering price. Underwriters then choose the final offering price within the predetermined range. Moreover, dealers play a limited role in the secondary market for KOSDAQ stocks and this role appears to have decreased over time. Dealers lost a significant role in 1996 when KOSDAQ market replaced the organized OTC market and the auction replaced the quote system. Even so, at the time the KOSDAQ market was launched, the underwriter of each newly listed stock was still required to post quoted prices for the stock and accept buy/sell offers at the quoted prices up

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[5]. It is dubbed the 'certification hypothesis'. See Barry et. al. (1990) and Meggison and Weiss (1991).
[6]. For example, see Anand and Galetovic (2001).

to certain amounts, but this regulation was subsequently removed, further reducing the role of dealers.

Therefore, the regulatory and institutional aspects of the KOSDAQ market work directly through the investing public without relying on the participation of investment banks. Due to this characteristic, individuals are accustomed to participating in the market with little expectations from investment banks. Whether this situation is sustainable in the long term is questionable, and so it demands a policy resolution.

CONCLUDING REMARKS

Since the Asian crisis of 1997, the unbalanced structure of financial markets in Asian countries, which tilted steeply toward the banking system, may have delayed development of the financial system and exacerbated the credit crunch after the crisis. In theory, bank loans and direct financing through capital markets are likely to be complementary, offering different mechanisms for risk-sharing. Bank loans retain comparative advantage in resolving information asymmetry, while direct financing has advantages in lower intermediary costs, signaling, and propensity for system risk. So, the typical argument goes, in order to introduce diverse risk-sharing schemes and to improve pricing functions of financial markets, Asian countries need to develop capital markets.

Irrespective of the general validity of that argument, in the case of Korea, capital markets have already been an important financing channel for non-financial corporations. Although it is not widely known, the corporate bond market in Korea maintained strong growth since the late 1970s. When the economic crisis erupted in 1997, bonds accounted for sixteen percent of corporate external financing. Equity also explained about fifteen percent of outstanding corporate financing in 1997. Overall, direct financing including equity, bonds, and short-term bills comprised about forty percent of corporate financing, compared to only thirty-six percent of financing from bank loans.[7]

The trend in the 1980s and the 1990s that capital markets were increasingly important venues for corporate financing has further strengthened in the post-crisis years. In particular, equity financing surged, raising the portion of direct financing in external financing of non-financial firms to forty-three percent in 2000, while the portion of loans diminished by four percent since 1997. The growth of the

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[7]. For a brief overview on the Korean capital market and financing pattern of firms, see Shin and Park (2001)

KOSDAQ market, among other factors, produced this change.

Therefore, taking a historical point of view, the capital market in Korea was a financial engine of economic growth from the 1980s until the economic crisis of 1997. Furthermore, with the development of the KOSDAQ stock market and the changing structure of the economy, the Korean capital market is set to play an even larger role in the future, as evidenced by recent trends.

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CHAPTER 10

FINANCING TAIWAN'S KNOWLEDGE-INTENSIVE FIRMS

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INTRODUCTION

The era of the knowledge economy has dawned and technological knowledge has already increased significantly over the last decade. At the start of the 21st century, the idea of the knowledge economy is widely adopted and it has become an important yardstick in the drive towards economic growth. The production inputs of labour, machinery, and land are no longer the sole motive power ensuring continuing economic development; now economic development must be founded on knowledge and information.

In 1980 Taiwan embarked on a process of industrial upgrading, which brought extremely rapid growth in the island's high-tech industry along with a steady increase in high-tech businesses' share of total production value. On 31 August 2000, the Administration Authority of the Executive Yuan approved the Knowledge Economy Development Project, which set out development strategies and measures for the drive towards the knowledge economy. Knowledge-intensive industries usually mean those industries that create value in products through innovation. They might be traditional or high-tech industries, although most knowledge-intensive industries are high-tech industries. The project of the Administration Authority demonstrates that continued promotion of the high-tech industry and technological upgrading would be vital aspects of future industrial development in Taiwan.

A number of environmental factors are prerequisites for effective development of the knowledge economy. One of the most important of these is a sound financial environment. Advanced economies have highly developed financial systems and a wide range of financial institutions and financial instruments and offer high-tech firms a variety of financing sources. In order to develop its high-tech knowledge-intensive industry Taiwan must not only promote

R&D for technological upgrading, but also ensure that enterprises similarly have access to suitable funding, whether they have become established businesses or are still in the planning stage.

The government provided financial as well as technical assistance to high-tech firms that located in the new Hsinchu Science-based Industrial Park (HSIP). The Development Fund allocated funds for low-interest loans to start-ups and investment in new companies through selected state banks, and the Industrial Technology Research Institute (ITRI) transferred technology developed by its various divisions to the HSIP companies. This extensive government support was a great help in establishing the high-tech firms in HSIP. But government financial support should not be the mainstay for high-tech industries once an economy has a well-developed industrial sector and financial system. Therefore, establishing a sound financial system is a major prerequisite to facilitating funding sources for knowledge-intensive firms in Taiwan.

High-tech industries often have a greater level of risk than other industries, particularly enterprises in the start-up phase, which need seed capital. Providers of seed capital take on this greater risk, but they also have the prospect of earning higher returns. Thus, the high-tech industry needs a financial environment in which those who wish to invest in high-risk/high-return start-up activities can do so easily. Taiwan needs some financial reform in order to achieve such a financial environment.

This chapter describes the ongoing development in the financing of high-tech firms in Taiwan. It begins with a general overview of the funding environment for knowledge-intensive firms. Then the chapter examines three major categories of non-government financing, evaluating their past role in supporting high-tech and start-up enterprises and the expected changes. The third section examines indirect versus direct financing, the fourth section discusses the contribution of the stock market, and the fifth section examines the growth and operation of venture capital businesses. The concluding section argues that Taiwan needs to concentrate particularly on filling the financing gap for enterprises in the earliest stages of development.

THE FUNDING ENVIRONMENT FOR KNOWLEDGE-INTENSIVE FIRMS IN TAIWAN

Funding Requirements and Business Development

The financing needs of most enterprises, including high-tech ones, change as they develop from initial concept to established commercial operation. This study distinguishes six stages of business development—planning, establishment, mass production, expansion, maturity, and reorganisation. Other analyses of business development identify only four or even three stages. The exact number of stages is not important; the essential point is that enterprises need funding at all stages, and that their specific funding requirements change as the business develops.

An inventor or entrepreneur needs funds to turn a concept into reality and thus enterprises in the planning stage need seed capital. In the establishment stage, enterprises need to finance product development and marketing, and they need initial capitalisation. R&D expenditures account for a high percentage of their total funding requirements. Businesses in this stage inherently involve new products that carry a high level of risk. Because of this, newly established enterprises have difficulty securing loans from traditional financial institutions, such as banks, and they often depend on personal capital, government funding, and venture capital financing (whereby investors receive a share of the new company's equity in exchange for funding).

During the mass production and expansion stages, enterprises are developing their operations and expanding production capacity. They can obtain working capital to meet accounts receivable and increase inventories from commercial banks, but they may require additional funds to construct and expand factories as their sales grow. High-tech companies in the expansion stage may obtain medium-and long-term funding from development banks or from private sector financial institutions.

Once a high-tech firm has reached maturity, its operations have stabilized, and levels of risk as well as profits have fallen. Hence, a firm at this stage can obtain most of the funding it needs from financial institutions such as commercial banks and bills finance companies. It can secure long-term capital by listing on the stock exchange or from the OTC market. Mature firms may need to reorganise and transform in order to survive and grow in the wake of a major change in the business environment. Normally, they can go to the banking sector and stock market to obtain the funds to do this, but in times of recession the government may provide financial and tax measures to facilitate mergers and acquisitions among established companies.

Funding Sources and High-tech Industry Development

Not only do funding requirements change with an enterprise's stage of development, but also certain types of funding are best provided by particular financial institutions (Table 10.1). Consequently, enterprises depend on funding from different elements of the financial system over the course of their development. Government typically provides funds in the early stage of business development, while commercial banks tend to become involved at a relatively late stage (with specialist banks involved slightly earlier). Although individual investors may provide funds at any stage, venture capital companies are involved in the early to middle stages, while the capital markets play no funding role until much later on.

TABLE 10.1
Funding Sources at Different Stages of Enterprise Development in Taiwan

		Source of Funds					
Development Stage	**Type of Funding Required**	**Governmen t**	**Commercial Banks**	**Special Banks**	**Capital Markets**	**Venture Capital Companies**	**Individual Investors**
Planning	Seed capital	X					X
Establishment	Funding for establishment and early stages of operations	X		X		X	X
Mass production	Working capital and expansion funding	X	X	X		X	X
Expansion	Expansion funding		X	X		X	X
Maturity	Mature funding		X		X		X
Reorganisation	Reorganisation funding	X	X		X		X

Source: Compiled for this study.

In Taiwan, the government began to promote the high-tech industry in 1980. The Council for Economic Planning and Development's Ten-year Plan for Economic Construction singled out electronics and information along with machinery as industries of particular strategic importance. The government subsequently clarified the strategy and principles for the development of these strategic industries in the Plan for the Development of the Machinery Industry and the Plan for the Development of the Electronics Industry. In 1982, the Industrial Development Bureau collaborated with the Ministry of Finance, Chiao Tung Bank, and ITRI to encourage the development of strategic industries. Thereafter, in order to promote industrial upgrading, the government developed the concepts of Ten Emerging Industries, Important Technology Enterprises, Eight Key Technologies, and Sixty-six Key Components, and it provided funding and tax incentives to support the development of these industries and technologies.

The need for special government incentives to promote specific industries diminished as a result of the rapid growth in the high-tech sector and the steady improvement in the financial system during the 1990s. The trend is moving toward allowing the internal market mechanism of the financial system to allocate funds for industrial development. Indeed, throughout the 1990s the government shifted steadily away from industry-specific incentives towards more function-specific incentives.

Private funding through financial institutions, the capital markets, and individuals can play a significant role in supporting the growth of the high-tech industry. The private financial system can provide loans or investment funds to finance both medium and long-term capital expenditures–to purchase land or establish production facilities–and it can provide shorter-term working capital to fund everyday purchases and sales activities. As Taiwan's financial system was liberalised during the 1990s, new types of financial institutions and instruments started to appear, including venture capital businesses and stock market peripheral institutions, expanding the content of financial services. However, financial institutions in Taiwan are still not as competitive in providing financial services to industries as are their counterparts in advanced countries. Taiwan must further improve the financial services available to knowledge-intensive firms.

INDIRECT AND DIRECT FINANCING AND SUPPORT OF HIGH-TECH INDUSTRY

Historically, the great majority of business financing in Taiwan has come through indirect finance (mostly financial intermediaries), rather than direct finance (i.e., the financial markets). In 1980, over 80 percent of non-government financing was indirect, specifically commercial bank loans (Table 10.2). The share of indirect financing declined gradually from the early 1990s as alternative sources of financing began to develop, but at the end of 2001, indirect finance still accounted for just under two-thirds of the funds provided by the non-government sector.

Thus, in Taiwan an industry's development prospects, and the prospects of the high-tech industry in particular, depend critically on access to indirect finance. Banks are the main providers of indirect finance. The traditional industries, which were the main recipients of bank loans in the past, have grown weaker with the transformation in Taiwan’s industrial structure and the technology-intensive industries took their place as Taiwan's key industrial sector following the industrial upgrading of the 1980s. These now matured high-tech industries have easier access to both bank loans and direct finance, and government financial support is less important than before. For those high-tech companies that are just getting off the ground, though, obtaining loans from commercial banks is difficult because they lack collateral. Moreover, newly established high-tech firms find it difficult to secure direct financing because they lack a clear record of profitability and because Taiwan's capital markets are not functioning properly. Thus, the financial needs of start-up high-tech enterprises are not being served well by either traditional indirect financing or the developing capital markets.

TABLE 10.2
Direct and Indirect Financing by Non-government Sector, 1980-2001

	Indirect Finance		Direct Finance								Total	
	Loans		Subtotal		Listed Stocks		Sort-term Bills		Corporate Bonds			
	$NT 10 mil.	%	$NT 10 mil.	%	$NT 10 mil.	%	$NT 10 mil.	%	$NT 10 mil.	%	$NT 10 mil.	%
1980	10,008	83.37	1,996	16.63	1,087	9.05	659	5.49	250	2.08	12,003	100
1981	11,221	80.73	2,678	19.27	1,284	9.24	1,098	7.90	297	2.14	13,900	100
1982	13,051	80.31	3,199	19.69	1,515	9.32	1,333	8.20	351	2.16	16,250	100
1983	15,140	80.73	3,614	19.27	1,672	8.91	1,594	8.50	348	1.86	18,754	100
1984	17,028	79.89	4,287	20.11	1,904	8.93	1,959	9.19	424	1.99	21,315	100
1985	17,978	80.05	4,480	19.95	2,134	9.50	1,954	8.70	391	1.74	22,457	100
1986	19,653	81.64	4,420	18.36	2,408	10.00	1,545	6.42	466	1.94	24,073	100
1987	23,892	83.32	4,782	16.68	2,885	10.06	1,381	4.81	516	1.80	28,675	100
1988	33,030	86.00	5,377	14.00	3,563	9.28	1,293	3.37	521	1.36	38,406	100
1989	40,576	85.14	7,081	14.86	4,709	9.88	1,918	4.02	454	0.95	47,656	100
1990	46,434	83.34	9,280	16.66	5,293	9.50	3,471	6.23	516	0.93	55,714	100
1991	57,277	84.76	10,302	15.24	6,205	9.18	3,446	5.10	652	0.96	67,579	100
1992	72,309	85.74	12,027	14.26	7,400	8.77	3,961	4.70	666	0.79	84,336	100
1993	83,874	83.93	16,059	16.07	8,945	8.95	6,511	6.51	604	0.60	99,933	100
1994	96,735	83.73	18,802	16.27	10,809	9.36	7,286	6.31	707	0.61	115,537	100
1995	104,641	80.64	25,115	19.36	14,976	11.54	9,217	7.10	922	0.71	129,756	100
1996	106,951	75.30	35,076	24.70	18,935	13.33	13,636	9.60	2,504	1.76	142,026	100
1997	119,407	73.04	44,074	26.96	26,558	16.25	14,284	8.74	3,232	1.98	163,481	100
1998	125,323	68.19	58,454	31.81	35,248	19.18	18,017	9.80	5,189	2.82	183,777	100
1999	129,774	67.88	61,405	32.12	40,458	21.16	15,045	7.87	5,901	3.09	191,179	100
2000	135,445	66.48	68,302	33.52	48,564	23.84	12,665	6.22	7,073	3.47	203,747	100
2001	129,310	64.26	71,928	35.74	52,636	26.16	11,103	5.52	8,189	4.07	201,238	100

Note: Loans, listed stock and corporate bonds are outstanding (market) values.
Source: Compiled from Central Bank data.

A financial sector that offers a multi-functional mix of services will create a better environment for business funding. In order to support the development of knowledge-intensive firms, the financial system in Taiwan must offer a wider variety of both direct and indirect financing options. Toward this end, in 2001 the government approved the establishment of financial holding companies (FHC) in Taiwan. Thirteen new FHCs were established up to September 2002. A single FHC may own several different financial institutions including commercial banks, industrial banks, securities companies, insurance companies, venture capital businesses, and financial consulting agencies. At the same time, Taiwan also needs a healthy financial supervisory agency to oversee the activities of the financial system.

THE STOCK MARKET AND HIGH-TECH INDUSTRIES

The stock market in Taiwan is significantly larger than the bond market and it is the main source of direct financing for all companies. In 2001 the value of listed stocks was over six times the value of corporate bonds outstanding (Table 10.2). Moreover, the bond market is not a significant source of funding for newly established knowledge-intensive firms because it caters to larger firms.

Taiwan has two stock markets, the Taiwan Stock Exchange (TSE) and the Over-the-Counter Securities Exchange (OTC). The TSE listed 584 companies with total capitalisation of NT$4.1 trillion in December 2001 and the exchange's total trading volume that year stood at NT$18.4 trillion (Table 10.3). The OTC listed 333 companies with a total capitalisation of NT$0.68 trillion in December 2001 and it had a total trading volume of NT$2.3 trillion. In general, in order to be listed on the TSE companies must meet certain standards, including minimum years of establishment and profitability. Listing on the TSE is more difficult than on the OTC, mainly because the TSE requires minimum paid-in capital of NT$300 million compared to only NT$100 million for the OTC. Most SMEs, which dominate Taiwan's industrial structure, lack the liquidity and economies of scale to list on either the TSE or OTC. Hence, SMEs usually cannot use capital market funds to expand their scale of production or improve competitiveness.

TABLE 10.3
Characteristics of Taiwan's Stock Markets, 1995-2002

	Taiwan Stock Exchange			ROC OTC Securities Exchange			Unlisted Companies	
	No. of Listed Companies	Capitalisation NT$ billion	Trading Volume NT$ billion	No. of Listed Companies	Capitalisation NT$ billion	Trading Volume NT$ billion	No. of Companies	Capitalisation NT$ billion
1995	347	1,347	10,152	41	173	3	999	1,218
1996	382	1,661	12,908	79	264	454	1,110	1,346
1997	404	2,106	37,241	114	315	2,311	1,501	1,462
1998	437	2,734	29,619	176	381	1,198	1,801	1,519
1999	462	3,086	29,292	228	514	1,900	2,018	1,610
2000	531	3,661	30,527	300	677	4,480	2,257	1,519
2001	584	4,096	18,355	333	681	2,329	1953	1,518
2002 Jan.-Mar.	595	4,081	7,332	380	702	1,081	1,607	1,184
Growth Rate (%)								
1995	10.86	22.53	-46.04	192.86	1,666.85	392.25	8.94	1.11
1996	10.09	23.36	27.15	92.68	52.67	16,119.92	11.11	10.45
1997	5.76	26.79	188.52	44.30	19.22	409.51	35.23	8.66
1998	8.17	29.81	-20.47	54.39	21.44	-48.15	19.99	3.88
1999	5.72	12.76	-1.11	29.55	34.62	58.57	12.05	5.98
2000	14.94	18.75	4.22	31.58	31.46	135.79	11.84	-5.65
2001	9.98	11.88	-39.87	11.00	0.59	-48.01	13.47	-0.07

Source: Taiwan Stock Exchange; ROC Over-the-Counter Securities Exchange; Securities and Futures Commission and http://www.sfc.gov.tw

Both the TSE and the OTC have special listing standards intended to help high-tech start-ups secure direct funding by selling shares in the capital market, however. Such provisions include eliminating restrictions on years of establishment or profitability and lowering the minimum paid-in capital requirement. The OTC also has a Second Category for companies that have been in existence for at least one year with no accumulated losses but low capitalisation. In terms of the dispersion of equity, the TSE requires high-tech companies to have a minimum of 1,000 registered shareholders, at least 500 of whom must each hold between 1,000 and 50,000 shares. The OTC requires at least 300 shareholders each with between 1,000 and 50,000 shares, and with their combined holdings accounting for at least 10 percent of the company's total equity, or at least 5 million shares. Given its less rigorous financial requirements, the OTC requires a company to be recommended by at least two securities firms, whereas the TSE requires recommendation by only one.

Despite the relaxed listing requirements for high-tech firms on both exchanges, most high-tech firms choose to apply for listing as an ordinary company. A company that applies under the high-tech provisions must submit evidence from the government agency supervising its industry stating that (i) it is a high-tech company; and (ii) its product or technology development has been successful and it has marketable products or technologies. The Industrial Development Bureau (IDB) has formulated a set of guidelines for requesting such government support, but very few companies have applied for listing in accordance with those guidelines. This is mainly because most high-tech companies that apply for TSE or OTC listing can already meet the requirements for ordinary companies, so there is no need for them to apply as high-tech companies.

Investors in Taiwan's stock markets appear to prefer non-traditional over traditional industries, making it easier for high-tech companies to obtain capital market funding. In 2001, over 80 percent of the value of the shares of manufacturing firms listed on the TSE was attributable to companies in non-traditional manufacturing industries, which are mainly related to the high-tech sector. For companies listed on the OTC it was 95 percent (Table 10.4). Traditional industries, on the other hand, accounted for just 18 percent of the value of manufacturing shares on the TSE and for a mere 4 percent of the OTC. Most traditional industries are now declining industries, although they continue to generate about 60 percent of manufacturing output by value (Table 10.5).

TABLE 10.4
Value of TSE- and OTC-Listed Manufacturing Companies by Traditional and Non-traditional Industries, 1999-2001

	1999		2000		2001	
	NT$ million	%	NT$ million	%	NT$ million	%
TSE-listed manufacturing companies	8,986,189	100.00	6,194,553	100.00	5,404,444	100.00
Traditional industries	2,313,294	25.74	1,461,796	23.59	993,967	18.39
Non-traditional industries	6,672,895	74.26	4,732,757	76.41	4,410,477	81.61
OTC-listed manufacturing companies	1,052,939	100.00	576,709	100.00	507,449	100.00
Traditional industries	65,716	6.24	25,998	4.50	20,803	4.10
Non-traditional industries	987,223	93.76	550,711	95.50	486,646	95.90

Notes: Figures for 2001 cover January to October only. Traditional industries include food and beverages, textiles and garments, leather and fur products, wood and bamboo furniture, papermaking and printing, chemical materials and products, rubber and plastic products, petroleum, non-metal mineral products, basic metals, metal products and other manufacturing. Non-traditional industries include machinery, electricity and information, electronics and vehicle manufacturing.
Source: Complied from data supplied by the Taiwan Stock Exchange.

TABLE 10.5
Value of Manufacturing Output by Traditional and Non-traditional Industries, 1999 and 2000

	1999		2000	
	NT$ million	**%**	**NT$ million**	**%**
All manufacturing	2,470,012	100.00	2,549,927	100.00
Traditional industries	1,502,653	60.84	1,511,238	59.26
Non-traditional industries	967,359	39.16	1,038,689	40.74

Notes: Traditional industries include food and beverages, textiles and garments, leather and fur products, wood and bamboo furniture, papermaking and printing, chemical materials and products, rubber and plastic products, petroleum, non-metal mineral products, basic metals, metal products and other manufacturing. Non-traditional industries include machinery, electricity & information, electronics and vehicle manufacturing.
Source: Complied from data published by the Council for Economic Planning and Development.

High-tech companies can gain access to direct finance by listing on one of the stock exchanges, but what about unlisted companies? Many unlisted companies have made initial public offerings (IPOs). Investors are eager to buy such stocks just before they list, in order to enjoy the post-listing 'honeymoon' period during which prices typically rise rapidly. Trading in unlisted shares is unregulated in Taiwan, however. As a result disclosure by issuing companies is not controlled, the transaction process is not transparent, and investors' rights are not fully protected.

In an attempt to address these problems and strengthen the capital markets, the OTC is currently nurturing a market for unlisted shares, which it established in January 2002. The registration requirements for this new market are very loose. For example, a company simply needs to be recommended in writing by a minimum of two securities firms that do meet the listing requirements. How this market develops remains to be seen, but it should facilitate financing for promising high-tech start-ups.

VENTURE CAPITAL FINANCING AND TAIWAN'S HIGH-TECH INDUSTRIES

Venture capital financing developed rapidly in Taiwan during the 1990s, growing considerably faster than in most other countries. Taiwan ranked eleventh in total volume of venture capital investment in 1999 and third in terms of the average rate of growth of venture capital investment from 1995 to 1999 (Tables 10.6 and 10.7).

TABLE 10.6
Top 20 Countries by Amount of Venture Capital Investment, 1999

Rank	Country	Amount US$ billion	Rank	Country	Amount US$ billion
1	United States	97.6	11	Taiwan	0.9
2	England	12.3	12	Japan	0.8
3	Germany	3.4	13	Spain	0.8
4	France	3.0	14	Belgium	0.7
5	Italy	1.9	15	South Korea	0.5
6	Canada	1.8	16	Switzerland	0.5
7	Netherlands	1.8	17	Singapore	0.4
8	Sweden	1.4	18	South Africa	0.4
9	Hong Kong	1.3	19	Australia	0.3
10	Israel	1.0	20	Norway	0.3

Source: PriceWaterhouseCoopers.

TABLE 10.7
Top Countries, by Average Growth Rate of Venture Capital Investment for 1995-99

Rank	Country	Growth rate %	Rank	Country	Growth rate %
1	Sweden	201	10	England	39
2	Switzerland	119	11	Netherlands	32
3	Taiwan	60	12	France	30
4	Italy	59	13	Singapore	28
5	Belgium	58	14	Norway	25
6	Israel	54	15	Canada	24
7	Germany	42	16	Hong Kong	13
8	Spain	41	17	South Korea	4
9	United States	40			

Source: PriceWaterhouseCoopers.

The venture capital industry in Taiwan traces its origins to the November 1983 promulgation of the Regulations Governing Venture Capital Business Management. The industry developed slowly until the early 1990s despite government tax incentives for venture capital companies in 1984, the introduction of the Development Fund in 1985, and Chiao Tung Bank's investment in venture capital companies in 1991. Fewer than four new venture capital companies were established each year from 1984 to 1994, except for 1989 and 1990. Significant returns on past venture capital investments did not materialise until 1996, when the high-tech industry recorded strong growth and high-tech stock prices began to soar. Thereafter, the number of venture capital companies began to grow significantly. By the end of 2000, Taiwan had 184 venture capital companies with total capital of NT$128 billion and of these companies, 157 were established after 1996.

Industry growth was particularly strong with the run-up in high-tech stock prices in 1999 but it slowed since then. Forty-six new firms with a total capitalisation of almost NT$30.5 billion were started in 1999, but only 31 new companies with capitalization of NT$24.7 billion appeared in 2000, and a mere seven new venture capital companies were established in 2001. Moreover, only 176 of the 199 licensed companies in 2001 were actually operating. The remaining 23 had either yet to begin operations or had postponed their establishment, suggesting that venture capital companies were having difficulty raising initial funding.

The emergence of a venture capital industry in Taiwan provided strong financial support for the island's growing high-tech sector during the 1990s. Cumulative venture capital investment totalled NT$125.5 billion at the end of 2000. Virtually all (97 percent) of this amount was invested in high-tech industries, with less than three percent going to traditional industries, and almost three-fourths (73.7 percent) remained in Taiwan, with the rest going mainly to Silicon Valley and other parts of the United States (Table 10.8). By industry, venture capital funding concentrated in the semiconductor (18.4 percent of cumulative investment), information (17.6 percent), electronics (14.5 percent), communications (12.3 percent), and opto-electronics (9.8 percent) industries. By stage of business development, 45.3 percent of venture capital funding went to firms already in the expansion stage while less than one-third went to earlier stages of development—7.9 was invested as seed capital and 23.8 percent went to enterprises in the establishment stage.

Nevertheless, the role of venture capital in the early funding of enterprises in Taiwan did increase significantly during the 1990s. The proportion of total venture capital funds invested in seed capital and establishment stages rose from 14.2 percent in 1994 to 40.6 percent in 2000 and the proportion of projects in these two stages increased from 17 percent to 37 percent (Table 10.9). Almost one-third of the total venture capital investment in these two stages from 1984 to 2000 (NT$39.9 billion) occurred in the single year 2000. The increased availability of venture financing for new businesses was limited to firms in the establishment stage, however. By 2000, the share of venture capital investment, by number of projects as well as amount of financing, going to establishment stage firms had risen to over 30 percent, but the share going to nascent businesses as seed capital showed no discernible trend. Thus, there still appears to be a need to generate financial support for enterprises in the earliest stage of development.

TABLE10. 8
Venture Capital Investment by Industry and Stage of Development, Cumulative through 2000
(NT$ million)

	Industry Total		Industry Amount by Stage of Development				
	Amount	**%**	**Seed Capital**	**Establishment**	**Expansion**	**Maturity**	**Reorganisation**
Information	22,079.5	17.59	1,966.1	4,114.9	9,555. 4	6,191.0	252.1
Software	7,775.8	6.20	472.7	2,555.4	3,395.7	1,319.1	33.0
Internet	3,523.8	2.81	220.5	1,794. 1	1,044.8	437.4	27.1
Electronics	18,180.7	14.49	524.3	2,894.3	10,213.9	4,112.7	435.5
Semiconductors	23,144.8	18.44	1,905.0	5,696.9	10,264.3	5,196.6	81.9
Communications	15,387.6	12.26	1,759.5	3,936.3	7,045.3	2,426.5	220.0
High-end sensors	452.4	0.36	41.1	65.9	294.5	50.9	-
Pollution prevention	258.0	0.21	39.0	103.6	66.7	48.8	-
Precision machinery and automation	3,028. 8	2.41	86.2	189.2	1,459.0	1,289. 5	-
High-end materials	1,371.3	1.09	14.0	432.5	539.2	382.5	3.0
Special chemical products and pharmaceuticals	399.9	0.32	40.1	136. 8	223.0	-	-
Medical and healthcare	821.1	0.65	21.4	319.6	374.5	105.6	-
Aerospace	485.9	0.39	-	41.2	339.6	57.9	47.2
Resource development	645. 1	0.51	-	352.5	235.2	57.3	-
Opto-electronics	12,300.3	9.80	1,121.2	4,643.1	4,555.8	1,953.2	27.0
Biotechnology	3,571.2	2.85	452.2	1,067.7	1,197.7	833.6	20.0
Technical services	604.0	0.48	38.8	172.4	296.7	96.2	-
Other key technologies	4,202.2	3.35	222.6	404.3	2,794.1	752.2	29.0
Venture capital companies	2,216. 1	1.77	916.7	663.3	576.5	59.5	-
Traditional, low-tech industries	5,065.0	4.04	109.8	339.2	2,402.6	2,167.8	46.0
Venture capital total	125,508.3	100.0	9,951.2	29,923.3	56,874.2	27,538.4	1,221.4
Stage share of venture capital for all industries			7.93%	23.84%	45.32%	21.94%	0.97%

Source: Lin C-F. and Y-J. Ch'en. 2001. Suggestions Regarding the System for Transactions in Unlisted Shares in Taiwan, *Securities Transaction Data*, No. 471.

TABLE 10.9
Venture Capital Investment in the Early Stages of Enterprise Development, 1994-2000

	Seed Capital		Establishment Stage		Early Stages Subtotal	
	Investment Amount					
	NT$ millions	% Share	NT$ millions	% Share	NT$ millions	% Share
1994	133.0	3.80	363.0	10.40	496.0	14.20
1995	471.0	8.00	785.0	13.30	1,256.0	21.30
1996	889.0	10.10	1,569.0	17.80	2,458.0	27.90
1997	725.0	4.13	4,227.0	24.07	4,952.0	28.20
1998	2,013.1	9.32	5,450.4	25.24	7,463.6	34.56
1999	1,850.8	6.25	7,435.4	25.13	9,286.1	31.38
2000	2,406.4	7.81	10,109.8	32.82	12,516.2	40.63
	Projects					
	Number	% Share	Number	% Share	Number	% Share
1994	17	7.80	21	9.60	38	17.40
1995	31	8.50	21	15.10	52	23.60
1996	57	12.10	91	19.30	148	31.40
1997	49	5.15	203	21.35	252	26.50
1998	123	10.65	280	24.24	403	34.89
1999	120	8.01	361	24.08	481	32.09
2000	125	6.76	562	30.38	687	37.14

Note: % share denotes the percentage of the total for all stages, although the table shows only the two earliest stages.
Source: Lin C-F. and Y-J. Ch'en (2001), 'Suggestions Regarding the System for Transactions in Unlisted Shares in Taiwan' (in Chinese), *Securities Transaction Data*, No. 471.

Moreover, the recent slowdown in the venture capital industry may adversely affect the financing of high-tech businesses. One explanation for the slowdown is the phase-out of the 20-percent tax offset for investment in venture capital firms scheduled for 2000. This policy change does appear to have led certain investor groups to withdraw from venture capital business. From 1999 to 2000 the share of venture capital funds from all domestic corporate persons fell by 3.9 points, while the share from individual domestic investors increased slightly (Table 10.10). Among the various categories of corporate persons, the shares of most financial corporations increased, but the share of venture capital investment from high-tech companies was down 3.9 points and the share from ordinary non-financial companies was down 1.8 points. Hence, it appears that the abolition of the tax incentives may indeed have induced some high-tech and other non-financial corporations to decrease their investment in venture capital firms. The ultimate impact on the funding of high-tech firms may not be significant, however, because these same sophisticated investors are very likely to be attracted to invest directly in high-tech start-ups in order to continue to enjoy tax breaks.

TABLE 10.10
Composition of Venture Capital Funds by Source
(Percentage of total)

	1998	1999	2000
All corporate persons	**80.7**	**78.6**	**78.5**
Domestic	75.8	74.9	71.0
Foreign	5.2	3.7	7.5
Government agencies	2.5	1.7	1.7
State banks	0.8	0.7	0.4
Private banks (domestic)	4.6	4.6	5.0
Foreign banks	0.7	0.6	0.6
Insurance companies			
Domestic	5.8	7.0	8.7
Foreign	0.6	0.4	0.5
Pension funds			
Domestic	0.0	0.0	0.0
Foreign	0.0	0.0	0.0
Investment institutions			
Domestic	12.3	12.3	12.6
Foreign	3.3	2.5	6.1
Securities firms			
Domestic	0.6	0.0	0.0
Foreign	0.1	0.1	0.1
Non-financial corporate persons	49.5	48.5	42.8
Ordinary companies		34.8	33.0
High-tech companies		13.7	9.8
All individual investors	**19.0**	**20.2**	**20.6**
Domestic	18.9	20.1	20.6
Foreign	0.1	0.1	0.1
Other	**0.2**	**1.1**	**0.9**
Total	**100.0**	**100.0**	**100.0**

Sources: Survey of the Venture Capital Industry (1998–2000); *Venture Capital Investment Gazette* No. 21, 22, 23; Venture Capital Association of the ROC.

The slowdown in the growth of the venture capital business in Taiwan can also be linked to increasing global competition and the emerging global trend toward mergers and acquisitions. Companies in Taiwan are gradually making use of acquisitions, strategic alliances, and cross-investment to secure key technologies and increase their own competitiveness. These activities might lead companies and institutional investors to invest directly on their own rather than indirectly through venture capital companies.

The importance of venture capital in the development of knowledge-intensive companies is finally gaining official recognition. In 2001, the government Development Fund launched a project aimed at injecting partial funds directly into venture capital investment. It will be some time before the influence of this particular project on industrial development becomes evident, but the program is intended to stimulate high-tech industry investment through the growth of venture capital companies.

Access to venture capital should continue to improve, moreover, as the expected trend to establish financial holding companies (FHCs) takes hold in the financial sector. These new financial institutions will provide a comprehensive range of financial services, and one of these should be venture capital financing. Of the FHCs that have been established so far, however, few have venture capital subsidiaries. This suggests that there is room for further diversification of the financial products offered by Taiwan's financial sector.

CONCLUSION

Since the 1980s, industry upgrading performed well in Taiwan. The information services and electronics industries enjoyed the most rapid growth. On the other hand, biotechnology and pharmaceuticals, which is another 'hot' sector, did not experience similar vigorous growth in new enterprises. This industry may lag in new enterprises because it is in the early stages of development when investment risk is regarded as extremely high. In order to develop a knowledge-intensive economy, it is important for all knowledge-intensive industries to have access to loans. An ideal financial system should provide fluent channels for funds to companies during each stage of development. How to imbue Taiwan's financial system with this capacity has been an important issue.

The financing structures of industries change gradually. In recent years the previously unimportant direct finance channel, especially the stock market, attracted more funds for high-tech companies. Equity financing is expected to become nearly as important as debt financing.

The role of the government should just fill the gap when the market mechanism of the private financial system cannot meet industries' funding needs. The government provided some financial support for strategic, high-tech industries, but it should not be taken as a long-term measure. Stock market investors showed a strong preference for listed firms in high-tech industries over traditional ones, and venture capital businesses burgeoned along with the rapidly growing economy and soaring stock prices. Nevertheless, Taiwan continues to need to direct more investment funding to the early stages of enterprise development, rather than in the later stages. For example, potential business angels, i.e., those with adequate funds, need to organise themselves and exchange information about investment opportunities, in order to provide further funds to knowledge-intensive firms. The government should establish itself as a channel between demanders of funds and suppliers of funds

The knowledge economy and technological progress sparked a transformation in the world's industrial structure, encouraging new business formation and stimulating the development of the venture capital industry. Taiwan's high-tech industries have performed well so far, but the sustained growth of knowledge-intensive firms will depend on improving many aspects of the financial system.

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CHAPTER 11

THE FUTURE ROLE OF JAPANESE EQUITY INVESTMENTS IN THE INDUSTRIAL DEVELOPMENT OF EAST ASIA

Seiichi Masuyama and Donna Vandenbrink

INTRODUCTION

East Asian economies have achieved a remarkable catch-up industrialization by effectively using foreign direct investment centred on the key export sector. Many of these economies now seem to be at a critical stage in which domestic corporations need to play a larger role in order to drive economic development more endogenously. To support the development of domestic corporations, the East Asian financial system, which has been heavily bank-oriented, needs to diversify to accommodate capital markets more. Foreign portfolio investment should contribute to developing domestic capital markets. Japan, the regional economic giant, which has been a major provider of foreign direct investment to Asia, has been a marginal provider of foreign portfolio investment in the region. At the end of 2002, Japan's outstanding portfolio investment in Asia was ¥5,565 billion. This represented only 5% of Japan's total foreign portfolio investment outstanding and it was only 41% as large as Japan's direct investment outstanding in Asia.

This chapter looks at the scope for increasing the flow of portfolio capital, in particular stock investment, from Japan to East Asia to facilitate the industrialization of those economies. The focus is on stock investment because it is mainly through stock markets that economies develop the requisite infrastructure for robust capital markets, such as corporate disclosure and governance practices. The main question this paper asks is whether there is a role for Japanese investment in East Asian stocks to support the endogenous development of East Asian economies.

To answer this question we consider factors both on the receiving end and on the investing end of equity investment from Japan to East Asia. The first section discusses how foreign investment from Japan, which centred on FDI, benefited the East Asian economies and how the pattern of investment now needs to include more portfolio investment in order to generate development endogenously. The second section describes the framework of Japanese stock investment in East Asian economies, focusing on the channels for investment flows of distinct groups of investors. The third section discusses the conditions on both the Japanese and the East Asian sides that constrained past purchases of East Asian stocks by Japanese investors and considers some recent trends and developments. The final section proposes a path for East Asia's future development supported by investors in Japan purchasing the stocks of local companies.

JAPANESE INVESTMENT AND EAST ASIAN ECONOMIC DEVELOPMENT

FDI-Centred Japanese Investment in East Asia

In the past, private capital flowed from Japan to East Asian economies primarily as foreign direct investment (FDI) and as bank loans, and not as portfolio investment (FPI). At the end of 2002, outstanding Japanese FDI in Asia amounted to ¥7.0 trillion, which was 19.1% of Japan's total outward direct investment (Table 11.1)[1]. In contrast, only 1.5% of total Japanese FPI outstanding, or ¥2.4 trillion, was in Asia. Japanese foreign investment in advanced economies is more balanced between FDI and FPI. For example, at the end of 2002 North America accounted for 46.1% of Japan's outstanding FDI and 39.3% of outstanding FPI, and Western Europe accounted for 23.7% of FDI and 39.1% of FPI outstanding.

[1] Although the investment figures for Asia include India, they mostly represent investment in East Asia because India's share is very small. Japan's outstanding investment in Asia fell from ¥9.2 trillion at the end of 1996 because of write-downs connected with the 1997-98 Asia financial crisis.

TABLE 11.1
Japanese FDI and FPI Outstanding, End of 1996 and 2002

	Direct Investment		Portfolio Investment: Total FPI		Stocks		Bonds	
	1996	2002	1996	2002	1996	2002	1996	2002
	Amount (billion yen)							
Asia	9,180.0	6,973.7	5,565.3	2,428.4	2,564.2	815.9	3,031.1	1,612.5
North America	11,352.2	16,829.0	40,633.6	62,572.8	7,026.6	13,361.4	3,3607.0	49,211.4
Cent. & South America	1,389.3	2,168.6	9,433.6	24,463.4	933.7	2,290.1	8,499.9	22,173.3
Oceania	1,217.9	1,414.7	6,239.6	2,870.4	1,623.4	451.0	4,616.1	2,419.4
Western Europe	5,511.7	8,642.8	41,401.1	65,349.6	5,586.0	8,267.6	3,5815.1	57,081.9
E. Europe & Russia	22.8	87.4	1,128.9	150.4	210.3	6.7	918.6	143.7
Middle East	112.1	106.6	1.2	117.6	0.9	2.5	0.3	115.1
Africa	51.1	147.1	23.4	267.5	32.9	15.6	200.7	251.9
International organizations	-	-	4,053.4	7,438.7	2.1	-	4,051.4	7,438.7
Total	29,998.6	36,477.6	108,710.8	167,203.1	17,967.5	25,277.1	90,743.3	147,926.0
	Composition (%)							
Asia	30.6	19.1	5.1	1.5	14.1	3.2	3.3	1.1
North America	37.8	46.1	37.4	39.3	39.1	52.9	37.0	34.7
Cent. & South America	4.6	5.9	8.7	14.6	5.2	9.1	9.4	15.6
Oceania	4.1	3.9	5.7	1.7	9.0	1.8	5.1	1.7
Western Europe	18.4	23.7	38.1	39.1	31.1	32.7	39.5	40.2
E. Europe & Russia	0.1	0.2	1.0	0.1	1.2	0.0	1.0	0.1
Middle East	0.4	0.3	0.0	0.1	0.0	0.0	0.0	0.1
Africa	0.2	0.4	0.0	0.2	0.2	0.1	0.2	0.2
International organizations	-	-	3.7	4.4	0.0	-	4.5	5.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: Investment in Central and South American is mostly investment in the Cayman Islands.
Source: Bank of Japan.

In East Asia, corporate stocks make up a larger portion of Japanese FPI than they do in other regions. In 1996 stocks comprised almost half of Japanese FPI in Asia (46%) but only 17% of Japan's FPI in North America and 13 % in Western Europe. Stocks' share of FPI in Asia decreased after 1996, because bond investment did not decline as severely in the Asian Crisis. Japan's outstanding investment in Asian stocks declined from ¥2.5 trillion at the end of 1996 to ¥0.8 trillion at the end of 2002, while the outstanding Japanese investment in Asian bonds declined from ¥3.0 trillion to ¥1.6 trillion during the same period (Table 11.1).

Other data also reveal Japan's limited presence in East Asian capital markets compared to the presence of other advanced economies. For example, Japan accounted for only 4% of overseas investor cash trading on the Hong Kong Exchange from October 2002 to September 2003, trailing far behind the UK (25%), the rest of Europe (24%), the U.S. (22%), Singapore (9%), and Mainland China (8%)[2]. Japan accounted for only 3% of total funds under management in Singapore at the end of 1998,

[2] Hong Kong Exchange Cash Market Transaction Survey 2002/2003.

compared to Singapore's 21%, Europe's 20%, America's 14%, Hong Kong's 9%, and other ASEAN's 8%.[3] Japan's 1% share of foreign investment in Korean stocks in 2001 was insignificant compared to the U.S. share of 37% and the U.K. share of 18%.[4]

Direct investment from Japan is believed to have served the industrialisation of Asian economies well during the 1980s and 1990s for a number of reasons. First, along with FDI comes technological and managerial expertise that developing economies generally lack and that neither FPI nor bank loans can provide. Second, FDI is a stable source of capital inflow because it consists primarily of equity capital, takes longer to invest and divest than FPI, and is not subject to the market volatility of FPI. And third, FDI circumvents developing economies' usual lack of capacity to absorb FPI since multinational corporations can finance their investments in the capital markets of their home countries. Indeed, because of such advantages of FDI and disadvantages of other forms of investment for developing economies, FDI is the one form of capital flow consistently found by several empirical studies to be associated positively with domestic investment and growth (Prasad et al.). Arguably, the capacity-building aspect of FDI was as beneficial to the development of the East Asian economies as the financing itself, given their generally high savings rates and high levels of foreign reserves.

Foreign Investment and Endogenous Industrial Development in Asia

FDI will continue to be important for all the East Asian economies, but many economies in the region need to refocus their development strategy toward endogenously driven development led by a broad base of domestic corporations. For example, the newly industrialized economies (NIEs) have reached a stage in which they need to reduce their dependence on FDI and to increase their capacity to stimulate industrial development from within through robust industrial clusters where domestic corporations participate in synergy with foreign-owned corporations (Masuyama and Vandenbrink 2001). Indeed, most economies in the region need to create more knowledge-based and service-oriented firms and to enhance industrial clusters with greater participation of domestic firms in order to sustain their future economic growth under the continuing press of globalization and technological

[3] The Monetary Authority of Singapore (MAS) has not published Japan's proportion since 1999. The composition of sources of discretionary funds managed in Singapore is 30% from domestic sources, 25% from Europe, 14% from North America and 13% from the rest of Asia Pacific, of which Japan must be a very small percentage.

development.

To support such domestic corporations, East Asian economies need to provide not only debt financing, which is readily available under their bank-centered financial systems, but also equity financing in the capital market. Capital markets—equity markets, in particular—are important to the development of dynamic, efficient domestic corporations not only as a source of financing but also as a platform for corporate governance.

The Role of Foreign Portfolio Equity Investment

Foreign investment through a country's domestic stock market can contribute to establishing the conditions for long-run, endogenously generated growth. Foreigners' stock purchases on the primary market inject funds to domestic corporations and their purchases on the secondary market increase the market's liquidity, which in turn makes it easier for domestic corporations to issue new equity. Active participation by foreign investors from economies with advanced capital markets also stimulates the modernisation of local stock markets and encourages better corporate governance in local firms. Moreover, in transition economies such as China, where state-owned enterprises are being privatised or corporatised on a massive scale, participation by foreigners complements purchases by domestic investors to help absorb the increasing supply of stocks.

The greatest downside of FPI for developing economies is its volatility. Massive inflows of FPI may overheat the economy; sudden withdrawals can affect the availability and cost of financing for domestic firms, with concomitant effects on corporate profits and liquidity, and also adversely affect financial and currency markets as well as the real economy. The negative impact of FPI was witnessed clearly with the Asian financial crisis of 1997-98.

Diversifying foreign capital inflows to include more foreign portfolio equity investment (FPEI) adds a measure of financial stability to developing economies. While FPEI may be more volatile than FDI, as a source of equity capital it enhances the financial stability of domestic corporations by reducing debt-equity ratios. Moreover, by building up the capital market as an alternative to bank-based financing, FPEI can increase the overall stability of domestic financial systems in an

[4] Nihon Keizai Shimbun, 26 August 2002.

environment of globalizing capital markets. Sudden changes in risk and return in global markets can throw a narrowly bank-based system into crisis because banks tend to carry systemic risks within themselves for a long time. Capital markets, on the other hand, distribute risk rapidly and widely among many investors (T5 Policy Statement 2003). In order to limit the risks of FPEI and capture its benefits, Asian economies should encourage domestic investors to participate more actively in local stock markets, because local investors are likely to be better informed about local conditions and less likely to flee from the domestic market.

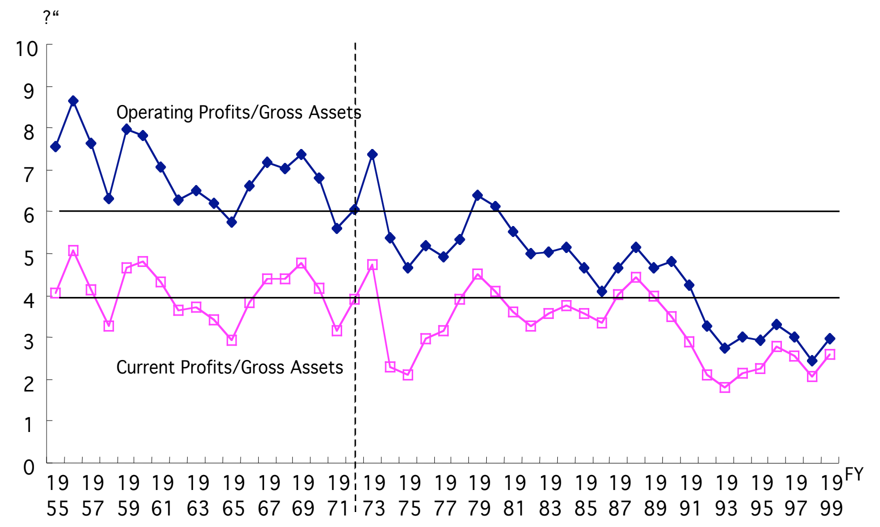
ROLE OF JAPANESE PORTFOLIO EQUITY INVESTMENT IN EAST ASIA

Benefits to East Asian Economies

In a number of ways, increasing portfolio equity, or stock, investment from Japan specifically should contribute to the industrial development of East Asian economies. First, it should diversify the overall risk to East Asian economies from foreign portfolio investment, because Japanese investors in corporate stocks have different characteristics and motivations from their North American and European counterparts, who are currently the main sources of FPEI to East Asia. Second, participation of Japanese investors will broaden the knowledge base of equity investment in East Asian markets. Since East Asia has become the global manufacturing base—with extensive linkages with Japan—and since East Asian stock markets list an increasing number of manufacturing companies, the analysis of manufacturing firms is crucial. Japanese investors' knowledge of the manufacturing industry developed at home will augment the store of knowledge about East Asian manufacturing stocks.

Third, more participation by Japanese investors can be expected to deepen the corporate governance structure in recipient countries. Americans and Europeans underestimate Japanese corporate governance in part because its structure is different. The weakness of corporate governance in Japan as a result of the weakened main bank system in the face of increasingly abundant money caused over-investment during the 1980s, which resulted in secular declines in the profitability of Japanese corporations and a bubble economy (Figure 11.1). Japanese investors are becoming aware that in order to generate higher returns from Japanese stocks they need to exercise better governance to force Japanese corporations to become more profitable. Recent improvements in corporate governance put Japanese portfolio investment in East Asia in a better position to influence governance in the region. While Japan's corporate governance structure is becoming more Americanized in the process of reform, it will retain its unique characteristics. As the Enron scandal and other incidents have revealed, the American system is not a panacea. The unique aspects of Japan's system should contribute to the governance of East Asian corporations by enhancing necessary diversity.

FIGURE 11.1
Japanese Corporations' Return on Gross Assets, 1955-99



Source Ministry of Finance

Finally, increased portfolio investment from Japan will benefit East Asian economies by building up a platform of expertise to support all foreign portfolio investment in the region. At present, since Japan's stock market dominates the market capitalization of East Asian stock markets as a whole, the managers of East Asian portfolios in American and European investment firms tend to manage the regional portfolios by focusing on the Japanese stock market with subsidiary responsibility for managing other markets in the region. The expertise that Japanese fund managers develop by more active participation in East Asian capital markets will strengthen the platform for other foreigners purchasing shares in East Asian companies.

Benefits to Japanese Investors

On the other side of the ledger, Japan stands to benefit significantly from directing greater flows of portfolio equity investment to the rest of East Asia. Stocks of East Asian companies offer Japanese the opportunity to diversify risk and generate higher returns. With the rate of return on investment in domestic stocks declining for decades, despite recent signs of recovery, Japanese investors need to find ways to earn higher returns (Table 11.2). This need promises to build as Japan's population continues to age rapidly, expanding the assets of pension funds and limiting investing opportunities in domestic markets. Investment in foreign stocks in general should provide an opportunity to improve the risk-return trade-off of investment portfolios; in particular, it is generally believed that pension portfolios should be diversified internationally.

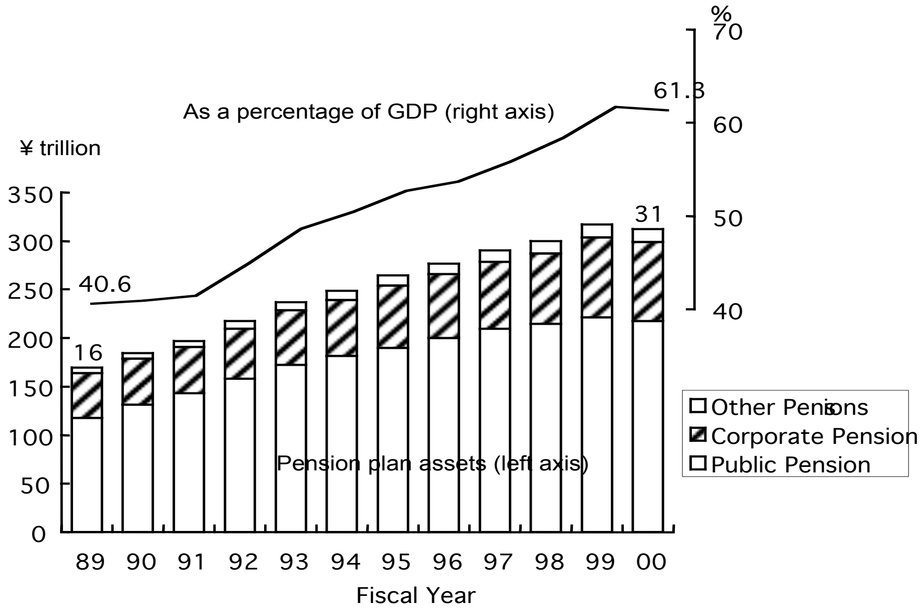
TABLE 11.2
Long Term Return on Investment in Japanese Stocks and Bonds
Percent

	Nominal Return			Real Return		
	Stocks	**Bonds**	**CPI**	**Stocks**	**Bonds**	**GDP Growth**
End 1960 to end 1970	8.21	8.79	5.92	2.16	2.71	10.2
End 1970 to end 1980	15.87	8.24	8.91	6.39	-0.62	4.5
End 1980 to end 1990	13.86	7.43	1.92	11.72	0.54	4.1
End 1990 to end 2000	-6.08	6.28	0.57	-6.12	5.68	1.3

Note: The return on stock investment is the annual compound rate based on the Nikkei225 including dividends. The return on bond investment is the annual compound rate based on the Nomura BPI.
Source: Junichi Ujiie ed. *Japanese Financial Markets*. Tokyo Keizai Shimposha. Calculated by Financial Research Centre, Nomura Securities.

After 2010, Japan will have the highest share of elderly in the world, with 22% of its population over age 65. With a smaller proportion of the population working, Japanese will need to depend more on the income generated from accumulated financial assets and to increase the return on those assets in order to sustain their standard of living. So far, the aging of Japan's population during the 1990s has translated into rapid growth of pension fund assets and this trend should continue for the foreseeable future (**Figure 11.2**). In general, stocks are a suitable place to invest pension assets since their long-run returns tend to be higher than for bonds. While the prolonged phase of deflation in Japan has reversed this relationship since the 1990s (Table 11.2), the normalization of this situation would generate a need for Japanese to diversify out of deposits at banks and postal savings and bonds, where they now keep most of their assets, into higher risk investments such as stocks.

FIGURE 11.2
Public and Private Pension Assets in Japan



Source: Bank of Japan

East Asian stocks can be expected to offer returns that are attractive to Japanese investors, and particularly to the growing pool of pension funds. The developing economies in the region should post high growth rates as they recover fully from the Asian Financial Crisis and as emergence of the Chinese economy has its impact. If such economic growth—albeit not as high as in the late 1980s and early 1990s—translates into higher performance of stock investment with necessary development of stock market infrastructure, investments in East Asian stocks should earn quite reasonable returns.

Finally, expanded Japanese investment in East Asian stocks should also benefit Japanese investors and businesses by facilitating the internationalisation of Japan's financial centres. Financial centres in Japan should be advantageous places for trading and managing the stocks of East Asian firms not only because of their size, bur also because of the economic interdependencies and the resulting dense information flows between Japan and the other parts of the region. As trading in East Asian stocks increases, the number of Japanese financial analysts covering East Asian corporations and economies will increase and a network of related services will develop. This would serve as an information infrastructure for business activities in East Asia.

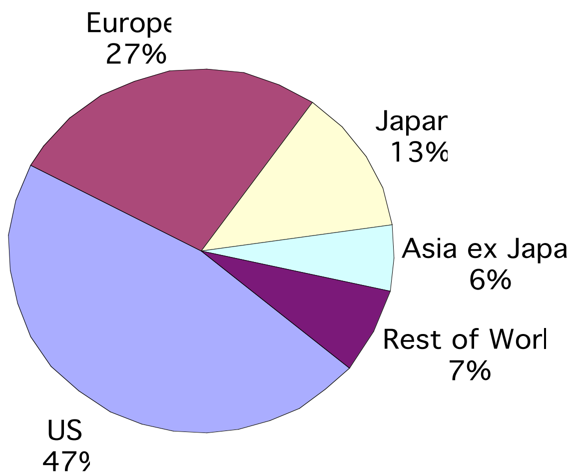
CONSTRAINTS ON JAPANESE INVESTMENT IN EAST ASIAN STOCKS

Despite these substantial benefits to both Japan and other Asian economies, actual Japanese investment in East Asian stocks so far has been extremely limited, as we have seen. In addition to the seemingly inherent disadvantages of FPI vis á vis FDI, other factors on both the recipient and the investment sides constrain Japan's portfolio investment in East Asia.

The Recipient Side

Deficiencies in pull factors—such as the availability of investible large firms, the efficiency of local stock markets, and the functioning of corporate governance[5]—constrain the flow of portfolio equity investment to East Asia by all international investors, not just Japanese investors. At the end of 1999 non-Japan Asia accounted for only about 6.0% of the world's total stock market capitalization compared with the U.S. market's 46.6% share, Europe's 27.3%, and Japan's 12.7% (**Figure 11.3**). In essence, the major constraint on Japanese and other foreign investment in East Asian shares is the incapacity of East Asian stock markets to absorb substantial quantities of investment funds.

FIGURE 11.3
World Stock Market Capitalization by Region



Weak corporate governance in East Asian economies is a serious obstacle to developing dynamic

[5] There is some empirical evidence that portfolio investment from international mutual funds is more likely to go to countries with a higher level of transparency (Prasad et al.).

local stock markets. Tight control by family owner-managers creates governance problems in firms throughout the region. In China, the structure of governance inherent in state-owned enterprises even presents a challenge to the concept of a stock market. With a majority of listed firms owned by the state or its agencies, it is extremely difficult to define and protect the ownership rights of minority shareholders from insider dealing among related state enterprises.

Some recent developments in the Asian economies point to improvements in the capacity of local stock markets and local companies. One is the emergence of indigenous firms, particularly IT firms in newly industrialising economies, that are seriously challenging firms in advanced economies such as Japan. Unconstrained by sunk investment in old technologies and organisational structure, these East Asian firms are able to readily adopt the new technological and organisational paradigm of the IT Revolution and "leapfrog" ahead of larger and more established firms in advanced economies. These firms are becoming accustomed to the norms of international capital markets as they rely heavily on venture capital and emerging company stock markets for financing.

A second positive change is the extensive reforms pursued throughout the region after the Asian Crisis in 1997-98 painfully revealed the weakness in corporate governance. The conditionality imposed by the IMF/World Bank for the crisis-hit countries included corporate governance reform, and other non-affected countries also strengthened their reform efforts. In essence, the reform in the region was to Americanize their corporate governance rules and practices. This has resulted in a considerable improvement in corporate governance in many regional economies. However, there is still has a long way to go until such a borrowed framework adapts to local conditions sufficiently to function effectively. An improvement in this area will weaken one of the most serious constraints to developing stock markets in East Asia and also to attracting FPEI to the region.

Another development is the rapid growth of corporations in China. Within the brief period of transition from a planned to a market economy, China has made remarkable progress in corporate development. Already, some Chinese corporations are more competitive than foreign corporations in certain domestic Chinese product market segments of consumer electronics, home appliances, and PCs. Given the size of its domestic market China has the potential to create large, world-class firms suitable to solicit international investment on domestic or foreign stock markets. Certainly, to realise the potential of its stock markets, China needs to address the fundamental problem caused by the listing of state-owned enterprises. The governance reform process, probably by privatization and rapid listing of privately owned companies, will be extensive and take some time to accomplish.

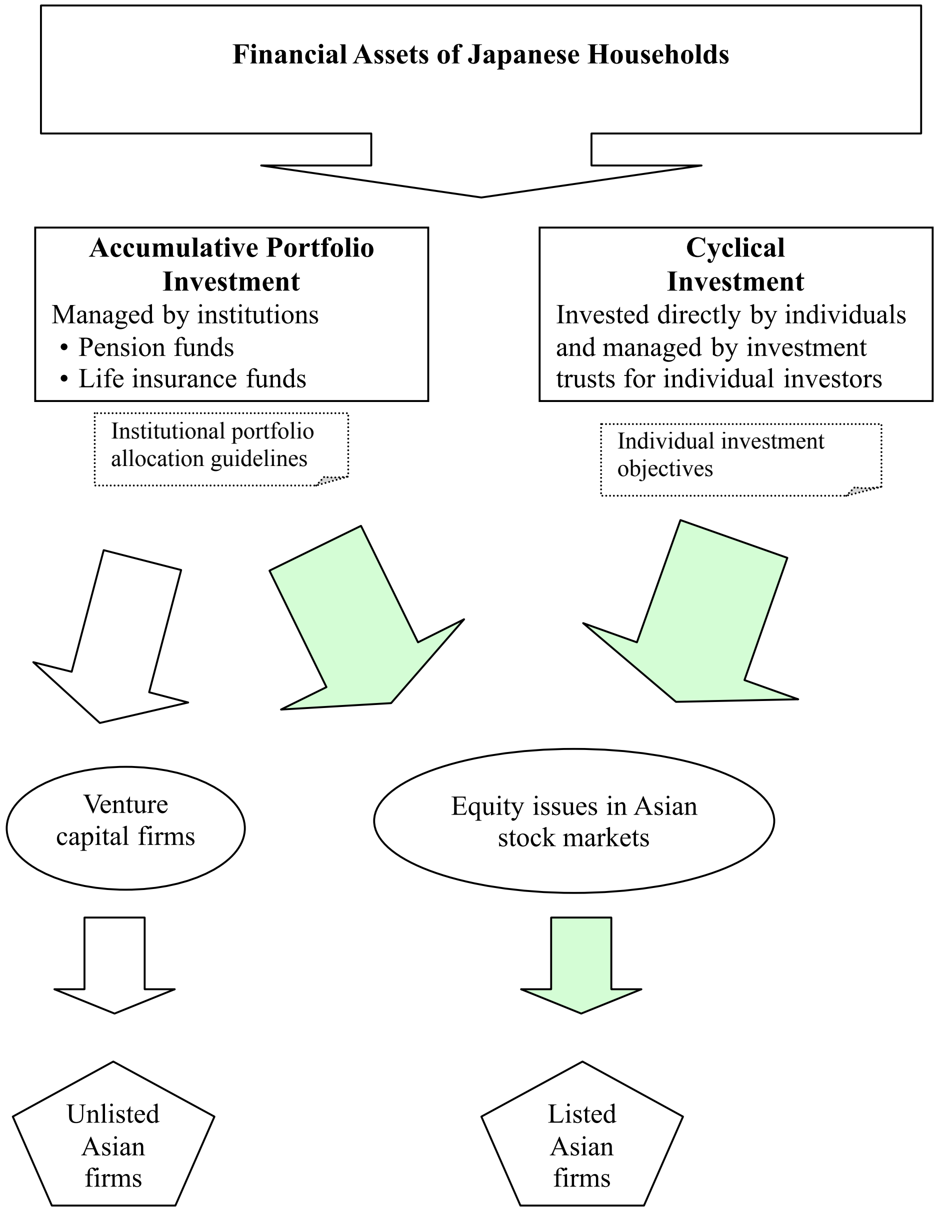
The Japanese Side

Of course, the total accumulation of household financial assets in Japan is the ultimate source of investment in securities. In order to understand the constraints on Japanese investment in Asian stocks, we start by depicting the various channels for investing Japan's household assets and identifying the key decision-makers, or keepers of the flow, and their motivations (Figure 11.4).

Channels of Japanese Investment in Asian Stocks

First, the mechanisms for Japanese to invest in Asian stocks differ for firms that are listed on exchanges and those that are not. Investment in listed stocks occurs through stock exchanges, while investing in unlisted firms must be done through specialized financial institutions outside of stock exchanges, such as venture capital firms (Figure 11.4). Although investment in unlisted stocks is particularly important in East Asia, we focus on the flow of investment to listed stocks because, so far, the flow through venture capital has been small.

FIGURE 11.4
Channels of Japanese Investment in Asian Stocks



Source: Authors.

Japanese household assets flow to firms listed on East Asian stock markets primarily in two channels in terms of investment patterns, as indicated by the shaded arrows in Figure 11.4. One channel is through portfolio investments made by institutions such as insurance companies, trust banks, and other large financial institutions, and the other is through stock purchases by individuals and by retail investment trusts owned by individuals. Investments through the second channel are largely determined by the preferences of individual investors since they trade among investment trusts such as country funds based on each one’s specific investment objectives. In general, investments through the second channel tend to be short-term and cyclical. The flow of Japanese household assets into East Asian stocks through this channel, then, depends on how individuals allocate their non-institutionalized assets to equity and on the portion of this equity investment they allocate to East Asia in particular, either by purchasing stocks directly or by choosing investment trusts that specialize in East Asian stocks.

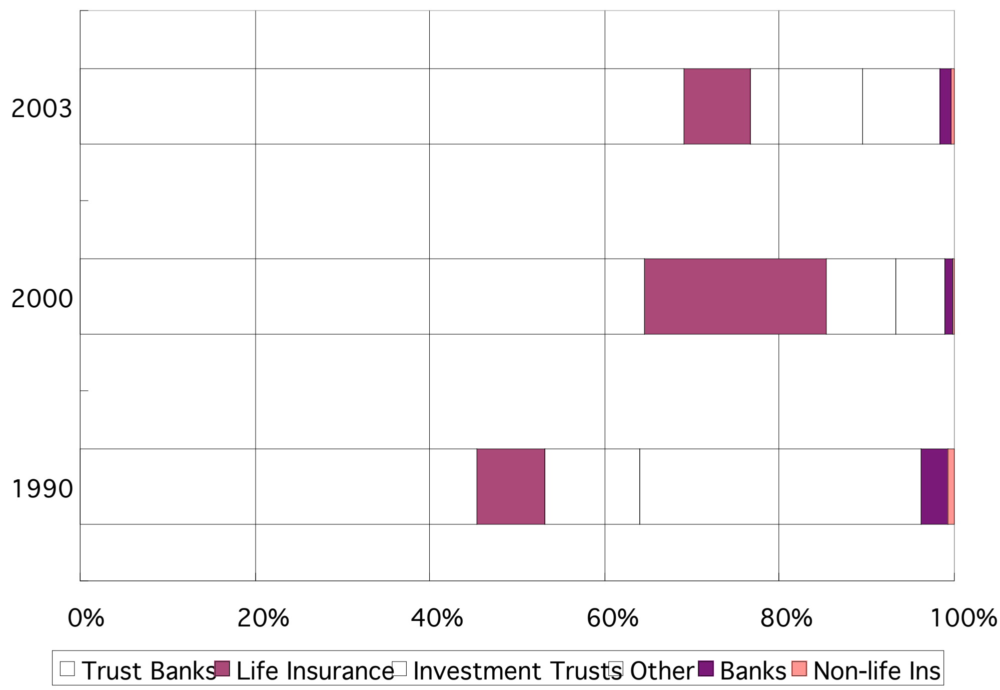
The flow of Japanese household assets into East Asian stocks through the first channel, on the other hand, tends to be less cyclical and much more stable. In contrast to individuals and investment trusts, institutional investors managing pension funds and other large portfolios tend to focus on the longer term and the diversification of risk. Usually, those investors manage funds by targeting market indices, which means that the asset allocation of their portfolios cannot deviate too much from market portfolios. Furthermore, investments of institutional investors reflect the asset allocation guidelines mandated by the fund sponsor. Since pension funds comprise the largest part of funds managed by institutional investors in Japan, investment flows through this channel depend significantly on the investment guidelines of pension funds, which often specify the share of foreign stocks in the portfolio.

Figure 11.5 gives an idea of which decision-makers control the overall flow of outward equity investment from Japan. Over the 1990s, institutional investors, specifically fund management firms other than investment trusts, became much more prominent in Japan’s outward flow of stock investment. In 2003 they accounted for over 75% of total outward investment in stocks (**Figure 11.5**). Trust banks and life insurance firms both manage pension funds, and life insurance firms also manage funds for life insurance policies. Trust banks' share of outward stock investment increased from 45%

in 1990 to 65% in 2000 and to 69% in 2003. While the share of life insurance companies more than doubled from 8% in 1990 to 21% in 2000, it fell back to 8% in 2003.

The increasing share of these institutional investors in Japan's outward stock investment came largely at the expense of the share of individuals. The share of outward stock investment by the "other" category, which is primarily individual investors, shrank from 32% at the beginning of the decade to only 6% in 2000. The share of investment trusts also fell from 11% to 8% between 1990 and 2000. Both investment trusts and the Other category increased their shares slightly from 2000 to 2003, with investment trusts surpassing their 1990 share by two percentage points.

FIGURE 11.5
Composition of Japan's Outward Stock Investment by Investor, 1990-2003



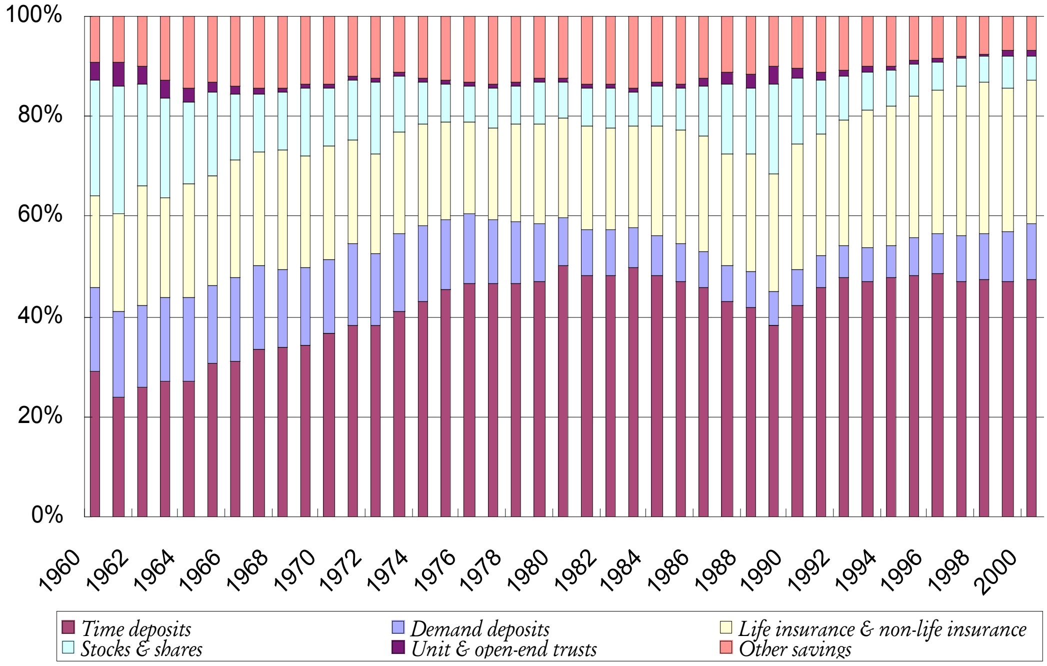
Source: Ministry of Finance. http://www.mof.go.jp/english/shoutou/monthstw.htm

Looking at Japanese investment in terms of this framework, we identify four characteristics that have limited the flows to East Asian economies: 1) individuals' bias against risky investments; 2) under-development of the fund management industry, 3) domestic orientation, and 4) non-Asian orientation.

Risk Averseness of Japanese Individuals

First, individual Japanese investors are extremely risk-averse in the allocation of their financial assets, with very limited exposure to equity investment. Japanese households have about ¥1,400 trillion in financial assets, but these are mainly deposited in banks and postal savings accounts rather than invested in stocks or equity-oriented investment trusts. Demand and time deposits reached 58% of household savings in 2000 and their share has been above 50% since 1991, after dipping to 45% during the bubble years of the late 1980s (**Figure 11.6**). Conversely, while the proportion of savings invested in shares and investment trusts increased during the 1980s, it declined sharply during the 1990s; in 2000, stocks and shares comprised a mere 5% of household savings and investment trusts, just 1.1%. (The ratio of life and non-life insurance, which includes pension funds, has steadily increased to over one-quarter of household financial assets, reflecting the aging of Japanese population.)

FIGURE 11.6
Composition of Household Savings, 1960-2000



Source: *Family Savings Survey.* Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications.

This preference for deposits over shares and investment trusts distinguishes Japanese households from their American and European counterparts. Only 11% of financial assets in the United States and 27% in Europe are held as deposits compared to over 50% in Japan. On the other hand, 46_ of American and 31% of European financial assets are held in shares and mutual funds, while less than

11% of Japanese are held this way (**Table 11.3**).

TABLE 11.3
Composition of Household Financial Wealth in Japan, Europe, and the United States, end 2000
Percent

	Japan	Europe (6)	United States
Currency and deposits	11.4	10.1	1.1
Time, savings, and other deposits	41.4	17.3	9.9
Money market funds	0.2	0.8	3.1
Securities other than shares	4.5	6.8	6.4
Shares and other equity	8.3	21.3	33.1
Mutual funds	2.4	9.5	12.9
Life insurance	17.7	17.2	7.1
Pension funds	9.7	10.7	23.8
Other	4.4	6.2	2.5
Total	100.0	100.0	100.0

Source: OECD, 2002, *Household Wealth in the National Accounts of Europe, the United States, and Japan*.

The propensity of Japanese individuals to hold the bulk of their assets as deposits is often attributed to risk-averseness. Survey data indicate that security and liquidity of savings are the top priority for 70 to 80% of Japanese households, while only 20% attach great importance to profitability (Nakagawa and Shimizu 2000). Nakamura and Shimizu calculate that Japanese households are several times as risk averse as those in the United States (p 9).

The dominant position of banks and the postal saving system in Japan's financial system probably contributed to this situation. During the 1990s, as private banks weakened due to the collapse of the stock market and bad loan problems, government-run financial institutions, especially the postal savings system continued to attract savers (Hayakawa 1996, p. 142). At the end of fiscal 1999, assets in the postal saving system amounted to ¥260 trillion, or 19% of Japan's total private financial assets. Government backing and tax advantages make the postal saving system attractive compared to private deposit-taking institutions and this attraction, in combination with the dominance of banks, leaves little money to flow to capital markets. In addition, Japan’s tax system favours investment in debt instruments over stock investments.

Underdevelopment of the investment trust industry is yet another factor in the bias against equity investments. Investment trusts offer professional management and an opportunity to diversify risk to individual investors, who usually lack expertise and time to manage their own portfolios. But in Japan, unlike in the United States and some European countries, the industry is not a significant alternative to individuals' managing their own stock investments. The Japanese investment trust industry still has a bad image based on past questionable sales and management practices and unattractive products. Japanese mutual funds captured only 2.4% of household financial wealth in 2000 compared to 9.5% in Europe and 12.9% in the United States (Table 11.3). In 1999, total assets of the entire Japanese investment trust industry stood at roughly US$400 billion, while the assets of U.S. equity-related mutual funds alone stood at US$4 trillion (Brown et al.10 2002, p. 4). Generally speaking, Japanese households regard the quantity and quality of investment information provided by financial institutions as insufficient. This environment naturally favours deposits over stock investment because of the lower information requirements (Nakagawa and Shimizu, p. 11).

Lastly, the sustained deflationary pressure since the beginning of the 1990s, which lowered returns on investment in Japanese stocks and raised returns on investment in fixed-income instruments, reinforced any inherent bias of Japanese against investing in stocks. In the environment of sharply decelerating inflation and stagnant economic growth during the 1990s, bonds yielded historically high real returns while Japanese stocks yielded poor returns (**Table 11.2**). To a large extent, the poor investment return on stocks reflects the long-term decline in the profitability of Japanese corporations (**Figure 11.1**). The most outstanding reasons for the declining profitability are the loss of economic dynamism due to population ageing, the mismanagement of the macro-economy that created the deflationary environment, and the malfunctioning of corporate governance due to inadequate development of capital markets. The persistent bear market in Japan since 1989 discouraged individual Japanese from investing in all stocks, domestic as well as foreign. Analysing portfolio selection by Japanese households, Nakagawa and Shimizu found that "deteriorating return on risky assets and the increase in precautionary demand for safe assets due to uncertainties about income have been the main factors that make households more reluctant to invest in risky assets . . . than they were before the 1990s" (p.ii.).

Underdevelopment of the Fund Management Industry

The underdevelopment of the fund management industry in Japan may have been an obstacle for Japanese institutional investors. The fund management industry in Japan lags behind that in other advanced economies, particularly the U.S. and U.K, in both size and expertise. Inexpert fund management kept institutional investors from accumulating a substantial pool of long-term funds, from allocating the funds rationally to international equities, including East Asian shares, and from exerting corporate governance on East Asian corporations.

After expanding rapidly in the previous decade buoyed by the appreciation of share prices and the expansion of pension fund assets, the fund management industry in Japan lowered its international standing during the 1990s due to a bear market. During the 1980s in response first to rising stock markets and then to population aging, life insurance companies shifted from long-term commercial lending to securities investment and in the early 1990s trust banks shifted dramatically away from long-term commercial lending toward managing corporate pension and public investment funds (Hayakawa 1996, p. 126). By 1992, institutional investors' assets in Japan stood at 78% of GDP, a higher percentage than in Canada or France and double the rate in Germany. During the 1990s, however, the industry shrank with the stagnant stock market and sharp fall in share prices. In 1999 Japan ranked well behind other leading economies in terms of assets of institutional investors, and as a percentage of GDP, assets of the fund management industry in Japan were less than half those in the United Kingdom or the United States (**Table 11.4**).

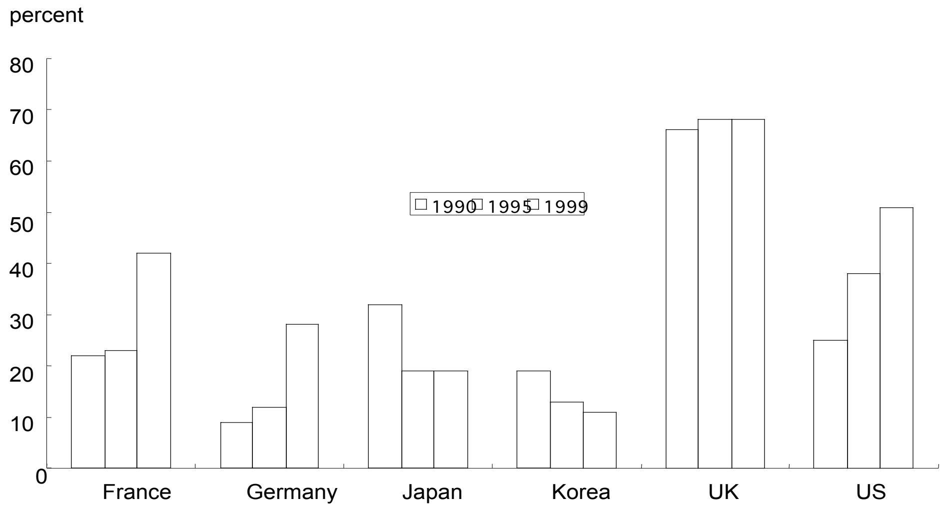
TABLE 11.4
Financial Assets of Institutional Investors in Selected Economies, 1992 and 1999
Percent of GDP

	1992	1999
Canada	66.8	112.7
France	61.9	125.4
Germany	34.0	76.8
Italy	21.8	96.9
Japan	78.0	100.5
Korea	51.8	88.5
United Kingdom	131.3	226.7
United States	127.7	207.3

Note: Institutional investors include insurance companies, investment companies, pension funds, and other forms of institutional savings.
Source: OECD, 2001. *Recent Trends in Institutional Investors Statistics*, No. 80 (Sept.).

Moreover, the share of institutionalized financial assets invested in stocks declined during the long market downturn. In 1990 over 30% of Japanese institutional investors' assets were invested in shares, well above the rates in the United States, France, Germany, and Korea although only half the rate in the UK (**Figure 11.7**). At the end of the decade, however, shares had fallen to about 20% of institutional investors' portfolios in Japan, while the rates in the United States, France and Germany increased, and Japan outranked only Korea in the percentage of shares in institutional investors' portfolios.

FIGURE 11.7
Shares as a Percentage of Financial Assets of Institutional Investors in Selected OECD Economies, 1990, 1995, 1999



Note: Institutional investors include insurance companies, investment companies, pension funds, and other forms of institutional savings.
Source: OECD. *Financial Market Trends*. No. 80, Sept. 2001.

Several factors prevented the development of expertise in the Japanese fund management industry. Institutionalisation is a relatively new phenomenon in Japan's financial market and heavy regulation of the fund management industry prevented the industry from acquiring management expertise. For example, until the 1990s only trust banks and insurance companies were allowed to manage corporate pension funds. In addition, under the so-called 5/3/3/2 Rule, corporate pension funds were required to allocate more than 50% of funds to "safe" assets such as government bonds and they could allocate no more than 30% to stocks, 30% to foreign currency-denominated assets, and 20% to real estate.

Besides regulatory constraints, the relationship-oriented characteristic of Japanese corporate culture obviated the need for investment expertise based on economic factors. For example, at life insurance companies and trust banks fund management decisions were heavily influenced by considerations of corporate relationships instead of considerations of financial performance.

Traditional job-rotation practices also constrained the development of portfolio management expertise at fund management firms.

Finally, the prolonged bear market of the 1990s substantially weakened the industry's ability to manage equity portfolios including international equity. Pension sponsors increasingly turned to foreign firms and opted for index-based management of their assets. The portion of passively managed assets of commingled accounts of trust banks increased over 8 percentage points from March 2000 to December 2001, and it is particularly high for foreign stocks (**Table 11.5**). As a result, the demand for active fund management capability in Japan as well as for research on international stocks declined.

TABLE 11.5
Weight of Passively Managed Commingled Accounts of Japanese Trust Banks

		Assets under management (billion yen)			Passively Managed Share (%)		
		Mar. 2000	**Mar. 2001**	**Dec. 2001**	**Mar. 2000**	**Mar. 2001**	**Dec. 2001**
Stocks	Domestic	12,842	11,230	9,571	38.6	38.9	45.4
	Foreign	6,192	5,538	5,693	48.3	50.4	56.5
Bonds	Domestic	10,606	9,393	9,428	28.4	31.8	35.5
	Foreign	2,203	2,970	3,101	20.7	31.6	38.0
Total		31,842	29,221	27,793	35.0	38.2	43.5

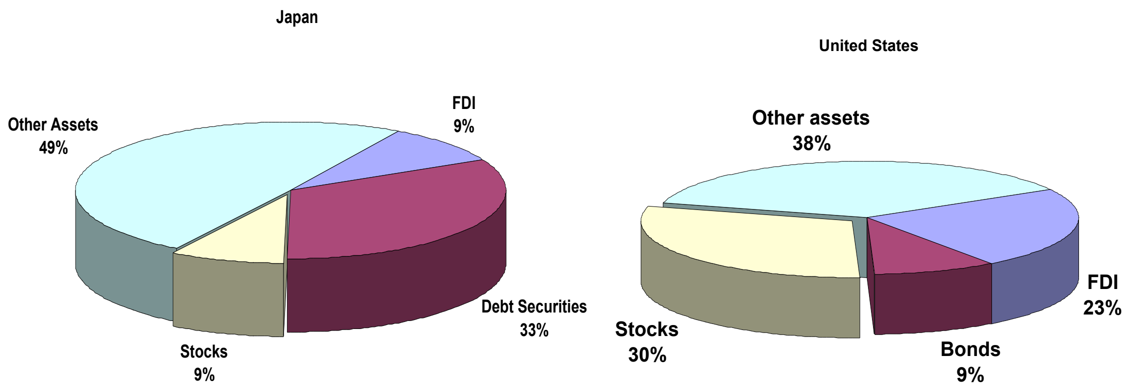
Note: Domestic bonds include convertible bonds.
Source: Nenkin Joho, No. 228. 4 March 2002.

Domestic Orientation of Stock Investment

Stock holdings of Japanese investors are not as internationally diversified as those of investors in other advanced economies. We can infer this by comparing the composition of international asset holdings in Japan and the United States in 2000 (**Figure 11.8**). Stocks made up only 9% of Japan's international assets while debt securities occupied 33%. The situation is just about reverse in the case of the United States, with stocks comprising 30% of international assets and bonds (the equivalent of debt securities in the Japanese statistics) only 9%. The propensity of Japanese to hold foreign assets as debt-instruments and of Americans to hold them as stocks reflects similar tendencies in the composition of personal financial assets in the two economies.[6]

[6] Another characteristic of Japanese international assets is the small share of FDI (9% compared to 23% for the U.S.). This must reflect the difference in the maturity of FDI activities between the two countries.

Figure 11.8
Composition of International Assets in Japan and the United States, 2000



Source: Hompo Taigai Shisan Fusai Zandaka. U.S. Department of Commerce, Bureau of Economic Analysis.

Two likely explanations for the comparatively low level of foreign stock investment by Japanese are the preference of individual investors in Japan for domestic over foreign stocks (including in their purchase of investment trusts) and the conservative management of government-controlled public pension funds. Individual investors could compensate for the inherent drawbacks of investing in foreign stocks—their additional currency risk and more limited information—by choosing investment trusts which have professional managers with wide access to financial information and which diversify risk by buying shares in a pool of many stocks. But Japanese investors do not utilize these vehicles for their savings to any great extent, as we have seen, and when they do they choose largely domestic-oriented ones. In October 2002, for example, only 5.3% of the assets of stock-oriented publicly offered investment trusts in Japan were foreign-currency denominated assets.[7]

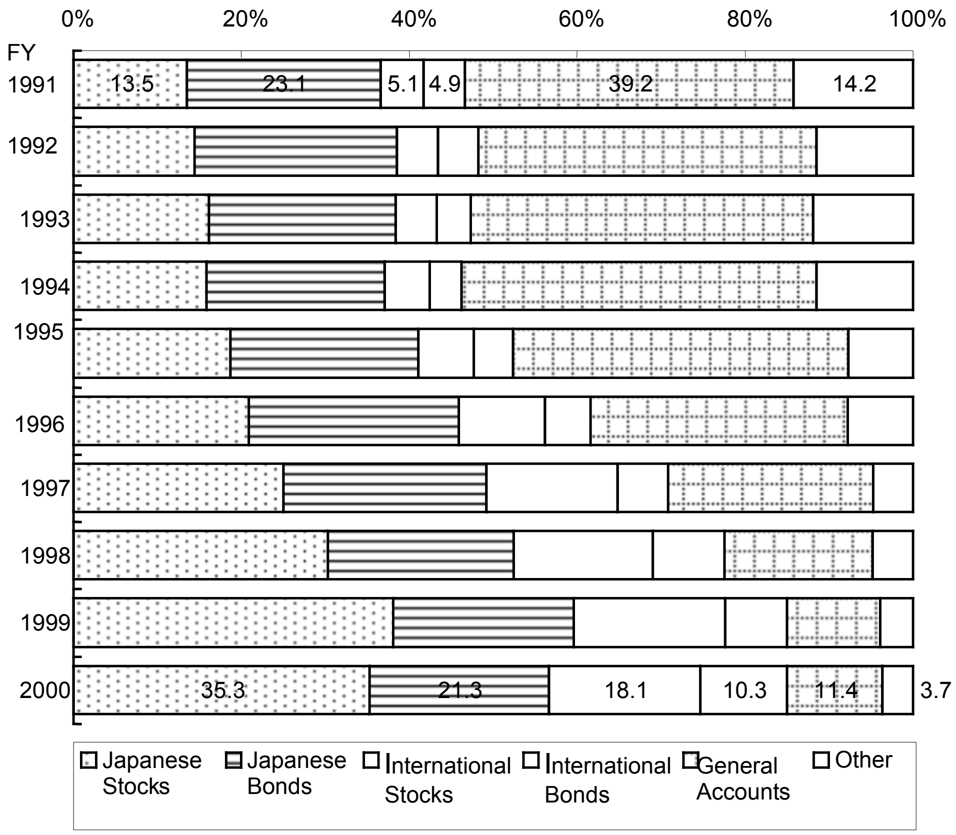
For pension funds, investing in foreign stocks can reduce the overall risk of a portfolio because returns on foreign stocks are not highly correlated with each other or with returns on domestic assets. Private corporate pension funds in Japan became much more internationally oriented during the 1990s. From 1991 to 2000 while the share of domestic stocks and bonds in their portfolios increased from 36.6% to 56.6%, the share of international stocks and bonds almost tripled from 10.0% to 28.4% (Figure 11.9). Moreover, in 2000, 18.1% of total investment by private corporate pension funds was

[7]Calculated from www.toushin.or.jp/result/getuji/g1-1.htm, which shows ¥852 billion in foreign currency-denominated assets out of ¥15.9 trillion total assets.

allocated to international stocks compared to 35.3% to domestic stocks.

In contrast, the public pension fund system in Japan is still heavily domestically oriented. The portfolio allocation of these assets is relatively conservative, emphasizing not only domestic over foreign investments but also less risky bonds over equities. For example, the basic portfolio strategy published in December 2000 stipulated 68% of public pension assets invested in domestic bonds and 7% in foreign bonds, with only 12% allocated to domestic stocks and 8% to foreign stocks, with certain allowances for deviation. Since the public pension system has several times more assets than private pension funds (Figure 11.2) the conservative allocation strategy for these funds is a big factor in the limited international diversification of Japanese assets overall.

FIGURE 11.9
Composition of Japan's Employee Pension Funds, 1991-2000



Note: Japanese stock category includes convertible bonds.
Source: Pension Fund Association.

Low Allocation of Japanese Stock Investment to East Asia

Finally, East Asia captures a very small portion of Japanese investment in foreign shares. In 2002 only 3% of Japan's aggregate outward investment in stocks went to Asia, mostly to East Asia, while over half (53%) went to the United States and almost a quarter (23%) went to Western Europe (**Table 11.1**). Japan's allocation to Asia is much lower than Asia's share (excluding Japan) of global market capitalization, which is roughly 7% (**Figure 11.3**). Even though Japanese investment trusts are not very active in international equity investment, their allocation to East Asian stocks is higher than the proportion of total outward investment from Japan that goes to East Asia. At the end of 2002, 22.2% of the ¥832 billion total foreign currency-denominated assets of publicly offered investment trusts was in stocks of East Asian economies (Table 11.6). Most of this amount (¥160 billion) was denominated in Hong Kong dollars (Table 11.7). Hong Kong captured such a large share because of the opportunity its market provided for Japanese to invest in the shares of Chinese companies by buying H-shares and red chips.

TABLE 11.6
Foreign Stocks, by Area, in Assets Managed by Japanese Investment Trusts, 1995-2002
(year-end market value)

	East Asia	North America	Europe	Other	Total
	Amount (billion yen)				
1995	820.3	175.6	46.8	52.5	1,095.2
1996	496.6	240.2	56.4	111.0	904.2
1997	193.4	269.2	196.5	54.8	713.9
1998	189.7	359.3	499.7	14.7	1,063.4
1999	205.2	561.6	338.5	63.6	1,168.9
2000	185.4	597.8	301.4	17.0	1,101.6
2001	211.5	636.7	253.6	39.4	1,141.2
2002	184.8	398.5	141.1	107.4	831.8
	Share of total (%)				
1995	74.9	16.0	4.3	4.8	100.0
1996	54.9	26.6	6.2	12.3	100.0
1997	27.1	37.7	27.5	7.7	100.0
1998	17.8	33.8	47.0	1.4	100.0
1999	17.6	48.0	29.0	5.4	100.0
2000	16.8	54.3	27.4	1.5	100.0
2001	18.5	55.8	22.2	3.5	100.0
2002	22.2	47.9	17.0	12.9	100.0

Source: Calculated from *Toshin Geppo*, Nihon Toshi Shintaku Kyokai.

TABLE 11.7
East Asian Stocks in the Assets Managed by Japanese Investment Trusts by Country
(year-end market value)

	Hong Kong	Thailand	Singapore	Malaysia	Korea	Taiwan	Others	East Asia Total
				Amount (billion yen)				
1995	391.0	118.9	122.1	149.7	0.8	--	45.3	827.8
1996	226.1	80.0	57.8	109.0	1.4	--	45.9	520.2
1997	122.7	17.6	21.7	12.7	0.7	--	8.4	183.8
1998	76.7	20.8	21.7	8.6	6.9	5.3	5.2	145.2
1999	96.9	33.1	29.1	5.5	29.8	24.7	7.1	226.2
2000	94.6	12.2	25.5	3.2	15.1	20.6	2.9	174.1
2001	144.4	11.6	14.4	4.0	22.1	25.4	1.5	223.4
2002	160.4	11.1	9.7	3.2	19.8	15.6	1.4	221.2
				Share of total (%)				
1995	47.2	14.4	14.7	18.1	0.1	-	5.5	100.0
1996	43.5	15.4	11.1	21.0	0.3	-	8.8	100.0
1997	66.8	9.6	11.8	6.9	0.4	-	4.6	100.0
1998	52.8	14.3	14.9	5.9	4.8	3.7	3.6	100.0
1999	42.8	14.6	12.9	2.4	13.2	10.9	3.1	100.0
2000	54.3	7.0	14.6	1.8	8.7	11.8	1.7	100.0
2001	64.6	5.2	6.4	1.8	9.9	11.4	0.7	100.0
2002	72.5	5.0	4.4	1.4	9.0	7.1	0.6	100.0

Source: Calculated from *Toshin Geppo*, Nihon Toshi Shintaku Kyokai.

One reason for the limited exposure of Japanese pension funds to Asian stocks is their misguided benchmarking of international equity portfolios. The Pension Fund Association advises fund managers to monitor their performance against the stock market indices of Morgan Stanley Capital International (MSCI), and according to industry sources, most institutional investors managing Japanese pension funds use MSCI's *Kokudai Index* (World excluding Japan) as the benchmark for their investment in foreign stocks. Companies managing pension fund assets aim their investments to track the benchmark within a range of 5 to 10%. Moreover, the tracking error must be close to zero on the more than half of pension fund assets that are passively managed. Thus, this index has a significant influence over the choices of East Asian stock investments by pension fund managers in Japan. But this index is a skewed measure of actual stock market performance in the region, because it includes only Singapore and Hong Kong stocks. Together Hong Kong and Singapore make up slightly over half of the total market for stocks in East Asia not counting Japan (Table 11.7). Korea and Taiwan, which are omitted from the MSCI index, represent another 30% of the Asian market, and Malaysia's market is roughly two-thirds the size of Singapore's. Moreover, listings in the Singapore and Hong Kong markets are predominately lower-tech service sector companies, while South Korea and Taiwan markets include many manufacturing stocks with significant technological resources.

Thus, the performance of the index does not reflect the underlying market portfolio of East Asia.

It is not difficult to see that the choice of this benchmark is likely to have constrained the flow of institutionally managed investment from Japan to East Asian markets other than Hong Kong and Singapore, particularly to the Korean and Taiwanese markets. Japanese managers of pension funds are reluctant to include Korean or Taiwanese stocks in their portfolios because that would increase the risk that their portfolio performance deviates from the benchmark. American and European investors do not face the same disincentive because they use an index that includes Japanese stocks as a benchmark for their investment in international markets. As Japan accounts for the lion’s share of their benchmark index, investment in non-Japanese Asian markets, which are not included in the index, will not have a very large effect on the overall performance of the portfolio.

Positive Developments in Japan

Conditions in Japan's financial markets have changed substantially in recent years. From late 1997 the Japanese government initiated efforts to restore the financial system and adopted a series of Big Bang reforms intended to make the financial system more capital-market based. Almost all of the planned measures were implemented by May 2001, but their full impact on the financial system has not yet been felt because of the continuing stock market slump. Once the prolonged economic malaise and stock market slump are overcome, these new financial market conditions should make for significant changes in the way Japanese allocate their assets and should increase the supply of investible funds from Japanese savers. Some of these changes also have direct implications for the flow of Japanese investment into foreign, and specifically East Asian, stocks. For example, the anticipated relaxation of investment guidelines on public pension funds will increase the pool of funds available for investment in foreign stocks.

Several regulatory developments may stimulate individual Japanese investors’ appetite for riskier, equity investments. One is the lifting of restrictions on the sale of investment trusts by financial institutions which began in December 1997. The outstanding amount of such funds sold by banks and other financial institutions reached \6 trillion in June 2000 and, importantly, the equity fund proportion of the funds sold by banks and financial institutions increased steadily, reaching almost 50% by November 2000 (Iwatani 2001, p. 36.). Moreover, this liberalisation likely contributed to the accumulation of investment trust accounts in Japan since investment trusts sold by banks have a much lower redemption rate than ones sold by securities companies (Ujiie 2002, p.62). Another is the introduction of a defined contribution pension program during fiscal 2001. The defined contribution system allows individuals to allocate their pension savings among investment options offered by private investment management companies. This option is expected to encourage individuals to become more knowledgeable investors, since the size of their pension benefit will depend on the success of their investments. In seeking higher returns, individuals may allocate some of their pension assets to stock purchases through investment trusts, for example (Ujiie 2002, pp.69, 122). Finally, the liberalization of stock commission fees together with the emergence of on-line stockbroking may also make it easier and more attractive for Japanese to invest in stocks. In September 2000, private investors carried out 26% of their transactions (by value) on-line, up from 3% in October 1999 when commission rates were fully deregulated (Iwatani 2001).

Big Bang reforms and financial market deregulation—such as opening pension fund management to investment advisory firms, allowing foreign firms to enter the fund management industry, and lifting the 5/3/3/2 Rule on the allocation of corporate pension funds—should also stimulate development of the fund management and investment trust industries. Liberalising entry into the corporate pension fund management business increased the share of investment advisory firms in the fund management industry. Competition has also intensified in the investment trust industry. Allowing asset management subsidiaries to conduct both investment trust and discretionary investment management has brought mergers between investment trust companies and investment advisory companies. Inroads by foreign companies have also intensified competition in the fund management industry. Until deregulation, the cost of setting up a separate company to do discretionary asset management discouraged foreign firms from entering the investment trust business.[8] Observers expect that these changes eventually will have an extremely positive impact on the investment capabilities and sophistication of Japanese fund managers and increase the industry's capacity to serve investors. Already, they are forcing domestic institutional investors to focus more on economic than on relationship criteria and leading to specialization among fund managers.

The trend among institutional investors such as pension funds to shift from country allocation to industry allocation bears mentioning as a factor that is likely to affect Japanese portfolio investment in East Asian stocks. Economic globalisation has created industries that span the planet without regard for national borders, a phenomenon that is particularly evident in the IT industry. With the emergence of such global industries, institutional investors are putting more weight in their investment decisions on sector or industry factors at the expense of country factors. In this environment, the issue of appropriate regional benchmark indices will lose significance. More importantly, companies in such global industries may begin to shun local stock markets as they seek listing in stock markets that have a global scope, such as the New York Stock Exchange, in order to benefit from recognition of global investors. In that case, institutional investors are likely to channel investment in global industries, such as IT, in multinational companies through markets in major global financial centres and not in local East Asian companies through local East Asian stock markets. Then, the absorptive capacity of local stock markets will become less constraining. However, the reality is that local markets will continue to be important even though global financial centres will take some share.

Finally, the gradual shift beginning in April 2001 to self-management of deposits by Japan's postal savings and postal insurance systems should increase the supply of funds to the Japanese fund management industry, some of which may be allocated to foreign stocks. Under the Trust Fund Bureau of the Ministry of Finance, postal savings deposits and postal insurance funds were entirely invested in domestic projects or used to make policy-based loans; under the new management the initial target is to allocate 5% of the funds to foreign stock investment. Since the combined assets of the postal saving and postal insurance systems amounted to ¥375.6 trillion at the end of fiscal 1999, even this relatively low allocation will generate a sizeable pool of new funds aimed at foreign stocks. For example, about ¥10 to ¥13 trillion of new money is expected to flow from the postal savings system into foreign stocks during the next 7 to 10 years as a result of the policy shift (Ujiie 2002, p. 77).

At the same time, profound changes taking place in corporate governance in Japan should greatly improve the profitability of Japanese corporations in the long run. Co-shareholding among Japanese corporations is being dissolved and corporate governance is improving as various legal measures are

[8] Bill Wilder interviewed in Finance Asia.com

implemented. The increased competition in the fund management industry will also serve to improve governance of Japanese corporations.

AGENDA FOR INCREASED JAPANESE INVESTMENT IN ASIAN STOCKS

Our analysis points to the following agenda of items to be addressed by Japan and by Asian economies to realise an increased flow of investment in Asian stocks from Japan for the mutual benefit of both sides.

Non-Japanese Asian Side

The recipient economies should further improve the infrastructure on which their local stock markets depend, including corporate governance, and they should pursue policies to increase the pool of investible domestic corporations. Creating modern corporations is key to increasing the supply of stocks attractive to international investors. Encouraging venture capital businesses and establishing stock markets for small and emerging companies will serve this purpose. To institute effective corporate governance and develop dynamic capital markets, East Asian economies need to reduce family control over local firms. Moreover, they must secure a healthy banking sector since this is a prerequisite for developing capital markets and since firms in developing economies that have weak information infrastructure must continue to rely on bank financing.

Japanese Side

In order for Japan to expand its equity portfolio investment in East Asia and play a constructive role in indigenous industrial development in the region, it is necessary to address the constraints on the individual investors and investment trusts on the one hand and on pension fund and institutional investors, on the other hand.

With regard to the former, it is necessary increase the risk appetite of Japanese individual investors. Winding down the prolonged deflation will help to some extent, but basic educational efforts to promote sound personal finance are also called for. A joint effort between the financial and educational sectors is necessary. Some policy biases such as excessive guaranteeing of deposits in both the banking and postal saving systems should be corrected. Investment trusts should become a basic instrument for individuals to invest in East Asian shares to overcome the asymmetry of information involving stocks, especially foreign stocks. Stronger educational efforts are needed to promote investment trusts among Japanese savers, and the investment trust industry needs to upgrade its management capability as well as its reputation by providing more and better public information about the products it offers and the potential risks and returns.

With regard to other institutional investors, the most fundamental factor to increasing the flow of investment in East Asian stocks is to raise the sophistication of the fund management industry in Japan. With deregulation of the industry largely accomplished, further improvement now depends on private-sector efforts. The fundamental weakness in governance among East Asian corporations means that Japanese fund managers need to monitor investments in East Asia particularly carefully and they may need to engage in dialogues on improving governance practices with market-related organizations and officials in the region. Finally, corporate pension funds in Japan should adopt a more appropriate index to measure the performance of their stock portfolios to remove the artificial constraint on Japanese investment in East Asian stocks.

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