

Financial Sector Development in Asia

**Sir Patrick Gillam Lecture
LSE**

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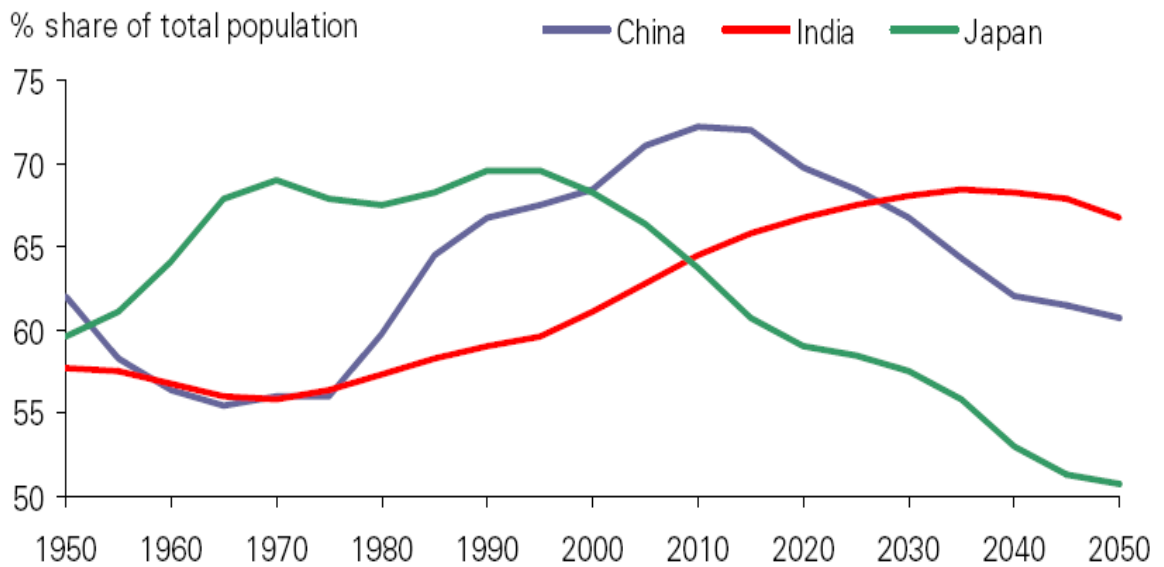
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Ray Huang: China - A Macro-History

- “As the world enters the modern era, most countries under internal and external pressure need to reconstruct themselves by substituting the *mode of governance* rooted in agrarian experience with a new set of rules based on commerce. Since commercial distribution focuses on exchange, all economic and social components within the society must accordingly be made interchangeable before the law.”
- This is easier said than done. The renewal process could affect the top and bottom layers, and inevitably it is necessary to recondition the institutional links between them. Comprehensive destruction is often the order; and it may take decades to bring the work to completion” (*Preface to the Turn of the Century Edition, xiii*)

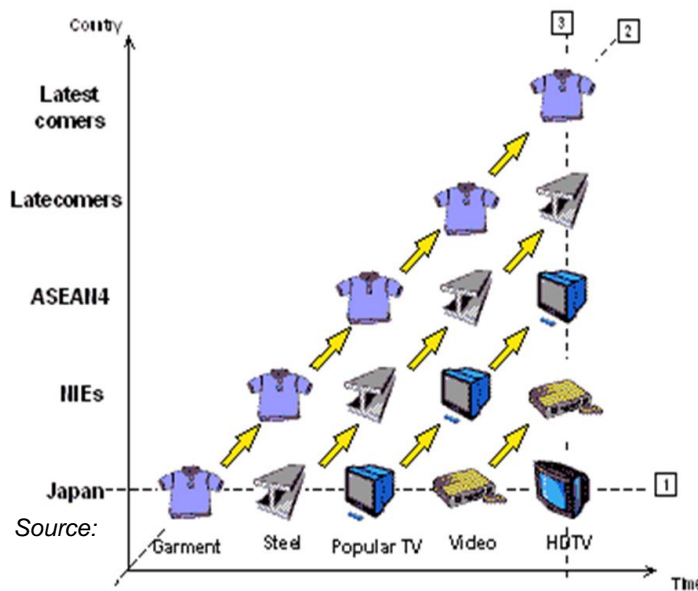
Asian Growth is Demographic Story



Source: UN Population Statistics

Structural Transformation - the Flying Geese

Asian Economies moved in V-formation, following Japan through copying, production and exports, eventually forming Global Supply Chain



Key customer was
USA, so key
currency pair was
Yen-Dollar

China's Six Degrees of Transition

1. **Demography**: from young labour force to mature and aging population.
2. **Wealth**: from poor to middle income economy.
3. **Globalization**: from closed to open economy.
4. **Knowledge**: from “hardware” economy to “software” knowledge-based economy with wealth creation through services.
5. **Market**: from planned economy to socialist market economy [from exports to domestic consumption].
6. **Governance**: from owner to regulator of socialist market economy.

I. Asian Financial Landscape since Asian Crisis (1997-1999)

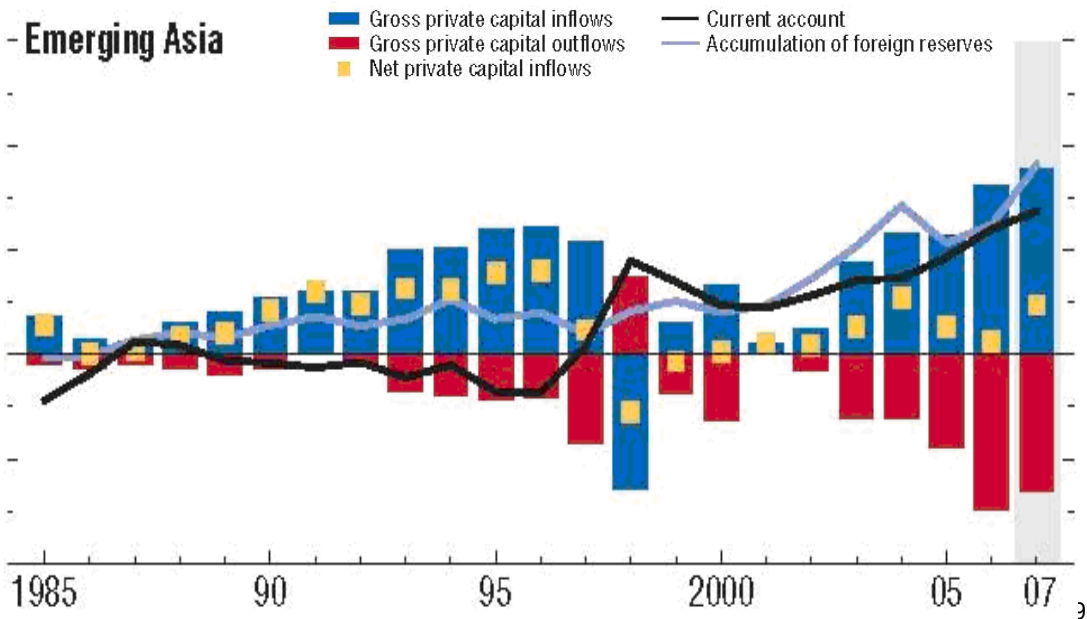
From Crisis to Recovery in Real Economy

Table 1. Real GDP Growth Rates (Annual Change in Percent)

	2005	2006	Estimate 2007	Projected 2008	
World Output	4.8	5.4	5.2	4.8	
United States	3.1	2.9	1.9	1.9	<ul style="list-style-type: none"> • The East Asian economies that were affected by the Asian financial crisis of 1997/98, are today enjoying robust growth. • Real GDP growth rates will remain faster than those of the US and Europe.
Euro Area	1.5	2.8	2.5	2.1	
Japan	1.9	2.2	2.0	1.7	
China	10.4	11.1	11.5	10.0	
South Korea	4.2	5.0	4.8	4.6	
India	9.0	9.7	8.9	8.4	
Africa	5.6	5.6	5.7	6.5	
ASEAN-5					
Indonesia	5.7	5.5	6.2	6.1	
Malaysia	5.2	5.9	5.8	5.6	
Philippines	4.9	5.4	4.0	4.5	
Singapore	6.6	7.9	7.5	5.8	
Thailand	4.5	5.0	4.0	4.5	

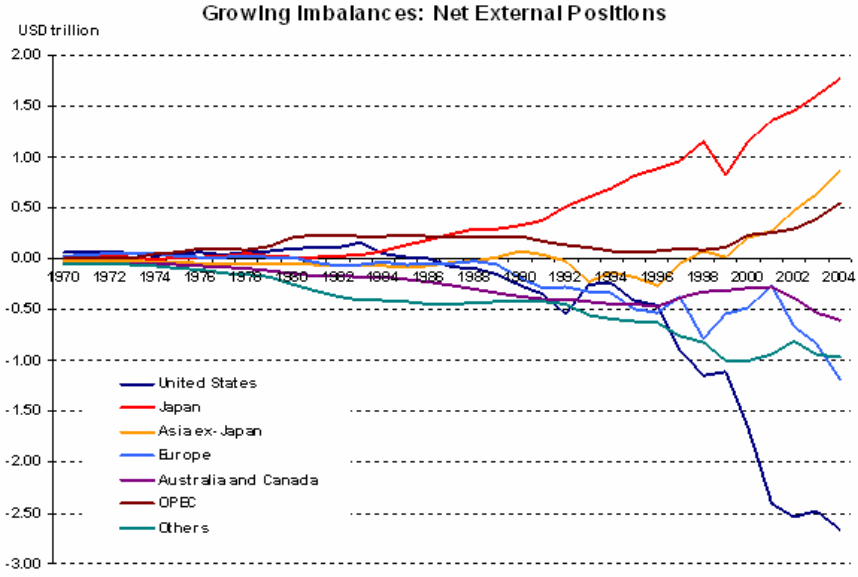
Source: IMF, World Economic Outlook.

Large Current Account Surplus and Capital Inflows led to Massive Accumulation of Foreign Reserves



Source: IMF, World Economic Outlook, October 2007

US Current Account Deficit is a Mirror Image of the Asian Surplus



Asian and oil exporting nations are counterparty to large United States current account deficit.

Source: World Bank Financial Structure Dataset, February 2006

II. Weaknesses in Asian Financial Markets

Still a bank-dominated system

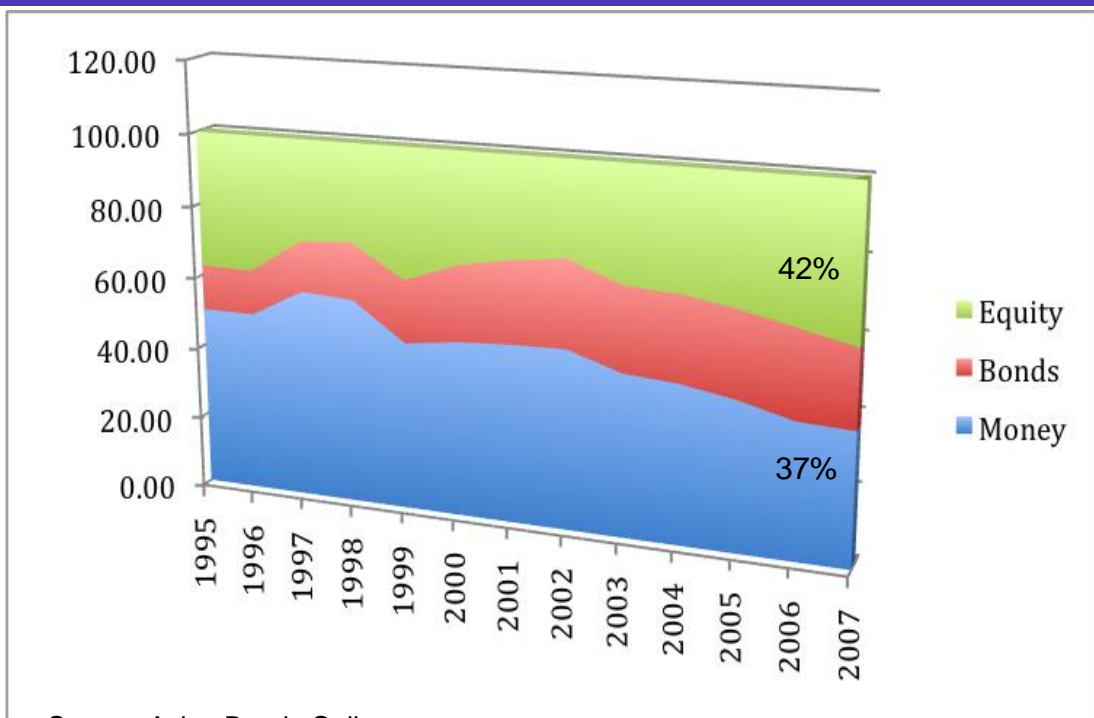
Basic Reforms in Asian Financial Markets

- **Corporate Governance improved and de-leveraged considerably.**
- **Banking system consolidated, with more foreign entry and supervision tightened (help of WTO, FSAPs).**
- **Fiscal position improved, gradual removal of exchange controls and build up of reserve holdings to reduce risks of external shocks.**
- **Exchange rates more flexible, but Samuelson-Belassa effect showing up in revival of asset bubbles, plus inflation. Real effective exchange rates are rising due to faster growth.**
- **Asian financial integration increasing, but slow due to political and other differences.**

Rise of Chinese and Indian Financial Markets will have powerful impact on Asian Markets

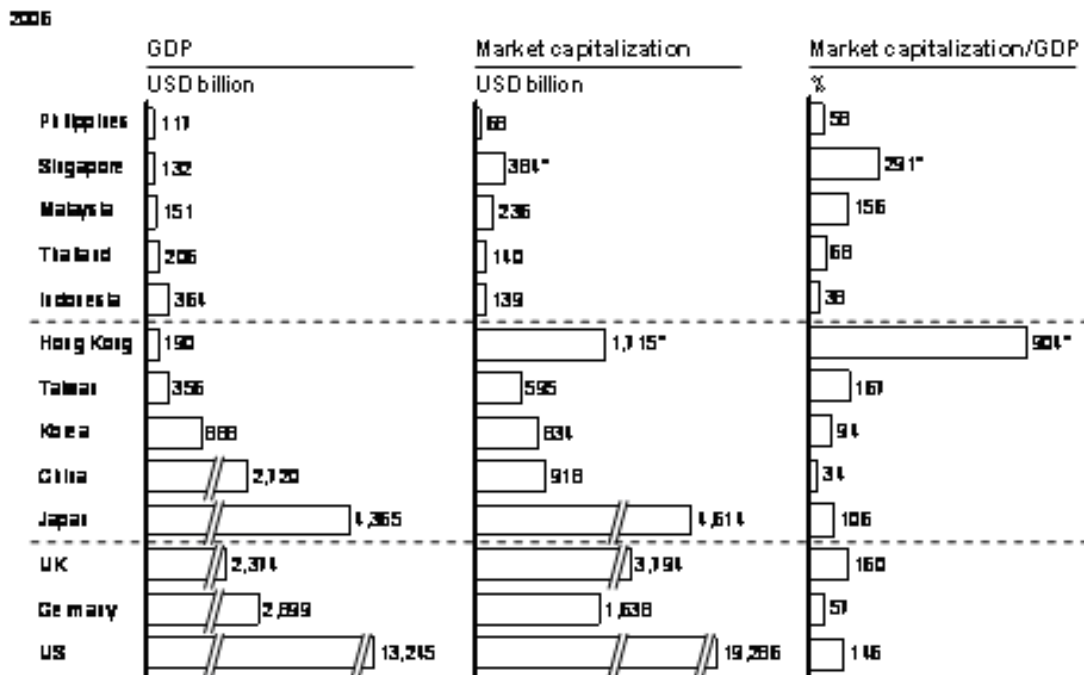
- Chinese Equity Market rose to fifth largest in world by end of 2007, US\$4.5 trillion in market cap, with 138.9 million accounts (market cap of only US\$396 bn in end of 2005).
- Chinese banking assets of US\$7.2 trillion at end of 2007 (231% of GDP), and GDP (US\$3.1 trillion) overtook Germany in size (third largest in world).
- Indian equity market is 10th largest in world in market cap, totally US\$1.8 trillion at end of 2007 or 180% of GDP.
- Indian bank assets US\$1 trillion (100% of GDP in March 2007).
- China's foreign exchange reserves topped US\$1.68 trillion end of March 2008, while India's FX reserves were US\$303 billion.
- Both stock markets are becoming highly liquid, with US\$6.4 trillion turnover in Chinese markets and US\$1.14 trillion in Indian markets in 2007.

Asian Domestic Financing Profile: Equity Financing (42%) Overtook Money Financing (37%) in 2007



Source: Asian Bonds Online

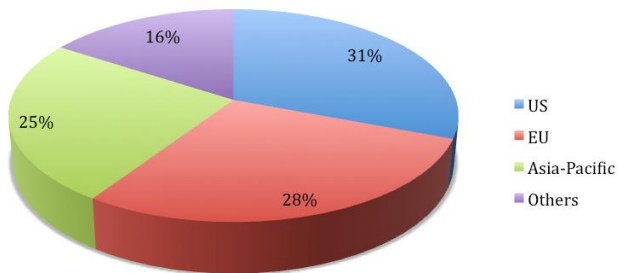
Still Lack of Depth in Many Asian Capital Markets



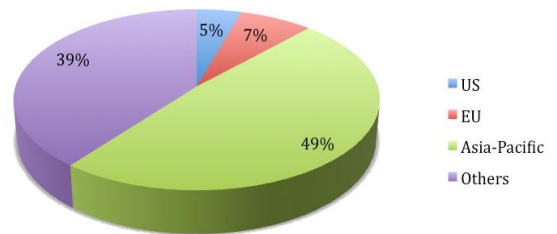
Source: "Exchange Collaboration and Joint Operation in South-East Asia", McKinsey & Co, July 2007

Asia Half of World Population but Quarter of Equity Market, 2006

Composition of Global Market Capitalization by Region

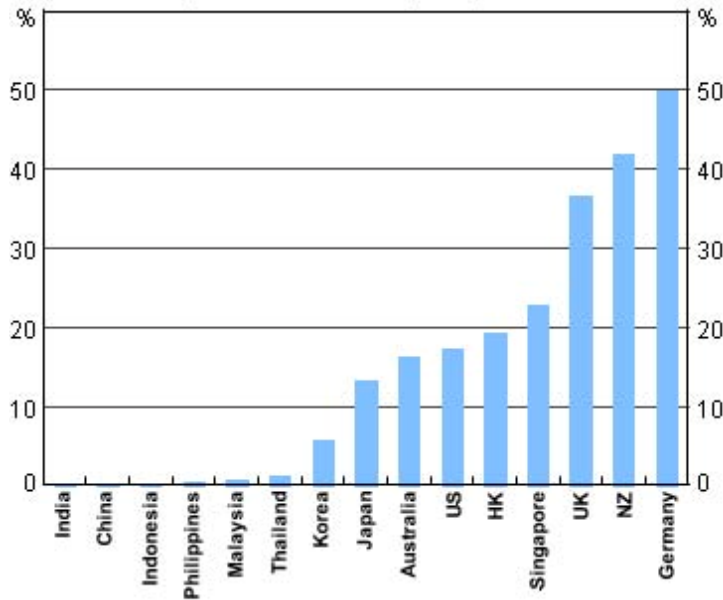


Composition of World Population by Region



Source: IFS, and CIA World Factbook

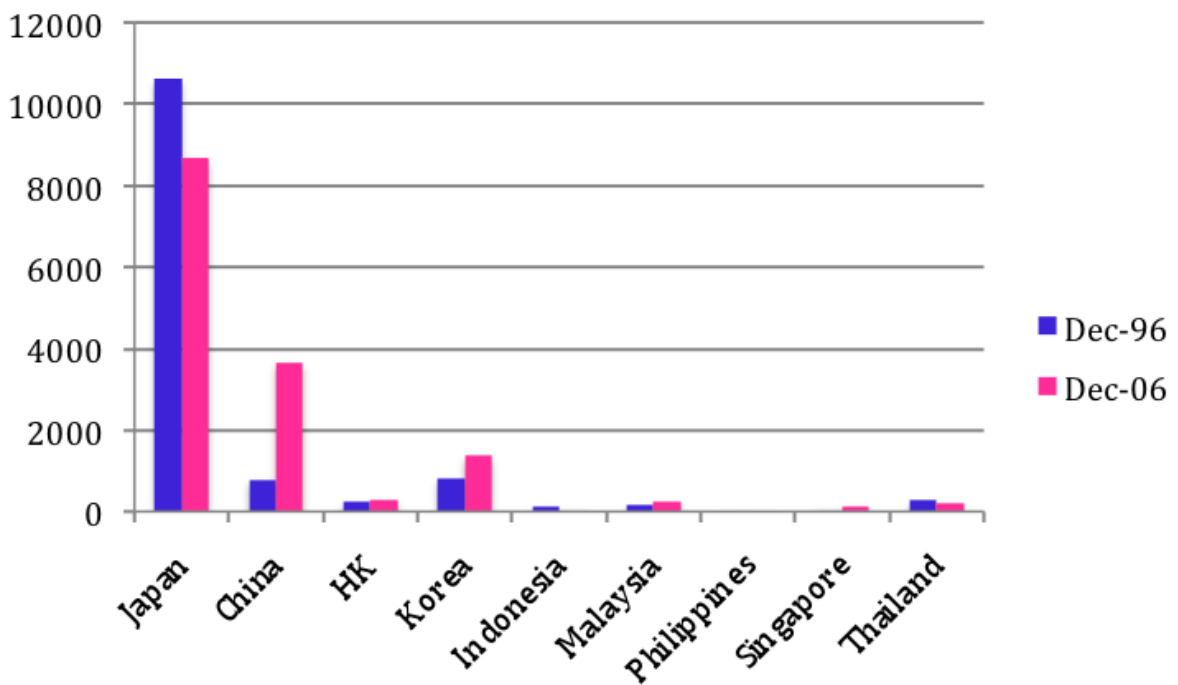
Low Foreign Share in Equity Portfolio



* 2006 except 2005 for India, Indonesia, Malaysia, Philippines, Singapore, Thailand and US
Sources: IMF; RBA; World Federation of Exchanges

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Shallow Debt (Credit + Bond) Financing in Most Asia Countries (US\$ billion)



Source: Asian Bonds Online

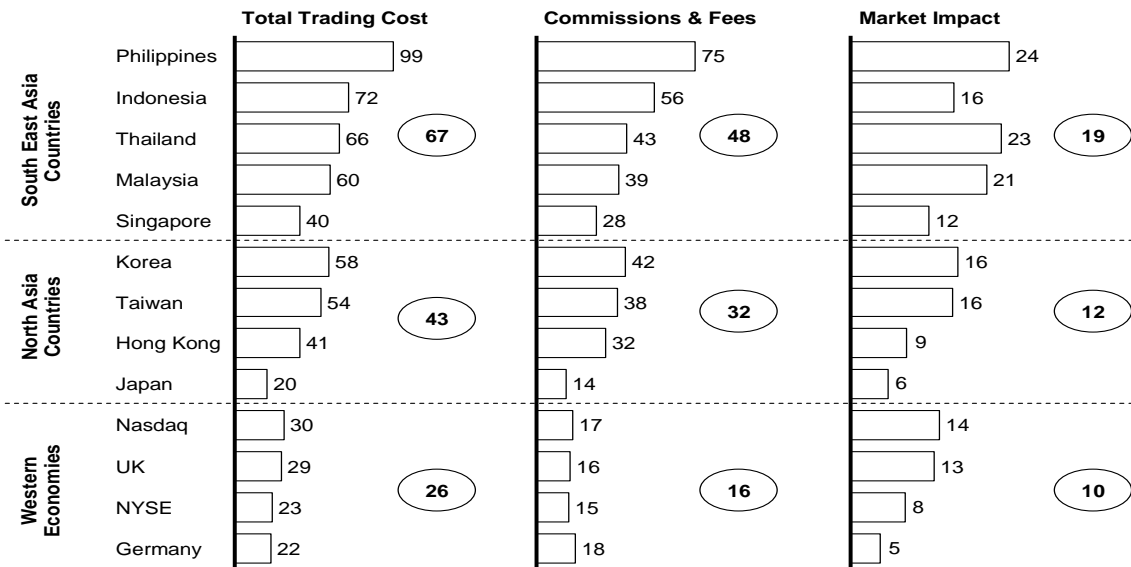
Transaction Costs in SEA Equity Markets More Than Double Those in US and Europe

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TRANSACTION COSTS IN SEA MARKETS MORE THAN DOUBLE THOSE IN US AND EUROPE

Basis points, 2005

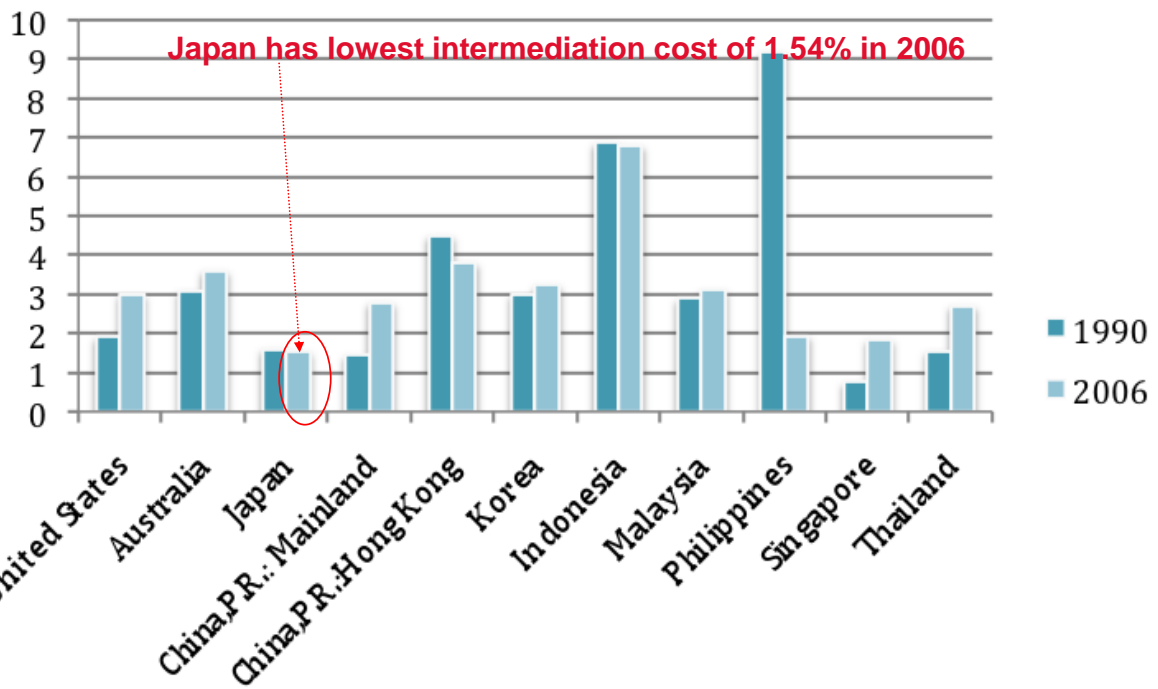
x Average



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Source: Elkins McSherry survey

Average Intermediation Costs (Money Market Spread) in Asia is Relatively High (3.12%, 2006)



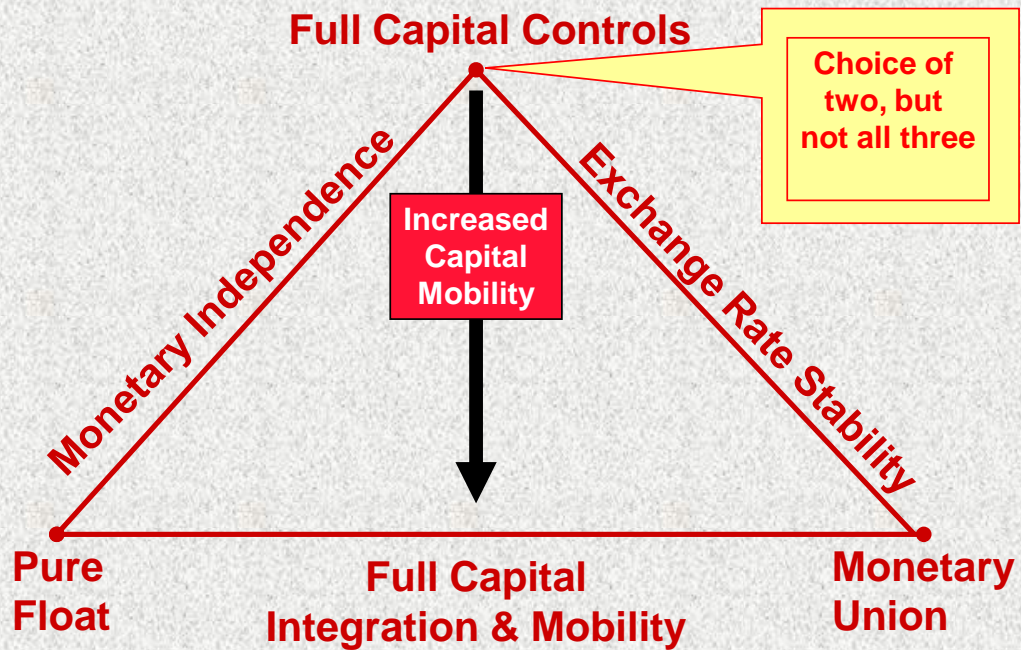
Source: IFS, IMF

Intermediation Cost = (Lending Rate – Money Market Rate)

III. Where Do We Go From Here?

**The Next Adaptive, Evolutionary
Financial Development**

The Asian Impossible Trinity



Institutional Reasons for Bubbly Markets

Globalization, Technology, Financial Innovation, Loose Monetary Policy, High Level of Savings (under-investment in emerging markets) created conditions for formation of bubbles in Asset Markets around the world.

Rise of new class of traders and investors - hedge funds, private equity and High Net Worth Individuals.

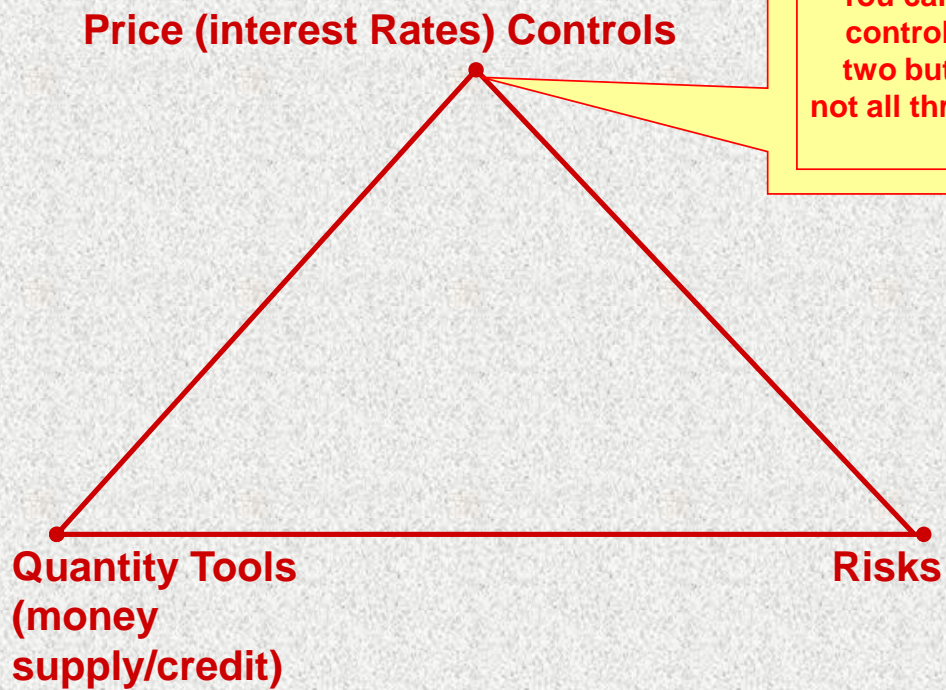
Reduction in transaction costs improved market liquidity and increased number of traders in emerging markets.

World markets have become two-tiered - highly technical professional market and very naive retail market.

Asian Crisis (97-98) vs Subprime (07-08)

- Excessive liquidity
- Large capital flows
- Asset bubbles
- Excessive leverage in corporations
- Financial Liberalization
- Lack of transparency
- Inadequate Supervision
- Moral Hazard – close banks
- Policy response – raise interest rates
- Cut fiscal expenditure
- Yes
- Yen-carry+
- Yes
- Yes, in household sector
- CDO and RMBS
- Lack of understanding of complex instruments
- Regulators caught off-guard
- Greenspan Put and Blanket Deposit Guarantee – rescue Northern Rock
- Lower Interest rates
- Increase fiscal stimulus

The Policy Impossible Trinity



Subprime Crisis is first derivative market crisis of 21st century

- **Asian Financial Crisis was still a classic banking crisis of “lend and hold model”, together with a currency crisis, caused by double mismatch, inadequate supervision and violation of Impossible Trinity.**
- **Subprime crisis was a crisis of the “Originate-to-Distribute” Model (wholesale banking), caused by financial innovation that evolved risks from subprime mortgages to CDO and CDO2 through embedded leverage, opaqueness and greed.**

Nature of Derivative Crisis

- **Derivatives create liquidity of lumpy “underlying assets” through leverage, low transaction costs and time (future) elements. They spread property rights + risks.**
- **Derivatives have high knowledge intensity and are “opaque”, with every evolution of derivative (Subprime→ABS→CDO→CDO2) embedding leverage, opaqueness and risks.**
- **When underlying assets get into trouble, the derivatives get into more volatility because of non-linear relationship and leverage**
- **Opaqueness+uncertainty→capital flight→illiquidity (debt trap).**

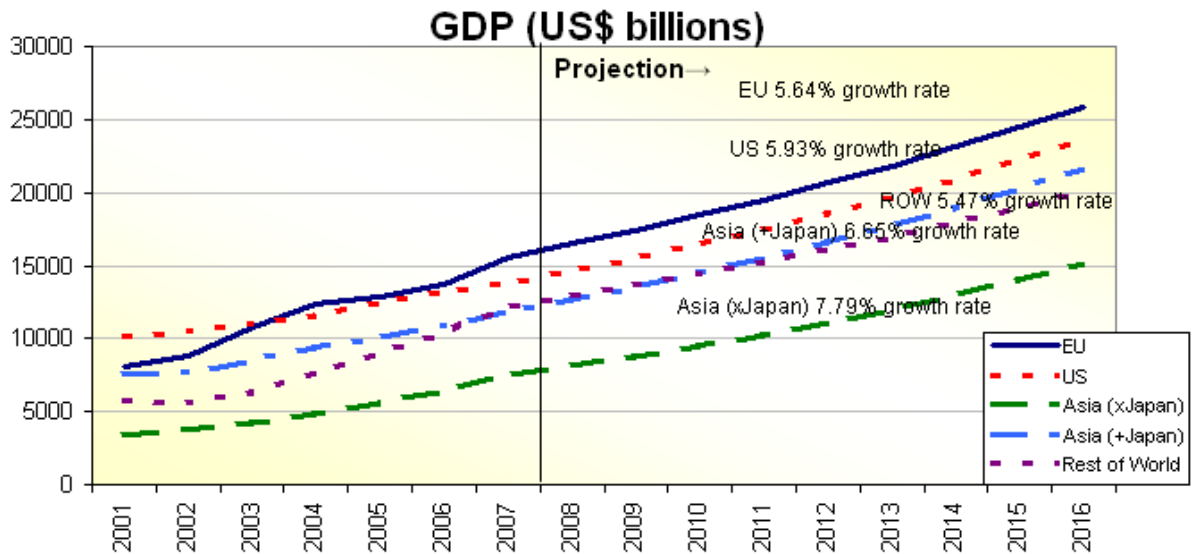
Contrast in Regulation of Financial Innovation

- Asian banking development was slow due to conservative nature of regulators to financial innovation and foreign competition.
- Openness to financial Innovation is like free entry into IPO market – how do we ensure that financial innovation is not toxic? Two classic methods -
- Merit-based vetting by regulator [Asian regulators tend to use this method] or
- Disclosure-based free entry, but subject to rigorous back-end enforcement to ensure that the issuer and distributors do sufficient due diligence and disclosure [preferred by G-7 regulators]
- Clearly gaps in supervision over evolution of leverage in derivative products in subprime.

IV. Looking 10 Years Ahead

The Need for Second Generation Reforms

Scenario GDP Projection to 2016

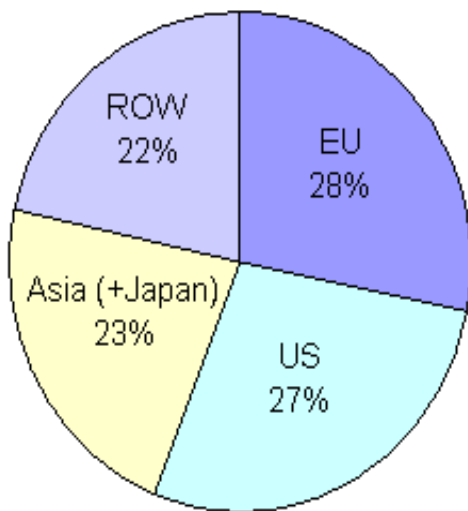


Source: Global Financial Stability Report, IFS, author projections, using 1980-2006 growth rates.

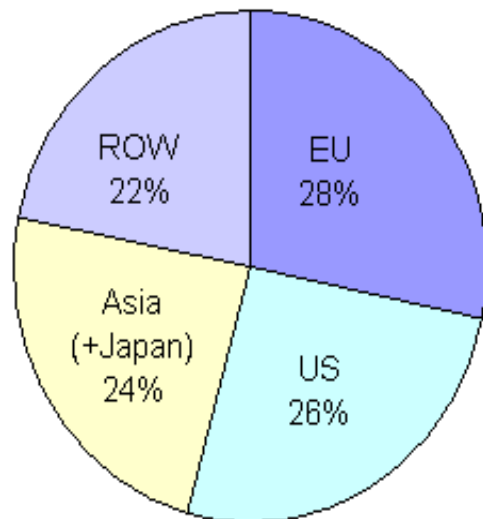
Projected Share of GDP (%): By 2016, EU > US > Asia (+Japan) > ROW

GDP Share (%)

2006



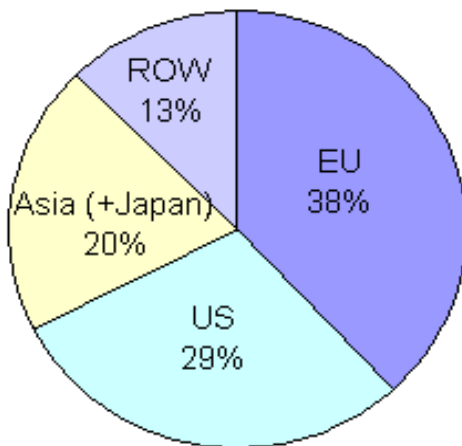
2016



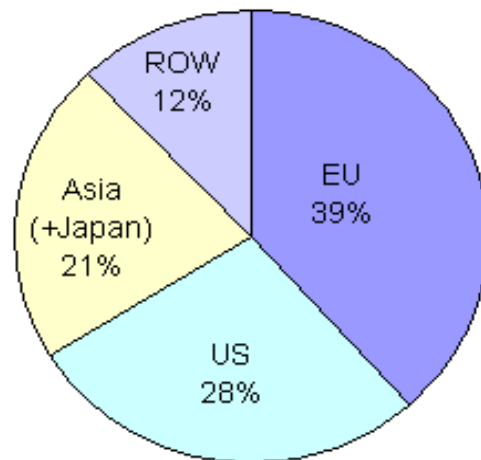
By 2016, EU > US > Asia (+Japan) > ROW

Share of Total Financial Assets (%)

2006



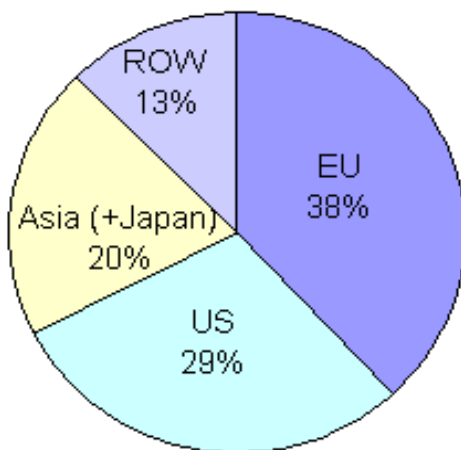
2016



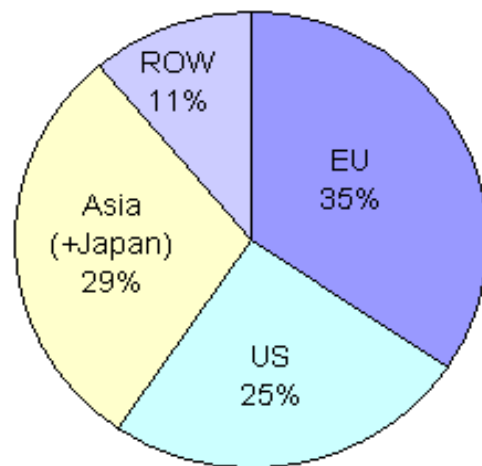
**Even with Financial Deepening Effect, by 2016,
EU > Asia (+Japan) > US > ROW**

Share of Total Financial Assets (%)

2006



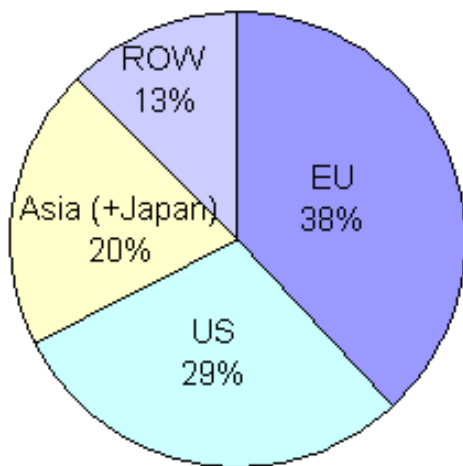
2016



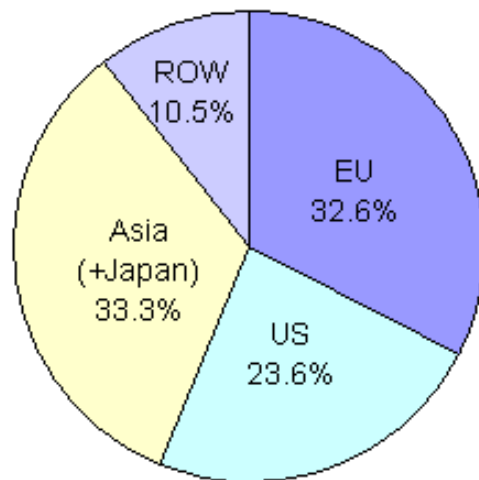
With combined Financial Deepening and Exchange Rate Effect, by 2016, Asia(+Japan) > EU > US > ROW

Share of Total Financial Assets (%)

2006



2016



Building Robust Financial Markets is tougher than predicted

- **The experience in East Asia is that building financial markets take time and development is a process of building modularly.**
- **There is a learning process at all levels, including officials and investors that has to be phased in.**
- **The Chinese call it “crossing the river by feeling the stones”.**
- **This is not a random process. It is a learning by building block by block. The process includes a learn and search mechanism, consider options, experiment in pilot phase, adapt to local conditions, and then push on national level.**
- **Since financial markets are highly knowledge intensive, there is no question that foreign partners are important.**
- **The sequence seems to be well accepted: first liberalize trade, then manufacturing, then services (distribution), then financial services.**

Globalization requires Domestic Market Strengthening to Global Standards

- **If the ultimate challenge is to integrate with global markets, then domestic financial markets must be built to global standards. This is no longer an issue, only a question of time.**
- **FSAPs and WTO rules are already forcing the pace. But the real drive for change is the changing demographics. As consumers and investors demand more products, financial institutions in Asia would have to offer a much wider range of financial services.**
- **This cannot be done without foreign partners.**

Regional Initiatives on Capital Market Reform in Asia

ASEAN Finance Ministers:

2003 ASEAN Roadmap for Financial and Monetary Integration.

2005 Agreement to develop an interlinked ASEAN securities market by 2010.

2005 FTSE/ASEAN Index Series to standardise market indices in the region.

ASEAN+3 (China, Japan, Korea):

2000 Chiang Mai Initiative: regional mechanism for a multilateral ASEAN Swap Arrangement and a series of Bilateral Swaps to address short term regional liquidity difficulties.

2003 Asian Bond Market Initiative (ABMI) to promote the issuance and trading of bonds within region.

2004 Asian Bond Online Website.

Executives' Meeting of East Asia-Pacific Central Banks (EMEAP):

Asian Bond Fund (ABF1 launched in 2003 and ABF 2 in 2005).

Asia-Pacific Economic Forum (APEC):

Finance Ministers' Process focusing on a range of policy and capacity building initiatives, including financial reform.

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Building the Integration Process Modularly

- **Modular Integration is about building institutional processes that are incomplete, but each process modularly belongs to a part of a larger structured process.**
- **This modular process ensures that the key step in strengthening that module would enable the next stage of reform to continue in an interoperable manner.**
 - **Example: Developing Treasury skills in banks and preparing investors for investment in overseas markets key to opening up of capital account.**
 - **Example: Chinese banking reform was preceded by enterprise reform. Only when banks were listed and had foreign strategic partners, could the banking system deepen sufficiently to change their focus from credit risks to market risks. This suggests that the next stage of development will be the bond market.**
- **Bond market development has also turned out to be tougher than anticipated. It requires actually a strong government bond market, trading and clearing infrastructure and a benchmark yield curve as a foundation. Without a strong government bond market, the inter-bank and term financing market would have difficulty taking off.**

Building Macro and Micro-Financial Stability

- **Second Generation Reforms are essentially institutional. How do we ensure that civil services and regulatory systems that are more responsive to market forces, have high transparency and accountability and promote distributive justice?**
- **In other words, as the world becomes more complex and global, domestic bureaucracies need to address both domestic issues, as well as ensure that the effects of globalization are taken into account. One of the key challenges is to minimize corruption and get higher levels of accountability and performance measures for bureaucracies.**
- **More attention should be given to addressing the micro institutional aspects of reform, and their embedded political-socio complexities, which fall outside the three-pillar approach to financial stability.**

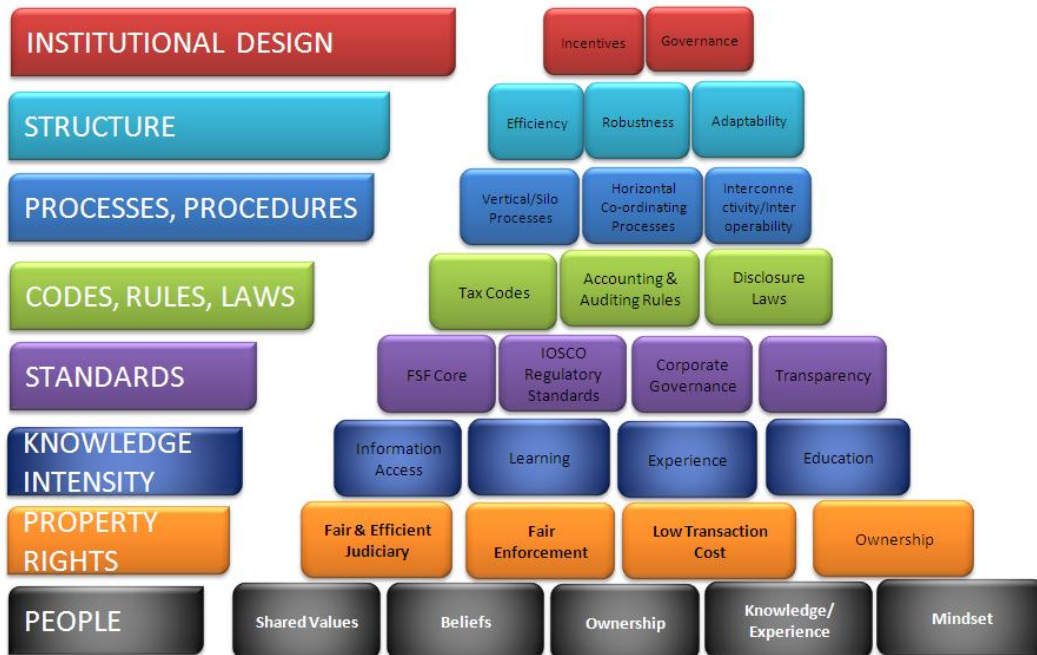
2nd Level Process: Micro Processes

Institutional Aspects of Market Reform

- The work of Douglass North provides a useful platform to think about the basic elements that shape institutions and what it takes to induce change.
- A market is a social institution of people and organizations bounded by the interaction of eight elements comprising:
 - Common values, beliefs and ownership
 - Defined property rights, resources and transaction costs
 - Information, knowledge, technology, wisdom/experience
 - Common standards
 - Codes, rules and laws
 - Processes and procedures
 - Structure, architecture, hierarchy
 - Incentives and governance
- Financial markets have three core features:
 - (i) protect and create value/property rights;
 - (ii) reduce transaction costs; and
 - (iii) are highly transparent.
- Investors simply drift to markets that offer the above, if their domestic markets destroy value, have high costs or low access, and are opaque and unfair.

Micro-Elements of Institutional Building

EIGHT ELEMENTS OF INSTITUTIONAL BUILDING



3rd Level Process: Regional Process

- **Domestic markets evolve through interaction regionally or globally (learning by trading).**
- **This means having to reconcile diverse national values and objectives and market structure (standards and rules, transaction costs, processes and systems) with those of the region.**
- **Vested interests of different stakeholders, intermediaries and investors affect objectivity of policy choice between national protection and regional openness.**
- **There is common fear of small members that the largest member will dominate them (winner takes all) or that the managing body of the regional structure would not look after their interests.**
- **Some kind of allocation or representation mechanism would have to be worked out.**

V. Concluding Thoughts

The New Asian Financial Landscape

- Currently, Asia uses US and EU financial markets for its higher value financial services. This is due to the inefficiency and lack of depth of Asian financial markets.
- As Asia demographics and emergence into middle class changes its savings pattern, the need for greater institutional depth in pension and fund management would arise.
- G10 experience suggests that if Asia does not handle the transition well, it may age without a proper social security and pension funding.
- Hence, matching global competitiveness, building strong and robust financial systems will be the next hurdle for Asia's development.

Financial Innovation in Asia

- Financial Innovation must continue if Asia is to compete in global financial services.
- For example, mortgage securitization is inevitable in Asia if only to reduce maturity mismatch of banks holding more and more long-term mortgages.
- Asian fast growth in GDP and wealth means that Asian currencies will appreciate in long run and Asians will have to improve their risk management.
- Therefore, asset securitization and development of CDS market to manage credit risks are important steps for Asian banks. However, many pre-conditions, infrastructure and legal changes will have to be made.

Cautiously Optimistic

- ❑ Asia is likely to continue its path towards catching up with Europe and North America, although bumps will be in the way.
- ❑ Much depends on ability of Asians to co-operate to establish stronger regional financial markets to better manage our risks.
- ❑ The benefits of Flying Geese in Unison are considerable - greater market liquidity, global voice, better intermediation, lower risks etc.
- ❑ Don't under-estimate US slowdown impact on Asia and don't think that China alone can carry the growth momentum.
- ❑ Possible risks - Global Warming, Terrorist attacks, Political Instability, Natural Disasters, all can blow the Asian flight path off-course.

**Thank you
Questions to
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