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.